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'Tis The Season

There is just something about the holidays. You know that time. You know that feeling. It can be restorative and enjoyable (even necessary) to purposefully turn from daily occupations—particularly if they involve navigating the current frustratingly volatile global markets—to spend time with family and friends in the celebration of health and good fortune. And given the similarities in their origin and many meaningful traditions, this season of holidays serves as a curiously convenient and timely opportunity for thoughtful reflection, renewal, and resolution, to which the calendar faithfully provides a convenient marker to get started. Although it seems we should resolve, in

an effort to preserve our better selves, to put the necessary distance between thoughts of work (and lament for the market's gyrations) and the gift of time with family and friends, too often our preoccupations can get the better of us.

So we must remember that the market has its own seasonal cadence—Earnings, Data, and Macro—a sequence of three fully distinct elements shaping the contours of our outlook and underpinning our positioning. The trouble comes when we rely too heavily on one or another of these elements to substantiate our preconceptions, regardless of whether they are bullish or bearish. Viewing this progression through the lens of a traditional calendar, Earnings season grabs investors' attention for approximately a month, four times a year (roughly, January, April, July, and October) following the end of each calendar quarter. The most recently completed earnings season (3Q18) was as robust as the quarters that immediately preceded it, though notably, management began to raise the specter of a slowing growth profile in 2019. Indeed, as we have written before, the growth in EPS (earnings per share) is expected to roll over—from ~23% year over year in 2018 to 8%-9% in 2019—as the

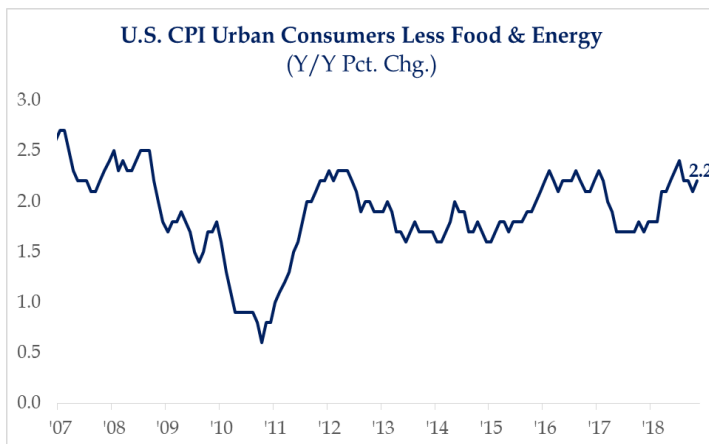
accounting impact of the corporate tax cut passed in December 2017 as part of the Tax Cut and Jobs Act begins to coincide with companies' 1Q19 results. The falloff, however, is not as dramatic as it would appear at first glance. Although we are generally hesitant to draw conclusions based on numbers plucked from the middle of the income statement (the bottom line is the bottom line), investors are likely to gain a better read on corporate profits by pairing the level of earnings with growth, expressed by the rate of change in EBIT (earnings before interest and taxes). Removing the corporate tax cut's accounting impact (lower taxes, higher net income, and all things being equal) highlights the relative consistency of profit growth from 2018 into 2019. Whereas the outright peak in earnings growth has likely been established for this cycle, the current and estimated slope of EBIT growth appears consistent with the current "Slowing Expansion" (i.e., increasing at a decreasing rate) economic backdrop. We will be watching for any noticeable decline in the rate of change of profit margins. With inflation and inflation expectations well anchored and commodity prices (notably, crude oil) falling, the bogeyman is likely to be wages. So far they appear digestible at ~3.1% year over year, but if past is prologue, an increase closer to 3.75%-4.00% would be worrisome. Strategas is

estimating S&P 500 profits to increase ~6% year over year to \$172 for 2019.



As corporate reporting winds down, Data season begins to dominate the debate. Do the backward-looking, so-called "hard" economic data corroborate the story framed by corporate profits? Do the timelier, mid quarter survey data foreshadow an inflection from the consensus course? What do the forecasting models say? Like earnings, the hard data generally have been firm, whereas the survey data have suggested a peaking of activity—not a contraction, but a shift to a softer growth profile. As Strategas' chief economist, Don Rissmiller, has highlighted, retail sales (ex-gasoline) and industrial production have been solid, supporting the Atlanta Fed's GDPNow tracker of ~3.0% (quarter over quarter annualized rate). The global output gap has narrowed, the economy is at full employment, wages continue to rise, supplier delivery times

have slowed, and operating rates are trending higher. This data package suggests that although inflation is likely to be higher next year, prices remain fairly anchored. (The US Core Consumer Price Index (CPI) is running at a moderate 2.2% year over year.)



