JUNE 2022

STRATEGAS insight

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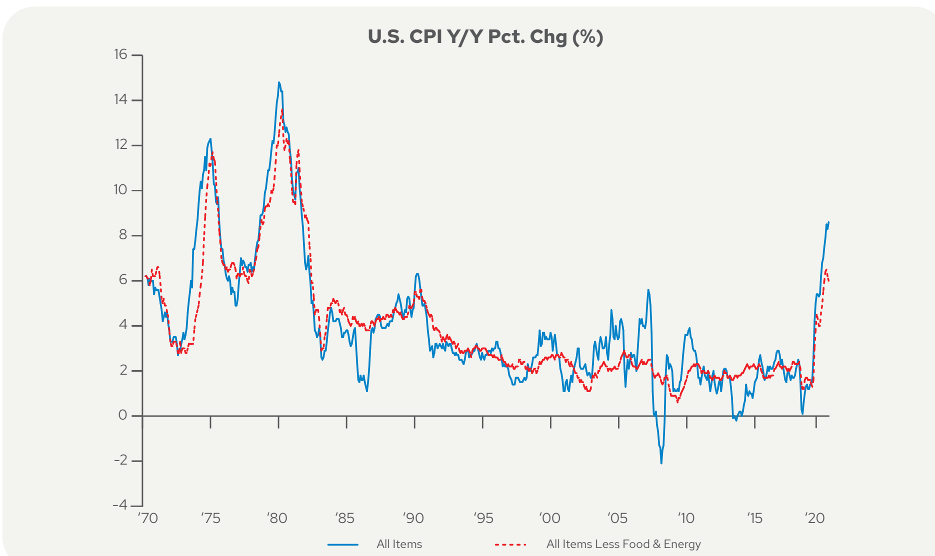
When Will It End?

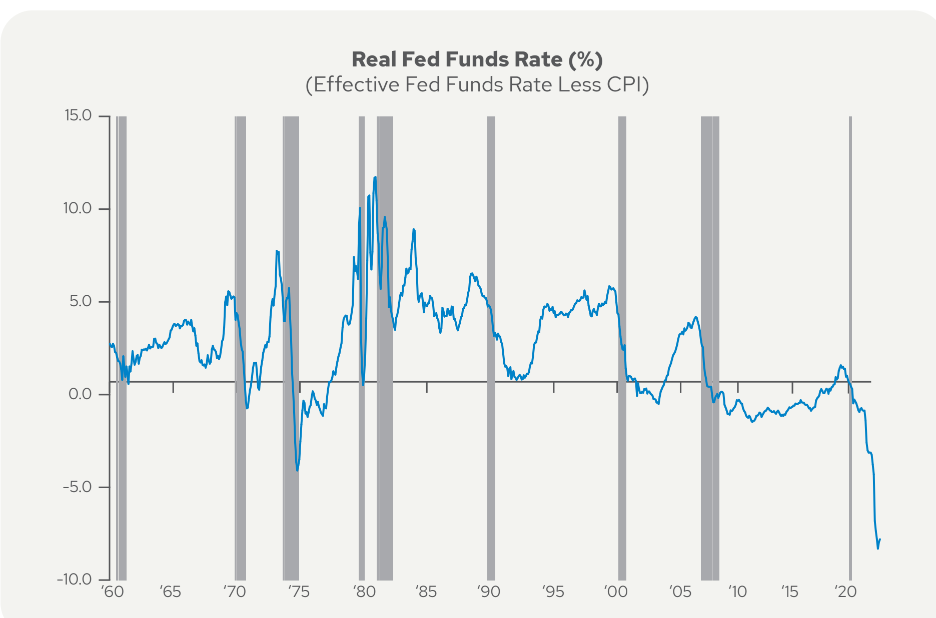
One surprising element of client positioning, given the heightened volatility that has marked the first half of the year, is the durability of optimism harbored for equities in general and for growth stocks in particular. Flows into equity and bond market mutual funds and ETFs indicate that old habits die hard. Consider that flows into the Ark Innovation ETF, which is down roughly 60% YTD, have exceeded flows into the entire Energy sector, which is up roughly 60% YTD. Residual strength in the labor market (i.e., 3.6% unemployment, 11.4 million job openings) and elevated consumer cash (~$2 trillion in accumulated savings from previous fiscal transfers) admittedly suggest that though growth is weakening, the economy has sufficient support to experience a "soft landing." We are not so sure. Few investors appear to have accepted either the pervasiveness of inflation or the policy application likely required to corral it. Even in the wake of the Federal Reserve's jump to a more aggressive tightening regime—resulting in further equity market drawdowns—a certain sense of complacency remains among our clients that this all will be over soon. We would offer that bottoming, particularly given the severity of current inflationary pressures, a battery of pandemic-related dislocations, and geopolitical uncertainty, remains a process.



