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# Doll's Deliberations

## Weekly Investment Commentary

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### Summary:

Stocks rose last week (S&P 500 +1.2%) with small caps leading the way. The soft landing narrative continues to gain traction along with further declines in inflation. Best sectors were energy (+3.6%) and communication services (+4.7%); worst sectors included consumer discretionary (-1.0%) and real estate (-0.4%).

### Key takeaways:

| EQUITY MARKETS (INDEX TOTAL RETURN) (%) | LAST WEEK | YEAR-TO-DATE |
|---|---|---|
| DJIA | 0.70 | 1.26 |
| S&P 500 | 1.23 | 2.78 |
| NASDAQ | 1.35 | 3.39 |
| RUSSELL 1000 | 1.08 | 2.37 |
| RUSSELL 1000 GROWTH | 1.22 | 4.33 |
| RUSSELL 1000 VALUE | 1.31 | 0.47 |
| RUSSELL 2000 | 1.62 | -2.49 |

| S&P EQUITY SECTORS (INDEX TOTAL RETURN) (%) | LAST WEEK | YEAR-TO-DATE |
|---|---|---|
| COMMUNICATION SERVICES | 4.72 | 9.35 |
| CONSUMER DISCRETIONARY | -0.97 | -2.42 |
| CONSUMER STAPLES | 0.79 | 1.08 |
| ENERGY | 3.62 | -0.83 |
| FINANCIALS | 1.79 | 2.65 |
| HEALTHCARE | -0.07 | 2.28 |
| INDUSTRIALS | 0.87 | -0.42 |
| INFORMATION TECHNOLOGY | 1.43 | 6.48 |
| MATERIALS | 0.41 | -3.49 |
| REAL ESTATE | -0.35 | -3.69 |
| UTILITIES | 0.45 | -3.33 |

1. Q4 U.S. real GDP came in a strong 3.3% with the consumer contributing about 60% of the growth (full year GDP was 3.1%). The GDP deflator was a respectable 1.5%.
2. The Conference Board's Leading Economic Indicator (LEI) posted its 22nd month in a row of decline. Meanwhile, the CEI (Coincident Economic Index) posted its 18th consecutive month of expansion, albeit moderate.
3. With the economy at full employment, and only the lower to middle income portion of the consumer base showing signs of strain, any recession is likely to be shallow, and maybe not much worse than the soft-landing scenario.
4. Houthi attacks on ships in the Middle East are significantly disrupting global trade, in the route to enter the Suez Canal. An estimated 12% of global trade passes through the Suez. Economists are suggesting that core inflation will rise 10-20 basis points from disruptions already caused due to higher shipping costs.
5. Although the dollar is overvalued, it is a counter-cyclical currency benefitting in the last 30 days from a deterioration in the global growth outlook, a scale back in expectations of Fed cuts this year, and its safe haven status given increasing tensions in the Middle East.
6. We continue to believe that Fed liquidity has been a major tailwind driving stocks higher since the mini-banking crisis of last April. We expect Fed liquidity to become a headwind in a few months once the RRP (reverse repo facility) is drained.
7. With the S&P 500 selling at circa 20x earnings, earnings estimates likely vulnerable, and Fed cut expectations still too high, we continue to think the risk-reward for stocks is not favorable.
8. While the S&P 500 YTD is up 3%, and some of the averages have made multiple new all-time highs, the average stock (equally weighted average) is once again struggling (R2000 is -2% YTD). This raises some questions about the sustainability of the uptrend, especially given that sentiment has turned bullish.
9. The probability of a Biden-Trump rematch continues to rise. Both candidates have nearly wrapped up their nominations. If accurate, this promises to be the longest general election campaign in modern history.
10. The Chinese stock market is struggling. While the official release was +5.2% real GDP in Q4, many argue China is in a recession complicated by a debt crisis and severe real estate problems in the short run, and a massive population shrink in the long run.

## Earnings Growth and Fed Cut Expectations Remain Robust

The odds of an aggressive Fed rate-cutting cycle receded further last week, with increasing evidence of economic resilience, if not an outright improvement in growth. Financial markets have been buoyant with valuations hitting fresh highs. The revival in risk markets has not been surprising given the significant Fed verbal stimulus delivered since late-October, via the drop in bond yields and rate cut expectations. Bond investors are still following central bank guidance, particularly the now-dovish Fed Chair Powell. Therefore, Goldilocks market conditions may persist until bond yields rise or economic/earnings growth disappoints.

Central banks and bond-bulls remain in a mindset that all roads lead to 2% inflation, having been so well rewarded in holding this view for most of the last decade. The 2020s, however, have been and will likely remain different, and the conditions for another upleg in bond yields exist. At the moment, economic conditions do not warrant aggressive rate cuts or, for the time being, any cuts at all. Such cuts may still occur.

The glide-path to low and stable inflation is far from assured, with signs of sticky core inflation in most developed economies. Manufacturing activity has been notably weak after the pandemic boom in goods demand cooled, causing a downturn in global trade. However, global trade has been gradually improving, especially in Asia. The service sector was impacted by weakness in manufacturing, and now PMI service sector gauges have also firmed outside of the euro area. In terms of gauging economic conditions, it has been helpful to focus on actual employment trends and hiring plans, along with income growth and debt servicing, as well as excess savings and balance sheets. These factors have delayed recession.

| INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN) (%) | LAST WEEK | YEAR-TO-DATE |
|---|---|---|
| MSCI ACWI | 1.24 | 0.91 |
| MSCI ACWI EX U.S. | 1.50 | -1.79 |
| MSCI EAFE | 1.46 | -1.10 |
| MSCI EM | 1.79 | -3.42 |

| FIXED INCOME MARKETS (INDEX TOTAL RETURN) (%) | LAST WEEK | YEAR-TO-DATE |
|---|---|---|
| BLOOMBERG U.S. AGGREGATE BOND | 0.20 | -1.19 |
| BLOOMBERG U.S. CORP HIGH YIELD | 0.50 | -0.18 |
| BLOOMBERG U.S. GOV/CREDIT | 0.19 | -1.15 |
| BLOOMBERG U.S. T-BILL 1-3 MONTH | 0.06 | 0.35 |

| ALTERNATIVES (INDEX TOTAL RETURN) (%) | LAST WEEK | YEAR-TO-DATE |
|---|---|---|
| REAL ESTATE (FTSE NAREIT) | -0.43 | -3.31 |
| COMMODITIES (DJ) | 1.45 | -0.14 |
| GLOBAL LISTED PRIVATE EQUITY (RED ROCKS) | 2.86 | -0.64 |
| CURRENCIES (DB CURRENCY FUTURE HARVEST) | 0.18 | 2.62 |

Continued above-potential economic growth and increasingly positive equity and credit markets (spreads have narrowed to historically low levels) challenge Powell's assertion that U.S. monetary conditions are "restrictive". U.S. employment conditions remain remarkably robust, off their best readings for the cycle but still historically elevated.

## Conclusion:

Near-term, the conditions for lower U.S. policy rates do not exist. The Fed may well decide to ease but the economy already is growing at or above potential which is likely to cause inflation to remain sticky. The risk to stocks are higher bond yields, further reduction in Fed cut expectations, and/or continued downward earnings revisions.

Data from Bloomberg, as of 1/26/2024.