As the quarter progresses, its health assessed and by now near fully discounted, investors have shown difficulty sitting on their hands—the result of that same tempting impulse that does not allow us to enjoy a break at the holidays. This is when the potpourri of Macro season roars into view. Unburdened by the distraction of data, with rarely a shortage of miscellany to consider and pundits’ eager to weigh in, investors have a tendency to don authoritative lenses milled by personal prejudice to get a better look at the landscape. Trade. The Federal Reserve. Brexit. Khashoggi. Mueller. Affordable Care Act ruling. It is almost too

much...but at a minimum, a number of notable topics potentially could affect investments.

Perhaps the most important change on the macro landscape is the shift from a net easing of global monetary policy (lower rates and asset purchases) to a net tightening (higher rates and asset runoff). This “quantitative tightening” effectively signals a withdrawal of liquidity from the market. In our view, this represents the most important near term consideration for investors, which is why all attention will be focused on the Fed. In our view, the Fed was very likely to “go” this week (e.g., we believed it would raise rates). Investors maintain a tendency to view the Fed as being nearly omniscient; not to have “gone” would have been deemed too dramatic an action for a market pricing in a ~70% probability of a hike. The key message was as advertised, to indicate a slower pace for future hikes than what was previously prescribed. The question is whether this new, presumably lower, data-dependent terminal rate will be closer to the level investors approximate as neutral, or remains so sufficiently in the paint cards that a material slowdown in growth becomes the base case. The market has clearly shown its hand, with the major indices down 13% over the last two-plus months and the pace of the sell-off accelerating in recent trading sessions.

We think we are approaching levels that discount the shifting outlook for a softer slope of economic growth. This is not to say that volatility will subside or, more directly, that the market is any less likely to overshoot to the downside as the broader menu of macro concerns finds resolution. Rather, making a base case for a US recession in 2019 remains difficult. Additionally, economic growth outside the US has decelerated to the point that as we move through 2019, we anticipate a global wave of fiscal stimulus (notably, China, France, and Italy) to accompany the US's year-old stimulus package.

So, as we muscle toward year end, we still could see the so-called “Santa,” or year-end, rally, but whether it should come to pass or time passes without it coming, we should remain mindful of time horizons. Are we investors or traders? Are we the precocious child excitedly rifling through stockings or scurrying beneath the tree for a present, any present, tearing it open only to move on to the next as quickly as we found the last? Or, are we more intent on sitting back, having discovered that nice, comfortable sweater, and while cradling that first warm cup of coffee as it simmers to just the right temperature, thoughtfully take in all the hysteria and darting about, thankful for all that we have, surrounded by family and friends, and content with the knowledge that this too shall pass.

We wish you all a Merry Christmas, very happy holidays, and a healthy and prosperous New Year.

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Nicholas Bohnsack is the President & Chief Executive Officer of Strategas Asset Management and a Managing Director of Baird.

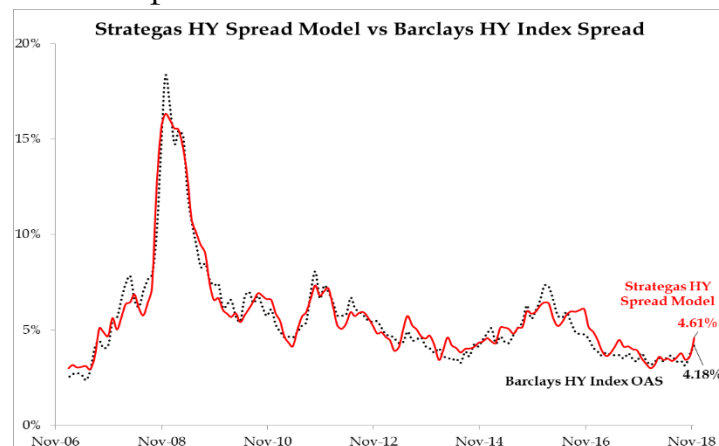
Yields Dipped Lower In November, but Spread Widening More Than Off Move

Corporate credit didn't fare well in November, with investment grade putting in its third straight month of negative returns, while high yield, USD emerging markets, and even bank loans saw drawdowns on the month. The key theme was that economic soft patch fears were rising again, and although the dollar was roughly flat on the month (allowing local currency emerging markets to scrape out positive excess returns), there was a clear move up in credit quality that persisted into November. That was until the Fed seemingly made a marginal pivot towards a more dovish stance at month end, allowing convertibles to pull together a strong month, while other credit sectors closed out the month on more solid footing, though still in negative territory. In anticipation of a more cyclical market move up the credit spectrum, we made another modest trim to our weightings to extended credit to start Q4. With that said, some of these sectors may have entered near-term oversold conditions in the event that 1) the fed does pause in Q1 next year and 2) there's no further escalation of trade frictions. If both of those conditions

hold, then December, as well as Q1, could see strong risk on moves, before once again the late stage nature of this credit cycle begins to bite.



