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STRATEGAS

insight

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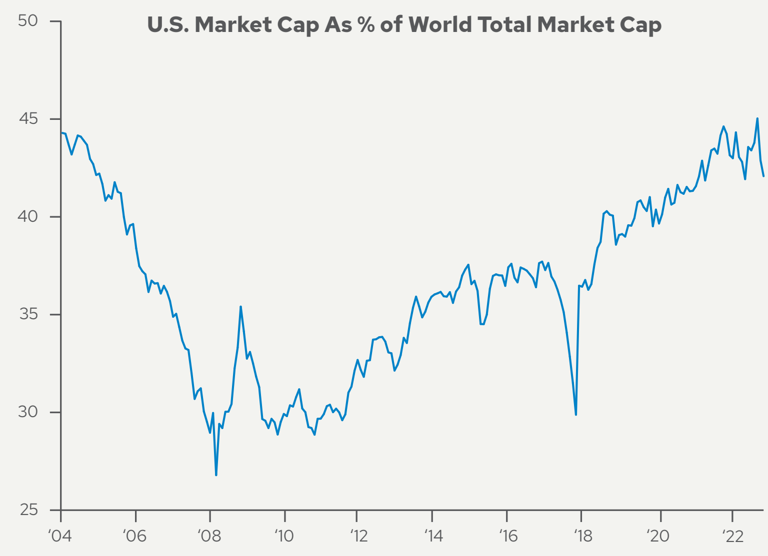
Recession Watch

The equity market has remained resilient off its October low. Investors, however, appear conflicted. While the consensus outlook for economic growth over the next 12-15 months almost universally involves recession, the appetite to start wading back into equities is palatable. We remain suspicious that the timing is right to do so. By our lights, bottoming is a process and bear markets associated with financial deleveraging and broad asset price corrections are conducive to strong countertrend moves.

Are we right? There would seem two important considerations when assessing the anatomy of a bear market: what type is it and has it run through all its phases? Modern markets appear to have produced three types of bears: 1) acute shocks that (can) reverse quickly, e.g., '87 Crash or Covid collapse; 2) financial crises that reveal systemic failures or weakness, e.g. '98 Asian Contagion, '07/'08 GFC; and, 3) recession-linked asset bubbles which require unwinding, e.g. '00/'01 Tech wreck and today's ZIRP normalization. Anticipating the onset of the first and second generally evades all but the keenest market observers and those investors at the epicenter (who are often powerless to avoid the fallout because of their very proximity). Asset bubbles are generally more recognizable, though their excesses are often excused, and can take far longer to work through than the consensus is prepared to accept. That's where we believe we are. Investors have not accepted their fate and all the valuation excess has yet to be wrung from the system. Volatility ensues in the form of, often powerful, counter-trend rallies. We saw this bear market first attack the speculative corners, e.g., SPACs and crypto. More recently, it has manifested as weakness in the long-duration names, e.g., growth stocks and bonds. Before it's over, the illiquid assets, i.e. private equity, will get marked down too. This has finally become what so many investors hoped for – *a stock pickers' market.*

Against this backdrop we continue to recommend an underweight allocation to equities. More recently, we have shifted our preference from

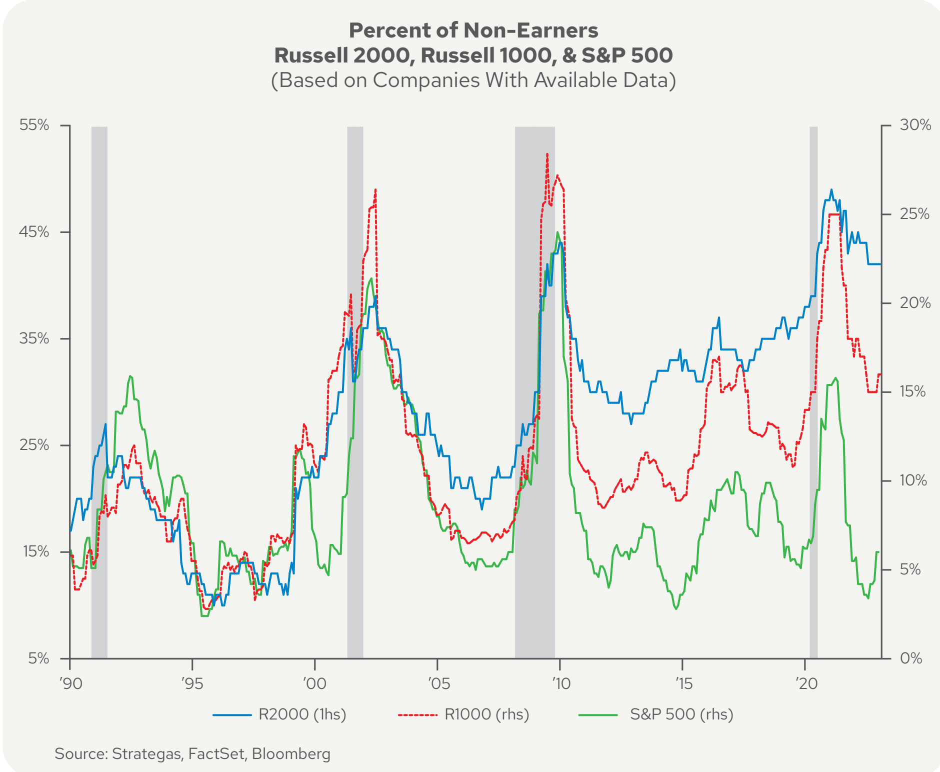


Source: Strategas, FactSet, Bloomberg

U.S. shares to an overweight position in International equities, specifically in Developed Economies. We have increased exposure to Emerging Market equities within our tactical allocation portfolios to neutral against the benchmark. The shift away from U.S. stocks is driven by four catalysts, each with different duration profiles. First, we find it inconsistent to be bearish on the Big Tech bellwethers while bullish on U.S. markets, given their still dominant index weights. Second, while everyone was watching for the Fed to pivot, China's reversal of their Zero Covid framework will likely result in a notable uptick in global demand, i.e., the "China re-opening trade." Third, global central banks are intent on normalizing monetary policy leading to the fourth catalyst, De-Globalization – capital is being called home. Income players can increasingly find attractive local market yield alternatives devoid of currency pressure and operators remain influenced by the reorganization of global supply chains.

