WealthIQ: Spring 2024

Wall of Worry

Executive Summary: The confidence that permeated markets since the Fall has been given a reality check in recent weeks as factors that helped drive the powerful 2023 year-end rally have shifted from a tailwind to a headwind. Add geopolitical risk to the fray, and suddenly markets are facing a 'wall of worry' as investors grapple with staying invested vs. taking profits. In investing, we are often reminded that financial markets and economies differ. This dynamic seems true today, as one of the biggest challenges markets face appears to be an economy that is too strong. Admittedly, that is likely as strange a sentence to read as it is an unusual one to type. However, with financial markets losing sight of the broader economic forest for the narrower narrative trees, recent volatility isn't all that surprising.

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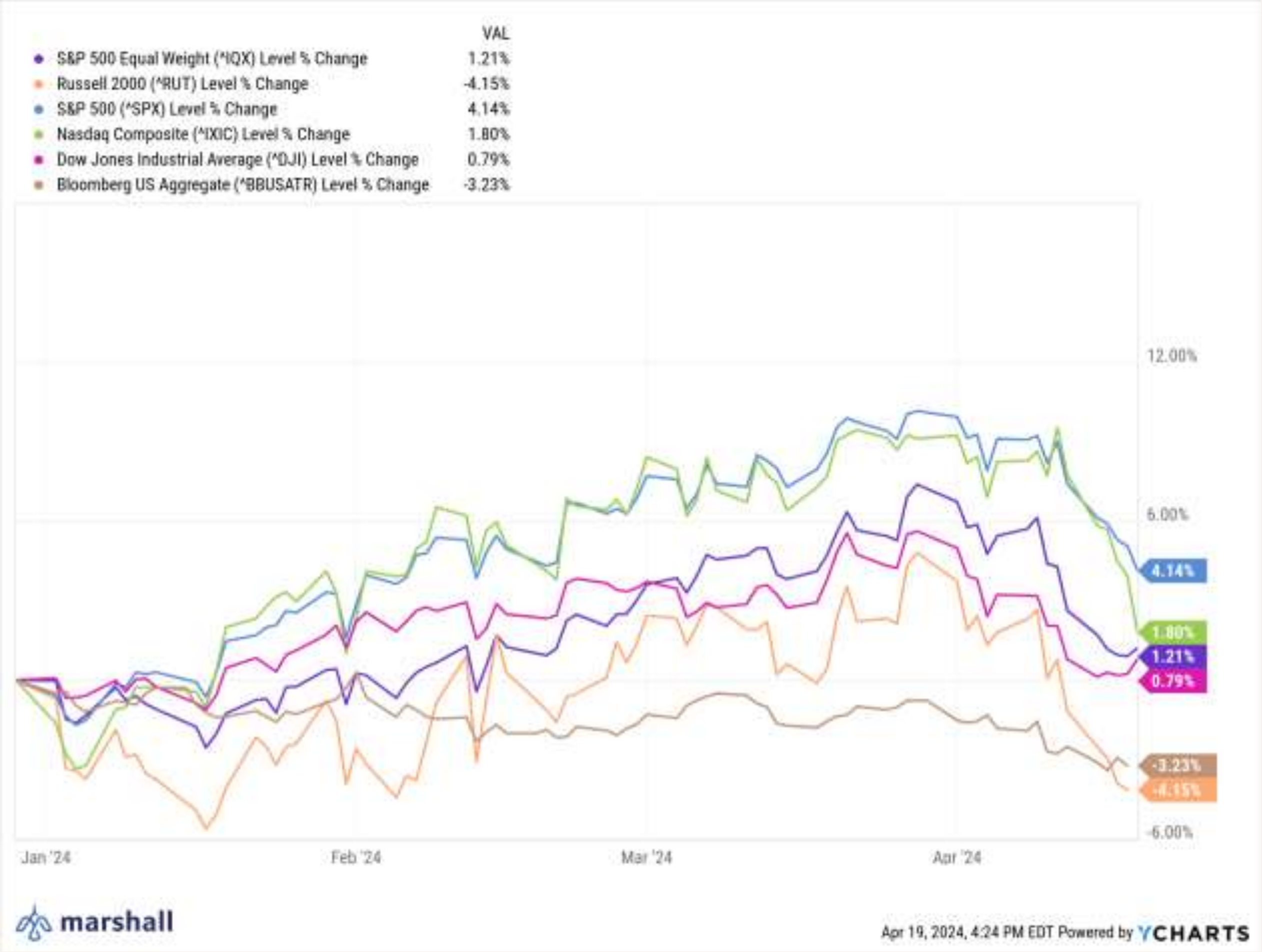
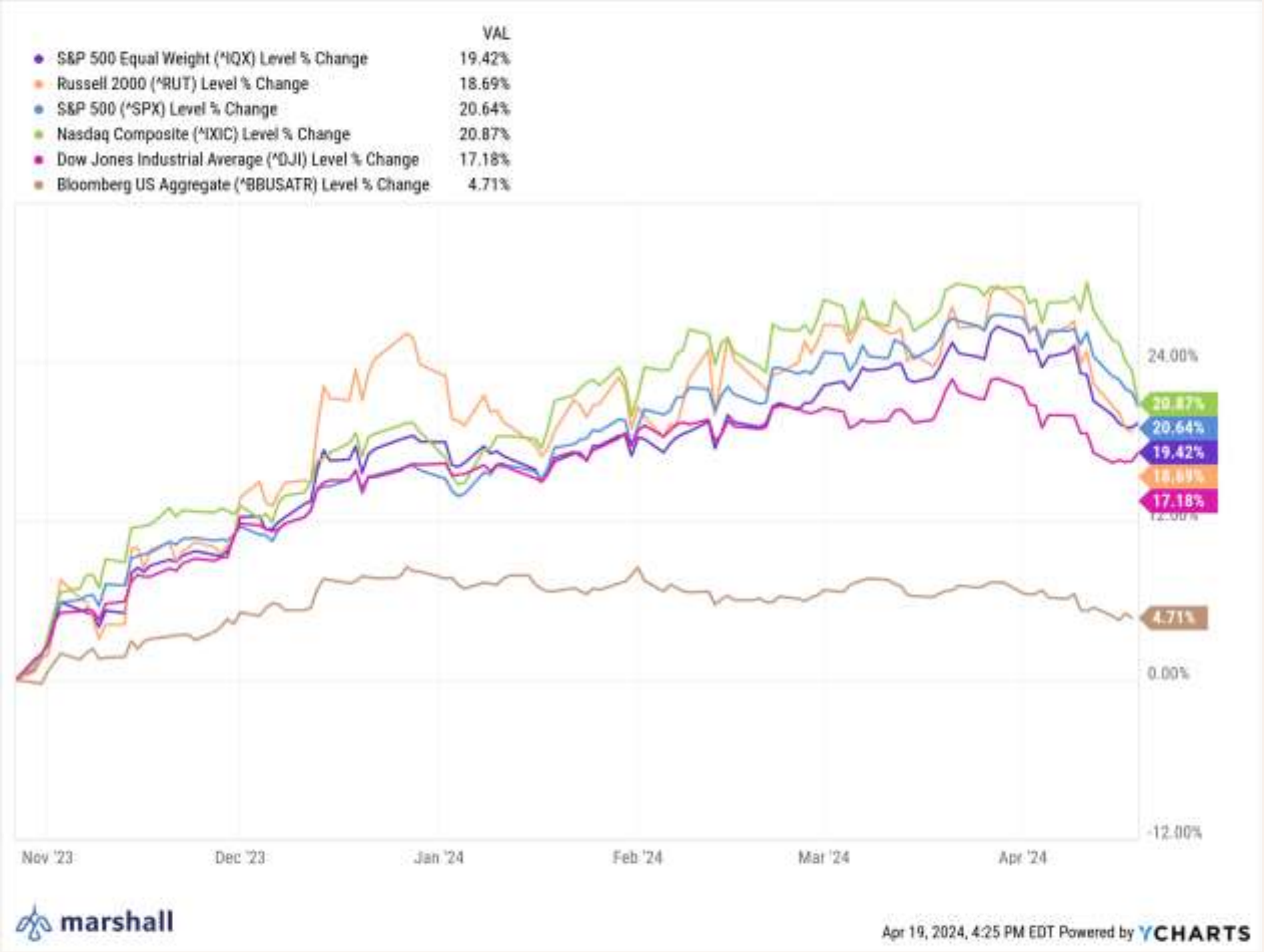