High yield spreads are unlikely to touch 300 bps again this cycle, fundamentals just don't justify it, but growth is likely to remain strong enough to keep spreads below 500 bps for most of 2019. One point worth noting is that historically, when spreads hit about 700 bps, this has been the point where credit contraction has amplified the economic slowdown. We estimate that because of substantially higher debt loads, this point is now closer to 600 bps.



Bank loans have provided a very steady stream of income in 2018. Nonetheless, investors have been spooked by headlines of “credit cracks” and worries that bank loans will be ground zero. We believe that some of these fears are misplaced, but the broader fear of a maturing credit cycle are well-founded. We pulled back in our weightings to start the quarter and would be slow to add back in Q1, despite the fact that credit in general may see some firmer valuations if trade fears subside.

Tom Tzitzouris is the Head of Fixed Income Research at Strategas.



December Recommended Asset Allocation

Strategas Recommended Asset Allocation (Dec'18)					
Equities			Bonds		Cash
B'mark	MSCI ACWI	70%	Barclays Agg	27%	3%
		60%		38%	2%
		M/M CHG		M/M CHG	
	Domestic	39%	Core Credit	23%	
	International	31%	Extended Credit	4%	
Bullish	Dev AC Core	21%	Corporates	9%	
	US LC Value	12%	Local Currency EMD	2%	
	EM AC Core	10%	US Dollar EMD	1%	
	US LC Core	7%			
	US MC Value	5%			
Neutral	US LC Growth	9%	Agencies	1%	
	US MC Growth	3%	US High Yield	1%	
	US MC Core	2%	TIPS	0%	
	US SC Core	1%			
Bearish			US MBS	8%	
			U.S. Treasuries	5%	
			AMBS/CMBS	0%	
			Convertibles	0%	
			Bank Loans	0%	

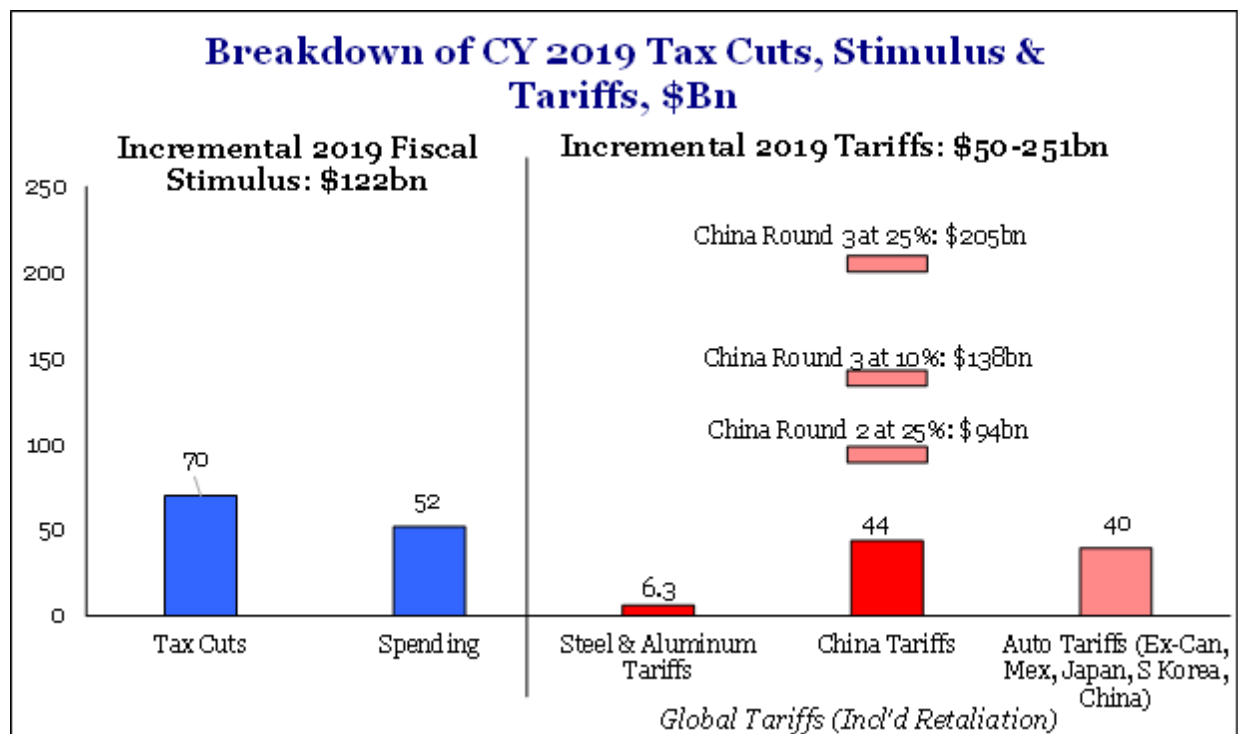
Stock Market Has Declined Without A Recession In The Past

