

# Doll's Deliberations<sup>®</sup>

## Weekly Investment Commentary



**Robert C. Doll, CFA<sup>®</sup>**  
Chief Executive Officer,  
Chief Investment Officer

### Summary:

U.S. equities were mixed last week as the S&P 500 (+1.62%) and NASDAQ posted solid gains, while the Dow and Russell 2000 were both lower. Breadth was narrow again. Upside was driven in large part by another rate rally and more soft-landing optimism. The best sector was technology (+6.43%); worst sectors were energy (-2.29%) and financials (-1.97%).

### Key takeaways:

- The U.S. CPI was flat m/m (3.3% y/y) and core (except food and energy) was +0.2% m/m (3.4% y/y) in May. While the downside surprise in the report is welcome, monetary policy will remain on hold.
- It will take several more months of data to gain confidence that inflation is behaving in a manner the Fed finds acceptable. We continue to believe the first Fed rate cut will occur in September at the earliest.
- Weekly initial unemployment claims rose to 242,000, the highest since last August. While still not at a high level, the direction points to economic slowing.
- The most recent string of U.S. economic releases signal that the U.S. economy is losing momentum and will eventually tip the economy into a recession.
- The recent broad-based strength in the U.S. dollar should prove temporary, because a broadening of global growth momentum is underway that should eventually result in a narrowing of global differentials and generalized dollar weakness.
- While earnings are better so far in 2024 than we expected, we remain skeptical about the 13% gain projected for 2025.
- Cuts in the Fed funds rate with the unemployment rate at 0.4% or lower are rare (only six times in history). Equity performance after rate cuts with unemployment 5% or lower is below average (stocks typically do well after rate cuts when unemployment is high).
- First quarter net income growth for the Magnificent 7 was 52%; for the remaining 493 stocks: -9%.
- The stocks of companies with the best quartile of earnings revisions YTD are up 21%, and the worst quartile is up only 6%.
- The largest 10 names in the S&P 500 make up 37% of the capitalization and 31% of the net income. This is a big difference from the tech bubble in 2000 (when capitalization far exceeded earnings).

| EQUITY MARKETS (INDEX TOTAL RETURN) (%) | LAST WEEK | YEAR-TO-DATE |
|---|-----------|--------------|
| DJIA                                    | -0.51     | 3.32         |
| S&P 500                                 | 1.62      | 14.63        |
| NASDAQ                                  | 3.27      | 18.25        |
| RUSSELL 1000                            | 1.55      | 13.57        |
| RUSSELL 1000 GROWTH                     | 3.48      | 20.18        |
| RUSSELL 1000 VALUE                      | -1.11     | 5.57         |
| RUSSELL 2000                            | 0.63      | 1.20         |

| S&P EQUITY SECTORS (INDEX TOTAL RETURN) (%) | LAST WEEK | YEAR-TO-DATE |
|---|-----------|--------------|
| COMMUNICATION SERVICES                      | 0.96      | 24.15        |
| CONSUMER DISCRETIONARY                      | 0.27      | 2.61         |
| CONSUMER STAPLES                            | -1.07     | 8.62         |
| ENERGY                                      | -2.29     | 6.06         |
| FINANCIALS                                  | -1.97     | 8.53         |
| HEALTHCARE                                  | -0.36     | 7.46         |
| INDUSTRIALS                                 | -0.98     | 6.71         |
| INFORMATION TECHNOLOGY                      | 6.43      | 29.64        |
| MATERIALS                                   | -0.89     | 4.36         |
| REAL ESTATE                                 | 1.48      | -3.08        |
| UTILITIES                                   | 0.00      | 11.40        |

## A good inflation report as the economy begins to slow

Global financial markets were whipsawed over the past week by both positive and negative economic and inflation data, the FOMC meeting and even a snap election in France. There is a general lack of conviction among investors because this decade has already generated some huge unforeseen jolts and left many uncertain on where the global economy and inflation are headed.

