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STRATEGAS

insight

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The Path Forward: Simple, But Not Easy

Investors thought the patience they showed as the market ratcheted back for six, low-volatility, FAANG-led months (from the February sell-off to fresh, all-time highs in August) deserved to be rewarded, with an uneventful upward move into year-end. *Or, at least they should be granted absolution from another sharp, confidence-rattling, broad market sell-off.* Instead, along came another *classic* October to test their mettle. Disheartening. Just like that, the market has evidenced its second 10% correction in as many months—and, it may not be finished yet. Wait. *It*? No, in the same way Anthony Edward's iconic Goose character admonishes Tom Cruise's Maverick in the 1986 action movie Top Gun, this is a function of *we*.

We put this market in its seat. We sold this market hard because we were told to. We saw the writing on the wall. Chairman Powell of the Federal Reserve (the Fed) suggested that monetary policy is not yet at a rate the Federal Open Market Committee (FOMC) considers neutral, and that it remains the Committee's intention to raise interest rates throughout 2019 and into 2020. Sell. President Trump suggested that if he and President Xi do not come to an accord on intellectual property theft and how to close the US-Sino trade deficit, then the U.S. Trade Representative will expand the list of Chinese goods on which we levy import tariffs by an additional $257 billion. Sell. In a short, albeit acutely polarizing, few months, investors have pivoted from discounting the opportunity multiple of a roughly $1 trillion fiscal package. Now they are hedging the probability that House Democrats, after reclaiming the Speaker's gavel, will move to claw back pieces of the tax cut by leveraging the debt ceiling next spring (April–May 2019). Sell. As we noted in July's *Insight*, "Assessing the Four Horsemen of the Economy," the principal levers with which policymakers manipulate the economy—fiscal, monetary, trade, and regulatory—all could be categorized

Strategas Asset Class Views

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

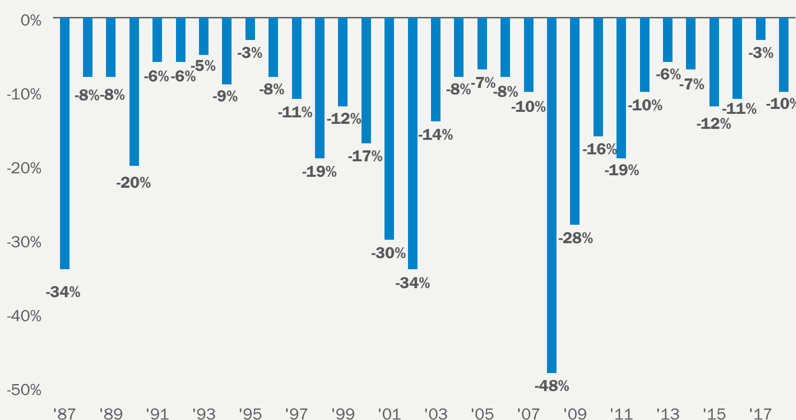
as supportive. Four months later, only the regulatory environment remains universally viewed as vertically accommodative.

Therefore, it is worth highlighting the dramatic shift in the election landscape over the past three months. The probability assigned to a Democratic "blue wave" has moved notably lower, as Republicans have evidenced sharp improvement in three key drivers of election success: money, message, and mobilization. To be clear, Democrats had, and still have, the "three Ms," but the GOP has narrowed the gap considerably since midsummer. Strategas' Washington team suggests that a very real likelihood exists for either party to end up with a majority in **both** chambers on Tuesday, November 6. Said another way, the consensus view is for Republicans to retain their majority in the Senate while Democrats pick up the House. We think the market is looking too far past the potential that Republicans actually maintain control of both the House *and* Congress. Foregoing the social implications of any outcome—GOP sweep, Democratic sweep, or the consensus split—the corresponding impacts on fiscal policy are worth highlighting. A Republican sweep would ostensibly leave the tax cuts—the party's signature legislative achievement—in place through at least 2021. But the Democrats' victory in the House, irrespective of their success in the upper chamber, increases the potential—even likelihood—that they will look to reverse key elements of the law. We soon will cross this uncertainty off the list.

Of course, *we* could buy this market if we wanted to. Indeed, since the market crash on October 19, 1987, the S&P 500 Index has withstood more than 20 corrections greater than 10%, half of which were ultimately unrelated to bear markets or recession. Rather, they each presented buying opportunities. In fact, since the market bottomed in March 2009, investors have chopped the S&P 500 Index down 10% not once, not twice, but on at least *four* occasions before buying the beaten stocks. But should *we* do it this time? The fundamental landscape looks intact. Gross domestic product (GDP) for the third quarter is trending at a respectable 3.5% SAAR (seasonally adjusted annual rate). Inflation expectations, for all the Fed's supposed concern, appear anchored globally. EBIT (earnings before interest and taxes) are 9.7% higher than they were a year ago. The unemployment rate is at a secular-low 3.7%—with a battery of gender, race, geographic, income, and educational segments expressing the universal robustness of the labor market, and wages are up 2.8% from a year ago.

