

DOLL'S DELIBERATIONS

WEEKLY INVESTMENT COMMENTARY

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	1.17%	-17.13%
S&P 500	-1.53%	-23.87%
NASDAQ	-3.11%	-33.62%
RUSSELL 2000	1.55%	-22.21%
RUSSELL 1000 GROWTH	-2.80%	-31.79%
RUSSELL 1000 VALUE	-0.68%	-16.51%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-1.86%	-39.15%
CONSUMER DISCRETIONARY	-4.09%	-33.51%
CONSUMER STAPLES	1.45%	-10.88%
ENERGY	-1.82%	50.84%
FINANCIALS	0.23%	-19.54%
HEALTHCARE	0.87%	-11.16%
INDUSTRIALS	-0.56%	-18.90%
INFORMATION TECHNOLOGY	-3.22%	-32.54%
MATERIALS	-1.86%	-23.55%
REAL ESTATE	-2.34%	-33.33%
UTILITIES	-2.58%	-11.32%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-0.75%	-24.88%
MSCI ACWI EX U.S.	-3.05%	-27.29%
MSCI EAFE	-2.47%	-27.52%
MSCI EM	-4.80%	-28.91%

SUMMARY:

A strange week for stocks! Equities fell four of the five days, declining 1.6% (S&P 500) for the week, due to a strong rally on Thursday. The 2Y finished the week near 4.50% and the 10Y yield at one point Thursday hit 4.22% before ending just above 4%. The path of least resistance remains to the downside amid the Fed's continued focus on raising rates to fight inflation and worries about economic slowdown. September CPI came in hotter than expected on both the headline and core measures. Best sectors were consumer staples (+1.5%) and healthcare (+0.9%); worst sectors were consumer discretionary (-4.1%) and technology (-3.2%).

KEY TAKEAWAYS:

- U.S. headline CPI growth accelerated to 0.4% m/m in September (from 0.1% m/m), surpassing expectations of a milder 0.2% m/m increase. Core CPI inflation increased to a 40-year y/y high of 6.6%.
- The horrible CPI report virtually guarantees a 75 basis point rate hike from the Fed on November 2.
- The Fed has raised interest rates by 300bps in six months. At this pace, something could break creating a credit or liquidity accident.
- The U.S. economic surprise index – which measures the extent to which the economic data is either beating or missing economists' forecasts – has recently moved back into positive territory.
- Retail sales for September were slightly stronger than expected (up 0.3%). This report reinforces our view that growth has been slowing, is anemic, but that we are not in a recession.
- Average hourly earnings have decelerated, labor participation over the last several months has increased, and job openings have peaked and are coming down. The labor market is softening on the margin, perhaps not as quickly as the Fed would like.
- The S&P 500 is expected to see earnings growth of 4.1% for Q3. Excluding the energy sector, earnings are estimated to be down -2.6%.
- The BBR (Bull Bear Ratio) last week dropped for the fourth consecutive week to 0.57 (the lowest since March 2009). So far, this indicator has not worked this bear market. Historically, readings below 1.0 often have marked the bottom of corrections.
- Thursday's big upside equity move following September's very disappointing CPI report caught many by surprise, including us! Explanations for the rally include short covering, technicals, the news from the U.K., and optimism about 3Q earnings season. We are skeptical, believing this is another bear market rally.
- Election momentum is tilting toward the GOP, as polls show that anxiety is rising again among voters over stubbornly high inflation. Last week, betting odds for the midterm elections flipped to a Republican sweep for the first time since early August. However, the Senate still appears to be a toss-up.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.78%	-15.49%
BLOOMBERG U.S. CORP HIGH YIELD	-1.19%	-14.56%
BLOOMBERG U.S. GOV/ CREDIT	-0.74%	-15.92%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.04%	0.71%

AN OVERSOLD EQUITY BOUNCE – NEEDS BOND RALLY TO BE SUSTAINED

Global bond markets have failed to calm in the face of high and sticky inflation, and ongoing hawkishness at the Fed. Without a sense that monetary conditions will pause before turning economically restrictive, corporate earnings expectations will continue to erode and risk-on phases will tend to fade before gaining significant momentum. Conditions remain oversold as bond valuations have dramatically improved versus a year ago, suggesting that a consolidation phase is possible. Stocks and bonds have moved from extremely overvalued to near fair value, but are still not cheap.

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	0.97%	-30.16%
COMMODITIES (DJ)	-2.90%	15.94%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	-2.01%	-43.64%
CURRENCIES (DB G10 CURRENCY FUTURE)	0.48%	5.57%

That such a huge rise in yields and decline in stocks only puts bonds and stocks near fair value reinforces the absurdly low starting point for bond yields and policy rates and the high valuation of stocks heading into 2022. While interest rates and expectations have surged this year, the level of rates and bond yields are still manageable for the relatively healthy and deleveraged U.S. economy. However, the speed of the rise in interest rates has been historically rapid. Bond market stresses have emerged to the detriment of risk asset markets, with equities and commodities at or near post-pandemic lows. Most markets are oversold and primed for a bounce, but a sustained risk-on phase will remain elusive until bond markets calm.

One of the strongest consensus views entering the current decade was that inflation was more-or-less dead and interest rates would stay low “forever”. Government

bond yields dropped into negative territory in some countries which was unprecedented in history, even during the Great Depression, and a few corporations were able to tap bond markets offering better-than-free money.

While the catalyst for the U.K.'s woes was an unfunded and ill-timed fiscal stimulus package, the root of the problem was that investors have been blindsided by the one outcome they assumed would never occur: a sustained rise in inflation and borrowing rates, which is crushing leveraged interest rate bets and will probably inflict significant pain on the overleveraged.

Our base-case scenario is for a substantial global growth slowdown, albeit with greater resilience than the consensus currently believes. In other words, a period of sub-par global growth or near recession, but not a protracted slump is likely. Possible upside surprises include a particularly resilient U.S., a euro area recovery after this winter, and a relaxation of China COVID restrictions that allow a more normal functioning in economic activity. The main downside economic risk is that inflation does not moderate in the next three to six months, forcing central banks, led by the Fed, to tighten well into restrictive territory. The longer the U.S. economy proves resilient, the greater the risk that inflation will not ease much.

CONCLUSION:

The global economic outlook is deteriorating, and a close monitoring of “weak links” is warranted. While not cheap, stocks and bonds are no longer valuation stretched. Most risk asset markets are very oversold and primed for a bounce, but a sustained risk-on phase will remain elusive until bond markets stop rioting.

Data from Bloomberg, as of 10/14/2022.

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