STRATEGAS
ASSET MANAGEMENT

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In this month's Insight, Nicholas Bohnsack and Gerald Hendricks discuss the reasons behind taking down their equity exposure as well the impacts of stickier inflation.

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Tempered Optimism, Raising Cash…

While the base tenets of economic recovery appear intact, the impact – and growing number – of "uncertainties" appear, at a minimum, to have impeded the economy's transition into self-reinforcing expansion sufficiently enough to warrant an expression of caution. We have been – and remain – generally optimistic on the course of global growth. However, we must acknowledge the underpinnings of our optimism for a less uneven progression into the belly of the cycle with the concomitant advance of asset prices likely needing to be checked in the near-term. Though we are inclined to maintain an "above benchmark" allocation to stocks (62% vs. a 60% neutral exposure) and relative positioning along geographic, size, and style lines , we are, with this writing, reducing overall exposure to Equities within our global allocation portfolios to 62%, as noted above, from 67%. Conversely, we are increasing our Cash reserve to 8% from 6%, inclusive of our current 4% allocation to Gold. Mindful, however, that the purpose of a core fixed income allocation is to serve as a balance for equity beta and believing, in this environment, that little protection is offered from Cash that cannot be achieved through exposure to short duration credit (e.g. Bank Loans, Investment Grade bonds), we are increasing our Fixed Income allocation to 30% from 27%, thus reducing our "below benchmark" position while continuing to shorten duration.

Strategas Recommended Asset Allocation (Sep'21)

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

Others raised the caution flag higher and earlier that we have, no doubt chastened by the same package of uncertainties we felt comfortable last month to list but ultimately look through: the resurgence of Covid-related dislocation (e.g. the Delta variant); less "transitory" by way of "stickier" inflation pressures; and, the geopolitical (and humanitarian) crisis exploding in Afghanistan. And to be fair, the average stock – indeed most stocks – and the Cyclical trade, in particular, evidenced weakness in the mid-June-to-August window. But the summer retreat didn't extend fully to the index level largely because rates fell and the anchor tenants (i.e., mega-caps) rallied.

So, what's changed? Why reduce equity exposure now?

An important consideration in our adjustment is the notable softening in economic data. Nonfarm payroll gains in August were only +235,000, down from June and July levels of 1mm+, and the "downshift" highlighted in the Fed's September Beige Book release stand case in point. In turn, growth estimates have been fallen significantly and to low levels. (Strategas' chief economist Don Rissmiller is estimating U.S. real GDP for 3Q'21 to come in around +2% Q/Q AR.) Supply chain dislocations are likely to persist well into, if not through, next year (CY'22). And though we remain closer to the start of the business cycle than the end, – and there is arguably enough under the surface to support growth – an 18-month supply disruption is certainly more difficult to weather than a 3-month shock. Longer supplier delivery times, as we see in the elevated readings of our Strategas Leading Indicator of Manufacturing (SLIM), ostensibly make price shocks less transitory. The knock-on effect for equity investors is an added pressure on, arguably, already elevated multiples. Taken together, this supports the conclusion that the Fed will need to taper its bond purchase program in the near-term. (Our best guess is they'll do so at their November meeting.) Despite the notion that the demand-side benefits of quantitative easing (i.e., The Fed's monthly bond purchase program) are not the right policy application during a supply-side driven soft patch in economic growth, the taper itself is not the problem. The problem is that the start of the taper has historically commenced the countdown to a tightening cycle. The Fed have not been successful in articulating the separation of these two operations. Despite Chair Powell's and Vice Chair Clarida's best attempts, the market doesn't believe them. It may take a pullback in equity prices – and the Fed not doing anything about it – for the market to come around. In our view, whether or not it is the "right" answer, it just doesn't seem the Fed has the political will, under current circumstances, to raise prevailing policy rates.

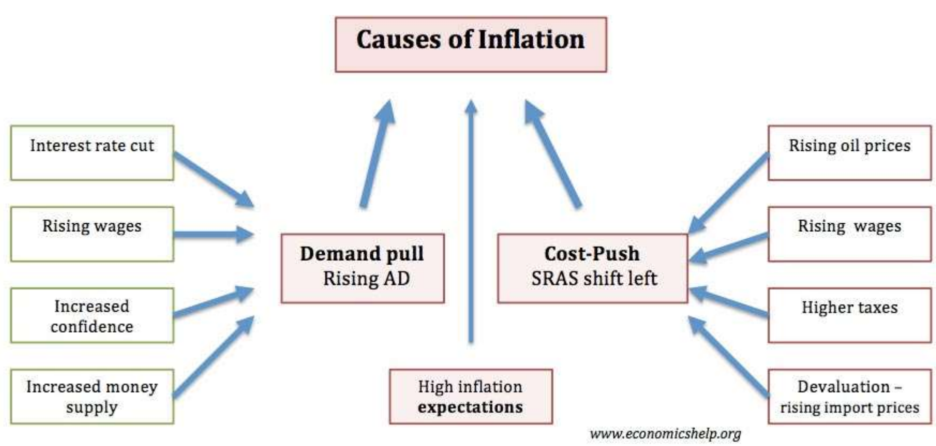
Still, the taper itself wouldn't appear to carry enough weight on its own to take the market lower. This makes the timing of the emerging policy debate worthy of investors' attention. At a high level it has all the makings of traditional Beltway drama: polarized policy ideologies, razor-thin majorities in both Chambers, and a multi-trillion Dollar price tag. More granularly, the Administration's proclivity to move forward with the most ambitious version of its agenda on the heels of eighteen-months of unprecedented, necessary, and bipartisan fiscal profligacy (is this the word you really want to use? I believe it means recklessness or wastefulness) raises the stakes for policymakers with a less-than-stellar track record of separating policy objectives from political aspirations and aligning one, the other, or both with the needs of the citizenry and economy. As our colleague and head of policy research Dan Clifton said, somewhat matter-of-factly, earlier this week, "Washington is going to be a problem." Regardless of investors' own political proclivities – from a market perspective – with an intense debate on the debt ceiling fast approaching, the outlook for each of policymaker's four economic levers – Monetary, Fiscal, Regulatory, and Trade – is at best unsettled and at worst inauspicious.

