

DOLL'S DELIBERATIONS

WEEKLY INVESTMENT COMMENTARY

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	1.80%	-3.70%
S&P 500	1.56%	-14.29%
NASDAQ	0.73%	-27.70%
RUSSELL 2000	0.76%	-16.00%
RUSSELL 1000 GROWTH	1.20%	-24.69%
RUSSELL 1000 VALUE	1.91%	-4.52%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	1.01%	-36.64%
CONSUMER DISCRETIONARY	1.14%	-30.77%
CONSUMER STAPLES	2.11%	1.02%
ENERGY	0.26%	72.26%
FINANCIALS	2.19%	-6.12%
HEALTHCARE	1.97%	-1.47%
INDUSTRIALS	1.92%	-3.00%
INFORMATION TECHNOLOGY	0.99%	-23.02%
MATERIALS	2.97%	-7.61%
REAL ESTATE	1.98%	-23.29%
UTILITIES	3.13%	1.38%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	1.64%	-15.71%
MSCI ACWI EX U.S.	1.80%	-15.33%
MSCI EAFE	2.37%	-13.51%
MSCI EM	0.38%	-21.20%

Doll's Deliberations this week summarizes some short-term expectations and some longer-term issues.

THE SHORT-TERM:

Observations

1. Stocks and bonds have both recorded three negative quarters in a row. This has not happened in nearly 50 years.
2. Central banks underestimated the level of interest rates required to cool economic growth and curb inflation pressures.
3. Money (M2) growth peaked at over 25% in late 2020 and is now negative.
4. The U.S. dollar has appreciated 25% since the beginning of 2021.
5. 57% of large cap U.S. managers outperformed for the first nine months of the year, the largest percentage in 15 years.

Inflation

Inflation was "0-2% forever." It rose quickly and peaked mid-year at 8-9%. We expect inflation will continue to fall irregularly to a still unacceptable 4-5% (on an annualized basis) by year-end. Inflation is declining due to:

1. The Fed raising rates to slow economic growth
2. Significant slowing in money growth
3. Dollar strength
4. Lower commodity prices
5. Some let-up in supply chain disruption

Fed

The Fed is probably in a position to slow the state of interest rate increases, but is not in a position to pivot. Necessary conditions for a pivot probably include:

1. Core inflation needs to point towards (but not reach) the 2% target.
2. Inflation expectations need to start dropping.
3. The labor market needs to weaken noticeably.

Recession

With the inversion of 90-day/10-year yield curve earlier this month, the probability of recession increases noticeably in our view. Reasonably healthy household balance sheets, healthy corporate balance sheets and profitability, a still strong job market, and a healthy financial system (especially banks) suggest to us that a recession (should we experience one) is likely to be mild.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	1.02%	-12.82%
BLOOMBERG U.S. CORP HIGH YIELD	0.95%	-10.74%
BLOOMBERG U.S. GOV/ CREDIT	1.05%	-13.39%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.05%	1.09%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	1.18%	-22.44%
COMMODITIES (DJ)	0.43%	18.05%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	1.72%	-31.73%
CURRENCIES (DB G10 CURRENCY FUTURE)	-0.32%	4.42%

Earnings

Earnings expectations for 2023 have been falling since peaking in the summer. Further downside is likely, especially if a recession occurs.

Short-Term Conclusions

1. The Fed has already tightened monetary conditions to a restrictive level that will likely lead to recession in 2023. The pace of tightening has been exceptionally fast so the lagged impact on the economy is still to be seen, notwithstanding the perception of lingering economic resilience. The 90-day/10-year yield curve inversion corroborates the recession signal.
2. U.S. inflation is likely to continue to move lower based on the combination of demand weakening and the easing of supply constraints, but we expect inflation will not retreat to the Fed's 2% target.
3. The U.S. dollar has experienced a remarkable rally increasing 25% over the past two years, and valuation is stretched. Relative economic growth (favoring the U.S.) and relative interest rates (also favoring the U.S.) have been the causes. We expect those advantages to shrink in 2023.
4. Earnings expectations for 2023 have fallen from a \$252 peak in the summer to \$230 now. We see potential risk down toward \$200 in a recession.
5. Stocks and bonds are no longer expensive, but aren't cheap either. Cash (Fed funds) returns have moved from 0% to $\approx 4\%$. Ten-year yields in 2020 have moved from $1\frac{1}{2}\%$ to $4\frac{1}{4}\%$ at peak. The S&P 500 P/E has moved from 22x at the start of the year to 16x at trough. As such, we expect the volatile sideways trading range that started mid-year to continue.

