STRATEGAS
ASSET MANAGEMENT

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In this month's Insight, Nicholas Bohnsack summarizes the list of worries for investors and discusses our current recommended asset allocation.

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Bullish In The Face Of Uncertainty

The list of things keeping investors up at night is not short:

- The debt market: How long will the Federal Reserve (the Fed) remain accommodative?; the surge in repo rates; an inverted yield curve; negative interest rates; ~$15 trillion of negative yielding sovereign debt; a new European Central Bank (ECB) president;
- Trade: the US with China; the US with the EU; the US with Canada & Mexico, (aka USMCA/NAFTA); Britain with the EU (aka Brexit); Japan with South Korea;
- Politics: the impeachment inquiry; the 2020 US election;
- The US economy: declining business confidence; a slowdown in manufacturing, the PMI falling below 50; weaker corporate profits; the resiliency of the US consumer; the potential for recession;
- Geopolitics: Syria and Turkey; Iran and Saudi Arabia; oil; Hong Kong; Argentina; and
- Potpourri: the Japanese VAT increase; European recession.

That said the items on the list seem manageable. The key for market "stability" (i.e., not dropping precipitously as it did last year in Q4) is that none of these manageable uncertainties breaks. Although the repo market put this thesis to the test at the quarter's end, we draw comfort from three sources:1) the liquidity gap did not 'bleed' into extended credit markets; 2) despite not anticipating the aforementioned liquidity or the market's response to the gap, the Fed was quick to contain the fire (a fire that they set, by the way…) by establishing a temporary repo facility; and 3) although critical of the system, comments from bank executives reporting Q32019 earnings suggested it was easily avoidable.

Indeed, an item now celebrating its first birthday on our list of uncertainties—the Trump Administrations game of Deal or No Deal with the Chinese—also has produced an off-character ray of hope in recent days. Developments in Washington over the weekend suggest that both sides recognize the importance of de-escalating tensions. While we are skeptical of the prospects for even this less ambitious "phase 1" deal between China and the US to be stamped 'complete' (in roughly a month's time) without another round of the mudslinging that has negatively affected the markets and dominated the headlines throughout, we remain hopeful. More importantly, the specific tenets of the deal are less important than the deal itself, as it serves to remove concern among operators, which has, by our lights, clearly damaged business confidence and slowed investment, in turn weakening both global economic growth and domestic corporate profits. This is a step in the right direction, and the market is likely to give it the benefit of the doubt.

So perhaps we have made enough of a case to reduce investors' angst over some of the bolder headline risks. (Perhaps not.) Why are we bullish? First, consider the question: What are you trying to solve for? Without being glib, the noble pursuits are noble by definition. The investor is either trying to manage assets: a) toward generating income on one extreme (more conservative); or b) to extract a return through deploying capital on the other (more aggressive). A static orientation, of course, is rare, thus creating navigation between these two paths. If our conversations with clients in recent weeks are any indication, a good many investors have left the aggressive path in favor of decidedly more conservative positioning. Given the headline perception of the balance of risks— and the not-too-distant memory of the market's sell-off yesteryear— this is not altogether surprising. Nevertheless, with a balanced risk outlook, the opportunity cost is in not being skewed toward the optimistic amplitude.

We place just a 30% probability of a recession in the US by the end of next year. Domestically, in the absence of renewed business confidence and increased capital investment, this outlook relies on the strength of the consumer. Mercifully, while operators focus on supply chain disruption and handicapping incremental investment opportunities, the US economy continues to grow under the strength of the consumer. How long can this last? Lower taxes and low interest rates certainly help. There has been little—to no—evidence of broad-based layoffs picking up; weekly jobless claims have risen only slightly (inclusive of the GM strike). Wage growth remains elevated, household net worth is at near-record levels, and strong consumer sentiment numbers last Friday (October 11, 2019) were a good sign. (For what it is worth, as Strategas's market technicians Chris Verrone and Todd Sohn have highlighted, inferring future market returns from monthly readings of the PMI that fall into the middle eight deciles of the historical range (which is to say 80% of them), is an exercise in futility. September's reading of 47.8, down from 49.1 in August, falls in the third decile.)

