STRATEGAS insight

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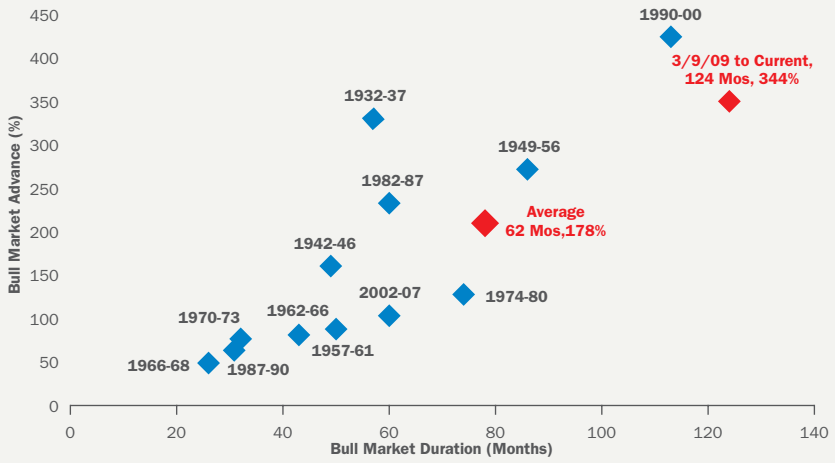
The Tension Rises

At the time of this writing, stocks are roughly one week removed from having made fresh all-time highs, their fourth close in previously uncharted territory in as many days. Another spurt could come at any time, yet the mood among investors appears decidedly more suspect than it has been at nearly anytime over the course of this ten-year bull market. That is a compelling statement. But, we mean it. Anecdotally, we would include the dramatic sell-off evidenced in Q42018 in this assessment and the many episodes of doubt that bubbled earlier this cycle that found their cause in the aftershocks and policy knock-ons of the global financial crisis. We knew why we were nervous, or at least more disposed toward caution. To recap the sell-off last winter, the market struggled with the likely damage posed by two potential policy errors (trade and monetary) and an impending standoff between the Trump Administration and Congressional Democrats (which ultimately would result in the longest government shutdown in history).

All three headwinds were of our own design—colloquially, they were "man-made"—and *easily* reversible. So although the pain was swift and severe—*the S&P 500 Index declined 19.80% from September 20, 2018 to December 24, 2018*—the antidote was readily known and available: *The Index retraced its decline, rising 25% through April 31, 2019.* As we know, the Federal Reserve (the Fed) quite quickly reversed course after its December 2018 rate hike and now stands poised to memorialize the change in tone with a 25-basis-point cut later this month. At first, progress was made on the trade front in Q12019…and then it was not. Despite a trade deal that was (and remains) "80 to 90% done," all hell broke loose in early May 2019. Mercifully, after a period of confidence-killing tariffs, escalating rhetorical lobs, and retaliatory measures, the late-June 2019 de-escalation and agreement between Presidents Xi and Trump to renew discussions to reach a substantive agreement has given investors a welcome shot in the arm.

S&P 500 Historical Bull Markets 1928 to Present



Source: Strategas

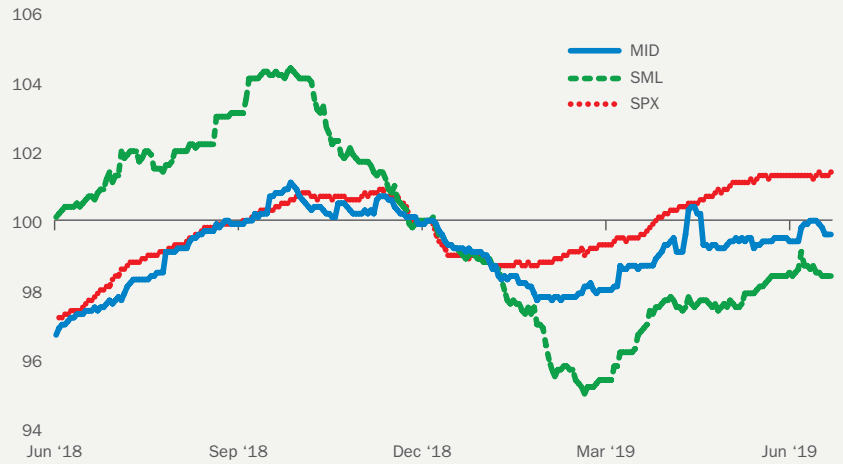
In the same frame as the equity market charting new highs, one has to marvel at the US business cycle moving through its record-long tenth year of expansion. So, what is gnawing at investors? On our travels through the US, Europe, and Asia—including participating in an intimate gathering attended by several central bankers—the outlook nearly universally has been glum. There have been pockets of optimism, but on the whole, although not bearish, investors have been far from ebullient. Perhaps the current crop of uncertainties is too amorphous. *Global growth is slowing. Inflation is too low.* And the antidote is less clear. Either way, the Fed has signaled its intent to lower interest rates, and global central banks are in hot pursuit to match cards. With equities trading higher and doubts continuing to mount with respect to the fundamental health of the economy, we can conclude that investors see the Fed's rate cuts as likely to have a less-than-desired impact on Chair Powell's wish to "prolong the expansion."