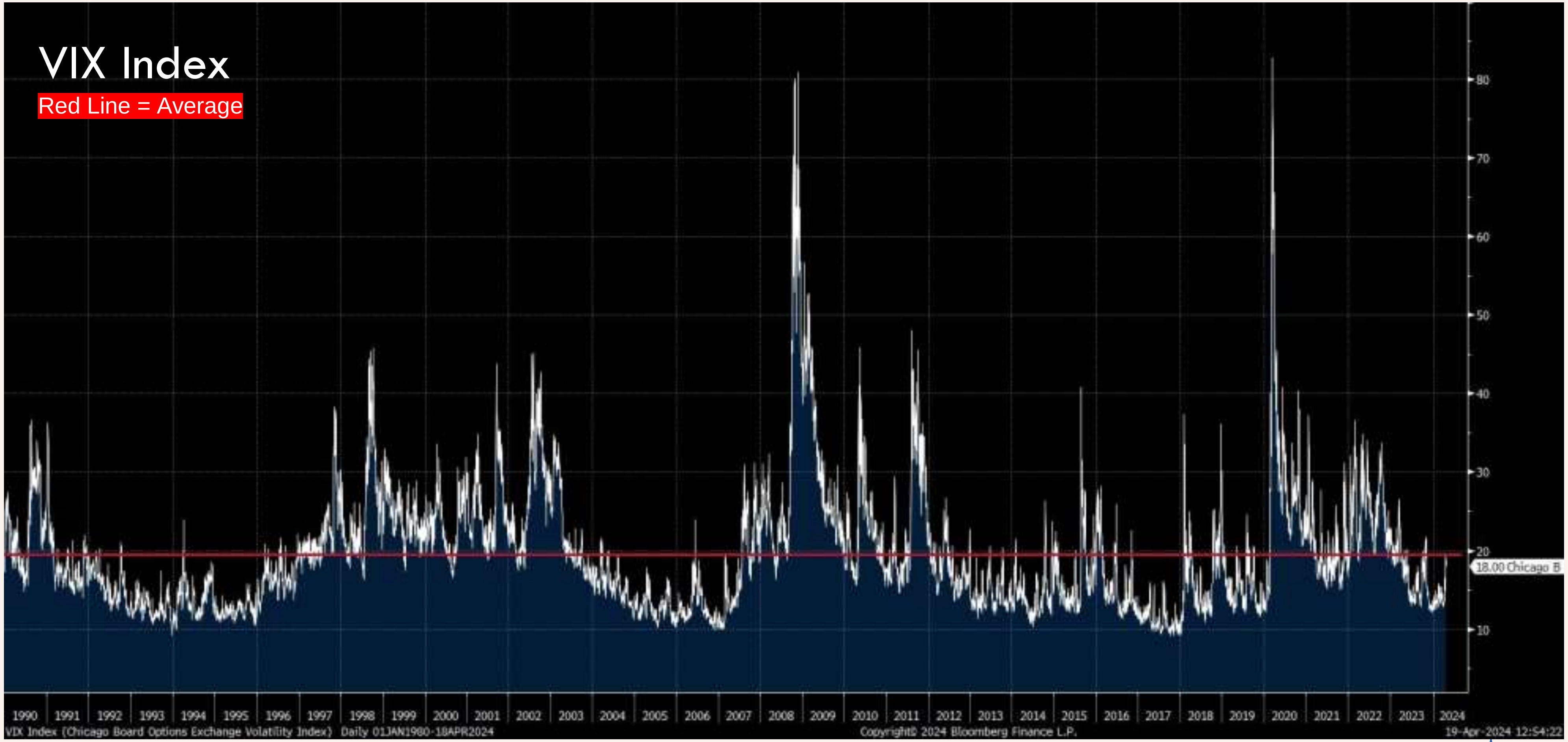
1) A sharp market rally that began last October has begun losing steam as markets react to recent inflation data, the prospect of delayed interest rate cuts, and geopolitical conflict. Robust year-to-date gains have faded as investors face a ‘wall of worry’ with a decision between taking profits or staying invested. Nonetheless, it’s important to remember that market performance doesn’t move in a straight line, and returns since the Fall remain quite strong.