By our lights, we see enough concerning signposts to ask whether the US economy is close to recession. Just in recent days we have seen: a new low in the University of Michigan's measure of consumer sentiment; falling vehicle sales; the inversion of the 2YR/10YR Treasury yield curve; the continued decline of M2; and another decline in mortgage applications, etc. After a weaker-than-expected Q12022, US real GDP is tracking in barely positive territory for Q22022. We have lowered our forecast for US real GDP growth in Q22022 to 1.0% Q/Q AR based on this package of weaker data.

So why the disconnect? Why has the Fed taken a harder line to curb inflation while investors continue to anticipate a soft landing for the economy and a faster rebound in the equity market? For investors, it may simply be, as Strategas' chief strategist, Jason Trennert, has suggested, that nearly fourteen years of quantitative easing has robbed market participants of sufficient institutional memory to remember that V-shaped outcomes are not the norm following periods of financial dislocation. At the same time, and due in no small part to pandemic-related supply constraints, the economy is weakening without the cycle-resetting flush that historically has accompanied job loss and severe cuts to industrial production. If one believes—as we do—that time is an important element in curbing inflation, even if we were to evidence a "jobs-plentiful recession" in 2022, the Fed knows, as Strategas chief economist, Don Rissmiller, has posited, it likely will need to do more to curb elevated inflation. So, despite a slowing economy, if unemployment does not increase, employers are likely to see continued upward pressure on wages. Thus today's growth slowdown may not be sufficient to remove mounting inflationary pressure. To the extent monetary policy acts with a lag, Don wonders whether we are setting up for twin recessions, like the early-1980s paradigm... the last time we faced the wretched scrooge of inflation.

Though recent selling pressure has become increasingly indiscriminate, capitulation remains a process. When will this end? In our view, investors need to emotionally level set expectations for the trajectory of economic growth with their proclivity for a growth-driven, V-shaped market reaction recovery. Both trailing and forward earnings multiples are, in our opinion, too high relative to previous major market bottoms. Somewhat more disconcerting is that the entirety of the decline in the major indices has been due to multiple compression rather than downward earnings revisions. The current weakness in productivity will drive up unit labor costs and put downward pressure on margins. Further realignment of risk asset prices and their underlying fundamentals



would seem in order. The inverse relationship between inflation and earnings multiples is clear and robust. Strategas's own econometric model suggests that the forward P/E ratio on the S&P 500 Index should be closer to 15x. It is currently around 17x. History suggests bear markets have bottomed with multiples near 12x. Ultimately, inflation expectations will need to be anchored. If supply cannot rise to meet demand, then demand must fall. Numerous central banks (including the Fed) are likely to raise interest rates until they are confident longer-term inflation expectations are stable, even in the face of data indicating a cyclical slowdown. Theoretically, it is difficult to get control of inflation until the federal funds rate is above the inflation rate.

We remain neutral equities (60% in our 60/40 benchmark allocation portfolio), a position we established several months ago after carrying a material overweight during much of the post-pandemic rally in stocks. Though it is always possible for a strong countertrend rally to metathesize, we would be more inclined to sell into any that develop in the near term, and would position in the comfort of higher-quality and more defensive shares for the intermediate term. Within equities, however, our portfolio construction since Q42021 has tilted increasingly toward US domestic shares, particularly large cap value with targeted neutral-to-underweight allocations to large cap growth, large cap core, developed international, and emerging markets. We see too many unresolved issues to elicit a true shift in momentum. Thematically, we remain positioned in four areas: "*Inflation for Longer,*" "*Quantitative Tightening,*" "*Cyclical Defensives,*" and "*De-Globalization.*"