Major S&P Declines Without a Recession

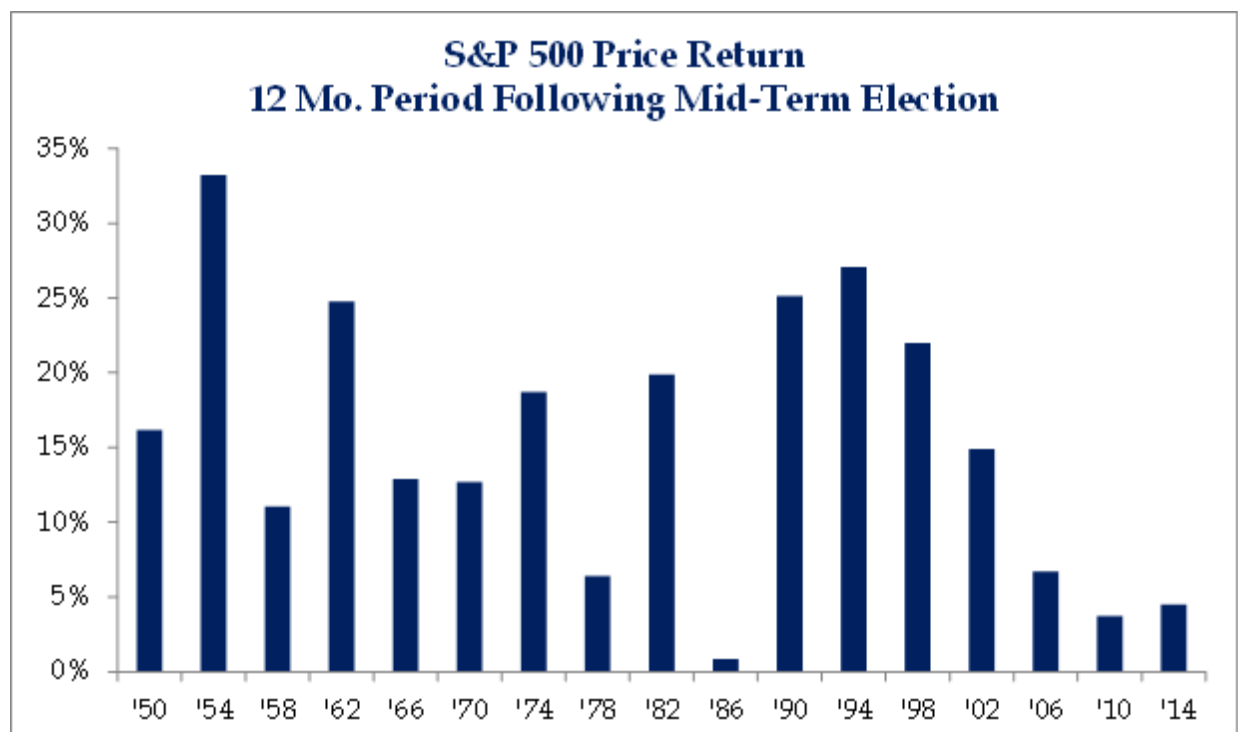
1945 to Present

<u>Start Date</u>	<u>End Date</u>	<u>% Decline</u>	<u>Recession?</u>
5/20/2015	2/11/2016	-15.2%	<i>No</i>
5/2/2011	10/4/2011	-21.6%	<i>No</i>
7/20/1998	10/8/1998	-22.5%	<i>No</i>
8/25/1987	10/20/1987	-35.9%	<i>No</i>
9/21/1976	3/6/1978	-19.4%	<i>No</i>
2/9/1966	10/7/1966	-22.2%	<i>No</i>
12/12/1961	6/26/1962	-28.0%	<i>No</i>
5/29/1946	5/19/1947	-28.5%	<i>No</i>

