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DOLL'S DELIBERATIONS

WEEKLY INVESTMENT COMMENTARY

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	-0.05%	-6.02%
S&P 500	-1.16%	-10.39%
NASDAQ	-2.58%	-18.37%
RUSSELL 2000	-0.76%	-10.17%
RUSSELL 1000 GROWTH	-1.63%	-17.23%
RUSSELL 1000 VALUE	-1.18%	-4.79%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-3.27%	-25.96%
CONSUMER DISCRETIONARY	-1.57%	-17.82%
CONSUMER STAPLES	1.97%	0.81%
ENERGY	1.30%	46.76%
FINANCIALS	-1.72%	-9.66%
HEALTHCARE	-0.55%	-4.91%
INDUSTRIALS	-0.97%	-5.76%
INFORMATION TECHNOLOGY	-1.66%	-14.70%
MATERIALS	-2.43%	-11.69%
REAL ESTATE	-1.91%	-12.54%
UTILITIES	1.29%	10.26%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-0.29%	-12.12%
MSCI ACWI EX U.S.	-0.74%	-14.66%
MSCI EAFE	-0.81%	-14.99%
MSCI EM	-0.69%	-16.25%

SUMMARY:

Equities declined last week (S&P 500 -1.2%) with the bulk of the decline coming toward the end of the week. The decline came after four straight weeks of gain. Downside occurred due to Fed commentary indicating determination to fight inflation and therefore more rate increases. Downward earnings revisions and stretched valuations were also of concern. Best sectors were consumer staples (+2.0%), utilities (+1.3%) and energy (+1.3%). Biggest decliners included communication services (-3.3%), materials (-2.4%) and REITS (-1.9%).

KEY TAKEAWAYS:

1. The Conference Board's U.S. leading economic indicators have declined for a fifth consecutive month (and now stands at zero y/y). A contraction in this measure tends to precede recessions.
2. Existing home sales fell for the sixth consecutive month to the lowest level since May 2020 and down 26% from the start of the year.
3. We believe trend inflation will settle in at roughly 4-5%, meaning that inflation will relatively easily fall back to these levels but they will be sticky. A significant increase in the unemployment rate and likely recession will be required to send inflation from 4% to 2%.
4. The minutes of the FOMC July meeting state that some participants observed that the real Fed funds rate is still negative, implying that more work needs to be done.
5. With over 90% of companies reporting 2Q earnings, EPS growth of nearly 10% is well above the original estimate of +5.5%. But 2023 earnings estimates have moved from a peak of $252 to $244 and are likely headed lower.
6. The stock market has been rallying since June 16 on assertions that inflation has peaked and the expected recession might not happen.
7. Technically, stocks showed a bullish sign with more than 90% of stocks above their 50-day moving average. On the other hand, last week stocks reached their 200-day moving average and began to decline again.
8. The Bull-Bear Ratio advanced from 0.60 to 1.64 over the last eight weeks to its highest rating since January, a cautionary sign.
9. Bulls believe that inflation has peaked, that Fed tightening is nearly over, and there will be no recession. Bears argue that the Fed has a lot more work to do, that earnings estimates will continue to fall, and a recession may be inevitable.
10. Despite the overall market P/E moving above 18x, there are lots of attractive stocks with P/E's of single digits or low double digits.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.27%	-9.14%
BLOOMBERG U.S. CORP HIGH YIELD	-0.67%	-8.29%
BLOOMBERG U.S. GOV/ CREDIT	-0.27%	-10.02%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.03%	0.34%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-1.06%	-10.79%
COMMODITIES (DJ)	-0.67%	24.17%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	-2.32%	-27.85%
CURRENCIES (DB G10 CURRENCY FUTURE)	0.19%	5.45%

IS THE RALLY RUNNING OUT OF STEAM?

The risk-on phase since June 16 has been significant. The rally in equities has been supported by good corporate profit trends and the calming in government bond markets and interest rate expectations. However, a durable rally in equities requires an easing in recession fears. Such a development would ultimately be a double-edge sword – it will improve earnings expectations, but also signal that the pause in bond yields is nearing an end, raising the odds of renewed de-rating pressures on stocks. The end point of this cycle is not yet on the horizon, but we expect that it will end with monetary policy becoming restrictive, along with even higher government bond yields and a bear phase in stocks.

While the Fed and other central banks have talked hawkishly and lifted rates aggressively in recent months, the starting point of zero or negative interest rates and massive QE has meant that conditions are still accommodative. Cooling inflation, sluggish economic growth and heightened uncertainty herald a downshift by most central banks to a less aggressive tone and rate-path ahead.

The global economy has some weak spots, but monetary conditions are not the cause in the case of China and Europe. Most of the economic drags are not the typical recessionary forces, and a debt deleveraging and cleansing-type economic contraction in unlikely. Corporate earnings will cool in the coming months, but margins are holding at high levels and some relief is likely due to some decline in input costs (lower oil and commodity prices and borrowing rates.)

The sluggish overall global economic outlook means that the pause in the cyclical uptrend in government bond yields may persist for the foreseeable future. So far, there has been little easing at the short end of the U.S. yield curve, as the Fed is still on track to lift rates further in the coming months.

The next yield upleg is likely to be driven by diminishing recession fears and a more robust recovery in global service sectors, which could take some time to develop. Cyclical risks in government bonds will remain elevated for as long as inflation is well above central bank targets. This is why we see bond rallies as only being part of pause phases within a cyclical pattern of yield upwaves.

CONCLUSION:

A cooling in inflation after the spike in the past year will prolong the pause in government bond yields. This, in turn, has provided support to equity and credit markets. We are not in the recession camp, but expect sluggish economic conditions to persist until service sector activity regains momentum, which may take until some clarity develops in Europe, or China relaxes its COVID-zero policy. Meanwhile, the U.S. economy should stay solid, despite an easing in booming employment conditions. Investors should approach equities tactically, meaning taking some profits on big rallies (like the one we just had) and reinvesting on pullbacks.

Data from Bloomberg, as of 08/19/2022.

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