What bothers us most, perhaps, is that lack of a good story to drive our optimism. The opportunity set seems just as amorphous as the uncertainties. *A China deal will spur capital spending. A steeper yield curve will bolster the consumer.* We suspect this is part of the problem investors see too. Although none of this—the good and the bad—is new, at the moment, it is all we have to sift through. **So tensions rise, waiting for either something to break or something to go right.**

In the near term, we believe this market can grind higher. A dearth of prerecession markers suggests a contraction is not imminent. For one thing, equity valuations are not extended. Although we certainly would be mindful of the impact that reduced earnings expectations for calendar year 2020 could have on shares trading toward the upper end of their acceptable valuation range, it likely would require a level of disappointment in Q22019 earnings not currently expected *plus* the wholesale markdown of expectations for second half 2019 and first half 2020 for the market to head decidedly lower. So far, that has not occurred. In fact, corporate profit expectations for the next 12 months continue to improve. The labor market has hung in and could even be described as ***strong***. The US economy created 224,000 new jobs in June 2019, just 3.70% of the workforce is unemployed, and average hourly earnings have grown 3.10% year over year. Not bad.

We continue to recommend an overweight allocation to global equities in our balanced 60/40 portfolio[1] (69% vs. our 60% benchmark allocation to the MSCI ACWI (MSCI All Country World Index). Traditional Dow Theory holds that a move in the Industrials sector should be "confirmed" by a move in the transportation companies that move its goods. This year, the transports have lagged, although it appears as though they are starting to catch up. In the late 1990s, we designed a variation on the theme for an American economy increasingly being led by the Information Technology sector rather than by smokestack industries. In the same regard, we concluded that a move in the Nasdaq should be "confirmed" by the performance of the companies that drove the revolution in high tech. After a brutal sell-off in May 2019, semiconductors stocks have made up a lot of lost ground in the last five weeks. A continuation of the rally in the Dow Transports (16% year to date) would give us greater confidence that the all-time high in the Industrials sector (17.2%) has legs.

NTM EPS: S&P Large, Mid, & Small-Caps
(Indexed to 100 on 12/31/18)



Source: Strategas

[1] *Strategas Asset Management Global Allocation Strategy*

Our Economics team has highlighted that the pricing of political risk has clearly become much more complicated. As attention shifts toward the 2020 election, both parties are intent on building their case with the American people. Although many (if not all) Congressional Democrats take umbrage with the President's methods, few have taken issue with the Administration's stated intentions and the substance of negotiations with China. Continued and definitive progress will be required to unlock corporate pocketbooks and spur further capital spending, but the process is likely to retreat to the back of the business section for a time. In its place, a new theater of regulatory focus has opened on the privacy front. Both parties are focusing on the regulation of personal information, which has wide-reaching implications, particularly for the US's largest tech companies. Not surprisingly, the impact has been—and will continue to be—most acute on business confidence. As our chief economist, Don Rissmiller, has noted, if the Fed is not proactive, a sluggish economic forecast may prove more correct than not, and the number of the FOMC's rate cuts is likely to increase.

What makes us nervous? On the horizon, we remain vigilant in monitoring the leveraged loan market for increased default activity, and are worried about the concomitant pressure this would have on the collateralized loan obligations (CLO) market. When the cycle turns, it will not be pretty. The application of broadly accommodative monetary policies globally has pushed institutional investors (pension fund, mutual fund, hedge fund, and private equity managers) into highly leveraged and highly illiquid instruments. As Don Rissmiller noted in the wake of one such default last week, "negative rates don't make sense." Thus, given the loan ownership of such instruments by the investment banks that underwrite them (estimated to be roughly 5% of issuance), when the music stops it is the pensioners, mutual fund shareholders, and hedge fund and private equity fund LPs that will be left 'holding the bag.' Stay tuned, and know what you own.

Advisor Takeaway:

The stock market reached new highs this month, after Presidents Xi and Trump de-escalated trade-war rhetoric, paused tariffs, and agreed to new discussions to resolve the impasse. Yet slowing global growth and low inflation are sparking less enthusiasm among investors, even though the Fed is signaling its intent to cut rates. Although the near-term outlook seems positive, a reason for optimism going forward seems to be lacking, despite hope for a China trade deal to spur capital spending and a steeper yield curve to bolster the consumer. A contraction does not appear to be imminent: Equity valuations are in line, Q22019 earnings are not disappointing thus far, nor do we see wholesale markdowns in the near term. Additionally, corporate profit expectations are improving, and June's 224,000 new jobs suggest a strong labor market. In our view, these data support a 69% overweight in equities in balanced portfolios. Taking a page from Dow Theory, tech stocks are recovering from their brutal sell-off in May, supporting the rise in the Nasdaq, and a continued rally in transports would confirm that the all-time high in the Industrials sector still has legs. Political risks are tougher to quantify, and the current focus on regulating personal information will have a far-ranging effect on tech stocks, potentially eroding business confidence and giving the Fed ballast to increase the number of cut rates. In the meantime, accommodative monetary policy has helped institutional investors load up on highly leveraged investments such as CLOs, and they may be hurt when the music stops. Wise investors should be aware of what their portfolio holds.

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 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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