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Doll's Deliberations®

Weekly Investment Commentary

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Summary:

U.S. equities advanced last week (S&P 500 +3.99%), posting their best weekly performance since last November and erasing the big decline of two weeks ago. Soft-landing optimism remains the key ingredient to the bullish narrative. Outperforming sectors were technology (+7.58%) and consumer discretionary (+5.25%); worst returns included real estate (+0.11%), utilities (+1.18%), and energy (+1.20%).

Key takeaways:

1. The U.S. CPI rose +0.2% m/m (2.9% y/y) and core (ex-food and energy) was +0.2% m/m (3.2% y/y). While inflation has certainly declined, it has not achieved the Fed's 2.0% target.

2. Strong retail sales suggest consumers are still spending down their savings, which is good news near term, but worrisome longer term, especially given the signs of softening labor markets.

3. The trade-offs have now clearly shifted for the Fed. The risks between growth and inflation are moving away from balance. Growth is the main risk now. This states the case for the Fed to lower interest rates by 25 basis points in September and signal further cuts.

4. As the economy continues to slow, we expect corporate and high-yield spreads to widen and defaults to increase.

5. While 2Q earnings exceeded expectations, earnings estimates for Q3 and for the next 12 months have been falling.

6. After achieving a multi-year high two weeks ago (≈66), the VIX has retraced all its advance and is back to the low level of the beginning of the month (≈16).

7. Equity valuation remains at risk especially if growth continues to decelerate and the Fed does not show urgency.

8. The Aug. 5 bottom witnessed an 8.5% peak-to-trough decline in the S&P 500. We remain on guard for choppy conditions to persist and don't rule out a growth scare (drawdown of 14-19%, similar to the 2010, 2011, and 2015-2016 pullbacks) if economic data releases continue to disappoint.

9. A few weeks ago, Trump had a small but important lead in the national polls, mid-single-digit leads in swing states like Arizona, Georgia, and Nevada, and small leads in the key Midwest battleground states of Michigan, Pennsylvania, and Wisconsin. He is now trailing in the national polls and in recent polls is behind in Michigan, Pennsylvania, and Wisconsin.

10. Good predictors of presidential elections include:
    - S&P 500 performance 90 days into the election (up favors incumbent party).
    - The VIX (peaking in summer favors the incumbent party).
    - The misery index (inflation plus unemployment); below 7.353 in October (for trailing 12 months) favors the incumbent party (it is currently 7.212).

EQUITY MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
DJIA	3.02	9.15
S&P 500	3.99	17.47
NASDAQ	5.35	18.00
RUSSELL 1000	3.72	16.26
RUSSELL 1000 GROWTH	5.27	20.45
RUSSELL 1000 VALUE	2.50	11.44
RUSSELL 2000	2.65	6.22

S&P EQUITY SECTORS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	1.00	22.49
CONSUMER DISCRETIONARY	5.25	4.35
CONSUMER STAPLES	1.68	14.84
ENERGY	1.20	10.53
FINANCIALS	3.23	17.25
HEALTHCARE	1.96	13.08
INDUSTRIALS	2.19	12.27
INFORMATION TECHNOLOGY	7.58	27.67
MATERIALS	2.31	6.83
REAL ESTATE	0.11	6.34
UTILITIES	1.18	19.59

What a reversal from last week!

After a few volatile weeks, conditions have calmed in global financial markets. Equity market sentiment remains fragile, as angst about a looming recession and/or a financial accident is lingering. Meanwhile, calls for central banks to accelerate rate cuts have notably increased. Some argue that even the Fed has now fallen behind the economic curve and must quickly cut policy rates due to recessionary labor market conditions. U.S. consumers are mixed despite the deceleration in job growth and rundown in excess savings.

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN) (%)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	3.30	13.00
MSCI ACWI EX U.S.	2.41	7.05
MSCI EAFE	2.80	6.96
MSCI EM	1.24	7.08

The gap between two-year Treasury yields and the Fed funds rate is as negative as it has ever been, on a par with the extreme in 2008 when the U.S. banking system and economy were in freefall. Previous gap extremes have slightly led the start of recessions, but investors could clearly see that economic conditions were already deteriorating, corporate profits were under assault, and financial markets were under far more pressure than what occurred recently.

FIXED INCOME MARKETS (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	0.34	2.70
BLOOMBERG U.S. CORP HIGH YIELD	0.60	5.15
BLOOMBERG U.S. GOV/ CREDIT	0.38	2.65
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.06	3.37

Guided by Fed Chair Powell, investors are assuming that the inflation threat is over, and one needs to be focused on the deteriorating labor market. Indeed, after a strong first quarter, U.S. inflation has been soft and the rebound in underlying inflation rates has reversed. The U.S. economy is operating above its long-run potential and the output gap is positive. This underscores that the risks over time are tilted toward higher U.S. inflation once the various post-reopening distortions fully unwind, and from higher levels than were recorded last decade.

ALTERNATIVES (INDEX TOTAL RETURN) (%)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	0.23	6.17
COMMODITIES (DJ)	0.31	0.36
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	3.87	8.94
CURRENCIES (DB CURRENCY FUTURE HARVEST)	1.30	8.33

Corporate profits are performing fine, and the economic outlook has improved as a consequence of lower bond yields and rate expectations. Government bond yields have declined markedly this summer, as "bond bulls" have front-run policy rate cuts. Meanwhile, equity markets have been grinding higher, and credit spreads continue to be remarkably well-behaved, which is not consistent with the recession/weak growth narrative.

Heightening geopolitical tensions have helped hold back equity buyers and encouraged bond bulls. The increased angst is not yet generating economic headwinds. Oil and natural gas prices moved up modestly despite the epicenter of recent tensions being in key oil-producing nations.

Conclusion

The global economic expansion remains intact and will benefit from rate-cutting expectations. Bond markets are likely to churn having rallied so strongly this summer under the expectation of weaker growth and an end to the inflation threat. For now, positive corporate profit trends and a calm bond market point to a reasonably good stock market.

Data from Bloomberg as of Aug. 16, 2024