Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

Key Takeaways from Strategas' Different Research Areas

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OVER-ARCHING INVESTMENT THESIS

We maintain our bias toward early-cycle sectors and styles—small over large, Value over Growth, and non-U.S. over U.S. Year-over-year economic and profit growth may have peaked for this cycle, but massive consumer and corporate savings rates, millions of job openings, and the prospects for still-accommodative fiscal and monetary policy—which we don't believe policymakers have a meaningful incentive to change—all make a U.S. recession look unlikely. Higher-than-expected inflation could provide that incentive (even as the term "transitory" is stretched to its limits), but the Fed seems concerned with achieving full employment in the U.S. first and foremost. And while mid-single-digit inflation may not look worrisome compared to the 1970s, we think it would still meaningfully affect earnings multiples and return expectations.

VERTICAL #1: **INVESTMENT STRATEGY**

Base case for our bullish U.S. equity forecast

- Money supply (M2) is growing at roughly +14% y/y; no real signs of Fed tightening monetary policy
- Low 10-year Treasury yields leave few attractive opportunities outside of public and private equities
- S&P 500 earnings are expected to be up +11% in 2022 after a +37% increase in 2021

Major risks to a bullish forecast

- Rising 10-year Treasury yields (due to higher inflation)
- Fiscal spending bill passed through reconciliation leads to tax hikes
- Rising regulatory pressure on the Tech sector
- Some signs that investor expectations for returns are overly optimistic

VERTICAL #2: **ASSET ALLOCATION**

Asset Classes

- **Equities.** Overweight across the globe (with a current preference for Developed International). Value over Growth. Small & Mid-cap over Large & Mega-cap. Sticking with the cyclical trade.
- **Cash/Gold.** Overweight. While tighter Fed policy could result in higher yields and be a headwind for inflation hedges, we don't believe this policy is imminent, nor do we think we're out of the woods on higher inflation expectations.
- **Fixed Income.** Underweight versus a 60/40 portfolio. The return of significant inflation would be detrimental to bonds.

Overweight Sectors

- **Industrials.** Poised to benefit from a weaker Dollar, increased government spending (especially around infrastructure), and the broad economic re-opening.
- **Financials.** Attractive as a short duration sector with high dividend and buyback yields. They are levered to higher Treasury yields and a steeper yield curve. Further, the sector has seen significant outflows over the past few months, allowing historically aggressive sentiment to clear out a bit.
- **Energy.** Stands to benefit from the global economic recovery, as increased demand has created upward momentum in oil prices (which should serve as a tailwind for positive earnings surprises). Limited industry investment in recent years should also be a boon. Finally, a tougher regulatory environment may actually be bullish for energy prices.
- **Materials.** Both the broad sector and commodities are beneficiaries of a structurally weaker US Dollar. Like Energy, demand recovery should be a benefit, while like Financials, recent outflows have cleared some aggressive sentiment.

VERTICAL #3: **TECHNICAL STRATEGY**

- **Frustrating but not fatal.** The last +5% from the S&P has been narrower than the performance off the March 2020 lows (i.e. fewer stocks contributing to index gains) and the "average" stock has been correcting since early-May (i.e. equal-weighted underperforming market-cap weighted). The environment is getting more challenging.

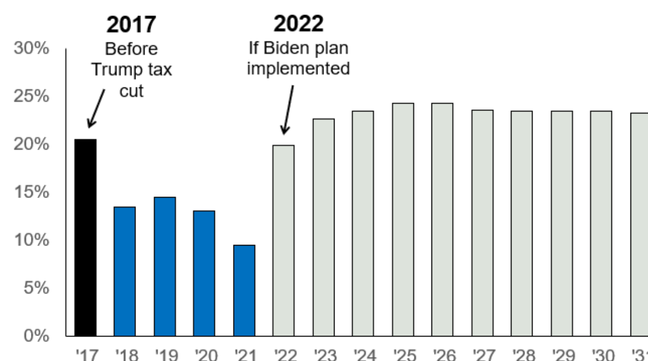
- **Stocks making 3-month lows recently surged** in sectors like Financials, Industrials, Energy, and Materials, while big ETF outflows in Industrials and Financials suggest that overconfident sentiment has been cleared out (a bullish signal).
- **Defensive groups seem unbothered.** In the two distinct phases of 2021—interest rates rising (Jan. through March) and interest rates falling (April through today)—neither traditionally defensive Consumer Staples nor Utilities outperformed (perhaps Technology has taken over the role of "defensive"). Either way, these defensive groups seem unworried by the economic outlook so far.
- **If you got the Covid story correct in early-2020, you likely got the market call wrong.** So on the variants, we don't know the ultimate impact and even if we did, we're not sure how the market will interpret it. Will stocks sell off on a slowing recovery or rally because lower growth keeps the Fed on the sidelines?

