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Doll's Deliberations®

Weekly Investment Commentary

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Summary:
Stocks fell last week (S&P 500 -0.49%). The S&P 500 and NASDAQ broke their five-week winning streaks. For the month, the S&P 500 was +4.80%, with the Dow lagging and the NASDAQ outperforming. Sadly, breadth continues to deteriorate. Best sectors for the week were energy (+2.04%) and real estate (+1.82%); worst sectors were technology (-1.45%) and industrials (-0.81%).

Key takeaways:

1. The Fed's favorite inflation indicator (y/y core PCE) remains stuck at 2.8%, certainly down from the highs, but not close to the 2% target.

2. Minneapolis Fed President Neel Kashkari said a Fed rate hike can't be ruled out. He joins other Fed officials with a more hawkish view.

3. Over the past two weeks, the U.S. 10-year yield rose more than 25 basis points before backing off a bit. We attribute the move in part to the drop from 99% to roughly 50% of a September Fed rate cut and rising inflationary expectations.

4. Corporate and high yield spreads remain tight. An economic slowdown (which we expect) will likely produce some spread widening.

5. Bifurcation continues: (1) high-end consumers are okay, while low-end and increasingly mid-income consumers are struggling, (2) AI capex is strong, but industrial capex is not, and (3) the S&P 500 is up 10% YTD, but nearly half the stocks in the index are down.

6. Much of the earnings growth in Q1 was still driven by a small handful of mega-cap tech stocks and their associated sectors. Earnings growth needs to become more balanced as the profit momentum of mega-cap tech stocks slows to more sustainable levels and firming global trade and manufacturing activity lift the earnings of cyclical sectors.

7. Investors have generally maintained a "can't lose" attitude, believing that either the growth outlook would remain solid, or the Fed would start cutting at the first signs of real weakness. We expect trading to become much choppier over the summer into a combination of softer-than-expected economic readings, stubborn inflation, overbought technical conditions, and extended investor sentiment.

8. Global equity returns are destined to moderate in the decade ahead following an extended period of strong gains, reflecting already elevated corporate profits and full valuations.

9. Growth has started rotating outside the U.S., which could pressure the dollar lower while technical indicators suggest the greenback is overbought.

10. China is trying to export its way out of its economic slowdown while the U.S. has formed a hawkish consensus on foreign policy and trade. Investors should be on alert as financial markets could be vulnerable in a new escalated phase of a trade war.

EQUITY MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
DJIA	-0.88	3.52
S&P 500	-0.49	11.30
NASDAQ	-1.09	11.82
RUSSELL 1000	-1.33	9.74
RUSSELL 1000 GROWTH	-1.18	13.08
RUSSELL 1000 VALUE	0.20	7.64
RUSSELL 2000	-0.63	1.99

S&P EQUITY SECTORS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-0.60	20.88
CONSUMER DISCRETIONARY	-0.26	0.73
CONSUMER STAPLES	0.11	9.18
ENERGY	2.04	12.38
FINANCIALS	0.08	11.16
HEALTHCARE	-0.58	5.78
INDUSTRIALS	-0.81	8.77
INFORMATION TECHNOLOGY	-1.45	17.31
MATERIALS	0.15	7.30
REAL ESTATE	1.82	-4.38
UTILITIES	1.69	15.82

Rates out the curve are key to the equity outlook

The risk-on phase has turned choppy as bond yields have edged higher. The corporate earnings backdrop is still reasonably good (although fraying a bit), which has been critical in sustaining the equity advance since last autumn. Equity markets have become vulnerable due to stretched technical conditions and pockets of elevated valuations. The durability of the rally hinges on whether bond yields stay relatively calm. Yields have been sticky but contained, as investors continue to bet on imminent policy rate cuts.

U.S. two-year yields are closing in on their previous high for the cycle, and an upside breakout would be bond-bearish as these yields tend to lead the long end of the yield curve during economic expansions. Meanwhile, the historic lifting of the global bond yield anchor, Japanese bond yields, has continued. German 10-year yields have recovered to six-month highs even as the ECB is set to reverse course and lower rates.

The key investment issue for the rest of the decade is inflation and whether the consensus, which expects a return to a low and stable backdrop like the 2010s, will be proven correct. We doubt it. The consensus view is closer to a return to a 2% inflation world than a longer-term view of sticky inflation. We anticipate a higher rate of inflation than last decade, with the U.S. notably at risk of inflation holding well above the Fed's 2% target. In other words, far from a 1970s-type spiral – just higher inflation than central banks and many investors are betting on. Unlike in recent decades, inflation and wage growth are on solid footing, and output gaps show much tighter conditions in many economies.

Most measures of consumer confidence are well below their best readings this decade. However, the measures that have accurately heralded consumption and GDP growth are still near or even above levels seen at previous cyclical peaks. While angst about the future is elevated, current conditions are bullish and supportive of continued above-trend consumption and overall economic growth (but the consumer is beginning to show signs of weakness). The U.S. remains the strongest of the major DM economies, and in no need of lower borrowing rates. That the Fed (particularly its Chair) is still keen to ease is puzzling, and such a decision would be a mistake. The situation in the euro area is much less clear, and it appears that the ECB will cut rates soon.

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN) (%)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-1.29	8.26
MSCI ACWI EX U.S.	-1.21	5.47
MSCI EAFE	-0.74	6.33
MSCI EM	-2.27	4.28

FIXED INCOME MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.32	-1.99
BLOOMBERG U.S. CORP HIGH YIELD	-0.22	1.42
BLOOMBERG U.S. GOV/ CREDIT	-0.33	-1.90
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.05	2.21

ALTERNATIVES (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	2.03	-4.27
COMMODITIES (DJ)	-1.84	6.79
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	-1.37	6.05
CURRENCIES (DB CURRENCY FUTURE HARVEST)	-0.08	9.51

We doubt that the Fed will match the considerate rate cuts that are discounted over the next 18 months. Meanwhile, the Bank of Japan (BoJ) will be moving in the opposite direction and is closing in on another rate hike, as signaled by the upside breakout in Japanese rate expectations and bond yields. Moreover, the BoJ may modestly accelerate the pace of rate hikes to stem yen weakness.

Conclusion

The risk-on backdrop is again under threat from rising government bond yields. The latter is in contrast with expectations for an ECB cut. Central banks are still banking on steadily lower inflation, and most are underestimating their economy's resilience/strength, especially the U.S. and, going forward, the euro area as well. Meanwhile, we will be closely watching the U.S. consumer for further signs of weakness.

Data from Bloomberg as of 5/31/2024

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