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GLOBAL INVESTMENTS

Doll's Deliberations

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SUMMARY:

U.S. equities were mixed last week (S&P 500 -0.2%) with some early week strength surrendered in multiple risk-off sessions impacted by economic data and hawkish Fed commentary. Fed peak rate expectations moved higher on a stronger than expected inflation report. Best sectors were consumer discretionary (+1.7%), consumer staples (+0.9%), and utilities (+1.1%); worst sectors were energy (-6.5%), REITs (-1.3%), and materials (-0.9%).

KEY TAKEAWAYS:

1. The U.S. CPI rose +0.5% m/m (6.4% y/y) and the core (ex food & energy) CPI was +0.4% m/m (5.6% y/y). U.S. inflation is still too high, and monetary policy needs to continue to tighten.

2. Whether the Fed pauses at mid-year or not, recent inflation data suggests the Fed may have more work to do to return to their target of 2%.

3. U.S. retail sales advanced 3% in January, the largest increase since March 2021, underscoring both robust consumer demand and inflationary pressures.

4. With 80% of companies reporting, it looks like 4Q earnings will be down 3% (7% excluding energy). Earnings beats are at a 10-year low (except for one quarter during the pandemic).

5. The U.S. dollar declined 11% between late-September and February 1, and since has gained 2%. This improvement coincides with positive U.S. economic data surprises over the past two weeks.

6. The CBO's updated projections point to a rapidly deteriorating fiscal situation, driven in large part by recent legislative changes, rising interest rates, and demographic problems over the long term.

7. Until last week, stocks in 2023 have staged a huge momentum reversal driven by rotation into high beta and hyper growth stocks which was exacerbated by short covering.

8. According to one big trading desk, short covering in tech stocks so far in February ranks in the highest percentage of historical observations.

9. The S&P 500 High Beta Index is up 22% year-to-date. We think beta has disconnected from the economic data unless we revert to a very strong economic growth pattern. (Unlikely!)

10. With equities trading near last summer's highs and at above-average multiples despite weakening earnings and the recent move higher in interest rates, we maintain that markets are overpricing recent good news and are complacent of risks.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	0.02%	2.35%
S&P 500	-0.20%	6.50%
NASDAQ	0.63%	12.76%
RUSSELL 2000	1.25%	10.41%
RUSSELL 1000 GROWTH	0.20%	9.84%
RUSSELL 1000 VALUE	-0.26%	4.34%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	0.23%	13.39%
CONSUMER DISCRETIONARY	1.66%	16.49%
CONSUMER STAPLES	0.94%	-0.99%
ENERGY	-6.46%	-3.59%
FINANCIALS	-0.29%	6.36%
HEALTHCARE	-0.32%	-2.82%
INDUSTRIALS	0.85%	4.91%
INFORMATION TECHNOLOGY	-0.33%	12.48%
MATERIALS	-0.91%	4.67%
REAL ESTATE	-1.26%	7.29%
UTILITIES	1.14%	-2.86%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	0.22%	7.19%
MSCI ACWI EX U.S.	0.22%	7.30%
MSCI EAFE	0.55%	7.93%
MSCI EM	-0.22%	5.81%

2% INFLATION? VERY UNLIKELY

Investors largely shrugged off a historically high U.S. inflation report last week. It is remarkable after the events of the past two weeks that investors continue to bet on a return to the low inflation world of the past decade. At most, bond investors have recently pushed expected U.S. policy rate cuts a bit further into the future, but are still discounting lower rates sooner than we expect will occur. Unlike in 2022, when equity and credit markets were undergoing a meaningful bear phase, investors so far this year seem to believe that such an inflation and rate outcome can coincide with better economic growth. Stock markets are up nicely year-to-date even in the U.S. where equity valuations have again become historically elevated and profit margins are likely to erode.

We strongly doubt that such a benign inflation and economic outcome looms. Global economic activity is on track to perform better than was envisioned by the consensus in late-2022, but inflation will prove much stickier and higher than the forward markets are discounting. The longer-term trend in inflation may not become evident until 2024 since last year's huge spike will unwind over the course of this year. However, even the forecast of sequentially lower inflation this year is not without risks; there are already some indications of stickiness in U.S. inflation in areas which should be steadily decelerating in the past year's surge in prices was merely a series of one-off increases. Our view is that a self-reinforcing inflationary process is underway, which has impacted wage demands and will ultimately leak into expectations. In other words, the world is not going back to the era when inflation was consistently 2% or less.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.68%	0.85%
BLOOMBERG U.S. CORP HIGH YIELD	-0.64%	2.43%
BLOOMBERG U.S. GOV/ CREDIT	-0.72%	0.70%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.08%	0.54%

So far, central banks seem content to ignore the recent easing in financial conditions, which is supportive of the risk-on phase continuing. Last year's boom in energy prices has come full circle, with oil and natural gas prices back to levels seen at the start of 2022, which represents a positive tailwind to global growth. And the previous strong U.S. dollar has corrected meaningfully, which is also a plus for many non-U.S. economies, especially in the EM world, and reinforces our rotation out of the U.S. investment theme.

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-0.57%	8.15%
COMMODITIES (DJ)	-1.88%	-4.97%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	1.24%	14.28%
CURRENCIES (DB G10 CURRENCY FUTURE)	0.07%	1.03%

U.S. inflation is decelerating, but there are some longer-term warning signs that inflation is going to be more persistent than investors and the Fed anticipate. Indeed goods inflation has dropped decisively but services inflation has a solid head of steam, and its expected deceleration phase will only be mild. The implication is that core inflation will remain well above the Fed's target. Moreover, the dearth of economic slack, especially in the labor market, points to upside risks to inflation should the U.S. economy prove resilient.

CONCLUSION:

The cyclical investment backdrop is still negative, as this year's deceleration in inflation will come up well short of central banks' target of 2% and inflation may creep higher thereafter. Little economic slack means that the underlying inflation trend, absent the one-time boosts to select prices generated by post-pandemic distortions, will be up until the next recession.

Data from Bloomberg, as of 2/17/2023.

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