So how should investors address portfolio construction in this environment? As we wrote above, investors have had to handicap the outcomes for a laundry list of uncertainties. Provided nothing breaks, the equity market should, in our estimation, continue to ratchet higher, albeit with confidence shaking spurts of volatility. Far from whistling past the graveyard, we duly acknowledge the path forward is far from a long boulevard of unbroken green lights. This path remains a winding one. We hold the line this month in our recommended asset allocation, favoring modest, above-benchmark exposure to equities—weighting our portfolios with 65% exposure to stocks versus benchmark exposure of 60%. We are less constructive on fixed income, particularly Treasuries, with a bias toward very short duration—we are carrying just 27% of the portfolio in bonds plus an outsized 8% in cash versus the non-equity benchmark exposure of 40%.

Within equities, we continue to focus assets up the cap spectrum, favoring large cap shares and domestic names. For the time being, we harbor no bias between value and growth, finding attractive opportunities across three macro thematic conclusions: 1) "things you want" over "things you need"; 2) "superior operators" to "marginal operators"—watch the yawning divergence in evidence during the now underway Q32019 earnings season; and 3) in the vacuum between news and noise as captured, for example, in our Strategas Policy Opportunities Portfolio.

It also is informative to consider next steps. We would be inclined to weigh a shift in our size, style, and geographic bias over the coming months should some of the aforementioned uncertainties find greater clarity. Against classic late cycle slowing expansion dynamics, we would shade our equity exposure down cap, in favor of small and mid-cap operators, and give preference to value over growth and international over domestic.

Strategas Recommended Asset Allocation (Oct'19)

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

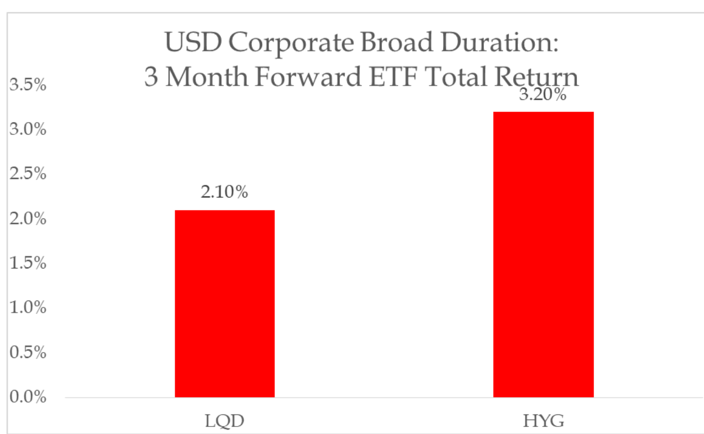
In this month's Insight, Tom Tzitzouris discusses how bond beta has gotten too rich.

Tom Tzitzouris is a Director at Strategas, leading the firms Fixed Income Research efforts.

Bond Beta Has Gotten Too Rich

Typically, we see high beta bonds outperform lower beta assets after large drops in the term premium of longer duration Treasuries. That is to say that after a deep and overbought bottom in Treasury yields, we usually see corporate and emerging market credit outperform, with weaker to middle tier credits usually performing the best. Nevertheless, this outperformance has typically been modest, while the difference in return volatility has been enormous. Today we see a high yield bond market that is the richest it has been relative to our fair value model in the last 12 years, and spreads that are still near cycle lows. With this level of richness as a backdrop, and the observation that any beta rally after the bottom in Treasuries is likely to be volatile and modest, we found less reason to add high yield in the past month, and even found reasons to reduce bank loans. In contrast, we saw opportunity to add both short and longer duration investment grade corporates, and we continue to believe that at current valuation levels, these investment grade sectors are the optimal location to add beta and carry for fixed income investors.

On average over the last 8 years, we have seen high yield outperform broad market IG corps by about 100 bps in the 3 months after a bottom in 10-year TSY yields. This is modest, but when we consider that the standard deviation of the high yield returns is 100 bps higher, and the already rich high yield valuations, we find little appeal in reaching for yield by adding high yield at this point.



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