CROSSMARK
GLOBAL INVESTMENTS

Doll's Deliberations

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SUMMARY:

Equities were lower last week (S&P 500 -2.3%) as stocks fell for the first week in four. Reasons for the downside included the Fitch U.S. debt downgrade, a higher for longer Fed, stretched sentiment, and rising energy prices. Earnings releases were mixed. Best sectors were energy (+1.2%), consumer discretionary (-0.2%), and financials (-0.8%); underperformers included utilities (-4.7%), technology (-4.1%) and communication services (-2.9%).

KEY TAKEAWAYS:

1. U.S. payroll employment rose a solid, but slightly below expectations, +187,000 in July. Average hourly earnings increased +0.4% m/m and 4.4% y/y, i.e., still problematic.
2. Wage growth is increasingly outpacing inflation growth which could cause downward margin pressure. (The profitability cycle often leads the employment cycle.)
3. The U.S. Federal Reserve Senior Loan Officer Survey (SLOOS) showed that U.S. banks continue to tighten lending standards.
4. 2Q productivity was stronger than expected, increasing 3.7% q/q. On the surface this is good news, but some are cautioning that productivity improved because of weakness in the labor market.
5. Fitch downgraded U.S. debt last Tuesday, underscoring the severity of the medium-term and long-term deficits and the dysfunction of America's political system. In our view, the Fitch downgrade is an "excuse," not the "reason" for the sell-off in both bonds and stocks.
6. With 80% of companies reporting 2Q earnings, 2023E EPS has been revised up 0.8% and 2024 up 0.4%.
7. The Brent crude futures price rose to $85 a barrel from its recent low of $72. This could create a bump in the declining inflation story.
8. The U.S. dollar is expensive. Similar periods of overvaluation in history have been associated with subsequent structural downtrends in the currency.
9. The story for the stock market so far this year is stronger corporate earnings and earnings expectations along with a lower equity risk premium offsetting a back-up in interest rates.
10. The virtuous cycle of rising stock prices, easing financial conditions and positive surprises remains intact. At the same time, valuations are stretched, and momentum is showing some early signs of turning. However, we don't see a broad selloff until (1) economic data weakens, and/or (2) inflation proves to be stickier than expected.

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	-1.11%	7.04%
S&P 500	-2.26%	17.75%
NASDAQ	-2.84%	33.53%
RUSSELL 2000	-1.00%	12.32%
RUSSELL 1000 GROWTH	-2.82%	29.41%
RUSSELL 1000 VALUE	-1.57%	6.78%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-2.83%	41.62%
CONSUMER DISCRETIONARY	-0.22%	35.25%
CONSUMER STAPLES	-1.90%	1.96%
ENERGY	1.20%	0.64%
FINANCIALS	-0.77%	3.03%
HEALTHCARE	-2.09%	-1.78%
INDUSTRIALS	-1.77%	11.12%
INFORMATION TECHNOLOGY	-4.14%	40.35%
MATERIALS	-2.03%	8.60%
REAL ESTATE	-2.17%	2.08%
UTILITIES	-4.59%	-7.85%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-2.24%	15.20%
MSCI ACWI EX U.S.	-3.04%	10.16%
MSCI EAFE	-3.24%	11.39%
MSCI EM	-2.59%	8.14%

HOW LONG CAN GOLDILOCKS CONTINUE?

The market has embraced the Goldilocks scenario of decent global growth, declining inflation and central bank interest rate cuts beginning in 2024. We continue to think this combination is like threading a needle – possible, but difficult. Either a recession will occur (still our guess) or inflation will not recede to Fed targets without further punitive action. Last week's Fitch downgrade of U.S. government debt to AA+, while of little fundamental significance, has added to underlying upward pressure on U.S. and G7 government bond yields. Stable bond yields are a crucial component of the Goldilocks scenario, and are now being questioned by investors. A breakout in G7 government bond yields could trigger a further risk-off period following the big gains in equities and credit year-to-date.

We have been and remain reasonably constructive about the near-term economic outlook, believing that household and corporate fundamentals in the U.S. and euro area are acceptable. However, core inflation in the U.S. and Europe will likely not decelerate toward the 2% target level against a backdrop of a sturdy global economy and interest rates that are not yet decisively restrictive. As a result, the Fed and other central banks will not be able to cut interest rates in the year ahead, as markets are pricing. That creates a headwind for bonds as well as expensive U.S. growth stocks. We believe this is not the start of a new economic and investment cycle, but instead is the late-stages of the cycle that began in 2009 and was briefly interrupted and then distorted by the pandemic. Several years of solid economic earnings growth, low inflation, and stable or lower interest rates, are not on the horizon, nor do current asset valuations offer significant re-rating potential.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-1.41%	0.46%
BLOOMBERG U.S. CORP HIGH YIELD	-0.72%	5.85%
BLOOMBERG U.S. GOV/ CREDIT	-1.31%	0.63%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.08%	2.82%

The uptrend in global equities has strengthened in the past two months, as investors have upgraded the U.S. economic outlook. Recent global strength has been driven by the U.S. market, which has gone into overdrive in the past three months, with breadth spreading from the mega-caps to the broader market. The rise in stock prices year-to-date has been due largely to an increase in the 12-month forward P/E ratio rather than in 12-month forward earnings. (Forward earnings are basically flat YTD.) The U.S. forward P/E ratio is well above its long run average of 16, and was only higher than the current level during the late-1990s stock market bubble and following the pandemic-fueled stimulus period in 2020-2021, when earnings expectations were still depressed. U.S. stocks are discounting an overly bright earnings outlook.

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-1.45%	3.27%
COMMODITIES (DJ)	-1.11%	-3.24%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	-3.25%	17.36%
CURRENCIES (DB CURRENCY FUTURE HARVEST)	-0.02%	4.48%

The overall U.S. market is expensive and increasingly vulnerable to a consolidation or correction phase, and has limited sustainable upside from a fundamental standpoint. The twelve-month forward P/E ratio for U.S. stocks at the time of the Fed's last rate hike in March 1995 was 12.5 compared with over 20x today. The current risk-on climate notwithstanding, we continue to favor an overweight stance in cash within a multi-asset portfolio on a 6-12 month horizon, given cash's attractive absolute and relative yields. Cash is particularly attractive relative to G7 longer-term government bonds, whose yields may have another upleg once central bank rate-cut expectations unwind.

CONCLUSION:

Stocks will have a tougher period over the next 6-12 months following the big gains year-to-date. The re-rating of global stocks, especially U.S. stocks, is vulnerable to a reversal especially if bond yields rise, while earnings upside is limited even as the economic expansion is sustained.

Data from Bloomberg, as of 8/4/2023.

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