STRATEGAS

insight

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Don't Move the Goal Posts, Change the Play

Conservative is too charged a word at this moment. *Pragmatic* is better; *cautious* circles the wagons. However you get there, humans tend to be most protective when it comes to their family, their health, and their livelihood. Rarely in history—*and all the more so outside the envelope of war*—has society been forced to face potentially dire circumstances for all three. The global pandemic forced the unprecedented decision to mandate billions of people to shelter in place in an effort to mitigate the spread and "flatten the curve." That decision both shocked the global economy to a near-subsistence crawl and created the universal uncertainty against which we are not just reminded of the broad philosophical divisions rooted in society—*and (again) made witness to some of its uglier and altogether too-frequent tragic manifestations*—but now, more than ever, are compelled to do something about them. As we described it a month ago, this is a "generational moment." Any one of these issues would require time to reconcile (at least universally, if not to investors' satisfaction); taken together and made personal, the road to resolution likely will be longer than they anticipated.

In periods of heightened uncertainty, we believe investors are wise to stick with **first principles**. Isolate the handful of directional markers that will aid *(in this case)* in understanding the depths of decline, breadth, and durability of an ensuing recovery. In the chaotic volatility of March, we identified four signposts:

1. The containment of and cure for the virus;
2. An understanding of trough levels of activity;
3. The slope of the normalized forward demand curve; and,
4. An organic growth catalyst to transition the economy from recovery to expansion.

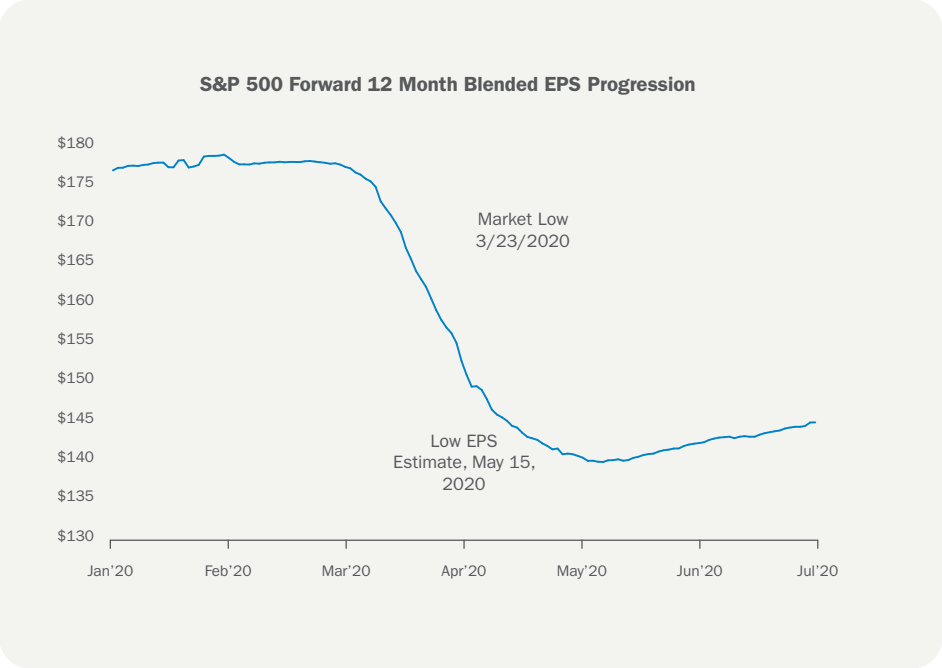
The sell-off metastasized into the period of yawning market and economic divergence that defined late April and May. This simple exercise, meant to help organize our thoughts and provide unbiased guidance throughout the current period of consolidation and fundamental realignment that began in early June, continues to help frame our outlook on the economy and the markets.

The virus, presumed (by some) to have been contained enough for the economy to reopen, now seems to be severely affecting new areas and, without question, remains uncured. With this in mind, we return to the conventional wisdom that human beings will (generally) act with consideration in matters related to their health, well-being, and livelihood. Thus, it may be that only the development and distribution of therapeutics to treat the infected, or a vaccine to inoculate those not yet exposed, will arrest the broad behavioral accommodations that continue to severely dampen commercial appetites in their absence. By this measure, it would appear necessary to temper any unconstrained optimism.