Domestically, we continue to rely on the same analytical framework for handicapping the market's bottoming process that we've had since this time last year: 1) anchor inflation expectations; 2) level set valuations; and, 3) identify organic drivers of growth that will pull private capital into the real economy. While a reasonable case can be made that the Y/Y rates of change in the various inflation measures have peaked, wage pressures and the probability of a recession in the U.S. over the next 12-15 months, both remain stubbornly high. Interest-rate sensitive sectors, like housing, are already showing the effects of tighter monetary policy. Moreover, as Strategas' chief economist, Don Rissmiller reminds us, U.S. nominal activity is slowing. The U.S. PPI was down -0.5% M/M in December of last year, nominal retail sales declined -1.1% M/M with the retail control group down -0.7%, and U.S. industrial production also declined -0.7% M/M in December with downward revisions to prior months. The NY Fed manufacturing index plunged in January. Though this may overstate the weakness in the whole economy, other regional surveys are also showing some cracks. It seems, however, few investors have made the corresponding adjustment in their outlook for corporate profits or, by extension, their expected value forecast.

We expect tighter monetary conditions to exist for some time. This is likely to have a continued and negative impact on companies' ability to expand operating margin. While the "money illusion" can result in higher levels of nominal earnings and make recession-related percentage declines appear less severe than they would in low inflation regimes, contracting operating leverage in combination with tighter financial conditions has historically led to lower earnings and earnings growth. Though estimates for aggregate S&P earnings for CY'23 have seen notable downward revision – to ~$225 from $250-$255 as recently as July – it is important to note that recession-related earnings declines have averaged -30% from their **actual** peak (i.e. ~$222 in 3Q'22) not their **estimated** peak. The Street's estimates still imply profit **growth** for CY'23. This is inconsistent with the near universally held view that the U.S. economy will contract in the next year. We reiterate our estimate of $200 for S&P 500 EPS in CY'23 and believe aggregate profits will continue to decline through 2Q'24 – falling toward ~$180 – before beginning to recover into year-end CY'24.



We would be mindful of changing theses underpinning optimism. It is tempting to get lulled in by a strong tape. In addition to granular security selection, we believe the major themes driving the market to start the are fourfold: Recession Protection, Cash Flow Aristocrats, Energy Security, and De-Globalization. To the extent to which many investors are currently gloomy, we believe that sentiment remains the strongest asset for the overall market today. Further declines in the rate of inflation could also help the overall tone of the market, but risks to economic growth skew to the downside and are likely to continue to do so for some time.

Strategas Recommended Asset Allocation Jan'23		
	Equities	Bonds
Overweight	Dev AC Core US LC Value US MC Value US SC Core	
Neutral	EM AC Core US MC Growth	ABS/CMBS US Dollar EMD IG Corporates
Underweight	US LC Core US LC Growth	US MBS U.S. Treasuries

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Founded in 2006 by Jason DeSena Trennert, Nicholas Bohnsack, and Don Rissmiller, the Firm was acquired by Baird Financial Group in 2018. Strategas operates independently as a wholly-owned subsidiary of Baird and offers institutional securities services through Strategas Securities, LLC, a broker-dealer, and investment management solutions, including this commentary, through Strategas Asset Management, LLC, a registered investment advisor.

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Index Overview & Key Definitions

Fed, The Fed or FED refers to the Federal Reserve System, the central bank of the United States. Fed Funds Rate, the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The Gross Domestic Product (GDP) rate is a measurement of the output of goods and services produced by labor and property located in the United States. Real Gross Domestic Product (GDP) is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year. Nominal Gross Domestic Product is gross domestic product (GDP) evaluated at current market prices. The S&P 500 Index is an unmanaged index comprised of 500 widely held securities considered to be representative of the stock market in general. The Russell 1000 Index is a market capitalization weighted benchmark index made up of the 1000 largest U.S. companies in the Russell 3000 Index. The Russell 2000 Index is an unmanaged index considered representative of small-cap stocks. The PCE (Personal Consumption Expenditure) Index of Prices is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data including U.S. Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures; essentially a measure of goods and services targeted towards individuals and consumed by individuals. The Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services. FAANG is an acronym for the five of the market's most popular tech stocks, namely Facebook, Apple, Amazon, Netflix and Alphabet's Google. The North American Free Trade Agreement (NAFTA) is an agreement signed by Canada, Mexico, and the United States, creating a trilateral trade bloc in North America. The Seasonally Adjusted Annual Rate (SAAR) is a rate that is adjusted to take into account typical seasonal fluctuations in data and is expressed as an annual total. SAARs are used for data affected by seasonality, when it could be misleading to directly compare different times of the year. The Atlanta Fed GDPNow forecasting model provides a "nowcast" of the official estimate prior to its release by estimating GDP growth using a methodology similar to the one used by the U.S. Bureau of Economic Analysis. GDPNow is not an official forecast of the Atlanta Fed. Rather, it is best viewed as a running estimate of real GDP growth based on available data for the current measured quarter.

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