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Doll's Deliberations

Weekly Investment Commentary

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Summary:

Stocks were higher for the fourth consecutive week (S&P 500 +1.60%). The S&P is on track for its best month of the year and has more than erased April's decline. Best sectors were technology (+2.95%) and real estate (+2.53%); worst sectors were industrials (-0.30%) and consumer discretionary (-0.03%).

Key takeaways:

1. U.S. headline CPI inflation decelerated to a softer-than-expected 0.3% m/m (3.4% y/y) in April, from 0.4% m/m (3.5% y/y). Core CPI eased from 0.4% m/m (3.5% y/y) to 0.3% m/m (3.4% y/y).

2. The U.S. Citi Economic Surprise Index has recently dipped below zero, indicating that U.S. economic data releases have been disappointing expectations. U.S. retail sales were unchanged in April, a downside surprise from expectations of 0.4% m/m growth. This is symptomatic of deteriorating consumer fundamentals.

3. Delinquencies are up, especially for younger borrowers (now well above pre-COVID levels for autos and credit cards), despite still-low unemployment. So, with labor cooling, credit looks set to worsen.

4. The University of Michigan Consumer Confidence Index was much weaker than expected and is beginning to decline with middle-income consumers. Long-term inflationary expectations moved higher as well.

5. Credit spreads continue to price in a Goldilocks scenario as U.S. investment grade and high-yield bonds have tightened from their October peaks.

6. First-quarter earnings are likely to be up 5-6%, the strongest quarter since 1Q22.

7. Investor optimism regarding the economy and corporate earnings borders on complacency. Yet so far investors have been right to be optimistic. Stocks have climbed a wall of worry and currently stand at record highs. Risk-on is likely to continue until either recession worries surface or the Fed has to contemplate a rate hike to tame sticky inflation.

8. Over the last 12 months, federal interest expense rose by 39% to an all-time high of over $800 billion. The CBO projects that publicly held federal debt will reach an all-time high in 2029 (surpassing the level reached following World War II. Policymakers are unlikely to address the problem until the market pushes back hard (i.e., Treasury yields climb higher).

9. Presidential candidates Trump and Biden are trying to outdo one another in terms of being tough on trade with China. The result of higher tariffs could be higher inflation and a possible recession.

10. The world is becoming a more dangerous and unstable place. So far, the impact on financial markets has been relatively isolated and muted. We believe the risks are going to remain elevated and geopolitical threats could become a more prominent issue for financial markets no matter who wins the election.

EQUITY MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
DJIA	1.35	6.90
S&P 500	1.60	11.80
NASDAQ	2.15	11.47
RUSSELL 1000	1.45	11.18
RUSSELL 1000 GROWTH	1.84	13.34
RUSSELL 1000 VALUE	1.26	8.95
RUSSELL 2000	1.80	3.91

S&P EQUITY SECTORS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	1.70	21.30
CONSUMER DISCRETIONARY	-0.03	2.89
CONSUMER STAPLES	0.80	10.51
ENERGY	1.22	14.52
FINANCIALS	1.39	13.28
HEALTHCARE	1.88	7.75
INDUSTRIALS	-0.30	10.38
INFORMATION TECHNOLOGY	2.95	15.08
MATERIALS	0.31	8.03
REAL ESTATE	2.53	-2.53
UTILITIES	1.52	15.23

Relatively easy monetary policy fuels risk-on capital markets

Global financial markets remain dominated by swings in Fed rate expectations. The risk-on rally ran into trouble briefly in April as much stronger than expected U.S. economic and inflation data brought into question whether the central bank could deliver previously promised rate cuts. However, Fed Chair Powell was quick to reaffirm the central bank's entrenched dovish bias in the press conference that followed the latest FOMC meeting. Thereafter, the bond market found some near-term comfort in the moderation of the U.S. non-farm payrolls report. Bonds rallied further after last week's CPI release, even though the trend in underlying inflation has leveled off well above the Fed's target of 2%.

Although any moderation in inflation is currently perceived to support the Fed's desire to cut policy rates, the irony is that both data releases signal an economy that continues to run hot and remains inflationary. We expect the stickiness of underlying inflation will prove problematic as the year progresses. However, for now, a calm bond market is helping to fuel the risk-on rally, with the S&P 500, NASDAQ, Dow Jones, and the global equity benchmarks all pushing to all-time highs. The fundamental misjudgment that Powell and company have made is in asserting that monetary conditions are "very restrictive." If that were the case, then time would work to undermine U.S. economic growth and create disinflation. Also, equities, credit, and other risk assets would suffer losses until the Fed provided the necessary rate cuts to reduce the economic drag. Instead, policymakers have struggled to provide broad-based evidence to support their claims.

The reality is that U.S. domestic final demand and labor market conditions are reasonably good and do not show much evidence of fundamentally weakening. Meanwhile, inflation remains sticky at elevated levels. Most measures of financial conditions signal that settings are currently easy, and speculation has returned to capital markets. Equity prices have pushed to new highs, corporate bond spreads are at historical lows, and even U.S. home prices are rising again, even when adjusting for inflation. Financial markets are providing a clear message that the world remains flush with excess liquidity and rate cuts are not required.

In 2021, Fed Chair Powell was determined not to lift policy rates while using the word "transitory." Now he is determined to cut rates while using the word "restrictive." The central bank admits to now being "data-dependent" and focused on monthly consumer price inflation, which is a choppy and lagging macro indicator. The lack of confidence in its ability to forecast the economy has also left the Fed with a strong dovish bias, since policymakers would much rather face persistent above-target inflation than risk a recession. The net result is that investors are being given an ongoing green light for risk-taking, where above-trend economic growth and improving corporate earnings are still being subsidized by easy monetary and financial conditions.

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN) (%)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	1.60	9.97
MSCI ACWI EX U.S.	1.80	7.76
MSCI EAFE	1.65	8.04
MSCI EM	2.55	8.15

FIXED INCOME MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	0.82	-1.16
BLOOMBERG U.S. CORP HIGH YIELD	0.44	1.90
BLOOMBERG U.S. GOV/CREDIT	0.80	-1.13
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.06	2.00

ALTERNATIVES (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	2.46	-2.77
COMMODITIES (DJ)	2.98	9.42
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	1.65	7.31
CURRENCIES (DB CURRENCY FUTURE HARVEST)	1.00	8.85

Conclusion

U.S. inflation is proving stubborn, and holding well above the Fed's 2% target. In addition, the economy continues to grow in excess of its long-run potential rate, implying that the inflation threat will persist. Inflation is less of a threat outside of the U.S., but is expected to level off above pre-2020 levels in most developed economies. For now, a calm bond market means a continuation of the risk-on phase, with further upside in equities despite overbought conditions.

Data from Bloomberg, as of 5/17/2024.