

# DOLL'S DELIBERATIONS

## QUARTERLY EDITION

### Tug of War Between Cyclical Tailwinds and Higher Inflation and Interest Rates

Among the major averages, only the S&P 500 closed up in Q3 (+0.2%). All other averages fell, with the worst being the Russell 2000 (-4.6%). The path of least resistance remained higher for most of the quarter with the support of easy financial conditions, accommodative monetary policy, earnings beats, stock buybacks, and retail inflows. However, September was difficult as concerns about peak policy, peak growth, and peak earnings mounted. The Delta variant, supply chain pressures, and inflation concerns weighed on sentiment. Ten-year Treasury yields started the quarter at 1.45% and ended at 1.53% after dipping to 1.13% during the quarter. Growth stocks (+1.6%) handily beat value stocks (-1.5%). Best sectors were financials (+2.3%), communication services (+1.4%) and technology (+1.1%); worst sectors were industrials (-4.6%), materials (-3.9%), and energy (-2.8%).

Global growth momentum has moderated from an economic boom to something that is still very solid and above what the market consensus anticipates. Likewise, U.S. core consumer price inflation will fall back from its post-pandemic spike but ultimately settle at a higher rate than investors expect. The near-term downshifting of the global economy could cause a temporary growth scare and briefly fuel the narrative that the world economy is returning to secular stagnation. If so, financial market volatility will increase as investors worry about risk assets, while bond yields may not offer a relief valve. However, the eventual realization that the global economy will continue to perform above the low growth and low inflation environment of the 2010s will encourage a gradual upward revision in longer-term expectations.

The dramatic policy-induced surge in the global economy over the past year is unsustainable, and the base effects from the deep contraction of a year ago will unwind. However, the key for investment strategy is determining how much economic growth will decelerate and to what sustainable level. Given the substantial distortions in the current economic data and heightened uncertainty due to unprecedented events, most market participants and central bankers have merely adopted the 2010s economic/inflation backdrop as their base-case endpoint once the dust settles. However, this assumption ignores the end of powerful headwinds in the U.S. and euro-area economies, including fiscal austerity and household sector deleveraging. The end of deleveraging for the U.S. and the euro-area household sectors is lifting underlying growth in the global economy above the last decade. However, there is also room for upside surprises given the accumulation of excess household savings, strong job prospects, and recent massive wealth gains from both housing and financial assets, all of which provide firepower for consumer spending over the next year and beyond.

In terms of inflation, investors and central banks have discounted this year's spike as being predominantly "transitory." U.S. core consumer price inflation will ease after surging to levels not seen in decades, given that base effects and supply bottlenecks have exaggerated it. However, our estimate of the underlying trend in inflation is above the pre-pandemic rate and rising steadily across a wide set of goods and services. Surprises will be to the upside beyond the near term, with U.S. core inflation showing resilience and eventually settling in closer to 3% rather than returning to 2% or lower. Economic slack in the U.S. is rapidly being absorbed and will contribute to a sustained period of price pressures until the next global recession. Also, many of the structural drags on consumer price inflation faded last decade, including the impact of globalization and adjustments to private sector balance sheets. Technology-related disinflation will need to intensify to keep underlying price pressures from rising, especially since monetary policy is ultra-accommodative and most central bankers are aggressively aiming for above-target inflation.

#### **FIXED INCOME**

The message from Jackson Hole is that the majority of the FOMC is ready to begin tapering asset purchases before year-end. The Fed is trying to communicate a separation of the balance sheet and interest rate components of its monetary policy, hoping to limit bond volatility stemming from markets pulling forward the timing of rate hikes during the taper. A tightening U.S. labor market will make that separation difficult given the shallow path for interest rates currently discounted in the U.S. yield curve, particularly if the current surge in U.S. inflation proves not to be transitory as the Fed is expecting. G7 government bond markets are priced for the current boom to give way to a resumption of the low growth and low inflation environment of the 2010s. This is not supported by underlying macro fundamentals. Fixed-income will represent a drag for multi-asset portfolio performance over the next 6-12 months. We expect higher Treasury yields as the Fed transitions from talking about tapering to actual tapering and, eventually, to rate hikes starting late 2022. Within a fixed-income portfolio, we recommend remaining maximum underweight government bonds while favoring inflation-protection and spread product, although absolute returns will be low by historical standards.

## EQUITIES

Equities have started to stumble as of late as growth concerns mount and bond yields move higher. Our constructive cyclical view on the global economy points to continued upside for earnings and underlying support for equities. However, share prices have moved decisively ahead of improving underlying fundamentals, leaving market leaders overbought at a point when growth conditions are moderating. Given this outlook, we recommend near-term caution. The major offset for our near-term cautiousness on equities is that the global economy will remain stronger than investors expect and support a continued rise in corporate earnings. Also, policy conditions are hyper-accommodative, and the world is flush with liquidity. Real interest rates are very negative and continue to encourage growth and risk-taking. Outside of an adverse shock, sustained selloffs typically only occur in response to tighter policy conditions.

Equity leadership indicates a reluctance among investors to embrace a constructive longer-term economic outlook. Nonetheless, the combination of extremely forceful policy reflation and the rapid recovery in the global economy to where it left off pre-crisis have caused equities and other risk assets to be bid up dramatically over the past year. The primary risk for equities is that they have materially front-run improving underlying fundamentals, at a point when growth conditions are moderating and could lead to a temporary growth scare. In recent months, there have already been some major corrections underneath the surface in individual stocks and sectors, a trend that is likely to persist. As a result, we recommend being discriminate and scaling back on the leaders who have elevated earnings expectations and will be more vulnerable to another move up in bond yields. U.S. highly valued growth stocks which face tough earnings comparisons will lose some relative appeal if bond yields rise. We recommend some caution in high-duration equities. Conversely, many of the value-oriented equity laggards (e.g., financials) have healthy relative valuations cushions that should help protect against near-term uncertainty and will eventually benefit from an upward revision to longer-term growth, inflation, and interest rate expectations.

## COMMODITIES AND CURRENCIES

Commodity prices are overbought and vulnerable to near-term downside, but good growth conditions should provide support on a 6-12 month horizon. The U.S. dollar is likely to face headwinds when investors eventually raise their longer-term global growth expectations.

## CONCLUSION

Near-term caution is warranted as the global economy downshifts. However, our constructive cyclical macro outlook favors equities on a 6-12 month horizon. This is supported by a resilient expansion in the global economy but tempered by the likelihood of higher bond yields and cyclically building inflation pressures.

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