CROSSMARK GLOBAL INVESTMENTS

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DOLL'S DELIBERATIONS

WEEKLY INVESTMENT COMMENTARY

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	-0.78%	13.65%
S&P 500	0.43%	13.84%
NASDAQ	1.85%	9.50%
RUSSELL 2000	2.18%	18.73%
RUSSELL 1000 GROWTH	1.84%	8.64%
RUSSELL 1000 VALUE	-0.50%	18.71%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	0.82%	18.12%
CONSUMER DISCRETIONARY	1.63%	6.93%
CONSUMER STAPLES	-0.72%	5.59%
ENERGY	-0.50%	47.80%
FINANCIALS	-2.37%	28.07%
HEALTHCARE	1.95%	10.14%
INDUSTRIALS	-1.73%	17.25%
INFORMATION TECHNOLOGY	1.39%	9.13%
MATERIALS	-2.02%	19.35%
REAL ESTATE	2.02%	25.62%
UTILITIES	1.17%	6.28%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	0.46%	12.15%
MSCI ACWI EX US	0.23%	11.10%
MSCI EAFE	0.34%	11.60%
MSCI EM	0.08%	7.81%

SUMMARY:

Equities were mixed last week, with the S&P 500 +0.4%. Small-cap stocks were also higher on the week ending up over 2%. The widely anticipated May CPI report came in higher than expected, with headline prices seeing the biggest year-over-year increase since 2008 and core prices up the most since 1992. However, the report did not do much to shift the inflation debate, and bond yields actually fell on thoughts that inflation concerns may have peaked. A busy week of infrastructure stimulus headlines continued to highlight a challenging path to a bipartisan deal and an increased likelihood of Democrats ultimately having to try to go it alone via budget reconciliation. The focus now shifts to this week's FOMC meeting, where the big question will be whether Powell says the Fed has begun informal discussions about tapering. Strongest sectors were REITs (+2.0%) and healthcare (+1.9%); weakest sectors were financials (-2.4%) and materials (-2.0%).

KEY TAKEAWAYS:

1. The jump in core CPI inflation to a 28-year high of 3.8% in May shows signs of emerging inflationary pressures in some sectors, including housing costs and restaurant prices, suggesting that not all of the current upward pressure on inflation will prove transitory.
2. Fed tapering discussions are likely sooner rather than later as a way of safeguarding inflation expectations against a possible accumulation of upside surprises.
3. The President's agenda is in some jeopardy due to lack of agreement among the Democratic Congress, rising crime, increased unease regarding China, and rising prices for many items. A watered-down infrastructure bill still has a chance of winning enactment, although a second bill covering a wide range of social spending is increasingly unlikely.
4. President Biden has ordered an intelligence community analysis of the origin of Covid. It is very likely the report will be inconclusive on the origin of Covid-19 but conclusive that China provided false information. This will add fuel to the fire and lead to a more aggressive U.S. policy response to China.
5. The 80+ basis point increase in yields from year-end to Q1 peak pushed U.S. 10-year Treasurys deep into oversold territory. This triggered a rally that brought yields down to under 1.50% recently. The next decisive upward move in U.S. Treasurys is likely to occur due to a repricing in investor expectations regarding Fed policy which could come on the back of higher inflation readings.
6. We maintain a bearish outlook for the dollar. A weaker dollar is ultimately reflationary for the global economy and favors stocks over bonds and international stocks over U.S. stocks.
7. Multiple (P/E) contraction is the main threat to equities over the next twelve months, and a shift in Fed policy is the most likely de-rating catalyst.

