



Doll's Deliberations

Weekly Investment Commentary | January 17, 2023 | Issue 3.3

SUMMARY:

Stocks closed higher last week (S&P 500 +2.7%) at their highest level in a month. The main macro tailwinds include the decline in inflation (CPI) and improved consumer sentiment. Best sectors were consumer discretionary (+5.8%) and technology (+4.6%); worst sectors were consumer staples (-1.5%) and healthcare (-0.2%).

KEY TAKEAWAYS:

1. U.S. headline CPI inflation eased from 7.1% y/y (0.1% m/m) to 6.5% y/y (-0.1% m/m) in December raising the likelihood that the Fed will downshift the pace of rate hikes to 25 basis points. The labor market remains too hot to make the case for rate cuts anytime soon.
2. While the rate of inflation has peaked, there are components of inflation – wages, rents, government spending indexed to inflation, and the price of oil – that we believe are structural.
3. The Atlanta Fed's GDPNow model suggests that real GDP rose by 3.8% in Q4, up from 3.2% in Q3 and -1.1% in the first half of 2022.
4. A hot labor market continues to cause many to make the case that there will be no recession in 2023. We continue to believe that a mild recession is likely in 2023 given yield curve inversion, negative Leading Economic Indicator readings, and a troublesome drop in money growth.
5. Interesting, there is no negative yielding debt left anywhere in the world. What a contrast from the last several years!
6. The U.S. fiscal situation continues to deteriorate. April tax revenues will be down substantially. Interest costs are up 44 percent in the last three months and now represent the largest share of the U.S. economy since 2000. A serious crisis over defaulting on the U.S. debt looms by summer.
7. In a little talk about geopolitical risk, Iran is now only months away from having a nuclear weapon.
8. The consensus scenario among economists is that the U.S. economy is heading into a recession this year and that stock prices will fall during the first half of this year, possibly to a new bear-market low by mid-year, setting the stage for a strong bull-market rally during the second half of this year.
9. With the early 2023 rally, the S&P 500 is back testing its 200-day moving average.
10. YTD through the close on January 13 (9 trading days), U.S. stocks are up +4.2%, while non-U.S. stocks are up +7.8%; small stocks (R2000) up +7.1% and big stocks up +4.2%; value and growth are nearly similar (4.4% and 4.3%, respectively).

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	2.01%	3.54%
S&P 500	2.71%	4.22%
NASDAQ	4.83%	5.88%
RUSSELL 2000	5.27%	7.17%
RUSSELL 1000 GROWTH	4.04%	4.37%
RUSSELL 1000 VALUE	1.92%	4.48%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	4.27%	8.18%
CONSUMER DISCRETIONARY	5.77%	8.15%
CONSUMER STAPLES	-1.45%	0.30%
ENERGY	2.69%	2.69%
FINANCIALS	2.05%	5.54%
HEALTHCARE	-0.15%	-0.29%
INDUSTRIALS	1.53%	4.29%
INFORMATION TECHNOLOGY	4.62%	4.87%
MATERIALS	4.31%	7.91%
REAL ESTATE	4.41%	7.02%
UTILITIES	0.45%	1.16%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	3.37%	5.44%
MSCI ACWI EX U.S.	4.16%	7.17%
MSCI EAFE	4.25%	7.04%
MSCI EM	4.18%	7.70%

RISK-ON REIGNS – FOR NOW

The current choppy risk-on phase will likely persist for as long as government bond markets stay calm. Ten-year government bond yields have fallen approximately 25 basis points since year-end creating a positive backdrop for stocks. While there are some attractive opportunities as investors finally branch out from only favoring U.S. asset markets and the dollar, the pause in interest rate rises is likely a pause, not the end of the cycle. While much improved over extremely poor valuations at the end of 2021, neither bonds nor stocks offer compelling values in a world where inflation is likely to prove higher and stickier than at any point in the last 40 years. Although core inflation will be lower this year than in 2022, the rate in 2023-2024 should be well above the average rate over the prior 40 years. In other words, while the spike in inflation last year likely will represent a peak for a long time, we do not envision a return to low inflation; rather, core CPI should be well above 2% with a tendency to trend higher whenever growth is good.

The risk of the U.S. and global economy stumbling into recession still exists but several economic risks in 2022 have improved: 1) the risk of the euro economy imploding due to the energy crisis has sharply receded, and the economy has been strengthening, 2) the threat of central banks tightening too much and for the rise in bond yields to turn open-ended have also diminished, and 3) China abruptly abandoned its Covid-zero policy in December. While the economic data will be noisy due to surging infections, the direction is towards better growth.

The rise in interest rates last year will have a dampening economic effect in 2023 as monetary policy operates with a long and unpredictable lag. Absent a recession, we see little further decline in bond yields. There are already high expectations for much lower inflation data ahead and longer-term bond valuations are still not compelling. Keep in mind that many bond investors and most central banks still expect a return to a 2% inflation world. Such entrenched biases will not be easily changed, especially in the face of a deceleration in inflation. By reducing the near-run chances of a recession, market action ironically could help to sow the seeds for another bout of rising bond yields, increased central bank angst and de-rating pressures on equities.

The U.S. economic outlook for 2023 is more nuanced than for the euro area and China. Perhaps a rolling slowdown/recession label better describes prospects, with some sectors notably weakening after two strong years, and others improving or at least holding up well. Pandemic beneficiaries and interest rate-sensitive sectors (such as housing) are weakening (recessionary), which has been reflected in layoff announcements and pessimistic headlines. However, other U.S. economic sectors are still in good shape and overall consumption trends have been solid. This strength/resilience is reflected in overall employment trends (slowing, but solid) and persistently low aggregate unemployment claims (and still no increase in unemployment levels).

CONCLUSION:

The recent risk-on phase should persist given prospects for lower inflation and the likelihood of an eventual Fed rate pause. The risk is that global growth and inflation will be more resilient than is discounted in government bond markets. We continue to favor non-U.S. equity markets and currencies.

Data from Bloomberg, as of 1/13/2023.

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FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO- DATE
BLOOMBERG U.S. AGGREGATE BOND	0.88%	2.74%
BLOOMBERG U.S. CORP HIGH YIELD	1.58%	3.84%
BLOOMBERG U.S. GOV/ CREDIT	0.89%	2.65%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.07%	0.12%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO- DATE
REAL ESTATE (FTSE NAREIT)	4.35%	6.76%
COMMODITIES (DJ)	3.30%	-0.92%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	7.20%	10.96%
CURRENCIES (DB G10 CURRENCY FUTURE)	-1.39%	-0.42%