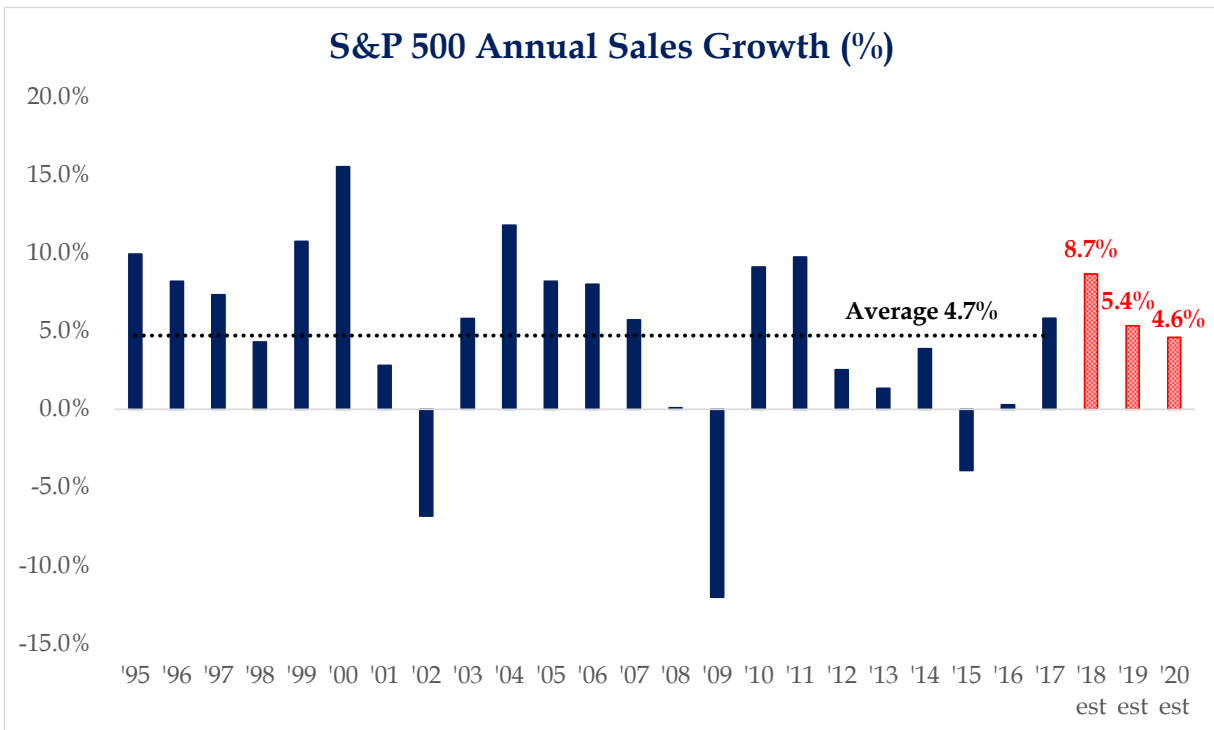
The Administration Fully Aware of Tariff Impact



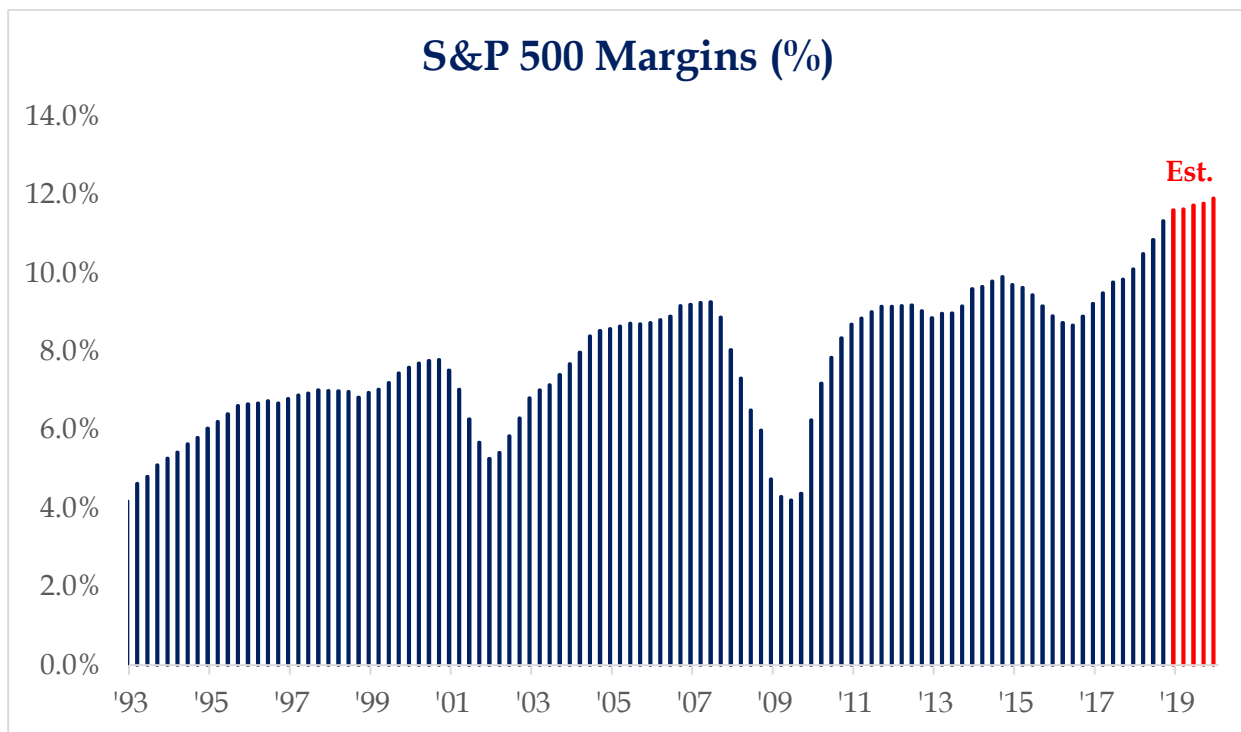
On Averages S&P Is Up 15% Following Mid-Term Elections



