STRATEGAS

insight

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Rip or R.I.P.?

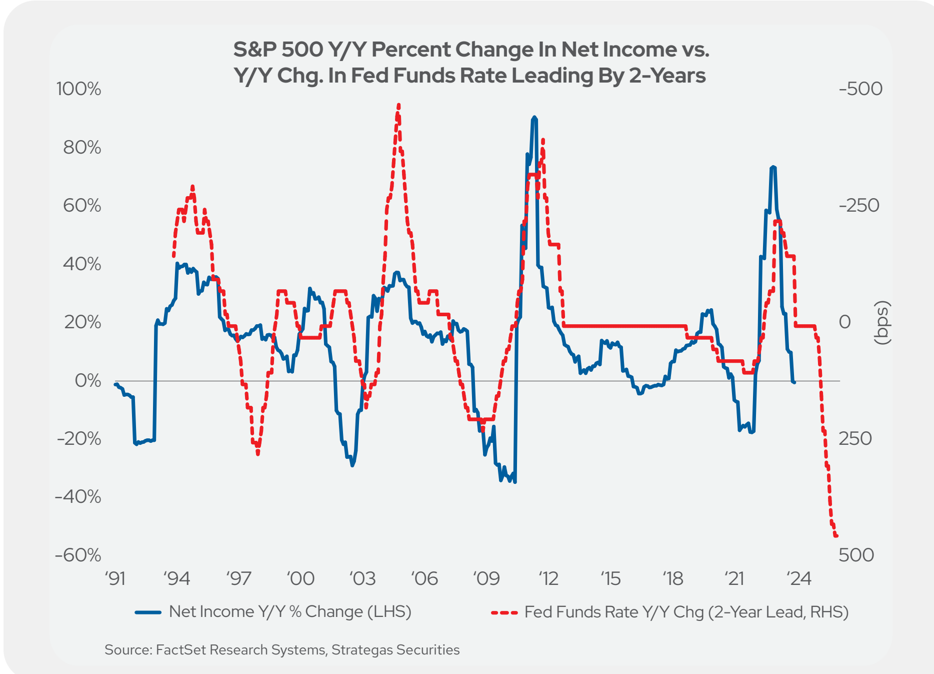
Annual S&P 500 Contribution of 10 Largest Weights During Positive Performance Years		
Year	Top 10 as % of Total	S&P 500 % Perf.
2023 YTD	**95.6%**	**9.2%**
2007	78.7%	3.5%
2020	58.9%	16.3%
1999	54.5%	19.5%
2021	45.0%	26.9%
1998	36.8%	26.7%
1996	33.9%	20.3%
2017	33.3%	19.4%
2019	32.8%	28.9%
1991	28.6%	26.3%
2006	27.6%	13.6%
2016	26.6%	9.5%
2003	23.6%	26.4%
1995	22.3%	34.1%
2014	22.2%	11.4%
2004	21.1%	9.0%
2005	20.5%	3.0%
2010	19.6%	12.8%
2012	19.2%	13.4%
1997	19.1%	31.0%
2013	17.6%	29.6%
2009	15.5%	23.5%
1992	14.9%	4.5%
1993	12.2%	7.1%

Source: Strategas Securities & Bloomberg, 5/22/2023

The major equity indexes have largely traded sideways for the better part of two years. The S&P 500 stood at ~4,200 at the end of May 2021. It closed May 2022 at ~4,160, off roughly -1% from the year earlier, and trades at ~4,150 as May 2023 draws to a close. There has been some action in between, of course, but mathematically the market's performance has demonstrably been fueled by a narrow clutch of mega-cap bellwethers i.e., FANG & friends. Year-to-date, the ten largest stocks in the S&P have accounted for more than 95% of the Index's +9.5% return! That blows away the second most concentrated contribution of the top ten (2007 at 79%). Interestingly, the FANG-led Nasdaq Composite is also flat Y/Y and down -8% from May'21. This market profile is frustrating for most investors. When the market thins out, the allure to double down on winners can be difficult to resist.

