Market Strategy
by STRATEGAS A BAIRD COMPANY

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Key Takeaways from the 6 Strategas Research Areas

March 5, 2024

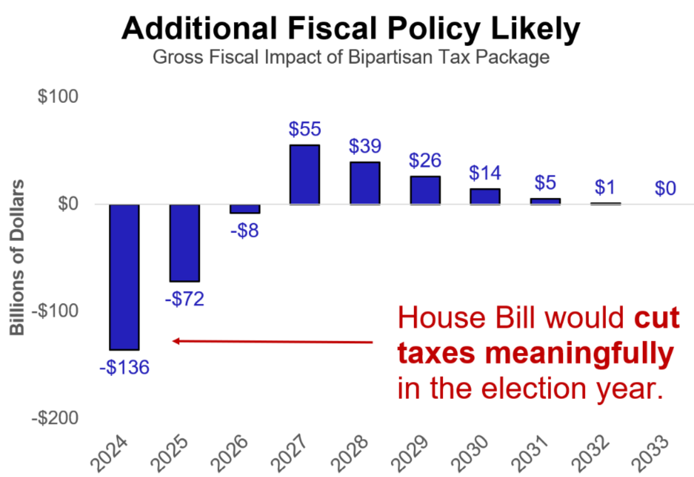
A SNAPSHOT AND AN OUTLOOK

At Strategas, we look at the markets and the economy from several angles. Periodically, we gather our separate research areas into one note that serves as a snapshot of both where we are today and an outlook for the months ahead. As we move through the first quarter, we thought it would be useful to undergo this exercise once again.

INVESTMENT STRATEGY: JASON TRENNERT, CHAIRMAN, CHIEF INVESTMENT STRATEGIST

- **Elections.** With 40% of the world's population facing national elections of some sort this year, policymakers have a strong incentive to try to avoid recessions. In the U.S., this has meant deficit spending equivalent to 7% of GDP, the cancellation of ~$140 billion of debt, periodic drawdowns of the Treasury General Account, slashing the supply of Treasury coupon issuance, and keeping the Strategic Petroleum Reserves at 40-year lows. These factors helped keep the U.S. out of recession last year and it would be naïve to assume they won't be used again. Pair this dynamic with the fact that the Fed is likely to cut interest rates this year, and it is difficult to become too bearish on risk assets.

- **Inflation.** Of course, the cost of avoiding a recession could be renewed inflationary pressure. Twelve years of quantitative easing seem to have blinded policymakers to the potential risks of deficit spending; it might be naïve to assume that there won't be another wave of inflation as we get closer to 2025 and 2026 (historically, inflation often comes in waves). Further, our Washington team believes we're likely to see new tax legislation amounting to an additional ~$136 billion in fiscal stimulus this year. Perhaps the fiscal largesse and possibility of inflation could bring the return of bond market vigilantes (and with them, higher long-term interest rates). Regardless, the negative real interest rates enjoyed during the QE era seem unlikely any time soon.



- **Geopolitics.** The costs of deglobalization – a higher cost of doing business, supply chain disruptions, and greater defense spending – are likely to be more apparent in 2024 and beyond.

- **Earnings.** It's difficult to make a strong case for multiple expansion with the 12-month forward P/E north of 21x. Returns in line with earnings growth are likely. Strategas' estimate for 2024 S&P 500 earnings growth is +6% year over year.

- **Markets.** All of this suggests that investors would be wise to stick with shorter duration equities that are not dependent upon the kindness of strangers to grow. That is to say, companies that generate their own cash flows or that can access debt capital more cheaply should outperform.

- **Artificial Intelligence.** The hope and hype surrounding AI is real and will continue to stoke an arms race as companies rush to exploit the new technology. We don't know yet what the implications of this shift will be, but we are reminded of Bill Gates' observation regarding technology writ large – "most people overestimate what they can achieve in a year and underestimate what they can achieve in 10 years."

