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Doll's Deliberations®

Weekly Investment Commentary

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Summary:
U.S. equity indexes were mixed last week with the market largely rotating out of big tech/momentum/growth into value/cyclicals/small caps. The S&P 500 Index was down (-1.95%); the NASDAQ fell (-3.65%); and the Russell 2000 Index was up (+2.33%). Themes included soft-landing hopes, expectations for a Fed rate pivot, and a surge in the "Trump trade." Best sectors were energy (+2.06%), real estate (+1.32%), and financials (+1.19%); worst sectors were technology (-5.14%), communication services (-2.87%), and consumer discretionary (-2.68%).

Key takeaways:

1. Initial jobless claims rose 20,000 in the last reporting week. While alarming at the headline level, Hurricane Beryl caused as much as half the increase. But the labor market is definitely weakening.

2. The earlier in the month negative June CPI reading may be signaling some weakness in revenues and pricing power.

3. Fed governors are strongly hinting at a September rate cut even before its July meeting, essentially "delivering" the September cut early as downside risks to the economy are growing.

4. The Fed's Beige Book confirmed that the deceleration in U.S. activity continues. We continue to think that investors are overstating the chances of a soft landing (e.g., P/E ratios are well into the 20s). The long and variable lags from the Fed's massive rate hike in a short period of time have taken time to impact the economy, with more consequences to come.

5. We are only into the second week of 2Q earnings reports, but estimates have already fallen from 10% to under 9%.

6. In the eight days ending July 17, the Russell 2000 was up 10.4%, while the Magnificent 7 was down -7.2%. These eight days have erased roughly half of the Magnificent 7 lead over small stocks year-to-date.

7. The small cap rally feels more like a trade than the start of something bigger. Earnings projections for small cap stocks are improving, but still mediocre. And the fact that companies with high short interest are outperforming suggests a short covering rally.

8. The odds of Donald Trump winning the presidency have risen markedly (PredictIt shows 67%) following President Biden's poor showing at the June debate, the attempted Trump assassination, and a successful Republican convention. Increased tariffs on imports, decreased inflows of immigrants, widespread deregulation, and an extension of Trump tax cuts are likely, especially if a Republican sweep occurs.

9. The Republican party has largely realigned with a populist/protectionist thrust, leaving the old mantras of free trade and international foreign policy engagement.

10. According to Wolfe Research, Trump's proposed tariffs (10% baseline and 60% on Chinese imports) could cause a 1.7% hit to GDP, a 66-basis point increase in core inflation, and a $1,500 "tax" per household.

EQUITY MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
DJIA	0.73	8.01
S&P 500	-1.95	16.30
NASDAQ	-3.65	18.55
RUSSELL 1000	-1.18	16.12
RUSSELL 1000 GROWTH	-3.95	19.78
RUSSELL 1000 VALUE	0.67	9.87
RUSSELL 2000	2.33	9.26

S&P EQUITY SECTORS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-2.87	23.48
CONSUMER DISCRETIONARY	-2.68	7.10
CONSUMER STAPLES	1.01	11.33
ENERGY	2.06	12.28
FINANCIALS	1.19	14.86
HEALTHCARE	-0.26	9.34
INDUSTRIALS	0.56	10.35
INFORMATION TECHNOLOGY	-5.14	27.02
MATERIALS	-0.44	6.22
REAL ESTATE	1.32	2.92
UTILITIES	-1.56	12.60

Is the stock market broadening?

After a prolonged period of extraordinarily thin equity market leadership focused on a few mega cap tech and related shares, the past week or two has witnessed an abrupt change in market dynamics. Some laggard sectors within the market have jumped to new highs, and the equally weighted index has finally broken above its recent trading range. Market commentators have noted that this shift mostly reflects some profit-taking in the high-flyers and short-covering in the laggards. However, it is usually the case that an initial rise in laggards reflects short-covering after a long period of underperformance. If the fundamentals subsequently improve, then the shift in leadership will prove durable. If not, then the pop in laggards will likely fade.

It is too soon to decisively claim that a major change is indeed underway, despite calls for such a shift for some time. The abrupt shift in equity market dynamics appears to have been spurred by a favorable CPI report and then increased odds of a Republican sweep in the U.S. elections this November. There are high hopes for an even more pro-business environment, as well as lower interest rates.

There will be some economic offsets arising from former president Trump's stated intentions. These include greater protectionism and tariffs, which will be clear negatives for foreign economies and parts of the U.S. economy as well. (Already, semiconductor stocks have been hit after Trump implied that the U.S. might not defend Taiwan in the event of an attack by China.) Time will tell what actions will actually be taken and the magnitude of the policies, and the election is still almost four months away. However, for now, hopes will remain elevated that the economic expansion will roll on.

We do not expect a significant rate-cutting cycle, especially for the Fed. Rather, disappointment looms beyond the next three to six months, as we expect the path for rate cuts to narrow. The forward markets remain keen to discount much lower rates over the next two years, which is pro-growth and supportive of risk-on. Ironically, the front-running of rate cuts ever since the rate-hiking cycle began has undermined the central banks' intentions to cool growth to bring down inflation.

At the end of the day, inflation is the key issue for the U.S. and global economy that will determine whether a Goldilocks world will exist for an extended period, or only briefly. Our view is that inflation is not on track to fade away as it did last decade. The fact that many economies have sticky domestically sourced inflation despite soft/weak growth in the past one to two years is a warning to policymakers.

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN) (%)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	-1.33	13.52
MSCI ACWI EX U.S.	-1.39	8.66
MSCI EAFE	-1.47	8.46
MSCI EM	-1.52	9.85

FIXED INCOME MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.09	0.73
BLOOMBERG U.S. CORP HIGH YIELD	0.39	4.10
BLOOMBERG U.S. GOV/ CREDIT	-0.09	0.70
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.06	2.95

ALTERNATIVES (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	1.66	3.65
COMMODITIES (DJ)	-3.15	1.81
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	0.63	10.40
CURRENCIES (DB CURRENCY FUTURE HARVEST)	-0.45	11.15

Conclusion

The period of extremely thin equity market leadership may be ending, with a broadening in participation favoring select laggard sectors and non-U.S. markets. The overall Goldilocks environment is likely to persist, given the keenness of central banks to ease at a time when global growth is gradually broadening and strengthening. The long-run outlook, however, is unchanged: Domestically sourced inflation will remain sticky and most central banks will have less latitude to ease than the forward markets are discounting.

Data from Bloomberg as of July 19, 2024

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