Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

U.S. Equity Sector Allocation

July 6, 2021

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CYCLICAL RECOVERY BIAS INTACT | FOCUS ON NEAR-TERM VALUE

We continue to believe that inflation will be stickier than the Fed has suggested it will be, but also that policy doesn't appear to be moving toward normalization anytime soon. The Fed's recent attempt at a balanced tone strikes us as an effort to wriggle out of last summer's "we're not even thinking about thinking about raising rates" while providing cover for broadly accommodative policy to continue. Meanwhile, we've noticed renewed urgency from Democrats eager to move on the President's infrastructure and tax agenda.

These observations have led us to consider the "duration" of our equity exposure. Companies with valuations tied to future expectations seem especially vulnerable to higher long-term interest rates. As Jason Trennert wrote recently, if you believe that inflation will be higher and last longer than the consensus believes it will, you would likely favor investments that pay regular dividends or buy back stock.

We remain comfortable with our cyclical bias toward Financials, Energy, Materials, and Industrials, with our portfolios positioned for the continued improvement in economic growth and the transition from recovery to expansion.

There is one instance in which our bullishness for Financials could abate. Although the market's focus on inflation and interest rates are linked, an environment could develop where inflation is stickier than expected and monetary and fiscal policy keep interest rates near the lower bound of expectations. This outcome would likely renew interest in the same mega-cap tech names that carried the market higher in 2020 as well as growthier shares in general. We don't believe we're there yet, but we aren't blind to the possibility.

Sector Allocation Summary
U.S. Equities

OVER	Industrials Financials Energy Materials
NEUTRAL	Technology Communications Healthcare Discretionary
UNDER	Utilities Real Estate Staples

Strategas U.S. Recommended Sector Allocation Summary

	Sector	Rationale	Risks
Overweight	Industrials	This is the sector most correlated to the broader market and is a direct beneficiary of the weaker US dollar. Economic reopening and the Biden infrastructure plan ostensibly provide a multi-year tailwind for Industrials.	Growing persistence of the virus in Europe and parts of the U.S. could soften the demand ramp in 2Q21. Supply chain dislocation remains an issue globally. Investors may grow wary of potential fiscal drag of Biden's proposed increase in the corporate tax rate.
	Financials	The domestic outlook is strengthening. Rate-sensitive regional banks and broker/dealers continue to strengthen. We are watching commerical Real Estate exposure and non-performing loans. Higher yields and steeper curve benefit bank loans and net-interest margin. Attractive as a short-duration sector.	Increased regulatory scrutiny from Biden appointments to Treasury sub-cabinet plus the upcoming nomination to replace Fed VC Quarles are likely to weigh on the sector. Non-financial "financials" taking share.
	Energy	Exxon and Chevron compriseabout 46% of the sector. The economic recovery is firming. The narrowness of the Democratic Senate majority will limit the ambitiousness of the "Green New Deal" agenda. We're watching the U.S. dollar. Trends are improving.	Production cuts from OPEC+ countries coupled with lockdown-related demand weakness. The Biden administration has wide latitude over federal land usage; we expect curtailing of Trump-era policies. The push into electric vehicles is irreversible. Any adjustment to filibuster rules in the Senate could bolster the green agenda.
	Materials	Materials are a direct beneficiary of the weaker U.S. dollar. Early signs of reflation are appearing and have created a bid for the sector.	Demand weakness from staggered global lockdowns. Sustained dollar strength (which we think is unlikely) could be a negative for the sector.
Neutral Weight	Technology	Apple and Microsoft make up about 12% of the S&P 500 and about 43% of the sector. Sector fundamentals appear to be positioned well for average revenue growth in a low-nominal-growth world. Software-as-a-service (SaaS) companies are somewhat insulated from the broader halt in consumption and semiconductors remain strong.	Is there a tipping point for passive concentration? We remain focused on valuation. A liquidity-driven recover has outpaced corporate earnings and revenue recovery. Tension with China could be a headwind. Cyclicals are gaining traction relative to the "stay at home" stocks. Higher rates could impact Tech bid.
	Communications	Facebook and Alphabet make up 5% of the S&P 500 and about half of the sector. Liquidity-driven price recovery has outpaced the revenue and earnings recovery. We expect social media to come under increasing regulatory scrutiny from the Biden administration.	The secular trend of digital content and advertising remains positive. We expect the arms race for content to continue. Non-digital segments should rebound as more widespread vaccination is achieved and the economy reopens.
	Healthcare	The Biden administration is likely to seek expansion of the Affordable Care Act. The narrowness of the Democratic Senate majority prevents large-scale disruptions to the sector.	The narrow Democratic majority raises the possibility of a directed attack on drug prices (but this appears to be delayed for now)
	Discretionary	Together Amazon and Tesla are almost half of the sector and about 6% of the total S&P 500. The pandemic signaled an important shift to ecommerce as online retailers took share. The outlook for leisure, lodging and restaurants is improving with vaccines widely available. Anchor of "re-opening trade"	A K-shaped recovery that leaves some behind has shown higher-income consumers reduced spending but lower-income spending has been backstopped by government assistance. Could this reverse? Unemployment and savings rate remain elevated.
Underweight	Utilities	Valuations remain extended for the sector. Limited pricing power. Poor performance in the current rate environment is not encouraging. Utilities are underperforming cyclical peers.	Less exposure to foreign business and global supply chains. Yield compression could cause investors to search for yield in the sector. An extended "soft patch" could bring a bid to this sector.
	Real Estate	Mall and Retail REITs are hurting from the failure of traditional retail venues. Commercial Real Estate is at the scene of the Covid-19 accident. Future rent payments remain in jeopardy.	Cloud-based infrastructure being built and needs warehousing. Apartment REITs can benefit from inclination to rent vs. buy. "Reopen" REITS could outperform. Sector recently made a relative high.
	Staples	Valuations remain extended . Limited pricing power. Consumption shift to Discretionary as the worst of lockdown conditions are behind us. Supply chains work; retail hoarding has declined.	Yield compression could cause investors to search for yield in the sector. Broader risk-off move could see significant bid in sector. Sector bellwethers performing well.

Allocations are labeled as over-, under-, and neutral weight compared to sector weightings in the S&P 500 index. The Standard & Poor's 500 is an index of the 500 largest U.S. publicly traded companies. It is market-capitalization weighted, giving very large companies greater influence over the index's movement. This also contributes to the balance of sector weights, as is noted in a few places in the table above. The exact sector weightings in the S&P 500 index can float from day to day as normal trading causes shares within the index to rise or fall in price. It is not possible to invest directly in an index.

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