Market Strategy
by STRATEGAS A BAIRD COMPANY

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Private Wealth Management

Strategas FAQs

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Amid noisy headlines and against a volatile economic backdrop, Strategas answers questions on the 2023 rally, the looming debt ceiling, how they're currently allocating client money, and more.

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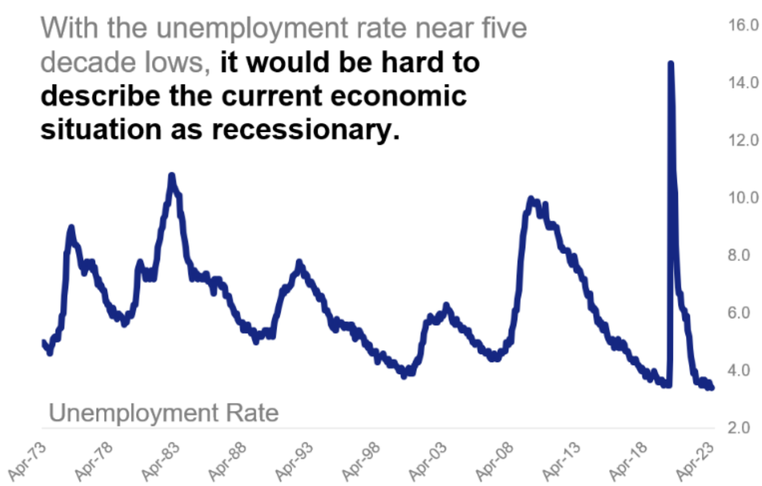
FREQUENTLY ASKED QUESTIONS FROM CLIENTS

Why do you have a bearish outlook? Two themes underlie our bearishness on the economy and the markets: **1)** We're at the end of more than 12 years of artificially low interest rates and heightened fiscal stimulus and the bill is coming due (as it always eventually does). and **2)** The Fed's aggressive tightening over the last 13 months has made a recession more likely. However, in this business the unexpected happens more frequently than one might think.

What might make you alter that outlook? We'd reconsider our bearishness if one of the following came to pass: **1)** The rate of inflation drops rapidly enough (in the absence of a financial crisis) that the Fed feels comfortable cutting interest rates, **2)** The Fed decides that the economic cost of fighting inflation is too high and lets inflation run hot (even though this would be rough for the economy in the longer term), and **3)** The labor shortage becomes so acute that the Fed's policy could eliminate job openings (~9.5 million now) without affecting existing jobs. This may be the most likely way to avoid a recession.



Why hasn't that bearishness borne out yet? It would be hard to describe the current economic situation as recessionary. The economy and corporate earnings, while both showing signs of strain, have been better than we expected. Additionally, the debt ceiling and banking turmoil have led to injections of liquidity into the economy. The Treasury has drawn down its general account in the absence of new debt issuance and the Fed has slowed rate cuts. The irony is that the market could actually face greater headwinds once those two issues are (more or less) settled.

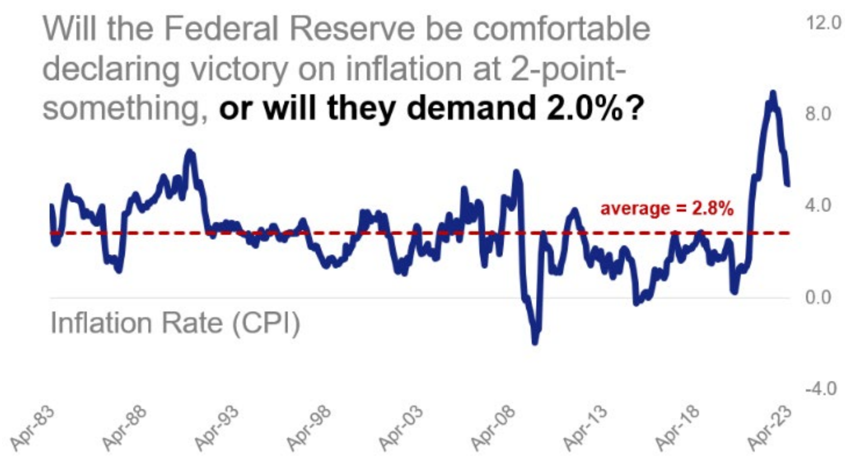
What is the likelihood of U.S. default? The threat of a default of the U.S. debt is low. Policymakers often talk about default on the U.S. debt during debt ceiling debates, but this is a political argument designed to pressure the other side. The U.S. government has enough cash flow to pay interest even if the default date is reached. We believe those payments will be made, based on current law and plans that Treasury outlined in 2013. Treasury said then that principal and interest payments on Treasury bonds would continue, with a daily decision made on other spending. If Congress fails to raise the debt ceiling, the government would have enough money for Social Security, Medicare, Defense, and interest. Other government spending would come to a halt, which is akin to a government shutdown. In this current cycle, the period of triage in government spending would be short lived, because the Treasury expects new tax revenue on June 15 and new extraordinary item cash on June 30, which could cover through the end of July. As such, we see little chance of default even if Congress does not act. But we do believe Congress will act before June 1, making these mechanics less relevant.

