Doll's Deliberations

Weekly Investment Commentary | December 4, 2023 | Issue 3.48

SUMMARY:

The S&P 500 was up (+0.8%) for the fifth week in a row. Small cap stocks again powered higher (Russell 2000 +0.1%). Treasuries had a strong week with the ten-year yield falling 25 basis points. Best sectors were real estate (+4.7%) and materials (+2.8%); sectors losing ground included communication services (-2.5%) and energy (-0.1%).

KEY TAKEAWAYS:

1. The Fed's latest Beige Book delivered a softening message for the U.S. economy. (Half of the 12 districts reported slight declines in activity, two indicated that "conditions were flat to slightly down," and the remaining four experienced modest growth.)
2. U.S. home prices climbed to a new all-time high in September (now up 3.9% y/y). And yet, new home sales contracted by 5.6%. Rising mortgage rates have dampened demand for housing.
3. Core PCE has come in below +0.20% in four of the last five months. This is good news for the fight on inflation. (However, this is putting pressure on corporate pricing power, and therefore, earnings.)
4. Consumer confidence data show that consumers are becoming less upbeat about the labor market. Should the unemployment rate rise to 5%, as this indicator suggests, consumption would slow considerably. (What is ironic is that this is occurring at a time when the expectation of a U.S. recession over the next 12 months is at the lowest levels in the last 18 months.)
5. If the Fed meets market expectations and starts cutting aggressively in 2024, it likely will be against a backdrop of a sharply slowing economy and rising unemployment.
6. The best sector from an earnings surprise factor during Q3 was consumer discretionary (+13.6% earnings surprise); the worst was energy (-0.8%).
7. With some top line slowdown pressure as well as some margin pressure due to cost increases, next year EPS growth could end up more flattish than up a double-digit percentage.
8. While dividend yield as a stock market factor has underperformed year-to-date, dividend growth (always our favorite dividend factor) has outperformed.
9. According to the latest AAII survey, bulls have moved up to 45.3% from as low as 24.3% at the start of November (above its historical average of 37.5%). Similarly, the share of the bearish respondents has fallen from 50.3% to 23.6%. (At extremes, investor sentiment can be used as a contrarian indicator that a reversal is likely.)
10. In recent months, the rally was too concentrated in large growth stocks and lacked market breadth. The number of stocks in rally mode has broadened out which is a positive sign. During the month of November, ten of eleven sectors gained ground.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	2.60%	11.68%
S&P 500	0.83%	21.52%
NASDAQ	0.41%	37.76%
RUSSELL 1000	0.35%	20.58%
RUSSELL 1000 GROWTH	0.38%	37.20%
RUSSELL 1000 VALUE	1.95%	6.81%
RUSSELL 2000	0.14%	4.20%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-2.48%	48.32%
CONSUMER DISCRETIONARY	1.59%	35.94%
CONSUMER STAPLES	0.74%	-1.73%
ENERGY	-0.07%	-0.83%
FINANCIALS	2.17%	7.18%
HEALTHCARE	0.52%	-1.77%
INDUSTRIALS	2.20%	12.12%
INFORMATION TECHNOLOGY	0.35%	52.28%
MATERIALS	2.78%	8.89%
REAL ESTATE	4.67%	5.54%
UTILITIES	1.33%	-7.69%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	0.35%	16.60%
MSCI ACWI EX U.S.	0.37%	10.08%
MSCI EAFE	0.14%	12.27%
MSCI EM	0.70%	5.69%

GOLDILOCKS?

Global equities rallied in November on optimism that the Fed and other central banks have completed their tightening cycles, bond yields will continue to retreat, and an economic recession can be avoided. Equities corrected significantly beginning in August, with rising bond yields causing stocks to de-rate even as forward earnings expectations had been trending higher. The bullish (or Goldilocks) thesis for equities is that the rise in forward earnings expectations will persist, allowing stock prices to continue their recent uptrend. There is limited run room for the equity market to advance significantly given the late stage of the economic cycle, already elevated corporate earnings (in the U.S.), the threat that sturdy global economic growth will compel central banks to ultimately keep interest rates steady in 2024 rather than cut them as markets are discounting, and valuation levels.

Equity investors betting that Fed rate cuts will both prevent a recession and somehow allow a new sustained economic reacceleration and equity bull market phase to develop are destined to be disappointed. Equities may be able to thrive over the near-term in response to the recent pullback in bond yields and given the ongoing rise in expected forward earnings, but the run room on any upleg will be limited. Consensus expectations for corporate profit margins are elevated by historical standards, which reinforces that upside for earnings expectations is likely to be limited. Margins surged during the pandemic, and it is unlikely that they could return to their earlier highs unless global economic growth accelerates meaningfully in the year ahead. A significant pickup in corporate revenue growth is already built into consensus earnings expectations. While a pick-up in economic or corporate revenue growth is not implausible, such an outcome would not be consistent with current market expectations that the Fed et al will be reducing interest rates over the next year. Return on equity is also high by historical standards, further supporting the conclusion that upside for corporate earnings is unlikely to be significant or lasting.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	1.18%	1.64%
BLOOMBERG U.S. CORP HIGH YIELD	0.98%	9.37%
BLOOMBERG U.S. GOV/ CREDIT	1.10%	1.97%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.06%	4.65%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	2.56%	2.47%
COMMODITIES (DJ)	0.15%	-5.67%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	1.93%	24.62%
CURRENCIES (DB CURRENCY FUTURE HARVEST)	0.23%	9.68%

Equities de-rated this summer as G7 real interest rates rose sharply, but have recently gotten some respite from market expectations that the Fed has completed its tightening cycle. Optimism that the Fed could be cutting interest rates next year even as both U.S. earnings and revenue growth are accelerating is misplaced. Rate cuts against a backdrop of accelerating corporate revenue and earnings growth would risk re-igniting underlying inflation pressures. The Fed may be reluctant to create a recession, but they are also unlikely to risk allowing inflation to get a second wind if the economy continues to prove resilient.

CONCLUSION:

Equity upside is likely to be limited because a sturdy global economic growth backdrop implies sticky core inflation and would preclude the easing in G7 monetary policy that is currently discounted. Markets are pricing in a pick-up in corporate revenue growth that ultimately is inconsistent with easing monetary policy. We continue to believe that the recent retreat in bond yields is temporary and global equities are in a topping out process and as such are sellers on strength rather than buyers on weakness.

Data from Bloomberg, as of 12/1/2023.