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GLOBAL INVESTMENTS

Doll's Deliberations

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SUMMARY:

Equities were higher last week (S&P 500 +1.0%, briefly topping 4600 on Thursday). The Fed raised rates by 25 basis points as was widely expected. Earnings continue to be reasonably firm, although full-year estimates are little changed. Best sectors were communication services (+6.9%), materials (+1.8%), and energy (+1.7%); worst sectors were utilities (-2.1%), real estate (-1.8%) and healthcare (-0.9%).

KEY TAKEAWAYS:

1. The July FOMC meeting proceeded as expected. Fed Chair Jay Powell tried to keep forward guidance vague in his post-meeting press conference.
2. Futures suggest a 50% chance of one more 25 basis point hike later in the year but many believe that the hiking cycle is now complete. It seems however, that inflation is not going to stay down without a fight.
3. The 10-year US-Treasury yield poked above 4% briefly last week on a better than expected 2Q GDP (+2.4%) and comments from Japan on yield curve control bands.
4. The perception of a soft landing has increased, but in our view, odds of a soft landing remain low. It is still early – the first rate hike was only 16 months ago.
5. Monthly mortgage payments set a new all-time high due to mortgage rates hovering near 7%, a resilient labor market, and constrained supply due to a decade of underbuilding.
6. Nearly one-half of the S&P 500 has now reported Q2 results. More than 70% of reports have exceeded consensus EPS expectations, similar to the 77% five-year average.
7. Labor unions have grown, their members are striking, and employers are being forced to meet their demands, adding a wage-price spiral to our worry list.
8. According to Empirical Research, this year the market's multiple has expanded by three points, or by almost +20%, a gain in the top sixth of those seen in the last 70 years.
9. Due to the heavy concentration of stock outperformance at the mega level, actively managed long-only funds are underperforming their benchmarks so far this year.
10. The bulls believe that the stock rally, fueled by falling inflation and the likelihood of an economic soft landing, can continue as market strength broadens. The bears believe that the odds of such an easy victory over inflation, and therefore a soft landing, remain low, and the markets are likely to give back some of the gains that have been heavily concentrated in just a few mega-cap stocks.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	0.66%	8.24%
S&P 500	1.03%	20.47%
NASDAQ	2.03%	37.43%
RUSSELL 2000	-0.27%	11.92%
RUSSELL 1000 GROWTH	1.65%	33.17%
RUSSELL 1000 VALUE	0.27%	8.49%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	6.85%	45.75%
CONSUMER DISCRETIONARY	1.24%	35.56%
CONSUMER STAPLES	0.72%	3.93%
ENERGY	1.72%	-0.55%
FINANCIALS	-0.20%	3.83%
HEALTHCARE	-0.80%	0.32%
INDUSTRIALS	0.57%	13.12%
INFORMATION TECHNOLOGY	1.28%	46.41%
MATERIALS	1.83%	10.84%
REAL ESTATE	-1.80%	4.34%
UTILITIES	-2.08%	-3.42%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	0.40%	16.93%
MSCI ACWI EX U.S.	1.03%	13.21%
MSCI EAFE	0.76%	14.93%
MSCI EM	2.05%	10.15%

"HIGH RISK, BULL PHASE" CONTINUES

Global financial markets have settled into a Goldilocks view, expecting just enough economic growth to support corporate earnings, yet believing that inflation will decelerate sufficiently to end Fed rate hikes and, eventually, allow rates to be cut. We expect this view will be as short lived as other such episodes in the past 6-12 months. We expect underlying inflation to be above pre-pandemic and central bank target levels. The Fed is data dependent meaning that it will take stronger economic data and/or clear evidence of persistently high inflation to trigger more rate hikes. Despite badly misreading the inflationary outcome in the past two years, policymakers and bond markets remain biased towards a return to the 2010's world of sluggish growth and low/stable inflation. The labor market is still tight, with wage pressures and their effect on service sector inflation remaining a roadblock to returning to a stable 2% inflation world.

The choppy risk-on phase has persisted, helping drive the global stock/bond total return ratio to new heights. Narrowing corporate high-yield and EM spreads over Treasuries are also giving positive economic signals. Relatively flat long-term bond yields since last autumn, even as most central banks have continued to hike rates, have helped to buoy economic activity and risk asset prices. The biggest disagreement with the positive economic message from equity and credit markets comes from the long end of government bond curves, where yields remain pinned down and most yield curves have progressively and significantly inverted. The same bond-bullish bias is evident in policy rate expectations, where a sizable rate-cutting cycle is discounted starting next year.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.75%	1.54%
BLOOMBERG U.S. CORP HIGH YIELD	-0.05%	6.48%
BLOOMBERG U.S. GOV/ CREDIT	-0.75%	1.65%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.08%	2.72%

The consensus has an entrenched bias towards expecting a non-recessionary return to the low and stable inflation environment of last decade, despite the many significant cyclical and structural differences. The era of cheap money and persistent asset bubbles ended once inflation revived. The longer monetary conditions are not restrictive, the greater the odds that inflation becomes entrenched. By capping bond yields and allowing central banks to pause, the global economic expansion may prove durable, preventing a rebuilding of economic slack that would sustain disinflation. Thus, we expect the deceleration of underlying inflation to disappoint bond bulls, with evidence of inflation's resilience likely to be clear by year-end.

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-1.25%	4.89%
COMMODITIES (DJ)	1.07%	-2.16%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	-0.10%	20.79%
CURRENCIES (DB CURRENCY FUTURE HARVEST)	0.31%	4.50%

The ECB has been tracking Fed policy with a lag, and there are building expectations that it also may soon be finished hiking rates. Euro area employment demand has stayed robust, the labor market has tightened further and consumers are steadily becoming less pessimistic. Near-term, the euro area economy has hit a soft spot, no doubt made worse by the extreme heat which is causing some economic drag. However, the foundations under the economy are solid and prospects are sufficiently positive to support the case for sticky underlying inflation and higher wage demands.

CONCLUSION:

In the near run, economic resilience and disinflation will support risk assets so a "high risk, bull phase" for equities continues. The biggest risk seems to be inflation remains stubbornly high.

Data from Bloomberg, as of 7/28/2023.

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