STRATEGAS ASSET MANAGEMENT

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In this month's Insight, Nicholas Bohnsack notes the importance of keeping a watchful eye on the potential change in inflation and interest rates despite the bullish set up and potential powerful re-opening of the economy.

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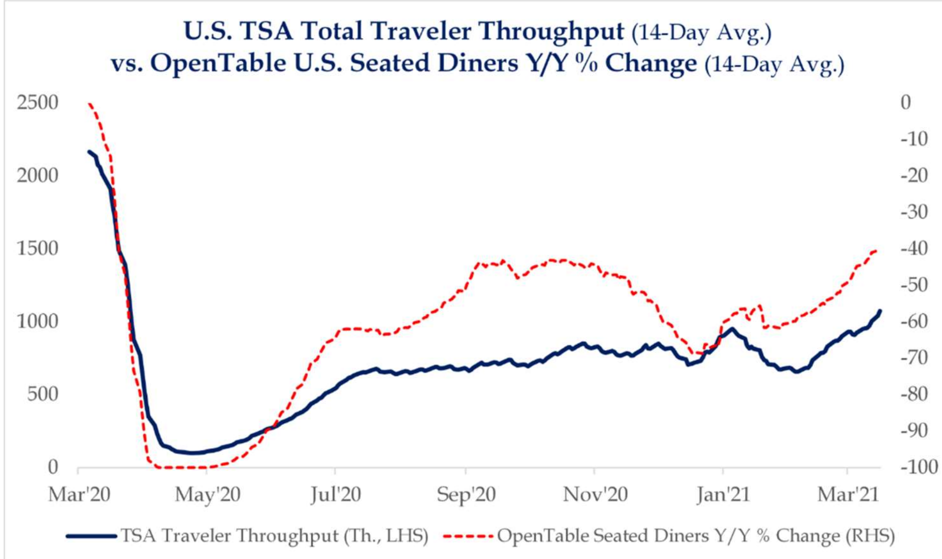
Bullish. Why the Long Face?

In 2000-01 (Technology) and 2007-08 (Housing) the excessive and speculative allocation of capital – directed almost exclusively toward a small clutch of hyper-growth market segments – resulted in the provision of an oversupply of incrementally sub-caliber goods and services to markets increasingly approaching saturation. The resulting disequilibrium was sufficient, in both cases, to not only curb speculative excess in the extended investment sectors but to trigger a broad market sell-off and an economic contraction. In turn, each crisis was followed by a long period of fundamental repair (and institutional indifference) for the industry at the scene of the accident.

That is not what happened this time.

A year ago, the entire world faced off with an acute medical problem (to put it mildly) that required (said simply) a medical solution. While the onset of the global pandemic caused a wild period of panic selling and institutional deleveraging, the aggressive program of fiscal and monetary stimulus policymakers have undertaken – globally – has clearly helped to bridge the gap between those two points – the virus and the vaccine. As graphed onto the traditional scaffolding of cyclical recovery investors have been presented with an economic muscle on steroids. With extra-ordinary fiscal and monetary stimulus revving the engine for corporate investment and retail consumption, the presentation of a recovery catalyst – in this case the re-opening of the economy – should lead, in succession, to an exaggerated increase in activity, demand, output, revenue, investment, and profitability. **Bullish**.



Aggregate revenues for the S&P 500 are expected to increase as much as +11% Y/Y for CY'21 and corporate profits may rebound as much as 30% Y/Y. Given the considerable progress that has been made in the administration of the vaccine, the combination of an additional +$1.9 trillion of fiscal stimulus and +$1.3 trillion Y/Y of incremental household savings being injected into the U.S. economy should condition investors for "right-tailed" outcomes. Said simply, the data could be stronger.

Accordingly, Strategas Asset Management maintains an above-benchmark exposure to Equities in our tactical allocation portfolios, 67% relative the traditional 60/40 framework. More granularly, within global equities, we favor 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 are overweight Financials, Industrials, Energy, and Materials. We remain generally underweight to Fixed Income with 27% gross exposure against the benchmark (40%).

