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GLOBAL INVESTMENTS

Doll's Deliberations

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SUMMARY:

Stocks fell slightly last week (S&P 500 changed by less than 1% for the third straight week). The bull view is renewed soft landing expectations, easing banking sector stresses, good start to Q1 earnings and short covering. The bear view focuses on credit concerns in the banking sector, a backup in interest rates, a firming of May rate hiking odds, concerns about margin compression, and valuation. Best sectors were consumer staples (+1.7%) and REITs (+1.6%); worst sectors were communication services (-3.1%) and energy (-2.5%).

KEY TAKEAWAYS:

1. Small cracks are developing in the U.S. labor market, e.g., initial jobless claims rose again last week (to 245,000).

2. The Conference Board's Leading Economic Index fell for the twelfth month in a row while the Coincident Economic Index moved up for the fourth consecutive month. The mixed data suggests that while the economic situation is holding up, the LEI's are warning of a deterioration ahead.

3. Fed funds have had the sharpest increase in 40 years, the yield curve is significantly inverted, and M2 has fallen 5% y/y. Any one of these could deliver a recession. All three together suggest recession risks are not overblown.

4. While the Fed faces a trade-off between inflation and financial stability, tighter lending standards and falling credit demand are an intended consequence of the tightening cycle.

5. The Fed still seems likely to push forward with another rate increase in early May if economic data stays mixed.

6. With the labor market tight and most employers reluctant to reduce payrolls due to labor shortages, it will be difficult for companies to avoid negative operating leverage as revenue growth slows.

7. With the fastest Fed policy shift in 40 years, we think more negative surprises lie ahead for investors. For example, earnings forecasts remain too optimistic.

8. Profit margin contraction is expected for the first half of this year but Wall Street has margin expansion occurring beginning in 3Q23. This is inconsistent with the expectation for economic slowdown/recession later this year.

9. The recent decline in stock market breadth is perhaps a warning that we are not out of the woods with the bear market.

10. REMINDER: Stocks often bottom before the end of a recession, but never before the beginning of one.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	-0.19	2.65
S&P 500	-0.09	8.21
NASDAQ	-0.42	15.64
RUSSELL 2000	0.48	2.05
RUSSELL 1000 GROWTH	-0.06	14.19
RUSSELL 1000 VALUE	-0.10	2.20

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-3.05	20.52
CONSUMER DISCRETIONARY	0.53	14.79
CONSUMER STAPLES	1.79	3.34
ENERGY	-2.53	-1.87
FINANCIALS	0.99	-2.44
HEALTHCARE	-0.22	-0.78
INDUSTRIALS	0.78	2.88
INFORMATION TECHNOLOGY	-0.46	19.47
MATERIALS	-0.31	4.34
REAL ESTATE	1.59	1.40
UTILITIES	1.09	-0.50

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-0.21	8.45
MSCI ACWI EX U.S.	-0.24	9.10
MSCI EAFE	0.11	11.49
MSCI EM	-1.05	4.01

SIGNS OF SLOWDOWN CONTINUE, BUT THE ECONOMY CONTINUES TO MAKE FORWARD PROGRESS

Global financial markets have calmed after the banking crisis in March. However, the shift to a more inflationary backdrop than last decade and the subsequent sharp policy rate-hiking cycle may have additional consequences, namely an economic slowdown/mild recession. The near-term impact from the banking problem has, ironically, provided a slight boost to the global economic outlook, albeit less so for the U.S., since the U.S. is experiencing some tightening in credit conditions at regional banks. More positively, developed market bond yields have eased since the bank bust and there are increased odds that the policy rate-hiking cycle will soon pause (excluding the ECB). Any economic boost will likely be modest and temporary as there are other signs of economic slowing.

U.S. ten-year Treasury yields have settled into a trading range since peaking in October 2022. Equity markets have recovered modestly since the brief SVB-related selloff, with several euro area markets hitting new highs. Non-U.S. equities have outperformed the U.S. market since the October low, especially in U.S. dollar terms. The key to sustaining what has been a choppy risk-on phase since late 2022 is for interest rate expectations and bond yields to stay quiet. As has been the case throughout the rate cycle, a close monitoring of short-term bond yields is warranted, because a breakout in short-term yields would likely be the catalyst for higher long-term bond yields and, thereafter, an end to the risk-on phase.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.07	2.90
BLOOMBERG U.S. CORP HIGH YIELD	-0.49	3.93
BLOOMBERG U.S. GOV/ CREDIT	-0.08	3.09
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.10	1.39

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	1.42	0.62
COMMODITIES (DJ)	-1.99	-5.03
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	0.33	9.43
CURRENCIES (DB CURRENCY FUTURE HARVEST)	-0.57	0.29

The economic news from China and the euro area has generally stayed positive/improved. Conversely, the data in the U.S. has been more mixed, and the economy remains in a modest deceleration phase. While the U.S. has experienced some increase in unemployment claims, the increase has not been broad based, and the level of new claims is still historically low relative to total employment. The rise can signal a meaningful economic slowdown and outright recession if the trend steepens and broadens. However, the Fed is not going to be able to return inflation to near its 2% target without triggering a recession. Thus, we expect the trend in new claims to eventually steepen and broaden.

U.S. commercial real estate is now under the scrutiny of investors as a potential catalyst for ending the cycle. Fears of contagion onto the banking system may keep investors on edge and provide a further bid under government bond markets. Meanwhile, economic slack is worrisome for the inflation outlook, and service sector inflation gauges and wage demands are likely to prove sticky absent a meaningful period of economic weakness and rising unemployment. The longer economic activity is reasonably solid and prices and wages are rising, the greater the odds that the inflation process will become entrenched.

CONCLUSION:

The calming in government bond markets has allowed the choppy risk-on phase to grind ahead. Most central banks should soon pause, although the conditions for rate cuts are not likely to develop in 2023. This implies that current rate cut expectations will unwind in the second half of the year. (In fact, the odds are tilted towards an eventual resumption in rate hikes if our view of sticky core inflation pans out.) Relative prospects for select non-U.S. assets and currencies are still positive.

Data from Bloomberg, as of 4/21/2023.

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