CROSSMARK
GLOBAL INVESTMENTS

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DOLL'S DELIBERATIONS

WEEKLY INVESTMENT COMMENTARY

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	-2.08%	-10.81%
S&P 500	-2.35%	-15.12%
NASDAQ	-2.77%	-24.35%
RUSSELL 2000	-5.42%	-22.23%
RUSSELL 1000 GROWTH	-2.90%	-23.61%
RUSSELL 1000 VALUE	-1.84%	-7.46%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-0.16%	-25.01%
CONSUMER DISCRETIONARY	-3.38%	-26.11%
CONSUMER STAPLES	0.31%	0.52%
ENERGY	-2.61%	46.87%
FINANCIALS	-3.54%	-13.83%
HEALTHCARE	-0.88%	-8.39%
INDUSTRIALS	-2.51%	-11.65%
INFORMATION TECHNOLOGY	-3.47%	-22.00%
MATERIALS	-2.44%	-8.60%
REAL ESTATE	-3.85%	-16.31%
UTILITIES	-1.07%	0.53%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-4.36%	-17.96%
MSCI ACWI EX U.S.	-3.61%	-17.19%
MSCI EAFE	-3.11%	-17.15%
MSCI EM	-4.23%	-19.33%

SUMMARY:

U.S. equities were lower last week (S&P 500 -2.4%) for the sixth straight week (the longest stretch in over ten years). During the midweek selloff, the S&P 500 hit the lowest point since March 2021 and the NASDAQ since November 2020. The bearish case for equities focused on monetary tightening, persistent inflation, China COVID lockdowns, recession fears, and extended valuations. The only positive sector for the week was consumer staples (+0.3%); the worst sectors were REITs (-3.9%) and financials (-3.5%).

KEY TAKEAWAYS:

1. Headline CPI rose 0.3% m/m in April, a significant slowdown from March's 1.2% m/m gain. On a y/y basis, inflation was up 8.3%, down 0.2 points from March. Most of the April gain resulted from increased service components like airfares and shelter costs. We believe inflation peaked in March, but it will fall to stubbornly high levels.
2. The UMich measure of the consumer sentiment declined 6.1 points to 59.1, well below consensus. Inflation continues to weigh on real incomes and is the likely reason for the drop.
3. The big question is if inflation can get back to 3% without the Fed causing a recession. Financial conditions will tighten, and markets will likely struggle until that question is answered.
4. The 2-yr-10yr part of the yield curve is back to its steepest levels since January, perhaps delaying recession concerns. Economic growth will slow, but a recession is being talked about much more than it is being priced in the treasury market. The U.S. unemployment rate is still low, payroll employment gains have been robust, and initial jobless claims remain low.
5. Treasury yields dropped last week, with half of the decline attributable to a decline in inflation expectations.
6. Just as gasoline prices hit record highs last week, the Biden Administration announced that it is canceling plans for new drilling for oil in Alaska and has halted plans for new leasing in the Gulf of Mexico.
7. 1Q earnings are nearly complete. Earnings growth is now expected to be 10+%, with revenue growth at 13+%. A common theme during the reporting season is concern about higher costs, slowing growth, and rising inflation. The result is a weakening outlook for profit margins.
8. Last week, the Investors Intelligence Bull/Bear Ratio (BBR) fell further below 1.00 to 0.68. Readings below 1.0 often create good buying opportunities.
9. S&P 500 P/E ratio is down to 17x; the 3-year average is 19.5x, the 5-year average is 18.5x, and the 30-year average is 16x.
10. We have been emphasizing quality (of earnings, balance sheets, management) in our equity security selection. One good measure of quality is Return on Equity – e.g., the long portfolio of our Equity Market Neutral Strategy has an ROE of 25.3%; the short portfolio is 0.5%.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	1.29%	-9.36%
BLOOMBERG U.S. CORP HIGH YIELD	-1.32%	-10.50%
BLOOMBERG U.S. GOV/ CREDIT	1.23%	-10.04%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.00%	0.07%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
FTSE NAREIT (REAL ESTATE)	-5.65%	-17.06%
DJ COMMODITIES	-1.54%	29.61%
RED ROCKS GLOBAL LISTED PRIVATE EQUITY	-4.32%	-31.73%
DB G10 CURRENCY FUTURES	-1.26%	3.66%

TIME FOR AN OVERSOLD STOCK AND BOND RALLY?

Will a peak in inflation (so far, March was the peak), horrible sentiment, and an oversold condition set the stage for a tradeable rally? We think probably so, but we suspect we have not seen the high in bond yields or the low in stocks for this period. Remember, the middle of March produced a quick 10% S&P 500 rally and a 16% NASDAQ bounce before a reversal set in.

While a bounce is possible, if not likely, the cyclical outlook is not good, as U.S. and global inflation is broad-based and has solid momentum, and central banks will eventually have to bring inflation back down. However, since there has been a deeply entrenched view at central banks (and in government bond markets) that the 2% inflation world will eventually return, there likely will be a bias to turn less hawkish as U.S. core inflation eases for a time. Any bond market reprieve will be countertrend in nature. The improvement in service sector activity will reinforce the nascent uptrend in service sector inflation and wages over time and, therefore, gradually put upward pressure on longer-term inflation expectations.

The global economy had significant tailwinds coming into this year. There will be some cooling in manufacturing activity as goods demand slows, but overall growth should still be decent. Consumers and the business sector will be resilient, especially once the Chinese lockdowns end. There are still low odds of a recession in the next twelve months, assuming that bonds markets calm for a period. However, the longer-term implication of economic resilience is that it ultimately will sow the seeds for another upleg in bond yields. For now, the risk-off phase has capped the rise in bond yields, and easing U.S. inflation data should allow bond markets to calm for 3-6 months.

The equity outlook is challenging, with the cyclical peak in many growth-related sectors already in the past. However, some economic-sensitive and value sectors could undergo a solid bounce as bond yields are steady. We remain neutral on equities. The capital markets cycle hit thin ice once inflation moved higher, meaning that being aggressive on the long side has been (and will remain) a risky position. Corporate earnings are still supportive of equities and credit. However, the growth rate in profits will slow, especially since margins are already very elevated and cost pressures will continue to worsen. We expect the U.S. dollar to peak and gradually depreciate once the non-U.S. economic outlook is more clearly firming, especially in the euro area and China.

The equity de-rating that has occurred over the past six months has been quite severe, especially for the U.S. The rebound in global bond yields broke a long-term downtrend and profoundly challenged the complacency that developed during the free money era when all assets inflated massively. Investors will have to be more tactical in order to achieve decent absolute returns going forward and lower their long-run expected returns. Such a tough backdrop will persist until the valuation distortion in government bond markets is fully unwound and inflation is tamed.

CONCLUSION:

The cyclical outlook is still bearish for bonds, but a temporary pause in the yield uptrend is probable. Sequential U.S. inflation data should improve in the coming months, and recession worries could help government bond market sentiment for a time. The odds of a recession are still low, given the powerful economic tailwinds heading into this year and the further re-opening of service sectors. Equities have been significantly de-rated and will benefit from firm corporate profits, suggesting a reprieve in the equity selloff should also develop. However, it hinges on a calming in bond markets. However, the longer-term outlook remains a concern, as the odds of a benign soft economic landing and return to low inflation seem unlikely.

Data from Bloomberg, as of 05/13/2022.

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