

Doll's Deliberations[®]

Weekly Investment Commentary



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Summary:

Stocks ended higher last week (S&P 500 +0.89%) with small caps and equal weight S&P 500 strongly outperforming the other major indexes following post-CPI rotation out of big tech. Best performers were real estate (+4.38%) and utilities (+3.93%); the only negative sector was communication services (-3.45%).

Key takeaways:

- Headline June CPI declined 0.1% m/m (versus consensus of +0.1%) (up 3.0% y/y). It was the first monthly drop since July 2022. Core CPI was +0.1% m/m (+0.2% consensus) and 3.3% y/y.
- The June payroll report disappointed, with the employment rate rising to 4.1%, the highest reading since November 2021. (Up from the 3.4% low in late 2022.) (Job growth exceeded expectations by 16,000 jobs, but the prior two months were revised down by 111,000 jobs.)
- The ISM manufacturing PMI ticked lower in June, from 48.7 to 48.5. The production, employment, and new report orders subcomponents all contracted, and new orders declined for a third consecutive month. The ISM Services PMI plunged from 53.8 to 48.8, its fastest pace of contraction since May 2020, far below expectations.
- The Fed no longer has the luxury of focusing purely on inflation as the labor market weakens.
- An increasing number of economic disappointments coupled with a few good inflation reports suggest to us that the Fed will cut in September and December.
- The Atlanta Federal Reserve GDPNow model estimates 1.5% annualized GDP growth in Q2, down from 4.2% in early May.
- We expect continued softening in the U.S. economy will lead to decelerating wage growth, which is the principal consumption driver. This will likely eventually lead to a recession.
- Early 2Q earnings reports (the banks) were disappointing.
- Stock prices "should" have been falling on the recent batch of weaker-than-expected economic news, but the bad news has been greeted as good news since it increases the odds that the Fed will start easing monetary policy sooner rather than later. In other words, investors are counting on the "Fed Put" again.
- President Biden spent the better part of the week rejecting calls for him to exit the race, while former President Trump survived an assassination attempt.

EQUITY MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
DJIA	1.61	7.22
S&P 500	0.89	18.61
NASDAQ	0.25	23.04
RUSSELL 1000	0.45	16.83
RUSSELL 1000 GROWTH	-0.39	24.70
RUSSELL 1000 VALUE	2.76	9.13
RUSSELL 2000	4.86	5.61

S&P EQUITY SECTORS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-3.45	27.13
CONSUMER DISCRETIONARY	0.38	10.05
CONSUMER STAPLES	0.10	10.22
ENERGY	0.45	10.02
FINANCIALS	2.01	13.50
HEALTHCARE	2.65	9.63
INDUSTRIALS	2.39	9.73
INFORMATION TECHNOLOGY	0.53	33.89
MATERIALS	2.97	6.69
REAL ESTATE	4.38	1.57
UTILITIES	3.93	14.38

So far, risk assets interpreting economic weakness as bullish (Fed can ease!)

Fed Chair Powell nearly declared victory in his Congressional testimony last week regarding an easing in labor market conditions and the overall inflation threat. That reinforced the narrative that policy will now soon steadily ease back from restrictive territory. Another better-than-expected U.S. CPI print last week also helped to support this narrative. These prints have followed a series of high-side misses, underscoring that monthly data are volatile, fraught with measurement issues, and can mask the underlying trend. We doubt that a new downtrend in inflation is underway, just noise in the past two months as the underlying inflation rate settles into a range that should be well above 2%.

Although the U.S. economy is weakening, the labor market is still tight, and we expect inflation to prove sticky at levels above those witnessed last decade. The economy has indeed cooled, and many key economic and inflation gauges have been trending lower since peaking in 2022. Inflation is a lagging indicator and after two years of choppiness and generally weak conditions, the major non-U.S. economies are gradually improving. This, in turn, will add to the risks for those betting on a return to the inflation world of the 2010s. Having broken out of a 40-year down/flat trend, it will take a recession or at least a prolonged period of subpar growth to fully return inflation to low and stable levels.

Expectations for lower global policy rates continue to put downward pressure on bond yields. Two likely Fed rate cuts (our guess is September and December) will provide support to the bond market. This, plus still solid corporate profitability, have allowed the stock market to maintain an uptrend in the face of widespread calls for equities to correct. In fairness, there is a considerable amount of unease about the sustainability of the equity uptrend, since gains have been dominated by a few high-flying mega-cap tech and related stocks, primarily in the U.S.

In the end, as go corporate profits, so goes the economic cycle and equity market. Until now, companies have been able to pass on higher input costs, and consumers have been able to successfully demand higher wages. A key question is, how long can all this good news last in light of increasing signs of economic slowdown, which will eventually lead to downward earnings estimate revisions. A lasting risk-off phase normally only occurs when corporate earnings deteriorate, or there are high expectations for such an outcome. Once meaningful economic roadblocks develop, investors discount lower profits ahead to the detriment of credit and equity markets.

Political developments could yet create an economic roadblock, as there are a number of contentious elections in several major countries this year. The recent UK election was taken in stride by investors, as the outcome was highly anticipated and not seen as likely to have any near-run economic ramifications. The French election was less anticipated but ultimately produced a stalemate, rather than a negative economic outcome. We do not expect the important U.S. election to provide either a positive or negative boost to economic sentiment in the near run.

Conclusion

The choppy risk-on phase is likely to persist, as central banks slowly lower rates. A calm bond market plus ongoing strength in corporate profits are supportive of equity prices, although the upside should be modest given already stretched technical conditions and pockets of excessive valuation and speculation. The choppy risk-on phase will persist until either bond yields undergo another upleg, or more likely, economic activity deteriorates, causing earnings question marks.

Data from Bloomberg as of July 12, 2024

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INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN) (%)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	0.84	14.46
MSCI ACWI EX U.S.	1.76	9.73
MSCI EAFE	1.62	9.36
MSCI EM	1.93	11.66

FIXED INCOME MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	0.59	0.58
BLOOMBERG U.S. CORP HIGH YIELD	0.62	3.51
BLOOMBERG U.S. GOV/ CREDIT	0.54	0.57
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.06	2.85

ALTERNATIVES (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	3.76	1.25
COMMODITIES (DJ)	-1.61	5.11
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	2.44	8.84
CURRENCIES (DB CURRENCY FUTURE HARVEST)	0.03	11.65