



In this month's Insight, Nicholas Bohnsack discusses the gnawing tension between growth and inflation.



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

Macro Winds

With a resurgence of Covid-related dislocation (e.g. the Delta variant), increased uncertainty at the intersection of nascent economic growth and just how “transitory” inflation pressures will prove to be, and the geopolitical (and, increasingly, humanitarian) crisis exploding in Afghanistan, it is little wonder investors have given scant credit to the generally robust fundamental outlook corporate operators have laid out for 2H’21 on the back of strong 1H’21 results. By our lights, the traditional early-cycle progression remains intact whereby an increase in activity leads, in succession, to improvement in: demand, output, and revenue. The fork in the road is what companies choose to do with the free cash derived from the increase in revenue. While companies effectively have seven outlets into which they can deploy surplus cash – dividends, buybacks, acquisitions, retire debt, labor, capex, and save (i.e. profits) – investing in the business, either through traditional capex or hiring more workers, OR taking the top-line growth to the bottom-line are really the two areas that inform the slope of transition from economic recovery to self-reinforcing expansion. We acknowledge, however, that the uncertainties we highlight above are likely to have an outsized effect on sentiment – and, by extension, activity – in the weeks (and months?) ahead. This could moderate the revenue cycle, but is more likely, given current levels of operating leverage, to delay corporate investment. Given that equity indices are near all-time highs and prevailing multiples in need of fundamental follow-through to support current levels, we anticipate these pressure points will ultimately contribute to further market volatility over the intermediate-term.

As we have mentioned throughout the pandemic, we are limited in our ability to offer much insight on the progression of the virus beyond relaying what we observe and take away from conversations with clients and those with true expertise. The same is decidedly true for unfolding geopolitical events, specifically those created by the withdrawal of U.S. and Coalition forces from Afghanistan. Both the virus and the humanitarian crisis will (rightfully) command a share of investors’ mindshare in

coming days. Given our limitations on the subject matter we will confine our comments to the gnawing tension between growth and inflation as well as two additional areas of uncertainty – U.S. fiscal policy and China commercial policy.

On the former, Strategas' chief economist Don Rissmiller has noted his discomfort with the current underlying inflation dynamics, particularly the recent increases in wages and rent. Don views this as a form of “stagflation-lite” given global supply chain disruptions. Our SLIM survey for August indicates supplier delivery times will be extremely stretched over the next month, as 68 percent of the survey respondents report slower supplier deliveries. The lengthening of delivery times is consistent with the recent news headlines of supply-chain disruptions caused by the Delta variant (i.e. halted production, port closures, astronomical freight rates, numerous cargo ships sitting at sea, worker shortages & strikes). We do not (yet) foresee a 1970s-style stagflation, but believe inflation, in and of itself, will prove less transitory than policymakers believe (or are hoping for). To be fair, given the prevailing level of U.S. long rates (roughly 1.xx% as of this writing) it does not appear either the bond or equity market is reflecting much concern at this point.

While far from the easiest topic to discuss – given the increasingly divergent political proclivities within the U.S and the messiness associated with any far-reaching policy initiative – it is worth spending a moment considering the challenges the Administration and their Congressional partners face following the summer recess. As our Washington colleagues have highlighted, the overhang of the President's tax proposals is real (and punitive to high innovation segments of the economy like Technology and Health Care). To date, and much like inflation, the market has looked through the issue. As Dan Clifton, Strategas' head of policy research, has noted, “the market will care when it is time to care.” Our treatment of the Biden tax proposals with likely areas of compromise could slow Index earnings growth by -5% next year. Of course, the range of outcomes is quite large; it could turn out that global growth absorbs the tax increase impact, but there will be a “cost to doing business.” We think the time to pay attention is now.

While we continue to believe the developing – albeit jagged – recovery in economic growth should transition into a

synchronized global expansion, we will admit this sequence may take longer-than-expected, particularly when one makes even general assumptions on the ultimate sweep of the Xi regime's crackdown on the competitive positioning of whole segments of Chinese industry. Inasmuch we are further reducing our exposure to Emerging Market equities and lowering our relative weighting to Neutral from Overweight. We remain generally optimistic on non-China EM as a class given the relative age if the business cycle, but the weight placed on Chinese equities in the major tracking indices (e.g. 40%+) makes the practical implications difficult to ignore

Strategas Recommended Asset Allocation (Aug'21)

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

NB

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