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insight

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2022 Will Be Different, Right?

It is hard to believe just how long the world has been battling the Covid-19 pandemic—*stress on the "19."* Long enough that despite true tragedy and disruption and in the face of the virus's gnawing persistence (i.e., the Delta variant), we saw an emerging complacency among investors as we made the move into Q4 and toward year end. For many investors, the outlook appeared to be defined by four areas of focus: a marked—albeit asymmetric—reacceleration in growth; an understanding that inflation was already—and would likely remain—higher (and for longer than policymakers cared to acknowledge); the tepid return to a "new" normal, itself frustratingly rife with accommodation; and the somewhat unsurprising revelation that an even greater distance exists between the partisan poles of politics. But despite all of this, a general acceptance of the range of likely outcomes for each focal point emerged—*the hallmark of complacency.* Case in point, the S&P 500 Index powered to a succession of 87 new all-time highs after recovering from the February 2020 prepandemic high of 3,386, en route to posting a 110% advance off the March 2020 low of 2,237. But everything must go right for Goldilocks to persist, and on cue, the emergence of the Omicron variant and the Federal Reserve's (Fed's) pivot on inflation clearly disrupted an increasingly perfunctory consensus as we entered December.

So what do the latest developments portend for the economic recovery, and how should investors adjust their portfolio? As we have discussed with clients over the last several weeks, the cyclical trade faces a stiff headwind, but in our opinion, the cyclical recovery appears intact. The recent spate of volatility (which perhaps is short dated) will likely provide further discomfort into year end, as little evidence exists to indicate that investors are not more worried about the Fed's intention to accelerate the pace toward policy normalization than the impact of Omicron. The Fed's policy mix clearly left it behind the mark on inflation in its meeting last week, but the FOMC elected to double the pace at which it is tapering bond purchases—*which now are expected to end in March 2022*—and foreshadowed three rate increases for next year—*ostensibly one each in Q22022, Q32022, and Q42022.* At first pass, this seemed enough for investors: Markets rallied on the announcement. Tactically, we are on hold. We remain comfortable with the more moderately bullish, and generally cyclical, positioning we established in our global allocation portfolios back in September. Equities are now 62% of the baseline portfolio (down from 67% vs. 60% neutral exposure), and cash is 8% (up from 6% vs. a 2% baseline).

Inasmuch as the Fed believes it now has aligned the direction of policy with the intention of stemming the tide of higher inflation while allowing the labor market to recover, it understands that labor force participation in the short and longer run is likely to be different. As Strategas's chief economist, Don Rissmiller, has highlighted—*and Chair Powell acknowledged*—we simply are not heading back to the same economy that we had in February 2020. This may suggest that the permanency and disequilibrium of the *new normal* is intensifying. As we wrote last month, is it too outside the box to think the adjustments made by corporate operators to adapt to these new conditions may collectively reveal themselves as one of the great organic drivers of growth the economy

needed to hasten the transition from jagged recovery to self-reinforcing expansion? Increasingly, we think so. Without attempting to be cavalier about the virus, we wonder whether the emergence of Omicron is just enough of a scare (and at just the right time) in tandem with a more hawkish Fed to make the "transitory" disruption to our daily lives and operating norms more permanent or, at least, super cyclical. It seems clear to most that the return of shelter-in-place mandates is both socially and politically untenable. As Strategas's chief strategist, Jason Trennert, noted last week, political leaders in some parts of the world appear to be fixated on lockdowns to slow the spread of the virus. Unfortunately, the costs to our economic, social, mental, and physical health are acute.

As we look into 2022, the investment outlook seems decidedly more neutral than it was a year ago at this time. The markets remain buoyed by ample liquidity, strong corporate profits, and elevated profit margins. At the same time, aggressively accommodative monetary policy is reversing into an environment defined, in part, by lofty market multiples. This cocktail suggests that market returns will continue to be highly correlated with the yield on 10-year sovereign debt. Although current valuations may be sustainable with a 10-year Treasury note yielding 1.45%, we should see some upward pressure on long-term interest rates as the biggest player in the Treasury market steps away. The omnipresent growth names may have called forward a fair amount of the present value of future cash flows. In short, value may be where the growth is. If supply chain issues continue to ease, the cyclical recovery should continue to transition into a self-reinforcing expansion, though perhaps less robust than most hope for.

As a check on this muted optimism, we are focused on seven data points to outline the durability of the cyclical recovery:

1. BAA corporate spreads widening above their September 2020 highs (~18bps);
2. Further flattening of the yield curve;
3. A meaningful decline in TSA travel & mobility and OpenTable seated diners data;
4. Deterioration of S&P 500 Index profit margins;
5. Weakness in the relative performance of cyclicals versus defensive shares;
6. Renewed school closures; and
7. A meaningful increase in unemployment claims.

For now, investors have no alternative to equities, but stock and sector selection may be critical in generating absolute equity portfolio returns greater than midsingle digits next year. Among US equity sectors, we continue to recommend above-benchmark exposure to the Consumer Discretionary, Energy, Industrials, Financials, and Materials sectors on an equal-weighted basis. This leaves our US equity sector portfolios with neutral exposure to Health Care, Information Technology, and Real Estate. We are underweight Consumer Staples and Utilities shares, but note the energized performance of both in recent weeks. We are maintaining below-benchmark exposure to Communication Services.

We wish all of you a Merry Christmas and happy holidays.

Strategas Recommended Asset Allocation (Dec '21)

	Equities	Bonds
Overweight	Dev AC Core US LC Value US SC Core US MC Value	IG Corporates Bank Loans
Neutral	US LC Growth US MC Growth EM AC Core	ABS/CMBS Agencies TIPS 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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