Strategas Market Outlook

February 22, 2023

While the market has started the year with a sizeable rally, we remain cautious overall. In our updated outlook note below, we discuss our concerns around the potential for stickier inflation, higher-for-longer interest rates, weakening corporate profits, and tensions in Washington, before discussing how we are positioning money today.

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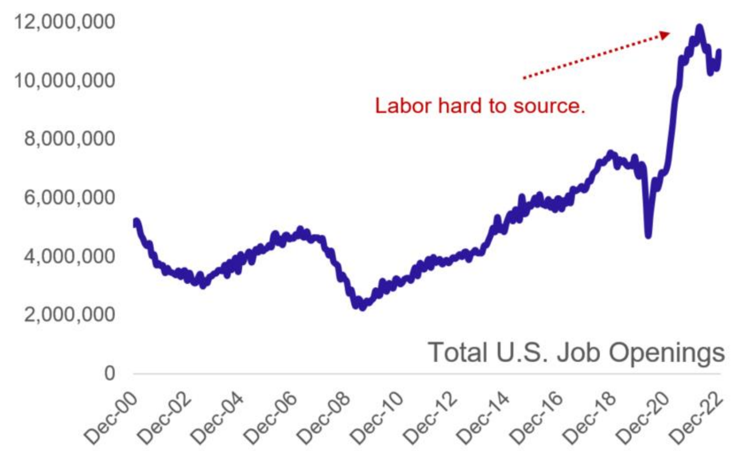
REMAINING CAUTIOUS IN SPITE OF A STRONG YEAR-TO-DATE RALLY

To sum up our market call simply, we'd say this: For the last year or so, we've been cautious, and today we remain so. Though it would be very difficult to describe the economy as being in recession and while we would absolutely stipulate that it appears that inflation has peaked, **we feel quite strongly that the decline in profit margins, the inversion of the yield curve, and stress on the consumer are all things that don't augur particularly well for the economy, corporate profits, or the markets in the near future.**

As of today, we put 50% odds on a recession in 2023. Two of the big items left unchecked on our recession watch list are weaker labor markets and a downturn in capital spending. In our opinion, there's been a fair amount of labor hoarding going on because it's been so difficult to hire workers, but we believe that as corporate profit margins start to decline, it will unfortunately be more likely that companies will start to lay people off. And while capital spending is surging, business confidence – which can be an indicator of future investment – has turned lower. So again, unfortunately, we're of the view that a recession is more likely than not in the next few years.

As we mentioned above, we wouldn't really argue with the assertion that inflation has peaked. But it's also our opinion that inflation is likely to be stickier above the Federal Reserve's 2% target and a more structural phenomenon going forward. Perhaps most importantly, we've had a very strong trend towards globalization since the Berlin Wall came down in 1989, boosted even further when China joined the World Trade Organization in 2001. **But we believe the trend towards globalization is now reversing, or, at a minimum, slowing significantly.** Today, there are many geopolitical issues that are causing businesses to worry about their supply chains, and while it could be great for the U.S. in the longer term to shore up supply chains and bring jobs back home, it's certainly not cheap. So, it's something that will lift put upward pressure on prices and inflation. Secondly, labor markets are as a tight as a drum. **There are roughly 11 million job openings vs. 6 million unemployed people actively looking for work.** And that's putting upward pressure on wages, especially in the services sector. This is important because the U.S. economy is very service-oriented, and that wage pressure could help keep inflation higher for longer than many would hope.



We believe the current bout of inflation is likely to prove more structural (and therefore more difficult to root out of the system for **six key reasons:**