Last month (May 2022) we increased our broad allocation to fixed income by 200 basis points, to 32% from 30%, by deploying some of our cash (we retain a 6% position in cash & equivalents, of which 4% is in gold). Although we remain tactically below benchmark within fixed income, we continue to add duration to our portfolio via U.S. Treasurys and long duration investment grade corporates as we close the gap between our core fixed income holdings and the benchmark. We have now more than doubled our allocation to Treasurys from the start of the year, and are within a quarter of a year short duration (and inclined to close that gap completely on any further rise in Treasury yields). We remain hesitant to establish long duration positioning at this point, however, fearing that yields are still, at least, ~20-30 bps away from peak for this cycle. We are funding this duration increase by exiting our allocation to bank loans, with the view that spread and credit risk are now a greater threat to our portfolio than interest rate duration risk. As we did last month, we are further reducing our allocation to short duration investment grade corporates. In both cases, these two sectors have been the outperformers on the year, and could still have another month or more of strong relative performance, but we would rather be early to take profit than late.

Strategas Recommended Asset Allocation Jun'22

	Equities	Bonds
Overweight	US LC Value US MC Value US SC Core	IG Corporates
Neutral	Dev AC Core US LC Growth EM AC Core US MC Growth	Agencies ABS/CMBS US Dollar EMD
Underweight	US LC Core US MC Core	US MBS U.S. Treasuries Bank Loans

As speculative unwind persists, the opportunity rises for reallocating portfolios back toward an emphasis on fundamentals and thematic momentum. Tactical adjustments to long-term portfolio goals can enhance returns as the disequilibrium in the economy corrects. Stay focused.

About Strategas

Strategas is a global institutional brokerage and advisory firm. The Firm provides macro research, capital market and corporate advisory services, and investment management solutions to institutional investors and corporate executives in more than twenty countries around the world.

Founded in 2006 by Jason DeSena Trennert, Nicholas Bohnsack, and Don Rissmiller, the Firm was acquired by Baird Financial Group in 2018. Strategas operates independently as a wholly-owned subsidiary of Baird and offers institutional securities services through Strategas Securities, LLC, a broker-dealer, and investment management solutions, including this commentary, through Strategas Asset Management, LLC, a registered investment advisor.

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For more information, please visit www.envestnet.com, subscribe to our blog, and follow us on Twitter (@ENVintel) and LinkedIn.

Index Overview & Key Definitions

Fed, The Fed or FED refers to the Federal Reserve System, the central bank of the United States. Fed Funds Rate, the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The Gross Domestic Product (GDP) rate is a measurement of the output of goods and services produced by labor and property located in the United States. Real Gross Domestic Product (GDP) is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year. Nominal Gross Domestic Product is gross domestic product (GDP) evaluated at current market prices. The S&P 500 Index is an unmanaged index comprised of 500 widely held securities considered to be representative of the stock market in general. The Russell 1000 Index is a market capitalization weighted benchmark index made up of the 1000 largest U.S. companies in the Russell 3000 Index. The Russell 2000 Index is an unmanaged index considered representative of small-cap stocks. The PCE (Personal Consumption Expenditure) Index of Prices is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data including U.S. Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures; essentially a measure of goods and services targeted towards individuals and consumed by individuals. The Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services. FAANG is an acronym for the five of the market's most popular tech stocks, namely Facebook, Apple, Amazon, Netflix and Alphabet's Google. The North American Free Trade Agreement (NAFTA) is an agreement signed by Canada, Mexico, and the United States, creating a trilateral trade bloc in North America. The Seasonally Adjusted Annual Rate (SAAR) is a rate that is adjusted to take into account typical seasonal fluctuations in data and is expressed as an annual total. SAARs are used for data affected by seasonality, when it could be misleading to directly compare different times of the year. The Atlanta Fed GDPNow forecasting model provides a "nowcast" of the official estimate prior to its release by estimating GDP growth using a methodology similar to the one used by the U.S. Bureau of Economic Analysis. GDPNow is not an official forecast of the Atlanta Fed. Rather, it is best viewed as a running estimate of real GDP growth based on available data for the current measured quarter.

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