Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

Key Takeaways from Strategas Research Areas

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OVERRIDING INVESTMENT THESIS

While labor market strength, robust corporate and consumer balance sheets, and still-accommodative monetary policy lead us to believe that recession is unlikely in the next year, we believe the risks to the equity markets are rising due to the likelihood of aggressive central bank tightening to fight inflation. Although we are in line with the consensus for 2022 S&P 500 earnings (~$230), our models suggest that current rates of inflation are inconsistent with a market price-to-earnings multiple of 19x. In our view, a multiple of 16-17x might be more appropriate if the CPI drops from its current level of 8.5% to the 4-6% range by year-end. In the short-term, tight labor markets, rapid home price increases, and environmental policies that keep the price of oil and gas higher for longer are all likely to lead to stubbornly-high rates of inflation. In the long-term, a trend toward de-globalization may also contribute to higher inflation. Given these risks, we think it is important for investors to favor high-quality, shorter-duration stocks of companies willing to distribute cash to shareholders.

VERTICAL #1: **INVESTMENT STRATEGY**

Base case for our bearish U.S. equity forecast

- There has historically been a strong inverse correlation between the rate of inflation and earnings multiples.
- The Fed appears committed to tightening monetary policy aggressively.
- Higher input costs such as labor and commodities may negatively impact profit margins and hamper earnings.

Major risks to forecast

- The spread between the S&P 500 earnings yield and the 10-yr Treasury remains wide.
- S&P 500 earnings are expected to be up 8.5% in 2022, with potential for upside surprise.
- Resolution to supply-chain woes might cause inflation to drop faster than expected and allow the Fed to slow.

VERTICAL #2: **ASSET ALLOCATION**

Asset Classes

- **Equities.** Neutral with a preference toward Value over Growth and Small and Mid-cap over Large-cap. We think the China/Covid-19 situation, global central bank tightening, and other growth challenges will keep volatility high.
- **Cash/Gold.** Overweight. Comfortable with our positioning in these hedges amid elevated market volatility.
- **Fixed Income.** Underweight. The twin tightening tools of higher rates and balance sheet reduction will pressure bonds.
- **Alternatives**. Establishing a position in Commodities as a hedge against rising stock/bond correlation, a play on the increasingly structural dislocation in global supply chains, and a way to access the momentum behind de-globalization.

Overweight Sectors

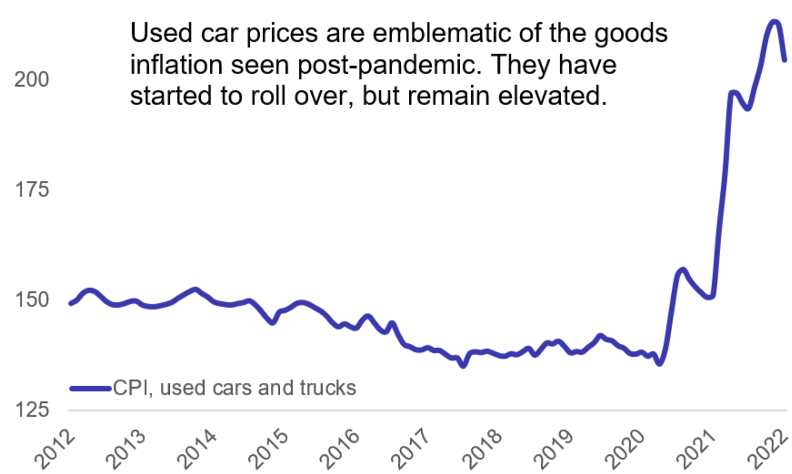
- **Industrials.** Diverse sector, devoid of major concentration risk, set to benefit from economic reopening and infrastructure spend. Aerospace & Defense can benefit from geopolitical tensions, while travel recovery is a tailwind for Airlines.
- **Health Care.** Late cycle, defensive sector. The longer-term relative return performance profile is also favorable for outperformance. Drug pricing keeps falling down the list of priority policy items; status quo remains favorable for Pharma.
- **Energy.** Levered to economic reopening. Despite higher prices, robust demand combined with limited industry investment in recent years (and proposed environmental constraints moving forward) leads to upward price pressure.
- **Materials.** Have acted well amid the surge in commodity prices. Climate and more traditional infrastructure spend should keep demand high, while profits margins and free cash flow generation have been surprisingly resilient.

