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Doll's Deliberations

Weekly Investment Commentary

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Summary:
Stocks advanced again last week (S&P 500 +1.4%) as the S&P 500 closed above 5,000 for the first time and small stocks beat big ones for the fifth time in the past seven weeks. Earnings exceeded expectations and treasury yields increased. Best sectors were technology (+3.3%) and consumer discretionary (+1.5%); worst sectors were utilities (-1.9%) and consumer staples (-1.3%).

Key takeaways:

1. The consensus view has shifted from expectations for the U.S. economy to glide down for a soft landing to a growing belief that the U.S. won't experience any downturn. Hardly any mention of the word "recession".
2. The Challenger layoff report showed an uptick in layoff announcements for January (concentrated in Financials and Tech).
3. The U.S. Federal Reserve Senior Loan Officer Opinion Survey (SLOOS) continues to show the impact of the Fed's tightening cycle. Banks are still tightening lending standards as signs that credit performance is deteriorating build.
4. We anticipate some stronger inflation data for the next couple of months before there is another chance for inflation to recede again.
5. 2023's S&P 500 EPS is now tracking at $223 (flat vs. 2022's actual). Meanwhile, 2024's S&P 500 EPS forecast is now tracking at $243 – down from $245 a few weeks ago.
6. The stock market dilemma: the market is pricing in no risk of a downturn and is looking for earnings reacceleration, but at the same time the expectation is for aggressive Fed cuts and continued disinflation. All this with a P/E of 20x.
7. Regional banks have been in the spotlight since mid-cap regional New York Community Bank (NYCB) shocked investors two weeks ago with an enormous credit loss. The KBW regional bank index fell as much as 12%, while NYCB lost almost half its value, careening to a 24-year low. Most analysts agree that this is a one-off and not a systemic problem.
8. Small caps are witnessing more downward revisions to 2024 earnings.
9. International stocks continue to lag the U.S. with U.S. averages up 3-5% already this year. Non-U.S. markets are down modestly so far this year. The outperformance of U.S. stocks is largely attributed to the relatively greater weight of tech in the U.S. index.
10. China's domestic deflation highlights the need for greater policy support. Authorities have yet to deliver the large-scale stimulus that is needed to end the deflationary dynamics plaguing the economy and drive a recovery.

EQUITY MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
DJIA	0.09	2.74
S&P 500	1.40	5.52
NASDAQ	2.34	6.58
RUSSELL 1000	0.88	4.61
RUSSELL 1000 GROWTH	2.58	8.78
RUSSELL 1000 VALUE	0.14	1.09
RUSSELL 2000	0.89	-2.26

S&P EQUITY SECTORS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	1.02	12.05
CONSUMER DISCRETIONARY	1.47	2.32
CONSUMER STAPLES	-1.31	1.95
ENERGY	-0.22	-0.50
FINANCIALS	0.23	3.90
HEALTHCARE	1.43	5.69
INDUSTRIALS	1.18	2.66
INFORMATION TECHNOLOGY	3.25	10.25
MATERIALS	0.03	-2.84
REAL ESTATE	0.25	-4.06
UTILITIES	-1.94	-4.85

Hard Landing → Soft Landing → No Landing → Taking Off?

Economic activity is broadening and strengthening. PMI manufacturing surveys are firming after a notably weak 2023, catching up to somewhat better economic data and consistent with evidence of a revival in the global trade cycle. The brightening economic outlook will be reinforced by the recent significant easing in monetary and financial conditions, sparked by expectations of a meaningful rate-cutting cycle. This has led to much higher risk asset prices since October. The main investment implication from the evolving global economic outlook is that the post-October drop in bond yields will end the same way as previous countertrend declines during 2022-2023, namely with another upleg in yields. This, in turn, will flip the recent re-rating trend in asset markets to reversed de-rating pressures.

We do not expect economic and inflation issues to be as significant as the last couple of years but rather just better growth (for now) and for inflation to hold above pre-pandemic levels with inflation risk tilted to the upside. For the time being, the economic and inflation outlook will likely cause investment risks to increase over time. The risk-on phase since late-October has driven the stock/bond ratio to new highs, and spurred a further narrowing in credit spreads. Non-U.S. equities continue to lag, but have been grinding higher.

The economic backdrop is indeed improving, as highlighted in recent PMI surveys. Even commodity markets have provided some economic stimulus, with prices staying low, which helps to suppress inflation fears and provides an economic tailwind. Weak food and energy prices that reflect plentiful supplies, rather than deteriorating demand, are a good kind of deflation, as they act to stimulate growth over time.

Longer-term inflation expectations have stayed calm after recovering from the pandemic deflation scare. This action reflects a deep-seated complacency over the inflation outlook. Ironically, investors' willingness to accept low real bond yields and by persistently expecting significant rate cuts helps to boost economic activity which increases the longer-term inflation risks.

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN) (%)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	0.62	2.54
MSCI ACWI EX U.S.	0.20	-1.21
MSCI EAFE	-0.02	-0.57
MSCI EM	0.95	-2.51

FIXED INCOME MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.73	-1.38
BLOOMBERG U.S. CORP HIGH YIELD	0.04	0.07
BLOOMBERG U.S. GOV/ CREDIT	-0.74	-1.32
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.06	0.55

ALTERNATIVES (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-0.15	-4.55
COMMODITIES (DJ)	0.39	-1.11
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	1.22	0.23
CURRENCIES (DB CURRENCY FUTURE HARVEST)	0.77	3.43

Looking further into 2024, the Fed and other central banks have to validate market expectations for much lower policy rates just for government bond yields to hold near current levels. We doubt that the Fed will comply, even if some rate cuts occur this year. Instead, renewed upward pressure on bond yields looms as markets unwind aggressive rate cut expectations in response to continued solid U.S. and improving global economic growth.

Conclusion:

Renewed economic strength, plus strengthening global trade and signs of life in manufacturing indicators, reinforce the upbeat message from equity and credit markets. That is, global monetary conditions are not restrictive. For now, the brightening growth outlook has helped to sustain the post-October risk-on phase. This will persist until upward pressure on government bond yields intensifies. We expect such a development to gradually take hold as central banks will not validate current expectations for aggressive rate cuts.

Data from Bloomberg, as of 2/9/2024.

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