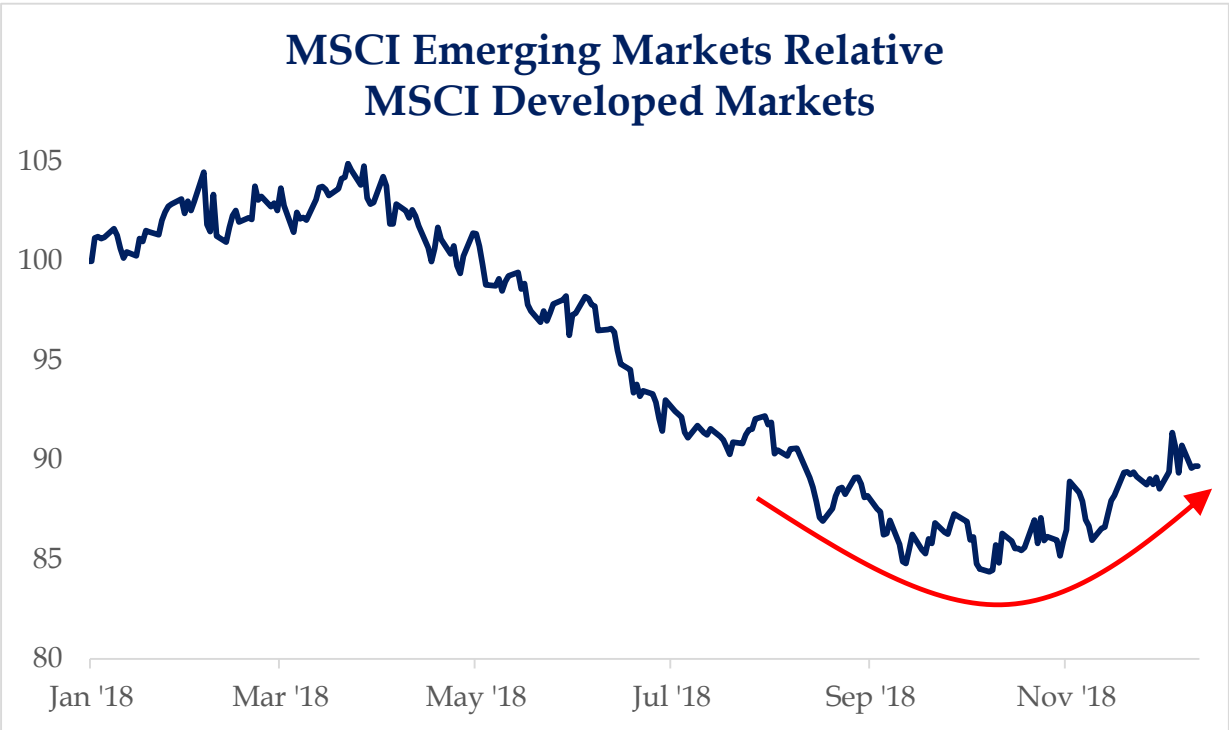
Sales Growth Slowing But Still Expected to Be Above Average



