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STRATEGAS

insight

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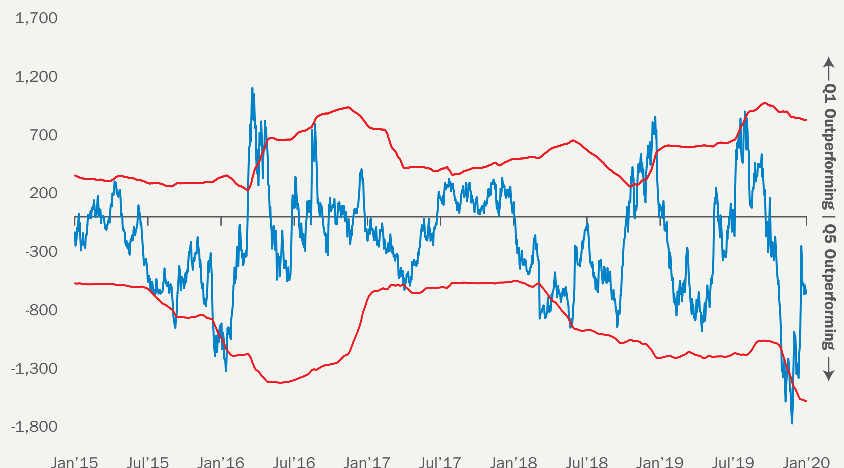
The Divergence Widens

A casual glance at the equity market in recent weeks would reveal little about the intensifying procession of abysmal economic data flashing on investors' screens. Few ways appear to square this apparently obvious inconsistency than to acknowledge that although most investors have made the emotional adjustment to expect near-term data to qualify as '*the worst ever,*' or '*the worst since… [some sufficiently unfathomable point in history]*,' they simply view current circumstances, dire though they seem, as transitory. How transitory? We have found investors generally take one of three points of view on the road ahead. They either: 1) continue to press—*or chase*—near-term (three months) liquidity-driven price momentum; 2) harbor a relatively strong belief—*or hold out hope*—that the economy will rebound to prelockdown levels of activity over the intermediate-term (three to 12 months); or, 3) are acutely focused on making selective, long-dated (12+ months) investment choices in a market that appears increasingly disaggregated.

In the short term, it is tough not to heed the late Marty Zweig's sage counsel. But can we simply expect risk assets to advance as long as the Federal Reserve remains historically accommodative? Perhaps. Admittedly, we do not see the current beta-driven rally as being near its natural exhaustion point. High-beta shares are notorious for leading strong retracement moves off of even moderately oversold conditions. They do, at a point, tend to fade, either into the arms of more durable fundamental leadership or with a retest of prior lows. But in the absence of any information that it has not already dismissed as '*the worst…*' the market gladly will ride the coattails of liquidity with the promise of something '*less bad*' on the horizon.

When will *less bad* begin to emerge, and how *less bad* will it be? To believe the consensus is to harbor a view that the economy will get back to peak levels of output by the second