ASSET ALLOCATION: NICHOLAS BOHNSACK, PRESIDENT, HEAD OF PORTFOLIO STRATEGY

- **Market-weight Equities, underweight Bonds, overweight Cash.** With our outlook shifting more bullish due to stronger-than-expected earnings and economic growth, an increasingly supportive fiscal backdrop, and a Goldilocks inflation/labor market mix fueling risk, we believe now is not the time to tilt too far on the risk spectrum. Absent an exogenous event, interest rate cuts will likely be limited, reducing capital appreciation in the fixed income space and maintaining a little extra cash seems prudent now with money market funds yielding ~5%.

- **Bias toward Value and Large-caps.** Growth has trounced Value over the past six months but if a second wave of inflation materializes, a Value tilt would likely provide some downside protection. Value has also outperformed inflation in every decade since the 1940s. Large-cap companies have extended debt maturities and thus will be less sensitive to interest rates in the next 12 months.

- **Overweight:** *Industrials, Health Care, Discretionary, and Communications.* Earnings growth for the cyclical sectors has been strong for the past six months and is giving no indications of a potential slowdown. Investment from previously passed fiscal policy is making its way into the economy and helping the Industrials, a strong employment picture is boosting Consumer Discretionary, and the potential for productivity improvements from AI could support modern Communications (while stable long-term rates support legacy Telecom). Meanwhile, Health Care saw large earnings revisions last year alongside significant investors outflows, so the bar is already low for future outperformance.

- **Neutral Weight:** *Energy, Financials, Materials, and Technology***.** Energy remains mixed as oil and gas production sit near all-time highs, but geopolitical instability abroad helps support prices. Financials are bifurcated with smaller regional banks left exposed to commercial real estate issues while large banks remain too big to fail. Technology has performed well this year given semiconductor outperformance, but the largest weight within the sector has lagged.

- **Underweight:** *Staples, Utilities and Real Estate***.** Our preference to be underweight in the more defensive-oriented sectors is due to increase in competition for yield and the challenges lower growth sectors face when economic and earnings growth are showing signs of acceleration. In the event of a deterioration of economic strength or material rate cuts by the Fed, these sectors would likely benefit.

  (Click here for our full Asset and Sector Allocation framework)

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TECHNICAL STRATEGY: CHRIS VERRONE, HEAD OF MACRO AND TECHNICAL STRATEGY

- **Base case.** The status quo is intact with few blemishes to be found. The S&P's ~7% year-to-date advance through February is the 13th best start to a year since 1950, with forward performance from the historical examples strong over the next 4 and 10 months. Strength often begets strength in this business and that's certainly on display with this data set. Strength remains embedded within market leadership – for instance, Consumer Discretionary (cyclical) is outperforming Consumer Staples (defensive) everywhere we look (large caps, small caps, abroad, etc.) – while credit conditions look solid. Global participation is broad, with European strength underappreciated. U.S. Health Care is also improving. Overall, the trend is strong in most corners of the market, and the bar looks high for bond yields to go up from here.

- **Potential risks.** Sentiment is running hotter amid a soft seasonal period. Within Tech, inflows are now very aggressive (sentiment again), and the types of charts seen in the A.I. adjacent space (going vertical) do not correct without some pain. Further, a few mega-cap Tech names have already started to top and could weigh on a very concentrated market over time. Finally, interest rates and oil are worth keeping an eye on – either one rallying significantly would be a major weight.

- **Five plausible surprises:** **1.)** S&P 6,000 before it's all said and done. **2.)** Small caps start to outperform Big Tech. **3.)** The nascent Chinese rally is more than just a bounce, but rather, a strategic low. **4)** Bond yields surprise meaningfully lower. **5.)** The U.S. dollar finally weakens meaningfully (as breakouts in other global currencies are suggesting it could).

ECONOMICS: DON RISSMILLER, CHIEF ECONOMIST

- **Inflation.** Inflation has been painful in many countries over the past several years. Despite a pop in the January data, the first wave of inflation still appears to be over (with inflation expectations seemingly anchored). But history suggests that once inflation gets going, a second wave tends to build (with a hit rate of 87% of the time globally).

