Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

Key Takeaways from Strategas Research Areas

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OVER-ARCHING INVESTMENT THESIS

Based on the shape of the yield curve, the drop in unemployment claims, and a vast reservoir of personal savings (~$2 trillion), **we believe the odds of a U.S. recession in 2022 are low**. And while a labor shortage, increasing rents, and still-accommodative monetary policy lead us to believe that inflation will be stickier-than-expected, it's important to remember that it is not inflation itself that is most dangerous for financial assets—it's the willingness of central banks to fight inflation (i.e. raise interest rates, perhaps aggressively). Given our concerns about inflation and long-term interest rates, we favor shorter-duration stocks in Value-oriented sectors like Energy, Materials, and Financials. We are also maintaining our bias to small over large and non-U.S. over U.S. markets.

VERTICAL #1: INVESTMENT STRATEGY

Base case for our bullish U.S. equity forecast

- While Fed tapering is imminent, real tightening seems unlikely before 2H22 at the earliest
- The S&P 500 earnings yield (EPS / stock price) is still well-above the 10-year Treasury yield
- Equities are natural hedges to inflationary pressures
- S&P 500 earnings are expected to be up +8% in 2022 after a +49% increase in 2021

Major risks to a bullish forecast

- Higher input costs (e.g. labor, commodities) may negatively impact profit margins and slow growth
- Higher inflation readings and tapering could lead to unexpectedly large jumps in long-term rates
- Rising regulatory pressure on the Tech sector
- China's growth is slowing while its foreign policy is becoming increasingly hostile

VERTICAL #2: ASSET ALLOCATION

Asset Classes

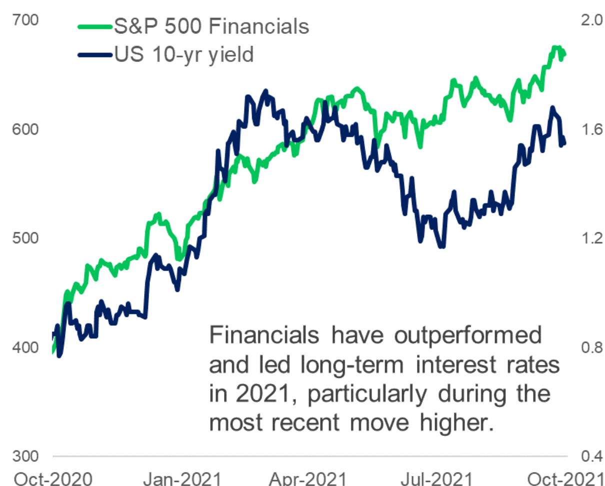
- **Equities.** Overweight (though less so since September), with a preference for Developed International, Value over Growth, and Small & Mid-cap over Large-cap. Remaining constructive on the cyclical trade.
- **Cash/Gold.** Overweight. Fed policy could be a headwind for inflation hedges (e.g. Gold), but we don't believe tightening is imminent, nor do we think higher inflation expectations will recede.
- **Fixed Income.** Very underweight vs. a 60/40 portfolio. Continued inflationary pressure will be detrimental to bonds.

Overweight Sectors

- **Industrials.** Poised to benefit from a weaker US dollar and economic reopening. Biden's infrastructure plan ostensibly a multi-year tailwind, but we remain wary of tax increases / fiscal drag.
- **Financials.** Have shown broad-based price momentum and relative leadership. Attractive as a short duration sector with high dividend and buyback yields. Rising interest rates also supportive (though flattening yield curve could be a risk).
- **Energy.** Economic recovery and increased demand + limited industry investment in recent years + proposed environmental constraints moving forward = upward price dislocation for crude oil and Energy more broadly.
- **Materials.** A beneficiary of consistently weaker US dollar. Revamped auto investment, China's economic pivot, and domestic infrastructure spending should all contribute to structural demand for commodities.
- **Consumer Discretionary.** Tailwinds are strong consumption/consumer trends, broad price momentum (particularly travel/leisure), re-emerging cyclicality, and global growth prospects.

VERTICAL #3: **TECHNICAL STRATEGY**

- **Growth scare well-known.** We suspect the growth scare of the last six months is either over, ending, or so well-known at this point that the impact on markets is sufficiently priced in.
- **Shifting positioning.** Flows into Growth/Tech are aggressive while flows into cyclicality are restrained (a reversal of early-2021). Changing: Positioning on US dollar (very short to very long) and Copper (very long to less so). Positioning is a contrarian indicator for us.
- **Financials are leadership.** Even as yields fell all summer, Financials held up. Now, with rates punching higher again, the Financial sector has reasserted itself as leadership (while Staples and Utilities have offered no hint of relative outperformance all year regardless of rate backdrop).
- **Credit conditions benign,** despite barrage of headline risk (inflation, China, Washington, etc.).



