STRATEGAS

insight

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The Forces Changing 60/40

The devastating onset of war between Israel and Hamas reminds us, once again, of the continued fraying— and in some cases, outright fracture— of long-held, global operating conventions. In the last several years, an increasingly multi-polar world has seen the gnawing uncertainty of "de-globalization" encircle everything from trade relations and natural resource procurement to defense alliances and technology and IP sharing. For some, a breakdown of the status quo is viewed as positive, by others, less so. But all in, it is difficult to see changes with the potential reach, ostensibly on this order of magnitude, and under the cloud of multiple wars in the fog of Western political dislocation resulting in less volatility at a macro and geopolitical level and, by extension, in the capital markets. Yet domestically, the consensus remains centered on a "soft landing", as the most likely economic outcome from here. However aided this view is by the price performance of the "Magnificent 7," cyclical cross currents offer us little confidence on intermediate-term health of the economy. Stickier-than-hoped-for inflation data, tighter financial conditions, and increasingly notable upward pressure across the labor market leave us suspicious, in the absence of organic drivers of growth, of the durability of economic growth. Played forward, the recent appearance of consumer fatigue coupled with outsized, in our view, expectations for corporate profits leave us less bullish than the consensus.

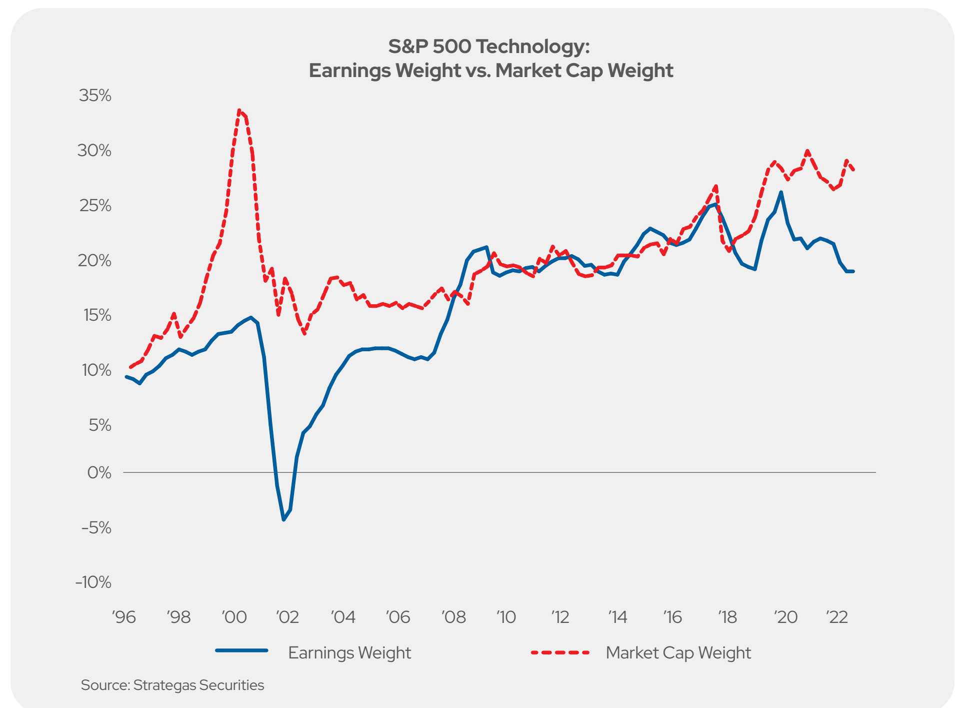
To navigate these waters, we have increasingly turned our focus to the inoculating powers of corporate cash flow when constructing increasingly granular portfolios. By our lights, free cash flow provides corporate operators with optionality; specifically, with seven decision points with which to deploy cash: three "return on" outlets – *1) acquisitions, 2) capex, 3) pay workers more/pay more workers,* three "return of" outlets – *4) share buybacks, 5) debt retirement, 6) dividend payments,* and the flexibility to make those choices another day – *7) retained earnings*. Corporate profits remain integral to cash flow

Source: Strategas Securities

generation and, as we note above, we remain less bullish than the consensus. Strategas is estimating S&P 500 EPS to finish this year at ~$214 vs. a Street estimate of ~$222 and next year down Y/Y to $209 (rebounding into year-end from our estimated 2Q'24 cycle low) vs. a Consensus estimate of $248, +12% Y/Y. Another way of looking at this data is to consider divergences across the Index between the sectors' index earnings contribution and capitalization weight. Largest among these is Energy, where the sector's earnings weight in the Index is ~8.7%, +400bps above its index capitalization weight of 4.7%. This represents a significant divergence in favor of the sector's fundamentals over price. Conversely, in aggregate, Tech shares are running ~900bps below the sector's cap weight in the Index (18.3% vs. 27.2%), representing a -33 pct. point fundamental deficit to price.