VERTICAL #4: **ECONOMICS**

- **No financial crisis.** Pre-pandemic, there were some economic headwinds but the global economy was growing amply. Covid-19 hit confidence in early 2020, and activity plunged by 2Q20. However, central banks acted quickly so there was not a financial crisis on top of a health crisis (as there could have been) and big firms were able to access credit markets.
- **Fiscal policy made up the gap for lower-income positions** (where most of the job loss has been concentrated). If the decade after the '08 Crisis was about embracing aggressive central-bank policy (e.g., quantitative easing), this cycle appears to be about embracing government debt and fiscal spending. Neither the US bond market nor the currency market seem to be objecting so far, but we'll keep an eye on it.
- **Key sectors have adopted remote work quickly** (e.g. finance, tech), and successful vaccines promise a more complete resumption of in-person service activity shortly. As such, U.S. real G.D.P. has retaken pre-pandemic levels in 2Q21. Further, the business cycle should lengthen if recent productivity (output per hour) gains can be continued. There are promising signs on this front, though it is early to make a concrete conclusion as many epicenter industries have yet to resume fulltime activity.
- **Inflation concerns are on the rise** after a disinflationary shock in 2020. The Fed has called inflation "transitory," and that fits with price surges in used cars, airfares, hotels and other "re-open" categories. Temporary supply chain bottlenecks are also contributing to this effect. But rents are starting to rise, and this could yield "stickier" inflation in future months (especially if expectations change). Bottom line: the type of policy tools that have been used to combat deflation could eventually prove inflationary, as the Fed's long-run plan now allows for an overshoot. How long they will let inflation run hot is a key question for investors at this moment.

VERTICAL #5: **WASHINGTON POLICY**

- **More spending and tax hikes are coming.** Following historic Covid-19 stimulus, Congress is turning towards longer-term spending in the areas of physical infrastructure and social spending. We expect this to come in two forms:
  1. A bipartisan infrastructure package with $500-$600bn of new spending.
  2. A Democrats-only package around $2-3T in spending (down from a hoped-for $3.5T) + tax hikes. Our base case is a 25% corporate rate, 18% GILTI rate, 25-28% capital gains/dividend rate, a 39.6% top personal income rate, and changes to the estate tax. The changes will cut 2022 S&P 500 earnings growth down to 5.5%.



- **Fiscal and monetary policy decisions are getting tougher.** During the pandemic, there was an unlimited amount of policy relief, but as the pandemic fades, decisions will become tougher: Congress will need to raise the debt ceiling, the Fed will need to taper asset purchases, and the U.S. is facing a budget deficit reduction of roughly 8% of G.D.P. in 2022 (the largest fiscal contraction since the end of WWII). The looming fiscal cliff is likely manageable with high personal savings and strong job creation, but if the reopening is delayed (or reversed), it will become harder to manage.
- **Increased regulation.** Most of the Biden Administration's early focus has been on pandemic relief. That will shift now that regulators are being seated. We expect to see major new proposals on M&A, tech firms, climate change, and banks.
- **Realignment of U.S. policy with China**. Investors initially saw the Biden Administration as being softer on China than Trump, but the U.S. is now adopting a more hawkish position. Particularly after the pandemic, the U.S. and its allies are less willing to concede to China on contentious issues. At the same time, China is becoming increasingly aggressive geopolitically and economically. This will lead to a further decoupling of the U.S. and China under President Biden.

VERTICAL #6: **FIXED INCOME STRATEGY**

Treasury yield outlook

- **0 to 2 years**. Should remain firmly anchored at or below 0.30% for the remainder of 2021.
- **3, 5, 7 years.** Should find little respite from volatility this year, but eventually move higher.
- **10 to 30 years.** Should ebb and flow with the growth outlook. Ultimately, we see a steeper yield curve (higher long-term rates vs. short-term rates) based on stickier inflation, Fed tapering, etc., but the potential tax hikes will help keep the 10-year Treasury below 2% in 2021. A more hawkish-than-expected Fed would similarly cause the 10-year to inch lower.

Sector outlook

- **Investment-grade (I.G.) corporate credit.** Fairly valued, with a strong near-term free cash flow outlook, profit margins expanding (especially at large-cap firms), and seemingly backstopped by the Federal Reserve.
- **High-yield (H.Y.) credit**. About fairly valued, but more at risk of correction than I.G. in our view. Nonetheless, we anticipate spreads (yield above Treasurys) are likely to remain well-behaved, and H.Y. to resist a major selloff in 2021.
- **USD Emerging market debt.** Relatively cheap compared to most alternatives, though at risk if long-term yields were to jump due to broadly higher durations (i.e.. how long it takes to be repaid by a bond's cash flows) across the sector.
- **CMBS and M.B.S.** Likely to underperform I.G. corporates rest of year due to tight spreads and Fed tapering. Still, both could offer tactical opportunities to return to overweight depending on the evolution of the yield curve and pace of Fed.

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