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Interest Rates and the Wall of Worry

It has been an interesting month to kick off our schedule of 2021 (virtual) client meetings. Although we have no shortage of worthy topics, most of our client discussions 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 toward 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. In 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, with acute shifts in trend among important market yardsticks—*the dollar (stronger); interest rates (higher); inflation expectations (surging)*—and a growing chorus of debate on everything from cryptocurrencies to meme stocks *(multiple Clubhouse chat rooms are discussing each)*, it is hardly surprising that investors have moved to take down risk.

Although a recalibration of the consensus outlook for recovery seems warranted, we struggle to see signs of the Minsky moment that normally envelops markets before a panic. Our antennae are up, but it seems that 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 have 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*—it 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 mentioned 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 10-year U.S. Treasury Note yielding ~1.30%, with nominal GDP growth that could approach 8% this year. Although a correction in the equity market is possible at any moment, 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 now, that we are a long way from such an unhappy occurrence. But make no mistake, investors—in our view—are keen to test the Federal Reserve's mettle on this point.

So when—and at what level—do long rates begin to hurt equities? They will at some point. Higher interest rates increase the risk in the equity markets, but given the current dynamics, *when* does not seem to be *now*. The US government response seems intent on providing additional fiscal aid to bridge the gap, and then some, for any lockdown-related imbalances. As Strategas chief economist, Don Rissmiller, has highlighted, this largely has been accomplished by running up deficits, while monetary policymakers seem comfortable with 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 six-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.

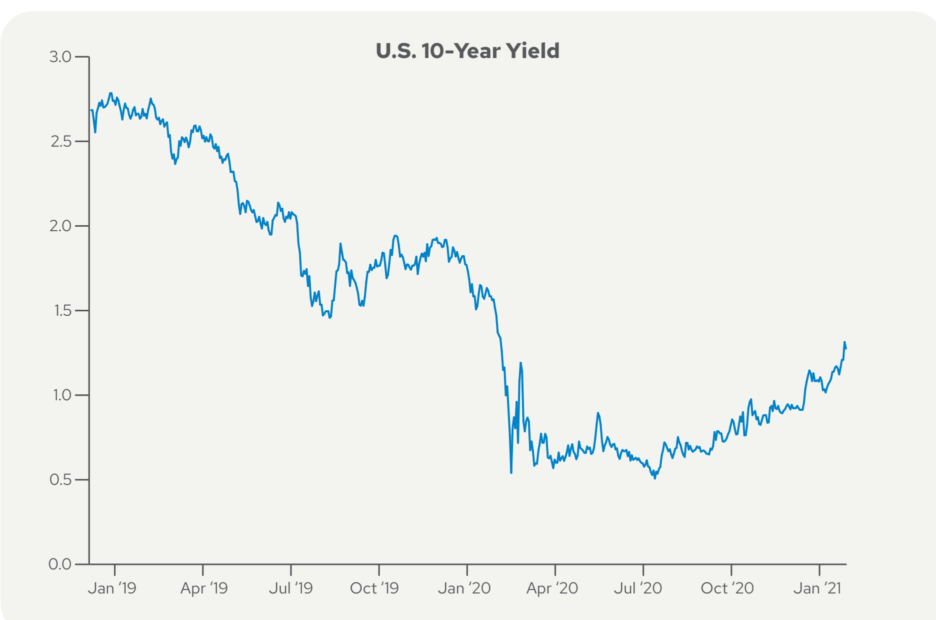
The causation of a cyclical recovery (reopening increases activity, demand, output, revenue, investment, and profitability) would appear to give merit to the six tenets of the bull case:

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 Index are now beyond year-end 2019 levels.
6. Companies are currently carrying inordinately high levels of cash on their balance sheet.

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, suggests speculative excesses are building.
2. News of greater vaccine distribution may make it easier for public policymakers to lock down the economy.
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 US dollar. This, in turn, could decrease 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 Value US LC 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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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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