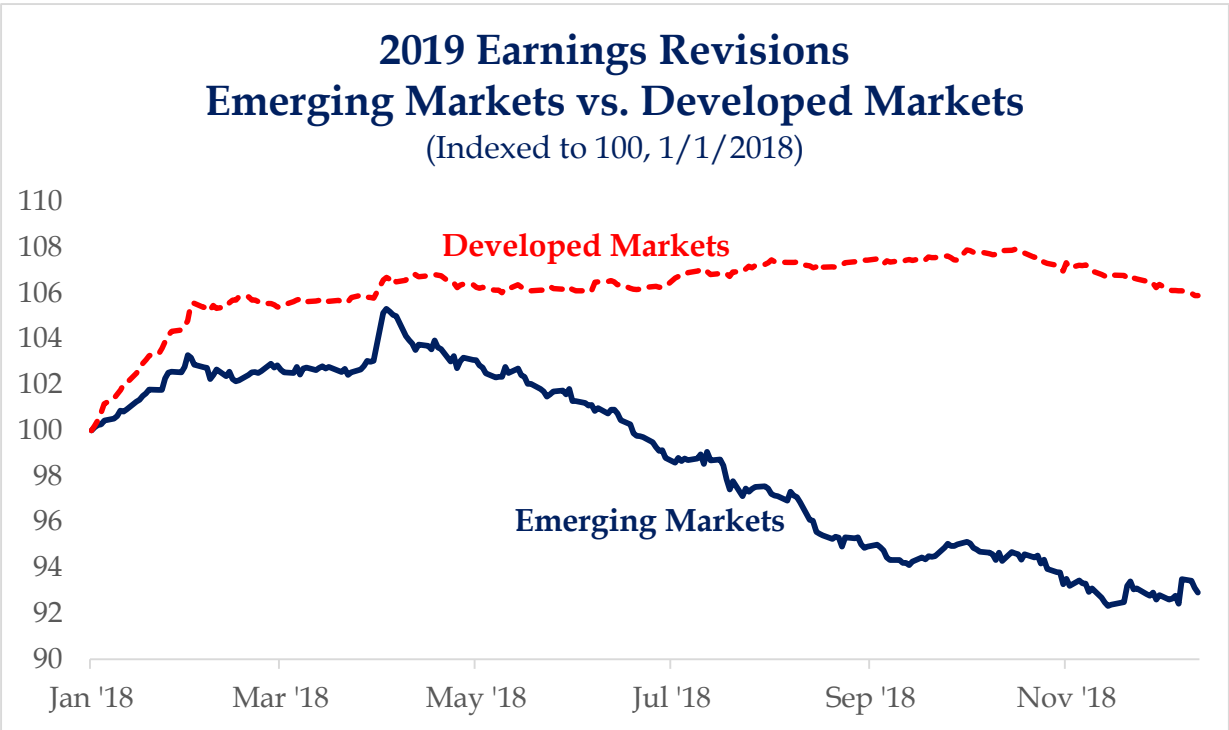
Margins Not Expected to Peak Just Yet



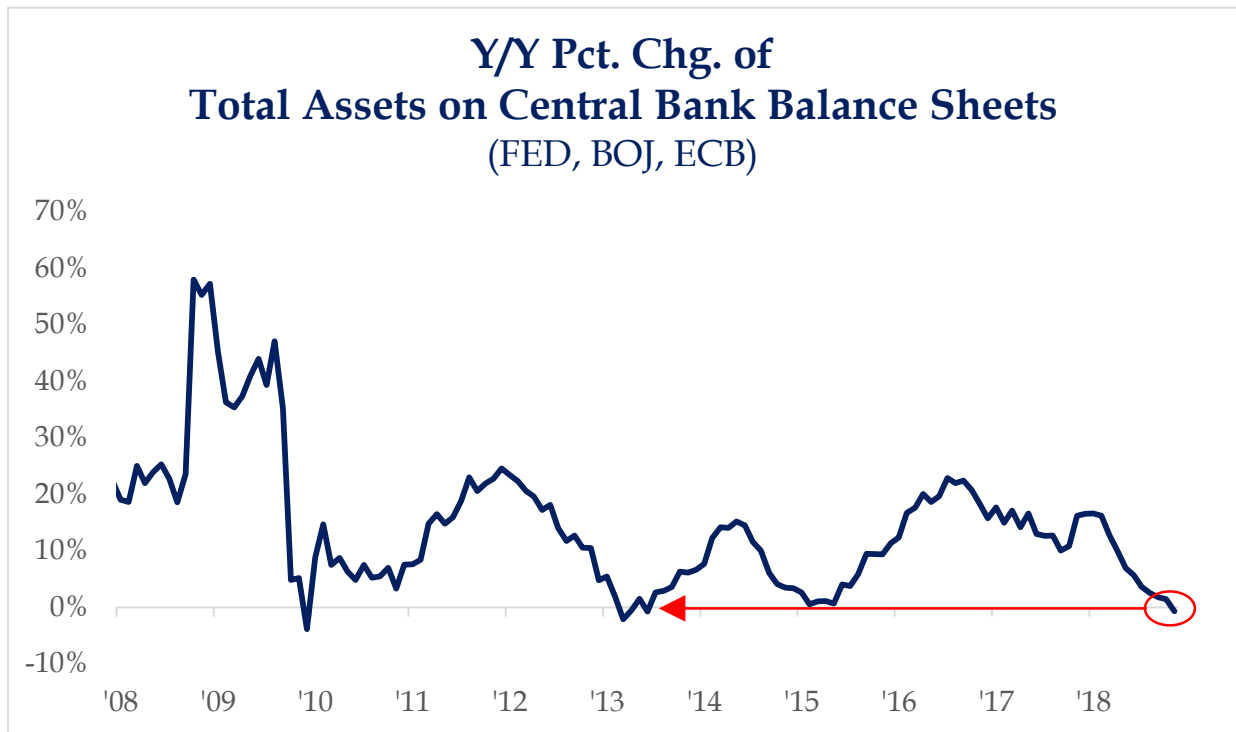
Emerging Markets Beginning To Outperform Developed



