

DOLL'S DELIBERATIONS

WEEKLY INVESTMENT COMMENTARY

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	-4.56%	-12.78%
S&P 500	-5.04%	-17.60%
NASDAQ	-5.59%	-27.26%
RUSSELL 2000	-1.69%	-17.12%
RUSSELL 1000 GROWTH	-5.45%	-26.39%
RUSSELL 1000 VALUE	-4.14%	-8.95%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-4.13%	-27.86%
CONSUMER DISCRETIONARY	-6.06%	-29.72%
CONSUMER STAPLES	-2.59%	-6.54%
ENERGY	-0.84%	61.67%
FINANCIALS	-6.75%	-16.42%
HEALTHCARE	-3.38%	-10.63%
INDUSTRIALS	-4.95%	-13.81%
INFORMATION TECHNOLOGY	-6.37%	-24.84%
MATERIALS	-5.77%	-9.51%
REAL ESTATE	-6.09%	-20.04%
UTILITIES	-4.09%	0.42%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-1.73%	-14.80%
MSCI ACWI EX U.S.	-1.05%	-12.25%
MSCI EAFE	-1.78%	-13.27%
MSCI EM	0.64%	-12.56%

SUMMARY:

U.S. equities were sharply lower last week as the S&P 500 (-5.0%) fell for the ninth time in the past ten weeks, recording its worst weekly performance since January. Continued inflation fears and recession concerns dominated the headlines. All sectors were lower; the worst sectors were financials (-6.8%), technology (-6.4%) and REITs (-6.1%).

KEY TAKEAWAYS:

- An upside surprise in inflation for May was reported last week (1.0% m/m, 8.6% y/y). Culprits included energy, food, and rental prices. These numbers are new highs for the cycle. We continue to expect (as we said at the beginning of the year) that inflation will peak in Q2 and fall somewhat in the back half of the year.
- We think it is unlikely that oil prices will fall in the U.S. unless oil companies are encouraged to increase their production. The environmentalists wouldn't be happy, but American consumers would be.
- Considerable impediments to global economic activity remain supply chain disruptions, high energy prices, and food price/availability in emerging markets.
- According to Strategas, costs for the S&P 500 are rising at the fastest pace since the early 2000's with the current year over year percentage change at 14.7% (higher labor, material, and transportation costs).
- Corporate profits are transitioning from the extremely favorable 2H20 and 2021 period to something less bullish. With the Fed further dampening an already slowing economy, profits are at risk. A soft landing should result in flattish profits; a recession will lead to an outright profit decline.
- Contracting valuations have driven the year-to-date U.S. equity selloff as inflation has reared its ugly head and interest rates head higher. Meanwhile, forward earnings estimates have been trending higher. Downward revisions, which have started recently, could become a risk to equity prices.
- The Fed's hope is that tighter monetary policy will slow demand enough to reduce the number of job openings – of which there are currently almost two for every unemployed person – without leading to a significant increase in layoffs and the unemployment rate.
- The cost of buying a home in the U.S. is up nearly 60% y/y. Inventories are beginning to build.
- Home purchase applications declined 18% year-on-year and underscore slower demand for housing amid surging mortgage rates..
- The U.S. stock market peaked at the very beginning of this year at 62% of global equity market capitalization. Since then, the U.S. has underperformed and is now 60.5% of global capitalization. We expect U.S. underperformance to continue.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.70%	-9.91%
BLOOMBERG U.S. CORP HIGH YIELD	-1.24%	-9.51%
BLOOMBERG U.S. GOV/ CREDIT	-0.67%	-10.59%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.00%	0.11%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-3.41%	-16.45%
COMMODITIES (DJ)	1.23%	36.92%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	-1.60%	-26.81%
CURRENCIES (DB G10 CURRENCY FUTURE)	0.53%	5.46%

RECESSION, SOFT LANDING, OR SOMETHING IN BETWEEN?

The debate continues about whether a soft landing or a full-blown recession will develop. The U.S. still has considerable momentum to sustain good consumption growth via income gains, courtesy of a strong labor market, and still-elevated savings due to massive fiscal transfers and pent-up demand. Growth has been moderating this year after the prior boom phase, but forward-looking indicators remain positive and strong consumption will sustain a solid expansion. We are upbeat on euro area economic prospects, as mobility has increased notably since the winter and the critical summer tourist season will be very strong, helping to offset the ongoing drag from the Ukrainian war and high energy prices. Even the ECB is still expecting above-potential growth, despite downgrading its expectations this week. China is now set to re-join the global expansion, as the authorities tentatively unwind the COVID lockdowns. Chinese demand for imports will also rebound, providing a direct boost to the rest of the world.

To be sure there are economic headwinds, especially with regards to expensive energy prices and, in some countries, elevated food prices, as well as emerging concerns over higher borrowing rates after an era of “free money”. Moreover, good economic growth may not translate into higher risk asset prices. There is a negative consequence of good economic growth – inflation will prove sticky and hold well above central bank targets, and will be prone to trend higher over time. Therefore, the risk is that even if corporate earnings continue to grind higher, higher bond yields and policy rates will ensue, muting equity price upside and possibly triggering additional de-rating. Although we expect some reprieve from ever-higher annual U.S. inflation rates, the deceleration should prove temporary and still leave the core rate well above 2%. Global earnings momentum is showing signs of cracking at the edges, with prior uptrends in several sectors now

weakening. While we do not expect an earnings recession in the year ahead, the risk of near-term downgrades is increasing, which will test investor sentiment.

For the financial markets, the key will be whether the trend towards more hawkish Fed rhetoric will cool for a period of time, allowing bond yields to plateau. Here the outlook is modestly favorable, as the Fed and other major central banks seem convinced that a recession will not be needed to return to a low inflation world. This year's rise in U.S. interest rate expectations should level off for a period, assuming inflation data eases further. While the Fed has been content to idly stand by in the face of this year's risk-off backdrop, we doubt that it will be as sanguine should market losses deepen and risk-taking seize up.

Should this view of a calming in U.S. interest rate expectations pan out, the implication is that this year's risk-off phase will give way to a better environment for a period of time, as recession concerns diminish, albeit we expect any equity upside to be modest and choppy.

CONCLUSION:

The cyclical outlook for bonds is still bearish, and central banks will eventually be forced to tighten into restrictive territory. Until then, the global economic expansion is expected to continue, and inflationary pressures are becoming entrenched. Equity markets are again oversold, and due for a reprieve should bond markets calm for a time, as we expect. 2Q earnings and forward guidance will be key. Investors will need to be nimble when making tactical moves in asset markets, as the mega-tailwind from “free money” is over.

Data from Bloomberg, as of 06/10/2022.

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Crossmark Global Investments, Inc.
15375 Memorial Drive, Suite 200, Houston, TX 77079
888.845.6910 advisorsolutions@crossmarkglobal.com
crossmarkglobal.com

DD-WKLY-COMM-2.23 06/22