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GLOBAL INVESTMENTS

Doll's Deliberations

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SUMMARY:

Stocks were higher last week (S&P 500 +2.5%) as small stocks led the way. Stocks advanced in part on the strength of the bond market. Best sectors were technology (+4.4%) and energy (+3.8%); worst sectors were utilities (-1.7%) and consumer staples (-0.3%).

KEY TAKEAWAYS:

1. The US added a better than expected 187,000 jobs for the month of August. Importantly, the unemployment rate was 3.8%, up from July and the highest since February 2022.
2. Both the headline and core PCE deflators rose 0.2% m/m in July. They were 3.3% and 4.2% on a y/y basis. (The core rate rose an annualized 2.9% rate over the past three months.)
3. Fed Chair Powell's Jackson Hole speech was more hawkish than expected, saying that the Fed wouldn't hesitate to raise interest rates further to bring inflation back down to the Fed's 2.0% target. The Fed is likely to skip a rate increase in September, but will likely raise rates 25 basis points before the end of the year (futures peg that probability at under 50%).
4. The pessimistic manufacturing outlook captured by various Fed surveys suggest that there is scope for the US economy to disappoint going forward.
5. We continue to believe that the economic impact of the Fed's aggressive tightening campaign will intensify and ultimately weigh on the US economy and US equities.
6. The outlook for the federal budget right now is unprecedented – crisis-size deficits as far as the eye can see. The interest costs of the federal government are exploding higher, which is going to massively increase the supply of treasuries that will need to be sold going forward.
7. In August, the S&P 500 and the NASDAQ suffered their first monthly declines since February. One of the more prominent headwinds facing stocks in August was the backup in interest rates.
8. Growth stock valuations have only corrected modestly relative to value and remain well above their long-term average. Earnings revisions continue to favor growth relative to value, but the gap has started to narrow suggesting that growth's dominance on the earnings front is fading.
9. Small cap stocks remain oversold and cheap and are still well positioned to benefit if risk sentiment improves. However, small caps typically have narrower margins and are more exposed to a deterioration in the economic environment.
10. For a market that has seen momentum erode all summer, the energy sector remains the noted exception, with 100% of constituents above the 50-day moving average. (There's not another sector with even 50% above the 50-day.)

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	1.57%	6.73%
S&P 500	2.55%	18.95%
NASDAQ	3.27%	34.86%
RUSSELL 1000	2.47%	18.58%
RUSSELL 1000 GROWTH	3.43%	32.20%
RUSSELL 1000 VALUE	1.94%	6.41%
RUSSELL 2000	2.53%	8.96%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	3.47%	44.38%
CONSUMER DISCRETIONARY	3.14%	34.01%
CONSUMER STAPLES	-0.22%	-1.07%
ENERGY	3.78%	5.43%
FINANCIALS	2.08%	2.35%
HEALTHCARE	0.06%	-0.93%
INDUSTRIALS	2.10%	11.71%
INFORMATION TECHNOLOGY	4.44%	44.99%
MATERIALS	3.72%	8.93%
REAL ESTATE	1.48%	1.87%
UTILITIES	-1.57%	-9.78%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	2.41%	14.80%
MSCI ACWI EX U.S.	2.31%	8.77%
MSCI EAFE	2.78%	10.87%
MSCI EM	0.96%	4.55%

SOME CRACKS SHOWING UP

As Treasury bond yields were heading higher and briefly moved above last October's highs, some weaker economic data arrived and capped yields. While the danger of a risk-off phase has receded as a result, and equity markets have stabilized, the action reinforces the view that the main threat to risk asset markets is the potential for bond yields to rise further, rather than a sudden slide into recession (although that risk has not disappeared). On the positive side, inflation will continue to decelerate and sustain the hopes of bond bulls and central banks that a relatively painless return to a low inflation world is possible without more monetary tightening. Conversely, sufficiently robust global economic growth will likely put a floor under inflation at well above pre-pandemic and central bank target levels. Therefore, a risk is higher bond yields, lower P/E ratios, and no rate cuts for the next six months.

There is still an entrenched expectation among many investors of a return to the macro environment of the 2010s (sluggish growth but little inflation, and thus depressed bond yields). We expect this view to unravel in the coming year or two. At some point, we expect bond yields will move to new highs and set the stage for truly restrictive monetary conditions and another risk-off phase. The first step will be a further unwinding of lower policy rate expectations for 2024. Higher rates will eventually bring on the much anticipated recession.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	0.95%	1.37%
BLOOMBERG U.S. CORP HIGH YIELD	0.94%	7.13%
BLOOMBERG U.S. GOV/ CREDIT	0.90%	1.53%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.08%	3.24%

Payroll growth has decelerated, but from extraordinarily high levels and is still sufficient to sustain a tight labor market. Wage growth should cool as well, but is not likely to return to the low levels that prevailed last decade until after there is a meaningful rise in unemployment. US consumers are slowly becoming less upbeat on employment prospects, again from historically elevated levels. US consumption is holding at a solid growth rate and prospects are still positive especially for the service sector. The cooling in demand for goods has triggered a global manufacturing downturn. There has been an unprecedented divergence between goods and services demand due to first the pandemic and then the globally staggered re-opening. While the US economy has undergone a solid period of better-than-expected growth in the past six months, we anticipate conditions will cool, perhaps noticeably.

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	1.80%	1.90%
COMMODITIES (DJ)	1.29%	-2.12%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	4.12%	16.57%
CURRENCIES (DB CURRENCY FUTURE HARVEST)	0.41%	6.17%

As noted, there have been some small cracks, or at least a marked deceleration in US employment data. However, we expect the "weak link" economies to crack well before the US economy finally succumbs to higher interest rates and heads into recession. The former have the most indebted household sectors and inflated housing market prices relative to income, and thus the greatest interest rate sensitivity.

CONCLUSION:

Bond yields may stay capped for a while as a consequence of ongoing disinflation and cautious central banks. If so, then the risk-on backdrop should continue. So far, the economic cracks are still too small to significantly increase the odds of a global recession but we expect those probabilities to grow. We expect no policy rate cuts for the foreseeable future and, eventually, another upside breakout in bond yields.

Data from Bloomberg, as of 9/1/2023.

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