But, we have run through all of this before.[1] So, is the issue now weighing on the market as simple as handicapping the impact of Chairman Powell's and President Trump's policy proclivities? Insofar as we view equity prices as a function of earnings and interest rates, it may be that simple—at least for the near term. But market timers (those investors focused on anything less than a one-year holding period) may need a few more constructive signposts before moving back in. And those in for a longer ride are wise to consider two important axioms as the business cycle shifts into its later—*though not final*—stages. First, the "Slowing Expansion," or third phase of the business cycle,[2]

S&P 500 Largest Intra-Year Drawdowns



Source: Standard & Poors, Strategas

[1] The opening paragraphs of the August and September versions of Insight presented a similar roll call of the various and sundry economic and market statistics investors seem enamored with. All beating at a healthy cadence.

[2] Using widely disseminated measures of economic activity, Strategas Securities' Research department has deconstructed the US business cycle into four component phases: Recovery; Accelerating Expansion; Slowing Expansion; and, Recession.

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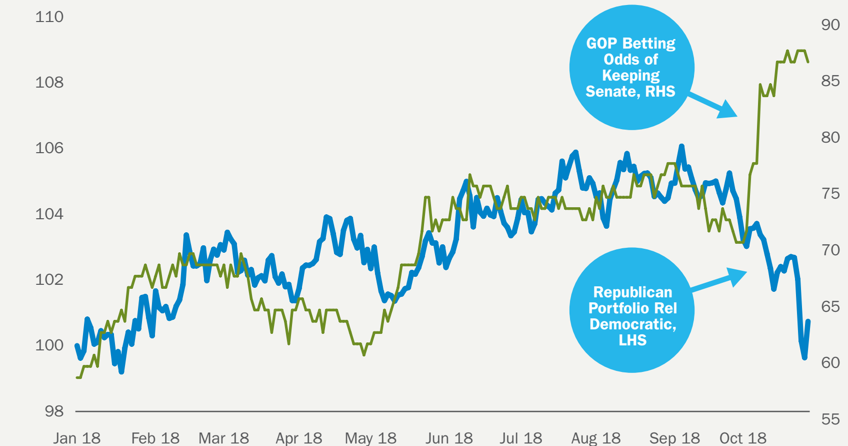
historically has been the longest (measuring 32 months, on average, in the 11 business cycles the US has experienced since 1950), suggesting we have some time before this cycle evidences a contraction. Second, as the business cycle matures past its midpoint, the divergence between superior and marginal operators becomes increasingly transparent. To wit, roughly a third (36%) of the constituents of the Russell 2000 and wholly 13% of Russell 1000 constituents are *not* profitable.

But achieving clarity on these points may not be as easy. The Fed is not likely to be persuaded by our tantrum selling, nor has a slowdown in housing activity, auto sales, or in the emerging markets convinced it to alter the preferred pace of policy normalization. And, as Strategas' chief economist, Don Rissmiller, highlights, a notable spread remains between the terminal funds rate that the Fed believes the economy can withstand and the rate that *we*, the market, would prefer. Not much we can do but wait out the Fed. Chairman Powell's press conference following the December FOMC meeting appears to be the next substantive event. Some softer guidance would be welcome news. Stay tuned.

As President Trump said last week, **he** is ready to make a deal, but **they** are not ready yet. Conventional wisdom suggests the Chinese, uncertain in how to negotiate with this president, could be waiting for the US midterms to play out before engaging in serious discussions to see whether ideological checks and balances will be re-established. We are not so sure even a Democratic wave would do the trick, as we have no clear evidence suggesting Democrats are opposed to waging a trade war with China. Some propose that the more liberal political leanings often associated with Silicon Valley in general, and the management teams of bellwether technology concerns in particular, could help persuade the Democratic congressional majority—or a certain gavel-wielding representative from California's 12th district—to check the Administration. However, we are not convinced this would either occur or amount to anything more than anti-all-things-Trump posturing. Although few politicians would champion tariffs as sound economic policy, the view that the Chinese engage in the willful and broad theft of US intellectual property—a problem particularly punitive to our technology industry—has stood as a bipartisan rallying point justifying the end, if not entirely the means. Stay tuned.

Strategas' Republican Relative to the Democratic Portfolio & GOP Odds of Keeping Senate



Source: PredictIt, Strategas

Advisor Takeaway:

The election will be resolved on Tuesday, but clarity on Fed tightening and trade with China will take more time: The Fed will continue normalizing interest rates, and no matter which party prevails in the election, both agree that China's business practices harm our technology industry. Should we wait for transparency before we buy this market? The intact fundamental landscape, including strong GDP, manageable global inflation, solid corporate earnings, low unemployment, and rising wages, may be enough to encourage investing in the short-term. Longer-term investors may want to note that although we are in the third phase of the business cycle, it may have some time to run before we see a contraction. And once the cycle extends beyond its midpoint, history demonstrates that the profitability of companies in the Russell 1000 and 2000 indices begins to decline. Thus, we continue to believe advisors should revisit clients' allocation across assets and reposition equities to favor value shares over growth.

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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 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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