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DOLL'S DELIBERATIONS

WEEKLY INVESTMENT COMMENTARY

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	1.12%	18.30%
S&P 500	1.66%	22.39%
NASDAQ	1.30%	17.68%
RUSSELL 2000	1.14%	16.88%
RUSSELL 1000 GROWTH	1.81%	21.05%
RUSSELL 1000 VALUE	1.56%	22.57%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-0.61%	22.52%
CONSUMER DISCRETIONARY	1.49%	17.65%
CONSUMER STAPLES	0.91%	8.68%
ENERGY	1.18%	59.06%
FINANCIALS	2.79%	39.73%
HEALTHCARE	2.89%	17.40%
INDUSTRIALS	1.84%	19.47%
INFORMATION TECHNOLOGY	1.61%	22.28%
MATERIALS	0.86%	18.53%
REAL ESTATE	3.22%	33.37%
UTILITIES	2.34%	9.67%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	1.28%	16.30%
MSCI ACWI EX U.S.	0.72%	9.30%
MSCI EAFE	0.62%	11.13%
MSCI EM	0.75%	1.95%

SUMMARY:

U.S. equities finished higher last week, with the Dow (+1.1), S&P (+1.7%), and the NASDAQ (+1.3) all up for a third straight week. 3Q earnings were the main reason for the upside, as the robust demand backdrop helped ease some of the concerns surrounding supply chain and input price pressures. Fiscal stimulus headlines were positive as Democrats seemed to be moving closer to a deal. Best sectors were REITs (+3.2%), healthcare (+2.9%), and financials (+2.8%); the only sector to decline was communication services (-0.6%).

KEY TAKEAWAYS:

1. With nearly a quarter of the S&P 500 having now reported, Q3 earnings have exceeded expectations by 13%. This is down from 16% in Q2 and 22% in Q1 but still well ahead of the 8% five-year average positive surprise rate.
2. Corporate America fears higher expenses – transportation, energy, and labor in particular. So far, much of the cost pressures are being passed on through price increases. We are dubious about how long that can last.
3. Negotiations on a compromise reconciliation bill produced a market positive development last week with the likely removal of a corporate tax hike from consideration.
4. Fed officials are beginning to acknowledge that inflation is more persistent than initially thought (in other words, not all inflation is transitory).
5. Inflation in the U.S. and many other countries is likely to follow a trajectory of higher highs and higher lows for the foreseeable future. Goods inflation will ease in 2022, and energy price pressures will likely abate. Any decline in inflation will be short-lived, however. Tight labor markets will bolster wages. Rent inflation is also poised to pick up, especially in the U.S.
6. The S&P 500 YTD return of roughly 20% has been the result of earnings estimates climbing 30% and P/E ratios falling 10%.
7. P/E multiples are very likely to remain under pressure due to inflation, Fed tightening, and rising risk aversion. Hopefully, earnings increases will be offsetting.
8. Copper prices are once again on the rise. "Dr. Copper" is often a good lead indicator for economic activity.
9. The dollar is likely to weaken as growth momentum rotates from the U.S. to other developed economies and as the Fed lags many other major central banks in normalizing monetary policy.
10. The revelation that China tested a new hypersonic missile is likely to drive increases in defense spending in the U.S., NATO, and Japan.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.37%	-2.09%
BLOOMBERG U.S. CORP HIGH YIELD	-0.08%	4.26%
BLOOMBERG U.S. GOV/ CREDIT	-0.41%	-2.48%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.00%	0.03%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
FTSE NAREIT (REAL ESTATE)	2.38%	29.83%
DJ COMMODITIES	-0.51%	32.70%
RED ROCKS GLOBAL LISTED PRIVATE EQUITY	3.72%	29.71%
DB G10 CURRENCY FUTURES	0.12%	7.69%

AMAZING PROFITABILITY AND A MOUNTAIN OF CASH SUGGESTS A RESUMPTION OF ABOVE-TREND GROWTH

Investors have become less dismissive about the rise in inflation, as have some central bankers, although this is far from the majority view. Perhaps it is just the fact that bond yields have been edging higher that has caused some investors to become nervous about their inflation views. The bet seems to be that any increase in interest rates will be temporary because it will presumably undermine economic growth and lower inflation. The lack of confidence in the durability of a robust economic expansion still leads many to assume that the inflation upturn will be easy to reverse once supply chain woes ease and economic growth settles at a pace similar to last decade's slow growth rate. We expect yield curves to rise and steepen because we expect both a more resilient economic expansion and an upward tilt to underlying inflation once the impact of re-opening and supply chain woes filters out of the data.

The investment implication of our economic/inflation view is to expect stocks and cash to outperform bonds, despite some near-run headwinds. Equities have outrun the positive corporate profit outlook, which makes us wary of being aggressively positioned in stocks, particularly since investors are still hesitant to rotate out of winners such as U.S. equities and large-cap growth stocks. Corporate earnings will continue to climb, and equities will be well supported on a 6-12 month basis; corrections should prove temporary in nature. 3Q earnings releases so far are impressive given the surge in input costs and cooling in economic growth rates. So far, many companies have been successful in passing on higher costs to end-users, i.e., the backdrop is inflationary. Underlying corporate profitability has been stellar and is consistent with elevated hiring plans and our view that longer-term economic expectations will eventually be upgraded as investors realize that a return to the slow growth environment of the 2010s is unlikely.

Last week's flash PMI surveys confirmed that a peak in growth rates has occurred but that conditions remain fairly robust, especially in the face of ongoing supply constraints. In addition, many economies have not yet fully re-opened, and there is considerable pent-up demand in service sectors. A large portion of U.S. government income transfers are still sitting in bank accounts, as consumers have either been unable to spend it due to supply problems/lack of re-opening in some service sectors or have chosen to sit on the cash. The corporate sector is also sitting on a large pile of cash. Therefore, there is still a considerable amount of sidelined funds that could be spent, even independent of the ongoing strength of income growth via both job creation and higher wages. Additional fiscal stimulus will not be critical for driving the economic cycle at this stage since job creation is already in high gear in most developed countries because of solid corporate profitability.

CONCLUSION:

We suggest positioning for stocks to beat bonds over the next 6-12 months. But we expect equity gains to be more difficult and with higher volatility. Sentiment towards inflation is starting to shift but has a long way to go before the consensus is discounting a sustained rise in underlying inflation. Meanwhile, strong corporate profitability and a mountain of sidelined savings from prior fiscal transfers and some pent-up demand suggest continued above-trend economic growth.

Data from Morningstar Direct, as of 10/25/2021.

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