STRATEGAS

insight

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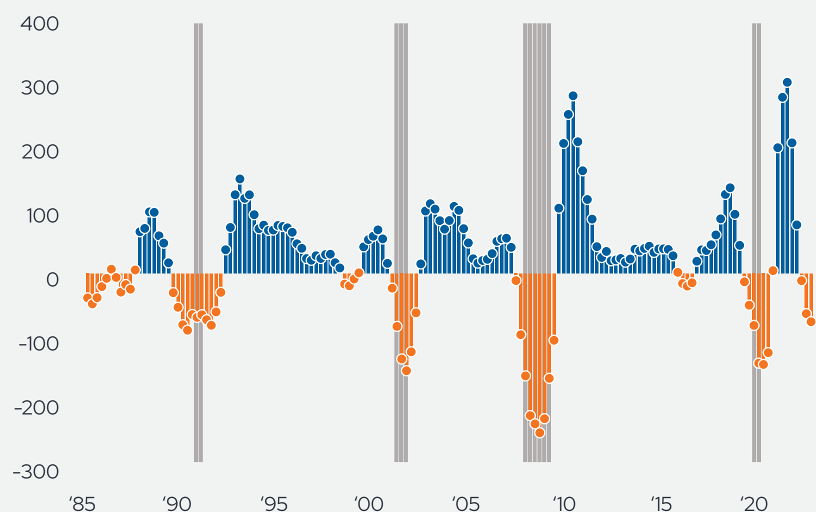
An Important Question Confronts Investors

Investors remain conflicted on the prospects for economic growth with most investors either forecasting (or, accepting the inevitability) of recession, given the gnawing imbalance of economic supply and demand. Not surprisingly, however, the good outweighs the bad in investors' calculus with continued strength in the labor market, improved consumer spending data, and the alluring pull of higher equity prices increasingly rendering the negative points moot. At the end of the day, the stock market is going up, which generally nullifies all other points of concern. As readers know, we have been cautious and while we have looked wrong in the midst of powerful counter-trend rallies, we would encourage investors to stay on their toes... Our focus remains on the deteriorating outlook for corporate profits and the lagged effects that normalizing monetary policy and combating inflation are likely to have on the durability of any recovery in economic growth. Both, in turn, have historically shown to be detrimental to risk asset prices.

While the Y/Y change in headline inflation measures (i.e., CPI) have moved lower, stickier price components (e.g., wages, rents) remain elevated. This should serve as a reminder of the acute pressure corporate operators face in maintaining mid-cycle levels of profitability. Given the share these inputs represent of aggregate corporate costs margins are likely to continue to deteriorate into 2H'23, dragging corporate profits lower (and the market with it). Pushing back, some investors are quick to point out the notable downward revision estimates for CY'23 S&P earnings have already experienced – to ~$220 from $250-$255, last summer. 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. Despite the sharp



revision, the Street's estimates still imply profit growth for CY'23 and CY'24. This outlook for corporate profits is inconsistent with the view that the U.S. economy will contract in the next year. The framework we have used over the past year to assess the health of the economy holds up well in this frame of observation as well: anchor inflation and the volatility of inflation expectations; level set valuations; and, identify durable organic drivers of growth. On inflation, we have seen notable progress, but are entering the more difficult phase of arresting prices back to an acceptable level (and the Federal Reserve knows it). On the second of these tenets, we reiterate our estimate of $199.50 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. Lastly, we remain in search of the drivers of growth that will call capital into the economy – either from corporate operators investing in their own franchises or from the sidelines by speculators looking for above market returns.

As our Chief Economist Don Rissmiller has noted, the economy is not balanced and the longer it is not in recession – *to correct those imbalances* – the greater the risk the economy overheats and more severely it contracts. So as we start the year with some pockets of momentum, while ostensibly welcomed, we may be both delaying and exacerbating the pain. Moreover, while some central banks have paused rate normalization programs (or are expected to pause soon) the Fed, eager to not repeat the mistakes it feels it made adjudicating monetary policy during the inflation fight in the 1970s, does not appear to be done. We expect "sufficiently restrictive" policy to persist through 2023.

So how does this play out for investors? The key may lie in diagnosing the bear market discounting this imbalance. By our lights, modern markets 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 (e.g., '00/'01 Tech wreck and today's ZIRP normalization), which require unwinding. As we have written in the past, 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 – as we may be experiencing currently – and can take far longer to work through than the consensus is prepared to accept. 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 the bear first attack the speculative corners, i.e. SPACs, crypto. More recently it has manifested as weakness in the long duration names, e.g. growth stocks, bonds. Before it's over, the illiquid assets, i.e. private equity, will get marked down too. In as much we remain cautious on equities, generally, and on the prospects for long-duration operating franchises. We have a modest tilt toward International equities, specifically Developed Economies, over U.S. domestic names. We find it inconsistent to be bearish on the Big Tech bellwethers, while bullish on U.S. markets given their still dominant index weights.

Strategas Recommended Asset Allocation Feb'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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