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Doll's Deliberations

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SUMMARY:

Stocks were broadly lower last week (S&P 500 -2.9%), closing below their 100-day moving average for the first time since March. It was a risk-off week as investors contemplated "higher for longer" interest rates. Least declined sectors included healthcare (-1.2%) and utilities (-1.7%); worst sectors were consumer discretionary (-6.4%) and real estate (-5.4%).

KEY TAKEAWAYS:

1. The Fed held the Fed Funds rate steady but significant changes were made to economic and interest rate projections. GDP growth was revised up, the unemployment rate forecast was adjusted downward, and inflation was left unchanged for next year. Fed Funds are estimated to rise once more this year and cut twice next year (down from four cuts).

2. Last Thursday's release of US weekly jobless claims (201K, an eight-month low) and continuing claims delivered a positive surprise about labor market conditions.

3. The Conference Board's leading economic indicators logged yet another monthly decline in August, down 0.4%, amid weak new orders, deteriorating consumer expectations, and high interest rates.

4. Emergency policy measures undertaken during the pandemic appear to have lengthened the lags between rate hikes and palpable economic slowing. Though it's taken considerably longer than the consensus expected for a recession to arrive, we believe it has merely been postponed, not cancelled.

5. Cracks are starting to show in the US consumer including falling quits rates, tightening credit, rising delinquencies, and mixed retail sales.

6. The S&P 500 is down 6% from its July 31 peak. The combination of rising oil prices, an appreciating US dollar, and rising US bond yields is a difficult cocktail for stocks.

7. Bullish talking points continue to revolve around peak Fed soft landing expectations, disinflation traction, cautiously optimistic corporate commentary and an expected 2H earnings rebound. Bearish talking points revolve around upward pressure on rates, energy price spike, waning disinflation momentum, sticky wage pressures and looming consumer headwinds.

8. Historically, government shutdowns have little impact on growth and stocks. But, coupled with the auto strike, higher gasoline prices, and a more hawkish Fed may cause a downward shift in sentiment.

9. Voters have removed the party in power in eight of the past nine elections. Talk is building of a third-party candidate entering the race, using a "unity ticket" of a Republican and Democrat to win over disaffected voters across the political spectrum.

10. Like many, despite being cyclically concerned about our economy, we remain constructive on the energy sector due to historically strong capital discipline, a supply-demand imbalance, the best earnings revisions of any sector, and not extended valuations.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	-1.89	4.13
S&P 500	-2.91	13.88
NASDAQ	-3.61	27.02
RUSSELL 1000	-2.77	13.91
RUSSELL 1000 GROWTH	-3.35	25.32
RUSSELL 1000 VALUE	-2.56	2.74
RUSSELL 2000	-3.52	2.28

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-3.22	40.45
CONSUMER DISCRETIONARY	-6.34	27.01
CONSUMER STAPLES	-1.78	-2.84
ENERGY	-2.33	4.65
FINANCIALS	-2.79	-0.10
HEALTHCARE	-1.16	-3.03
INDUSTRIALS	-2.68	4.96
INFORMATION TECHNOLOGY	-2.61	34.83
MATERIALS	-3.64	2.36
REAL ESTATE	-5.31	-4.10
UTILITIES	-1.70	-8.05

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-2.56	11.16
MSCI ACWI EX U.S.	-2.23	6.71
MSCI EAFE	-1.75	8.96
MSCI EM	-2.90	2.13

"Higher for Longer" Causes Indigestion

The Fed paused on its rate-hiking cycle last week. The pause reinforced the consensus among investors and central banks that monetary tightening is almost over, and the next big move will be rate cuts starting in 2024. As has consistently been the case since policy rates started to rise in 2022, we envision both policy rates moving higher and staying higher for longer. The Fed finally reduced its expected rate cuts next year (from four to two); we foresee further shifts ahead towards both a higher terminal rate and perhaps no cuts in 2024.

As noted often by us, central banks and investors are still overly wedded to the framework of the past two decades, when inflation was quiet for most of the time and any threat quickly evaporated. Central banks' efforts were generally aimed at promoting growth rather than applying the economic brakes. The backdrop this decade has profoundly changed because of the end of household sector deleveraging and strengthening de-globalization forces, plus the emergence of significantly greater labor disputes and rising wage demands due to excessively stimulative monetary and fiscal policies in recent years, which have resulted in very tight labor markets.

Time generally worked for bond bulls prior to this decade, but now works against them. The environment is also less favorable for equities, but not as bearish as it is for bonds because the global economic expansion still has legs and profit margins have stayed sufficiently elevated to support acceptable corporate earnings, despite huge input cost increases. Nevertheless, equity de-rating pressures will periodically develop as long as inflation proves sticky and bond yields are under upward pressure. Equity and credit markets are vulnerable should bond yields continue to climb.

A further rise in bond yields could develop when it becomes clear that the deceleration in underlying inflation will stall out well above the central bank target of 2%. Last week's FOMC meeting saw the Fed keep Fed funds unchanged, yet lift its GDP forecast and lower the expected unemployment rate, all the while maintaining its benign inflation forecast. Such a goldilocks combination reinforces the notion that they are still banking on inflation eventually returning to the 2% area without having to cause a recession.

The Fed has finally started to acknowledge that the policy rate will follow a higher path over the coming years than it has been signaling. Higher bond yields and/or tightening monetary policies will eventually trigger a further de-rating in risk asset markets, as such conditions will increase the odds of a recession.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.87	-0.61
BLOOMBERG U.S. CORP HIGH YIELD	-0.71	6.26
BLOOMBERG U.S. GOV/ CREDIT	-0.80	-0.40
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.09	3.57

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-4.71	-3.16
COMMODITIES (DJ)	-1.06	-2.27
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	-2.78	14.54
CURRENCIES (DB CURRENCY FUTURE HARVEST)	0.68	7.66

CONCLUSION:

Early signs that headline inflation is leveling off well above the Fed's target have rocked investors. While inflation will likely fall further, it is likely to hold well above central banks' targets. The implication is that long-term government bond yields ultimately have further upside and lower policy rates in 2024 may not happen. This environment is challenging for bonds and for equity valuation levels.

Data from Bloomberg, as of 9/22/2023.

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