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Doll's Deliberations®

Weekly Investment Commentary

Robert C. Doll, CFA®
CEO/CIO

Summary:

U.S. equities hit a new all-time high (S&P 500 +1.39%). Gains came in a week that saw the Fed's long-awaited dovish pivot and data releases continuing to support a soft-landing thesis. Best sectors were energy (+3.80%) and communication services (+3.73%); worst sectors were consumer staples (-1.18%) and real estate (-1.15%).

Key takeaways:

1. The Fed lowered rates by 50 basis points (bp), the higher end of 25-50 bp expectations. In essence, the Fed is stating that its main focus now is fighting rising unemployment, having tacitly declared a near victory on inflation.
2. This is the second-longest length of time between the last Fed rate hike and the first cut (146 days). But, it is the strongest for the S&P 500.
3. According to Piper Sandler, the last two times the Fed cut rates 50 bp for the first cut, recessions followed.
4. The combination of 10 more 25 bp cuts in Fed funds coupled with double-digit earnings growth would be unprecedented and indicate a successful soft landing.
5. The economic outlook depends on the labor market and resultant consumption patterns. With labor softening (both jobs and wages) and credit levels rising, consumption is likely to weaken despite rate cuts (because monetary policy works with long lags).
6. The Atlanta Fed's GDP Now model raised Q3 real GDP to 3.0% from 2.5% following the better-than-expected retail sales and industrial production reports from August.
7. University of Michigan consumer confidence rose more than expected to 68.5 from 67.9.
8. After the first rate cut, historically the best sectors are consumer staples, healthcare, and utilities.
9. It is possible that a mild recession or even a noticeable slowdown could lead to a more significant stock market downturn due to high earnings growth expectations and high valuations.
10. Net interest expense as a percentage of tax revenue is now 17%, almost as high as the defense budget.

EQUITY MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
DJIA	1.67	13.21
S&P 500	1.39	20.78
NASDAQ	1.51	20.21
RUSSELL 1000	1.72	20.22
RUSSELL 1000 GROWTH	1.63	23.48
RUSSELL 1000 VALUE	1.37	15.32
RUSSELL 2000	3.23	12.23

S&P EQUITY SECTORS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	3.73	26.51
CONSUMER DISCRETIONARY	2.30	12.26
CONSUMER STAPLES	-1.18	18.41
ENERGY	3.80	8.37
FINANCIALS	2.36	22.15
HEALTHCARE	-0.51	14.92
INDUSTRIALS	2.03	17.76
INFORMATION TECHNOLOGY	1.00	28.11
MATERIALS	1.56	11.05
REAL ESTATE	-1.15	13.54
UTILITIES	2.00	28.68

Is the Fed taking away the punch bowl or just priming the pump for more asset inflation?

The Fed surprised some by beginning the rate cut cycle with a 50 bp cut. While delayed by a day, the stock market celebrated as the Fed provided dovish guidance to the end of 2025. The Fed believes that the inflation threat is over and is now keen to support the economy. Fed Chair Powell has previously suggested that the link between better economic growth and higher inflation broke down in recent decades, because inflation remained subdued independent of the economy's performance.

The Fed has focused only on consumer price inflation and has been willing to ignore rapid asset inflation, and recently has given investors a green light to take on greater risk. Many are arguing that the U.S. economy is neither in need of a monetary boost nor suffering under the burden of an excessively high cost of capital. Nor were asset markets struggling and starved for liquidity.

The recent economic slowdown, evident primarily in certain areas of consumption and labor, as well as subdued inflation has caused the Fed to start the cutting cycle. Some argue that the U.S. economy is receiving monetary assistance, which will prove reflationary. If true, the ongoing rise in house prices will persist, which is at odds with the Fed's claim that policy has been highly restrictive. Improved housing activity will add to an economy that is already growing well above its long-run potential. While a progressively lower Fed fund rate may cap Treasury yields for a time, the latter are also likely to have limited downside since rate cut expectations are already aggressive. The biggest beneficiary of Fed rate cuts might ultimately be risk asset markets including equities, credit, and house prices.

This argument goes on to say the Fed will be cutting rates for an extended period unless economic growth meaningfully inflects higher, which in turn would further boost already rising corporate earnings. Lower rates will support, if not boost, valuations (especially for previously lagging, relatively less expensive U.S. equity sectors and for non-U.S. markets), and if rate cuts stop due to better growth, then the bullish baton will be passed to corporate earnings. What this logic perhaps misses is the delayed impact of the longest and fastest rate-hike cycle in modern history, which may just now be impacting the economy.

The bearish economic message from the U.S. yield curve has been missed by global equity markets (and credit markets, with historically narrow high-yield corporate bond spreads over government debt). In the end, it is the aggregate cost of capital that matters, and the latter never became economically restrictive.

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN) (%)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	1.54	16.87
MSCI ACWI EX U.S.	1.38	11.10
MSCI EAFE	1.25	11.48
MSCI EM	1.67	9.74

FIXED INCOME MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.15	4.78
BLOOMBERG U.S. CORP HIGH YIELD	0.86	7.89
BLOOMBERG U.S. GOV/ CREDIT	-0.13	4.68
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.08	3.93

ALTERNATIVES (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-0.64	13.74
COMMODITIES (DJ)	2.14	3.42
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	4.09	18.85
CURRENCIES (DB CURRENCY FUTURE HARVEST)	1.68	8.34

Conclusion

The Fed is positioning for the elusive soft-landing scenario. While a difficult balancing act, the Fed is hoping that rate cuts will offset any economic weakness and assure inflation is nearly conquered.

Data from Bloomberg as of Sept. 20, 2024

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