ENVESTNET

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STRATEGAS

insight

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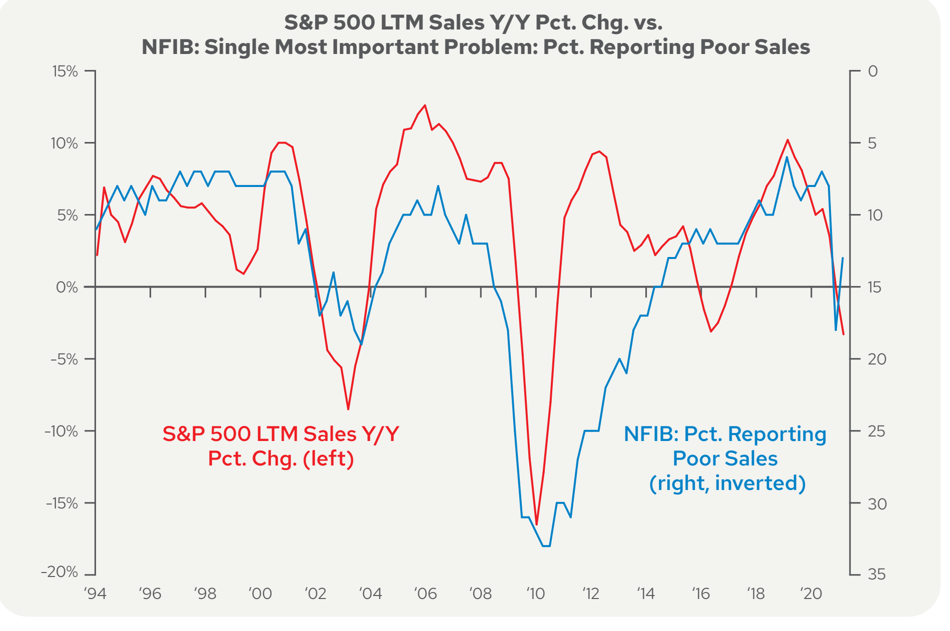
The Building Blocks of Expansion

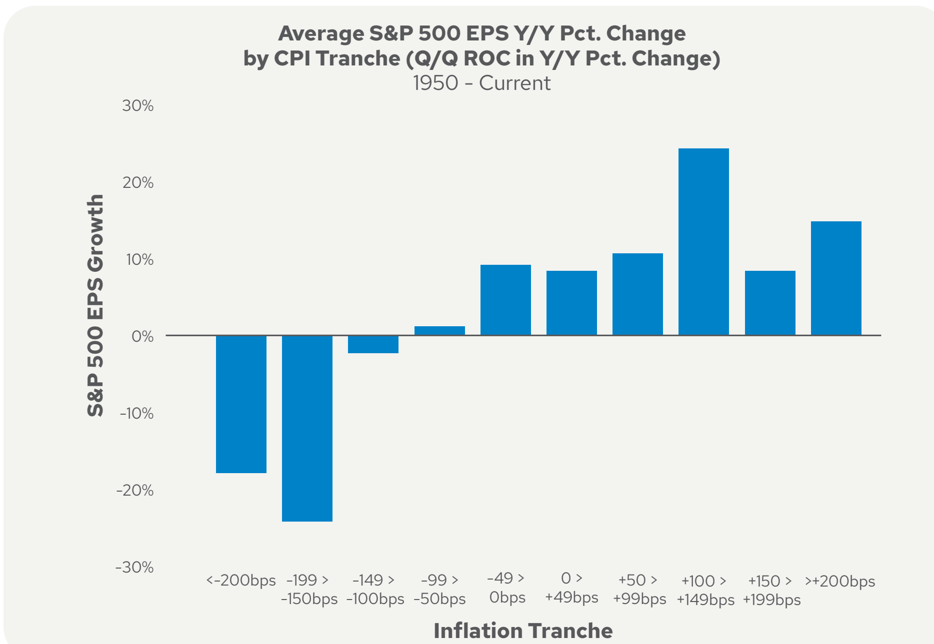
On its face, we see little evidence that the equity market is reacting negatively to the recent—*and concerning*—surge in positive COVID-19 cases. Some of this may be, as we noted last month, a function of *looking through* the surge to the recent run of positive vaccine news and the accompanying—*and generally optimistic*—narrative of "getting back to normal." Although the drumbeat of anxiety around "sheltering in place," "self-isolating," and even "work from home" has been steady and palatable for some time, we have noticed a sharp increase over the last month. Folks want to move on and to get out and about. They want to get back to normal. Of course they always did; but now they can see circumstances that would allow it. This is pent-up demand.

