CROSSMARK GLOBAL INVESTMENTS

Doll's Deliberations

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SUMMARY:

Stocks fell again last week (S&P 500 -0.3%) with big tech hit hardest. Inflation remains the primary concern despite a good CPI report on Wednesday – PPI report on Friday was less good. Best sectors were energy (+3.5%) and healthcare (+2.5%); worst sector was technology (-2.9%).

KEY TAKEAWAYS:

1. The monthly headline and core inflation CPI reports for July were both unchanged at 0.2% m/m. Monthly core inflation fell below 2% for the second consecutive month. Inflationary pressures are likely to remain subdued over the next few months, but beyond that indicators point to inflation remaining stubborn at too high a level.

2. The United Auto Workers union is starting negotiations with the auto industry by demanding a 20% immediate wage increase and an additional 5% during each year of the contract. Unionized workers are a relatively small percentage of the labor force, but their contracts can have an influence on wages in the nonunionized sector.

3. A weak Chinese economy is helping to bring inflation down in the U.S. due to falling Chinese export prices.

4. Earnings for 2Q are expected to decline -4.2% which is a smaller decline than what was originally expected (-5.7%).

5. The "soft landing" narrative has become popular largely due to solid job growth, wage gains, and rising consumer expectations. While we don't see an imminent downturn, we expect the lagged impact of rate hikes to cause real consumer spending to continue to weaken as 1) revolving credit turned negative in June, and 2) credit card and auto loan delinquencies returned to pre-Covid levels even before student loan repayments restart.

6. Our sense is that the market believes that the "Fed Put" remains in place. Put differently, the market expects Powell & Co. to come to the rescue once again at the first real signs of weakness.

7. Federal government revenues are down 11% so far this year and expenditures are up 8%. Ouch!

8. 2022/2023 back to back years have been the most volatile for bonds since the 1980s.

9. The rebound in the S&P 500 has been led by forward P/E, which rose from 15.1 on October 12 last year to 19.6 on July 31. So it rose 29.8% over this period, while the S&P 500 rose 28.3%. We think the S&P 500 could churn in the 4200-4600 range over the rest of the year.

10. Moody's cut the credit ratings of several small to mid-sized U.S. banks, warning that the sector's credit strength likely will be tested by funding risks and weaker profitability. We expect M&A activity in the sector to provide a boost to the bank stocks.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	0.69%	7.78%
S&P 500	-0.27%	17.43%
NASDAQ	-1.87%	31.04%
RUSSELL 2000	-1.76%	10.13%
RUSSELL 1000 GROWTH	-1.04%	28.07%
RUSSELL 1000 VALUE	0.33%	7.14%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	0.32%	42.08%
CONSUMER DISCRETIONARY	-0.96%	33.95%
CONSUMER STAPLES	0.34%	2.31%
ENERGY	3.56%	4.23%
FINANCIALS	0.03%	3.06%
HEALTHCARE	2.46%	0.63%
INDUSTRIALS	0.62%	11.80%
INFORMATION TECHNOLOGY	-2.82%	36.39%
MATERIALS	-0.98%	7.53%
REAL ESTATE	0.84%	2.94%
UTILITIES	0.96%	-6.97%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-0.12%	14.97%
MSCI ACWI EX U.S.	0.15%	11.07%
MSCI EAFE	0.58%	13.04%
MSCI EM	-0.90%	7.42%

P/E'S HAVE PEAKED – NOW IT'S UP TO EARNINGS

Bond yields have bounced around with an upward bias. This has arrested the rise in P/E ratios that began with the market low last October, even as earnings have eroded somewhat. So far, the economic expansion has been reinforced by expectations for lower policy rates down the road. Prolonging the economic expansion will require bond yields to behave. Stocks outperforming bonds is inconsistent with the view that monetary conditions are restrictive and the global economy is vulnerable to sliding into recession. Credit spreads are sending the same signal, i.e., spreads have recently narrowed to historically tight levels.

The risk-on backdrop has been given a reprieve with the Fed allowing investors to believe that it is pretty much done hiking rates. While near-run conditions are supportive, the cyclical investment landscape is risky, as the economic and inflation backdrop is profoundly different than last decade, and thus less supportive of bonds and risk assets.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.28%	1.01%
BLOOMBERG U.S. CORP HIGH YIELD	0.46%	6.72%
BLOOMBERG U.S. GOV/ CREDIT	-0.32%	1.10%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.09%	2.93%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	0.25%	2.75%
COMMODITIES (DJ)	-0.22%	-3.46%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	-0.53%	18.45%
CURRENCIES (DB CURRENCY FUTURE HARVEST)	0.45%	4.95%

We believe the equity outlook likely hinges on the bond market. The rally in equities in late 2022 took hold once the sharp rise in bond yields halted. The stock market rebound has been solely driven by higher equity valuations, as forward corporate earnings have fallen since the start of the year. The re-rating phase followed a brutal de-rating for much of 2022, whereby stock prices fell sharply even as corporate profits performed well, underscoring that bond markets can occasionally overwhelm the trend in earnings. Our concern is the possibility of another upleg in bond yields, and thus another round of de-rating in equities, followed eventually by weaker economic growth and a downturn in corporate earnings. We do not envision a lasting return to low (2%) inflation without an economic recession (and thus a contraction in corporate earnings). In other words, we expect inflation to prove sticky until an actual economic downturn develops which is sufficiently severe to undermine the business sector's ability to lift selling prices.

It is remarkable, given the post-pandemic boom in job openings, that U.S. hiring intentions have stayed upbeat this year and remain consistent with further solid employment gains. While net payroll gains have slowed this year, there is little risk of outright weakness ahead. Thus, the labor market will remain quite tight. Wage trends are still well above levels seen in many decades.

While there will be more ebbs and flows to the global economic expansion, the end point is inevitable, namely a recession. Our current view is that U.S. headline inflation will soon bottom with core inflation likely to modestly decelerate further and level off in the first half of 2024 at well above both pre-pandemic levels and central bank targets.

CONCLUSION:

Tight stops are warranted since valuation levels require good earnings generation, a well-behaved bond market, and continued moderating in inflation (especially core). This combination is like "threading a needle," or somewhat unlikely as we have argued throughout this period.

Data from Bloomberg, as of 8/11/2023.