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Doll's Deliberations

Weekly Investment Commentary

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Summary:

After three straight weekly declines, equities were higher last week (S&P 500 +2.68%). Corporate earnings, especially big tech, were a key driver. Best sectors were technology (+5.11%) and consumer discretionary (+3.52%); worst sectors were materials (+0.66%) and energy (+0.74%).

Key takeaways:

1. 1Q GDP came in lower than expected (1.6% vs. 2.4%), but internals were generally okay. Core PCE inflation, however, was expected to be 3.4% but instead came in at 3.7%.
2. After last week's stronger than expected inflation reports, market participants reduced the number of Fed cuts expected by year end to just one. Inflation remains sticky, but the bar to raise rates is very high.
3. PMIs suggest growth in the U.S. might be slowing. The manufacturing index declined to contraction territory of 49.9 from 51.9, falling short of expectations of 52. The services PMI also disappointed, coming in at 50.9, versus expectations it would improve from 51.7 to 52.
4. Excess savings are dwindling and have little scope to support consumption further. Lending standards are tight and borrowing costs are on the rise; income growth – arguably the largest driver of consumption growth – has already decelerated; and forward-looking indicators suggest further weakness ahead.
5. The middle class is the pivotal class for consumption. They are beginning to show fatigue with slowing incomes and some joblessness.
6. Early observations in earnings are that EPS are trending above expectations but revenue shortfalls are more prevalent than usual.
7. Until recently, equity sentiment has been very bullish (a contrarian cautionary signal). Over the last two weeks, sentiment has turned neutral.
8. The 10 largest stocks in the S&P 500 are now 33.5% of the index, another new all-time high.
9. A second Trump term could bring higher tariffs, attempts to weaken the dollar, even higher deficits, deportation of illegal immigrants, and other policies that could put upward pressure on inflation.
10. The IMF's latest fiscal monitor report highlighted the dangers that rising sovereign debt alongside rising deficits pose to advanced economies. The IMF projects that fiscal deficits in the U.S. will stay above 3% of GDP per year over the next five years, with debt-to-GDP reaching 134% of GDP by the end of the decade. At some point, this is likely to cause pressure on the dollar.

EQUITY MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
DJIA	0.67	2.05
S&P 500	2.68	7.38
NASDAQ	4.23	6.32
RUSSELL 1000	1.67	5.95
RUSSELL 1000 GROWTH	3.69	8.43
RUSSELL 1000 VALUE	1.44	5.29
RUSSELL 2000	1.72	-1.88

S&P EQUITY SECTORS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	2.72	17.56
CONSUMER DISCRETIONARY	3.52	1.11
CONSUMER STAPLES	1.56	6.68
ENERGY	0.74	15.32
FINANCIALS	1.06	8.98
HEALTHCARE	0.75	3.09
INDUSTRIALS	1.83	8.04
INFORMATION TECHNOLOGY	5.11	8.54
MATERIALS	0.66	4.98
REAL ESTATE	1.60	-8.30
UTILITIES	1.18	5.38

Volatility to continue in both directions

The recent rise in bond yields and further unwinding of U.S. rate cut expectations have been sufficient to halt the post-October risk rally. The Goldilocks phase of both easing/flat bond yields and improving corporate earnings backdrop is over, at least for now. This does not necessarily mean that an equity bear market looms, only that the "free lunch" is over. A more volatile and choppy investment environment is developing, where selectivity will become important.

The economic and investment cycles are likely to end in the traditional fashion, namely when monetary conditions become more restrictive, with borrowing rates too high for marginal credits. That eventuality is necessary to slow the overall economy and spur a rebuilding of some economic slack that, in turn, is essential to drive inflation back toward Fed targets.

Geopolitical developments could still upset the economic apple cart. However, we would note that the global economy has managed to stay on its feet and is now showing some improvement despite already stiff political and geopolitical headwinds. But, expectations for aggressive Fed rate cuts have all but disappeared. It is likely that monetary conditions need to tighten further before becoming restrictive. Corporate earnings remain reasonably good, but valuations are under downward pressure, particularly among high growth, mega-cap tech, and related shares.

The path ahead for the stock and credit markets will be bumpier than in the past six months, making the case for further correction more likely than a rally back to the highs. Credit spreads have provided consistently positive signals for the equity market in recent years. Therefore, investors should not ignore the modest widening in high-yield bond spreads in the past week. A sustained widening in such spreads would be equity-bearish.

Sustained equity bear markets coincide with contracting corporate profits. While earnings are likely to disappoint high expectations of two years of double-digit gains, a profit contraction is unlikely. However, investors should be prepared for higher volatility and more frequent setbacks in equities.

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN) (%)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	1.69	4.45
MSCI ACWI EX U.S.	1.67	1.89
MSCI EAFE	1.46	2.29
MSCI EM	2.45	1.06

FIXED INCOME MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.34	-3.44
BLOOMBERG U.S. CORP HIGH YIELD	0.36	0.17
BLOOMBERG U.S. GOV/CREDIT	-0.35	-3.28
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.06	1.69

ALTERNATIVES (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	1.11	-8.38
COMMODITIES (DJ)	-0.03	6.17
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	1.27	2.19
CURRENCIES (DB CURRENCY FUTURE HARVEST)	1.44	7.80

Conclusion:

Risk asset markets have ended the Goldilocks phase for now, and more frequent bouts of risk-off are probable. Still, the positive corporate earnings backdrop means that periods of risk-on are probable whenever bond markets calm.

Data from Bloomberg, as of 4/26/2024.