Setting the epidemiological aspect aside, we should be careful not to conflate signs of recent economic improvement and the initial bounce off of Depression-comparable activity levels, however notable and robust, as anything more than helping

to define the trough in activity. But it is an important step in the process, as it both aids in resetting the valuation baseline (which still matters), and informs the necessary growth calculus for the economy to recover to previous levels of activity, output, and profitability. We likely have experienced the bottom in economic activity—*inasmuch as we probably will not shutter the whole of the economy again*—and are now defining it numerically. But we remain suspicious (and without discernable information) of the slope of the normalized forward demand curve and the durability of the nascent recovery. Adding unanswered questions and a broadening set of virus-related concerns to the equation makes visibility increasingly cloudy.

Where do we go from here? To a degree, market action in June and July has helped renew our faith in the longstanding relationship between the underlying economy's health and growth trajectory and the valuations reflected in shares. Late-May's yawning disconnect appears to have relaxed. It seems less prone to tease the conditions typically preceding a volatile recalibration, should the economy not live up to its end of the bargain. The second-quarter earnings season will help to level set expectations. Although the Street remains generally optimistic about reaching previous peak levels of activity, output, and profitability by the tail end of 2021, note that prevailing estimates for S&P 500 profits remain **flat** for the next twelve months. The gap between the 12-month horizon and the quarters on the long end of the estimate curve is typically not so wide. Either the Street is too cautious on the next 12 months or too optimistic on the six months thereafter. In the absence of solutions to the persistently vexing public health concerns—*to ignite a durable recovery*—and without a discernable organic catalyst—*to attract capital and feed the transition from recovery to expansion*—we expect longer-dated expectations will be revised lower.



But all is not lost. Such an environment provides a compelling backdrop for both tactical allocators. We remain comfortable with our current allocation across stocks (64%), bonds (27%), and cash (9%). This translates to a modest (+400 bps) overweight to equities, a significant (-1,100 bps) underweight to fixed income, and a material reserve of cash and equivalents (+700 bps above benchmark). We introduced a 2% allocation to gold in June as a subset of our cash and equivalents allocation as we watch the peaking of the US dollar and an uptick in the volatility of inflation/deflation expectations. Although keeping a particularly close lookout for any green shoots, we are in no rush to draw on cash reserves to jump at perceived pockets of strength (though we are particularly mindful of investors' stated desire for equities to decline before putting money to work).

Believing the recovery will play out over a longer period than the consensus maintains, our style bias remains tilted in favor of growth shares from the neutral positioning we have held over the last six months. When growth is scarce, go for growth. The natural calculus of economic data is likely to present investors with an urge to rotate into value during the anticipated "Q3 bounce." Our current position is that this bounce will amount to a "v-shaped head fake." In addition, we have pulled down our exposure to both international shares and local emerging markets debt, allocating to US domestic shares in the equity column and agencies on the debt side. And it seems reasonable that achieving a sustainable rally in equities will

require bond yields to rise. Funding of increased equity exposure is more likely to come at the expense of longer-dated fixed income exposure, particularly in U.S. Treasurys.

From another angle, the compound challenges faced by investors attempting to drive alpha by constructing portfolios of well-considered, long-dated, single-stock investments can perhaps best be viewed in the three largest single-stock weights in the S&P: Microsoft (6%), Apple (6%), and Amazon (5%), which now make up nearly a fifth of total index share. They are effectively their own quintile. Beginning roughly with the bursting of the Tech Bubble, the shift to holistic, product-based wealth management and the proliferation of ETFs helped emphasize flows over fundamentals in price discovery (i.e., the active-to-passive shift). Over the past two decades, this trend has been exacerbated and reinforced by fundamental (no pun intended) changes in market structure: decimalization, the volume shift away from the Floor, and the advent of co-location and high-frequency trading, to name a few. The coup de grace came in the form of permanently accommodative monetary policy and the marked increase in corporate share repurchases, which presented the interesting dichotomy of both lifting share prices and not allowing the market to clear dead weight.

Historically, following a market-clearing recession, the dispersion in operating results among companies is **low**, and aggregate forward returns are **high** (+18.7% when starting below the 25th percentile since 1990), which creates a high bar for stock pickers; *better to be in the market than be selective*. As the cycle matures, however, stronger operators pull away from the pack, marginal operators fall from it, and the variance increases. When operating dispersion is **high**, aggregate forward returns tend to be **low** (+6.6% when starting above the 75th percentile since 1990); *better to trim the fat and concentrate holdings*. Although this cyclical ebb and flow persists, the lower bound has been raised: Dispersion is higher inasmuch as the market is not clearing. Market performance remains more a function of flows than fundamentals.

Despite the pockets of uncertainty, investors should discover the market-moving force, and use it to their advantage.

Strategas Recommended Asset Allocation (Jul '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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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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