What does a debt ceiling deal look like? Congress is negotiating a debt ceiling deal. Progress has been slower than we anticipated, but we expect negotiations to intensify. We expect a two-step process. The first would provide a short-term debt ceiling increase locked in with a topline agreement. The second step would fill in the details of the topline agreement and raise the debt ceiling past the 2024 presidential election. We think the most likely outcome is a cap on discretionary spending, rescinding of unspent COVID funding, and energy-permitting reform. We expect several other items to be added to get a deal, but we don't think work requirements for entitlement programs will pass. This is not a straight line—policymakers may fail before they succeed—but the debate is "how" not "whether" to raise the debt ceiling and that is an important distinction.

What are the investment implications of the debt ceiling? We have argued that the debt ceiling itself is less of an issue than the austerity measures that get included to raise it. In 2011, nearly all of the decline in the S&P 500 happened *after* President Obama and Speaker Boehner reached a deal. This is because austerity levels were much greater than expected and economic growth expectations had to be revised down. Amid the debt ceiling debate, the Treasury is injecting liquidity into financial markets by spending down its general account, which we believe is boosting equity markets. However, under the surface we see nearly identical trends to 2011—defensive winners from the 2011 fight outperforming the losers, Gold rallying, and underperformance from companies levered up to government spending. This trend is important as there is likely more risk to financial markets after the debt ceiling is raised. The U.S. economy is slowing, the liquidity currently being provided will get removed, and there will be new austerity.

How does inflation tie into recession fears? The economy remains imbalanced. If supply cannot come up to meet demand, then demand has to fall to meet supply. Demand falling substantially is another name for recession, and cracks have been appearing on both the supply and demand side of the global economy. Judging by the extreme volatility in U.S. growth, macroeconomic policy has had trouble getting supply and demand to match. We are likely now headed for a considerable period of below-trend growth, as "sticky" inflation takes a bite out of real activity and policy (both fiscal and monetary) reorients.

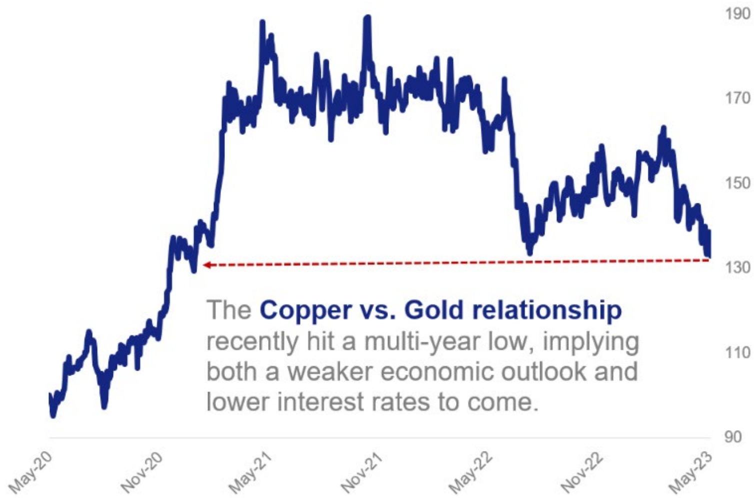
What could make that economic set-up less worrisome? Our question is: What is the actual inflation target? Does "2%" mean exactly 2.0%? The case for managing inflation without entering a recession probably involves declaring victory at 2-point-something. The U.S. CPI inflation rate has averaged 2.8% over the last 40 years. If we can get below 3% and declare victory without destroying existing jobs, then a soft(er) landing is in play. The sub-3% rate would have to be stable enough to keep inflation from popping back up as soon as monetary policy eases.



