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STRATEGAS

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Better to Be an Hour Too Early Than a Minute Too Late

Well, that escalated quickly. The sleepy dog days of summer have given way to a bit of autumn drama in the bond market. US yields have gapped a full 20 basis points higher in the three weeks ending October 9 to take the prevailing rate on the 10-year Treasury to near 3.20% for the first time since 2011. Despite this, in a historical context, yields are far from demonstrably punitive levels. It is likely that the greater cause for investors' concern rests in *how* yields notched up to current levels—quickly—and, given the Federal Reserve's (the Fed) proclivity to normalize the cost of capital, the likelihood that rates will become less supportive sooner than anticipated. In a survey of the attendees at Strategas' fifth annual invitation-only Investment Forum at Tucker's Point, Bermuda over the Columbus Day weekend, the assembled investors predicted rates will climb a further 30 basis points to 3.55% over the next 12 months. That would seem tough to achieve without putting a serious stitch in the stock market's stride.

In that light, it is worth considering the current move in rates in context with the equity market's response. In fact, as of the close last Tuesday, October 9, the S&P 500 Index had 74 consecutive trading sessions since it last notched a move of more than 1%, up or down. This time around, equity markets remained relatively nonplussed to begin with. Although the market opened October on a moderately softer note, it was not until last Wednesday, October 10, that equities began to unpack the extent of the change in tone underpinning the market. And it did so in dramatic fashion, with the Dow plummeting 831 points, a decline of more than 3%, and the NASDAQ off more than 4%. This dramatic price action stands in sharp contrast to the move in equities last February, when yields on the 10-year Treasury Note backed up roughly 40 basis points, and stocks plummeted by 10% almost immediately from levels to which they

Strategas Recommended Asset Allocation

	Equities	Bonds
Bullish	Developed All-Cap Core	Corporates
	US Large-Cap Value	Local Currency EMD
	Emerging All-Cap Core	US Dollar EMD
	US Mid-Cap Value	
	US Mid-Cap Growth	
	US Mid-Cap Core	
	US Small-Cap Core	
Neutral	US Large-Cap Growth	Agencies
	US Large-Cap Core	US High Yield
Bearish	US Large-Cap Growth	US Mortgage-Backed Securities (MBS)
		US Treasuries
		Asset-Backed Securities/Commercial MBS
		Convertibles
		Bank Loans

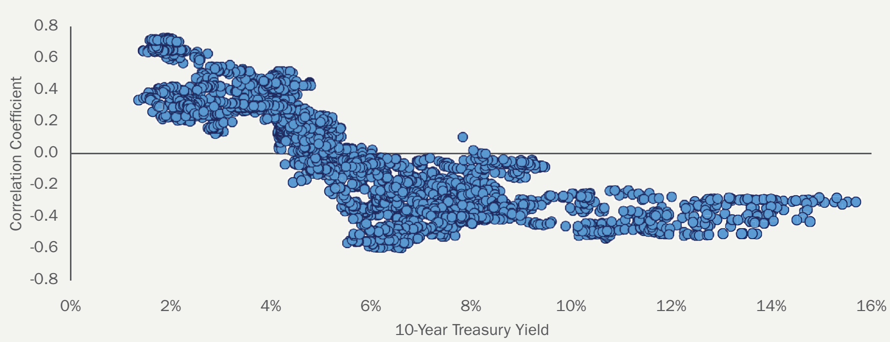
did not recover until late-summer (August 24). The dichotomy in the equity market's reaction to volatility in the bond market underscores two important considerations for investors going forward that did not appear to exist last spring.

1. The economy is on strong footing and remains primed to "outperform" the equity market, but investors' attention is adjusting to the nominal contours of growth and prices. This supports the case for active management and highlights the beginning of a shift from an environment favoring growth stocks to one which should favor value; and,

2. The impact of continued uncertainty on the policy front: 1) **Trade** tensions have eased in North America with the passage of the USMCA (the "new" NAFTA) and with Europe, where Trump Administration officials are now engaged in broad discussion, but continue to escalate with China; 2) Fed Chair Jay Powell has reiterated a pragmatic approach to **monetary** policy, suggesting policy remains significantly enough below neutral as to introduce an element of risk in owning long-duration assets; and 3) ratcheting political tensions have further energized Democrat and Republican voters, drawing the midterm election outcome into a coin-flip and, in turn, placing a question market on **tax** and **regulatory** policy—seemingly settled by the 2016 election.

October is often associated with choppiness in the markets, and 2018's October is certainly holding true to form. It can be difficult to keep the longer-term objectives of investing in mind when the market is providing sufficient daily distraction, but it is all the more important to do so. The US and global economies remain on firm footing and likely are shifting toward the stronger nominal growth regime typically associated with the slowing expansion phase of the business cycle. The presentation of full employment, modestly higher inflation, and strength in corporate profits has provided sufficient cover for the Fed to push forward with its plans to normalize interest rate policy over the intermediate term (next 12 months). That is OK. There is little to support the case that the economy requires a continuation of accommodative monetary policy. Although a moderate *tightening* of financial conditions runs counter to the Fed's longstanding post-financial crisis policy position (and will clearly require market participants to adjust), a full reckoning is unlikely to occur overnight. Indeed, it is difficult to qualify current monetary policy as restrictive—yet. But, given the contours of a changing market risk profile, investors would do well to recognize the opportunity to reallocate portfolios to take advantage of a late-cycle growth framework.

