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Doll's Deliberations

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SUMMARY:

Despite a big rally on Friday, equities fell last week (S&P 500 -0.8%). The bullish narrative continues to center around a Fed pause, earnings strength, and strong labor markets. Growth fears were a bearish factor reflecting the latest bout of banks stress and weak energy/commodity prices. Best sectors were technology (+0.6%), healthcare (+0.1%), and utilities (+0.1%); worst sectors were energy (-5.8%), financials (-2.7%), and communication services (-2.3%).

KEY TAKEAWAYS:

1. The Fed raised rates +25bps to 5.0%-5.25%, despite recent banking stress and dropped language anticipating further policy firming. The Fed reiterated that they are "strongly committed" to their objective of 2% inflation (that's not dovish).
2. Fed policy operates with long and variable lags... (The Treasury curve inverted in the summer of 2006. The Fed paused. Then for the next 18 months, the economy seemed okay. The S&P rallied +20%, and employment continued to increase until a nasty recession hit and a big bear market.)
3. The April employment report was stronger than expected but wage acceleration is problematic for the inflation fight.
4. The biggest driver of structural inflation is wage inflation. Cooling wage inflation will require more labor supply or less labor demand. Reducing labor demand generally results in lower corporate profits.
5. Three $100 billion plus bank failures on the heels of U.S. regional bank interest rate dislocation may force Washington to contemplate overdue changes to banking rules. We are not convinced anyone knows the depth or implications of U.S. regional bank problems.
6. Companies are putting up strong 1Q results relative to lowered expectations. But, earnings quality continues to deteriorate and full-year earnings estimates are not being raised.
7. Stocks remain toward the high side of their twelve-month trading range due to better than expected Q1 earnings and anticipation that will continue and that the Fed will lower rates in the 2H.
8. It is difficult to justify a market trading at 20+x trailing earnings and over 18+x forward earnings when inflation is still well above 4% and sticky and earnings are still declining year/year.
9. The odds are high that the debt ceiling will be resolved. The political backlash associated with the possibility of millions of citizens not getting their checks from the federal government will force a compromise. One possible outcome could be a "kick the can" solution for several more months.
10. U.S. Federal Government debt is $31 trillion, half of which matures in the next three years, and on which the weighted average coupon is 1.9%. Therefore, the interest on the debt will rise considerably unless interest rates fall significantly.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	-1.23%	2.25%
S&P 500	-0.78%	8.33%
NASDAQ	0.09%	17.22%
RUSSELL 2000	-2.82%	-1.96%
RUSSELL 1000 GROWTH	0.08%	15.58%
RUSSELL 1000 VALUE	-1.73%	0.75%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-2.29%	22.19%
CONSUMER DISCRETIONARY	-0.35%	14.64%
CONSUMER STAPLES	-0.37%	4.06%
ENERGY	-5.81%	-7.24%
FINANCIALS	-2.61%	-5.10%
HEALTHCARE	0.09%	-1.28%
INDUSTRIALS	-0.46%	1.77%
INFORMATION TECHNOLOGY	0.62%	23.13%
MATERIALS	-1.10%	3.00%
REAL ESTATE	-0.82%	2.10%
UTILITIES	0.10%	-1.34%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-1.76%	6.93%
MSCI ACWI EX U.S.	-0.53%	8.14%
MSCI EAFE	-0.54%	10.93%
MSCI EM	-0.04%	2.73%

VOLATILE TRADING RANGE CONTINUES

The investment outlook is complicated by fundamental crosscurrents. U.S. recession fears linger, but hard data are consistent with a resilient rather than faltering economy. Moreover, central banks will likely take advantage of cooling headline inflation to pause their interest rate hiking cycles, which will help extend the economic expansion. While already discounted, a pause is supportive of equities, bonds, credit and other risk assets. Beyond the near-term, however, the combination of a mature global economic expansion and stickier than expected inflation implies limited sustainable upside for most asset classes and an unappetizing overall cyclical outlook.

Despite a rally on Friday, bank stock prices came under renewed pressure following the collapse of First Republic Bank. We do not rule out further stress in individual banks in the U.S., but believe the aggregate sector has reasonably sound fundamentals and that some tightening of lending standards that will help slow the economy. However, non-interest rate policy support is needed to bolster confidence in the sector. The U.S. debt ceiling battle also looms as a near-term threat for capital markets and the global economy, although we continue to believe that a default will be avoided.

It is impressive that equities have been able to advance against the backdrop of elevated U.S. Treasury volatility. Equity and bond volatility remain directionally correlated, but equity volatility is at its lowest level since before the Fed began its hiking campaign, while bond volatility is sharply higher. It is unlikely that equity volatility can remain at its current level unless bond market volatility steadily diminishes. That is contingent on a clearer outlook for Fed policy.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	0.26%	3.85%
BLOOMBERG U.S. CORP HIGH YIELD	-0.71%	3.86%
BLOOMBERG U.S. GOV/ CREDIT	0.17%	4.00%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.01%	1.50%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-2.22%	-0.35%
COMMODITIES (DJ)	-1.20%	-7.20%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	-3.86%	5.84%
CURRENCIES (DB CURRENCY FUTURE HARVEST)	-0.14%	1.04%

CONCLUSIONS:

1. The rally in U.S. stocks over the past month or so reflects better than expected Q1 earnings and investor expectations of interest rate cuts over the coming year. (The soft-landing story.)
2. A soft economic landing remains unlikely. It is only possible if inflation soon falls close to the Fed's 2% target, permitting the Fed to cut interest rates back to neutral levels, before the labor market weakens enough that the U.S. economy slips into recession.
3. It is unlikely that financial markets are priced for a recession. Forward earnings have not yet adjusted to what is likely to be a double-digit percentage peak-to-trough decline in earnings during a recession, and the U.S. forward equity risk premium is below its historical average.
4. Outside the U.S., the valuation picture for stocks is more attractive than in the U.S. Global ex-U.S. stocks may fare better versus the U.S. over the coming few years.
5. The above views warrant a cautious position toward equities and a neutral position toward fixed income, implying some cash (or short-term fixed income) is also in order.

Data from Bloomberg, as of 5/5/2023.

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