STRATEGAS

insight

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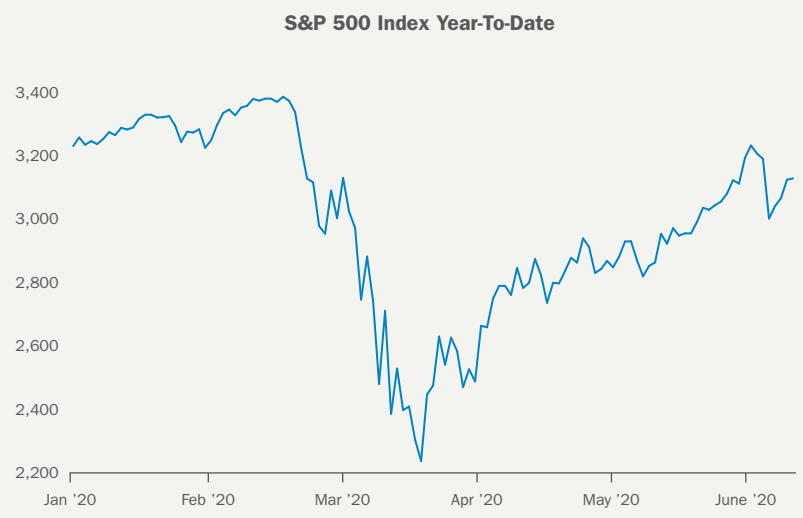
Navigating a Generational Moment

Consider that it was not all that long ago—*February*—that the market was breaking to the latest in a series of all-time highs, and the economy, although not overwhelmingly robust, was showing only the faintest signs of age. Perhaps more important, little evidence existed of the acute excesses that typically manifest in the top-heavy outcomes that ultimately lead to recession. This is not to suggest that the long cycle was set for perpetual expansion. Still, a good case could be made that the rolling block of persistently accommodative monetary policy paired with the semblance of a modest thaw in US-Sino trade tensions and the concomitant improvement of economic conditions in the developing world, generational low levels of unemployment, and a tax-incented increase in capital spending domestically could conspire to keep the US economy from going over the edge before 2021.

Earlier this year, we modestly reduced our recommended exposure to equities—to 64% from 68%— and increased our cash allocation, believing the economy was entering a recession. At that point, we cast a small preference for value versus growth and international versus domestic shares.

How quickly things can change…

The onset of the COVID-19 crisis left us with greater exposure to equities than desired, though we acknowledge the repair the market's advance has offered. We have shifted our equity allocation in favor of growth and have reduced our exposure to international equities, leaving us with an above-benchmark allocation to domestic shares. Our US equity sector allocation sits on this scaffolding, with a modest tilt toward growth sectors—recommending overweight exposure to Information Technology and Communication Services—and an internal bias to overweight Health Care and Industrials.



But larger issues seem to be at play. The COVID-19 crisis began with the rapid and global spread of a deadly coronavirus. But the unprecedented decision that mandated billions of people to shelter in place to mitigate the spread and "flatten the curve" shocked the global economy to a near-subsistence crawl. It also created the universal uncertainty against which we are not just reminded of the broad philosophical divisions existing in society, *witnessing some of its uglier and altogether too frequently tragic manifestations*, but are compelled to do something about it. This is a generational moment. The challenges inherent in making any discernable progress are daunting but worthwhile, regardless of any predisposition.

