CROSSMARK GLOBAL INVESTMENTS

March 18, 2024 | Issue 4.12

Doll's Deliberations

Weekly Investment Commentary

Robert C. Doll, CFA®
Chief Executive Officer,
Chief Investment Officer

Summary:
Stocks fell last week (S&P 500 -0.1%) and bonds fell (the 10-year yield was up more than 20 bp) due primarily to a higher-than-expected CPI. Best sectors were energy (+3.8%) and materials (+1.6%); worst sectors were real estate (-2.8%) and consumer discretionary (-1.2%).

Key takeaways:

1. U.S. headline inflation accelerated from 0.3% m/m to 0.4% m/m in February. (A rise in gasoline prices and shelter inflation accounted for 60% of this increase.) The annual rate of change in the headline index unexpectedly accelerated from 3.1% to 3.2%. Core inflation came in at 0.4% m/m and 3.8% y/y. Inflation is again showing itself to be sticky.
2. The New York Fed's Survey of Consumer Expectations showed an uptick in inflation expectations. Specifically, the three-year ahead measure rebounded from a record low of 2.4% to 2.7% and the five-year ahead gauge rose from 2.5% to a six-month high of 2.9%. The one-year horizon remained unchanged at 3.0%.
3. Fed funds futures now see two and one-half rate cuts in 2024, down from six and one-half at the start of the year.
4. Upward earnings revisions are rather unusual for index EPS figures, but 2025 has been revised up, expecting a growth rate of 13% (on top of 11% growth expected for 2024).
5. Slowing the stock market last week have been hotter-than-expected CPI and PPI reports for February. That increases the likelihood that Fed rate cuts will be fewer and later. Also, weighing on stocks are the weaker than expected February retail sales (+0.6% m/m, below the 0.8% expected) and some sluggishness in employment and employment claim releases.
6. The BBR (Bull/Bear Ratio) shows the highest reading since December 2017, yet another sign of the amount of bullishness among investors.
7. The largest 10 stocks now represent 25% of the S&P 500 index market capitalization, a new record.
8. The equity risk premium for the S&P 500 has dropped to a 20+ year low, suggesting prospective returns are likely to be mediocre.
9. Gold has had a big rally over the past few weeks, gaining 9.2% since Feb. 14 and reaching consecutive all-time highs. Causes include a fall in the dollar and a decline in interest rates (until last week).
10. While politicians seem unconcerned about the growing Federal debt and deficits, the credit rating agencies will be watching carefully as deficits of nearly $2 trillion per year become the norm.

EQUITY MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
DJIA	0.01	3.22
S&P 500	-0.09	7.63
NASDAQ	-0.68	6.58
RUSSELL 1000	0.44	7.94
RUSSELL 1000 GROWTH	-0.24	8.97
RUSSELL 1000 VALUE	-0.10	5.29
RUSSELL 2000	-2.42	0.48

S&P EQUITY SECTORS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	0.46	11.38
CONSUMER DISCRETIONARY	-1.18	1.41
CONSUMER STAPLES	0.56	5.42
ENERGY	3.77	9.31
FINANCIALS	0.47	8.52
HEALTHCARE	-0.70	6.69
INDUSTRIALS	-0.17	7.18
INFORMATION TECHNOLOGY	-0.36	10.87
MATERIALS	1.60	6.08
REAL ESTATE	-2.81	-2.51
UTILITIES	-0.46	0.17

Becoming More Concerned

Last week's inflation reports evidence that the glide path for a return to 2% inflation is not unfolding the ways the bulls and the Fed have been anticipating. Rather, in the case of the U.S., underlying inflation has leveled off near 4%. (We still see a possible path to 3%, but not 2%.) There has been a deeply entrenched view that all roads lead to low and stable inflation, and thus, substantial rate cuts have been expected this year. The timing of those cuts keeps getting pushed further into the future and fewer rate cuts are now discounted for this year than was anticipated at the end of 2023.

The ultimate end point for the U.S. fed funds rate has persistently held near 3.5%, which is below the economy's long-run nominal potential growth rate. Not surprisingly, the risk-on backdrop has continued against a backdrop of expected rate cuts and ongoing positive corporate profit trends. Fed Chair Powell has cornered himself, in our opinion, by claiming that monetary conditions are restrictive and thus lower rates will be needed to sustain the economic expansion. However, by definition, if policy were restrictive, the economy would be growing at a below potential rather than above potential rate, as is now the case. While the Fed has not yet signaled imminent rate cuts, it also has not pushed back on the widespread market view that rates have peaked for the cycle.

In addition, and infrequently noted by most market participants, the global economy outside the U.S. is showing signs of gaining momentum. Global trade is recovering and, now, manufacturing activity is firming after a notably weak past 12-18 months. The implication is that a durable and broader period of global growth is possible, if not likely.

Why has recession not happened? After all, the Fed raised rates the most and fastest in modern history, the yield curve inverted, and money growth turned negative. That severely curtailed bank lending as it normally does. So where did the money come from to sustain economic growth? Fiscal stimulus and excess savings from the pandemic are certainly part of the answer. On top of that, and unique to this cycle, was the private credit spigot (grew from zero to nearly $2 billion over the last decade, with nearly half of that growth coming in the last couple of years). So does that just postpone a recession or avert a recession? Given the deterioration in leading indicators for the labor market, (e.g., antiquated and therefore delayed data from the household survey – look at the significant negative jobs revisions in recent labor data, the NFIB hiring plans index deteriorating, and the decline in the Conference Board Employment Trends Index), our view is just a postponement of a recession. So far, the service portion of the economy has held up well.

The trend in inflation is the most critical macro variable at this time. An improving global economic outlook and ongoing U.S. economic strength warn against complacency on the inflation outlook. Already, recent data have confirmed the stickiness of inflation, with some firming in underlying measures.

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN) (%)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	0.22	6.57
MSCI ACWI EX U.S.	-0.26	4.05
MSCI EAFE	-0.94	4.78
MSCI EM	1.21	2.73

FIXED INCOME MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-1.16	-1.65
BLOOMBERG U.S. CORP HIGH YIELD	-0.12	0.89
BLOOMBERG U.S. GOV/ CREDIT	-1.07	-1.57
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.06	1.07

ALTERNATIVES (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-2.77	-3.39
COMMODITIES (DJ)	1.31	1.69
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	-1.45	3.66
CURRENCIES (DB CURRENCY FUTURE HARVEST)	0.20	4.55

Conclusion:

As explained above, we are still in the economic weakness/mild recession camp. In addition, with the stubborn inflation numbers of late, the increased number of weakening economic statistics, the signs of reduced liquidity starting soon, elevated bullish sentiment, and full, if not expensive, valuations, we are becoming more concerned about the equity market. The probability of a noticeable correction in stocks has increased, although predicting the end of a momentum run is generally a fool's errand.

Data from Bloomberg, as of 3/15/2024.

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