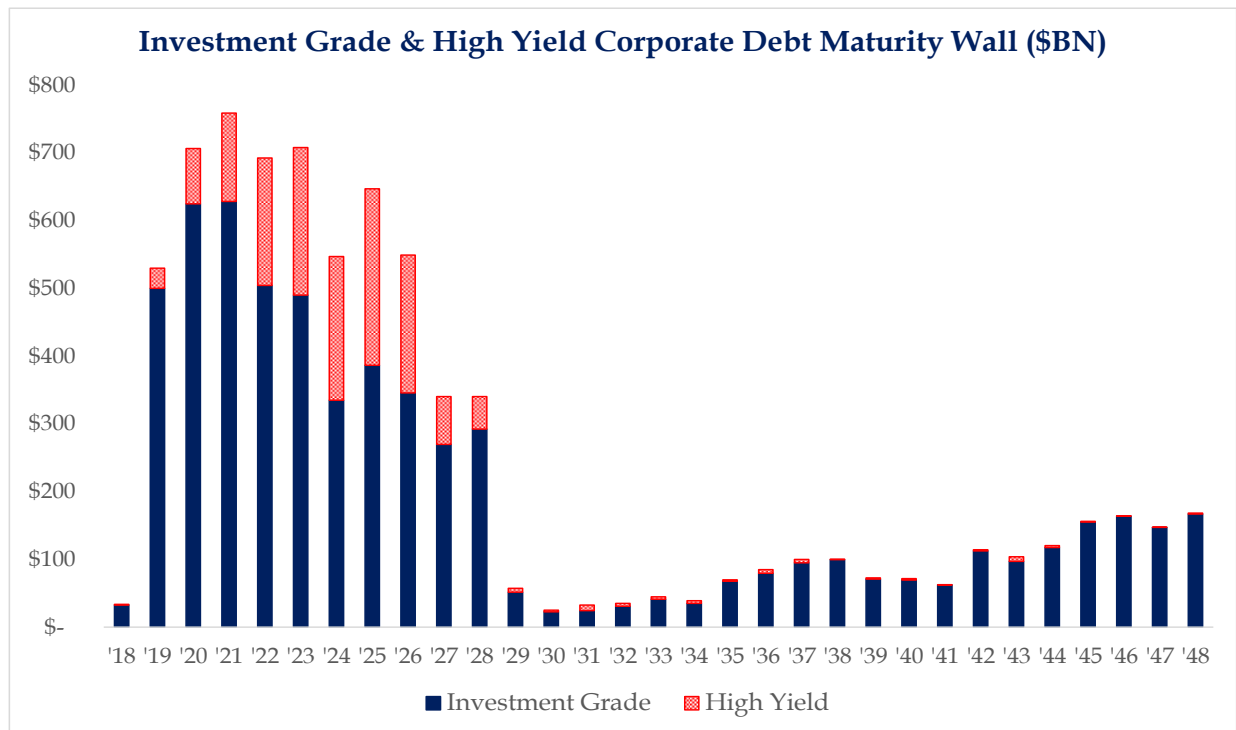
EM Earnings Revised Significantly Lower For 2019



Central Banks No Longer Growing Balance Sheets



Majority of Debt Coming Due In 2019 Is Investment Grade



APPENDIX – IMPORTANT DISCLOSURES

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