- **Growth.** Timely U.S. data have shown only spots of weakness vs. bigger challenges around the globe. There is downward pressure on activity in the first half of 2024, the lagged effects of existing policy, but that should be fading by the second half. We see a 30% chance of a U.S. recession, 60% soft landing, 10% upside surprise for 2024. For 2025, 15% chance of recession, 60% soft landing/expansion, and 25% upside surprise.

- **Policy.** Many central banks seem to be pausing, but this year likely involves a pivot to lower rates (justified by inflation coming down). The Fed has telegraphed three rate cuts but there's no rush to begin. We believe the first cut will be in June.

- **Risks.** The U.S. economy has (thus far) tolerated higher interest rates and banks tightening lending standards. Yet we wonder if unemployment under 4% will come with acceptable wage inflation once the U.S. labor market runs out of job openings to cut and starts cutting jobs (there may be over 1 million U.S. job openings that are "stale" and won't be filled).

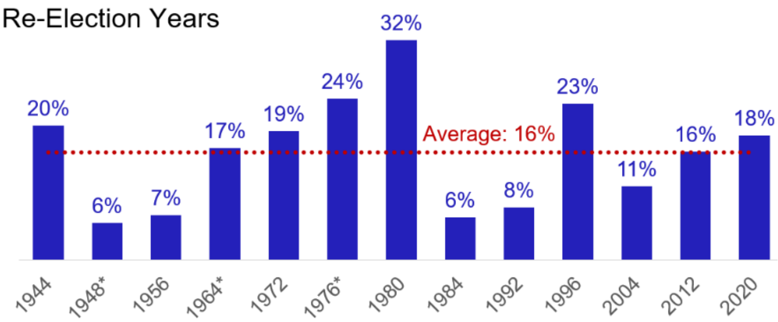
- **Hope.** Productivity (more output per hour) can alleviate a second inflation wave. Too much money chasing too few goods can be stymied by producing more goods. New technology is promising, but we're waiting to see better economic data.

WASHINGTON POLICY: DAN CLIFTON, HEAD OF POLICY RESEARCH

- **The election.** Super Tuesday is when financial markets begin to price the election. Donald Trump is expected to be the Republican nominee, but it's a long road to November 5. Legal and extraneous events are difficult for investors to gauge (e.g., Trump's potential conviction, the puzzle of Biden's low approval rating vs. a strong economy).

- **Re-election years.** The S&P 500 has increased in every presidential re-election year since 1944. That is 13 straight presidential re-election years (including those with recessions, like 2020). The market tends to outperform in re-election vs. open election years. We think that's because presidents use all available tools available to them to impact the economy ahead of their re-election, which leads to significant fiscal and monetary stimulus, helping to cushion the economy through a volatile election cycle.

The S&P 500 Has Increased in Each of the Last 13 Presidential Re-Election Years



*Re-election pursued by the sitting president at the time of the election

- **Fiscal stimulus.** We expect Congress to soon pass a bipartisan tax bill that modestly expands the child tax credit and restores three expired business tax credits (full expensing of the R&D tax credit, 100% bonus depreciation, and a more generous interest tax deduction). This bill will provide $136 billion of fiscal stimulus, or 0.5% of GDP, in 2024. In addition, Congress is trying to come to a full agreement to enact fiscal 2024 appropriations, which would avert $53 billion of planned spending cuts. Further, the IRS has said it will process the approximately 1 million applications still pending for the Employee Retention Tax Credit. If payments for those tax credits flow again, another $150 billion could be injected into the economy. Last year these payments were directly correlated to higher small business hiring and higher Q3 GDP. The risk to the Fed cutting rates this year is that there becomes too much fiscal policy.

