CROSSMARK GLOBAL INVESTMENTS

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DOLL'S DELIBERATIONS

WEEKLY INVESTMENT COMMENTARY

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	-0.25%	-0.25%
S&P 500	-1.83%	-1.83%
NASDAQ	-4.52%	-4.52%
RUSSELL 2000	-2.91%	-2.91%
RUSSELL 1000 GROWTH	-4.81%	-4.81%
RUSSELL 1000 VALUE	0.82%	0.82%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-2.50%	-2.50%
CONSUMER DISCRETIONARY	-2.59%	-2.59%
CONSUMER STAPLES	0.40%	0.40%
ENERGY	10.61%	10.61%
FINANCIALS	5.44%	5.44%
HEALTHCARE	-4.62%	-4.62%
INDUSTRIALS	0.65%	0.65%
INFORMATION TECHNOLOGY	-4.67%	-4.67%
MATERIALS	-1.49%	-1.49%
REAL ESTATE	-4.94%	-4.94%
UTILITIES	-1.61%	-1.61%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-1.52%	-1.52%
MSCI ACWI EX U.S.	-0.37%	-0.37%
MSCI EAFE	-0.29%	-0.29%
MSCI EM	-0.47%	-0.47%

SUMMARY:

Equities declined in the first week of the new year (S&P 500 -1.8%, NASDAQ -4.5%). The December FOMC meeting minutes reinforced the Fed's hawkish pivot and sent a scare to Wall Street. Unsurprisingly, the equity sell-off was led by long duration, high P/E, high growth stocks. Treasuries were under pressure all week, with 10-year yields up 26 bps to 1.77%. Sectoral performance was widely diversified: best sectors were energy +10.6% and financials +5.4%; worst sectors were REITs -4.9% and technology -4.7%.

KEY TAKEAWAYS:

1. The minutes of the December FOMC meeting pointed to rate hikes being on the horizon and to the balance sheet shrinking process happening earlier and faster than expected. This riled the markets last week.
2. Markets are unlikely to come under intense pressure unless it becomes evident that the Fed needs to slow demand growth aggressively. But, the Fed wants higher real yields, so investors should position for that outcome.
3. When the discount rate rises (i.e., when interest rates rise), the present value of a company's terminal value falls. Therefore, companies that have a near-term return on capital (cash flow, dividends, return on equity) outperform companies that will earn money "someday."
4. Payroll employment increased by a disappointing 199,000 in December. But, prior months were revised up noticeably, the unemployment rate fell 0.3% to 3.9%, and average hourly earnings jumped 0.6%. All this continues to point to the Fed being behind the curve.
5. Global CPI inflation accelerated sharply in Q4 to an estimated 5.9% with a broadening of price pressures. We forecast core inflation to stabilize in Q1 in the U.S. and overall inflation to fade but to a still too high 3-4%.
6. There are increasing signs that global supply constraints are starting to ease. This will likely cause the yield curve to steepen and value to continue to outperform growth.
7. The worst-case scenarios from an Omicron wave appear to be off the table thanks to lower severity, new therapeutics, and some effect from vaccines and boosters. Therefore, Omicron is not likely to be a significant demand shock.
8. 4Q21 S&P reporting season gets underway this week, and we anticipate another round of upward revisions during reporting season.
9. The meaningful deceleration in China's economy during the course of 2021 appears to be ending. The weakest link remains the property sector, where deleveraging conditions are likely to persist.
10. With Democrats facing an uphill battle to keep the House in the 2022 midterms, the next few months may well be their last opportunity to get significant pieces of their agenda passed. We expect a scaled-down version of Build Back Better, or a series of smaller bills, to be negotiated and finalized by the Democrats over the next few months.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-1.53%	-1.53%
BLOOMBERG U.S. CORP HIGH YIELD	-0.94%	-0.94%
BLOOMBERG U.S. GOV/ CREDIT	-1.71%	-1.71%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.00%	0.00%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-3.80%	-3.80%
COMMODITIES (DJ)	2.25%	2.25%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	-3.38%	-3.38%
CURRENCIES (DB G10 CURRENCY FUTURE)	-0.08%	-0.08%

RISING INTEREST RATES NEED TO BE COUNTERED WITH STRONG Q1 EARNINGS

As has been the case for some time, inflation continues to be the key risk to our outlook, along with its flow through into interest rates. While the Fed has retired "transitory" from its inflation lexicon, both it and markets are still overly complacent about the inflation outlook. This year, inflation will remain elevated, with demand-side pressures intensifying even as some supply chain effects gradually fade. Central banks will be compelled to rachet up their anti-inflation efforts. It is important to distinguish between the likely impact of rising interest rates on the global economy versus capital markets. Even the Fed rate hikes currently discounted in markets would leave both nominal and real rates historically low, even with the risk that the Fed will hike more aggressively. We see little threat to the U.S. or global economies from higher policy rates over the next 6-12 months. The impact of higher interest rates on capital markets is more problematic. Most bonds are overvalued and vulnerable to losses given our upbeat global economic outlook and above-consensus inflation forecast. Equities and other risk assets will be vulnerable to de-rating as hyper-accommodative monetary policy is gradually unwound.

The expected rise in U.S. (and global) government bond yields points to downward pressure on equities. The inverse relationship between bond yields and stock prices is unclear and broke down during the 2008-2012 period when deflation fears were elevated. However, since then, it has broadly resumed, underscoring the probability of an equity de-rating as bond yields rise. Ongoing global economic expansion favors further equity outperformance versus bonds. However, returns on stocks and bonds will be poorer in the next 6-12 months than last year, while volatility will likely be higher with more frequent and larger pullbacks.

Healthy economic growth points to a further rise in corporate cash flows and profitability. History indicates that rising earnings ultimately will be sufficient to offset any downward pressure on equity market multiples. However, history also indicates a high probability of painful, albeit brief, corrections when interest rates rise. This is especially the case for richly-priced U.S. growth stocks, which account for a large share of the global equity universe.

As mentioned, equities will still have earnings tailwinds, but bond market anxiety will inevitably spill over into equities. This underscores our Ten Predictions theme of "Tug of War Between Earnings Tailwinds and Valuation Headwinds." We will be more upbeat about equities once signs emerge that leadership is poised to shift more clearly toward non-U.S. equities, where earnings and valuations are less elevated, the disruption from higher interest rates will likely be less severe, and where upside potential is greater.

CONCLUSION:

Risk assets remain resilient and still have growth tailwinds but face a clear threat in the year ahead as global interest rates finally shift higher. As last week's markets jitters highlight, investors should expect a bumpy ride in 2022 with much lower overall portfolio returns than last year alongside greater volatility. A balanced global multi-asset portfolio will struggle to generate positive returns this year.

Data from Morningstar Direct, as of 01/10/2022.

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