



Doll's Deliberations

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SUMMARY:

U.S. equities were lower for the third straight week (S&P 500 -2.7%) posting the worst weekly performance since early December. The path of least resistance has been to the downside amid repricing around the Fed rate path. (Markets are now pricing in a peak fed funds rate of around 5.38%, up by 60bp over the last month.) Best sectors were energy (0.2%) and materials (-0.1%); worst sectors were consumer discretionary (-4.4%) and communication services (-4.4%).

KEY TAKEAWAYS:

- The economy has started out 2023 stronger than expected. (Payrolls surprised to the upside, service PMIs improved, and retail sales were strong.)
- The Conference Board's U.S. Leading Economic Indicators (LEIs) fell by 0.3% m/m in January, marking the 10th straight monthly decline. (The LEI is a leading indicator of recessions.)
- It is worth remembering that the first U.S. rate hike happened less than one year ago. While this has been more than enough time to weaken hyper-rate-sensitive housing investment, it has not yet been enough time to impact the broader economy. The current U.S. housing recession is possibly the canary in the coal mine for an economic recession that starts at some point in 2023.
- Our sense remains that the Fed will hike higher and/or for longer than the consensus expects making a recession more likely.
- It is possible that the Fed "pivot" will be accepting 3% inflation rather than insisting on 2%.
- Q4 estimates have fallen 1.7% since January 1 vs. an average increase of 2.8%, the largest decline in 24 years outside a recession.
- After the gargantuan returns in energy stocks in 2021 and 2022, calling for another year of outperformance raises skepticism. But in light of 1) strong cash flow, 2) capital discipline, and 3) China's reopening, we continue to favor energy.
- The budget deficit and federal debt will be a major issue this summer and for years to come.
- Having declared for President, Nikki Haley is attempting to make age/generational change a major issue for 2024 (obviously aimed at Joe Biden and Donald Trump).
- The cold war between the U.S. and China is worsening as China is hinting that it might send weapons to Russia, which would cross a "red line," officials in Washington contend.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	-2.97%	-0.69%
S&P 500	-2.66%	3.66%
NASDAQ	-3.31%	9.02%
RUSSELL 2000	-1.96%	8.49%
RUSSELL 1000 GROWTH	-2.94%	6.61%
RUSSELL 1000 VALUE	-2.43%	1.80%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-4.37%	8.43%
CONSUMER DISCRETIONARY	-4.43%	11.33%
CONSUMER STAPLES	-1.40%	-2.38%
ENERGY	0.17%	-3.42%
FINANCIALS	-1.95%	4.29%
HEALTHCARE	-2.67%	-5.41%
INDUSTRIALS	-2.64%	2.14%
INFORMATION TECHNOLOGY	-2.70%	9.44%
MATERIALS	-0.12%	4.55%
REAL ESTATE	-3.78%	3.23%
UTILITIES	-2.75%	-5.53%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-1.47%	5.14%
MSCI ACWI EX U.S.	-1.23%	5.28%
MSCI EAFE	-1.16%	6.22%
MSCI EM	-1.16%	3.37%

RISING RATE EXPECTATIONS DUE TO STICKY INFLATION HAUNT EQUITY MARKETS

The catalyst for higher yields is growing signs of a revival in previously lagging or weak economic areas. This raises the odds that inflation will prove stickier and level off well above 2% which is not consistent with current bond market (or perhaps stock market) pricing. Two-year government bond yields have hit a new cycle high raising concerns about the longer-end of the curve. The risk for bond market expectations is that central banks are not going to be able to pause beyond the near run as is widely expected, nor will rates be lowered thereafter. Rather, there are increasing odds that central banks will have to continue tightening policy, possibly spurring another upleg in bond yields.

A globally-induced, rather than domestically-driven, increase in borrowing rates in weaker economies could prove troublesome and expedite the end of the global economic expansion. A durable upside breakout in yields would resume downward pressure on equity and credit market valuations. The rise in bond yields initially hurts risk asset markets even if good economic activity supports corporate earnings.

While earnings expectations are eroding in the U.S., they are not (yet) expected to be meaningfully lower in 2023. Non-U.S. equity markets should witness improved earnings expectations this year, especially the euro area and select EM markets. These markets offer better longer-term value than the U.S.

Underlying inflation is showing signs of being sticky. Inflation has peaked in most countries, with the U.S. leading the way up and now leading in the deceleration phase. However, inflation is still far higher than at any time in the past 40 years throughout the developed world, even in perennially deflationary Japan. There are widespread indications that not all of the surge in inflation during 2021-2022 was one-off in nature, but involved self-reinforcing elements and, critically, has infected labor markets. Goods inflation may well return to zero or even briefly below, as is consistent with ongoing broad-based weakness in goods demand and the manufacturing sector. However, the same is not true for many service sectors, where a modest acceleration in activity is underway in many economies and where inflation will prove sticky.

CONCLUSION:

The equity market rebound that took equities to six-month highs reflected a view that recession could be avoided and that earnings could stay resilient. We believe that rally has ended due to 1) a yield curve that is heavily inverted, 2) declining money supply, and 3) rising interest rate expectations. The hoped-for central bank pause and expectations for lower rates down the road will prove misplaced (or at least very premature). The recent firming in global growth will reinforce the underlying uptrend in inflation and keep pressure on central banks, which will ultimately sustain the negative cyclical investment backdrop, and eventually lead to recession.

Data from Bloomberg, as of 2/24/2023.

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FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.34%	0.73%
BLOOMBERG U.S. CORP HIGH YIELD	0.04%	2.21%
BLOOMBERG U.S. GOV/ CREDIT	-0.29%	0.64%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.08%	0.63%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-2.13%	5.46%
COMMODITIES (DJ)	-0.83%	-5.76%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	-1.68%	11.77%
CURRENCIES (DB G10 CURRENCY FUTURE)	0.88%	1.92%