

# Doll's Deliberations<sup>®</sup>

## Weekly Investment Commentary



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### Summary:

Stocks fell significantly last week (S&P 500 -4.22%) posting the worst weekly performance in 18 months. Declines occurred on growth concerns, and soft economic data. Rising sectors included consumer staples (+0.64%) and real estate (+0.19%); worst sectors were technology (-7.05%) and energy (-5.60%).

### Key takeaways:

1. U.S. non-farm payrolls rose 142,000 in August, 19,000 less than expectations, and the last two months were revised down 86,000...yet another sign of economic slowing.
2. While the ISM Manufacturing PMI improved slightly in August, it was below expectations and extended a five-month contraction streak. Meanwhile, the ISM Services PMI recorded its second consecutive month of modest expansion.
3. The expectation of a major lowering in policy rates over the next 12+ months (< 200 basis points) is too aggressive unless a noticeable recession develops.
4. The 2-year/10-year segment of the yield curve is close to dis-inverting – historically this is a sign of economic weakness and possible recession, and bodes well for defensive stocks.
5. The personal savings rate declined to 2.9%, its lowest level in 16 years and has declined by a full percentage point since January. This has been an important reason behind strong consumption this year which is unlikely to persist.
6. Perhaps the biggest challenge to equity markets remains high valuation. At 21-22x earnings, stocks are in the top decile of valuation history and earnings growth expectations are high (11% this year and 15% next year vs. long-term average of 7%).
7. Since the peak a couple of months ago, the Magnificent Seven has given up half their YTD relative outperformance.
8. Equity market leadership has clearly changed. Starting in July, equal-weight has beaten cap-weight, tech has faded as leadership, and financials have asserted leadership.
9. U.S. ROE is elevated compared to international ROEs, which underscores the risk to U.S. earnings. (ROE is a function of profit margins, asset turnover, and leverage.) While the U.S. has advantage over non-U.S. companies (e.g., efficiency), the ROE gap overstates these advantages.
10. China is struggling – home prices are falling, stock prices are falling, retail sales are weak, bank loans and M2 are falling, deflationary pressures are mounting, 10-year yields have fallen from 3% to just above 2% in 18 months, and the long-term population headwind declines continue.

| EQUITY MARKETS (INDEX TOTAL RETURN) (%) | LAST WEEK | YEAR-TO-DATE |
|---|-----------|--------------|
| DJIA                                    | -2.90     | 8.51         |
| S&P 500                                 | -4.22     | 14.48        |
| NASDAQ                                  | -5.76     | 11.75        |
| RUSSELL 1000                            | -2.61     | 15.54        |
| RUSSELL 1000 GROWTH                     | -5.40     | 14.58        |
| RUSSELL 1000 VALUE                      | -3.06     | 11.56        |
| RUSSELL 2000                            | -3.84     | 6.15         |

| S&P EQUITY SECTORS (INDEX TOTAL RETURN) (%) | LAST WEEK | YEAR-TO-DATE |
|---|-----------|--------------|
| COMMUNICATION SERVICES                      | -5.04     | 16.90        |
| CONSUMER DISCRETIONARY                      | -2.81     | 3.38         |
| CONSUMER STAPLES                            | 0.64      | 18.43        |
| ENERGY                                      | -5.60     | 5.11         |
| FINANCIALS                                  | -3.15     | 18.72        |
| HEALTHCARE                                  | -2.13     | 13.84        |
| INDUSTRIALS                                 | -4.31     | 11.25        |
| INFORMATION TECHNOLOGY                      | -7.05     | 18.17        |
| MATERIALS                                   | -4.70     | 5.98         |
| REAL ESTATE                                 | 0.19      | 10.85        |
| UTILITIES                                   | -0.50     | 21.93        |

## Finally, a slowing economy is noticed

Stocks have been roughed up as investors finally recognize that economic growth is slowing. Until recently, investors have been pricing in high odds of a soft landing, somewhat ignoring the core reason why interest rate cuts are warranted. In Jerome Powell's speech at Jackson Hole in late August, he underscored that labor demand is weakening and that the Fed does "not seek to welcome further cooling in labor market conditions."

