STRATEGAS
ASSET MANAGEMENT

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In this month's Insight, Nicholas Bohnsack discusses policy as an added uncertainty heading into CY '22.

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The Five Bottlenecks of Uncertainty

Uncertainty remains the theme for our team. A laundry list of uncertainties compelled us to reduce broad exposure to Equities within our global allocation portfolios back in September (to 62% from 67% vs. 60% neutral exposure) and to raise Cash (to 8% from 6%). While there have been some discernible points of improvement on a number of fronts (debt ceiling, tax increases) altogether, too few of the uncertainties investors have been wrestling with since the summer have been eliminated entirely (or sufficiently enough to be crossed off the list). If anything, the list may have grown.

There may be no more prevalent uncertainty in the moment than inflation. What began mathematically as the Y/Y reciprocal to three months of deflationary price shocks in 2Q'20 and the "transitory" knock-on effects of mandating the global economy to a near subsistence crawl has metathesized into a worrisome guessing game centered on the duration and intensity of, what Don Rissmiller describes as, four global bottlenecks – product, transport, labor, and energy. We might add a fifth – policy, (though we're not sure that is either a new phenomenon or a particularly transient one). Headline and alternate measures of inflation continue to rise while real earnings remain negative. While policymakers have begun to accept the inflationary environment is cause for concern, they have yet to accept blame. And it would seem generally powerless to ease its burden directly despite pressure mounting for them to "do something."

If there is a positive note, however, Don and our economics team see some evidence that we may be approaching "peak bottleneck," which he describes as a pre-condition to "peak inflation." This would suggest that the worst-case scenario – a "'70's style" stagflation – may be off the table but it should be noted easing these dislocations operates with a notable lag. And there would seem sufficiently few signposts to support a return to pre-Covid levels of inflation during this economic cycle. Expansionary fiscal and monetary policies are very hard to stop without economic pain. Without making a normative judgement, given the far-ranging package of relatively dramatic policy changes being championed by the Congressional Democrats, it seems unrealistic to think the size and scope of our fiscal appetites will be curbed anytime soon. Thus, the pressure for the Fed to do something. Calls have intensified to both increase the pace of advertised tapering and to tighten (though it should be noted that tapering asset purchases must be completed before a tighten program can begin). Yet private sector engagement in the nascent recovery has been uneven. While retail sales – the sales of things – have been way above trend, (this will likely come down) the necessary offset, services, remains suppressed due to bottlenecks in the labor market. Considering their dual mandate, the Fed would appear to be in a pickle. But "who" is the Fed? If policy comes from its personnel, the President's

notable delay in putting forward a nominee to chairman the Fed is compounding the matter – and we would posit, borders on a policy error.

As we've noted, operating companies effectively have seven outlets to deploy corporate cash flow - buybacks, dividends, acquisitions, debt retirement, labor, capex, and profits. The sharp increase in operating profits has helped buoy the stock market but a less-than-enthusiastic embrace of the other six outlets – namely capex – has left the durability of the economy's transition from recovery to self-reinforcing expansion in question. Important barometers are starting to flash warning signs: profit margins have started to roll over and earnings yields have turned negative. Neither is typically associated with strong forward returns.

To be fair, absent some late summer/post-Labor Day volatility, the market has seen well to shrug off much of this uncertainty. While we have remained modestly bullish and are generally inclined to continue to selectively increase exposure to traditional cyclicals, we have not found sufficient rationale to reverse our September move to reduce exposure to Equities. We do, however, see merit in tactical adjustments to the fixed income side of the portfolio. We have further increased our underweight to duration, specifically trimming exposure to long duration Investment Grade corporates and increasing exposure to short duration IG bonds and Bank Loans given the higher likelihood of capital loss in longer duration paper from mounting inflation risk. High Yield doesn't offer the same protection to rising rates that it used to and we have also moved to reduce Mortgages within the portfolio as the marginal buyer has signaled their intent to move away from the asset class.

We see the investing landscape defined by choppiness associated with the five bottlenecks into mid-CY'22. Thereafter much will depend on how policy levers were pulled to get the economy flowing smoothly. The chance this will be accomplished without acute pockets of dislocation is low

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Strategas Recommended Asset Allocation (Nov'21)

	Equities	Bonds
Overweight	Dev AC Core US LC Value EM AC Core US MC Value US SC Core	IG Corporates Bank Loans
Neutral	US LC Growth US MC Growth	ABS/CMBS Agencies TIPS US Dollar EMD
Underweight	US LC Core US MC Core	US MBS U.S. Treasuries High Yield

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