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GLOBAL INVESTMENTS

Doll's Deliberations

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SUMMARY:

Stocks advanced for a third week in a row (S&P 500 +2.3%). Small stocks (Russell 2000) were up 4.1%. Disinflation optimism and weaker labor data supported peak Fed and soft-landing narratives. Best sectors were real estate (+4.6%) and materials (+3.7%); worst sectors were consumer staples (+0.6%) and energy (+1.5%).

KEY TAKEAWAYS:

1. U.S. Treasury yields fell sharply following a soft October CPI report, and investors have priced out all remaining rate hikes from the yield curve. The fed funds futures curve is priced for a 25 basis point rate cut by next June and for 50 basis points of easing by next July.
2. U.S. initial jobless claims have been trending higher in recent weeks, confirming that labor market conditions are deteriorating. Continuing claims are now at the highest level in two years.
3. Credit card and auto loan delinquencies are climbing (now above pre-Covid levels), despite near record-low unemployment. So when labor really cools, credit is bound to worsen.
4. Our expectation is that economic resilience to date does not imply that a recession has been postponed. Instead, we expect a continued deterioration of the labor market to eventually lead to an increase in the unemployment rate and in turn weigh down on spending, investment, and corporate earnings.
5. According to FactSet, the current Fed cycle has seen six premature dovish pivots. Absent the Fed calling for rate cuts (which they are not), could this be yet another head fake? The lagged effects of tighter policy (fed funds, QT, banks tightening lending, etc.) are still being felt.
6. A slowing economy will likely lead to reduced corporate pricing power and earnings estimate reductions.
7. The outlook on the credit rating of the United States was changed to "negative" from "stable" by Moody's, pointing to the nation's worsening fiscal position and political polarization.
8. The meeting between President Biden and Chinese President Xi will unlikely lead to changes in economic tensions or national security concerns. In our view, while China and the U.S. remain in a cold war, the meeting sends a signal that both Beijing and Washington would rather avoid increased confrontation at a time when both governments have their hands full with domestic concerns and geopolitical instability.
9. In recent months, investors have generally treated "bad news" as "good news" in a growing belief that the Fed will kick off a prolonged cutting cycle in the first half of next year as inflation continues to decline and the employment picture weakens. These assumptions are inconsistent with double-digit earnings growth in 2024.
10. Bulls cite the inflation data and resilience of cap-weighted indices as signs that a 'soft landing' is here. Bears cite slowing macro data, company -specific commentary, and persistent weakness of the average stock as signs that a 'hard landing' is on the horizon.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	2.06%	7.46%
S&P 500	2.31%	19.29%
NASDAQ	2.42%	35.98%
RUSSELL 1000	2.26%	18.68%
RUSSELL 1000 GROWTH	2.10%	35.25%
RUSSELL 1000 VALUE	2.88%	3.68%
RUSSELL 2000	4.07%	2.07%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	2.31%	50.20%
CONSUMER DISCRETIONARY	3.39%	32.78%
CONSUMER STAPLES	0.64%	-3.83%
ENERGY	1.47%	-1.01%
FINANCIALS	3.27%	3.83%
HEALTHCARE	1.57%	-4.44%
INDUSTRIALS	2.97%	8.86%
INFORMATION TECHNOLOGY	1.75%	50.82%
MATERIALS	3.72%	4.83%
REAL ESTATE	4.56%	-0.22%
UTILITIES	3.32%	-9.52%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	2.65%	14.73%
MSCI ACWI EX U.S.	3.44%	8.15%
MSCI EAFE	3.44%	9.82%
MSCI EM	3.59%	5.08%

DECLINING INFLATION SPUR ADDITIONAL STOCK AND BOND RALLIES

Rate cuts are coming! That's the newfound song that investors are singing post better than expected inflation reports. While possible, these cuts will likely occur only if we are in a recession, which would mean double-digit earnings growth isn't happening in 2024. Investors can't have it both ways – lower rates and double-digit earnings growth. A hallmark of the past 18 months has been the periodic and atypically aggressive willingness to front-run the end of the rate-hiking cycle and discount an easing in central bank policy. As with all prior front-running episodes (six so far) in 2022-2023, we expect the current one to prove premature. While the investment and policy cycles have become advanced, and government bonds offer reasonable value, the consensus economic outlook is not consistent with a durable return to low and stable inflation and interest rates.

The speed at which the backdrop has flipped from risk-off to risk-on has been impressive. The message from financial markets is that policy has not delivered an economic knock-out blow. The cycle will likely only end when a risk-off phase persists even as bond yields durably peak and roll over. In other words, a lasting cyclical peak in bond yields awaits a much weaker economic environment and high odds that economic slack is rebuilding.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	1.21%	0.38%
BLOOMBERG U.S. CORP HIGH YIELD	0.80%	7.73%
BLOOMBERG U.S. GOV/ CREDIT	1.17%	0.71%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.06%	4.44%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	4.54%	-0.86%
COMMODITIES (DJ)	0.41%	-5.44%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	4.52%	18.33%
CURRENCIES (DB CURRENCY FUTURE HARVEST)	-0.40%	8.50%

Having said that, inflation continues to decelerate, even at the core level. A broad-based unwinding of pandemic-era price distortions has been underway, and base effects are still generating lower annual inflation rates. Goods prices, in particular, are weak. However, and critically, weaker economic growth and much less tight labor markets are needed to set the stage for durably low inflation (2%) and, thus, an easing in monetary conditions and a sustained bond bull market. The Fed's attempts to slow growth for long enough to reduce inflation pressures and inflation expectations have been repeatedly undermined since risk asset markets rally strongly whenever bond yields decline. A cyclical peak in bond yields is not consistent with: 1) the recent sharp rally in equity prices, 2) a further narrowing in credit spreads, and 3) the new high in the global stock/bond ratio.

Investors celebrated the further easing in U.S. core CPI last week, and do not expect any bad inflation news for the coming months. However, the NFIB survey also showed a firming trend in its "planned price changes" index, and the "inflation is a problem" index remains resilient. These measures should be declining if a return to a 2% inflation rate was truly underway. Such signals will develop after demand is weakened considerably.

Global equities will generate lower real returns over the next 10 years relative to the prior several decades, given the starting point of elevated corporate earnings and valuations. Investors will need to be more tactical in order to generate good returns, since a buy and hold strategy will not work because the era of falling and/or mega-low interest rates has ended.

CONCLUSION:

The benign near-run inflation outlook will support the consensus view that the rate-hiking cycle is over and rate cuts loom. We anticipate that rate cut expectations for mid-2024 will be pushed out in time. We are neutral on bonds and are buyers on weakness given their much better value than in recent years. We are trimmers of equities on strength, as the investment cycle is into the late stages. Still, the endpoint of a global economic downturn is not yet on the horizon as conditions may not yet be sufficiently restrictive to trigger a downturn. The critical cyclical issue is the dearth of economic slack and thus the likelihood that the current deceleration in inflation will level off above 2%.

Data from Bloomberg, as of 11/17/2023.