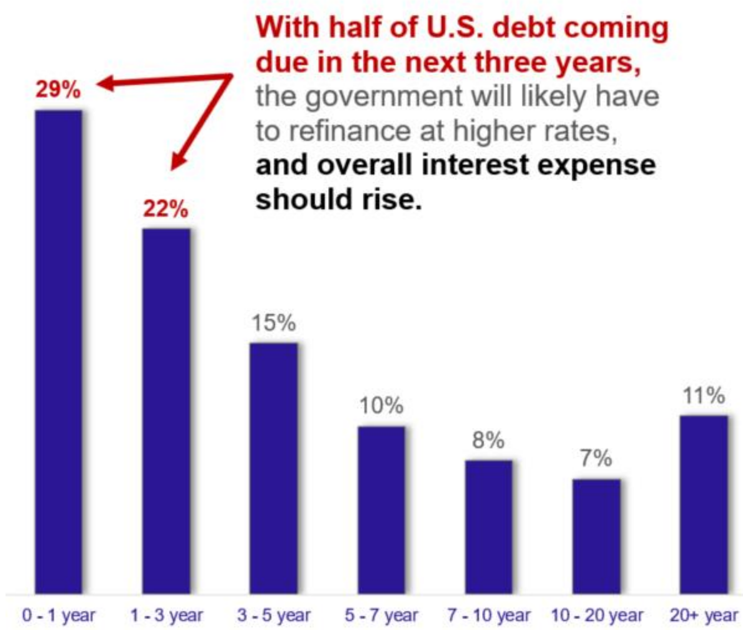
1. **Globalization** – a key source of disinflation – is waning in effect
2. **Money supply** (M2) is up 40% since Feb 2020
3. **Upward pressure on wages** from over 11 million job openings
4. **Inflation** – over 60% of the federal budget is indexed to inflation
5. **Rising home prices** (+7% y/y) are generally followed by rents, a big CPI weight
6. **Environmental policies** boost energy prices and the cost of doing business

There is a certain sense in which the Federal Reserve is actually fighting the federal government on inflation because roughly 60% of the federal budget is indexed to inflation (e.g., Social Security, Medicare and Medicaid). As an example, there are roughly 66 million people on Social Security, and their cost of living adjustment for this fiscal year is 8.7%. There are a lot of similar trends in government spending that are going to be difficult to reverse and will ultimately make it more difficult to get control of inflation. Finally, we're of the opinion that the Western world's pursuit of ambitious environmental policies without robust energy policies to back them up is going to keep the price of oil and gas higher for longer than might ordinarily be the case. And perhaps unlike past instances, we think producers are going to continue to be very cautious as far as it relates to capital spending, new drilling, etc., which should keep supply tight.

As far as the Federal Reserve is concerned, again, we wouldn't quibble with the idea that inflation has likely peaked. **But we are very cautious about the idea that the Fed is anywhere near a pivot to easier policy, and that's largely because there's never been a period in which the Fed started to ease policy (i.e., cut rates) before the Fed funds rate got above the rate of inflation.** It's very hard to get control over inflation if you have negative real rates. And while the gap is closing, the fed funds rate is still about 2 percentage points lower than the most recent CPI inflation reading. We suspect the gap will close this year, but it may take several months and could keep the Fed leaning hawkish in the meantime.

That, in our opinion, presents a problem for an S&P 500 that's trading at a valuation above its longer-term average (i.e., a forward P/E of 18.0), with an expectation for 2023 S&P 500 earnings to come in at $224 per share (~3% growth). The issue is that the effect of higher interest rates can take a significant amount time to really hurt corporate earnings. Simply, the more the Fed tightens, the more likely it is that profits decline. And that informs our below-consensus estimate of $200 per share for 2023 S&P 500 earnings.

Much of our outlook above is encapsulated by the idea that the bill is coming due for years of suppressed interest rates, unconventional monetary policy and profligate fiscal spending. We see this theme playing out in Washington as well. This month, the Congressional Budget Office released projections with regard to government spending, and one of the more shocking items had to do with our country's debt. As we show, 50% of our debt matures in the next three years, and the weighted average interest rate on that debt is 1.8%. Currently, 2-year Treasury yields are 4.6%. **And so, as we roll our debt forward to continue financing the federal government, it is not overly difficult to see a world where spending on interest expense rises significantly in coming years.** At a minimum, the federal government will have to make some difficult choices over the next couple of years (unless the Fed starts buying Treasuries again, which is possible, but would put us right back where we started as far as inflation). Again, in many ways, the bill is coming due for 13 years of quantitative easing and fiscal profligacy. In our view, that's something that's going to keep interest rates higher than we've been used to.



Maturity Timeline of U.S. Outstanding Debt.

So, the question really is what to do about it all? Right now, we're overweight the Healthcare and Consumer Staples sectors to be somewhat defensive, and we are also overweight Energy and Basic Materials. That might seem at odds with our calls for economic slowdown and market weakness, but we think there are structural issues that could be tailwinds for both markets. In Energy, as we noted above, we expect a tighter-for-longer supply situation for oil and gas. And then when it comes to Materials, we think China reopening and the electric vehicle revolution should support the price of industrial commodities for a lot longer. **It's a bit of a barbell approach in terms of sectors – some defensive and some cyclical/Value. But ultimately, we remain slightly underweight Equities, and favor U.S. Large Value, U.S. Small Cap, and Developed International.**

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