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GLOBAL INVESTMENTS

Doll's Deliberations

Weekly Investment Commentary | October 16, 2023 | Issue 3.41

SUMMARY:

U.S. equities were mixed last week with the S&P 500 (+0.5%) higher but NASDAQ lower. The small-cap Russell 2000 also trailed the broader S&P 500 for a second straight week. The Treasury rally was the key upside catalyst driven in part by flight-to-safety from geopolitical uncertainty and oversold conditions. Best sectors were energy (+4.5%) and utilities (+3.6%); worst sectors were consumer discretionary (-0.7%) and materials (-0.4%).

KEY TAKEAWAYS:

1. The September CPI rose +0.4% m/m (3.7% y/y) and the core (ex food and energy) CPI was +0.3% m/m (4.1% y/y). The Fed is likely to raise rates in either November or (more likely) December. It remains too soon to contemplate cuts.
2. It is our view that the labor market must weaken in order to have a sustained shift down in inflation. It typically takes 18-24 months for higher rates to boost joblessness. Also, it takes 24 months for a tightening in bank lending standards to lift unemployment. We are reaching both timeframes.
3. Post the Fed meeting in late September, Fed Chair Jerome Powell mentioned five troublesome developments: the UAW strike, a possible government shutdown, resumption of student loan payments, higher long-term interest rates, and the recent oil price shock.
4. Prior to the decline in bond yields over the last week-plus, the benchmark U.S. 10-year Treasury yield rose nearly 100 basis points in just over three months. A rise in yields of this magnitude typically ends in a financial accident.
5. Credit spreads have crept higher since mid-September. A further deterioration in credit would more than likely be a harbinger that more equity weakness lies ahead.
6. The Q3 earnings season is upon us. We will be watching profit margins carefully to see if companies have retained pricing power. Greater economic uncertainty and a deteriorating economic backdrop amid tight monetary policy are constraints on the ability to pass on higher costs to consumers.
7. Last Thursday marked the one-year anniversary of the bear market low. One year later, only 44% of the S&P is above the 200-day moving average, small-caps are up just +5%, and for the first time in history, bank stocks are down in the first year.
8. Between now and the end of the year, we believe that investors should position for another Fed rate hike, the 10-year yield potentially rising as high as 5%, oil prices rebounding with Brent potentially hitting $100, modest economic disappointments on the consumer front, growing concerns about a recession in 2024, and the start of a downward EPS revision cycle.
9. The U.S. government incurred a deficit of $2 trillion in FY 2023, doubling last year's deficit of $996 billion. Nearly one-third of American's outstanding debt matures within the next year.
10. The House cannot reopen for business until a Speaker is elected, and the Republicans are failing to get a Speaker over the finish line, at a time of great geopolitical stress.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	0.79%	3.29%
S&P 500	0.47%	14.19%
NASDAQ	-0.18%	28.94%
RUSSELL 1000	0.91%	14.46%
RUSSELL 1000 GROWTH	0.30%	27.93%
RUSSELL 1000 VALUE	0.44%	0.70%
RUSSELL 2000	-0.64%	-0.34%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-0.21%	44.67%
CONSUMER DISCRETIONARY	-0.68%	25.49%
CONSUMER STAPLES	0.18%	-7.55%
ENERGY	4.52%	4.84%
FINANCIALS	0.48%	-1.58%
HEALTHCARE	0.17%	-3.00%
INDUSTRIALS	1.00%	4.93%
INFORMATION TECHNOLOGY	0.17%	38.95%
MATERIALS	-0.41%	1.43%
REAL ESTATE	2.37%	-4.68%
UTILITIES	3.61%	-13.90%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	1.52%	11.28%
MSCI ACWI EX U.S.	2.45%	5.92%
MSCI EAFE	2.39%	7.61%
MSCI EM	2.73%	2.91%

BOND YIELDS ABRUPTLY REVERSE COURSE (AT LEAST FOR NOW)

An oversold condition in the bond market and then a war in the Middle East two weekends ago have allowed bond yields to ease, providing yet another reprieve for fixed income investors. Many investors have stated that rising bond yields will do the work for the Fed and allow it to stand pat. The Fed highlighted that rising bond yields were helping cool economic growth. Yields then turned abruptly and dropped over the past week partly reflecting expectations that the Fed is finished tightening and will lower rates next year.

Central banks have underestimated the inflationary process. Monetary conditions are not yet restrictive enough and unless some economic weak link snaps shortly, we expect higher bond yields and/or policy rates before the next recession develops. We believe that is necessary to generate some economic slack and thus a meaningful and durable disinflationary phase. Both the U.S. and Chinese PMI manufacturing indexes are moving in a positive direction, and any revival in the weak goods sector of the global economy, including trade, would provide a boost to economic sentiment and likely put a floor under goods prices. If so, our view of sticky inflation and an ongoing global economic expansion will pan out, to the detriment of bond markets.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	0.48%	-1.90%
BLOOMBERG U.S. CORP HIGH YIELD	0.52%	5.12%
BLOOMBERG U.S. GOV/ CREDIT	0.56%	-1.46%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.09%	3.89%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	2.10%	-5.22%
COMMODITIES (DJ)	2.75%	-2.83%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	1.33%	12.80%
CURRENCIES (DB CURRENCY FUTURE HARVEST)	-0.74%	7.98%

It is uncertain whether the Fed will have to raise rates further, which it clearly prefers not to do, or if the bond market does the Fed's work via higher long-term yields. Some combination may ultimately occur. At a minimum, next year's rate cut expectations will likely unwind, putting renewed upward pressure on bond yields.

While conditions in the Middle East are still uncertain, it does not seem likely that the war will have a significant impact on the global economic cycle. In fact, the initial market reactions in the past week point to more of the same: risk-on whenever bond yield and Fed rate expectations ease.

For equities, the danger of our somewhat guarded bond outlook is that while corporate earnings should provide some support, the larger influence on stock markets over time will be periodic bouts of de-rating whenever bond yields rise. This condition dominated bond market action last year and has repeatedly, but usually only briefly, been evident in 2023. In fact, such an episode was developing before the past week's abrupt decline in bond yields. It is possible that more such de-rating episodes in 2024 will occur until the economic outlook deteriorates, which will cast a shadow over earnings.

CONCLUSION:

Our investment stance is little changed despite the escalation of global geopolitical tensions. To the extent that the uptrend in bond yields has reversed, it will help to support growth and ensure inflation stays sticky. Valuations in fixed income have improved considerably in the past 18 months, causing us to suggest modest purchases of bonds, especially into weakness. Flat-to-lower bond yields will also allow equities to hold up for a while longer. 3Q earnings and earnings revision activity for 4Q and 2024 are key.

Data from Bloomberg, as of 10/13/2023.

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