CROSSMARK GLOBAL INVESTMENTS

Doll's Deliberations

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SUMMARY:

U.S. equities were mostly lower this week (S&P 500 -0.3%), though strength in big tech generated a gain for the NASDAQ and provided a notable cushion for the S&P (the equal-weight version of that index was down 1.1% for the week). There were mixed takeaways from the economic data but the overall picture is still largely consistent with the Fed pausing in June. Best sectors were communication services (+4.3%) and consumer discretionary (+0.6%); worst sectors were energy (-2.2%) and materials (-2.0%).

KEY TAKEAWAYS:

1. April CPI rose +0.4% m/m (4.9% y/y) and the core (ex food and energy) CPI was +0.4% m/m (5.5% y/y). The continued fall (albeit slowly) in inflation, the rise in initial unemployment claims, and the decline in credit availability create a likely Fed pause scenario. But sticky inflation argues against a Fed rate cut any time soon.
2. "As its tenth rate hike approaches (happened May 3), the central bank will need skill – and luck – to tame inflation without killing the economy. – Barron's, May 1, 2023
3. The NY Fed's probability of recession metric have moved up to 68%. Markets today have 85% odds of at least a -25bp rate cut by September. (We continue to think a recession is likely, but Fed cuts that soon are unlikely.)
4. The Fed's Senior Loan Officer Survey indicated that banks are tightening lending standards, and plan to do so throughout 2023. This matters because this tightening has been a leading indicator of job loss and economic weakness.
5. While banks generally remain well capitalized, there are exceptions. Losses have accumulated in bond portfolios with the rapid and significant rise in rates over the last 15 months. Losses in commercial real estate could challenge this assertion.
6. The U.S. national debt is roughly 118% of GDP, a level we have only seen immediately after World War II. And with interest rates up, interest expense will soon become a significant problem. The debt ceiling negotiations have started and encouragement should be found in the scheduling of another meeting and the request that staffers meet to negotiate. However, an agreement is still a LONG way off.
7. With the U.S. now facing rising debt servicing costs, the current 30-year trend of accommodative fiscal policy is ending. It is only a matter of time before the vigilantes arrive and the debt ceiling is just the opening act.
8. Earnings growth for the 1Q is coming in at -1% vs. -5% projected at the beginning of the quarter. But, full year estimates for both 2023 and 2024 are little changed.
9. The contradiction between the S&P 500 and what is happening with the average stock (only 52% of issues are above their 200-day moving average) is a reminder of how split this market remains.
10. The stock market has been range bound (3800-4200) for six months. With breadth narrowing and credit tightening, our guess is a break to the downside is more likely than a break to the upside.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	-1.04%	1.19%
S&P 500	-0.24%	8.07%
NASDAQ	0.44%	17.74%
RUSSELL 2000	-0.84%	-0.45%
RUSSELL 1000 GROWTH	0.53%	16.25%
RUSSELL 1000 VALUE	-1.05%	-0.28%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	4.34%	27.49%
CONSUMER DISCRETIONARY	0.63%	15.36%
CONSUMER STAPLES	0.01%	4.07%
ENERGY	-2.14%	-9.23%
FINANCIALS	-1.29%	-6.32%
HEALTHCARE	-1.09%	-2.35%
INDUSTRIALS	-1.05%	0.70%
INFORMATION TECHNOLOGY	-0.27%	22.79%
MATERIALS	-1.96%	0.99%
REAL ESTATE	-0.97%	1.11%
UTILITIES	-0.02%	-1.35%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-0.21%	8.24%
MSCI ACWI EX U.S.	-0.51%	8.47%
MSCI EAFE	-0.52%	11.12%
MSCI EM	-0.37%	2.93%

IS A RECESSION CLOSING IN?

There are rising hopes and opinions that the Fed has not only finished hiking rates, but that significant rate cuts will occur later this year. While we think that the Fed will institute a pause at the June meeting, we are unconvinced that rate cuts are around the corner.

The case for a Fed pause is: (1) interest rates have already risen considerably, and some consider the level to be economically restrictive, (2) economic growth has downshifted over the past year, with widespread calls for a recession at any time, (3) inflation continues to fall slowly but surely, (4) recent bank failures signal tighter credit conditions ahead, and therefore weaker growth, (5) commercial real estate is seen by many to be the source of the next financial crisis, with commensurate economic fallout, and (6) the U.S. debt ceiling debate could be dragged out and ultimately undermine economic sentiment.

On the other hand, if the economy avoids a recession, and inflation remains firm as we expect, there is a good chance that the Fed will eventually return to policy tightening. The key question for the U.S. inflation outlook is whether core services excluding the shelter component (which correlates closely with wages) will recede meaningfully. Our view remains that unless the Fed triggers a recession or achieves a prolonged period of below trend economic growth, wages and this segment of inflation will continue to prove sticky, making it very hard to return inflation to near 2%.

While the economy has remained stronger for longer than most forecasts, signs of weakness (including in labor) are showing up. A slowing economy, the failure of earnings estimates go up in the wake of better than expected first quarter earnings, and tighter credit conditions cause us to be cautious regarding the equity market. At best, choppiness is likely to continue. Eventually, it is likely that the earnings backdrop will deteriorate to the point where the stock market breaks down. Obviously, a banking crisis would end rallies in risk assets, but we anticipate that this particular source of recession concern will gradually recede.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	0.24%	3.78%
BLOOMBERG U.S. CORP HIGH YIELD	0.10%	4.31%
BLOOMBERG U.S. GOV/ CREDIT	0.25%	3.91%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.10%	1.61%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-1.16%	0.14%
COMMODITIES (DJ)	-1.62%	-8.71%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	-0.42%	7.95%
CURRENCIES (DB CURRENCY FUTURE HARVEST)	0.26%	2.16%

CONCLUSION:

In the short-term, the choppy sidewise (3800-4200 S&P 500) stock market is likely to continue. The easing in inflation will allow central banks to pause, but we do not envision a rate-cutting cycle for the foreseeable future. The intermediate-term backdrop is not market-friendly, as it is probable that a recession will be needed to sustainably return inflation to near central banks' targets. Thus, we remain cyclically cautious in terms of our investment stance.

Data from Bloomberg, as of 5/12/2023.

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