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Doll's Deliberations

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SUMMARY:

Stocks were modestly higher last week (S&P 500 +0.2%) making it six up weeks in a row. The main market narrative has been increased confidence about a soft- or no-landing economic scenario. Increasing sectors included communication services (+1.4%), consumer discretionary (+1.1%), and technology (+0.7%); worst sectors included energy (-3.2%), materials (-1.7%) and consumer staples (-1.2%).

KEY TAKEAWAYS:

1. November's employment figures were firmer than expected. (Total payrolls advanced 199,000. Average hourly earnings advanced 0.4% after a string of softer prints in the months prior.)
2. Our largest concern remains the lagged economic impact of past interest rate increases. (Remember the Fed raised rates 5.25% in 18 months.) (Fed rate cuts will likely not be a favorable development for risk assets, but rather a response to a deteriorating macroeconomic environment.)
3. The expectation of a recession in 2024 is based on the assumption that the Fed will not ease policy significantly in time to avert a meaningful increase in the unemployment rate. While inflation is falling, it probably will not fall fast enough to allow the Fed to cut rates meaningfully before a recession begins.
4. During the past month, the market has increased its expectations of Fed easing in 2024 from 80 basis points to 130 basis points. The market has now pulled forward the timing of the first Fed cut to March 2024 (60% probability).
5. Given the possibility of the U.S. economy entering a recession at some point next year and the negative trends in a broad range of fundamental credit market indicators, corporate bond spreads are probably too tight.
6. Earnings growth estimates for 2024 appear overly optimistic. Pricing power, or the ability to pass on costs to customers, has been one of the drivers of earnings growth this year. However, as inflation retreats, pricing power is also fading. As such, sales growth will likely be under pressure.
7. Despite #6 above, earnings estimates for both 2024 and 2025 have turned up over the past week with an expectation of a reacceleration of sales growth.
8. The "goldilocks" scenario of falling bond yields and improving equity market pricing of economic growth has lifted the S&P 500 P/E by 10+% over the past month.
9. A soft landing is now the consensus view. Investment banks' year-ahead outlooks mostly have 5000-5100 as their end-2024 target for the S&P 500. [One big difference vs. last year is that sentiment is now quite bullish, whereas a year ago it was very bearish.]
10. 2023 has been the worst relative performance year for the average stock compared to the cap-weighted index since 1998.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	0.04%	11.72%
S&P 500	0.24%	21.81%
NASDAQ	0.70%	38.73%
RUSSELL 1000	-0.19%	21.25%
RUSSELL 1000 GROWTH	0.72%	38.18%
RUSSELL 1000 VALUE	-0.31%	6.48%
RUSSELL 2000	0.32%	7.63%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	1.41%	50.41%
CONSUMER DISCRETIONARY	1.15%	37.51%
CONSUMER STAPLES	-1.20%	-2.90%
ENERGY	-3.21%	-4.01%
FINANCIALS	-0.07%	7.11%
HEALTHCARE	0.22%	-1.55%
INDUSTRIALS	0.26%	12.42%
INFORMATION TECHNOLOGY	0.74%	53.40%
MATERIALS	-1.71%	7.03%
REAL ESTATE	-0.32%	5.21%
UTILITIES	-0.21%	-7.88%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-0.21%	16.89%
MSCI ACWI EX U.S.	-0.21%	9.99%
MSCI EAFE	0.38%	13.00%
MSCI EM	-1.21%	3.89%

NEAR RECORD DROP IN BOND YIELDS OVER THE LAST FEW WEEKS

Bond investors are continuing to aggressively front-run a rate-cutting cycle. Such front-running is rare, especially with most of the global economy still well clear of recession.

However, the stampede to buy bonds and bet on lower policy rates is consistent with investors' persistent bias throughout the past two years to expect a peak in policy rates far below where they ultimately have risen. Investors and central banks continue to assume a relatively quick return to a 2% inflation world and, thus, are discounting rate cuts beyond the near run. That this investment strategy has generated significant losing outcomes in 2021-2023 is again being ignored. We would not be surprised to see similar disappointment this time, i.e., another rebound in bond yields is likely before the upcycle is over. The silver lining is that the next yield upleg should be smaller in magnitude than previous episodes because bond valuations are much better today.

After noting back in the fall that rising bond yields were helping the Fed to cool growth and creating a less tight labor market, Powell and company have been notably silent since bond yields headed lower. There has been a broad-based and sizable easing in financial market conditions, and a diminishing of the economic headwinds from tightening overall monetary conditions. The Fed wants to avoid a recession. The global stock/bond ratio has managed to hit a new high in the face of the sizable rally in bond prices as equities have rallied even more, which is not what usually occurs as the economy slides into a recession.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	0.56%	3.08%
BLOOMBERG U.S. CORP HIGH YIELD	0.51%	10.28%
BLOOMBERG U.S. GOV/ CREDIT	0.60%	3.38%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.06%	4.76%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-0.04%	4.87%
COMMODITIES (DJ)	-3.45%	-8.92%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	0.64%	26.62%
CURRENCIES (DB CURRENCY FUTURE HARVEST)	-0.65%	8.96%

Credit spreads have narrowed meaningfully and are below their long-term median. This also is not consistent with a near-run recessionary outcome, and reduces economic headwinds, especially since the absolute level of corporate bond yields has recently declined.

Measures of economic slack (and labor market conditions) indicate a more inflationary backdrop today than in the 2010s, unless a full-blown recession were to develop. It may take several months before it is clear that underlying inflation is closer to 3% and sticky (including wage rates), rather than near 2% or less. Until then, investors and central banks may live in hope, helping to sustain a decent investment landscape.

CONCLUSION:

The economic and inflation environment is much different from last decade, a view that has not yet been embraced by policymakers and most bond investors. The aggressive front-running of the next rate-cutting cycle is working at cross purposes to monetary policy and could prolong the expansion, as signaled by the sharp move from risk-off to risk-on in recent weeks. These rebounds should be historically modest, and will further confirm the stickiness of inflation.

Data from Bloomberg, as of 12/8/2023.

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