STRATEGAS
ASSET MANAGEMENT

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In this month's Insight, Nicholas Bohnsack discusses the even further divergence between the social and economic environment and the capital markets as a result of the current pandemic.

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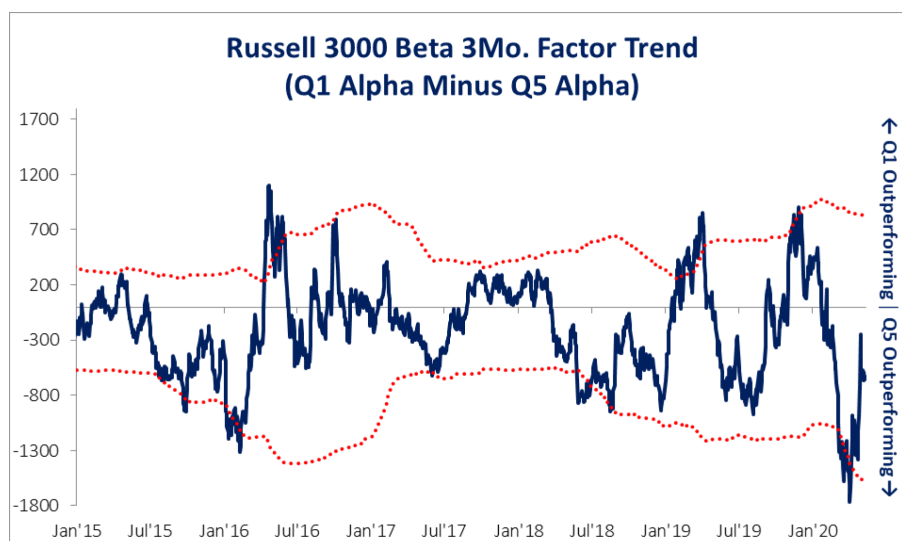
The Divergence Widens

A casual glance at the equity market in recent weeks would reveal little about the intensifying procession of abysmal economic data flashing on investors' screens. There would seem to be few other ways to square this seemingly obvious inconsistency than to acknowledge that while most investors have made the emotional adjustment to expect near-term data to qualify as 'the worst ever,' or 'the worst since… [some sufficiently unfathomable point in history]' they simply view current circumstances, as dire as they may seem, as transitory. How transitory? We've found investors generally take one of three points of view on the road ahead. They either: 1) continue to press – or chase – near-term (3 months) Fed-backed, liquidity-driven price momentum; 2) harbor a relatively strong belief – or are holding out hope – that the economy will rebound to pre-lockdown levels of activity over the intermediate-term (3 to 12 months); or, 3) are acutely focused on making selective, long-dated (12+ months) investment choices in a market that appears increasingly disaggregated.

In the short-term, it's tough not to heed the late Marty Zweig's sage counsel. But can we simply expect risk assets to advance as long as the Fed remains historically accommodative? Perhaps. Admittedly, we do not see the current beta-driven rally as being near its natural exhaustion point. High beta shares are notorious for leading strong retracement moves off of even moderately oversold conditions. (We experienced a severe oversold condition in late-March.) They do, at a point, tend to fade however, either into the arms of more durable fundamental leadership or with a 'retest' of prior lows. But in the absence of any information that it hasn't already dismissed as 'the worst…' the market will gladly ride the coattails of liquidity with the hope of something' less bad' on the horizon...