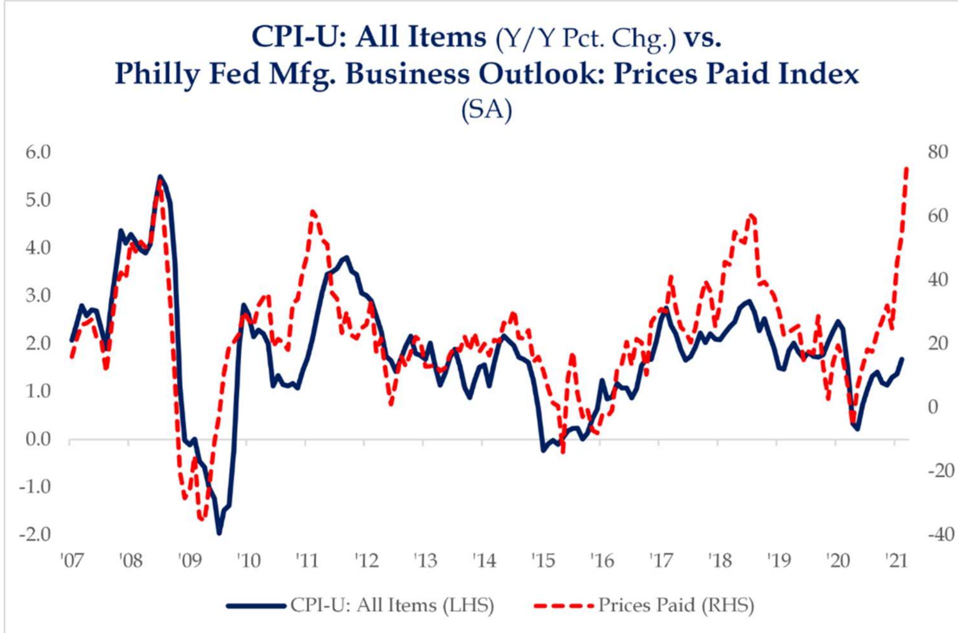
Strategas Recommended Asset Allocation (Mar'21)

	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

So why the long face?

How long will this robust set of circumstances last? There seems little impetus on the part of policymakers to curtail – what could increasingly be viewed as – profligate fiscal spending. Of course, as in all things, there is balance. The insistence that "more" spending will fill economic potholes – both both real actual and imagined – carries the very real potential (in our view) of creating an environment of fiscal resource misallocation similar to those seen in the 1930s and the 1970s. Making this more troubling is the seemingly casual indifference of the Federal Reserve to combat the concomitant effects of rising inflation. Consider the recent $1.9 trillion fiscal stimulus package, most of the money (~$1.2 trillion) will be distributed into the economy in the current federal fiscal year (ending Sept. 30th) with another ~$400 billion working through in FY'22 (Oct. 1st – Sept. 30th 2022). And the bond market's response? U.S. Treasury bonds have been sold hard year-to-date. The yield on 10-year Treasury bonds has moved from 0.92% at the start of the year to ~1.75% as of this writing. Now envision a scenario in which the Administration proposes a $2 trillion+ federal infrastructure bill. Sounds good, but given the current political climate and the available legislative levers, Congressional Democrats will likely have to use the same reconciliation process they used for the Mar'21 $1.9 trillion stimulus to put the new bill on the President's desk. Reconciliation, effectively makes new spending "revenue neutral" through the inclusion of "revenue raisers," i.e., higher taxes. Some will posit the "fairness" of this approach. We're not making a normative judgement. We would simply offer that if past is prologue, infrastructure spending generally takes longer to work through the economy. The American Jobs Creation Act, passed in the early days of the Obama Administration was championed as an investment in "shovel ready" public works projects. In reality the bulk of the federal distribution did not begin until the fifth quarter after the bill's passage (or 2Q'10). The offsetting tax provisions that would be necessary to pass the President Biden's infrastructure plan would likely take effect immediately. The result? Fair, or not, the structure of this legislative rollout raises the potential for net fiscal drag in FY'22-'23. Capital Market participants won't let this sneak by unnoticed. Policy uncertainty makes them nervous.

To address this, Strategas recently revised our estimate for S&P 500 EPS CY'21 to $184.50, a good $11 above the Consensus, with line-of-sight to $197.25 for CY'22 earnings. $197 in CY'22 is below the Street's prevailing ~$199 estimate for the same period. We would keep our eyes on inflation and interest rates to see when and where the winds shift from tailwind to headwind. The potential for a powerful re-opening of the economy in 2021 could mask the reckoning in the not-too-distant future. We hope we are wrong. History suggests we may not be.


CPI-U: All Items (Y/Y Pct. Chg.) vs.
Philly Fed Mfg. Business Outlook: Prices Paid Index
(SA)
6.0
5.0
4.0
3.0
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CPI-U: All Items (LHS)
Prices Paid (RHS)

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