STRATEGAS insight

Brought to you by Envestnet

How Much Longer?

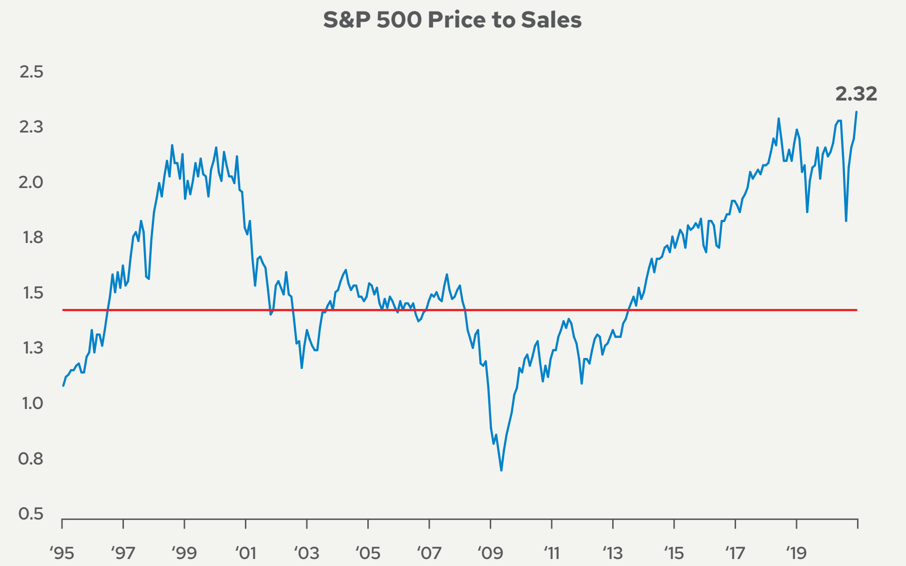
Time flies. Amazingly, it already has been five months since a large share of the global economy was mandated to a near-subsistence crawl. How much longer until we are back on our feet? Uncertain. Although we see continued evidence of emerging green shoots, suggesting we likely have seen trough activity levels, the persistence of the virus and related behavioral accommodations has dampened commercial appetites and made reopening the economy jagged… at best. For those predisposed to a period of pause, reflection, and relaxation before the traditional chaotic churn of the fall season gets underway after Labor Day, much remains to distract the mind—and even prevent such attention to one's physical and mental wellbeing. We see little to suggest our lives, at least in the short course, will either revert to their prepandemic norms (can they ever?) or at least evolve to a new, acceptable postpandemic normal. Of course, we know that day will come—eventually—but, for the moment, we seem to be in an almost suspended state.

As always in this forum, we aim to focus and comment on the intersection of where we were and where we may be headed from the vantage point of investors. We remain acutely aware, however, of the material impact the pandemic has had—*and continues to have*—on a personal and societal level. Around 750,000 deaths globally have been attributed to Covid-19, with ~165,000 tragically occurring in the US, and an estimated nearly one-fifth of the global workforce has lost work to the contraction. The US alone has lost as many as 30 million. Those are big numbers, and are bad, even in the abstract. Now imagine if it is you, or a member of your family, who makes the count just one higher. Not so abstract anymore.

With this binary severity in mind, we see **investors** presented with a series of decisions, increasingly well framed by varying time horizons, and most easily assessed—by our lights—through the prism of valuation. Admittedly, valuation is a poor timing tool, rendering its short-term utility questionable. With prevailing nominal rates effectively anchored to the lower bound across the curve (and negative in real terms at many points), an argument can even be presented attacking the utility of the exercise altogether.

So, in the near term—*in our suspended state*—investment decisions seem to be largely informed by the flow (and some frustrating ebb) of monetary and fiscal policy. As we write, the U.S. Congress continues to debate the size, shape, and focus of a **fifth** trillion dollar-plus *stimulus* package; not whether they should or should not pass another bill, but at what size and to what ends it should be targeted. In the vacuum of Congress's disagreement, the President has taken executive action (whether one agrees with the legality or efficacy is another topic). We feel safe in saying that unconstrained policy accommodation, regardless of the efficiency of its timing or allocation, is fueling the market's advance. In the wake of the 2008-2009 Global Financial Crisis, we turned to the phrase, "bullish 'til the bill comes due." We may need to dust it off again. And although it is likely that the bottom is in, and clear that the market continues to favors flows over fundamentals in the short term (which is bullish), we maintain that equity prices are ultimately a function of earnings **and** interest rates—not interest rates alone.

Thus, we believe corporate profits will begin to come back into focus as investors look down the road. Despite persistent uncertainty regarding the virus and lack of visibility of the path to normal (even a new normal), the Street continues to harbor rather optimistic expectations in the intermediate term (six to twelve months) for the economy to recover to previous levels of activity, output, and profitability. Fiscal policy, in current form, has amounted to trillions of dollars of income replacement and, in turn, a notable increase in the consumption of goods. Yet it is important to consider that: 1) Consumption is a far larger share of the US economy (~67%) than it is in the aggregation of S&P 500 Index revenue (~20%); and 2) Absent the President's executive order, which attempts to reallocate unspent CARES Act funds, the Congress has allowed specific extended unemployment allocations to expire. A greater challenge will be the reassembly of the S&P 500 Index revenue stack, heavily dependent on the provision of services. The jaggedness of the reopening has impaired the slope of recovery in the service economy, which helped the index achieve cycle (and all-time) peak profitability in the second half of last year. The continued dislocation—*and a lack of pent-up demand*—in the service economy make us uncertain of the broader economy's ability to transition from an income-replacement-driven *recovery* to an organic *expansion* fueled by private sector capital investment.



