STRATEGAS
ASSET MANAGEMENT

January 17, 2021

In this month's Insight, Nicholas Bohnsack discusses how he believes investors should focus on the emerging and longer-term strength in economic growth as well as the Fed's outlook on monetary policy.

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Cyclical Shift Underway

As we highlighted in our piece last month and despite ratcheting political dislocation – tragically (and hopefully) reaching a crescendo at the U.S. Capitol a week ago – we believe the building blocks have been laid for a strong cyclical rebound in economic growth. Not everyone agrees. And, there are certainly hurdles to clear. We would be the first to acknowledge that the overhang of covid appears to have intensified. The sharp rise in cases, both in the U.S. and abroad, and the still sluggish administration of the vaccine has clearly impacted the pace of economic re-opening. One need look no further than softness in the labor market from Thanksgiving onward to see this in evidence, i.e. U.S. non-farm payrolls declined -140,000 M/M in the Dec'20 report.

That said, there exists little ambiguity about the Fed's outlook on monetary policy. (They're not even thinking about thinking about...) And with the provision of yet another front-loaded fiscal package in the closing days of the 116th Congress coupled with an amplified message from the incoming Biden Administration, the Democrat-controlled 117th Congress should provide ample policy accommodation to support the continued improvement in activity, demand, output, revenue, and profitability. The societal impacts of this pandemic have been devastating; the knock-on effects will be felt in our communities for years to come. At the same time, while it may seem crass, there will be pockets of investment opportunity too. In the absence of a policy error – the odds of which, we would lamp, are greater in the target and mechanics of policy, as opposed to the size of accommodation – the current approach would seem a strong cocktail to aid the economy in transition from recovery to expansion.

For investors in our Tactical Global Asset Allocation strategies, we have increased overall exposure to Equities 67% from 64% by trimming back our position in Cash to 6% from 9%. This leaves us with a broad Stocks/Bonds/Cash positioning of 67%/27%/6%. Of course, nothing happens in a straight line, rendering the tactical tilts within asset classes important, particularly for an economy in transition. This is normally considered from a defensive perspective for economies weakening toward contraction, but it is, by our lights, equally true for an economy strengthening from recovery to expansion – as we have today. Thus, within Global Equities we have shifted our portfolios in favor of U.S. All-Cap Value, U.S. Small-Caps, and International shares, specifically commodity exporting Emerging Market countries. From a U.S. equity sector perspective, we believe traditional cyclical sectors will continue to benefit from the recovery in U.S. economic growth; we have increased positioning in Financials and Energy and maintain above benchmark exposure to Industrial and Materials.

The shift in market structure (benefitting market-cap weighted ETFs) has put the timing of taking down exposure to mega-cap names tricky. We believe, however, that the backdrop to do so has been developing over the last several months. After reducing exposure to the Communications sector in 4Q, we are parring-back our allocation to Technology with this writing, reducing Tech and Health Care to a neutral positioning relative the benchmark.

Strategas Recommended Asset Allocation (Jan'21)

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

We are aware of both the decidedly consensus nature of this adjustment in positioning and shorter-dated signposts which suggest that momentum may heading the other way in the nearterm. Note the recent weakness in Industrials and strength in the U.S. Dollar, for example. Despite this, we view the emerging and longer-term strength in economic growth as fundamentally supportive and would look to volatility as an opportunity to affect such a shift on positioning. As we note above, we maintain an above benchmark allocation to Cash (6%) as a hedge for volatility in both the equity and debt markets and as currency for adding additional exposure to risk assets as warranted. It has also been suggested that President Biden and a Democratic majority (however skinny) will be able to muscle through changes in tax policy viewed as disruptive to economic expansion; true or not (and in what form) we believe any knock-on effects for growth are more likely to manifest in later in his term, i.e. CY'22-'23.

As our Strategy team highlighted in our "5 Themes…" piece to start the year, some normalization of interest rates may lead to a reversion to the mean for stocks whose terminal values are now being discounted at negative real interest rates. We would expect the market to test the Fed on its stated proclivities as long-rates continue to push higher. For tactical investors, keen to position toward shorter-dated horizons, pay attention to the interplay between gold and real rates. The recent move up in real rates and concomitant move lower in Gold may also suggest some institutional players are starting to take down leverage. Given its negative carry, with no room to "roll down the curve" to offset losses, Gold is the first of the major asset classes to be sold into a deleveraging phase. This could be the opening for increased volatility against increasingly extended sentiment readings. Stay sharp.

I was struck but the clarity of a brief exchange at the end of a recent Strategas morning sales meeting was telling. It was noted that the consensus nature of our chips in cyclical call leaves the portfolio exposed to variant perception alpha. So what is the pain trade for 2021? "Market down -20% or Nasdaq up +30% and S&P up +10%." We would not disagree. The answer would appear to center on the interchange between real and nominal long rates. If, as we believe, the economy transitions from recovery to expansion (aided by re-opening and fiscal policy) it should be able to absorb much of the excess liquidity in the system and effectively "outperform" the equity market, supporting a rotation toward traditional cyclicals. If the facts change, we will too.

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