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GLOBAL INVESTMENTS

# Doll's Deliberations

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## SUMMARY:

Stocks were higher last week with the S&P 500 +0.9%. (Small cap stocks declined.) Earnings reports dominated the discussion, with mixed results. Best sectors were communication services (+3.8%) and technology (+2.4%); worst sectors were utilities (-1.0%) and industrials (-0.6%).

## KEY TAKEAWAYS:

1. 1Q GDP was weaker than expected (+1.1%), but real final sales grew 3.2% indicating strong consumption (inventory will need to be replaced which will boost GDP going forward).

2. So far, the economy has been remarkably resilient to the 500bps hike in the federal fund rate since early last year. It did trigger a financial crisis in mid-March, but that crisis hasn't turned into an economy-wide credit crunch and recession so far.

3. The market expects a reasonably high chance of a 25-basis point rate hike this week. The market then has the Fed on pause for one meeting and then cutting a cumulative 125 basis points over the subsequent year (we don't think these cuts will materialize).

4. Over the last year, commercial banks have tightened standards on loans to small businesses in a manner similar to what went on in 1990, 2000 and 2008, all recession years. (That was before the regional banks came under pressure in March.)

5. First Republic's quarterly results showed a more than $100 million drop in deposits. Unrealized losses in securities portfolios of banks is an ongoing systemic risk.

6. For all of the talk of a strong start to earnings season, annual estimates are still sliding. Companies are beating 1Q estimates, but future estimates are not being revised higher.

7. We remain cautious on stocks because we believe the odds of a recession are increasing. If the economy deteriorates, the market will likely be in for some turbulence.

8. The S&P 500 index staged an 8% rally so far this year, however the underlying market breadth by some measures is the weakest ever. Equity upside has been driven by a combination of very narrow growth leadership and rotation into safety.

9. Stronger global growth and a narrowing of interest rate differentials between the U.S. and the rest of the world explains why the U.S. dollar has weakened since last October. We expect further declines over the remainder of 2023.

10. The debt servicing cost of the U.S. is increasing for the first time in 35 years. According to Strategas, when net interest costs exceed 14% of tax revenues, financial markets begin to impose austerity on U.S. policymakers. (We are at 11.7% and headed to 14% by year-end.)

| EQUITY MARKETS (INDEX TOTAL RETURN) | LAST WEEK | YEAR-TO-DATE |
|---|---|---|
| DJIA | 0.86% | 3.53% |
| S&P 500 | 0.89% | 9.17% |
| NASDAQ | 1.28% | 17.12% |
| RUSSELL 2000 | -2.23% | -0.12% |
| RUSSELL 1000 GROWTH | 1.14% | 15.49% |
| RUSSELL 1000 VALUE | 0.32% | 2.53% |

| S&P EQUITY SECTORS (INDEX TOTAL RETURN) | LAST WEEK | YEAR-TO-DATE |
|---|---|---|
| COMMUNICATION SERVICES | 3.76% | 25.05% |
| CONSUMER DISCRETIONARY | 0.21% | 15.03% |
| CONSUMER STAPLES | 1.08% | 4.45% |
| ENERGY | 0.36% | -1.52% |
| FINANCIALS | -0.12% | -2.56% |
| HEALTHCARE | -0.59% | -1.37% |
| INDUSTRIALS | -0.62% | 2.24% |
| INFORMATION TECHNOLOGY | 2.43% | 22.37% |
| MATERIALS | -0.19% | 4.14% |
| REAL ESTATE | 1.52% | 2.94% |
| UTILITIES | -0.95% | -1.44% |

| INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN) | LAST WEEK | YEAR-TO-DATE |
|---|---|---|
| MSCI ACWI | -0.27% | 8.07% |
| MSCI ACWI EX U.S. | -0.61% | 8.09% |
| MSCI EAFE | -0.44% | 10.93% |
| MSCI EM | -0.86% | 2.17% |

