STRATEGAS
ASSET MANAGEMENT

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In this month's Insight, Nicholas Bohnsack discusses how he believes there is a wall of worry being built with equities moving higher in the face of the recent back-up in yields.

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Interest Rates & the Wall of Worry

It has been an interesting month to kick-off our schedule of 2021 (virtual) client meetings. While there is no shortage of worthy topics, most of our discussions with clients have focused on the ramifications fostered by the gnawing and continued tension between *freedom* and *safety*. That is, the virus – *in all its forms and effect* – remains our Scrooge; clear progress towards its containment and the eventual cure has only exacerbated the jaggedness of both the economy's reopening and the speed and force with which its nascent recovery can transition into a broad cyclical expansion. While attempting to converge on a new set of acceptable norms, the prevailing views of the principal constituencies governing the reopening – Scientific; Political; Financial; and, Societal – generally seem unaligned. As a result, acute shifts in trend among important market yardsticks – *the Dollar (stronger), interest rates (higher), inflation expectations (surging)* – to say nothing of a growing chorus of debate on everything from cryptocurrencies to meme stocks – *there are multiple Clubhouse chat rooms discussing each* – it can hardly be surprising that investors have moved to take down risk.

While a recalibration of the consensus outlook for recovery would seem warranted, we struggle to see signs of the euphoria Minsky posited would envelop markets before the panic. Though our antennae are up, it would seem the optimism underpinning a fast-developing, full-throated, liquidity-driven recovery in global economic growth has stepped in the very soft-patch we feared a vaccine-related *logistics gap* would cause. This is not to say all is lost. Perhaps the market is too short-sighted? One of the best lessons on perspective we've learned from observing investors and markets over many cycles reflects on their focus. When the intensity of it is trained on short-dated outcomes, bending to every price move, data release, or informational tidbit – *regardless of the calories* –pays to step back and consider longer-dated trends and opportunities. (No doubt the opposite is true as well.) The current setup compels us to turn away from tactical considerations for a moment and consider longer-dated factors. Inasmuch, the building blocks of cyclical expansion seem in place.

So, we turn back to the recent shifts in the market yardsticks we mention above. As our colleague and chief strategist, Jason Trennert, has noted, even in a world awash with ~$16 trillion in negative-yielding sovereign debt, there is something incongruent about the U.S. 10-year yielding ~1.30% with nominal GDP growth which could approach +8% this year. While a correction in the equity market is possible at any moment, we believe it is important to note that stock prices and bond yields can, and often do, increase simultaneously as a reflection of stronger economic activity. We view the risk to financial assets, particularly equities, to occur not when the specter of higher inflation reveals itself but when the central banks make it clear that they are ready and willing to stop it. It would seem, at least at present, we are a long way from such an unhappy occurrence. But make no mistake, investors – in our view – are keen to test the Fed's mettle on this point.

So when – and at what level – do long rates begin to hurt equities? There is a point. Higher interest rates increase the risk in the equity markets but given the current dynamics, *when* would not seem to be *now*. The U.S. government response would seem intent on the provision of additional fiscal aid to bridge the gap, and then some, related to any lockdown-related imbalances. As Strategas chief economist Don Rissmiller has highlighted, this has largely been accomplished by running-up deficits while monetary policymakers seem comfortable in the notion that any signs of increasing inflation will prove short-lived. Higher interest rates would signal alarm on this front. More empirically, Strategas' technical strategy team examined the sensitivity of the equity market to the 6-month net change in yields and found the current move to be well short of the rolling 95th percentile that has proved troublesome for equities… and cyclicality. Taken together, this suggests we have some room – both for equities to move higher in the face of the recent back-up in yields and until yields are deemed to have produced a more pronounced move relative to their rolling historical range. Thus is built the wall of worry…

The causation of a cyclical recovery – reopening increases: activity; demand; output; revenue; investment; and, profitability – would appear to have merit-based the six tenets of the bull case:

1) M2 is growing at 25% Y/Y and has been growing at more than +20% for six months now. The Fed has increased the amount of assets on its balance sheet by more than +70% since March of last year.
2) The Covid-19 vaccine appears likely to be widely distributed by mid-2021.
3) After a near-term pause, a combination of easy money, additional fiscal stimulus, and a full reopening of the economy in 2021 could lead to a boom in economic activity.
4) Consumer balance sheets remain strong; the personal savings rate is running at ~13% of disposable income.
5) Forward 12-month earnings expectations for the S&P 500 are now beyond year-end 2019 levels.
6) Companies are currently carrying inordinately high levels of cash on their balance sheets.

To be fair, and as we discuss above, the bear case is not without merit; as noted in the four tenets below:

1) Continued convergence of the public and private markets through the prolific issuance of SPACs coupled with leveraged activity from the retail channel suggest speculative excesses are building.

2) News of greater vaccine distribution may make the decision to lock down the economy easier for public policymakers.
3) Democrat control of the Administration, Senate, and House could increase regulatory pressures on the Financials, Energy, and Health Care sectors. Personnel is policy.
4) The likelihood of further deficit spending may put upward pressure on inflation and interest rates while pushing down the U.S. dollar. This, in turn, could put pressure on earnings multiples.

For the moment, we remain constructive and inclined toward the merits of the bull case.

Strategas Recommended Asset Allocation (Feb'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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