- **Sector performance leaning cyclical.** Energy is having its best calendar year performance in ~40 years. Financials are not far behind. Transportation, travel, and pharma also showing momentum.

VERTICAL #4: **ECONOMICS**

- **Inflation concerns sticking.** The Fed has called inflation transitory, which fits with price surges in used cars, airfares, hotels and other "re-open" categories. Central bankers have trained themselves to look through supply shocks. But rents are starting to rise and this could yield stickier inflation in the months ahead (if expectations stay elevated. The policy tools used to combat deflation could eventually be inflationary, as the Fed's long-run plan now allows for an overshoot of its 2% target rate. We're also watching energy prices closely this winter.
- **Fiscal policy in focus.** Central banks acted quickly over the past 18 months, avoiding adding a financial crisis to the lockdown by dusting off and expanding 2008's monetary policy tools. Big businesses were able to access credit markets and fiscal policy made up the gap for lower-income positions (i.e., where most of the U.S. job loss has been). If last cycle was about embracing central-bank balance sheet expansion, this cycle appears to be about embracing government debt. As we have noted, neither the bond market nor the currency market seem to be objecting much in the U.S. thus far.
- **Covid-19 still a risk.** COVID-19 hit confidence early last year and activity plunged in the second quarter. Lockdowns in some countries controlled the virus temporarily but variants have made global zero-Covid unlikely. In 2021, Q3 data showed the hit from the Delta variant.

- **But pandemic-necessary productivity looks promising.** Several models showing potential for sustained upticks in productivity (output per hour worked), though it is early to make any concrete conclusions. This would be very important, as enhanced productivity can lengthen a business cycle, juicing economic growth without stoking inflationary pressures. Key sectors (Finance, Tech, Healthcare) have adopted remote work quickly, and other efficiency gains (automation, e-commerce, etc.) look sticky.

VERTICAL #5: **WASHINGTON POLICY**

- **The range of outcomes is narrowing.** Momentum is building among Democrats to have a vote on the bipartisan infrastructure plan and an agreed-upon reconciliation framework. House progressives could push back the vote on the bipartisan bill, but a deal is likely. To date, stocks levered to negotiations have not priced in the proposed changes. But in 2017, tax reform did not price into the market until the House passed the bill. That playbook appears to be playing out this time as well.
- **Tax headwinds likely easing.** The new spending plan has a much less onerous tax framework. It doesn't increase the corporate tax rate and reduces other previously proposed hikes, limiting the impact on 2022 earnings. Proposed increases to the individual, capital gains, dividend and estate tax rates are scuttled in favor of surcharge taxes on extremely high earners.
- **Climate and healthcare the big winners.** Biden's framework proposes over $550 billion of spending on climate and spending increases for Medicaid and Obamacare subsidies. Very little prescription drug changes were made.
- **More dovish Fed in 2022 likely**. Biden's Fed Chair selection should come any day now. We've noted the correlation over the past three months of Powell's odds of reappointment and a flattening yield curve, as well as the outperformance of Growth stocks as Powell's odds rise. We take this to mean that the Fed in 2022 will be less focused on inflation relative to employment. The recent flattening of the yield curve could be the market pricing in another term for Powell.

VERTICAL #6: **FIXED INCOME STRATEGY**

Treasury Outlook

- **0 to 2 years**. Rising aggressively as market pulls forward expectations for first rate hike. We expect to see the Fed push back against this mantra, which would, if successful, bring 2-yr yields back down below 0.40% by end of the year.
- **3, 5, 7 years.** Expect volatility, as the market will find little certainty about the terminal Fed funds rate in the next few months, irrespective of the timing of initial liftoff. We ultimately expect rates to move higher from here into year-end.
- **10 to 30 years.** Should continue meander, with very little uptrend to match the path of inflation. Eventually, tapering will reduce the pace of Treasury purchases faster than supply drops, and the inertia towards higher yields could accelerate, but that may not be until winter of 2022.

Sector Outlook

- **Investment-grade corporate credit.** Fairly valued. The sector enjoys multiple backstops ranging from a large equity cushion for troubled issuers, strong free cash flow in 2021 and 2022, low interest rates, and a Fed that is expected to step back in if cracks appear. The largest risk to corporates is a surge higher in medium and long-term borrowing costs.
- **High-yield credit.** Fairly valued, but at higher risk of correction. Any squeeze on profit margins at the most levered firms should lead to a rise in distress in 2022, and wages + rising borrowing costs could be a trigger for margin compression.
- **USD Emerging market debt.** Relatively cheap, though greater duration increases curve-steepening risk.
- **CMBS and MBS.** Likely to underperform corporates rest of year due to tight spreads and Fed tapering. In MBS, we remain neutral on the view that a coming seasonal and cyclical shrinking of supply will offset the reduction in Fed purchases, and will likely lead to one more move lower in spread before tapering begins to take its toll in early 2022.

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