Though it is certainly possible the economy has enough shoulder to marshal an organic and relatively smooth transition into a durable and self-reinforcing expansion, we believe the risk temperature calls increases the burden of proof. We're comfortable pulling in the reigns for now. Mindful that we have cash to deploy should the fever break.

Inflation: A Sticky Business

"Inflation is like toothpaste. Once it's out, you can hardly get it back in again." – Karl Otto Pohl

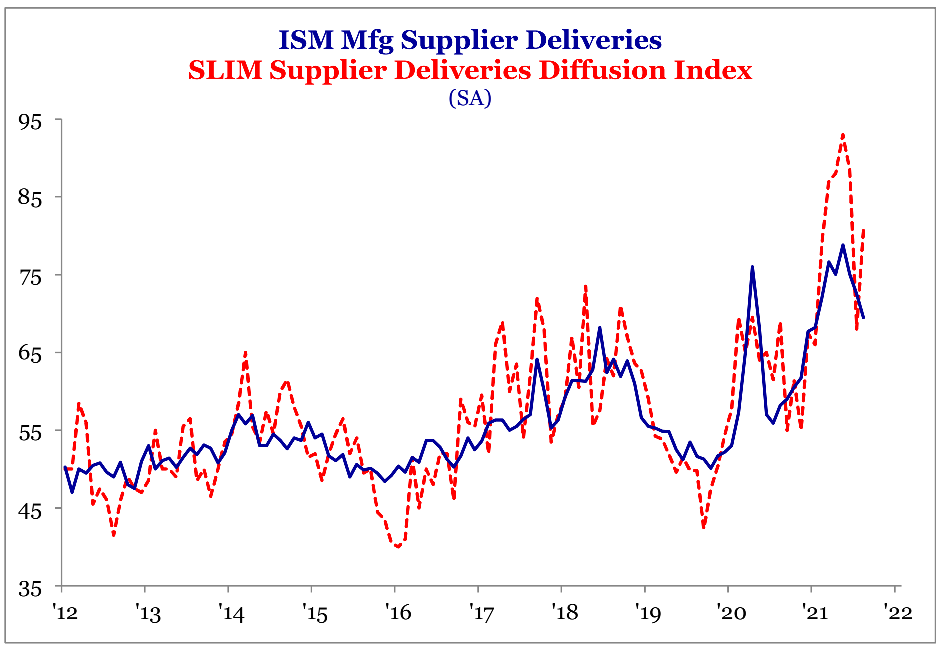
The economic highlight of a recent – and unfortunately rare – dinner outing was a sign that read, "due to inflation, all items are subject to price change." With an uptick in inflation notable from Main Street to Wall Street, it begs the question of why we're seeing such strong readings now despite the Fed's efforts to increase price levels, specifically as measured by the PCE deflator, in the years following the Global Financial Crisis. To figure out the inflation picture it probably is best to look at the various angles from which inflation comes from.



Source: economicshelp.org

The oft-quoted explanation for higher inflation is paraphrased as 'too many Dollars chasing too few goods.' This "demand-pull" concept – where the demand for goods and services exceeds production capacity – has been in evidence this cycle, particularly in its earliest stages behind the unprecedented provision of both fiscal and monetary stimulus. Abundant cheap (and free) money has, in part, driven the recovery in consumption. This concept has likely also contributed to the notable increase in house prices as would be home buyers emigrate from more densely populated urban areas in favor of a more expansive and less crowded suburban lifestyle. Demand-pull does not, however, stem from an increase in the money supply or low interest rates alone. Higher wages and increased confidence also play an important in consumer behavior.

A reciprocal concept impacting price levels is "cost-push" which occurs when higher prices of raw and intermediate goods in the supply chain result in an increase in the price of finished goods (and services). Commodity prices are a simple example of this as seen earlier this year with rising lumber prices. Of course, there is more than one way for cost-push pressures to mount. Disruption in the global supply chain from labor shortages to port closures continue to wreak havoc on the durability of the nascent recovery in global growth.



While the architecture of an economic recovery in and of itself serves as an organic cause for higher inflation, stubbornly high price levels, particularly during periods of lower-than-desired growth is problematic. Strategas' chief economist, Don Rissmiller, has noted recent, elevated, levels of inflation; while he does not believe they will "settle" at levels currently reflected in the PPI (~8% Y/Y) he is concerned that readings could become "sticky" at roughly ~3%. Well above the Fed's stated policy target of 2% and well above the experiential level familiar to producers, consumers, and investors. An offset, of course, is the level of interest rates. With the Fed's policy rate at 0% and U.S. long rates at 1.15% to 1.75% asset allocators are faced with a conundrum: bonds no longer appear adequate to hedge equity positions.

The Fed, of course, could raise rates, but as Strategas' chief investment strategist, Jason Trennert, has intimated, due to elevated debt levels, political circumstances, and a broader social mandate, the FOMC may not be as free to fight rising inflationary pressures as they have been historically. Stay tuned.

NB & GH

[1] Our allocation within Equities continues to favor: International over U.S. Domestic; Small & Mid-cap over Large & Mega-cap; and Value over Growth

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