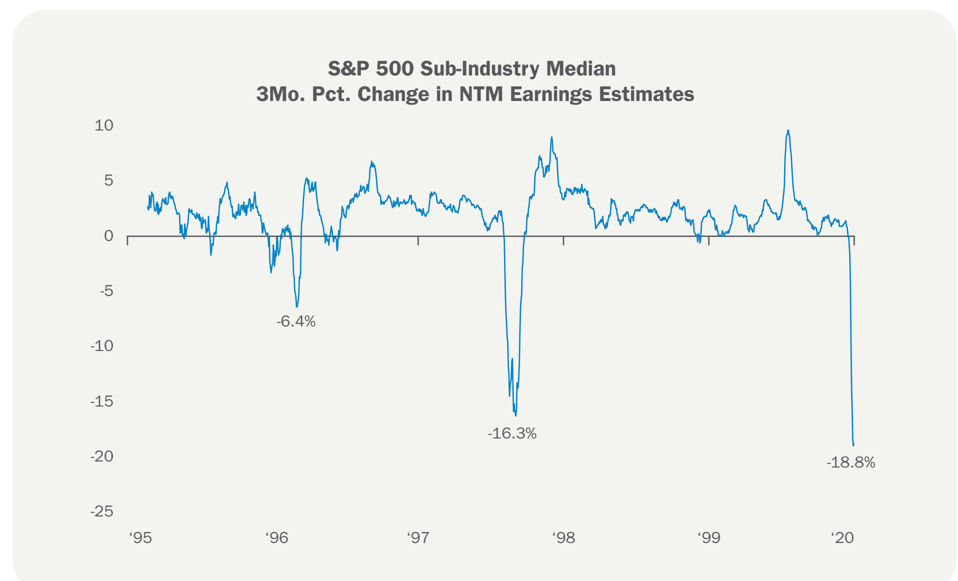


half of next year… roughly 15 months from now. It may seem dangerous to suggest, but this is not like anything we have seen in the last dozen cycles. For starters, we never have just shut down the global economy before. What is more, time does not appear to be on our side, inasmuch as we are battling two evils—*the cause* and *the cure*. To fight back *the cause*, we must develop a therapeutic to treat the infected or a vaccine to inoculate those who have not been. To counteract *the cure*, we must reopen the economy behind the strength of a discernable growth catalyst. Unfortunately, every accommodation we undertake to slow the spread and flatten the curve neither reduces the area under the curve or hastens the recovery. And once we do develop therapeutics, discover a vaccine—or both—and although it undoubtedly will serve as welcomed relief for the heavy toll the virus has taken, we still must contend with the lasting damage to the economy.

In this regard, investors should question the utility of the traditional post-recession playbook in the construction of client portfolios. It used to be that a sector was at the scene of the accident—*say, Technology in 2000 or Financials in 2008*. Excesses in that sector led to the top-heavy outcomes that ultimately tipped the economy into recession. From that point, however, investors could make reasonable assumptions about the structural damage to the industry in question and about the amount of operating impairment, if any, emanating away from the epicenter. Some investors would allocate capital to pockets of strength they identified in the wake of the contraction. Others would take a more defensive line, hold cash, and bide their time until the full steam of the recovery took hold. In the instance we face now, no single industry is at the epicenter of the crisis. Certainly there are obvious losers… and winners too, but broadly, this crisis is a commercially nuclear event. Consider the chart below. In the 2001 recession, following the bursting of the Tech Bubble, corporate profit expectations for the median subindustry in the S&P 500 Index fell 6.3%, suggesting not much collateral damage was done to the economy beyond the Tech sector. Eight years later, in the wake of the 2008-2009 Global Financial Crisis (a wider impact zone), the median decline reached 16.3%. Today, while still in the throes of the Great Lockdown, this measure already has fallen 19.0%. Said another way, the median subindustry is the worst it has ever been, it is still getting worse, and half are worse than that.

We believe the fallout will result in a greater dispersion between companies and industries with adaptable business models versus those with more rigid business models, and will favor companies with superior operators at the helm versus those entities with marginal operators minding the store. This will require us to look at the impact on every industry and, in the longer term, will favor a re-allocation from the passive asset stack into actively managed strategies. Bear in mind that at the same time that Wall Street is estimating S&P 500 Index earnings to break back to an all-time high in the four quarters ending December 2021, the vast majority of US corporations are pulling guidance and curbing, with few exceptions, management's traditionally optimistic outlook. Do not worry if you feel lost in this maze—management does not know either. Interestingly, if the consensus outlook for the recovery in corporate profits were to come to fruition, it would result in a tie for the third-shortest recovery in any cycle since the Second World War (The only shorter cycles occurred roughly forty years ago.) We are skeptical.

As our Economics team reminds us, more than 150 million people were on US nonfarm payrolls at the peak in February. In April alone, 20.5 million people lost their jobs, pushing the unemployment rate soaring to nearly 15%. Examining



the details of the report reveals that most unemployed workers view this as a temporary furlough. We worry that initial cuts to lower-paying jobs will lead to cuts in higher-paying positions later. Many companies have embraced a form of socially responsible capitalism, specifically in the form of pledges not to lay off workers while pivoting operations, often at cost, to aid in the fight against *the cause* (the virus) while intensifying the damage of *the cure* (the lockdown). Although these efforts are necessary and applaudable, investors are pricing securities on the idea that companies, and the economy, will return to prelockdown levels of activity and profitability in fairly short order. Companies either will need to rationalize the composition of their cost framework against a revenue stack that has gone through a commercially nuclear event, or investors will be forced to recalibrate the valuations they have applied to less profitable enterprises. We are not making a normative judgement on which direction is better—more socially conscious or a renewed intensity to derive a return on invested capital—but companies will choose one direction or the other, and the divergence between the two will grow wider.

Strategas Recommended Asset Allocation (May'20)

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

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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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