CROSSMARK
GLOBAL INVESTMENTS

Feb. 26, 2024 | Issue 4.09

Doll's Deliberations

Weekly Investment Commentary

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Summary:

Equities advanced again (15th up week out of the last 17) as the S&P 500 advanced 1.7%. The highlight of the week was AI optimism following Nvidia's record results. Best performers were consumer staples (+2.1%) and technology (+2.0%); worst performers were energy (+0.4%) and real estate (+0.9%).

Key takeaways:

1. January's Index of Leading Economic Indicators (LEI) was down by 0.4%, the 23rd straight monthly decline (one month short of a record). Meanwhile, the Conference Board backed off from its recession forecast.

2. The Fed minutes from their January meeting contained no surprises. As expected, pre-emptive rate cuts are unlikely. Our best guess remains June for the first cut.

3. A headwind for the Fed reducing rates this year is too much fiscal stimulus as incumbents try to boost the economy before the election.

4. Payroll gains have been robust and unemployment is only 3.7%, but the work week is down, temp jobs are below pre-Covid levels, and layoffs are rising.

5. Nvidia's blowout Q4 earnings report spurred many U.S. and global stock indices to all-time highs as the bull run continues.

6. According to BCA Research, 59 of the 85 S&P 500 companies that have issued Q124 guidance have guided lower. That rate is above both five and ten-year averages.

7. Earnings quality, especially for big-tech, seems to be deteriorating a bit – e.g., accounting changes to extend depreciation periods for certain equipment. This lowers depreciation expense and increases earnings.

8. The 15.4% bull-bear spread remains elevated above the historical average of 6.5%. (Bullish sentiment makes the stock market more vulnerable to disappointments.)

9. Although the next recession is likely to be mild, stocks could suffer. (The 2001 recession was one of the mildest, yet stocks fell 49% largely because they were overvalued going into the recession.)

10. Under current law, the CBO estimates that Federal budget deficits will accelerate over the next ten years from the current $1.5 trillion per year to at least $2.5 trillion.

EQUITY MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
DJIA	1.30	4.10
S&P 500	1.68	6.91
NASDAQ	1.41	6.67
RUSSELL 1000	1.48	6.53
RUSSELL 1000 GROWTH	1.65	9.24
RUSSELL 1000 VALUE	1.41	3.49
RUSSELL 2000	-0.91	-0.52

S&P EQUITY SECTORS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	1.51	11.91
CONSUMER DISCRETIONARY	1.55	3.14
CONSUMER STAPLES	2.13	4.33
ENERGY	0.45	2.66
FINANCIALS	1.61	7.11
HEALTHCARE	1.52	8.49
INDUSTRIALS	1.83	5.53
INFORMATION TECHNOLOGY	1.97	9.71
MATERIALS	1.93	1.41
REAL ESTATE	0.92	-3.32
UTILITIES	1.17	-2.19

Will Excesses Lead to a Turn?

The recession camp has far fewer adherents than a year ago, thinned out by the surge in U.S. growth, a revival in global trade and, more recently, signs of a trough in the global PMI manufacturing index. Similarly, few investors expect above-potential U.S. economic growth to last long enough to warrant a renewed tightening in monetary conditions. Therefore, the broad consensus appears to expect a "near-perfect" soft landing.

Investors and central bankers are not wavering in their expectation that inflation will eventually return to 2% or lower in the near or medium term. Throughout this rate-hiking cycle, there has been an unprecedented front-running of significant rate cuts just beyond the near term. We disagree with this assessment, and do not expect current market expectations for an aggressive rate-cutting cycle this year to pan out. Forward markets have recently unwound some of the expected rate cuts, but a further unwinding looms.

The equity outlook remains positive in the near term in part based on momentum, but is much more challenging on a 6-12 month horizon. The increasingly overvalued and frothy U.S. large-cap and tech sectors offer places for investors to lighten up on holdings and rotate into better valued, pro-cyclical issues and select international markets. The challenge is that all equity markets will ultimately be dragged down once the U.S. market stumbles. The latter will likely be triggered by another upleg in bond yields and rekindling of de-rating pressures.

Inflation is proving sticky as we had expected, due to the dearth of economic slack and the self-sustaining interaction between service sector inflation and wages. For equities, we counsel patience before downgrading as the risk-on phase should persist until bond investors capitulate and central banks are again forced to acknowledge their misreading of inflation. Credit spreads also remain supportive for equities, and have edged lower this year despite the rise in government bond yields. Investors weathered the Silicon Valley Bank episode last year, but additional scares are probable before the cycle ends, especially in commercial real estate. The inflation threat could fade if economic growth weakens significantly, which doesn't appear likely anytime soon. There are hopes that strong productivity will carry the day and allow revenues, profits and wages to all do well without higher inflation.

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN) (%)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	1.38	4.75
MSCI ACWI EX U.S.	1.06	1.52
MSCI EAFE	1.04	2.09
MSCI EM	1.34	0.67

FIXED INCOME MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.13	-2.14
BLOOMBERG U.S. CORP HIGH YIELD	0.29	0.13
BLOOMBERG U.S. GOV/ CREDIT	-0.01	-1.96
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.04	0.76

ALTERNATIVES (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	0.66	-3.80
COMMODITIES (DJ)	-0.78	-2.49
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	0.61	2.77
CURRENCIES (DB CURRENCY FUTURE HARVEST)	0.61	4.86

Conclusion:

The economic outlook is broadly supportive of stocks in the near term, especially with the Fed having adopted an easing bias. While stocks typically rise during economic expansions, rich valuations and already elevated earnings will be constraints on further upside, especially if markets continue to unwind Fed rate-cut expectations, as we expect. Only modest rate cuts this year will not be laying the groundwork for a sustained equity market advance, although they will temporarily prolong the economic expansion.

Data from Bloomberg, as of 2/23/2024.