



# Doll's Deliberations

Weekly Investment Commentary | January 9, 2023 | Issue 3.2

## SUMMARY:

U.S. equities finished the week higher (S&P 500 +1.5%) with 2023 opening with volatile sessions up and down capped by a big Friday rally. Treasuries were stronger with the 10-year yield dropping more than 30bp from the December close. The market remains focused on the same themes including the path of inflation, the state of labor market, and the Fed's policy response. Best sectors were communication services (+3.7%), materials (+3.5%) and financials (+3.3%); worst sectors were healthcare (-0.2%), energy (0.0%) and technology (+0.2%).

## KEY TAKEAWAYS:

- The U.S. ISM Manufacturing PMI fell deeper into contraction territory in December, falling to 48.4 from 49.0. While measures such as this suggest that economic conditions continue to weaken, the labor market remains robust.
- Headcount strength (+223k jobs) and slowing wage growth (+0.3% m/m, +4.6% y/y) reported in the December jobs report may be a move toward a soft landing, but could also be a slide toward recession. The decline in the unemployment rate to 3.5% is troublesome for the Fed.
- U.S. inflation has peaked, though the Fed must still work to contain stickier components like services and wage inflation.
- A recession will likely be mild as the credit markets are in far better shape now than at similar points in other cycles.
- The Fed's hawkish policy in response to persistently elevated inflation largely explains the dollar's strength in 2022. We believe the dollar is overvalued and that current bullish sentiment will eventually lead to weakness over the next few years.
- The Fed boosted the size of the money supply in a huge way because of Covid. This pushed up stock and bond prices as money always goes to the easiest place. Now with M2 contracting, the ratio of M2 to GDP is falling faster than it ever has before. The implication is potentially ominous for risk assets.
- The consensus continues to believe that earnings will grow roughly 4.5% in 2023 (to \$230). We have been of the view for some time that this figure remains high and will be lowered (we are using \$200).
- Stock market valuations are far from suggesting that a recession is priced in, largely because earnings estimates are probably too high, even if there is no recession.
- While technical analysis is not full proof, it is an overall market concern that Apple, the largest weight in the index, has broken down.
- So far in the new year (as was the case in 2022), the average stock continues to outperform the majority of mega-cap stocks (i.e., equal-weight portfolios are outperforming cap-weighted portfolios).

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	1.50%	1.50%
S&P 500	1.47%	1.47%
NASDAQ	1.01%	1.01%
RUSSELL 2000	-0.44%	-0.44%
RUSSELL 1000 GROWTH	0.32%	0.32%
RUSSELL 1000 VALUE	2.50%	2.50%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	3.75%	3.75%
CONSUMER DISCRETIONARY	2.25%	2.25%
CONSUMER STAPLES	1.77%	1.77%
ENERGY	0.00%	0.00%
FINANCIALS	3.42%	3.42%
HEALTHCARE	-0.17%	-0.17%
INDUSTRIALS	2.72%	2.72%
INFORMATION TECHNOLOGY	0.24%	0.24%
MATERIALS	3.45%	3.45%
REAL ESTATE	2.50%	2.50%
UTILITIES	0.70%	0.70%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	0.07%	0.07%
MSCI ACWI EX U.S.	1.43%	1.43%
MSCI EAFE	0.91%	0.91%
MSCI EM	2.90%	2.90%

## LOTS OF CROSS-CURRENTS → CONTINUED VOLATILITY

The economic, policy and capital markets landscape remains unusual, thereby complicating investment strategy. After a very difficult 2022, we expect equities and bonds to deliver better returns this year, but the ride is likely to be bumpy and littered with surprises, consistent with late-cycle conditions. Elevated uncertainty argues against positioning aggressively for major gains by either equities or bonds. The current late stages of the economic, policy and capital markets cycles provide ample scope for both positive and negative surprises. Thus, while on balance returns for equities and bonds will be better than last year, investors should be prepared for trying conditions.

Uncertainty about global growth is not only widespread, but is becoming more bifurcated. Based on consensus forecasts, economists are assigning a 65% probability of a U.S. recession this year, albeit a shallow one, a view with which agree. There is still a lot of concern about euro area economic growth, but increasingly widespread acknowledgement that the fallout from the energy crisis will be less than previously expected. China will be a positive for the global economy this year, but it is too early to determine how vibrant its rebound from Covid-zero restrictions will be.

Last year's anxiety about inflation has given way to investor confidence that it will fall noticeably in the coming months but to a still unacceptable level (and far from the Fed's 2% target). Inflation will likely prove stickier than expected, preventing central banks from fulfilling investor expectations of rate cuts by year-end. Such an outcome implies that bond yields are more likely to have another upleg down the road than to durably decline, and that bond volatility will remain elevated by historical standards, which suggests continued choppy performance for most risk assets.

Three scenarios for portfolios stand out as possibilities in the year ahead:

1) Mild recession (50% probability): In this scenario, inflation declines but proves sticky at a higher than acceptable level for central banks. Earnings downgrades (particularly in the U.S.) cap equity market returns and stocks produce moderate returns. 2) Soft landing (30% probability): In this scenario, global growth momentum stays positive as core inflation declines more sharply than expected. The easing of inflation induces central banks to halt their tightening cycles. 3) Average recession (20% probability): The odds of this scenario are diminishing given the euro area's resilience and the China reopening, but the global economy is still vulnerable to negative shocks. These could include a significant escalation of geopolitical tensions, or another energy shock, among other things, including overtightening by central banks.

## CONCLUSION:

1. The economy is weakening and will probably experience a mild recession in 2023.
2. Inflation is still too high even though it will probably come down during 2023.
3. The Fed is not done raising rates and those rates may stay higher for longer.
4. Earnings estimates are too high almost regardless of the economic contour.
5. Stocks and bonds are no longer expensive; but they are not cheap either.
6. Stocks have never bottomed before a recession started.
7. Own stocks that can weather the storm: strong income statements, solid balance sheets, and reasonable valuations.
8. Do some dollar cost averaging into international.
9. Expect some dollar weakness.
10. Don't fight the Fed; don't fight the tape.

Data from Bloomberg, as of 1/6/2023.

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FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO- DATE
BLOOMBERG U.S. AGGREGATE BOND	0.78%	0.78%
BLOOMBERG U.S. CORP HIGH YIELD	1.12%	1.12%
BLOOMBERG U.S. GOV/ CREDIT	0.75%	0.75%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.04%	0.04%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO- DATE
REAL ESTATE (FTSE NAREIT)	-0.38%	-0.38%
COMMODITIES (DJ)	-4.08%	-4.08%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	2.14%	2.14%
CURRENCIES (DB G10 CURRENCY FUTURE)	0.98%	0.98%