STRATEGAS

insight

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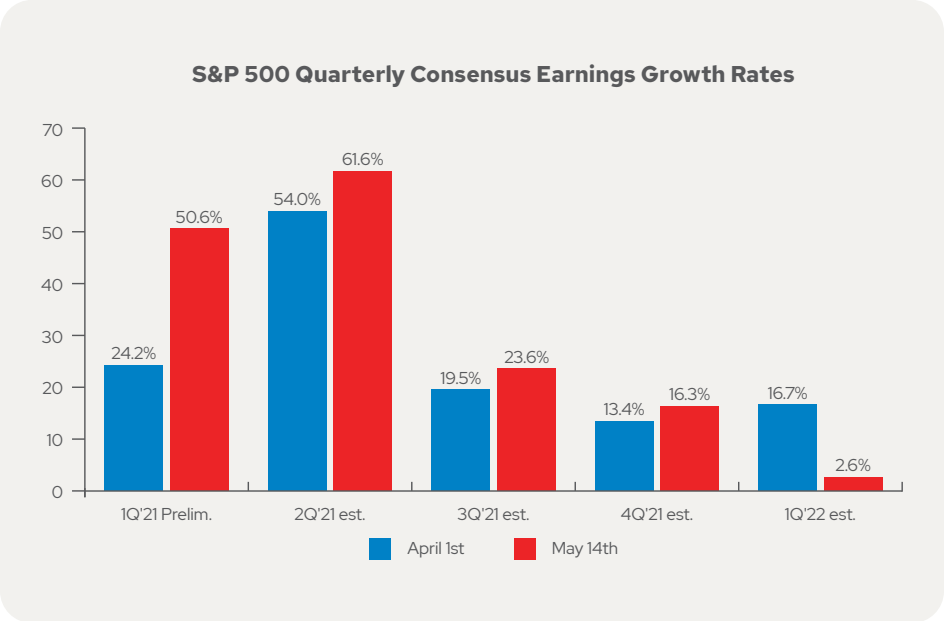
Watching Inflation and the US Dollar

At their base, equity prices should be considered a function of earnings and interest rates. Generally held, when a lower cost of capital (i.e., lower interest rates), improves the backdrop for longer-dated earnings growth, stocks go up. To a degree, that is what investors are seeing in the near term. The stock market, albeit with fits and starts over the last several weeks, has continued to press to a series of all-time highs against a backdrop of low interest rates—*U.S. 10-year Treasury Yields stand at 1.6x% as of this writing*—and a post-pandemic surge in corporate profits—*consensus S&P 500 EPS are expected to be up 61% year/year in 2Q2021*. Indeed, the Atlanta Federal Reserve's tracking estimate for 2Q2021 real GDP is currently at a 10.5% increase quarter/quarter annual rate.

Real rates remain in negative territory, and the money supply is growing at more than 24% year/year. Although history suggests the second year of a bull market can be more difficult than the first year off the low, we take comfort in the fact that credit spreads are still tight as a drum. Tactically, we remain bullish on equities in the short-to-intermediate term.



Of course, some are suspicious of how long this setup can last. After an extremely strong increase in March, US retail sales were flat month/month in April. Though the level of sales activity remains above trend—*a reflection, in our view, of the considerable provision of fiscal stimulus over the past several months*—consumer sentiment, as measured by the University of Michigan survey, declined 5.5 points in early May to 82.8. Most surprising so far, particularly to the professional forecasters, was the weakness of the April jobs report. The monthly release from the Bureau of Labor Statistics showed non-farm payrolls rose *just* 266,000 month/month in April—far below expectations—and was accompanied by a downward revision of 78,000 to prior months. So, although US GDP is approaching pre-pandemic levels, and corporate profits are already through them, jobs are not close. Prior to the onset of the pandemic US non-farm payrolls stood at ~152 million. Today they are

~144 million—a gap of roughly 8 million fewer jobs.

If that were not enough, the prospect of rising—*and more than transitory*—inflation pressures has riled investors. The US CPI surged 0.8% month/month in April, with the core measure (excluding food and energy) up 0.9%. On a year/year basis, the headline CPI was up 4.2% and the core rose 3.0% (the highest level since 1996). Concern is growing, as Strategas' Chief Strategist, Jason Trennert, wrote recently, that the Fed will find itself behind the curve and be forced to tighten in dramatic fashion. Such a move would run in the face of the central bank's stated proclivity to keep the policy rate low (and the size of quantitative asset purchases going) for the foreseeable future, and could be interpreted as a lack of control.

At the moment, investors do not appear overly concerned about any shortcomings in the Fed's control over the objectives of its stated monetary policy. Although recent weakness in headline data should provide the Fed with sufficient cover to stay the course, investors' collective muscle memory for investing in periods of rising inflation is not strong, which has added some pressure to markets in recent weeks—*at least in thought, if not in deed.*

As Strategas' Chief Economist, Don Rissmiller, has observed, the market seems set to challenge the Fed over the short term. We would not be surprised. Investors will have an opportunity to shift portfolio exposures during bouts of dislocation and weakness.

At the moment, our highest-conviction theme currently revolves around the potential for increased pressure on the US Dollar. This is driven by the value of America's twin deficits approaching 20% of GDP, and the fact that the rest of the world can look forward to what the US already has achieved—massive increases in fiscal spending and mass vaccinations. There is a chance that the weakness in the greenback may be most acutely felt versus hard assets rather than fiat currencies, especially given a commitment to green energy that is highly dependent upon extractive industrials. We feel more confident about our overweights to the Materials and Energy sectors than we did when we established them late in 2020.

Strategas Recommended Asset Allocation (May'21)		
	Equities	Bonds
Overweight	US LC Value EM AC Core US MC Value US SC Core	IG Corporates
Neutral	Dev AC Core US LC Growth US MC Growth	ABS/CMBS Agencies TIPS Bank Loans US Dollar EMD
Underweight	US LC Core US MC Core	US MBS U.S. Treasuries

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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