Against this developing backdrop we have steadily reduced exposure to Equities in our risk-adjusted tactical allocation portfolios[1] from 67% (Aug'21), against a 60/40 benchmark, to 56% (Mar'23) where it remains as of this writing. Our Fixed Income exposure ex-Cash & Equivalents now sits at 36%, which we increased from 34% last month (Sep'23) as we began to – *modestly* – extend duration. We acknowledge that the cycle peak in rates may not be in but the risk-adjusted return opportunity in the coupon market vs. Cash and shorter duration paper positions us for an early-onset hard-landing.

In addition to secular and cyclical developments noted above and the (resulting and coincident) increased covariance between stocks and bonds, another area of development we believe critical to the evolution



of portfolio construction is the emergence of "retail access points," i.e., exchange traded products, for historically, institutional asset classes. Though small in total AUM (~$150 billion) vs. Equity (~$5.7 trillion) and Fixed Income (~$1.4 trillion) ETFs, the "Alt" space has seen a sharp increase in issuance over the past several years; nearly 60 products have been launched year-to-date.

Ultimately, these trends build— in our view— to the evolution of the "60/40" portfolio. Wealth managers are likely to continue to increase exposures to non-traditional portfolio exposures, as institutional allocators have for years (though we suspect "60/40" will remain the common lexicon for tactical asset allocation, regardless). We have included an allocation to Gold, ranging from 2-4% of our "Cash & Equivalents" sleeve since the onset of the Pandemic (May'20) and have held a small position (2%) in Diversified Commodities within the Alternative sleeve since Apr'22.

While the investment options generally classified as "Alts" are numerous and varied in construction, as a thought exercise we examined the long-term performance profile of the traditional 60/40 portfolio, against a broad asset portfolio with 50% exposure to global equities (as measured by the MSCI ACWI), 40% to fixed income (Lehman/Barclays Aggregate), and 10% to alternatives (CRB All Commodities Index). The performance statistics are interesting. The traditional 60/40 portfolio pips our theoretical 50/40/10 portfolio in average annual return by just 0.1%, +7.5% to +7.4%. While the no-Alt portfolio broke to a higher-high in our post-1975 sample (+45% Y/Y vs. +43.1% in Aug'86) vs. the 50/40/10 construction, the 60/40 also suffered a lower-low (-28.5% Y/Y vs. -26.2% in Feb'09 during the GFC). Inasmuch, the 50/40/10 saw a lower standard deviation of return over the period (10.3% vs. 10.9%). Tangentially, CRB All Commodities Index expresses a similar profile vs. the MSCI All Country World Index back to 1970[2].

1 **Strategas manages eight global allocation portfolios using ETFs for investors risk profiles ranging from "Aggressive Growth" to "Capital Preservation" plus "Core Bond."**
2 **The Lehman Aggregate (now Bloomberg Aggregate) was created at Kuhn, Loeb in 1973.**

The severity of geo-political dynamics in the company of pronounced macro dislocation, reminds us of the importance of marrying long-term financial planning with the flexibility to adjust course as needed.

Asset Class & Portfolio Returns (From 1975)					
	Stocks	**Bonds**	**Commodities**	**60/40**	**50/40/10**
Avg 12M Pct Chg	8.6%	6.8%	2.9%	7.5%	7.4%
12M High	62.4%	35.2%	52.3%	45.0%	43.1%
12M Low	-48.4%	-15.7%	-32.2%	-28.5%	-26.2%
Std Deviation	16.6%	7.2%	12.7%	10.9%	10.3%

Source: Strategas Securities

Strategas Recommended Asset Allocation Oct'23		
	Equities	**Bonds**
Overweight	Dev AC Core US LC Value US MC Value	
Neutral	EM AC Core US MC Growth US SC Core	IG Corporates US MBS US Dollar EMD
Underweight	US LC Core US LC Growth	U.S. Treasuries ABS/CMBS

Source: Strategas Securities

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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