To travel, as we do, is to hear it from clients on both sides of the argument and across geographies, mandates, and styles. Optimists build a case in support of a new, already-underway, durable bull phase... The "**ready to rip**" camp has been supported off the Oct 2022 lows by the resilience of labor and the abundant availability of liquidity. Pessimists continue to lay in wait for the onset of recession... perhaps the most anticipated in a generation. Continued weakness in corporate earnings coupled with the sharp back-up in interest rates have underpinned the "**rest in peace**" thesis just as long, if not longer. Though optimistic at heart, we defer to unbiased measures when drawing investment conclusions. In this regard, we continue to turn to the same scaffolding on which we have relied the last several years to assess the durability of any economic green shoots and concomitant market moves: 1) has the level of inflation and the volatility of inflation expectations been arrested back to a level acceptable to both policymakers and investors; 2) are valuations commensurate with the probability-adjusted outlook for earnings and interest rates; and, 3) have capital allocators been induced by the return prospects and durability of emerging organic drivers of growth?

In some respects, recent developments have been positive across all three points of observation; in other respects, less so. This is the genesis of investors' frustration. Most notably, the Y/Y rates of change in most broad measures of inflation are now well off their cycle peak. Good news. Still worrisome, however, is the stubbornly high – and decidedly *not* transitory – rates of change still evident in "stickier" price elements



e.g., wages and rents. Moreover, Fed chair Jay Powell seems intent on wrestling inflation all the way back to the FOMC's stated long-run target of 2% (despite increasing acceptance among business operators and consumers that inflation will, going forward, be higher than it has been in the last decade). The "cost" to the economy to extract that result (i.e., 2% Y/Y CPI) is, by our lights, not linear and would likely have an outsized and negative effect on the operating conditions and growth prospects for many industries. Though corporate profits have bettered expectations in each of the last two quarters (4Q'22 and 1Q'23) those expectations have been lowered materially since aggregate corporate profits peaked in 3Q'22.

More concerning is the contraction of profit margins and the decline in the participation rate (the pct. of companies expressing positive Y/Y growth in earnings). Despite these results, the consensus still lamps corporate profits to increase more than +10% Y/Y in CY'24 vs. CY'23. If the participation rate increases and corporate operators can produce the expected levels of profit growth, stocks will still be expensive relative to prevailing valuations at historically similar periods, but the directional re-acceleration would likely pull the market clearly in favor of the bullish case. If follow through is – *as we suspect* ¬– less than desired. Stocks may have a fair amount of price to give back.

Pursuant to organic drivers of growth, while the commercial applications and use are still being formed, the vocal championing of, productivity-enhancing investments in and, commercial roll-out of applications for, artificial intelligence (or "AI") appears to have all the makings of a durable, long-term trend. Is AI enough to pull this economy out of its malaise? We are watching it closely but remain unconvinced as to the power this new pocket has in the near-to-intermediate-term to offset the cost of global economic disequilibrium and the growing list of deterioration we see developing domestically. The leading indicators of economic activity keep us worried. We remain cautious on the prospects for the economy and the capital markets and, as we have written in these pages in the past, "comfortable wrong" on our base case vs. the increasingly narrow performance profile of the equity markets. From a portfolio perspective we believe tactical shifts toward an increasingly defensive position are prudent to best inoculate capital from the weaker macro conditions. With this writing we are reducing exposure to both U.S. Small-Cap Core and Emerging Markets. The rolling regional bank crisis and unrealized recovery in Chinese economic growth support a reduction in these beta exposures. We have increased exposure to U.S. Large and Mid-Cap Value and International Developed Markets in proportion. Within Equities we maintain above-benchmark allocations to International equities vs. Domestic, Value vs. Growth and Large vs. Small.

Strategas Recommended Asset Allocation May'23

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

Source: Strategas Securities

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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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.

Disclosures

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