STRATEGAS
ASSET MANAGEMENT

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In this month's Insight, Nicholas Bohnsack recaps 4Q while looking ahead to CY '22.

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2022 Will Be Different, Right?

It is somewhat hard to believe just how long the world has been battling the Covid-19 pandemic – stress on the "19." Long enough that despite true tragedy and disruption in the face of the virus' gnawing persistence (i.e. the Delta variant), there appeared an emerging complacency among investors as we made the move into 4Q and toward year-end. For many investors, the outlook appeared to be defined by four areas of focus: a marked – albeit asymmetric – reacceleration in growth; an understanding that inflation was already – and would likely remain – higher, longer than policymakers cared to acknowledge; the tepid return to a "new" normal, itself frustratingly rife with accommodation; and, the somewhat unsurprising revelation their exists an even greater distance between the partisan poles of politics. But, with all of it, emerged a general acceptance – the hallmark of complacency – for the range of likely outcomes for each. Case in point, the S&P 500 powered to a succession of 87 new all-time highs after recovering through the Feb'20 pre-pandemic high of 3,386 on route to posting a +110% advance off the Mar'20 low of 2,237. But, everything must go right for goldilocks to persist and on queue, the emergence of the Omicron variant and the Fed's pivot on inflation clearly disrupted an increasingly complacent consensus as we entered December.

So what do the latest developments portent for the economic recovery and how should investors adjust their portfolio? As we have discussed with clients over the last several weeks, while the cyclical trade faces a stiff headwind, by our lights, the cyclical recovery appears intact. While perhaps short-dated, the recent spate of volatility is likely to provide further discomfort into year-end as there has been little evidence that investors are not more worried about the Fed's intention to accelerate the pace toward policy normalization than the impact of Omicron. While it had been clear the Fed's policy mix left them behind the mark on inflation, during their meeting last week, the Committee elected to double the pace at which they're tapering bond purchases – which are now expected to end in Mar'22 – and foreshadowed three rate increases for next year – ostensibly one each in 2Q'22, 3Q'22, and 4Q'22. At first pass, this seemed enough for investors as markets rallied on the announcement. Tactically we're on hold. We remain comfortable with the more moderately bullish, and generally cyclical positioning, we established in our global allocation portfolios back in September. Equities are now 62% of the baseline portfolio – down from 67% vs. 60% neutral exposure – and Cash is 8% – up from 6% vs. a 2% baseline.

Inasmuch as the Fed believes it has now aligned the direction of policy with an intention of stemming the tide of higher inflation while allowing the labor market to recover, it understands that labor force participation in the short and longer-run is likely to be different. As Strategas chief economist Don

Rissmiller has highlighted – and Chair Powell acknowledged – we are simply not heading back to the same economy as we had in Feb 2020. This would appear to suggest that the permanency and disequilibrium of the new normal is intensifying. As we wrote last month, is it too outside the box to think the adjustments made by corporate operators to adapt to these new conditions may collectively reveal themselves as one of the great organic drivers of growth the economy needed to hasten the transition from jagged recovery to self-reinforcing expansion? Increasingly, we think so. Without attempting to be cavalier about the virus, we wonder whether the emergence of Omicron is just enough of a scare, and at just the right time, in tandem with a more hawkish Fed to make the "transitory" disruption to our daily lives and operating norms more permanent – or, at least, super-cyclical. Though it would seem clear to most that the return of shelter-in-place mandates are both socially and politically untenable as Strategas' chief strategist Jason Trennert noted last week, it appears some political leaders in some parts of the world remain fixated on lockdowns to slow the spread of the virus. Unfortunately, the costs, to our economic, social, mental, and physical health are acute.

As we look into 2022, it would seem the investment outlook is decidedly more neutral than it was a year ago at this time. The markets remained buoyed by ample liquidity, strong corporate profits and elevated profit margins. At the same time, aggressively accommodative monetary policy is reversing into an environment defined, in part, by lofty market multiples. This cocktail suggests that market returns will continue highly correlated with the yield on 10-year sovereign debt. While current valuations may be sustainable with a 10-year Treasury note yielding 1.45%, with the biggest player in the Treasury market stepping away we should see some upward pressure on long-term interest rates. The omnipresent growth names may have called forward a fair amount of the present value of future cash flows. In short, Value may be where the growth is. If supply chain issues continue to ease the cyclical recovery should continue to transition into a self-reinforcing expansion, albeit less robust that perhaps most hope for.

As a check on this muted optimism, we're focused on 7 datapoints to outline the durability of the cyclical recovery:

1. BAA corporate spreads widening above their Sep'20 highs (~18bps)
2. Further flattening of the yield curve
3. A meaningful decline in TSA travel & mobility and OpenTable seated diners data
4. Deterioration of S&P 500 profit margins
5. Weakness in the relative performance of Cyclicals vs. Defensive shares
6. Renewed school closures
7. A meaningful increase in Unemployment Claims

For now, there remains no real alternative to equities, but stock and sector selection may be critical in generating absolute equity portfolio returns greater than mid-single digits next year. Among U.S. equity sectors, we

continue to recommend above benchmark exposure to the Consumer Discretionary, Energy, Industrials, Financials, and Materials sectors on an equal-weighted basis. This leaves our U.S. equity sector portfolios with Neutral exposure to Health Care, Technology and Real Estate. We are underweight Staples and Utilities shares but note the energized performance of both in recent weeks. We are maintaining below benchmark exposure to Communications.

We wish all of you a very Merry Christmas and Happy Holidays. NB

Strategas Recommended Asset Allocation (Dec'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

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