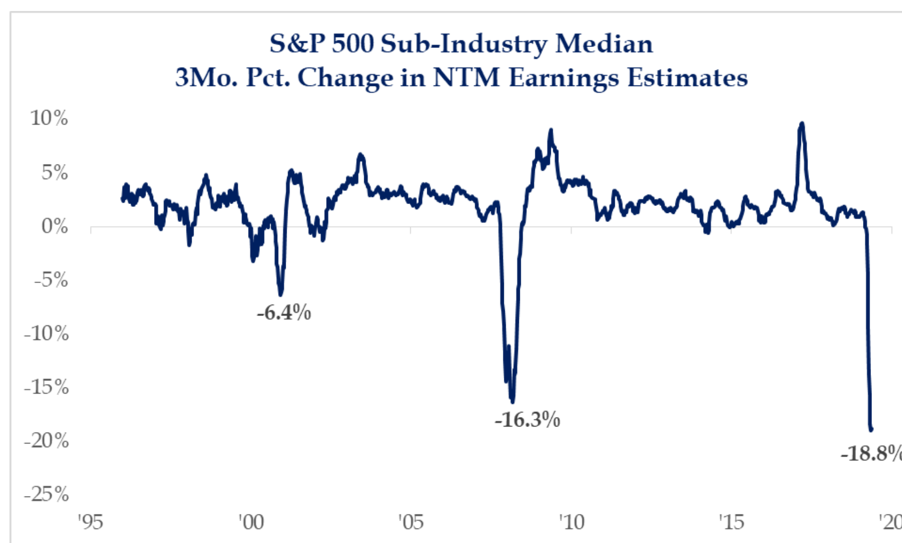


When will less bad begin to emerge and how less bad will it be? To believe the consensus is to harbor the view that the economy will get back to its previous peak levels of output by the second half of next year… roughly fifteen months from now. It may seem dangerous to suggest it's different this time, but this is certainly not like anything we've seen in the last dozen cycles. For starters, we've never just shut down the global economy before. The ramifications of that act will be debated for decades (and about as passionately as the Great Depression is still debated today). What's more, time does not appear to be on our side inasmuch as we're battling two evils – the cause and the cure. To fight back the cause, we must develop a therapeutic to treat the infected and a vaccine to inoculate those who haven't been. To counteract the cure, we must reopen the economy behind the strength of a durable growth catalyst. Unfortunately, every accommodation we undertake to slow the spread and flatten the curve neither reduces the area under the curve or hastens the recovery. And once we do develop therapeutics, discover a vaccine – or both – while it will undoubtedly serve as a welcomed relief for the heavy toll the virus has taken, we must still contend with the lasting damage to the economy.

In this regard, investors should question the utility of the traditional post-recession playbook in the construction of client portfolios. It used to be that there was an industry 'at the scene of the accident' – say, Tech in 2000 or Financials in 2008. Excesses in that sector led to the top-heavy outcomes that ultimately tipped the economy into recession. From that point, however, investors could make reasonable assumptions about the structural damage to the industry

in question and about the amount of operating impairment, if any, emanating away from the epicenter. Some investors would allocate capital to pockets of strength they identified in the wake of the contraction. Still, others would take a more defensive line, hold cash, and bide their time until the full steam of the recovery took hold. In this instance, there appears no single industry at the epicenter of the crisis. Certainly, there are obvious losers… and winners too, but broadly this crisis is a commercially nuclear event.

Consider the chart below. In the 2001 recession, following the bursting of the Tech Bubble, corporate profit expectations fell -6.3% for the median sub-industry in the S&P suggesting there was not much collateral damage to the economy beyond the Tech sector. Eight years later, in the wake of the Global Financial Crisis, a wider impact zone; the median decline reached -16.3%. Today, while still in the throes of the "Great Lockdown," this timely measure has already fallen -18.8%; said another way, the profit outlook for the median sub-industry is the worst it has ever been. It's still getting worse, and half are worse than that.



We believe the fallout will result in a greater dispersion between companies and industries with adaptable business models versus those with more rigid business models and will favor companies with superior operators at the helm versus those entities with marginal actors driving affecting strategy. This will require investors to look at the impact the cause and the cure has, and will have, on every industry. We believe this will devolve into a volatile process separating winners from losers and shift emphasis from a flows-driven market to a fundamentally-supported protocol. That would

result in a re-allocation away from the passive asset stack in favor of actively managed strategies. Bear in mind that at the same time Wall Street is estimating S&P 500 earnings to break back to an all-time high in the four quarters ending Dec. 2021, the vast majority of U.S. corporations are pulling guidance and curbing, with few exceptions, management's traditionally optimistic outlook. Don't worry if you feel lost in this maze, management doesn't know either. Interestingly, if the consensus outlook for the recovery in corporate profits were to come to fruition, it would result in a tie for the third shortest recovery in any cycle since the Second World War. (The only shorter cycles occurred roughly forty years ago.) We're skeptical.

As our Economics team reminds us, there were more than 150 million people on U.S. non-farm payrolls at the peak in February. In April alone, 20.5 million people lost their jobs, pushing the unemployment rate to nearly 15%. Looking through the details of the report reveals that most unemployed workers view this as a temporary furlough. We worry that initial cuts to lower-paying jobs will lead to cuts in higher-paying positions later, prolonging the pain. Many companies have embraced a form of socially responsible capitalism, specifically in the form of pledges to not lay off workers while pivoting operations, often at a cost, to aid in the fight against the cause (the virus). By our light, this only intensifies the damage caused by the cure (the lockdown). While these efforts are necessary and applaudable, investors, all the while, are pricing securities on the idea that companies, and the economy, will return to pre-lockdown levels of activity and profitability in fairly short order. Either companies will need to rationalize the composition of their cost framework against a revenue stack that has gone through a commercially nuclear event or investors will be forced to re-calibrate the valuations they've applied to enterprises that will now be less profitable. We're not making a normative judgement on which direction is better – more socially conscience or a renewed intensity to derive a return on invested capital – but companies will choose one direction or the other and the divergence between the two will grow wider.

Strategas Recommended Asset Allocation (May'20)

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

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