STRATEGAS insight

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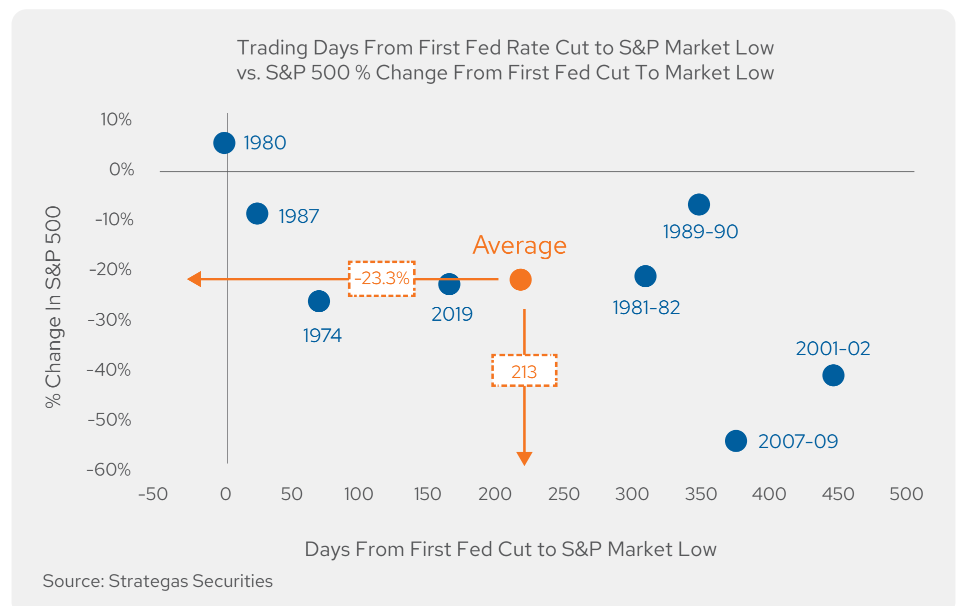
What to Watch While the Market Rises

Sometimes a bull market is a bull market. Though equities have been choppier in recent weeks, given a package of modestly-less-robust economic data (unemployment, retail sales, inflation, etc.) coming on the heels of a nearly uninterrupted four-month advance, there appears little – *at the moment* – to force the current bull market into abeyance. Price leadership has broadened – *a welcomed positive* – and the Fed has signaled their intent to cut policy rates this year, providing a further boost to stock prices. (Our best guess is three cuts beginning at the June meeting.) Consider, however, that rate cuts are not always the panacea they seem. They generally come in response to weakness in the economy or to a negative shock. Since 1974, the S&P 500 has averaged a -23% decline in the first 200 days following the first cut of the cycle. Be careful what you wish for... Alternatively, a Fed "on hold" has historically been accompanied with stronger share prices, i.e., the economy is digesting the prevailing policy of day and continuing to expand. Case in point, the current pause – *at approximately 240 days* – ranks second to only the 446-day pause (and +22% S&P move) that preceded the Global Financial Crisis cuts. With that as a backdrop, no cuts may be a good thing.

If our antennae are tuned to anything it remains the long-term building blocks of stock prices – *earnings and interest rates*. Here the situation is less optimistic than stock prices would suggest. Not enough to throw in the towel but mixed enough to keep our attention. Despite some positive outliers (specifically A.I. and adjacent Tech), aggregate Index earnings have been flat for nearly two years. Though "soft landing-friendly," we continue to harbor some concern over the yawning divergence between expectations for corporate profits on the long-end of the earnings curve (i.e., +9, +12, +15 months) and the tepid growth rate of actual earnings. At ~13 pct. points, the NTM-TTM spread of sub-industry positive-to-negative earnings growth sits near its widest divergence in 20+ years. While few investors we speak with seem overly concerned about current valuation levels – *in general or relative to history* – the flows-fueled



Source: Strategas Securities

move higher is worth watching in the absence of notable earnings growth. **We remain neutral equities against the benchmark seeing little pull to put new money to work.**

As we note above, the Fed's intention is to begin to ease monetary policy this year, leveraging a combination of headline-grabbing policy rate cuts in concert with a slower pace of quantitative tightening. They remain on hold for the time being, however. As stated in the March FOMC statement, the Committee will, "wait for greater confidence that inflation is moving substantially toward 2 percent." The scrouge remains inflation. Headline and Core CPI was hotter-than-expected in February coming in at 3.2% Y/Y and 3.8% Y/Y, respectively. The Employment Cost Index, Producer Price Index and Core PCE deflator are all running above expectations and policymakers' desired targets. Strategas' fixed income strategist, Tom Tzitzouris, makes the interesting observation that, in a zero-sum game, unless productivity is expected to average 2% over the next few years, then either the high yield market is over-estimating corporate earnings growth potential (as we highlight above) or the Treasury market is underestimating the breakeven rate of inflation. At the same time, Treasury supply continues to rise and coupled with sticky inflation, is serving to drive term premiums higher across the curve; though off their highs, term premium for 10-year Treasuries are ~30bps and remain in a secular uptrend. **We remain long duration. At the same time, the downtrend in investment grade spreads has continued toward multi-year lows. We remain neutral vs. the benchmark.**

We would note the recent strong performance of Gold (an asset we have included Strategas' Tactical Allocation Portfolios). The metal's strength could be taken as a sign of continued volatility. As Strategas' chief economist, Don Rissmiller, has observed, "it's tough to have Gold and Goldilocks (stocks + bonds) work at the same time." Something has to give. It will be growth vs. inflation going forward which underpins our interest in the outlook for earnings and interest rates.

Source: Strategas Securities

With a bull market at our backs and uncertainty surrounding the degree of optimism investors should harbor for the fundamental backdrop, the thematic setup becomes quite compelling. In our work four themes continue to gather the thematic momentum we find compelling:

Artificial Intelligence – While still early days for the business use, i.e., the benefits must accrue beyond the purveyors of the technology, A.I. is likely to be an important driver of organic growth that will continue to attention and capital from tech and non-tech corporate operators looking to expand their franchise.

Cash Flow Aristocrats – At its base level, companies have just seven options for free cash expenditure. Three return on capital outlets: 1) Acquisitions; 2) traditional PP&E Capex; and, 3) pay Labor more or hire more Labor. Three return of capital outlets: 4) Buybacks; 5) Debt retirement; and 6) Dividends. Or, 7) Retained Earnings. With the economy digesting tighter financial conditions, economic opportunities for capital have become increasingly competitive. Strong free cash flow begets optionality. Companies with optionality have an advantage when the competition for capital intensifies.

De-Globalization – The gnawing uncertainty (and opportunity) of multi-polar world is likely to result in the continued breakdown of long-held, post-World War II, operating conventions. The industrial implications will, in our view, be numerous impacting everything from trade relations & supply chains, natural resource procurement & energy security, and defense alliances, to technology alignment & IP sharing, and labor.

Downside Protection – While we maintain a generally bullish posture and experience tells us that markets can – *and often do* – remain overbought for far longer than they can remain oversold, we are mindful of the extremes to which some corners of the equity market have traded. Even if those upside trends are and remain intact, the prudent investor will be wise to maintain some exposure to safe harbor names which may help to mitigate a portfolio from sudden changes in tone and direction.

About Strategas

Strategas is a global institutional brokerage and advisory firm. The Firm provides macro research, capital market and corporate advisory services, and investment management solutions to institutional investors and corporate executives in more than twenty countries around the world.

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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