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Doll's Deliberations®

Weekly Investment Commentary

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Summary:
U.S. equities rose for the fifth week in a row (S&P 500 +1.13%) closing at an all-time high. Banks were strong as Friday earnings boosted the stocks. Treasuries were weaker (the 10-year yield is up 35 basis points [bps] over the past eight sessions.) Best sectors were technology (+2.51%) and industrials (+2.11%); worst sectors were utilities (-2.55%) and communication services (-1.28%).

Key takeaways:

1. Core CPI was +0.3% (above consensus of 0.2%). Headline CPI was +0.2% (above consensus 0.1%). Annualized core and headline inflation numbers are 3.3% and 2.4%, respectively. While inflation remains lower than it was over the last couple of years, it is still not down to the Fed's 2% target and unlikely to get there absent a recession.

2. Initial unemployment claims jumped to 258,000 (vs. 230,000 expected). The upside was likely driven by Hurricane Helene. This result and the less-good-than-expected inflation number highlighted the Fed's dilemma of continuing to fight inflation while also dealing with less-good employment reports.

3. The quit rate declined, consistent with rising unemployment and slowing wages. ISM Manufacturing came in weak with the employment component down.

4. September's 50 bp rate cut was at least partly about mitigating downside growth. The rate cuts we are likely to see into year-end are about activity slowing down and about underlying inflationary pressures moderating. (We expect two more 25 bp cuts this year.)

5. Annual government data revisions resulted in a significant upward revision in GDP growth since Q2 2020. Revisions also show that the savings rate has been on an uptrend since its 2022 trough, reaching 5.2% in Q2, against previous measures showing a steady downtrend since the beginning of 2023. These revisions are material. A higher savings rate would imply that households have more consumption dry powder than previously believed.

6. Consensus earnings growth expectations for Q3 at the beginning of the quarter were +7.3% and at the end of the quarter were 3.2%. The 3Q earnings reports have just begun.

7. Historically, value outperforms growth when the 10-year Treasury yield is above 4%. The P/E ratio of the top 10 stocks is 30.5x vs. the remaining 490 trading at 18.4x.

8. In the nearly 100 years since the creation of the S&P 500, the 10 best Jan. 1–Sept. 30 performance years were followed by three up and seven down Octobers. Average performance was -2.6%.

9. S&P 500 by quartile breakdown is as follows: Q1 (smallest), Q2, Q3, Q4 (largest); P/E ratio: 14.2, 16.9, 21.0, 23.0l YTD performance: -5%, +8%, +13%, +18%.

10. With high valuations and high profit margins, the prospect for above-average equity returns has diminished. That likely favors dividend and dividend growth strategies.

EQUITY MARKETS (INDEX TOTAL RETURN %)	LAST WEEK	YEAR-TO-DATE
DJIA	1.22	15.42
S&P 500	1.13	23.25
NASDAQ	1.13	22.89
RUSSELL 1000	0.49	21.61
RUSSELL 1000 GROWTH	1.42	26.10
RUSSELL 1000 VALUE	0.92	17.66
RUSSELL 2000	-1.09	9.12

S&P EQUITY SECTORS (INDEX TOTAL RETURN %)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	-1.28	28.98
CONSUMER DISCRETIONARY	-0.84	11.86
CONSUMER STAPLES	0.35	17.19
ENERGY	-0.54	14.39
FINANCIALS	1.82	25.12
HEALTHCARE	1.46	14.28
INDUSTRIALS	2.11	22.77
INFORMATION TECHNOLOGY	2.51	32.90
MATERIALS	1.01	13.74
REAL ESTATE	-0.19	11.14
UTILITIES	-2.55	28.15

Will sticky inflation and a weakening labor market eventually trouble equities?

Equity markets have generally moved higher in the absence of notable bad news, underscoring that the path of least resistance for stock prices is up. Encouragingly for stock bulls, the breadth of gains has broadened beyond just tech shares, and cyclically important sectors such as financials and industrials have continued to move to a series of new highs. Improved market breadth typically results in more upside.

Periodic economic scares have had an impact on investor sentiment, but only briefly, because stock corrections immediately spur lower bond yields. And such scares also have been just that—only a scare, not a lasting period of economic weakness. Geopolitical tensions are running at a high level and may yet trip up risk asset markets by undermining economic activity and confidence. To this end, and given the location of the most worrisome current geopolitical concerns, namely large oil producers, it is notable that oil prices have stayed low in historical terms despite a recent rise. A surge in oil prices toward $100 per barrel would likely be needed to meaningfully hit global equity markets.

That equity and credit markets have been so strong over the past year, while the fact that the U.S. economy has motored along above its potential growth rate, confirms that U.S. monetary conditions never really became restrictive, despite such claims from Fed Chair Powell and others. The chronic expectation of much lower policy rates throughout the rate-hiking cycle, in expectation of a return to a low inflation world, was unprecedented and ultimately provided support to the economic expansion.

With evidence of employment slowing and inflation remaining sticky (albeit at low levels), especially in the service sector, the Fed's job gets more difficult and more complicated. Inflation is unlikely to return to the Fed's 2% target without some economic slack (i.e., a recession or at least a prolonged period of sub-potential GDP growth). A consequence of economic slowdown is the cut in Q3 earnings expectations over the last few months, making actual earnings reports (and Q4 outlooks) increasingly important.

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN %)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	0.11	18.19
MSCI ACWI EX U.S.	-0.70	12.08
MSCI EAFE	-0.13	10.30
MSCI EM	-1.88	15.50

FIXED INCOME MARKETS (INDEX TOTAL RETURN %)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-0.44	2.94
BLOOMBERG U.S. CORP HIGH YIELD	-0.35	7.44
BLOOMBERG U.S. GOV/CREDIT	-0.46	2.86
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.05	4.21

ALTERNATIVES (INDEX TOTAL RETURN %)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-1.36	9.68
COMMODITIES (DJ)	-1.16	6.50
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	-1.20	16.43
CURRENCIES (DB CURRENCY FUTURE HARVEST)	-0.22	9.65

Geopolitical and/or U.S. political developments could yet throw a monkey wrench into asset market performance in the coming months. Geopolitical tensions will remain elevated for the foreseeable future, which likely has already helped government bond markets performance, as investors hedge against a "bad" outcome. In terms of the U.S. election, the outcome for both the presidency and Congress are too close to call and therefore the outlook is more uncertain than usual.

Conclusion

The recent selloff in Treasuries is an early warning that still-aggressive rate cut expectations for the next 12–18 months, especially for the U.S., are likely to unwind. Earnings will be key to determine the direction of equity markets.

Data from Bloomberg as of Oct. 11, 2024