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Doll's Deliberations

Weekly Investment Commentary

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Summary:

Equities posted their best weekly performance this year (S&P 500 +2.31%). The rally was sparked by dovish takeaways from last week's Federal Open Market Committee meeting. Best sectors were communication services (+4.78%) and technology (+2.94%); worst sectors were real estate (-0.38%) and healthcare (+0.40%).

Key takeaways:

1. There were no meaningful adjustments to the Fed's communication last Wednesday. Chair Jay Powell noted that the risks to achieving the Fed's goals are coming into better balance. The dot plot set the dovish tone with a 70 basis point upward revision to 2024 growth, 20 basis point increase to core PCE projections, and the same median 2024 dot. (In theory, a stronger growth and inflation outlook "should" have translated to a higher projection for rates.)
2. The most important variable driving consumer spending overall is employment. There have been small cracks in the U.S. job picture. The FOMC is likely to wait and gather more data on this issue as well as the stickiness of inflation before deciding to cut rates.
3. Manufacturing activity firmed in March as the manufacturing PMI climbed to 52.5%, the highest since June 2022.
4. a) The February Leading Economic Index (LEI) ticked up 0.1%, its first increase in over two years.

   b) Last week marked the longest inversion of the Treasury yield curve (625 days), surpassing the previous record in 1978. (An inverted yield curve has been the best predictor of recession through history.)
5. Our economic slowdown (and eventual recession) expectations stem from a depletion of pandemic era excess savings, banks tightening of lending standards leading to less ability to access credit, and expected deceleration in nominal and real wage growth.
6. U.S. investment grade and high yield spreads have tightened roughly 40 and 130 basis points, respectively, since their October 2023 highs, resulting in the outperformance of both fixed income sectors relative to equivalent-duration Treasuries. As economic growth slows, we expect a reversal in that tightening process.
7. The 2024 and 2025 annual EPS estimated growth rates are 11% and 13%. Both of these figures remain well above the long-term average growth rate for the index.
8. Since 1950, on average, the S&P 500 is up 5% between the last Fed tightening and the first rate cut. However, after the first rate cut in a series, the market has fallen 23% on average.
9. The top market concern of a potential Trump presidency revolves around tariffs, which Trump has promised to raise to 60% against rivals like China. A trade war will be a huge concern for the markets. A secondary concern is potential isolationism.
10. "Prices reflect near perfection, yet today's world is particularly imperfect and dangerous."
    – Jeremy Grantham, March 2024

EQUITY MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
DJIA	1.97	5.25
S&P 500	2.31	10.12
NASDAQ	2.86	9.63
RUSSELL 1000	2.51	9.97
RUSSELL 1000 GROWTH	2.85	12.08
RUSSELL 1000 VALUE	1.66	7.03
RUSSELL 2000	2.91	3.83

S&P EQUITY SECTORS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	4.78	16.70
CONSUMER DISCRETIONARY	2.79	4.25
CONSUMER STAPLES	1.02	6.50
ENERGY	1.76	11.23
FINANCIALS	1.86	10.54
HEALTHCARE	0.40	7.12
INDUSTRIALS	2.90	10.29
INFORMATION TECHNOLOGY	2.94	14.13
MATERIALS	1.00	7.14
REAL ESTATE	-0.38	-2.87
UTILITIES	1.49	1.66

Double-Digit Earnings Growth and Multiple Fed Rate Cuts Seem Incompatible

The Fed met and, as expected, did not move rates, but seems determined to cut rates with the timing getting pushed further into the future. Its latitude to ease policy has diminished noticeably this year, as economic activity has been robust and inflation has already shown signs of stabilizing well above the target rate. It is apparent that aggregate global monetary conditions are not restrictive and liquidity remains plentiful, as manifested in both the ongoing global economic expansion, which is showing signs of firming and broadening, and the risk asset rally in almost all markets since October, which is showing signs of overheating.

The weakest global economies and sectors need to be closely monitored, because this is where the next global recession will ultimately take hold. For now, the cracks in the weak-link economies are not sufficient to warrant shifting to a defensive investment stance, and the decline in bond yields in developed markets since October has provided a reprieve.

The forward markets have persistently, and often aggressively, front-run rate cuts. Historically, as the Fed has tightened, investors eventually discounted an overshoot in policy rates and bond yields would climb well into undervalued levels. At that point, economic damage would occur, which would sow the seeds for the next rate-cutting cycle. Such overshooting has not happened this cycle, although bond yields seemed on track to do so last autumn before Fed Chair Powell's abrupt dovish pivot.

With corporate earnings grinding higher, equity markets have celebrated the "easing" in overall conditions since October. The Fed remains dovish and is still signaling three rate cuts over the balance of the year. This dovishness is out of sync with recent higher-than-expected inflation and an upgrade in the Fed's GDP forecast for 2024. The combination of dovishness without an offsetting economic downside seemed a clear signal for investors to take risk. The latter have taken heart from the fact that the Fed seems unconcerned about asset inflation.

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN) (%)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	2.07	8.08
MSCI ACWI EX U.S.	1.36	4.80
MSCI EAFE	1.39	5.83
MSCI EM	1.38	2.78

FIXED INCOME MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	0.40	-1.33
BLOOMBERG U.S. CORP HIGH YIELD	0.54	1.32
BLOOMBERG U.S. GOV/CREDIT	0.35	-1.30
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.06	1.17

ALTERNATIVES (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	1.18	-2.40
COMMODITIES (DJ)	-0.39	1.30
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	2.59	6.47
CURRENCIES (DB CURRENCY FUTURE HARVEST)	0.60	5.18

We expect sticky consumer price inflation and resilient economic growth to eventually force the Fed to pivot to a less dovish stance. Given recent data, it is odd to see such persistent dovishness, particularly since the Fed so badly missed the upside in the inflation and economic outcomes since 2021. The dovish bias is the consequence of an entrenched belief that all roads lead to 2% inflation. Although the Fed may still cut rates this year, either resilient growth and firming inflation will force the Fed to abandon cuts thereafter, or an economic slowdown will cause earnings to disappoint.

Conclusion:

Further near-term upside is probable in risk asset markets as momentum indicators continue to flash green lights. Monetary conditions are not restrictive but most central banks are determined to ease policy as soon as possible. Inflation has proven sticky. It is unlikely the markets can enjoy both double-digit earnings growth and Fed rate cuts.

Data from Bloomberg, as of 3/22/2024.

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