## RECESSION STILL ELUSIVE, BUT LURKS ON THE HORIZON

Investors lack conviction in the outlook based on the mixed messages from financial markets.  The rapid rate-hiking cycle caught most flat-footed and the fluctuations in economic activity including significant divergences between the major economies, have further confused investors.  There are a wide variety of views with a sizable, but shrinking, recession camp, a soft-landing camp, and an increasing number admitting they have no clue.  This unsettled backdrop is reflected in market action so far this year, alternating between bullish and bearish.  Equities are being held back by expensive valuations at a time of decelerating earnings growth, combined with elevated global economic uncertainty with periodic bouts of angst about a looming recession.

Bond markets are showing mixed trends.  U.S. Treasury yields are in a sideways-to-slightly-lower pattern consistent with at least a further moderation in growth.  Meanwhile, German Bund yields are in an upward channel which is consistent with the re-acceleration in that regional economy.  A sizable policy rate easing cycle is discounted later this year and into 2024, presumably due to expectations of a recession and/or much lower inflation ahead.

| FIXED INCOME MARKETS (INDEX TOTAL RETURN) | LAST WEEK | YEAR-TO-DATE |
|---|---|---|
| BLOOMBERG U.S. AGGREGATE BOND | 0.27% | 3.01% |
| BLOOMBERG U.S. CORP HIGH YIELD | 0.18% | 4.28% |
| BLOOMBERG U.S. GOV/ CREDIT | 0.29% | 3.22% |
| BLOOMBERG U.S. T-BILL 1-3 MONTH | 0.04% | 1.45% |

Therefore, it is a challenge to express a clear message from global financial markets and sectors.  Bond yields have upside if better growth in the euro area and China continues and inflation remains stubbornly high.  Conversely, stocks and credit have a downside if a recession takes hold in 2023 (which is still our view).  While Q1 GDP headline was weak, this reflects a sharp drawdown in inventories – underlying real final demand was a solid 3+%.  But, the U.S. economy has decelerated after the 2021-2022 boom, and the increase in layoff announcements has recently translated into slightly higher new unemployment insurance claims.  A good portion of these layoffs have come from pandemic beneficiaries, and are the result of prior excessive optimism, rather than part of a generalized downturn in employment conditions.  A meaningful and sustained increase in claims usually coincides with a recession and thus the recent rise should not be dismissed.

| ALTERNATIVES (INDEX TOTAL RETURN) | LAST WEEK | YEAR-TO-DATE |
|---|---|---|
| REAL ESTATE (FTSE NAREIT) | -0.14% | 0.66% |
| COMMODITIES (DJ) | -1.10% | -6.07% |
| GLOBAL LISTED PRIVATE EQUITY (RED ROCKS) | -0.52% | 8.05% |
| CURRENCIES (DB CURRENCY FUTURE HARVEST) | -0.10% | 0.19% |

The Fed's backstopping of the banking system and market-driven easing in interest rate pressures will help to extend the economic cycle.  If so, then U.S. core inflation will ease only slightly and hold well above the Fed's target for the foreseeable future.  The starting point for bond yields (and policy rates) this cycle was absurd: the lowest levels in history, including during the Great Depression of the 1930s.  There is a significant risk that the inflation backdrop will not be similar to the recent past, when inflation was stable at very low levels for a long time.  Persistently low actual inflation depressed long-term inflation expectations.  There is a material risk that inflation will be higher than last decade in the coming years, which would cause fair value for 10-year government bond yields to move higher over time and create a headwind for equity valuations.

## CONCLUSION:

We remain cautious on equities believing earnings estimates for 2023/2024 are too high and valuation is a bit rich.  The interest rate-hiking cycle is not on the verge of reversing, in contrast with forward rate expectations.  Thus, we are cyclically cautious.  We continue to favor international equities over the U.S.

Data from Bloomberg, as of 4/28/2023.

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