April 16, 2021

In this month's Insight, Nicholas Bohnsack suggests how investors should keep a close watch on the horizon to despite how well 2021 is shaping up on an economic front.

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Two Time Horizons Emerging

By our lights 2021, is shaping up to be quite a good year on the economic front. Clear progress continues to be made in the administration of the vaccine; and, despite some setbacks – new variants (California, Europe) and potential side effects (AstraZeneca, J&J) – it appears both official and self-imposed restrictions on mobility have eased considerably. The economy continues to re-open and should continue to transition from recovery to expansion through the traditional mechanism, a catalyst – in this case, the successful administration of the vaccine – leads to successive increases in activity; demand; output; revenue; investment; and profitability. A package of recent data would appear to highlight the pickup in activity – monthly activity surveys, like the Philly Fed have poked to multi-cycle highs, labor market gains have ticked-up considerably, and corporate profits for quarter ending March 31st have started to come in well above expectations.

Given the severity of the economic dislocation experienced in the past year and the size of the fiscal response aimed at offsetting it, investors could be forgiven for anticipating a spate of right-tailed, i.e., better-than-expected, outcomes, concluding we are out of the woods, and setting their portfolios on "expansion" mode. Indeed, consensus positioning – which we don't disagree with prima facie – would appear to reflect this view. Tactical allocation portfolios over the last six months have tilted to favor of value over growth, small & mid-cap shares over large, and even non-U.S. over domestic issues. We have made similar adjustments to our own clients' portfolios, maintaining above-benchmark exposure to Equities at 67% (relative to 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. We have also started to increase exposure to non-U.S. Developed Markets at the expense of domestic issues. 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%).

An important building block remains – in our view – conspicuously absent, however. What organic driver (or drivers) of growth will emerge to carry the expansion beyond its pent-up demand-fed, stimulus-backed, liquidity-driven surge? In the traditional cyclical recovery sequence, we highlight above (catalyst, activity, etc.), the revenue-to-investment transition mechanism depends on this.

At the same time – and without making a normative political judgement – the Biden Administration has recently proposed a sizable expansion in federal spending. Some would posit these proposals are just what the doctor ordered to attract capital and fuel growth. Hopefully so. But, by deign of proposal's requirement to offset spending with revenue through the legislative process of "reconciliation," sufficient uncertainty has emerged to require investors assess the longer-term implications. Indeed, price action in recent weeks suggests investors have pulled away from the intermediate-term cyclical positioning that defined 2H'20 and early-1Q'21 performance and have adopted a more neutral "wait-and-see" stance with placeholders for growing concern over long-dated inflation and fiscal trends. The next ~6 months, fueled by anabolic stimulus and replete with tantalizing Y/Y comps, may mask the true impact of the developing policy shift now underway.

What sits beyond that horizon?

If the policy is well-considered and its application well-administered, concerns will fade and the benefits will be quickly discounted; alternatively, and without evidence in hand, the market will rely on the natural and, ostensibly, binding constraints of economic theory. Our policy research team in Washington, DC have observed that the budget proposals laid out by the Administration take advantage of some nifty accounting to match revenue and expenses, with the ten-year window used to measure the proposal's costs offset with a fifteen-year window to capture revenue. What's more, the nature of infrastructure spending, however defined, tends to be backend loaded while tax increases generally accrue on the front-end. While much will depend on the detail, this framework sets up the very real potential for fiscal drag in 2022. Investors will do well to watch these developments closely in coming months.

Strategas Recommended Asset Allocation (Apr'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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