How low can 10-year Treasury yields go in 2023? If we assume that CPI struggles to dip below 3.0% this year and next year, and the Fed finds that it can only bring the fed funds rate down to about 3.0% in the next recession, then we would expect to see 10-year yields bottom somewhere around 3.25%. There's obviously a lot of wiggle room here, depending on the severity of the next recession. If it's shallow (unemployment rises 1.0%–2.0%) and there are no major adverse credit events, then most of the curve should find a stable home near, but north of, where the fed funds rate is expected to bottom (which right now is about 3.0%). And this level should be reinforcing if we assume inflation and inflation expectations settle in around 3.0%, because breakeven inflation expectations should begin to migrate higher towards 3.0%. If there's a major risk-off event, induced by fear of a credit channel collapse, then a move below 3.0% on the 10-year is easily within play. If the Fed hikes rates from here, a deeper recession becomes more likely—as does the 10-year yield moving down to 3.0%--as long-run inflation expectations would likely stall out below 3.0%.

What's the biggest obstacle to shifting to a more positive view on risk assets? As buoyant as the indices have been, Bank stocks have barely rallied and the broader Financial sector remains in a weak absolute and relative position. With the S&P 500 now seven months off its lows, Bank stocks shouldn't be down—it's unprecedented in 100 years of market history.

Who's right, Big Tech or the Bond market (i.e., the yield curve)? In theory, you could have two very different portfolios and be having an equally good year either way. **Portfolio 1:** own "Big Tech," own luxury goods, own Homebuilders. **Portfolio 2:** sell Banks, sell Small-caps, sell Retail, own Gold, own Bonds. Both are working, but which is right? We're not convinced the market has even made up its mind, but we're curious if credit will ultimately break the tie. There's some modest widening in credit default swaps recently (i.e., rising risk of default), and while it's subtle for now, it bears watching. We suspect that if 10-year yields fell decisively south of 3.30%, it would be a negative macro message as well, particularly with the Copper/Gold ratio already breaking down (see the chart to the right).



What is your base case on the U.S. dollar? To steal a phrase from one of the giants of the investment business, "it's complicated!" We generally lean bearish, but are picking our spots, and still believe "long Gold" is the best way to express dollar skepticism – at least for now.

What's the most bullish input you can come up with? Investor sentiment. We've spent the last few months on the road, and regardless of geography, we find it striking that equity investors are content to park client money in short-term Treasuries rather than going out and searching for longer-term opportunities.

Are there any international equity markets on your radar? Japan is home to some of the best internal trends out there, but investors are not overwhelmingly shifting dollars into that market. It's a supportive contrarian setup, and there's plenty of room for sentiment to get more aggressive toward the region. Conversely, for all the attention investors tend to give Chinese equities, we find it surprising that the annualized return over the last 30 years is just +1% (accompanied by immense volatility).

Where do you stand on your earnings estimates? A look within the S&P 500 shows that there's already been a fair amount of profit margin degradation. The percentage of S&P sub-industries estimated to post positive earnings growth over the next twelve months has fallen dramatically and the downtrend is intact, suggesting weakness is broadening. Consensus growth estimates for 2023 and 2024 have only been reduced modestly, suggesting either: a quicker moderation in inflation (and the repair of global supply chains) coupled with the emergence of durable organic growth drivers is afoot, or a more negative revision to the outlook is ahead of us. Given the environment, we'd side with the latter. We estimate $200 for 2023 S&P 500 EPS and think aggregate profits will decline through mid-2024 before somewhat recovering into year-end, finishing at $187.

How does your economic forecast square with your recommended asset and sector allocations? We remain cautious on the outlook for the economy and markets despite the index being buoyed by the market heavyweights. We continue to recommend clients underweight both Equities and Fixed Income relative to their risk-adjusted benchmark. We have used a small allocation to Commodities and an above-benchmark allocation to Cash (with Gold as a subset) in an attempt to protect our tactical allocation portfolios from the headwinds of inflation and broader economic weakness. Despite some indexes trading near 2023 highs, leadership remains more defensive under the surface and we remain skeptical that the narrow leadership can endure.

From a sector perspective, we remain **Overweight** Energy, Staples, Healthcare, and Materials and **Underweight** Technology, Communications, Discretionary, and Financials.

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