Source: Strategas

As the broader equity market presses back to prepandemic highs—having already achieved them in some corners, most notably Big Tech—the question is whether corporate profits will hold up their end of the bargain. In our view, this outlook is built mostly on a "return-to-normal" thesis. The post-Financial Crisis earnings recovery had "return-to-normal" undertones, inasmuch as the material impairment of asset prices (the major cause of the earnings decline) was slowly reversed or written off, whereas traditional economic sectors such as services recovered. The postlockdown recovery appears to have the opposite construction.

Putting pen to paper, the S&P 500 Index currently trades ~23x **trailing** twelve months (TTM) earnings (~$144). A *modest* (and conceivable) 10% upward move in the index from current levels (to ~3,600), and the realization of prevailing consensus 2020 earnings estimates (~$124) could cause the trailing multiple on the index to eclipse 30x by the end of this year. That will raise eyebrows. For those inclined to keep an eye on the horizon, the same 10% upward price move on **next** twelve month (NTM) estimates (~$150) would keep multiples at a more *acceptable* 25x. Bear in mind, the index has traded above a 25x multiple in only eight quarters over the last 70 years (all of which occurred in the late 1990s and early 2000s).

To put this into context, and as we have examined through numerous numerator/denominator pairings, two distinct trends appear to be driving multiples at any point in time. One is secular, informed by interest rates, but also inflation expectations, regulation, and the supply/demand of the capital stock of equities (IPOs vs. buybacks). The other is cyclical, driven by the slope of the earnings curve (or the outlook for corporate profits). The combination of these

S&P 500 P/E Sensitivity Analysis							
	Cyclical Trend	Secular Trend	Current TTM P/E		Fwd 12M Multiplier		Implied P/E 12M Fwd
1	Expansion	Expansion	23.1x	↗	1.17	→	27.1x
2	Expansion	Contraction		→	1.03	→	23.9x
3	Contraction	Expansion		→	0.97	→	22.4x
4	Contraction	Contraction		↘	0.91	→	21.0x

two trends yields four distinct expansion/contraction scenarios. Each, interestingly, has been extant approximately 25% of the time (measured in months) over the last ~70 years, although the sensitivity of multiples in each regime varies.

In periods pairing secular **and** cyclical expansion, multiples can expand quickly. This was the case in the late 1990s, in which multiples expanded from ~16x, when former Federal Reserve Chair Alan Greenspan warned of investors' "irrational exuberance" in December 1996, to more than 30x three short years later in the dot.com bubble. The global application of aggressive monetary policy arguably provides the catalyst for financial **prices** to move higher. But, in the absence of a discernable growth driver to attract capital and help the economy transition from an income-replacement *recovery* to an organic *expansion*, the economy becomes increasingly reliant on the efficient allocation of the increasing mountain of fiscal "stimulus" to drive **earnings** higher. So it would seem that being bullish has merit… at least until the bill comes due. Such an environment begs for caution or hope (and hope has not proved itself a sound investment strategy).

Strategas Recommended Asset Allocation (Aug '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

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.

About Envestnet
Envestnet, Inc. (NYSE: ENV) is transforming the way financial advice and wellness are delivered. Our mission is to empower advisors and financial service providers with innovative technology, solutions, and intelligence to make financial wellness a reality for everyone. Over 103,000 advisors across more than 4,900 companies including 16 of the 20 largest U.S. banks, 46 of the 50 largest wealth management and brokerage firms, over 500 of the largest RIAs, and hundreds of FinTech companies, leverage the Envestnet platform to grow their businesses and client relationships.

For more information, please visit www.envestnet.com, subscribe to our blog, and follow us on Twitter (@ENVintel) and LinkedIn.

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.

Disclosures
Envestnet and Strategas are non-affiliated entities. This commentary is provided for educational purposes only and does not necessarily reflect the views of Envestnet. The information, analysis and opinions expressed herein reflect the judgment of the author as of the date of writing and are subject to change at any time without notice. They are not intended to constitute legal, tax, securities or investment advice or a recommended course of action in any given situation. All investments carry a certain risk and there is no assurance that an investment will provide positive performance over any period of time. Information obtained from third party resources are believed to be reliable but not guaranteed. **Past performance is not indicative of future results.**

Exchange Traded Funds (ETFs) are subject to risks similar to those of stocks, such as market risk. Investing in ETFs may bear indirect fees and expenses charged by ETFs in addition to its direct fees and expenses, as well as indirectly bearing the principal risks of those ETFs. ETFs may trade at a discount to their net asset value and are subject to the market fluctuations of their underlying investments. Income (bond) ETFs are subject to interest rate risk which is the risk that debt securities in a portfolio will decline in value because of increases in market interest rates.

Alternative Investments may have complex terms and features that are not easily understood and are not suitable for all investors. You should conduct your own due diligence to ensure you understand the features of the product before investing. Alternative investment strategies may employ a variety of hedging techniques and non-traditional instruments such as inverse and leveraged products. Certain hedging techniques include matched combinations that neutralize or offset individual risks such as merger arbitrage, long/short equity, convertible bond arbitrage and fixed-income arbitrage. Leveraged products are those that employ financial derivatives and debt to try to achieve a multiple (for example two or three times) of the return or inverse return of a stated index or benchmark over the course of a single day. Inverse products utilize short selling, derivatives trading, and other leveraged investment techniques, such as futures trading to achieve their objectives, mainly to track the inverse of their benchmarks. As with all investments, there is no assurance that any investment strategies will achieve their objectives or protect against losses.

Index Performance is presented for illustrative purposes only and does not represent the performance of any specific investment product or portfolio. An investment cannot be made directly into an index.

 ENV-STRA-0820