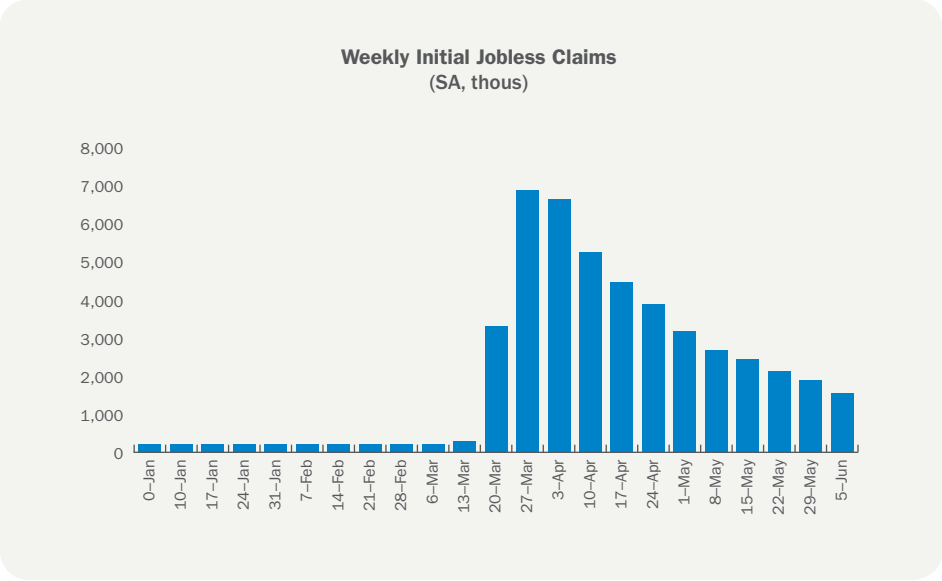
Investors are wise to focus their attention on what they are trying to solve. For some, the weightier societal issues are (or will become) the focus, but for most, their objectives will remain the same. Navigating the environment may prove more challenging.

Although we generally have been (and remain) less optimistic than the consensus on just how quickly the broader economy will ultimately return to previous levels of activity, demand, and profitability, we have had a healthy respect for the rally in shares off their late March lows. Given the overwhelming application of monetary policy, it is not surprising that liquidity-driven momentum has been such a powerful price catalyst. Based on this data, we have focused on the relationship between high and low-beta shares. Examining previous beta-led rallies shows two things. First, they are notorious for breaking from one extreme—*high beta oversold relative to low beta*—to the other—*high beta overbought relative to low beta*. Second, after moving to an extreme overbought position, they either will fall into the arms of durable, fundamentally-supported leadership or fall back into a consolidation phase until more discernable directional evidence is presented. This past week, high-beta shares broke to a +2 standard deviation extreme relative to low-beta shares. Investors appear convinced that recent signs of improvement off historically bad (i.e., Depression-comparable) activity levels should be extrapolated into a steep, normalized, forward demand curve.

As our Economics team has highlighted, although the health-related impact of the pandemic is clearly not over, evidence shows a durable bottom developing in global economic activity. The timing of the bounce was uncertain, which should have been anticipated after such a severe plunge in business. The worst-looking growth rates likely appear to be passing. At issue is whether the recent emergence of cyclical leadership will amount to anything more than a "v-shaped head fake" in the absence of a discernible growth catalyst. The second-quarter data will prove important in making, or refuting, the case.

Believers gravitate to the "transitory shock" narrative, extrapolating a flatter COVID-19 curve and the marked improvement in non-farm payrolls into a series of smooth reopenings and the timely recovery to prepandemic levels of output and profitability. Skeptics highlight the absence of both a therapeutic to treat the infected and a vaccine to inoculate the rest of us. This, in turn, translates into a broad behavioral accommodation that is severely dampening commercial appetites and rendering a more permanent dislocation and structural damage to the economy.

These competing tensions have framed many of our recent conversations with clients. We harbor concern for overly optimistic forecasts of normalized forward demand with 20+ million people receiving ongoing unemployment benefits and the number of permanent job losses continuing to increase. Too bearish? Perhaps. Many market observers have highlighted both the broadening participation of stocks in the current rally (95% of S&P 500 constituents are above their 50-day



moving average) and the recent (but modest) outperformance of value as the starting blocks for a substantive rotation. Although we generally are not disposed to such caution on the prospects for US economic growth, we are mindful that the calculus of data construction will present what appears to be significant improvement with even a partial reopening. We may be too cautious about taking the long view, in the absence of both an epidemiological solution and a discernable growth catalyst, but we believe the recovery will take longer than the consensus currently expects.

Strategas Recommended Asset Allocation (Jun '20)		
	Equities	**Bonds**
Overweight	US LC Growth US MC Growth	IG Corporates
Neutral	Dev AC Core US LC Value US LC Core US MC Value US MC Core US SC Core EM AC Core	Agencies ABS/CMBS US Dollar EMD TIPS High Yield
Underweight		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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