VERTICAL #3: **TECHNICAL STRATEGY**

- **Time to rebuild needed.** At a minimum, significant time will be needed to repair trends among some of the market's most important groups and constituents. Stocks are short-term oversold, but our best guess remains that major support will ultimately be found where the speculative Covid-19 ramp-up began.
- **Where's the bottom?** We are unconvinced a capitulative moment has been seen yet – the investor surveys reflect pessimism, but the V.I.X. (market's fear gauge) is still in check and put/calls have not flagged extreme negativity. Momentum and risk-seeking leadership both absent so far. Until this changes, we'll view bounces in resistance skeptically.
- **Emphasize leadership.** Energy, Basic Resources, Defense Contractors, Pharma, REITs, Insurance, Utilities, Staples remain best trends in the market (and we are inclined to view pullbacks here opportunistically).
- **Yields on watch.** Expecting volatility in 10-year Treasury yields around 3.00-3.25% – it's the 40-year trend line and we don't expect the bond bulls to roll over without putting up some fight. Equity leadership (counter-cyclical) suggests a pause or correction in yields may be close as well.
- **Currencies on watch.** For months, we've been noting the macro significance of the Japanese yen (historically a safe haven) selloff. We continue to believe this reflects a structural breakout / regime change, and ultimately, the Yen makes a compelling case that the ceiling on Japanese government bond yields is likely to fail.

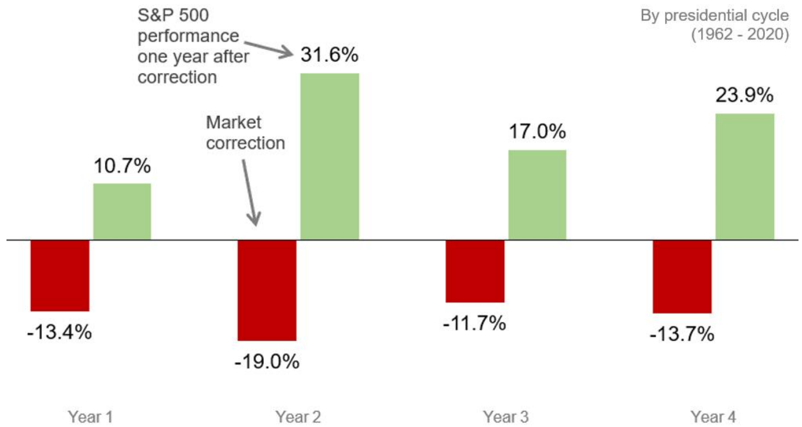
VERTICAL #4: **ECONOMICS**

- **How did we get here?** Pre-pandemic, there were economic headwinds (China tariffs, etc.) but the global economy was growing adequately. Covid-19 hit confidence in early 2020, and activity plunged around the second quarter. Lockdowns controlled the virus temporarily, but additional variants have made "zero-Covid" policies tough to maintain.
- **Fiscal & monetary support filled the gap.** With aggressive policy action, demand bounced back. Central banks acted quickly, so there was not a widespread financial crisis in addition to the lockdown (as there easily could have been, had 2008's tools not been dusted off quickly & expanded). Big businesses were able to access credit markets.
- **Temporarily transitory.** By 2021, vaccines provided hope and U.S. core inflation started to ease. But this didn't last. The Delta variant hit, and child-care and U.S. schools opened cautiously in the fall of 2021. Then the Omicron variant hit just as US labor markets started to overheat. Global supply-chain interruptions and surging wage data spooked the Fed in 4Q21, while 1Q22 saw new supply shocks (war in Ukraine, lockdowns in China) added to the pressures.
- **This is where we are.** The market has digested that the Fed is pivoting from emergency monetary policy (0% fed funds rate) to neutral (2-3% fed funds rate + quantitative tightening). We have seen some "peak inflation" evidence (e.g., used-car prices reversing), so the Fed does not yet have to aim for overly "tight" (4-5% fed funds). But Fed Chair Powell has indicated that rate hikes should accelerate, as there's a desire to get to neutral quicker...just in case that's not enough.



