ENVESTNET PMC

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STRATEGAS insight

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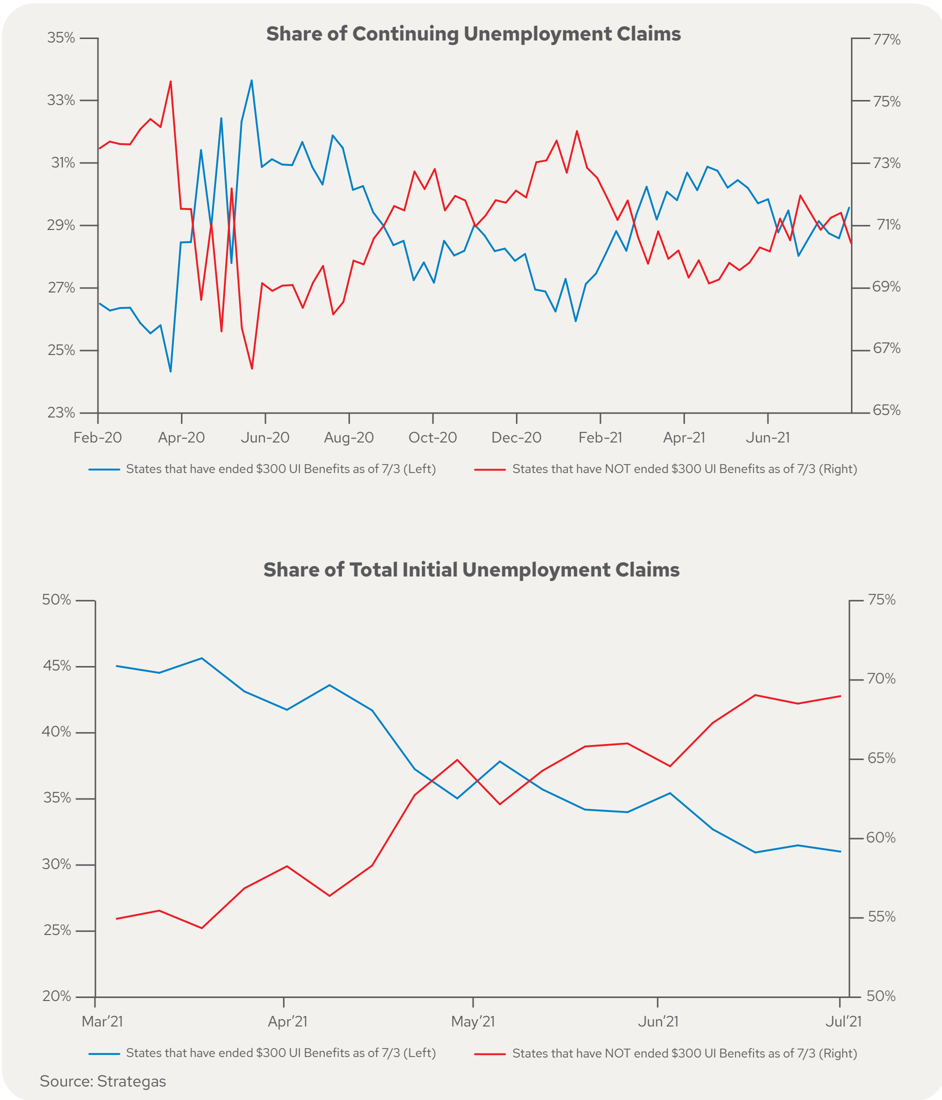
At the Junction of *Wrong* or *Right*

Readers of our work will know we have remained generally optimistic (some would say, hopeful) about the prospect that the nascent recovery in global growth, albeit frustratingly jagged, will continue to transition into a cyclical economic expansion. No doubt we are mindful of the narrative tugging at the market's advance, suggesting the current improvement in—and levels of—*activity, demand, output, revenue*, and *profitability* are little more than the manifestation of a generationally accommodative policy framework... susceptible to moderation (or even reversal) should the proclivities of the Federal Open Market Committee (FOMC) change.

For the six-plus months ending March, investors' bias appeared to tilt toward our base case (i.e., a strengthening cyclical recovery). Positioning within equities tended toward traditional cyclicals (with many in the financial arena focused on resurgent value shares almost to the exclusion of all else). **Fixed income exposures remained generally below benchmark, short duration, and peppered with larger-than-normal positions across extended credit sectors.** In the period since, most acutely, early May, the consensus appears to have shifted its sympathies toward (or, at least acknowledged more fully) the policy-driven narrative. Indeed, the strong move into value has abated. Growth shares, although not running away entirely, have seen sufficient inflows to level the tape. The long end of the curve has been relatively well bid: The yield on the 10-year U.S. Treasury Note has fallen from ~1.75% in late-March to ~1.30% with this writing, the yield curve (2s/10s) has flattened, and the dollar has strengthened.

