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insight
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Geopolitical Distractions Underscore Value Of Active Management

Global equity markets continued their uneventful grind sideways through much of May, until… a heated verbal volley between President Trump and North Korean leader, Kim Jong Un, put their planned mid-June summit at risk. Separately, after largely capitulating on tariff threats that had stoked escalating US-Sino trade tensions a month ago, the Administration proposed a battery of tariffs against longtime European trading partners. Not surprisingly, the market took a generally negative view on both of these late-month developments, ushering stocks to a weak close for the month amid the rising drumbeat of calls to "sell in May, and go away."

In the "Age of Trump," the tendency exists for comparably insignificant geopolitical developments to garner undue attention, which too often results in an undesirable impact on risk assets. Irrespective of one's political views, however, investors should consider the strong economic backdrop against which this theater is unfolding. As we noted in last month's *Strategas Insight*, "the global economy in general, and the U.S. economy in particular, appear to be in healthy shape with few, if any, discernable signs that a material slowdown or recession is imminent." What's more, US corporations reported record profits in Q12018, up 26.4% year over year. Although this growth was due, in part, to the tax cut passed last December, organic growth was also impressive—and welcome—

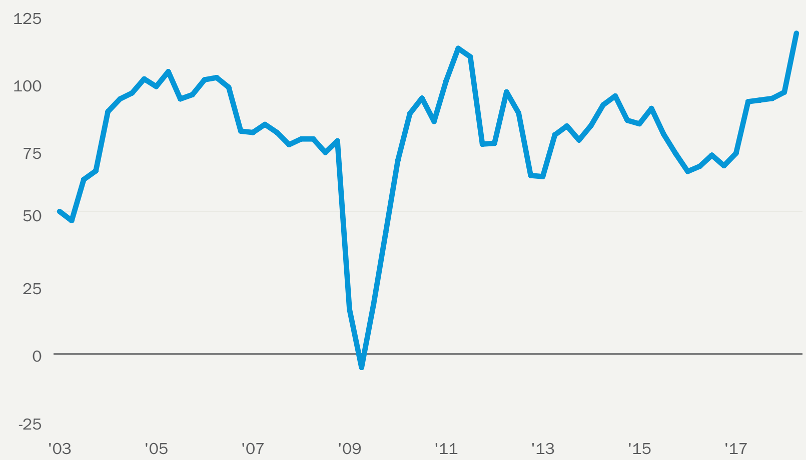
Russell 1000 Operating Result Dispersion
(Historical Standard Deviation of TTM EPS Y/Y Pct. Chg.)

Source: Strategas. The chart represents the amount of variation in earnings growth for companies in the Russell 1000. An increasing line means higher variation while a decreasing line means lower variation. Trailing Twelve Months (TTM) is the timeframe of the past 12 months used for reporting financial figures. Earnings Per Share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. Year over year (Y/Y) is a method of evaluating two or more measured events to compare the results at one time period with those of a comparable time period on an annualized basis.

following three relatively lackluster years ending in calendar year 2016. S&P 500 revenues were up 8.3% year over year for the quarter. Looking forward, before investors mark shares too much lower or simply “go away,” as the above axiom suggests, they should consider the Atlanta Federal Reserve’s GDPNow model, indicating Q22018 real gross domestic product (GDP) growth is tracking above 4.5%, and CEO confidence, which closely correlates with capital spending, is strong, and, as measured by the Business Roundtable, now eclipses its pre-financial crisis highs.

To be sure, geopolitical uncertainty is not the fault of US leaders alone. Recent comments from eurozone leaders about Italy and the emergence of the populist parties will, in our view, only serve to strengthen the positions of those movements. One senior member of the European Commission remarked, “markets will teach Italians how to vote.” Angela Merkel, the German Chancellor, hinted that Italy will face a fate similar to Greece under austerity. Whereas Italians are likely and willing to level complaints on both their political leaders and their own country, they, like most of us, meet criticism from outside the “family” with resentment. Many Italians have a hard enough time accepting direction from Rome, much less from Brussels. Remember how well the Brits reacted to President Obama’s visit to the UK to lobby for Britain to stay in the EU? Not only will it not work, but it also is counterproductive. Until Europe focuses on structural reforms that liberalize their respective economies, it’s difficult to see things improving much, if at all.

CEO Economic Outlook Survey Diffusion Index (50+ = Expansion)



Source: Strategas. The CEO Economic Outlook Survey is designed to provide a picture of the future direction of the US economy by asking CEOs to report their plans for their company’s sales, capex, and employment for the next six months. The data are used to create the Business Roundtable CEO Economic Outlook Index and sub-indices for sales, capex, and hiring expectations. These indices are diffusion indices that range between -50 and 150 — where readings at 50 or above indicate an economic expansion, and readings below 50 indicate an economic contraction. A diffusion index is defined as the percentage of respondents who report that a measure will increase, minus the percentage who report that the measure will decrease.

This outlook gains further currency, given the strength in last Friday’s US employment report. May US Nonfarm Payrolls increased 223,000 vs. estimates of an increase of 190,000, with strong positive revisions to April, and the unemployment rate came in at 3.8%. Wages rose 0.3% month over month, which matters. The unemployment rate cannot be pushed down indefinitely without resulting in rising wages, and it looks as though the economy is at that point. It is very likely the Federal Reserve (Fed) will move to raise rates at its June meeting, which would increase the fed funds rate close to the rate of inflation—that is, a zero real rate. As Strategas’ Chief Economist, Don Rissmiller, says, “Here’s where things start to get interesting.”

The Fed is moving toward a full roll-off of its balance sheet (beginning approximately in September 2018). In our view, we think of this quantitative easing (QE) drain as a “tightening,” even though it’s a modest one. So, after (likely) tightening in June, the Fed could choose to skip September, leaving it on pace for three rate hikes this year. But, if the QE drain is not perceived to be doing much by September—which is possible—the Fed may move to raise the funds rate, staying on track for four tightenings this year. That would likely knock some steam out of the market’s stride. Portfolios too heavily allocated toward passive strategies would probably suffer a greater share of the drawdown.

More than nine years after it started on March 9, 2009, the current bull market, as measured by Strategas’ own Bull Market Top Checklist and other popular measures of market sentiment, is nevertheless largely unloved and under-owned. Corporate credit spreads remain tight as a drum, upward earnings revisions as a percentage of all earnings revisions are still above 60%, and the initial public offering (IPO) market continues to be rather moribund. And even more surprising, flows into bond market mutual funds and ETFs are dwarfing flows into equity vehicles: Equity market mutual funds and ETFs have had net outflows both year to date and since the start of 2017. Mergers and acquisitions (M&A) activity, as measured by dollar volume, is getting a bit frothy, as is the number of stocks making new 52-week highs, although they have come in as of late. Even so, we're a far cry from the heady days we witnessed heading into bull market tops in the years 2000 and 2007.

The tax cuts and subtly easing burden of regulation have greased the skids for stocks to move higher. But the combination of modestly higher inflation expectations, the Fed's proclivity to raise short rates, the backup of rates on the long-end, increased equity market volatility, and a steeper earnings curve have conspired to provide the necessary counterweight to mute the slope of cyclical multiple expansion. The net effect is increased dispersion in stock performance. Historically, dispersion is lower earlier in the business cycle—a rising tide lifts all boats—and is higher later in the cycle, as cracks in the economy emerge. Generally, the backdrop for stock picking is improving.

Advisor Takeaway:

The emerging tension between strong fundamentals and increased geopolitical concerns underscores the opportunity for increased exposure to active strategies and the importance of security selection in portfolio construction as the cycle matures.

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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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