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Doll's Deliberations

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SUMMARY:

Stocks were lower (S&P 500 -0.2%) in volatile trading last week. Economic data was mixed including August CPI and PPI as well as retail sales. Best sectors were utilities (+2.7%), consumer discretionary (+1.7%), and financials (+1.4%); underperformers included technology (-2.2%) and industrials (-0.6%).

KEY TAKEAWAYS:

1. CPI jumped +0.6% m/m (3.7% y/y) and the core (ex food and energy) CPI was +0.3% m/m (4.3% y/y). The monthly trend in core inflation has been encouraging, but August was too high. The labor market does not appear to have rolled over enough to remove concerns about wage inflation yet. The Fed can likely pause in September, but it's too early to consider Fed cuts.

2. There is evidence that the job market is starting to cool. The number of job openings versus job seekers continues to trend down, and the labor market supply/demand gap is starting to narrow.

3. In our view, the market is largely ignoring the lagged impact of Fed rate hikes on real consumer spending. Over the past 20 years, real consumer spending has lagged by 18 to 24 months. If we are correct and this relationship continues to hold, it means real consumer spending has most likely only just started to feel impacts from the Fed's tightening cycle that began in March 2022.

4. While the economy had a stronger first half than expected, we continue to believe a recession is coming within the next 6-12 months. The Fed has hiked rates by 525 basis points, excess savings are shrinking, payroll growth looks set to slow and eventually contract, and global manufacturing and trade are weakening.

5. The ECB hiked +25 basis points to 4.50% for its main refinancing rate. (Headline CPI slowed to 5.3% y/y in August, still way above ECB's 2% target.) A Eurozone recession seems highly unlikely.

6. August was the first month since March 2022 in which the 3-month average of S&P 500 upward earnings estimate revisions as a % of total revisions exceeded 50%.

7. We remain concerned about the ability of corporations to deliver outsized expectations for earnings growth over the next twelve months. (S&P 500 EPS 2024 expectations are +12%.)

8. Equities are up 16% YTD mostly on multiple expansion while real rates and cost of capital are moving deeper into restrictive territory. History suggests this relationship is becoming increasingly unsustainable, posing risk to the equity multiple, especially since earnings expectations already face a high hurdle for 2024.

9. The largest 15 companies in the S&P are up 41%, while the median company is up just 3%. Incredible concentration!

10. Tax policy will likely be a dominant issue in the 2024 election, as both parties fight over the expiring Trump cuts.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	0.14%	6.14%
S&P 500	-0.12%	17.30%
NASDAQ	-0.37%	31.78%
RUSSELL 1000	1.04%	18.55%
RUSSELL 1000 GROWTH	-0.69%	29.66%
RUSSELL 1000 VALUE	0.47%	5.44%
RUSSELL 2000	0.86%	7.14%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	0.55%	45.12%
CONSUMER DISCRETIONARY	1.72%	35.61%
CONSUMER STAPLES	0.51%	-1.08%
ENERGY	0.15%	7.15%
FINANCIALS	1.48%	2.78%
HEALTHCARE	0.11%	-1.89%
INDUSTRIALS	-0.59%	7.85%
INFORMATION TECHNOLOGY	-2.23%	38.44%
MATERIALS	-0.11%	6.22%
REAL ESTATE	0.44%	1.28%
UTILITIES	2.74%	-6.46%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	1.15%	14.78%
MSCI ACWI EX U.S.	1.34%	8.75%
MSCI EAFE	1.25%	10.44%
MSCI EM	0.94%	4.88%

INFLATION REMAINS FAR FROM 2%

Although global corporate earnings continue to grind higher, equity markets remain hostage to the whims of the bond market, resulting in a choppy, stop-start backdrop. Bond markets remain on edge, testing their cyclical yield highs, yet with the hope that disinflation will intensify and spur a reversal in the policy rate-hiking cycle in 2024. We continue to think that inflation will remain sticky, that bonds will tread water at best, and that equity valuations (and perhaps earnings) will be challenged.

Even as forecasts for a US and global recession gradually recede, most investors and monetary authorities are still banking on continued disinflation and, eventually, return to the 2% inflation world of the last decade. Last week's US CPI report provided a sober reminder that inflation may very well be more entrenched than at any time in the past several decades, absent a recession. The path to 2% inflation hit a bump with the second monthly rise in US headline CPI and signs that core inflation excluding rent was stickier than most expected. The rebound in headline CPI is occurring sooner and at a higher level than many had anticipated, and a similar outcome is possible for core CPI. The drag on headline inflation from the huge deceleration in energy prices has reversed and the deflation in food prices has also calmed. Meanwhile, many service sectors are witnessing persistent and historically elevated inflation.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.09%	0.50%
BLOOMBERG U.S. CORP HIGH YIELD	0.31%	7.14%
BLOOMBERG U.S. GOV/ CREDIT	-0.15%	0.59%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.09%	3.46%

It will take another six months or more to resolve the disinflation versus sticky-inflation debate, and we expect periods of good and bad news ahead while economies continue to re-normalize as the huge pandemic-era price and supply distortions fully unwind. When the dust settles by early 2024, we expect underlying inflation to be well above pre-pandemic readings and central bank targets. The increase in coupon income has not been sufficient to offset even a modest drop in bond prices and while US equities have outperformed their global peers, this outperformance has been driven by a handful of stocks in sectors that will be vulnerable to renewed de-rating pressure if bond yields move higher.

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	1.18%	1.92%
COMMODITIES (DJ)	1.41%	-1.23%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	0.86%	16.95%
CURRENCIES (DB CURRENCY FUTURE HARVEST)	0.32%	6.93%

The US economic expansion continues apace. Consumption and service sector activity remain solid, whereas manufacturing continues to struggle. Given the historical bellwether nature of the manufacturing sector, any rebound here without a downshift in other economic sectors would likely spark a rethinking by bond bulls, economy bears and the Fed.

CONCLUSION:

The upside for equities should be limited and the timeline to an eventual economic recession will finally come into view if bond yields undergo another meaningful upleg as we expect. The timing of an upside breakout in bond yields is still uncertain, given ongoing disinflation and expectations that central banks are almost finished raising policy rates. However, any period of calm will prove temporary as we anticipate inflation at rates well above central bank targets. Therefore, expectations for upcoming policy rate cuts are premature. The latter will rekindle de-rating pressures on equity markets.

Data from Bloomberg, as of 9/15/2023.

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