- **Treasury supply.** The Treasury Department's November 2023 decision not to increase long-term debt issuance and to instead finance the deficit with more T-bills (i.e. short-term debt), led to a significant liquidity injection that suppressed long-term bond yields and pulled cash out of reverse repos – which then helped boost stocks. However, that is expected to change with Treasury set to increase coupon issuance in Q2. If the Fed is unable to cut rates due to inflation, Treasury issuance becomes a bigger problem as net interest costs comprise a larger portion of the federal budget.

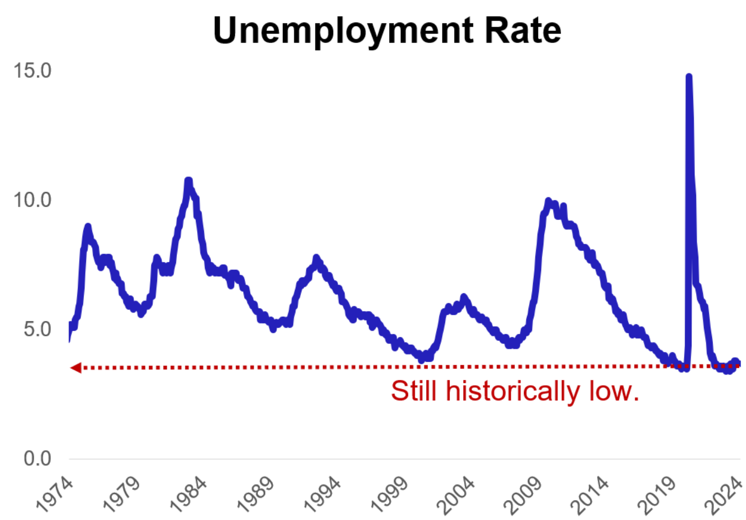
FIXED INCOME: TOM TZITZOURIS, HEAD OF FIXED INCOME RESEARCH

- **Inflation.** Inflation should continue to drift lower over the next few months, but this is already priced into market-based expectations. What's not priced in is the risk that inflation becomes sticky above 2.5%, or worse, accelerates higher by early 2025. As of right now, markets are assuming that inflation can drift down toward 2% and the Fed can still deliver 100 bps or more of rate cuts in the next 12 months without triggering a second wave of inflation. We are doubtful that this would be outcome, particularly in light of fiscal stimulus still to come in the middle of 2024.

- **Supply.** A 3-month reprieve in the barrage of Treasury supply ended in February. The reprieve came in the form of market sentiment, as coupon supply itself has continued to increase. But now the market is showing angst again with the never-ending coupon auctions, which show no sign of diminishing. With supply likely to stay at current levels for at least the next 2 quarters, and then likely to begin rising again post-election, the risk to the market is that the Treasury's deficit results in a large-scale liquidity drain from banks and financial markets.

- **Treasury Cash.** To minimize this risk that the federal government drains vital market liquidity, the Treasury is likely to return to its cash management operations via the Treasury General Account, which has been used successfully to smooth yield gyrations over the last 16 months. This strategy relies on the fact that there about $500 billion of excess liquidity is still stored in the Fed's reverse repo facility, and depending on the pace of quantitative tightening, as well as the timing of any rate cuts, the Treasury may be able to use cash to smooth liquidity drain for another ~5 months. That still leaves the Treasury (and the market) prone to liquidity drain in the second half of the year—unless the Fed eases by June.

- **Fed Policy.** The Fed is likely to cut rates this year, perhaps as soon as June. Many Fed speakers have recently mentioned the need to begin moving away from what they see as restrictive policy. This isn't the first time that FOMC members have verbally "hoped their way towards easier policy," but this time may carry more weight now that manufacturing data has taken a leg lower. Still, the gold standard of data is the jobs report. If the labor market shows any hints of weakness, we would expect the bond market to move back towards a base case expectation for rate cuts and quantitate tightening tapering to begin in May. If that report continues to show a strong labor market, then Fed doves may once again appear aspirational in their projections, and yields would likely inch higher again (with 10-year Treasury yields making a firm move out towards 4.50%).



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