



# Doll's Deliberations

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## SUMMARY:

U.S. equities closed lower last week as the S&P 500 (-1.1%) fell for the first time in three weeks and Nasdaq (-2.4%) in six weeks. WTI crude was up 8.6%, the best week since early October. Treasuries turned into a headwind due to a repricing of the Fed rate path. The only positive sector was energy (+5.0%); the worst sector was communication services (-6.6%) due in part to Google (-9.7%).

## KEY TAKEAWAYS:

- The economic outlook around the world is looking better than it did last fall. (E.g., recent U.S. employment report, inflation falling, mild winter in Europe, China re-opening.)
- Given the January incredible nonfarm payrolls report and persistently low unemployment claims, what appeared to many investors as an inevitable recession in 2023, is a lot less certain today. However, after strong January job growth, job gains are likely to fall noticeably over the next few months.
- According to the senior loan officers survey, the percentage of banks becoming less willing to lend to consumers increased to a level that has never not been associated with a recession.
- Now well past the halfway mark of this earnings season, we have seen fewer stocks beat expectations. Full-year S&P 500 estimates continue to fall. Estimates will likely be taken lower as the impacts from tighter Fed policy weigh on the economy.
- Corporate profit margins have fallen from 17.7% to 16.2%. Historically, declines in profit margins of 150 basis points or more have been consistent with recessions.
- It may be hard to keep the stock market rally going as long as Fed officials are threatening to weaken the economy and financial markets with higher rates. It is difficult to see a cessation of Fed hikes if one takes the central bank at its word based on its own stated commitment to reach its 2% inflation target.
- The economy has been in transition for an exceptionally long time. The persistence of the transition period helps explain the volatility of risk-on/off factor rotations within the stock market, and the continued elevated level of uncertainty.
- The S&P's current 18.5x multiple on 2023 expected earnings of \$224 looks too rich given current economic uncertainties and our economic expectations.
- The recent relative outperformance of international equities and currencies relative to their U.S. counterparts is consistent with the fact that positive economic data surprises have emanated from abroad, rather than the U.S.
- Investors should not underestimate the risks associated with the deepening cold war between the U.S. and China. The demographic and property problems have permanently damaged China's long-term growth potential.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	-0.11%	2.33%
S&P 500	-1.07%	6.71%
NASDAQ	-2.37%	12.05%
RUSSELL 2000	-3.52%	8.84%
RUSSELL 1000 GROWTH	-1.52%	9.62%
RUSSELL 1000 VALUE	-0.97%	4.61%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-6.59%	13.13%
CONSUMER DISCRETIONARY	-2.11%	14.59%
CONSUMER STAPLES	-0.52%	-1.91%
ENERGY	5.05%	3.07%
FINANCIALS	-0.34%	6.67%
HEALTHCARE	-0.19%	-2.50%
INDUSTRIALS	-0.68%	4.02%
INFORMATION TECHNOLOGY	-1.02%	12.85%
MATERIALS	-1.65%	5.63%
REAL ESTATE	-2.00%	8.66%
UTILITIES	-0.26%	-3.95%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-1.09%	7.30%
MSCI ACWI EX U.S.	-0.65%	8.22%
MSCI EAFE	-0.29%	8.73%
MSCI EM	-1.36%	7.18%

## SOME CAUTION IS WARRANTED

The global economy is proving resilient, inflation is poised to continue to ease in the coming months, and major central banks are likely to pause their hiking cycles by or before mid-year. After last year's bloodbath, stocks, bonds, commodities and even cryptocurrencies have rebounded significantly this year with price trends for many assets now in a decidedly positive direction. Economic momentum in Europe, China, and the U.S. (at least in labor) has improved.

### BUT...

1. Current unemployment rates and corporate profitability are among those factors consistent with late rather than early-cycle economic conditions. The global economy is not poised to begin an extended or synchronized new expansion.
2. A decent global and U.S. economy imply that inflation will be stickier/higher than is embedded in markets, including the inflation component of nominal bond yields.
3. Fed rate-cut expectations by year-end are too optimistic and will likely disappoint. The risk is that bond yields eventually will move higher as rate-cut expectations are unwound.
4. Equity markets are looking through further earnings downgrades in the first-half, in anticipation of an upturn thereafter. Yet elevated corporate profit margins and return on equity limit the scope for any subsequent earnings upturn.
5. Valuations for equities already reflect an improving macro backdrop. We see little scope for further global re-rating in the year ahead that would coincide with strong price appreciation. (Stocks are trading at 18.5x 2023 consensus earnings expectations.)

Against this backdrop, we advocate taking some risk off the table. The recent risk-on climate has driven the global stock/bond total return ratio to an all-time high. A global 60/40 portfolio of global equities and G7 10-year government bonds has recouped about 40% of the peak-to-trough losses last year. Global equities are 15-20% above their 2022 lows, while G7 10-year government bond total returns have increased 5-10% from last year's low. There remains considerable uncertainty and debate about the economic outlook, but our view remains that a noticeable economic slowdown and likely mild recession will occur this year. Leading economic indicators (strongly inverted yield curve, negative money growth, PMIs below 50, LEIs rolling over) unfortunately are supportive of that view.

The underperformance of U.S. stocks is consistent with the deterioration in relative twelve-month forward earnings. Our forecast that the U.S. economy will continue to slow in the coming months while the euro area, China and other parts of the world pick up implies that the recent decline in U.S. relative earnings has further to run. To that end, we continue to recommend an overweight in international equities. We continue to favor value stocks over their growth counterparts, with the former benefitting from the anticipated better-than-expected global economy, while the latter are still vulnerable to earnings downgrades after over-earning during the pandemic.

## CONCLUSION:

An improving macro environment should delay somewhat a noticeable slowdown/mild recession and may cushion earnings estimate downgrades, but equity upside will likely be capped by a richly priced market with already elevated earnings expectations.

Data from Bloomberg, as of 2/10/2023.

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FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-1.00%	1.99%
BLOOMBERG U.S. CORP HIGH YIELD	-1.01%	3.89%
BLOOMBERG U.S. GOV/ CREDIT	-1.01%	1.87%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.07%	0.45%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-2.65%	8.33%
COMMODITIES (DJ)	1.59%	-3.15%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	-2.43%	14.30%
CURRENCIES (DB G10 CURRENCY FUTURE)	0.53%	0.95%