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Doll's Deliberations

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SUMMARY:

Equities were mixed last week with the S&P 500 +0.7%. Small stocks had a good week and the NASDAQ lagged. Corporate earnings were mixed. There was evidence of dampening pricing power and therefore slowing revenue growth. Best sectors were energy (+3.5%), healthcare (+3.5%), and financials (+3.0%); worst sectors were communication services (-3.0%) and consumer discretionary (-2.3%).

KEY TAKEAWAYS:

1. Growth expectations are being revised higher and recession start dates are being pushed back or indefinitely postponed.
2. The University of Michigan's Survey of Consumers generated positive surprises and is at the highest level since September 2021.
3. Meanwhile, the Conference Board's Leading Economic Indicator fell for the 15th consecutive month in June, its longest streak of declines since 2007-2008.
4. The M2 measure of money supply continues to drop. The drop is starting to have consequences, including lower headline inflation and slower economic growth.
5. It is hard to see a drop in core inflation down to 2-3% levels without economic pain. Historically, a drop in core inflation of 1.5% or more over the course of two years has always produced a recession.
6. Anecdotal evidence continues to roll in of sharply lower prices for commercial office buildings and more defaults on commercial real estate loans.
7. One of the biggest strikes in US history looms if negotiations by UPS and the Teamsters fail to reach an agreement by July 31.
8. Hopes for an improvement in relations between the US and China have further faded. The good news is that both sides are talking; the bad news is that there have been no agreements on key issues.
9. Early last week, NASDAQ was trading at 38% above its 200-day moving average, exceeded only by the tech bubble in March 2000.
10. We remain cautious on equities as we think that ultimately the fundamentals will win out. Our conviction on that is high, but our timing of when it happens is low.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	2.13%	7.54%
S&P 500	0.70%	19.24%
NASDAQ	-0.57%	34.69%
RUSSELL 2000	1.87%	12.62%
RUSSELL 1000 GROWTH	-0.53%	31.01%
RUSSELL 1000 VALUE	2.12%	8.20%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-3.01%	36.40%
CONSUMER DISCRETIONARY	-2.28%	33.90%
CONSUMER STAPLES	1.75%	3.18%
ENERGY	3.53%	-2.23%
FINANCIALS	2.95%	4.05%
HEALTHCARE	3.48%	1.13%
INDUSTRIALS	0.90%	12.48%
INFORMATION TECHNOLOGY	-0.08%	44.56%
MATERIALS	0.58%	8.84%
REAL ESTATE	-0.50%	6.25%
UTILITIES	2.40%	-1.37%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	0.25%	16.54%
MSCI ACWI EX U.S.	-0.41%	12.32%
MSCI EAFE	-0.32%	14.34%
MSCI EM	-0.98%	8.30%

RISK-ON PERSISTS, BUT SOME FRAYING IN MEGA-CAPS

The risk-on environment may persist as long as government bond yields do not break out to the upside. Bond bulls remain keen to discount much lower underlying inflation and a reversal in the monetary tightening cycle beyond the near run. Headline inflation is indeed decelerating steadily as last year's unsustainably large price increases have ended. However, ongoing historically tight labor markets and the highest wage gains in decades warn that underlying inflation will remain elevated, particularly in many service sectors. While respecting current momentum, we are still cyclically cautious. No market is cheap, including government bond markets despite much higher yields than a year ago. And some equity sectors are quite expensive, primarily in the US. The end point of this cycle likely will be the same as most others – restrictive monetary conditions and higher bond yields. The timing of these outcomes, however, has constantly been pushed into the future, aided by the actions of bond bulls and timid central banks, both of which are too hopeful that a benign economic and inflation outcome will unfold.

While real rates were very low in the US and euro area last decade, that period was marked by deleveraging, a subpar economic expansion, quiet labor markets and stable/low inflation as well as some important structural headwinds to inflation. None of these conditions exist today, and most of these structural headwinds have diminished, or even reversed from a global perspective. The key to timing the end of the current investment cycle will be to gauge when monetary conditions finally become restrictive enough to trip up the weakest global economic sectors and trigger lasting disinflationary pressures.

US Treasury yields have tracked sideways since last fall, allowing equity prices to rebound solidly and corporate high-yield bond spreads to narrow. There have been signs of improvement in interest rate-sensitive economic sectors such as housing. This is an indication that monetary conditions are not truly restrictive and that a recession is probably not imminent. The economic rebound suggests that central banks have probably not yet delivered a knock-out blow, partly because bond bulls have helped to limit the rise in longer-term yields causing near-record yield curve inversion. The implication is that the economy will, once again, prove more durable than bond bulls expect. This probably means that any rebuilding of economic slack is still not on track. The latter is critical if central banks hope to return to a low and stable inflation world. The longer it takes to return to a 2-3% inflation world, the greater the chances that a durable or secular inflationary process become entrenched.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.05%	2.24%
BLOOMBERG U.S. CORP HIGH YIELD	-0.03%	6.39%
BLOOMBERG U.S. GOV/ CREDIT	-0.01%	2.36%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.09%	2.62%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-0.33%	5.80%
COMMODITIES (DJ)	1.64%	-3.20%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	1.45%	21.16%
CURRENCIES (DB CURRENCY FUTURE HARVEST)	-0.42%	4.09%

Aside from the recent positive economic influences from rallying risk asset prices, another positive economic impulse is the decline in oil prices (although a floor may be developing). Somewhat related, there has been renewed bearishness in expectations towards the US dollar. The dollar is no longer benefitting from rising relative policy rates, as other central banks are playing catch-up to the Fed's earlier lead in hiking rates.

CONCLUSION:

The tactical risk-on phase will likely persist until government bond yields resume rising. Such a rise may be deferred further, keeping alive the hope for policy rate cuts for a while longer. Now that the mood is brightening, growth expectations are being revised higher and recession start dates are being pushed back or indefinitely postponed, we see less scope for equities to continue to rise. The risk reward for overweighting equities has become less appealing.

Data from Bloomberg, as of 7/21/2023.

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