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GLOBAL INVESTMENTS

Doll's Deliberations

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SUMMARY:

Stocks fell again last week (S&P 500 -2.4%) due to another rise in Treasury yields and an unsettled geopolitical situation. Ten-year Treasuries reached 5% before rallying. Increasing sectors included consumer staples (+0.7%) and energy (+0.7%); worst sectors were real estate (-4.6%), consumer discretionary (-4.5%), and technology (-3.1%).

KEY TAKEAWAYS:

1. The U.S. retail sales report delivered an upbeat view on U.S. consumption. Overall spending increased by 0.7% m/m (above the 0.3% expected). The increase was broad-based.

2. Initial jobless claims fell to a low of 198,000 despite recent concerns about labor strikes.

3. The FOMC minutes revealed that the discussion among policymakers is shifting from how high to lift interest rates to how long to keep policy restrictive.

4. Fed Chair Powell implied that the rise in interest rates out the curve is accomplishing some of their work for them. (At their November meeting, the Fed is likely to stay on hold but keep future rate hikes on the table.)

5. The yield curve is dis-inverting: the spread between the 2-year and 10-year Treasury has narrowed to under -20bp from over -100bp in early July.

6. The Index of Leading Economic Indicators fell 0.7% in September, a record 18 months in a row. This indictor still suggests a recession is in our near-term future.

7. While stocks have declined so far, the sell-off is relatively mild given the bond market implosion.

8. The key unknown (for markets) for the Middle East war is whether or not Israel et al., will attack Iran oil facilities.

9. The top ten stocks in the S&P 500 have accounted for 96% of the year-to-date returns through September 30.

10. Bulls are focusing on dovish Fed speak, a good start to Q3 earnings, a strong labor market, and a soft landing. Bears are focusing on the magnitude and pace of the bond yield backup, lagged effects of Fed tightening, growth headwinds, and the increased geopolitical tensions.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	-1.57%	1.67%
S&P 500	-2.38%	11.47%
NASDAQ	-3.16%	24.87%
RUSSELL 1000	-1.15%	12.54%
RUSSELL 1000 GROWTH	-2.86%	24.27%
RUSSELL 1000 VALUE	-1.84%	-1.15%
RUSSELL 2000	-0.98%	-2.15%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-0.54%	43.88%
CONSUMER DISCRETIONARY	-4.45%	19.90%
CONSUMER STAPLES	0.83%	-6.78%
ENERGY	0.71%	5.59%
FINANCIALS	-2.91%	-4.45%
HEALTHCARE	-1.62%	-4.56%
INDUSTRIALS	-2.97%	1.81%
INFORMATION TECHNOLOGY	-3.13%	34.60%
MATERIALS	-3.02%	-1.64%
REAL ESTATE	-4.63%	-9.09%
UTILITIES	-2.12%	-15.72%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-1.40%	8.84%
MSCI ACWI EX U.S.	-1.76%	2.76%
MSCI EAFE	-1.66%	4.35%
MSCI EM	-2.15%	-0.49%

BOND YIELD RISE TRIPS UP EQUITIES YET AGAIN

Despite being oversold, bonds sold off in the face of further signs of good U.S. consumption and a better Chinese economy than the pessimistic consensus had expected. Yields surged to new highs for the decade. The view that monetary conditions are restrictive continues to be incorrect as admitted by Fed Chair Powell especially for the U.S. After a strong Q3, GDP growth will slow in the current quarter, in part due to a possible government shutdown and ongoing historically large labor strikes. Such drags will likely be insufficient to abort the economic expansion, although they could briefly ease the pressure in bond markets. The net result has been to increase the attractiveness of now reasonably high nominal yields at the short end of the Treasury curve.

The possible economic impact from development in the Middle East are a concern although, so far, the U.S. dollar and oil prices have been calm. Only if oil facilities are disrupted will those risks get triggered. Nevertheless, the escalation in geopolitical tensions dating back to late last decade when protectionism/nationalism erupted between the U.S. and China followed by the war in Ukraine, is a net negative for risk assets. Such tensions increase both inflation and economic uncertainty to the detriment of investment returns.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-2.03%	-3.44%
BLOOMBERG U.S. CORP HIGH YIELD	-1.07%	4.01%
BLOOMBERG U.S. GOV/ CREDIT	-1.91%	-2.87%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.06%	4.00%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-3.37%	-8.61%
COMMODITIES (DJ)	0.61%	-2.24%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	-3.43%	7.04%
CURRENCIES (DB CURRENCY FUTURE HARVEST)	-0.66%	7.27%

So far, the increase in economic uncertainty has not been sufficient to cool overall labor market demand, as companies have generally been able to maintain profitability. The sharp increase in input costs in the past few years has been passed on to end-users without undermining demand, albeit it has resulted in much higher consumer price inflation. While inflation is decelerating, we still anticipate that inflation rates will level off well above pre-pandemic and central bank target rates, because of a dearth of economic slack and resilient demand.

So far, global equities are holding up – no longer advancing, but not yet breaking down. Similarly, credit spreads have widened a bit of late, but not unduly relative to the riot in government bond markets. Trouble for equities however seems inevitable. Stocks face a squeeze from de-rating pressures whenever bond yields rise. And the latter will only end when corporate earnings falter. The only way to avoid such an endpoint would be if inflation could return to near central bank targets without triggering a recession. Indeed, the one-off boosts to inflation related to pandemic-era distortions are unwinding, but underlying inflation is proving sticky. This coincides with the strongest wage gains in decades, which act in a self-reinforcing fashion.

CONCLUSION:

A sustained rise in bond prices will only occur once the start of a meaningful Fed easing cycle comes into view, which is still not on the horizon. The rate cuts priced in the forward markets for 2024 will likely unwind in the coming months. For equities, sustained bond market relief will only develop after an economic and earnings recession takes hold. Stocks should firm whenever bond yields ease although upside will be limited, and de-rating pressures will intensify whenever bond yields rise.

Data from Bloomberg, as of 10/20/2023.