THE LONG-TERM

2022 has witnessed a major inflection in the global interest rate climate, effectively ending the 40-year era of declining inflation and interest rates. Global bonds and equities have corrected sharply in response to the surge in interest rates. History suggests that it will take time for investors to fully adapt to the new era of higher/positive real bond yields. There is considerable uncertainty about the long-term economic outlook. Productivity growth has been chronically disappointing, China has downshifted more rapidly than expected to a much slower underlying growth path and public sector debts have ballooned since the start of the pandemic. Households, businesses and governments face a much higher cost of debt than they became accustomed to in recent decades. An intensifying geopolitical contest between the U.S. and China add to the economic uncertainty. The bigger challenge for capital markets and investors is that the era of declining/low interest rates significantly inflated asset prices. The hit to asset prices this year has been painful, yet it is difficult to assert that things are cheap.

The economic outlook over the next decade is likely to be sufficient to generate decent real returns for realistic investors. Intense deleveraging pressure rather than secular stagnation was the primary cause of subpar growth in the U.S. and euro area last decade, which has now passed. The rise in yields means that bonds should contribute positively to multi-asset portfolio real returns over the next decade, which was frequently not the case for much of the past ten years. We expect inflation to be stickier than markets are discounting, with the prior dampening effect of globalization fading, labor less quiescent than in the past and growing populist pressures to reduce income inequality. We expect inflation to be higher for longer, and less friendly to capital markets than was generally the case since the early 1980's. The long-term outlook for a balanced portfolio has improved following this year's price declines, but setting realistic return expectations for the next decade is tougher because capital will no longer be cheap, liquidity no longer assured, and a central bank "put" no longer reliable. Past returns will no longer be a good guide to prospective returns, even over the longer term.

Real global economic growth over the next decade will likely resemble that of the past ten years. Inflation, however, is poised to be higher as key dampeners of recent decades fade. The U.S. and euro area economies are projected to grow at a faster pace over the next decade than in the last, which was subdued by chronic deleveraging pressures after the Global Financial Crisis. A rebound in labor productivity growth should more than offset slowing population growth. China will grow at a markedly slower pace primarily reflecting demographic changes. The population is forecast to be flat over the next decade but declining in the later years, with risks to the downside as evident from the contraction in 2021. Thus, economic growth will be driven by labor productivity growth, which is also moderating, albeit still high by global standards.

Central banks may be rhetorically-committed to returning inflation to their 2% target, but we do not expect them to succeed. The surge in inflation over the past two years represents a clear break with the past four decades, when globalization and other forces kept consistent downward pressure on goods prices. Goods price inflation will generally be higher as companies build greater buffers into supply-chains and selectively re-shore manufacturing. We expect the recent acceleration in wage costs to be sticky compared with recent decades, in part reflecting aging populations. Central banks may not formally abandon their current inflation targets, but they will not sacrifice growth to achieve them. The trend decline in interest rates over most of the past 40 years had a hugely positive impact on asset prices, but could only be sustained when inflation was falling and/or stable at very low levels. The Fed, ECB and other central banks still cling to the notion that equilibrium real policy rates will remain very low in the future, but higher prospective inflation, a higher inflation risk premium, and an unwinding of central bank balance sheets indicate that policy rates will broadly align with nominal GDP growth less a modest term premium.

Fixed Income

The 40+-year era of falling and low government bond yields has passed, but the adjustment to the era of higher real policy rates, higher inflation, and greater inflation uncertainty will take time. G7 government bonds have suffered severe losses this year as yields have risen. Staggeringly, the combination of rising nominal bond yields and high inflation have wiped out the prior 14 years of real returns for G7 10-year government bonds. Despite the sharp rise in 2022, yields are likely to rise irregularly over the course of the next decade, consistent with the rise in central bank policy rates.

Equities

The long-term outlook for global equities has brightened modestly following this year's bear market, but aggregate real returns in the decade ahead will significantly lag those of the past 40 years. We anticipate a swing in relative performance from the U.S. to non-U.S. markets given the relative earnings and valuation starting points. Three factors determine the outlook for prospective returns over the next decade, namely the growth of corporate earnings, the anticipated P/E ratio and the dividend yield. Earnings growth will likely be tepid in the decade ahead, against a backdrop of moderate global economic growth and an already very elevated return on equity. More positively, the global P/E ratio has fallen well-below its historical mean over the past 18 months. This implies potential upside in the decade ahead. Dividends should contribute significantly to equity returns in the decade ahead, generating approximately half of the returns. The dividend payout ratio is near the lower end of the historical range, indicating ample scope for dividend payments to be sustained in a moderate global growth climate. Overall, we expect global equities to generate an annual real return of 4-5% which is below that of the past decade, but sufficient to support decent total returns in multi-asset portfolios.

Long-Term Conclusions

1. The recent surge in G7 government bond yields improves the outlook for bonds over the next decade, although real returns will still be low compared with recent decades.
2. Investors should expect mid-single digit real returns on global equities in the coming decade, well below the norms since the early 1980s.
3. Much of the equity return will come from dividends with low real earnings growth.
4. The U.S. is poised to underperform in the next decade.
5. Active management will be well-positioned to potentially outperform buy-and-hold and passive strategies.

Data from Bloomberg, as of 11/25/2022.

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