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# Doll's Deliberations

## Weekly Investment Commentary

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**Summary:**
Equities were higher last week (S&P 500 +1.9%) with megacap leadership resuming. Catalysts for the rally included soft landing momentum, disinflation optimism, and a rally in short maturity fixed income. Best performers were technology (+4.9%) and communication services (+3.6%); worst performers were energy (-2.4%) and utilities (-1.9%).

### Key takeaways:

1. The Thursday CPI was firmer than expected; the Friday PPI was weaker than expected. All this paves the way for the Fed to lower rates – the starting point, the pace, and the number of cuts are still up for debate. (We still think a March cut is unlikely.)
2. 2023 CPI inflation was 2.6% (headline) and 3.2% (core). While inflation is approaching the Fed's 2% targets, the path for monetary policy and interest rates this year depends a lot on whether inflation stalls out at its current pace or continues to slide.
3. The Atlanta Fed's U.S. Wage Growth Tracker stalled at 5.2% in December, unchanged from November. Notably, after falling from a peak of 7.1% in June 2022, this indicator has stabilized at still-elevated levels.
4. The Fed may face a dilemma: – cut rates early in an attempt to avoid a recession but at the risk of not taming wage inflation, or delay rate cuts to attempt to lower wage inflation but risk an economic downturn.
5. We reiterate our prediction (#4) that credit spreads will widen this year – in short, credit is unattractively priced relative to U.S. Treasuries.
6. Crude oil prices jumped higher as brent crude crossed $80 per barrel on escalating hostilities in the Middle East.
7. 4Q earnings season has just begun. Estimates are for an increase of 1-2% (down from 8-9% before the quarter started. The 7% drop is a very big one.) The key will be managements' outlook for 2024 and analysts' revisions of their 2024 expectations.
8. Fed liquidity has been a key driver of stock market gains in recent months. This tailwind is likely to lessen significantly in coming months as reverse repo balances are depleted, even as the Fed continues its quantitative tightening program.
9. The S&P 500 has been trading at around 4,750 since the middle of December which coincidentally is the consensus median end-of-the-year price target for 2024. This represents a 19.5 P/E ratio on earnings growth of 11% this year. This analysis suggests that there is little room for further gains and we believe the risk/return trade-off is unfavorable for equities, especially as a soft landing remains elusive.
10. U.S. technology shares saw huge gains in 2023, driven mostly by multiple expansion. The sector will have to deliver strong earnings in 2024 to validate the past year's run-up.

| EQUITY MARKETS (INDEX TOTAL RETURN) (%) | LAST WEEK | YEAR-TO-DATE |
|---|---|---|
| DJIA | 0.35 | -0.21 |
| S&P 500 | 1.87 | 0.34 |
| NASDAQ | 3.09 | -0.24 |
| RUSSELL 1000 | 1.76 | 0.11 |
| RUSSELL 1000 GROWTH | 3.66 | 0.84 |
| RUSSELL 1000 VALUE | -0.28 | -0.62 |
| RUSSELL 2000 | 0.23 | -3.51 |

| S&P EQUITY SECTORS (INDEX TOTAL RETURN) (%) | LAST WEEK | YEAR-TO-DATE |
|---|---|---|
| COMMUNICATION SERVICES | 3.58 | 2.42 |
| CONSUMER DISCRETIONARY | 1.53 | -1.97 |
| CONSUMER STAPLES | 1.18 | 1.23 |
| ENERGY | -2.39 | -1.29 |
| FINANCIALS | -0.51 | -0.11 |
| HEALTHCARE | 0.96 | 3.08 |
| INDUSTRIALS | 0.57 | -1.59 |
| INFORMATION TECHNOLOGY | 4.87 | 0.63 |
| MATERIALS | -1.02 | -2.43 |
| REAL ESTATE | 0.66 | -1.25 |
| UTILITIES | -1.87 | -0.07 |

## Fed rate cut expectations still lofty

Global financial markets are off to a somewhat bumpy start following two months of huge gains. Investors had overly embraced the positive combination of increased chances for lower central bank policy rates (which triggered a sizable decline in government bond yields) as well as ongoing solid improving economic growth. The best of both worlds (Goldilocks) is not a likely outcome. Either economic momentum is too strong to allow economic slack to rebuild and, thus, there are low odds of returning to a 2% inflation world, or economic growth slows (our best guess) and earnings disappoint.

| INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN) (%) | LAST WEEK | YEAR-TO-DATE |
|---|---|---|
| MSCI ACWI | 0.99 | -0.60 |
| MSCI ACWI EX U.S. | -0.38 | -1.85 |
| MSCI EAFE | -0.17 | -1.43 |
| MSCI EM | -0.73 | -2.80 |

Since October, there has been a huge shift in policy rate expectations and asset pricing, yet no meaningful signs of weaker global growth. Current expectations for a major Fed easing cycle will likely unwind even if the Fed eases a few times in the belief that its inflation forecast will pan out. Such an unwinding will probably end the positive financial market backdrop that developed in late October. Consequently, there are higher odds of stickier inflation down the road. Monetary conditions were getting close to restrictive territory last autumn but have since pulled back considerably. Fed Chair Powell suggested that policy was well into restrictive territory and thus purposefully embraced a significant dovish pivot in late October.

| FIXED INCOME MARKETS (INDEX TOTAL RETURN) (%) | LAST WEEK | YEAR-TO-DATE |
|---|---|---|
| BLOOMBERG U.S. AGGREGATE BOND | 0.71 | -0.50 |
| BLOOMBERG U.S. CORP HIGH YIELD | 0.79 | -0.34 |
| BLOOMBERG U.S. GOV/ CREDIT | 0.68 | -0.53 |
| BLOOMBERG U.S. T-BILL 1-3 MONTH | 0.06 | 0.14 |

Fed Chair Powell does not want to trigger a recession in this politically challenging period. It appears that Powell sees the current bout of falling inflation as confirmation that policy must be restrictive despite the lack of broad economic weakness and the recent easing in financial conditions. Our view remains that inflation will settle above 2% this year and subsequently remain firm if economic growth exceeds its long-run potential rate. The investment implication is that with economic slack no longer present, central banks will be spending more time fighting inflation than in recent decades, and there likely will be less asset inflation.

| ALTERNATIVES (INDEX TOTAL RETURN) (%) | LAST WEEK | YEAR-TO-DATE |
|---|---|---|
| REAL ESTATE (FTSE NAREIT) | 0.10 | -1.50 |
| COMMODITIES (DJ) | -0.58 | -0.49 |
| GLOBAL LISTED PRIVATE EQUITY (RED ROCKS) | -0.20 | -3.82 |
| CURRENCIES (DB CURRENCY FUTURE HARVEST) | 0.36 | 1.54 |

The conundrum of the current backdrop is that investors are betting that profit growth will be strong, while at the same time expecting a sizable decline in policy rates. Such a combination is unlikely, or at least unlikely to be sustained for very long.

## Conclusion:

Economic growth prospects were already modestly upbeat last fall, and have subsequently improved further due to the stimulative impact of lower policy rate expectations and the sizable rebound in global financial markets. The combination of both better corporate profits and much lower policy rates is unlikely. Aggressive rate cut expectations will unwind over 2024. An unwinding of aggressive rate cut expectations and possible upward pressure on bond yields will halt the equity rally at some point, and warrant taking profits on stocks.

Data from Bloomberg, as of 1/12/2024.

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