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Doll's Deliberations®

Weekly Investment Commentary

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Summary

Stocks fell last week (S&P 500 -2.58%), reversing some of the prior week's gains, but still 16% above its April low. Concerns included Moody's government debt downgrade, the debt/deficit consequences of the "Big Beautiful Bill" and President Trump's Friday morning commentary that tariff discussions with the EU were going nowhere. Best sectors were consumer staples (-0.36%), communication services (-0.63%), and materials (-1.18%); worse sectors were energy (-4.12%), technology (-3.45%), and real estate (-3.26%).

Equity markets (Index total return %)	Last week	Year-to-date
DJIA	-2.43	-1.56
S&P 500	-2.58	-0.82
NASDAQ	-2.45	-2.71
Russell 1000	-1.99	-0.20
Russell 1000 Growth	-2.71	-2.52
Russell 1000 Value	-2.52	1.15
Russell 2000	-3.19	-7.81

S&P equity sectors (Index total return %)	Last week	Year-to-date
Communication services	-0.63	1.44
Consumer discretionary	-3.09	-7.55
Consumer staples	-0.36	6.53
Energy	-4.12	-3.47
Financials	-3.07	3.98
Heathcare	-2.13	-4.89
Industrials	-2.00	7.24
Information technology	-3.45	-3.84
Materials	-1.18	2.70
Real estate	-3.26	0.59
Utilities	-1.48	7.82

Key takeaways

1. The "hard" economic data still do not indicate a U.S. economy in distress. Some activity has likely been pulled forward ahead of the implementation of tariffs, so the jury is still out on the degree of slowing we will experience.
2. May PMIs confirm an improvement in confidence. Manufacturing flash PMI numbers showed resilience. The services PMIs were more mixed.
3. Initial unemployment claims are off their lows, and going sideways. Housing remains weak, but manufacturing activity improved a touch as businesses try to time the tariffs. Services also improved a bit. We are down to 25% recession odds, but uncertainty is still high.
4. University of Michigan consumer inflation expectations for the next year increased from 6.5% to 7.3%, while long-term expectations moved up from 4.4% to 4.6%.
5. The 30-year U.S. Treasury bond yield closed above 5.00% for the first time since October 2023. Bond investors are nervous about tariffs, sticky inflation, and President Trump's "Big Beautiful Bill." (Out the curve, yields have increased by roughly 100 basis points [bps] since the Fed began easing last September.)
6. Compared to the end of the 1Q24 earnings season, the full-year EPS guidance from corporations this year has far fewer increases and far more decreases as corporations temper expectations, given macro uncertainty.
7. Government policies look likely to diminish the long-run growth rate of the U.S. economy, increase budget deficits, and modestly raise inflation. As such, they suggest slower-growing corporate profits and higher interest rates, a tough combination, particularly for a highly valued stock market. It could also lead to a further decline in the U.S. dollar.
8. Federal debt service is now a bigger burden than defense spending, which has marked a tipping point historically for great global powers.
9. MRB (among others) says, "Nobody wins a trade war, just some lose less than others."
10. The adoption of AI may get an extra push from the current economic uncertainty, as AI's ability to offset tariff costs or higher interest rates by enhancing productivity will likely incent more executives to try it.

The bond vigilantes are awake!

International equity markets (Index total return %)	Last week	Year-to-date
MSCI ACWI	-1.05	4.26
MSCI ACWI EX U.S.	0.55	13.28
MSCI EAFE	1.11	15.62
MSCI EM	-0.56	9.42

Fixed income markets (Index total return %)	Last week	Year-to-date
Bloomberg U.S. Aggregate Bond	-0.45	1.56
Bloomberg U.S. Corp High Yield	-0.35	2.06
Bloomberg U.S. Gov/Credit	-0.38	1.55
Bloomberg U.S. T-Bill 1-3 Month	0.09	1.71

Alternatives (Index total return %)	Last week	Year-to-date
Real estate (FTSE NAREIT)	-3.43	-0.84
Commodities (DJ)	1.81	5.75
Global listed private equity (Red Rocks)	-2.51	-1.13
Currencies (DB Currency Future Harvest)	-0.16	-1.56

The key pressures on asset markets are shifting back to those that existed prior to the tariff war. The risk of recession has receded, which will reinforce the stickiness of inflation. There is a growing threat of higher bond yields and the attendant downward pressure on equity valuations. Fresh fiscal stimulus (from many countries, including the U.S.) reduces economic downside, but also puts upward pressure on bond yields via the combination of inflation risks tilting upward and the ever-greater demand on savers to buy government debt. The starting point for both budget deficits and government debt levels relative to GDP is historically worrisome, especially in the U.S.

The U.S. Congress is working hard on a budget bill, the contents of which are still partly unclear (despite the passage of the bill by the House that will now go to the Senate.) What is known is that any bill will markedly increase the federal budget deficit and debt over the foreseeable future, adding to risks for the U.S. Treasury market.

It must be noted that the tariff war is not over (as witnessed by President Trump's message to the EU Friday morning), and will still have some adverse economic impact. The presumed eventual new level of tariffs will be higher than before, and economic uncertainty will persist.

We believe the premium U.S. equity and dollar valuations associated with the U.S. exceptionalism theme have further to unwind. Not only is Washington getting ready to generate even larger budget deficits, despite attempts at some "creative" accounting, the country has been running historically huge deficits during a period of solid economic growth. (Previously, large deficits only occurred during significant recessions.) The percentage of the budget taken up by interest payments is rising rapidly, aided by higher interest rates. The rise in interest rates will eventually put pressure on high equity valuation levels. Most other DM countries are also in a similar, albeit less extreme, position in terms of government finances.

Notably, the spread of 30-year Treasury yields over 10- and 2-year yields has recently surged. The reasons for the bear steepening of the curve include: deteriorating government finances, the U.S. dollar decline, and concerns about the long-run outlook for inflation.

Conclusion

The focus of U.S. policy initiatives is shifting from tariffs to the federal budget, which represents a change from being anti- to pro-growth. Consequently, the investor focus is moving from worrying about downside risks to the U.S. and global economy and the potential for central bank rate cuts to concerns about sticky inflation and ever-greater government debt burdens. Equity de-rating pressures will intensify if bond yields move higher.

Source: Bloomberg as of May 23, 2025