The unemployment rate has been rising for over a year and especially since last summer. We do not view the rise in the unemployment rate and a weakening in U.S. labor demand as "good news" for the U.S. economy or for corporate profits. Many investors are more sanguine because of their view that the labor market is merely returning to normal levels from an overheated state. In the post-WWII era, the U.S. unemployment rate has never stopped rising at a low level once it begins to move higher. The unemployment rate has risen by more than 70 basis points over the past year, which has always been associated with a recession since 1950.

It is still too early for the Fed to declare "mission accomplished" regarding inflation as Core CPI remains above 3% on a year-over-year basis. While the Fed has made major progress in returning inflation back to target, the process is not yet complete. Indicators of labor demand suggest the Fed will likely soon run out of time to return inflation back to its target without a recession, even though U.S. interest rates will likely begin their descent.

2024 and 2025 and long-term earnings growth expectations for the U.S. are elevated. Twelve-month forward EPS expectations have been higher in the past, but this typically happens early in an economic recovery. Long-term earnings growth expectations have only been higher in the late-1990s, in 2018, and during the pandemic.

The looming U.S. election between two presidential candidates with starkly different policy biases would normally be a key driver of capital markets in the near term. Instead, however, investor focus will be on U.S. economic data and monetary policy over the balance of this year. Moreover, the outcome of both the presidential and Congressional elections are still too close to call, although clearly Vice President Harris now has momentum on her side. We reiterate that the victor in the presidential race will be severely hamstrung in their legislative capacity unless their party also controls both chambers of Congress.

## Conclusion

For the first time since the onset of the pandemic, the Fed is about to begin reducing interest rates later this month. Equity investors are likely to continue to treat the onset of easier monetary policy as a bullish catalyst for stock prices over the near term, but this view assumes that the Fed will be able to successfully return the unemployment rate, inflation, and interest rates all to equilibrium levels. In the post-WWII environment, there have been no cases in which the Fed avoided a recession once late-cycle rate cuts began in the context of a rising unemployment rate. Labor demand is already weakening, which in past cycles has shifted quickly into a recessionary rise in unemployment. We continue to recommend an underweight stance toward risky assets.

Data from Bloomberg as of Sept. 6, 2024

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| INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN) (%) | LAST WEEK | YEAR-TO-DATE |
|---|-----------|--------------|
| MSCI ACWI   | -2.50     | 13.07        |
| MSCI ACWI EX U.S.                                   | -2.29     | 8.67         |
| MSCI EAFE   | -2.42     | 9.24         |
| MSCI EM   | -2.13     | 7.21         |

| FIXED INCOME MARKETS (INDEX TOTAL RETURN) (%) | LAST WEEK | YEAR-TO-DATE |
|---|-----------|--------------|
| BLOOMBERG U.S. AGGREGATE BOND                 | 1.15      | 4.25         |
| BLOOMBERG U.S. CORP HIGH YIELD                | 0.24      | 6.54         |
| BLOOMBERG U.S. GOV/ CREDIT                    | 1.18      | 4.17         |
| BLOOMBERG U.S. T-BILL 1-3 MONTH               | 0.05      | 3.69         |

| ALTERNATIVES (INDEX TOTAL RETURN) (%)    | LAST WEEK | YEAR-TO-DATE |
|--|-----------|--------------|
| REAL ESTATE (FTSE NAREIT)                | -0.05     | 10.47        |
| COMMODITIES (DJ)                         | -2.37     | -1.45        |
| GLOBAL LISTED PRIVATE EQUITY (RED ROCKS) | -3.17     | 9.00         |
| CURRENCIES (DB CURRENCY FUTURE HARVEST)  | -1.40     | 6.87         |