CROSSMARK
GLOBAL INVESTMENTS

Doll's Deliberations

Weekly Investment Commentary | January 30, 2023 | Issue 3.5

SUMMARY:

U.S. equities finished higher last week (S&P 500 +2.5%), closing above the 4000 level for the first time since early December. The path of least resistance remains higher even though earnings season continued to undershoot expectations. Best sectors were consumer discretionary (+6.4%) and technology (+4.1%); worst sectors were healthcare (-0.9%) and utilities (-0.5%).

KEY TAKEAWAYS:

1. Q4 GDP was not nearly as strong as the +2.9% headline. Inventory investment boosted GDP growth by 1.5ppts. Thus, real final sales were up just 1.4%.

2. U.S. core PCE inflation rose +0.3% m/m in December and 4.4% y/y. With Fed funds at 4.25%, we are now approaching positive real (inflation-adjusted) interest rates, a necessary condition historically for a bear market to end.

3. Roughly 60% of U.S. CPI is derived from service sector inflation, while 20% comes from goods, and the final 20% comes from food and energy.

4. The labor market still seems strong. Initial claims for unemployment insurance claims are still very low. But the job market is a LAGGING indicator of economic health and jobless claims should be expected to be at or near a bottom very close to the peak in the business cycle.

5. The Conference Board's Leading Economic Index (LEI) fell by 1.0% in December, following a 1.1% m/m drop in November. U.S. LEI has contracted by 7.4% year-on-year. Contractions in this index are a reliable recession indicator, especially when they coincide with an inversion in the yield curve and restrictive monetary policy.

6. U.S. money supply (M2) fell in December (-0.7% m/m). This is a record percentage decline back to 1959 and is one of our reasons for expecting a mild recession.

7. The dollar has declined more than 10% since its peak four months ago. This has fueled a rally in precious and industrial metals.

8. We attribute the recent "risk on" rally to the market looking through near-term economic weakness and toward the next Fed cutting cycle – even though the current hiking cycle isn't over yet.

9. High beta stocks are up more than 15% so far this year, while low beta stocks are down fractionally. The move to aggressive stocks has been stark.

10. The biggest differences between sector market cap weights and their respective earnings weights are in energy and technology sectors. Energy represents 12.4% of the Index's earnings but make up only 5.2% of its market cap. Technology represents 21.4% of earnings but 26.3% market capitalization.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	1.81%	2.60%
S&P 500	2.48%	6.11%
NASDAQ	4.32%	11.07%
RUSSELL 2000	1.92%	8.10%
RUSSELL 1000 GROWTH	3.40%	8.33%
RUSSELL 1000 VALUE	1.78%	4.77%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	3.28%	15.04%
CONSUMER DISCRETIONARY	6.40%	14.48%
CONSUMER STAPLES	0.45%	-2.02%
ENERGY	0.78%	4.26%
FINANCIALS	2.54%	5.97%
HEALTHCARE	-0.84%	-2.22%
INDUSTRIALS	2.13%	2.97%
INFORMATION TECHNOLOGY	4.07%	9.89%
MATERIALS	0.71%	7.36%
REAL ESTATE	2.82%	9.21%
UTILITIES	-0.49%	-2.29%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	1.88%	7.15%
MSCI ACWI EX U.S.	1.29%	8.80%
MSCI EAFE	1.15%	8.28%
MSCI EM	1.57%	10.09%

INFLATION AND EARNINGS ESTIMATES CONTINUE TO DECLINE

While central bank set rates have continued to move higher in recent months, yields have actually declined for government bonds and credit. The perception is that the early interest rate-hikers are set to pause, which has encouraged a choppy risk-on phase. It has not yet reduced recession fears, but these fears have stopped intensifying and there are mounting signs of a modest sequential firming trend in the lagging economies, especially the euro area and Japan with China/Asia to soon follow.

The peaking headline inflation has opened the door for central banks to possibly wait and see in terms of the cyclical rate-hiking cycle, and we expect the Fed to eventually pause. Likewise, government bond yields have settled into a trading range, and the intense de-rating pressure on risk assets from rising yields that dominated the investment landscape last year has ended for now. Higher policy rates have far less economic bite when market-set rates and yields are easing, as has recently been the case.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	0.14%	3.04%
BLOOMBERG U.S. CORP HIGH YIELD	0.40%	3.93%
BLOOMBERG U.S. GOV/ CREDIT	0.16%	2.92%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.07%	0.28%

Credit remains well behaved, which is so far inconsistent with recession fears. Investment-grade credit spreads are near a 9-month low, while high-yield spreads also have narrowed. The rolling over in the previously strong U.S. dollar is another plus for the global growth and risk asset market outlook. The dollar has been steadily eroding on a broad-basis in recent months, with the euro being the big beneficiary. Moreover, the Fed will soon slow its pace of rate hikes and the market continues to expect U.S. rate cuts later this year. We doubt that rates will be cut, but our view will only be validated in the second half of the year, and thus we expect the dollar to struggle for now. Dollar weakness has been the catalyst for a shift in investment flows in favor of non-U.S. equity markets. We expect this trend to persist.

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	1.81%	8.19%
COMMODITIES (DJ)	-0.37%	-0.71%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	3.48%	13.68%
CURRENCIES (DB G10 CURRENCY FUTURE)	0.46%	0.74%

The debate over whether a U.S. and global recession looms will likely persist. Economic uncertainty is elevated for valid reasons, reflecting so many atypical developments this decade, starting with the pandemic, the massive policy response, the stop-start nature of re-opening, the war in Ukraine and resulting energy crisis last year, and the surge in inflation to 40-year highs.

The end of the free money era and lifting in policy rates will remain economic drags. However, the amount of prior policy stimulus was massive, and some of it has still not been spent, especially huge fiscal transfers. The key going forward will be the health of corporate profitability, which has been underestimated by the recession camp and has manifested in slowing but still positive employment and hiring conditions. There are many leading recession indicators such as the inverted yield curve, negative money growth, and PMIs below 50. Therefore, the probability of a mild recession continues to be substantial. On the other hand, should economic growth continue, it will prevent economic slack from building and, ultimately, this will put a rising floor under core inflation

CONCLUSION:

As headline inflation steadily decelerates and central banks slow their rate hikes, and pause thereafter, risk assets can drift higher. Pushing in the other direction is continued earnings estimate erosion. We expect these cross currents to cause trendless stock and bond markets.

Data from Bloomberg, as of 1/27/2023.