REMAINING MODESTLY CONSTRUCTIVE ON EQUITIES WHILE WATCHING TREASURY YIELDS CAREFULLY

Financial markets have been relatively calm recently as the upside in equity prices and bond yields have dissipated. The recent modest easing in bond yields will support both a broadening economic expansion and risk asset prices. The significant rise in equities after the powerful burst of momentum that took hold last November when successful vaccination results arrived has now priced in a substantial upgrade in earnings expectations and a continued massively supportive policy backdrop, leaving investors with few additional positives to

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG BARCLAYS U.S. AGGREGATE BOND	0.12%	-2.17%
BLOOMBERG BARCLAYS U.S. CORP HIGH YIELD	0.28%	2.53%
BLOOMBERG BARCLAYS U.S. GOV/CREDIT	0.17%	-2.78%
BLOOMBERG BARCLAYS U.S. T-BILL 1-3 MONTH	0.00%	0.02%

discount in the near term. The persistence of the economic expansion at a solid pace should be enough to keep equity prices well bid, providing no negative developments occur on other fronts.

We remain bearish on bonds in a multi-asset portfolio despite the recent lull in yields, as the latter remains well below levels likely to restrain economic growth and, thus, are ultimately unsustainable as the global economic expansion will roll on. Our bond bearishness and elevated equity valuations keep us from taking more overall stock market risk at this time. With monetary and fiscal policies so highly accommodative and with promises from all the major developed world policymakers that such support will persist for a long time, one wonders what could cause problems. The expansion is unlikely to fade on its own, nor are higher taxes likely to create a roadblock, even if pockets of the equity market might react poorly. It is likely that the traditional catalyst for weaker growth and a sizeable risk asset setback will be needed, namely monetary conditions shifting from accommodative to the restrictive end of the spectrum. Such a transition is not yet visible.

This year's move in bond yields was reflective of rising economic expectations. It would, however, be harmful to the economy and equity markets if bond yields were to rise not because of better growth expectations but due to fears of tight monetary policies presumably to prevent higher consumer price inflation. Concerns about tight monetary conditions are not present, even though market-based measures of inflation expectations have risen since last fall. The rise should be seen as some investors hedge against the possibility of higher inflation down the road. Nominal bond yields are still depressed, policy rates are near zero with low odds of any hikes in the next year or longer, and corporate bond spreads are at cyclical lows. We ultimately expect the U.S. and, to a lesser extent, global inflation to rise sufficiently to meaningfully lift bond yields and warrant an end to hyper-accommodative policy conditions. This is likely to occur in waves with extended pauses. The current break will last until the consensus shifts from expecting the bounce in U.S. core inflation to be transitory with a subsequent return to 2% or lower levels to investors realizing that the underlying trend is up.

The rally in risk assets was significantly compressed versus past cycles because the policy response last spring was so overwhelming and the TINA effect ("there is no alternative") so strong. For now, stocks should continue to outperform bonds. This year's rise in bond yields was not threatening as it ended with yields still at very depressed levels. One possible catalyst that could cause problems would be if the U.S. dollar were to break down badly. This, in turn, would further lead to rising inflation expectations and possibly spark selling pressure on U.S. bonds.

If growth remains as strong as we expect over the next 12-18 months, investors should expect bond yields to rise. The Fed will try to forestall such an outcome, but bond investors will inevitably demand compensation for the inherent inflation and policy risks that sustained strong growth would create. Such an outcome would not imply an end to the economic recovery or the underlying bull market in risk assets. Yet a marked, even if gradual, rise in real bond yields would almost certainly increase market volatility and induce shifts in relative positioning within and across asset classes.

The intermediate equity outlook is moderately bullish. Pent-up demand does not show signs of waning, supply chain bottlenecks are yet to be resolved, and stimulus checks and excess savings are yet to be spent. All of the above is to contribute to robust earnings growth. Having said that, we believe that in the near term, the market is ripe for a consolidation/correction. The market is fully valued, so there is not much valuation cushion left to absorb any negative shocks.

CONCLUSION:

We remain mildly favorable toward risk assets. Strong economic and earnings growth, resilient inflation, and hyper-accommodative monetary conditions will be the key macro forces in the coming year. We expect another up leg in global bond yields that could trigger a risk-off phase in equities for a period of time. We also expect a rotation in relative equity and currency performance out of the U.S. at some juncture.

Data from Morningstar Direct, as of 6/14/2021.

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