Mercifully, not all optimism is built on that hope. It is hard not to be impressed with the resiliency of the broader economic recovery over the last several months. Even with the notable absence of additional fiscal support, the US economy as a whole appears to have enough steam to post a second successive quarter of double-digit GDP growth (the Atlanta Fed GDPNow measure stands at 11.2 Q/Q AR for Q42020). All else equal, it would not be unreasonable to justify a firm bid for equities in this environment. Although it could be argued the market has gotten a touch over its skis in the short term, we have become more constructive on the economy's ability to clear the disruptive hurdles it currently faces. The near-universal right-sizing of industry and central banks' provision of abundant liquidity, coupled with the post-vaccine reopening of the economy and concomitant unwinding of aforementioned pent-up demand, should provide the scaffolding for a material boost in **activity, demand, output, revenue,** and **profitability**. In the absence of a policy error, it seems this combination could provide the global synchronized expansion we missed out on following the 2008-2009 Global Financial Crisis. Although this transition also may take some time to fully form, it seems more plausible now than it did just a few short months ago.



Although the building blocks appear to be in place for the economy to transition from recovery to expansion and for the emergence of a new profit cycle, we remain suspect of just how transitory the impact of the recent increase of restrictions will be in the short term. Compounding our concern are the additional challenges presented by scaling the manufacture and distribution of the necessary doses of the vaccine once the FDA approves it. This *logistics gap*—i.e., approved but not readily available—could result in an extended soft patch in economic growth. As a result, we are less optimistic on Q12021 than the consensus. What seems clear, as we have seen most recently in the UK (and, earlier this fall, across the Continent), is that any directive to limit mobility and lock down portions of the economy—however temporary—will result in a period of softer economic growth. The longer the lockdown, the more severe the soft patch... and, potentially, the greater the pent-up demand. The recent approval and distribution of Pfizer's vaccine in the UK should prove an important point of observation to gauge the soundness of our logic in the intermediate term.

What we know is that the US payroll report for November showed a rise of just 245,000 nonfarm payrolls from October, with weakness in the retail and government sectors. The unemployment rate declined to 6.7%, though the labor force participation rate fell 0.2% points to 61.5%. As Strategas' chief economist, Don Rissmiller, noted, household employment fell slightly month over month in November, but the economy still has ~10 million fewer jobs than at the prior cycle peak, **and** it is likely more lockdowns are still ahead of us. So we remain on watch for a soft patch into Q12021. How long it lasts will be a key dynamic in the economy's transition from recovery to expansion. Will it perhaps be delayed and more robust? Ultimately—*though with a longer lead than the consensus*—we anticipate the transition to expansion to underpin a material boost to corporate profits as we move toward and through calendar year 2022. Strategas has raised its calendar year 2021 S&P 500 Index EPS to $161.50 (which is still below consensus on account of our soft patch concern), and we are estimating S&P Index EPS of $183.25 in calendar year 2022.



One question that has started to work toward the top of investors' list of concerns is inflation. With the global equity markets generally back to and, in many cases, above previous cycle highs, a good many investors marry the same optimism we note above with the belief that we are nearly *out of the woods* as it relates to the economic impact of the pandemic. Right or wrong, we see a clear pivot of concern (supported by two generations of college economics courses) toward the implications of prevailing monetary policy regime. The signposts of concern are hard to ignore: M2 is growing at 24% year over year, the value of the assets on the Federal Reserve's (the Fed) balance sheet alone has increased by 70% since Labor Day, and Congress is likely to move on several more **trillion-dollar, short-term** spending bills. Given the short-term deflationary nature of the pandemic, policymakers seem nonplussed by potential longer-term consequences of their actions on the currency, the economy, and the capital markets.

Perhaps the strongest reason to suspect a potential for higher inflation in the US in the long run is that it seems unlikely the Fed will institute negative interest rates as other central banks did in the wake of the Global Financial Crisis. What ultimately may be seen as irony by economic historians, as Strategas' chief strategist, Jason Trennert, has posited, is that the appearance of negative rates actually made the end goal of higher inflation all but impossible. We would argue that most of the institutional investors harbor an increased anxiety about inflation in the future but see little chance of it evidencing itself in the short term. As we note above, COVID and the act of locking down whole segments of the economy had a deflationary effect on wages and rents. But over time, as the economy begins to reopen, the lessons of history will be important to consider. Mounting deficits and rapid money growth are, at the very least, a recipe for the further weakening of the dollar, particularly against hard assets like gold and real estate. It has been a long time since investors have had to worry about their real returns. At a minimum, all fiduciaries should start to put hedges in place. Thus we included an allocation to gold in our tactical allocation portfolios over the summer. Even a pickup in economic activity without inflation could propel long-term interest rates toward the 2% level, where they started the year. Add on the possibility of too much money chasing too few goods, and we could see inflation not only in financial assets but in goods and services as well. Equities will bear a price, and inflation is a low-quality way to beat the market.

Strategas Recommended Asset Allocation (Dec ’20)

	Equities	Bonds
Overweight	US MC Value EM AC Core	IG Corporates
Neutral	Dev AC Core US LC Value US LC Growth US MC Core US MC Growth US SC Core	Agencies ABS/CMBS US Dollar EMD TIPS High Yield Bank Loans
Underweight	US LC Core	US MBS U.S. Treasuries

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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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