CROSSMARK
GLOBAL INVESTMENTS

Doll's Deliberations

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SUMMARY:

U.S. equities were higher for the fourth week in a row (S&P 500 +0.4%) and are now 20% above the October low. Small-caps had a good week after lagging miserably so far this year. Best sectors were consumer discretionary (+2.4%) and utilities (+1.9%); worst sectors were technology (-0.7%) and consumer staples (-0.5%).

KEY TAKEAWAYS:

1. Initial job claims rose for the week ending June 3. This was the third consecutive weekly increase and the highest level since October 2021. A further noticeable increase in initial claims would signal a more meaningful deterioration in the labor market.
2. Near-term recession risk has receded as the debt ceiling crisis fades and the banking sector stabilizes. A firmer growth outlook may prompt the Fed to hike again in July after a likely June pause or skip.
3. The full impact of the Fed's aggressive monetary tightening has not yet been transmitted to the economy. Tighter bank lending standards and rising corporate defaults are bad signs. The weakest quarters for the U.S. economy are likely still in front of us. It looks headed towards a mild recession, and then an extended period of sluggish growth.
4. U.S. core inflation has declined only modestly in the past year. (Core PCE inflation peaked at 5.4% y/y in February 2022 has only eased to 4.7% as of this April, while core CPI inflation is only down to 5.5% y/y, from a peak of 6.4% y/y in March.)
5. The rate of upward EPS estimate revisions for the S&P 500 has improved to 57%, the best level this year, but still below the average bull market. We think corporate profit expectations remain too high and need to be lowered further.
6. Oil prices rose last Monday following Saudi Arabia's reduction in output by an additional 1 million barrels per day in July. These dynamics highlight that oil prices are in a tug-of-war between weak global demand and OPEC supply management.
7. Now that the debt ceiling is raised, Treasury needs to reload the Treasury General Account which implies a move from liquidity to illiquidity. This implies the dollar strengthens, value outperforms growth, and the S&P 500 outperforms the NASDAQ.
8. As of June 2, the S&P 500 was up 12% YTD. The seven largest constituents have surged 53% vs. just 0% for the remaining 493 stocks. The big run in mega-cap stocks has led to a recent rotation into the laggard stocks (i.e., small caps).
9. Rising real interest rate differentials between the U.S. and the rest of the world have created a tailwind for the U.S. dollar. Despite long-term concerns about the U.S. dollar as the world's reserve currency, a credible alternative has failed to materialize and is unlikely to do so.
10. The historic decline in money growth, the inversion of the yield curve, a likely continuation of Fed tightening, stricter lending standards, and the almost certain drain in liquidity from the system in the next few months all urge caution. "This is either the weakest start to a new bull market or the longest bear market rally in history." – Chris Verrone, Strategas.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	0.36%	3.26%
S&P 500	0.41%	12.82%
NASDAQ	0.15%	27.20%
RUSSELL 2000	2.74%	7.49%
RUSSELL 1000 GROWTH	-0.12%	23.63%
RUSSELL 1000 VALUE	1.03%	2.26%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-0.41%	33.92%
CONSUMER DISCRETIONARY	2.45%	25.89%
CONSUMER STAPLES	-0.50%	-1.03%
ENERGY	1.78%	-6.01%
FINANCIALS	1.10%	-2.59%
HEALTHCARE	-0.06%	-3.75%
INDUSTRIALS	1.42%	4.72%
INFORMATION TECHNOLOGY	-0.66%	35.54%
MATERIALS	0.56%	2.17%
REAL ESTATE	0.77%	1.16%
UTILITIES	1.96%	-5.13%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	0.40%	10.96%
MSCI ACWI EX U.S.	0.61%	8.37%
MSCI EAFE	0.47%	10.27%
MSCI EM	1.04%	4.88%

THE FED CALLS THE SHOTS – STILL DESIRING 2% INFLATION?

Last week's rate hikes by the central banks in Canada and Australia caught the consensus off-guard, and provided a clear reminder that the reprieve in inflation fighting was only going to be temporary. Global monetary conditions are still short of being restrictive, the global economic expansion continues to roll on and underlying inflation will remain sticky and historically elevated. In other words, any rate-hiking pause or skip by the Fed is likely to be temporary. The implication is that bond yields remain at risk of undergoing another upleg, and indeed yields have moved up in the past few weeks.

A breakout in bond yields would likely end the risk-on phase as it would force investors to face further restrictive monetary conditions which will eventually sow the seeds for a recession and broad-based contraction in corporate profits. Predicting the timing of that has proven elusive.

The choppy risk-on period has persisted recently, albeit the advance in equity prices has not enjoyed broad participation, despite some broadening last week. The easing in bond yields since last fall and depressed real borrowing rates have provided support to the economy. In addition, the fears of an energy-induced downturn that were prevalent a year ago have come full circle, with oil and natural gas prices now at depressed levels.

Decent global growth is ultimately bearish for financial markets because inflation has revived and will unlikely be tamed without a true cleansing phase, i.e., a recession. In other words, gains in risk asset markets will be self-reversing as they help to support growth and put a floor under core inflation, which will eventually cause monetary conditions to become outright restrictive.

The Fed's projection of a steady retreat in underlying inflation this year is proving to be too optimistic, although the gap between their projection and the actual core inflation outcome will only become clear later this year. Some FOMC members are becoming concerned that a skip or a pause in policy hiking is not warranted, but the Chair seems to be holding to the dovish-side, helping to buttress the bond bulls.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	0.06%	2.22%
BLOOMBERG U.S. CORP HIGH YIELD	0.16%	4.69%
BLOOMBERG U.S. GOV/ CREDIT	-0.03%	2.25%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.10%	2.01%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	1.50%	1.55%
COMMODITIES (DJ)	1.24%	-8.54%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	2.33%	13.85%
CURRENCIES (DB CURRENCY FUTURE HARVEST)	-0.28%	3.78%

CONCLUSION:

The easing U.S. and G7 bond yields since last fall provided support to the global economic expansion, which has remained more resilient than bond bulls and central banks and many investors have been discounting. This resilience is slowing the mild easing in underlying inflation pressures. Core inflation will likely remain well above pre-pandemic levels until the next recession develops. A reversal to risk-off will likely occur once expectations for lower U.S. policy rates fully unwind and government bond yields break out to the upside. A downgrade in equities is likely to be prudent as inflation remains stubbornly high and interest rates are flat to up.

Data from Bloomberg, as of 6/9/2023.