10 Year Treasury Yield vs. Correlation: Weekly S&P Returns & 10-Yr. Yield Movements (Data from 1964 to Current)

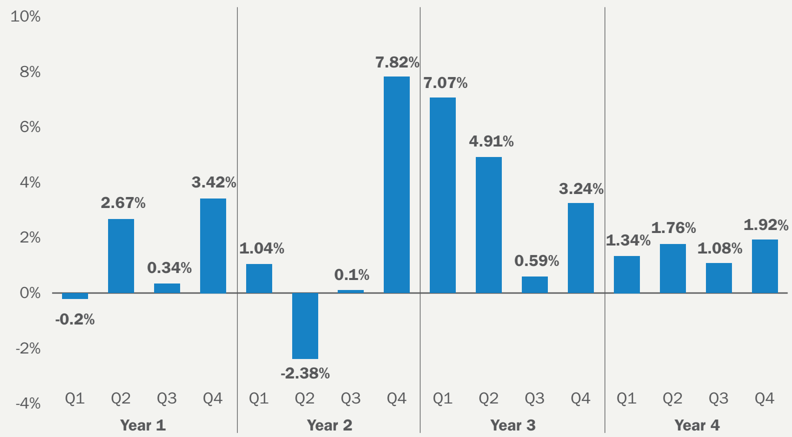


Source: Bloomberg, Standard & Poor's, Strategas Securities, LLC

Whereas Chairman Powell's press conference following the September Federal Open Market Committee (FOMC) meeting was likely the first substantive nonbullish data point the market has had to digest (suggesting the business cycle is shifting into its later stages), the next batch of substantive data may not be met with as much blowback. By all lights, corporate results for Q3 2018 and guidance for Q4 2018 underscore not just the current strength in the economy, but the C-suite's outlook for continued strength. This outlook is echoed in several recent robust business confidence survey readings. We are mindful—as we wrote last month—of the negative anniversary effect awaiting current year 2019 year-over-year earnings growth calculus. But the pace of growth in corporate sales and earnings before interest and taxes (EBIT) continues to exceed the pace of nominal gross domestic product (GDP) growth. If we must watch only one data set in the aggregate, we would focus on *profit margin* to reveal the impact of higher operating costs on the bottom line.

As Q3 earnings season draws to a close in November, the market also will see resolution on the direction of US politics for the two-year term beginning in January. Strategas' Washington team, led by Dan Clifton, believes investors are underpricing the possibility of an election sweep: The possibility of Republicans maintaining majorities in both the House and Senate is becoming as likely as Democrats wresting control of both chambers. Both of these are out-of-consensus outcomes. As it stands now, the equity market is pricing in political gridlock, with the highest probability assigned to the GOP retaining power in the Senate and Democrats picking up the necessary seats to take over the House of Representatives. But the outlook is shifting. Irrespective of one's political views, the Kavanagh confirmation hearings have galvanized the political right and left. Somewhat interestingly, Democrats' support among woman voters has fallen notably in recent polls (a Quinnipiac survey of Democrats' net lead to Republicans with "white woman voters" has fallen from 14% in July to 5% in September to 1% in October; and a Marist poll of Democrats' lead with "suburban woman" has fallen from 35 in early September to 14 in early October). Will this continue or prove temporary? We will not have to wait long: Election Day is November 6.

Quarterly S&P 500 Price Returns By Presidential Cycle (1950 – 2017)



Source: Standard & Poor's, Strategas Securities, LLC

Also worth highlighting, the midterm election historically has been an important inflection point for the equity market. In fact, since 1946, the S&P 500 Index has not fallen in the 12 months following a midterm election—17 consecutive election cycles. This includes 1986, in which 11-½ months after Election Day the S&P 500 Index fell more than 20% in a single day, on October 19, 1987. Further, stocks have historically been down 2.3% in the April-September period during the second year of a presidential term, but subsequently have rallied 15% on average in the six months beginning in October of that year.

Advisor Takeaway:

We are in the early innings of a shift from a liquidity-driven to a fundamental-driven market. Ongoing trade tensions, coupled with monetary policy and the implications of the midterm elections on tax and regulatory policy, have added uncertainty. However, advisors can remind clients that the US and global economies are on firm footing, and market dislocations are the natural progression of a slowing expansion phase of the business cycle. It is worth revisiting clients' allocation across assets and consider repositioning to take advantage of the late-cycle growth framework. The strong economy bolsters the case for active management and a switch from growth to value equities. Always better to be among the responsible few continuously challenging their assumptions than to be caught off-sides and looking to make up ground.

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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 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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