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Doll's Deliberations

Weekly Investment Commentary

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Summary:
Stocks were on a roller coaster most of the week (S&P 500 -3.04%, Dow Jones +0.05%, and NASDAQ -5.52%). Dominating the discussion were the geopolitical volatility in the Middle East and hawkish Fed rate conversation. Best performers were utilities (+1.87%) and consumer staples (+1.55%); worst performers were information technology (-7.26%), and consumer discretionary (-4.52%).

Key takeaways:

1. Fed Chair Powell sounded more hawkish, stating that it is likely to take longer than previously thought to achieve confidence that inflation is sustainably headed toward the Fed's 2% target.

2. Retail sales in the U.S. grew by 0.7% month-on-month in March, meaningfully outperforming expectations of 0.3%. This confirms that the U.S. consumer continues to be healthy.

3. The Philly Fed Manufacturing Survey reported improved new orders and shipments but a less rosy picture for profit margins and labor demand.

4. Oil prices have been rising in recent months because of a robust U.S. economy, a bottoming of the global manufacturing cycle, and production discipline from OPEC.

5. Oil prices have a modest Middle East war premium. Should the conflict become more intense, triple-digit oil prices will follow.

6. Excess savings are dwindling, lending standards to consumers are tight, and forward-looking indicators of wage growth, such as job openings, hiring, and quit rates are all in a downtrend.

7. We continue to think a soft landing in which inflation returns to the Fed's 2% target without a meaningful rise in unemployment is very unlikely.

8. The equity risk premium has dropped to the lowest level in over 20 years due to higher valuation and higher real interest rates. This portends low returns going forward.

9. The Federal budget deficit is tracking slightly below $2 trillion, which is about 6.5% of GDP. Fiscal policy may be the biggest threat to lower inflation and interest rates.

10. A political reality: For the U.S. consumer, the same grocery basket is 21% more expensive since the start of the Biden Administration. Under the Trump Administration, the cost of the same basket of groceries increased less than 7%.

EQUITY MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
DJIA	0.05	1.37
S&P 500	-3.04	4.58
NASDAQ	-5.52	2.01
RUSSELL 1000	-2.26	5.05
RUSSELL 1000 GROWTH	-4.93	4.57
RUSSELL 1000 VALUE	-0.70	3.79
RUSSELL 2000	-3.00	-3.77

S&P EQUITY SECTORS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-3.23	14.44
CONSUMER DISCRETIONARY	-4.52	-2.32
CONSUMER STAPLES	1.55	5.04
ENERGY	-1.19	14.47
FINANCIALS	0.81	7.83
HEALTHCARE	0.02	2.33
INDUSTRIALS	-2.00	6.10
INFORMATION TECHNOLOGY	-7.26	3.26
MATERIALS	-1.09	4.29
REAL ESTATE	-3.64	-9.75
UTILITIES	1.87	4.16

Stocks turn sloppy and are likely to continue to consolidate/correct

Equity markets have stumbled modestly because of yet another pivot by Fed Chair Powell. Powell sounded less dovish last week, which boosted Treasury yields and further reduced rate cut expectations. Still, with the corporate earnings backdrop supportive and the Fed a long way from signaling higher policy rates, the odds favor an equity correction or consolidation, rather than a transition into a bear market. Global bond yields have steadily advanced this year after a brief but intense countertrend decline following Powell's dovish pivot last autumn. With 20/20 hindsight, that was misplaced and, in fact, was ultimately self-undermining. Lower bond yields triggered a sharp rally in equity and credit markets, which helped to further boost already improving global economic prospects.

The Fed continues to misjudge the inflation backdrop and is offside on its assertion that monetary conditions are restrictive. The surge in financial asset prices after Powell's pivot last autumn reinforced our conviction that above-potential U.S. growth will persist for somewhat longer. There is little chance of inflation returning to the Fed's target of 2%. Add in a steadily improving global trade and manufacturing cycle, and the ingredients for sticky inflation and higher bond yields exist. Higher bond yields normally put downward pressure on P/E ratios, especially where conditions are stretched in valuation and sentiment terms, as is the case currently. After three high-side CPI misses, the U.S. is due for a low-side miss; the latter should temporarily calm bond investors' nerves to the benefit of equities.

For now, the economic and inflation backdrop is not consistent with U.S. rate cuts. In addition, the global economy is rebounding and underscores that overall conditions never became truly restrictive. The Fed will eventually be forced to pivot away from endorsing rate cuts to a neutral stance, and then ultimately have to acknowledge that rates might need to rise if inflation proves sticky, as we anticipate.

U.S. consumption continues to expand at a solid pace, aided by strong income growth and still some lingering excess savings built up during the pandemic. Employment conditions remain historically positive, even if off their best levels.

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN) (%)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-2.11	3.55
MSCI ACWI EX U.S.	-1.85	0.89
MSCI EAFE	-1.81	1.32
MSCI EM	-2.20	0.05

FIXED INCOME MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.73	-3.23
BLOOMBERG U.S. CORP HIGH YIELD	-0.67	-0.28
BLOOMBERG U.S. GOV/CREDIT	-0.67	-3.07
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.06	1.58

ALTERNATIVES (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-3.52	-9.90
COMMODITIES (DJ)	0.23	6.20
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	-2.57	1.18
CURRENCIES (DB CURRENCY FUTURE HARVEST)	-0.17	6.28

Conclusion:

Equity markets may stay under pressure until investors gain confidence that the bond market is not going to riot. A calming in bond markets should allow the risk-on phase to resume given the still positive corporate earnings backdrop and increasing signs of better economic activity around the globe, despite challenging valuations. From a longer term perspective, at some point a valid recession worry will develop. The equity environment will become more volatile and make selectivity crucial. We prefer stocks with strong earnings predictability, strong earnings persistence, and strong free cash flow.

Data from Bloomberg, as of 4/19/2024.