



Doll's Deliberations

Weekly Investment Commentary | January 23, 2023 | Issue 3.4

SUMMARY:

Despite a big Friday bounce, stocks fell for the week (S&P 500 -0.7%). Macro forces during the week included a soft-landing thesis as well as a soft inflation outlook despite a still-robust labor market. Bears argued that this was just a short covering bear market rally. Best sectors included communication services (+3.0%), energy (+0.7%) and technology (+0.7%). Biggest losers were industrials (-3.4%), utilities (-2.9%) and consumer staples (-2.9%).

KEY TAKEAWAYS:

- As a result of weak retail sales and industrial production in December, some market observers have moved from a soft-landing forecast to recession. (Market perceptions move much faster than the economy.)
- Central banks have already or will downshift the pace of rate hikes before ultimately pausing. However, it may be too late to avert recession. Elevated policy rates are a restraint on economic activity and central banks are unlikely to pivot to rate cuts without a sharp deterioration in economic conditions.
- The labor market remains strong with monthly initial unemployment claims falling again. There have been a lot of layoff announcements, but they largely come from industries that have a small share of overall employment.
- The S&P 500 tends to bottom 3-6 months before downward earnings revisions cycles are done. The earnings bottom is likely several months, if not quarters, away.
- Year-to-date, the best performing quartile stocks last year are up 1% while the worst quartile performers from last year are up 16%. The durability of this "dash for trash" is questionable.
- Our belief is that returns in 2023 will depend heavily on stock selection (e.g., Morgan Stanley outperformed Goldman Sachs by 12% on January 17 as both companies reported earnings.)
- Like in 2022, we expect short duration stocks (including dividend payers) will outperform long duration stocks in 2023. Dividends have accounted for more than half of the overall return of stocks in the long term. We expect a similar result this decade.
- There is a coordinated effort to introduce legislation in 7 states (CA, CT, HI, IL, MD, NY and WA) to impose higher taxes on the wealthy.
- There will be headlines ad nauseam regarding the upcoming debt ceiling issue. Positioning and finger pointing will go on until an agreement to raise the ceiling is absolutely necessary. There could be some market volatility at "the 11th hour."
- China's population fell by 850,000 in 2022, the first decline in over 60 years. Projections are that China's population may fall by nearly 50% by the end of the century, fueling fears of a demographic crisis.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	-2.66%	0.78%
S&P 500	-0.65%	3.55%
NASDAQ	0.55%	6.47%
RUSSELL 2000	-2.68%	4.30%
RUSSELL 1000 GROWTH	0.38%	4.77%
RUSSELL 1000 VALUE	-1.48%	2.93%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	2.97%	11.39%
CONSUMER DISCRETIONARY	-0.51%	7.60%
CONSUMER STAPLES	-2.85%	-2.45%
ENERGY	0.75%	3.45%
FINANCIALS	-2.08%	3.35%
HEALTHCARE	-1.10%	-1.38%
INDUSTRIALS	-3.33%	0.82%
INFORMATION TECHNOLOGY	0.68%	5.59%
MATERIALS	-1.21%	6.60%
REAL ESTATE	-0.75%	6.22%
UTILITIES	-2.93%	-1.81%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-1.65%	3.71%
MSCI ACWI EX U.S.	-0.42%	6.72%
MSCI EAFE	-0.49%	6.52%
MSCI EM	-0.18%	7.52%

CROSS-CURRENTS AND OPINION SWINGS CONTINUE

Risk assets have moved up year-to-date in anticipation of an eventual end to the rate-hiking cycle and perhaps a soft-landing. The consensus is shifting from expecting a U.S.-led recession, towards a more constructive global economic outlook. Few hold our inflation view, which is that it will prove sticky and hold well above central bank targets. Thus, the “Goldilocks” outcome that is necessary for risk-on conditions to continue is unlikely to persist beyond the next few months. Expectations for an improvement in the euro area and Chinese economies are valid, and are increasingly seen as being sufficient to offset sluggish conditions in the U.S. Better growth also means that the discounting of a reversal in the rate-hiking cycle will eventually be dashed.

For now, higher risk asset prices have resulted from a view that inflation will decelerate steadily and central banks will go on hold. Eventually, underlying inflation will level off well above 2%. That means that U.S. rate cutting expectations for later this year are unlikely to be met. Therefore, investors should enjoy the risk-on phase while it lasts, but stay cyclically cautious.

The anchors on global bond yields during the past decade are lifting and the era of zero interest rates is over. In the end, domestic conditions will remain the primary driver of U.S. Treasuries, but domestic forces likely will be “reinforced” with rising bond yields elsewhere. Lower bond yields and a weaker U.S. dollar represent a partial unwinding of global economic headwinds, and will help to extend the business cycle. That will sow the seeds for a higher and longer rate-hiking cycle than is currently discounted. Monetary conditions are not yet economically restrictive, and although the cyclical rise in bond yields is somewhat advanced, most bonds are still not undervalued.

The sharp drop in U.S. headline inflation will not likely be matched by much lower core CPI, as the core services rate will prove sticky. Critically, there is no slack in the U.S. economy, and the labor market is historically tight. This contrasts with the consensus view that inflation will eventually return to the world of the 2010's, when inflation averaged 2% or less. The key issue for global equities is whether the recent rally is merely a bear market bounce, rather than the start of a new durable bull phase. We are in the former camp believing a mild recession is likely sometime this year. Earnings expectations, which have already started to recede, have further downside.

CONCLUSION:

The key to sustaining the rally in risk assets is a goldilocks scenario of continued calm in government bond markets and improving global economic activity. Such an outcome will not persist indefinitely, and we expect the consensus low inflation and soft-landing view to prove misplaced. The rotation in performance in favor of non-U.S. equities and currencies is expected to prove durable.

Data from Bloomberg, as of 1/20/2023.

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DD-WKLY-COMM-3.4 1/23

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO- DATE
BLOOMBERG U.S. AGGREGATE BOND	0.61%	3.37%
BLOOMBERG U.S. CORP HIGH YIELD	-0.18%	3.66%
BLOOMBERG U.S. GOV/ CREDIT	0.63%	3.30%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.07%	0.19%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO- DATE
REAL ESTATE (FTSE NAREIT)	-1.64%	5.01%
COMMODITIES (DJ)	0.58%	-0.34%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	-2.61%	8.06%
CURRENCIES (DB G10 CURRENCY FUTURE)	0.71%	0.28%