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GLOBAL INVESTMENTS

Doll's Deliberations

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SUMMARY:

Stocks fell last week (S&P 500 -0.7%), although the NASDAQ and small stocks rose. The bearish narrative continued to reflect headwinds from the higher interest rate backdrop as the 10-year US Treasury yield reached the highest level in 16 years. Sectors that rose included energy (+1.3%) and materials (+0.2%); worst sectors were utilities (-7.0%) and consumer staples (-2.1%).

KEY TAKEAWAYS:

1. Nancy Lazar of Piper Sandler argues that seven factors have swung from tailwinds earlier this year to headwinds now: 1) student loan repayments, 2) excess savings, 3) gasoline prices, 4) auto production, 5) consumer services spending, 6) housing, and 7) capex.

2. The services PMIs deteriorated to 50.2 (the fourth consecutive month of slowdown) suggesting that service-sector activity is nearing contraction. (The manufacturing PMIs indicates that the pace of decline slowed.)

3. Government shutdowns create headline risk, but historically have had little impact on markets. The Federal Reserve is data-dependent. If there is a government shutdown, key data will not be available.

4. Investment grade and high yield credit spreads have risen modestly. While still fairly tight versus history, these spreads need to be watched carefully for signs of credit problems/recession.

5. Earnings revisions (which moved up briefly in August and September) have turned negative again for both 2023 and 2024. 3Q earnings are expected to be up 1.5%. Ex energy (projected -36%), earnings are expected to be +6.5%.

6. The S&P 500 P/E multiple has contracted from 19.5 to 18.0 since the July 31 stock market peak. The new level is still high relative to history and current levels of interest rates.

7. Rising rates are placing downward pressure on valuations. Later, we expect the lagged impact of past rate hikes to spark a recession. We believe consumers have only started to feel impacts from the sharpest Fed tightening cycle in 40 years.

8. Even as the economic environment deteriorates, supply-side dynamics are likely to keep oil markets tight as OPEC continues to manage production.

9. Even as it continues to strengthen (and may strengthen further), the dollar remains overvalued. (20% above the purchasing power parity (PPP) exchange rate.)

10. EM stocks are relatively cheap, trading at 11.6 (versus 18.6 for the US). However, weak fundamentals across most of the EM space warrant these cheap valuations. A revival in global manufacturing cycle and dollar weakness are necessary ingredients for EM stock outperformance.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	-1.34%	2.73%
S&P 500	-0.71%	13.07%
NASDAQ	0.07%	27.11%
RUSSELL 1000	-0.33%	13.29%
RUSSELL 1000 GROWTH	-0.27%	24.98%
RUSSELL 1000 VALUE	-0.92%	1.79%
RUSSELL 2000	1.06%	3.06%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-0.02%	40.43%
CONSUMER DISCRETIONARY	-0.27%	26.67%
CONSUMER STAPLES	-1.97%	-4.76%
ENERGY	1.31%	6.03%
FINANCIALS	-1.55%	-1.65%
HEALTHCARE	-1.10%	-4.09%
INDUSTRIALS	-0.44%	4.50%
INFORMATION TECHNOLOGY	-0.08%	34.72%
MATERIALS	0.24%	2.61%
REAL ESTATE	-1.41%	-5.45%
UTILITIES	-6.92%	-14.41%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-0.90%	10.04%
MSCI ACWI EX U.S.	-1.78%	4.87%
MSCI EAFE	-1.76%	6.71%
MSCI EM	-2.05%	0.88%

THE US ECONOMY – IS IT TOO STRONG CURRENTLY? WILL Q4 SHOW WEAKNESS?

The next few months are likely to be confusing as investors grapple with signs of sticky underlying inflation and bond yields rising to new highs yet central banks being on hold at a time of heightened uncertainty about the durability of the economic expansion. After stronger Q3 GDP, the economy will add to the confusion with the possibility of a weak Q4 due to strikes and a government shutdown. Importantly, strikes and government shutdowns while disruptive, rarely change the underlying economic trajectory because they are temporary in nature. Strikes and shutdowns however, will reinforce two longer-term negative factors for global financial asset markets via increased wage gains and the risk of further entrenching inflation, as well as highlighting the increasingly dysfunctional US political backdrop and the challenge of rolling back ever-larger government debt burdens. Next year's US presidential election promises to further reinforce the challenging political backdrop.

The main cyclical risk factor for investors remains the likelihood of even higher government bond yields and, eventually, outright restrictive monetary conditions. Since 2022, bond yield uplegs have eventually triggered risk-off phases, and indeed a whiff of such an outcome has developed in the past week or so. Nevertheless, the upside in bond yields has been held back by the widespread belief that policy rates will head lower next year. We continue to disagree with this assessment, believing that inflation will be sticky enough to prevent Fed cuts for most if not all of 2024.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.91%	-1.15%
BLOOMBERG U.S. CORP HIGH YIELD	-0.59%	5.68%
BLOOMBERG U.S. GOV/ CREDIT	-0.85%	-0.89%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.09%	3.68%

Oil prices have managed an impressive rally despite ongoing concerns about the Chinese economy and global growth in general. Pure supply-driven oil price bull markets are a drag on global growth, and thus a monitoring of energy market conditions is warranted. So far, however, our assessment has been that prices have lifted due to both better demand expectations and modest restraints on supplies. One clear negative development related to the rebound in oil and gasoline prices is that the deceleration in headline inflation has likely ended, at levels well above 2%. In addition, oil prices have a meaningful impact on short-term and long-term inflation expectations, and any further lift in the latter would be a concern to central banks (and the bond market).

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-1.65%	-5.42%
COMMODITIES (DJ)	-1.20%	-3.44%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	-0.98%	13.29%
CURRENCIES (DB CURRENCY FUTURE HARVEST)	1.04%	8.77%

The Conference Board's present situation and jobs plentiful less jobs hard-to-get indexes are below their peak readings, but still historically high and, thus, are supportive of above-trend growth. One interesting aspect of the debate about the speed at which monetary tightening hits the economy is that US household debt servicing burdens are still historically low. This reflects the success most mortgage holders had in locking in low longer-term rates before the sharp rebound in rates and yields over the past 18 months.

We have repeatedly noted that US consumers have both healthy balance sheets and income statements, and have not quite fully exhausted their excess savings built up during the pandemic, although that excess savings seems to be nearing an end.

CONCLUSION:

Interest rates will stay high until the next recession arrives, and the risks are still tilted to the upside for bond yields as policy rate cut expectations unwind. Good corporate earnings are needed to keep stocks from falling due to further multiple erosion. On that score, the evidence is mixed.

Data from Bloomberg, as of 9/29/2023.

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