STRATEGAS

insight

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Macro Winds

Investors face increased uncertainty regarding COVID-19-related dislocation (e.g., the Delta variant), the intersection of nascent economic growth and just how "transitory" inflation pressures will prove to be, and the geopolitical (and, increasingly, *humanitarian*) crisis exploding in Afghanistan. So it is little wonder they have given scant credit to the generally robust fundamental outlook corporate operators have laid out for 2H2021 on the back of strong 1H2021 results. By our lights, the traditional early-cycle progression, whereby an increase in *activity* leads, in succession, to improvement in *demand*, *output*, and *revenue*, remains intact. The fork in the road is what companies choose to do with the *free cash* derived from the increase in revenue. Companies effectively have seven outlets into which they can deploy surplus cash: *dividends, buybacks, acquisitions, retiring debt, labor, capex*, and *saving (i.e., profits)*. Investing in the business, either through traditional capex or hiring more workers, OR taking the top-line growth to the bottom line are really the two areas that inform the slope of transition from economic recovery to self-reinforcing expansion.

We acknowledge, however, that the uncertainties we highlight above are likely to have an outsized effect on sentiment—and, by extension, *activity*—in the weeks (and months?) ahead. This could moderate the revenue cycle, but, given current levels of operating leverage, it is more likely to delay corporate investment. Equity indices are near all-time highs, and prevailing multiples need fundamental follow-through to support current levels. Thus, we anticipate these pressure points ultimately will contribute to further market volatility over the intermediate term.

We have mentioned throughout the pandemic that we are limited in our ability to offer much insight on the progression of the virus, beyond relaying what we observe and take away from conversations with clients and those with true expertise. The same is decidedly true for unfolding geopolitical events, specifically those created by the withdrawal of US and Coalition forces from Afghanistan. Both the virus and the humanitarian crisis will command (rightfully) a portion of investors' mindshare in coming days. Given our limitations on the subject matter, we will confine our comments to the gnawing tension between growth and inflation as well as two *additional* areas of uncertainty: US fiscal policy and China commercial policy.

On the former, Strategas' chief economist, Don Rissmiller, has noted his discomfort with the current underlying inflation dynamics, particularly the recent increases in wages and rent. He views this as a form of "stagflation-lite," based on global supply-chain disruptions. Our Strategas Leading Indicator of Manufacturing (SLIM) survey for August indicates supplier delivery times will be extremely stretched over the next month, with 68% of the survey respondents reporting *slower* supplier deliveries. The lengthening of delivery times is consistent with the recent news headlines of supply-chain disruptions caused by the Delta variant (i.e., halted production, port closures, astronomical freight rates, numerous cargo ships sitting at sea, worker shortages and strikes). Although we do not (yet) foresee a 1970s-style stagflation, we believe inflation, in and of itself, will prove less transitory than policymakers believe (or are hoping for). To be fair, given the prevailing level of US long rates, neither the bond nor equity markets appear to be reflecting much concern at this point.

The increased divergence in US political proclivities and the messiness associated with any far-reaching policy initiative make this a challenging topic to discuss. But it is worth spending a moment considering the challenges the Administration and its Congressional partners face following the summer recess. As our Washington colleagues have highlighted, the overhang of President Biden's tax proposals is real (and punitive to high-innovation segments of the economy such as Information Technology and Health Care). To date, and much like inflation, the market has looked through the issue. As Dan Clifton, Strategas' head of policy research, has noted, "The market will care when it is time to care." Our treatment of the president's tax proposals with likely areas of compromise could slow S&P 500 Index earnings growth by 5% next year. Of course, the range of outcomes is vast: Global growth could absorb the tax increase impact, but it creates a "cost to doing business." We think the time to pay attention is now.

We continue to believe the developing—*albeit jagged*—recovery in economic growth should transition into a synchronized global expansion. But we admit this may be a longer-than-expected sequence, particularly when making even general assumptions on the ultimate sweep of the Xi regime's crackdown on the competitive positioning of whole segments of Chinese industry. Inasmuch, we are further reducing our exposure to emerging markets equities and lowering our relative weighting to neutral from overweight. We remain generally optimistic on non-China EM as a class, given the relative age of the business cycle, but the weight placed on Chinese equities in the major tracking indices (e.g., 40%+) makes the practical implications difficult to ignore for the average investor.

Strategas Recommended Asset Allocation (Aug'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

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 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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