# Doll's Deliberations

## Weekly Investment Commentary | August 21, 2023 | Issue 3.33


### SUMMARY:

Stocks fell again last week with the S&P 500 (-2.1%) and NASDAQ (-2.6%) both down for a third straight week. The decline was triggered by a backup in yields with the 10-year yield hitting 4.33%, the highest since 2007, due to stronger economic data and concerns that inflation will become problematic again. Best performers were technology (-0.8%), healthcare (-1.6%), and energy (-1.7%); worst performers were consumer discretionary (-4.1%) and real estate (-3.2%).


### KEY TAKEAWAYS:

1. Sentiment has quickly become more downbeat with upward pressure on rates, skepticism about any explicit near-term peak policy signals from the Fed, concerns disinflation momentum may start to wane, higher-for-longer rate policy from very resilient US growth, weak China growth and underwhelming policy response, and negative operating leverage risk for earnings (disinflation and wage pressures).
2. July retail sales exceeded expectations. With unemployment near 50-year lows, inflation edging down and wages rising faster than prices, businesses and individuals are still spending, keeping the labor market in very solid shape, but Americans are taking on record levels of debt to fuel their spending, and delinquencies on mortgages and car loans are inching up.
3. Odds of an additional Fed rate hike this year rose to nearly 40% (from single digits) after Fed minutes. In the minutes, officials felt the "potential need for higher rates" still exists. The downshift in core inflation will likely stop well above 2% by early 2024, which will take the probability the Fed lowers rates early next year off the table.
4. Consensus 2024 EPS growth of 12% is a high hurdle for an aging business cycle with very restrictive monetary policy, still rising cost of capital, eroding consumer savings and household liquidity, and rising oil prices.
5. Fitch warned it may have to downgrade dozens of banks. If commercial real estate (CRE) mortgage rates continue to rise along with bond yields, there will be lots more CRE loan defaults.
6. 2023 is shaping up as a record-breaking year for global oil demand with an estimated increase of 2.6% year over year. Demand growth is being led by China and India. Production discipline has kept supply below demand for the better part of the year.
7. Net interest payments as a percentage of federal government revenues have risen from 8.3% in April 2022 to an estimated 14% in July, the highest level since September 1998.
8. China's economic pain (slowing economy) has been the US's economic gain, as it has lowered the prices Americans pay for goods from China, pushing US inflation lower.
9. The stock market has been on edge ever since the 10-year yield crossed back above 4% at the start of the month. The S&P 500 is down 5% from its July 31 high for the year, now falling below its 50-day moving average.
10. Since the beginning of the pandemic, Wolfe Research estimates that housing values have pushed up household wealth by $12 trillion while stocks have pushed wealth up $7 trillion. With home affordability down, housing values need to be watched carefully.

| EQUITY MARKETS (INDEX TOTAL RETURN) | LAST WEEK | YEAR-TO-DATE |
|---|---|---|
| DJIA | -2.10% | 5.52% |
| S&P 500 | -2.05% | 15.02% |
| NASDAQ | -2.55% | 27.69% |
| RUSSELL 2000 | -3.85% | 6.04% |
| RUSSELL 1000 GROWTH | -1.89% | 25.65% |
| RUSSELL 1000 VALUE | -2.37% | 4.60% |

| S&P EQUITY SECTORS (INDEX TOTAL RETURN) | LAST WEEK | YEAR-TO-DATE |
|---|---|---|
| COMMUNICATION SERVICES | -2.74% | 38.19% |
| CONSUMER DISCRETIONARY | -4.09% | 28.47% |
| CONSUMER STAPLES | -2.37% | -0.12% |
| ENERGY | -1.18% | 3.00% |
| FINANCIALS | -2.79% | 0.18% |
| HEALTHCARE | -1.53% | -0.91% |
| INDUSTRIALS | -2.43% | 9.08% |
| INFORMATION TECHNOLOGY | -0.77% | 35.35% |
| MATERIALS | -2.33% | 5.03% |
| REAL ESTATE | -3.21% | -0.37% |
| UTILITIES | -1.74% | -8.58% |

| INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN) | LAST WEEK | YEAR-TO-DATE |
|---|---|---|
| MSCI ACWI | -2.34% | 11.75% |
| MSCI ACWI EX U.S. | -2.71% | 6.95% |
| MSCI EAFE | -2.78% | 8.64% |
| MSCI EM | -2.35% | 3.80% |

## STOCKS AND BONDS FINALLY PULL BACK

Government bond yields are testing their cyclical highs, although they have been partially held back by newfound softness in equity markets. The budding consensus seems to be that the huge run-up in equity and credit markets since October is vulnerable should bond yields break out to the upside. Equity and credit markets are indeed at greater risk after the strong gains in recent months, and there are more pockets of overvaluation. These assets have become vulnerable to the bond yield increase.

Most economies have held up fairly well in the face of the sizable rise in policy rates and bond yields. If central banks pause as widely advertised, the economic expansion could continue. The downside to this outcome is that continued decent economic growth will prevent underlying inflation from returning to central bank target levels. While continued economic growth will be positive for corporate profits, it could be insufficient to offset de-rating pressures on stocks. The magnitude of the current equity sell-off may depend on the bond market. While the rise in policy rates and bond yields in the past 18 months has been sizable, one must keep in mind the absurd starting point where monetary policy had been far too lax, for far too long. Moreover, an unprecedented dose of fiscal stimulus was pumped into many of the larger economies in 2020-2021 because of the pandemic.

The past year or so has been notable for the large number of false recession signals. General economic expectations were providing a misleadingly bearish picture. Consumer and business sectors (excluding manufacturing) are doing better than the headline sentiment measures have been indicating. A global recession will eventually develop most likely when the cost of capital becomes truly restrictive.

From a cyclical perspective, the sizable rise in bond yields in the past 18 months has only seen yields return to near fair value, i.e., bonds are still not undervalued. Perhaps the most worrisome long-term development for bonds is that measures of fair value are rising after a 40-year downtrend.

| FIXED INCOME MARKETS (INDEX TOTAL RETURN) | LAST WEEK | YEAR-TO-DATE |
|---|---|---|
| BLOOMBERG U.S. AGGREGATE BOND | -0.71% | -0.07% |
| BLOOMBERG U.S. CORP HIGH YIELD | -0.71% | 5.81% |
| BLOOMBERG U.S. GOV/CREDIT | -0.71% | 0.11% |
| BLOOMBERG U.S. T-BILL 1-3 MONTH | 0.09% | 3.04% |

| ALTERNATIVES (INDEX TOTAL RETURN) | LAST WEEK | YEAR-TO-DATE |
|---|---|---|
| REAL ESTATE (FTSE NAREIT) | -3.77% | -0.98% |
| COMMODITIES (DJ) | -1.17% | -4.59% |
| GLOBAL LISTED PRIVATE EQUITY (RED ROCKS) | -3.38% | 13.20% |
| CURRENCIES (DB CURRENCY FUTURE HARVEST) | 0.51% | 5.48% |

## CONCLUSION:

Global financial markets are at critical junctures. The risk-on phase since October is now in question as valuation challenges for both bonds and, in turn, stocks has caused pullbacks in both asset classes. Central bank actions and perceptions as well as inflation progress will determine the extent of the pullback.

Data from Bloomberg, as of 8/18/2023.

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