- **Bottom line.** The Fed is still trying for an economic soft landing. The pathway has become narrow for this outcome. This is going to have to be a joint effort (Fed + private sector). The Fed cannot bring inflation down by themselves without another pivot & shock to the financial system. The private and corporate sector will have to chip in on supply chains, etc.

VERTICAL #5: **WASHINGTON POLICY**



- **Midterm years are the most volatile of the four-year presidential cycle.** These years see an average intra-year correction of 19%. This year is no different although the timing has been faster and the scope of the decline has been deeper than usual. Interestingly, the S&P 500 has been trending very similarly to its 1982 pattern, the last time we were dealing with inflation, Russia, and a midterm election at once. The good news is that the faster and steeper the decline, the stronger the recovery has been with an average 32% gain of the S&P 500 off its midterm election low.
- **Fiscal policy, monetary policy, and geopolitical frameworks have all been upended.** During the pandemic, policymakers in Washington and at the Federal Reserve provided extraordinary support for the U.S. economy. Now, with inflation at 8%, the Fed needs to shift from preventing inflation to crushing it. Russia's invasion of Ukraine has fractured the post-Cold War mindset with borders changing, energy being used as a weapon, and a Russia, China, and potentially Saudi alliance facing off against a unified West, which can have enormous consequences for the U.S. dollar in the future.
- **Energy independence and onshoring are key themes.** With Russia using energy as a weapon and China cozying up with Russia, U.S. policymakers are increasingly pushing for energy independence (for the West) and securing U.S. supply chains, despite the current dragging of their feet in this high inflation and heightened geopolitical risk environment.
- **Democrats may still revive a slimmed-down Build Back Better bill:** Democrats fear that they are going to lose in the midterm elections and are making one last push for a slimmed-down Build Back Better. There are wide disagreements in the party over the best path to taxation and how much spending should be included. But with the clock running out and a wave election building, never rule out the possibility that something gets done before the August recess starts.
- **Democrats likely to lose both House and Senate:** Biden's approval rating remains in the low-40s which is consistent with losing both the House and Senate. In the key swing states, Biden has fallen by an average of 20 percentage points. Inflation is the top issue for voters but geopolitical issues, immigration, and crime are also important. These issues are all cutting against the Democrats. As such, a wave election is building against the Democrats. The equity market is already assuming a Republican takeover so the big question is whether the election is a tsunami or a ripple.

VERTICAL #6: **FIXED INCOME STRATEGY**

- **Tightening imminent.** May will likely deliver the most substantial tightening of monetary policy in the last 25 years, if not the last 40. But there's a great deal of room for surprise, both hawkish and dovish, and on both ends of the curve.
- **Wide range of outcomes.** On the front end of the curve, the market and Fed seem to be in agreement that a 0.50% hike is a done deal for May. Likewise, a 0.50% follow up in June seems to be the consensus, but there are whispers of both 0.25% and 0.75%. Collectively, we see room for a surprise to either side over the next two meetings, and with that, comes uncertainty in both the curve slope and the odds of a recession this year or next.
- **Quantitative tightening.** On the back end of the curve, balance sheet reduction is an even bigger wildcard, with no firm consensus from the Fed about how fast and high to cap reduction, nor a concrete roadmap about how to begin asset sales. We believe that balance sheet reduction is where the primary risk resides in 2022. On the high end of possibilities, if runoff and asset sales exceed $2T over the next 2 years, then we would expect 10-year yields to make at least one more major move higher, possibly to 3.5%, before stalling. Here, 10-year Treasurys would fall another 5% from current levels, and we would expect equity markets to be softer as well. If reduction comes in on the low end (less than $1.5T over the next 2 years), then we would expect the 10-year yield to stall near 3%, and eventually reverse lower. This scenario would likely lead to volatility in the 10-year and we'd expect to see credit and equity markets perform about flat from here to year-end.

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