Sticking with the cyclical trade—*value vs. growth, international vs. domestic, small and midcap vs. large and mega cap, higher long rates, and a weaker dollar*—is currently not in trend. Investors discounting economic growth to come in north of 10% year/year have had to settle for 7%-8%. Global bottlenecks undoubtedly persist. Peak earnings are a worry (and the market has not really begun to incorporate higher corporate tax rates). As our Economics team highlights, China's growth is slowing. Perhaps most concerning, uncertainties surrounding the "Delta variant" are waxing, as evidenced by increased case counts in geographic centers previously considered to have largely "cleared" the virus, or at least showed an improving trend. More than the rotation within equities (growth vs. value) or any concern that inflation could, ultimately, be "stickier" than policymakers have intimated (or hoped), recent strength in the US Dollar and the concomitant decline in long rates does suggest the consensus has lowered expectations for the slope of the normalized forward demand. Although slowing momentum appears to own the moment, not all data are so dire, particularly on the labor front (initial claims numbered just ~375,000 last week, and the number of job openings continues to increase). We are watching the interplay between expiring extended unemployment benefits—now in 27 US states—and lower unemployment levels. Although a hot political topic, the impetus to return to the workforce appears related to the government's provision of an income backstop for *not* returning to the workforce. We (and, *hopefully* is the right word in this case) believe this improving trend in employment will continue as schools reopen more fully in the fall.



Source: Strategas

As an aside, if reliance on monetary policy alone (or in large part) will govern positioning in the months ahead, it may be worth revisiting a point we made last month on these pages: We are hard pressed to recall a Federal Reserve (the Fed) meeting (and, subsequently, minutes) more picked over for the tiniest suggestion that the prevailing policy framework will change than that of the Fed's **June 15-16th** session. The amount of ink spilt (to use a phase) dissecting the shift in the FOMC's "dot plot" is a case in point. We remain of the view that the *modestly* hawkish tone of the post-meeting statement simply extricated the Chair from the persistent burden of inquiry as to whether the Fed is "thinking about thinking about" normalizing policy. As he articulated in the June press conference and in subsequent congressional appearances (as recently as this week), we believe Chair Powell has made clear that he does *not* believe the standard that would allow for such policy normalization has yet to be met. (Only one "dot" on the "plot" really matters.) Consider also that should Jay Powell desire to be nominated to another term as Chair of the Federal Reserve,[1] it is more likely the President would be inclined to do so if the Chair's stated position on monetary policy were viewed as generally supportive of the Administration's legislative ambitions. (This is not to overly politicize the process—*though it is*—or to suggest the Chair would subordinate his responsibilities to self-interest—*though what is the real difference between tapering in Q42021 vs. Q12022?*[2])

Returning to economic outlook, what are the merits of positioning for a counter-cyclical downturn? We believe it is fair, given recent market volatility, to say investors are convinced the Fed will remain in their aid for the foreseeable future. Further, although it would be fair to argue that the cyclical trade *had* been priced to perfection, cyclicals have roundly taken it on the chin in recent months. So, it would be mathematically unlikely that the market could evidence a protracted move lower without being led on the downside by the traditional growth segments. To say nothing of the gathering regulatory storm brewing overhead for Big Tech.

Although we are mindful that the atmosphere certainly seems to invite caution, as our technical strategists Chris Verrone and Todd Sohn have highlighted, we have not seen a confirming move into more traditionally defensive sectors like Consumer Staples and Utilities. Moreover, should the slowing momentum of the recovery prove itself less than transitory, we would envision credit offering a signal. Instead, spreads remain confined to a relatively narrow range.

Strategas' fixed income strategist, Tom Tzitzouris, has noted that the competing tensions in the direction of long rates are particularly pronounced. On the one hand, the impending debt ceiling debate and potential for tax hikes threaten to keep a lid on yields, while on the other, the potential for

[1] Jerome Powell's current term as Chair of the Federal Reserve ends in February 2022.

[2] Ben Bernanke's nominations to chair the Fed were made in October 2005 and August 2009, Janet Yellen's nomination was made in October 2013, and Jay Powell's was made in November 2017.

tapering bond purchases—*particularly mortgage-backed securities (MBS) and Treasury Inflation-Protected Securities (TIPS)*—against the threat of "stickier" levels of inflation conspires to push yields higher. And finally, should the momentum of the recovery slow too much, the provision of additional fiscal aid, beyond the Administration's stated policy initiatives, cannot be ruled out.

So, where from here? In a pocket of uncertainty, the tendency exists for investors to draw intermediate-term conclusions from every piece of timely "information" to hit the tape. At moments, this approach has merit. But we are not sure this is one of them. Roughly fifteen months off the lows in stocks and ten to 12 months removed from the trough in economic activity, should our bias be toward cyclicality or counter-cyclicality? As Strategas' chief strategist, Jason Trennert, reminds us, *the market has basically gone straight up for fifteen months; a little shakeout is okay.* Even welcomed. History reminds us that new investment paradigms (e.g., stagflation) take time to develop. Against that backdrop we believe "the call" is to be optimistic about an economy that appears much in the early stages of cyclical recovery. Inasmuch, we remain overweight to equities in our tactical allocation portfolio (67% vs. a benchmark allocation of 60%) and cash and equivalents (6% vs. 2%); we are underweight bonds (27% vs. 38%).

Thomas DiFazio, whose tireless effort and thoughtful analysis make these reports more useful than I could ever offer alone, said it simply earlier this week, "...one way or another, we're at the junction of finding out if we're *wrong* or *right*." I agree. Although trying desperately to remain open minded and more reliant on fair analysis and critical thinking, I remain optimistic.

Strategas Recommended Asset Allocation (Jul'21)

	Equities	Bonds
Overweight	Dev AC Core US LC Value EM AC Core US MC Value US SC Core	IG Corporates
Neutral	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 High Yield

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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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