The consensus view is that monetary conditions became restrictive over the course of 2022-23, despite little support for this view in terms of asset market behavior and overall economic activity, particularly in the U.S. The implication of this view is that bond yields and policy rates need to decline substantially to return to “normal” levels. We disagree, and are prepared for another possible upleg in yields down the road. Growth outside the U.S. is generally strengthening and broadening. Meanwhile, the U.S. economy is generating mixed signals.

The key cyclical investment issue is whether the developed economies, especially the U.S., are on track to return to 2% inflation, or whether our view of sticky inflation at levels above 2% pans out. The recent decline in bond yields and additional boost to risk asset markets via policy rate cuts (and expectations for a lot more cuts in the coming 18 months) reinforce our conviction that better global growth is in store. Central bankers will ultimately be frustrated that their 2% inflation target will not be met, albeit some of this failure will be due to their lowering of policy rates and further stoking asset inflation. In the end, even a determined-to-ease Fed will end up lowering rates by less than is discounted in the forward markets, and the bond market will eventually rein in next year’s rate cut expectations.

The starting point for this decade’s bond bear market was absurdly low yields, making it difficult for many investors (and central banks) to gauge what is “normal” for policy rates and bond yields. Although bond valuations have improved considerably in recent years, they are still not sufficient to ensure both lower inflation and significant upcoming capital gains.

In terms of Fed policy, U.S. rate expectations had risen considerably this year before easing this week courtesy of the CPI report, albeit from low levels to start 2024. Investors have chronically underestimated the rate-hiking cycle in recent years, and by doing so they have helped to support the economy; i.e., by continually pricing in lower future rates and causing the yield curve to be inverted. Upcoming CPI reports may yet allow the Fed to ease, should more low-side prints occur. However, we expect time to run out for taking such a step in the coming months, as the economy is too strong to allow service sector inflation to ease much further.

## Conclusion

Last week’s low-side U.S. CPI report followed high-side prints earlier this year and is not indicative of the underlying trend. Inflation remains “sticky” and set to hold above 2% in the coming year. The U.S. economy, albeit slowing, remains resilient and is growing above its long-run potential rate. Meanwhile, growth outside the U.S. is strengthening and broadening. While the near-term outlook for bonds is benign, another uptick in yields may be necessary to cool the economy, thereby putting pressure on equity market valuations, perhaps at the same time as earnings estimate begin to falter.

Data from Bloomberg as of June 14, 2024

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| INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN) (%) | LAST WEEK | YEAR-TO-DATE |
|---|-----------|--------------|
| MSCI ACWI   | 0.71      | 10.90        |
| MSCI ACWI EX U.S.                                   | -0.94     | 5.75         |
| MSCI EAFE   | -1.43     | 6.18         |
| MSCI EM   | 0.36      | 6.23         |

| FIXED INCOME MARKETS (INDEX TOTAL RETURN) (%) | LAST WEEK | YEAR-TO-DATE |
|---|-----------|--------------|
| BLOOMBERG U.S. AGGREGATE BOND                 | 1.20      | -0.03        |
| BLOOMBERG U.S. CORP HIGH YIELD                | 0.52      | 2.59         |
| BLOOMBERG U.S. GOV/ CREDIT                    | 1.14      | -0.03        |
| BLOOMBERG U.S. T-BILL 1-3 MONTH               | 0.06      | 2.42         |

| ALTERNATIVES (INDEX TOTAL RETURN) (%)    | LAST WEEK | YEAR-TO-DATE |
|--|-----------|--------------|
| REAL ESTATE (FTSE NAREIT)                | 1.20      | -3.30        |
| COMMODITIES (DJ)                         | 0.71      | 6.43         |
| GLOBAL LISTED PRIVATE EQUITY (RED ROCKS) | 0.76      | 5.18         |
| CURRENCIES (DB CURRENCY FUTURE HARVEST)  | 0.44      | 9.73         |