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In this month's Insight, Nicholas Bohnsack discusses the how inflation, the dollar, and the Fed impact our highest conviction call.

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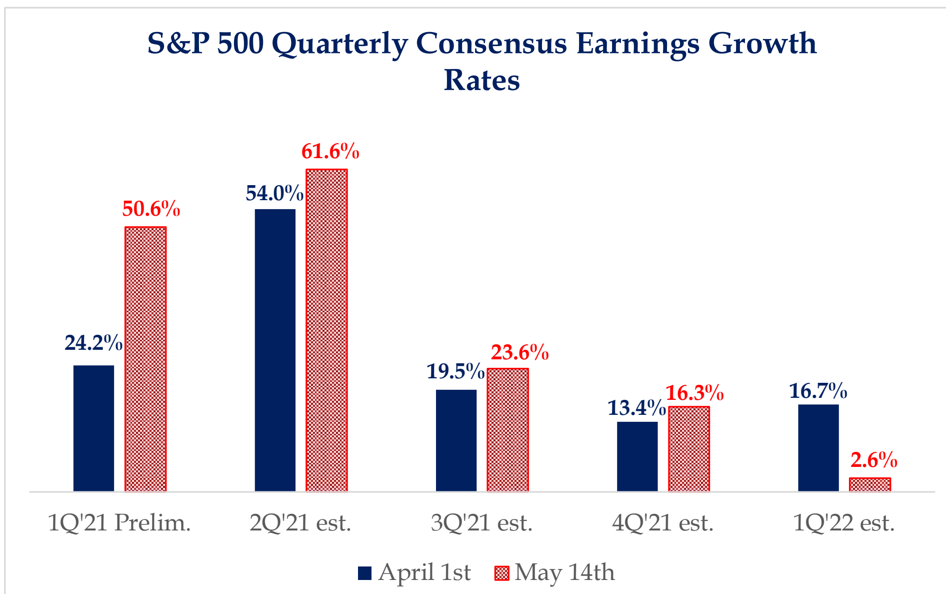
Watching Inflation & the U.S. Dollar

At their base, equity prices should be considered a function of earnings and interest rates. Generally held, when a lower cost of capital, i.e. lower interest rates, improves the backdrop for longer-dated earnings growth, stocks go up. To a degree, that is what investors are seeing in the near-term. The stock market, albeit with fits and starts over the last several weeks, has continued to press to a series of all-time highs against a backdrop of low interest rates – *U.S. 10-year Treasury Yields stand at 1.6x% as of this writing* – and a post-pandemic surge in corporate profits – *consensus S&P 500 EPS is expected to be up +61% Y/Y in 2Q'21*. Indeed, the Atlanta Fed's tracking estimate for 2Q'21 real GDP is currently at +10.5% Q/Q AR.



Real rates remain in negative territory and the money supply is growing at more than +24% Y/Y. While history suggests the second year of a bull market can be more difficult than the first year off the low, we take comfort in the fact that credit spreads are still tight as a drum. Tactically we remain bullish on equities in the short-to-intermediate-term.

Of course, there are those who are suspicious how long this setup can last… After an extremely strong increase in March, U.S. retail sales were flat M/M in April. Though the level of sales activity remains above trend – *a reflection, in our view, of the considerable provision of fiscal stimulus over the past several months* – consumer sentiment, as measured by the University of Michigan survey, declined -5.5 points in early-May to 82.8. Most surprising, so far, particularly to the professional forecasters, was the weakness of the April jobs report. The monthly release from the Bureau of Labor Statistics showed non-farm payrolls rose just +266,000 M/M in April – far below expectations – and was accompanied by a downward revision of -78,000 to prior months. So, while U.S. GDP is approaching pre-pandemic levels and corporate profits are already through them, jobs are not close. Prior to the onset of the pandemic U.S. non-farm payrolls stood at ~152 million. Today they are ~144 million – a gap of roughly -8 million jobs.

If that wasn't enough, the prospect of rising – *and more than transitory* – inflation pressures have riled investors. The U.S. CPI surged +0.8% M/M in April, with the core measure (excluding Food & Energy) up +0.9%. On a Y/Y basis, the headline CPI was up +4.2% and the core +3.0% (the highest level since 1996). There is growing concern, as Strategas' chief strategist Jason Trennert wrote recently, that the Fed will find itself behind the curve and be forced to tighten in dramatic fashion. Such a move would run in the face of the central bank's stated proclivity to keep the policy rate low (and the size of quantitative asset purchases going) for the foreseeable future and could be interpreted as a lack of control. At the moment, investors do not appear overly concerned about any shortcomings in the Fed's control over the objectives of its stated monetary policy. While recent weakness in headline data should provide the Fed sufficient cover to stay the course, investors' collective muscle memory for investing in periods of rising inflation is not strong, which has added some pressure to markets in recent weeks – *at least in thought, if not in deed*.

As Strategas' chief economist Don Rissmiller has observed, the market seems set to challenge the Fed over the short-term. We would not be surprised. Investors will have an opportunity to shift portfolio exposures during bouts of dislocation and weakness.

At the moment our highest conviction theme currently revolves around the potential for increased pressure on the U.S. Dollar. This is driven by the value of America's twin deficits approaching 20% of GDP and the fact that the rest of the world can look forward to what the U.S. has already achieved – massive increases in fiscal spending and mass vaccinations. There is a chance that the weakness in the greenback may be most acutely felt versus hard assets rather than fiat currencies, especially given a commitment to green energy that is highly dependent upon extractive industrials. We feel more confident about our overweightings to the Basic Materials and Energy sectors than we did when we established them late in 2020.

Strategas Recommended Asset Allocation (May'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

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