CROSSMARK GLOBAL INVESTMENTS

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Doll's Deliberations

Weekly Investment Commentary

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Summary:

In a volatile week, equities advanced (S&P 500 +0.56%) for the second straight week. On generally good earnings reports, big-cap tech stocks were the standout. Best sectors were utilities (+3.44%) and consumer discretionary (+1.60%); worst sectors were energy (-3.27%) and financials (-0.58%).

Key takeaways:

1. While we think Goldilocks will remain a fairytale, the April employment report certainly exhibited Goldilocks characteristics (job growth slowed to a still respectable 175,000, and average hourly earnings increased only 0.2% m/m and 3.9% y/y.) The unemployment rate (3.9%) stayed below 4.0% for the twenty-seventh consecutive month.
2. The Fed met and Chair Powell reiterated its data dependency for future rate changes. The economy is still growing, and while we think the risk of recession is higher than consensus views, it is simply too soon for Fed action.
3. Middle/upper income consumers are enjoying income and net worth growth, but are keeping inflation sticky. Low-end consumers, though, have recession-style poor sentiment and depleted savings.
4. Our base case remains a recession commencing prior to year-end that raises joblessness, cools incomes, weakens demand, and, importantly, tames inflation. In the meantime, liquidity from Uncle Sam and residual Covid savings keep the economy humming.
5. 1Q earnings reports are past the halfway mark. The degree of revenue surprises is the second lowest since the pandemic. On the other hand, earnings surprises are the best in ten quarters.
6. Markets fell in April as risk aversion rose, largely due to sticky inflation and worrying signs about the sustainability of growth. Hotter-than-expected inflation releases contributed to growing evidence that the Fed will begin cutting rates later than previously thought, pushing Treasury yields up nearly 50 basis points (bps) over the course of the month, while tightening lending standards also widened corporate bond spreads.
7. Stock market cautiousness is warranted due to poor monetary conditions, high valuations, and now, mixed technicals. There is some probability that we have seen the high for the equity market for 2024.
8. In the Russell 1000 (large cap), 17% of companies are losing money; in the Russell 2000 (small cap), the number is 43%.
9. The federal budget deficit should be declining with the above-average economic growth we have been enjoying. Instead, tax revenues are in fact growing while spending is growing faster, resulting in $2 trillion structural deficits.
10. Believe it or not, the S&P 500 is far less concentrated than foreign markets. (Top ten names in the U.S. are 34% of market capitalization, U.K 48%, France 60%, Japan 39%, and Germany 61%.)

EQUITY MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
DJIA	1.14	3.21
S&P 500	0.56	7.99
NASDAQ	1.44	7.85
RUSSELL 1000	-0.63	6.31
RUSSELL 1000 GROWTH	1.02	9.54
RUSSELL 1000 VALUE	0.02	5.32
RUSSELL 2000	0.72	-0.13

S&P EQUITY SECTORS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-0.55	16.91
CONSUMER DISCRETIONARY	1.60	2.73
CONSUMER STAPLES	0.41	7.12
ENERGY	-3.27	11.55
FINANCIALS	-0.58	8.34
HEALTHCARE	0.59	3.70
INDUSTRIALS	0.11	8.16
INFORMATION TECHNOLOGY	1.51	10.17
MATERIALS	0.00	4.97
REAL ESTATE	1.57	-6.86
UTILITIES	3.44	9.00

Cross currents abound – expect choppy markets

Swings in expected interest rate cuts by the Federal Reserve continue to drive global capital market performance. Recent data is consistent with a broadening global economic expansion and stubborn inflation pressures, especially in the U.S. (notwithstanding the more moderate monthly jobs report on Friday). The flow of economic data is also consistent with our long-standing view that monetary policy, or more accurately the level of interest rates, is probably not economically restrictive, as the Fed, other central banks and the consensus have argued. Indeed, with the U.S. consumer (at least high-end consumers) and business sectors (at least large corporations) in solid shape, signs that economic momentum in China and the euro area are improving, and global manufacturing and trade expanding, markets are still too optimistic about prospective central bank rate cuts over the next twelve months.

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN) (%)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-0.21	5.18
MSCI ACWI EX U.S.	0.56	3.18
MSCI EAFE	0.47	3.25
MSCI EM	1.15	3.54

FIXED INCOME MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	0.66	-2.54
BLOOMBERG U.S. CORP HIGH YIELD	0.54	0.95
BLOOMBERG U.S. GOV/ CREDIT	0.64	-2.44
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.06	1.79

ALTERNATIVES (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	1.04	-7.41
COMMODITIES (DJ)	-1.43	4.64
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	-0.56	2.78
CURRENCIES (DB CURRENCY FUTURE HARVEST)	-0.77	6.97

Stocks have struggled over the past month, unnerved by rising interest rates. Stocks were overbought as the second quarter began, and thus vulnerable to a consolidation or correction phase. Conditions for a pronounced drawdown are not in place. The recent pullback has resulted from a de-rating rather than a downgrading of earnings expectations. The outlook for equities is nuanced given elevated valuations on U.S. stocks and our forecast that bond yields may stay stubbornly high relative to the last decade. Stocks should be steady to higher if earnings continue to rise albeit with leadership shifting toward stocks, sectors, and geographies with attractive valuations and cash flow characteristics. Equities will remain vulnerable to de-rating pressure if bond yields stay high/rise further. There are many wildcards for investment strategy especially the tensions in the Middle East and the upcoming U.S. election.

For most of the past year, equity volatility has been historically low even as bond volatility has been historically high, a combination that is probably unsustainable. With financial markets still overly optimistic about prospective Fed interest rate cuts, investors should expect equity volatility to be higher in the coming months than over much of the past year.

The Fed indicated at last week's FOMC meeting that any rate cuts await clear evidence that the recent uptick in core inflation will prove fleeting. The implication is that the Fed will need to see a string of lower month-on-month inflation readings to fulfill market expectations of rate cuts. Hence, both equities and bonds are likely to react strongly to either positive or negative inflation surprises. We anticipate that inflation will be stickier than the Fed and markets expect, but predicting month-to-month inflation readings is impossible.

Conclusion:

Equities have already discounted a favorable macro climate, thereby limiting prospective upside. Both equities and bonds will react strongly to the next few U.S. inflation readings, and investors should expect above-average volatility until a higher-for-longer Fed policy rate is fully embraced.

Data from Bloomberg, as of 5/3/2024.

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