Data Source: YCharts

2) It's not unusual for markets to experience some type of extended drawdown during each year. Even in strong years like 2023, the market experienced separate drawdowns of around -7% and -10%. According to data from JPMorgan, the average intra-year drawdown for the S&P 500 since 1980 is about -14%. Underlying market volatility as measured by the VIX, aka the fear gauge, has climbed recently, but remains near it's longer-run average and is not indicative of widespread 'fear' bubbling in markets.



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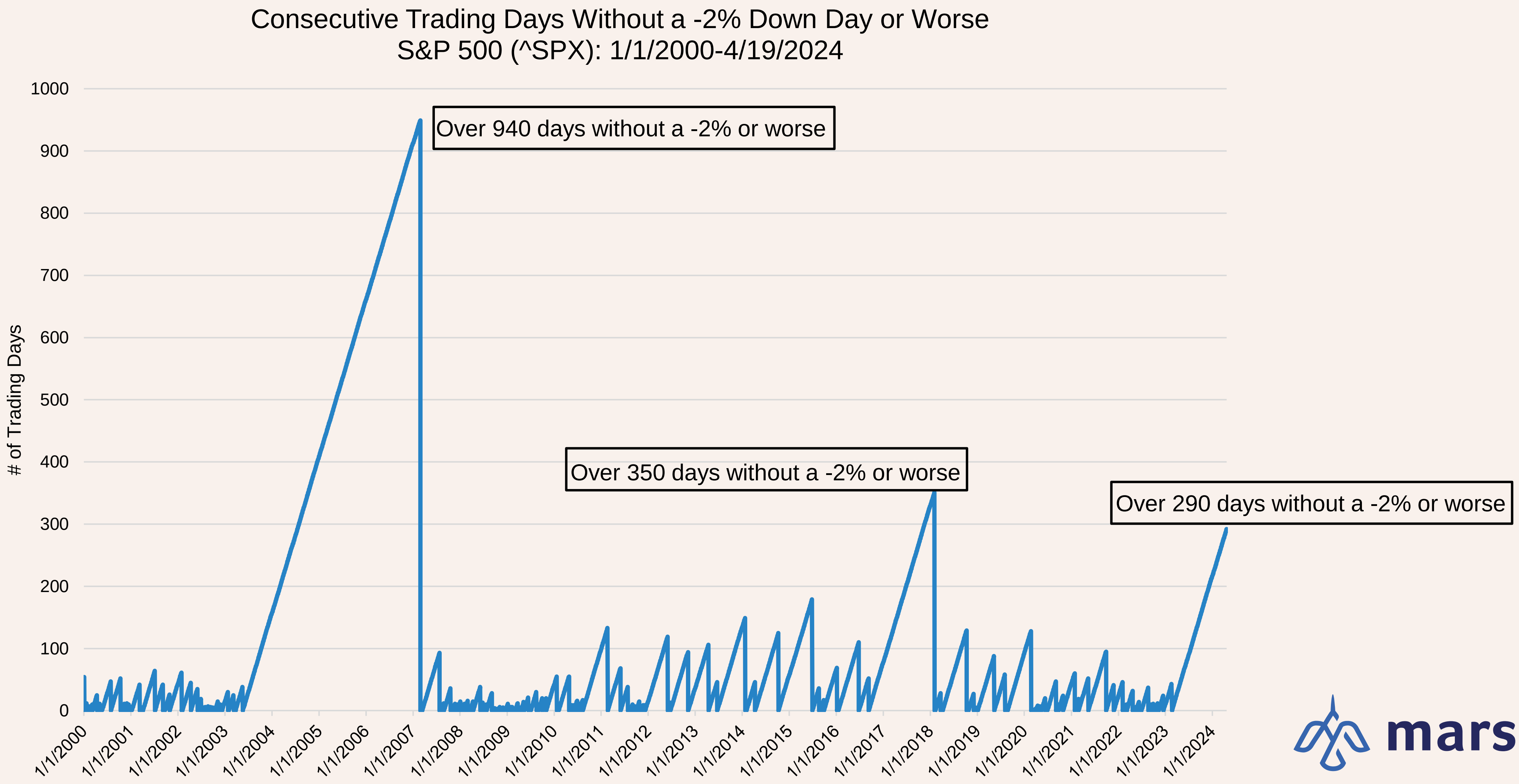
Data Source: Bloomberg, L.P.

3) Looking at market volatility in another way, as of this writing, the S&P 500 has logged nearly 300 consecutive trading days without experiencing a daily return of -2% or worse- an impressive run by historical standards.



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Data Source: YCharts

4) Aside from recent geopolitical events in the Middle East, one of the major drivers of recent volatility has been concern over the stickiness of inflation and its impact on rate cut expectations. There continues to be a gap between the consumer price index (CPI) and personal consumption expenditures (PCE), the two most popular inflation metrics. It is worth noting, PCE is the preferred inflation gauge of the Federal Reserve for three reasons: "The expenditure weights in the PCE can change as people substitute away from some goods and services toward others, the PCE includes more comprehensive coverage of goods and services, and historical PCE data can be revised (more than for seasonal factors only)."

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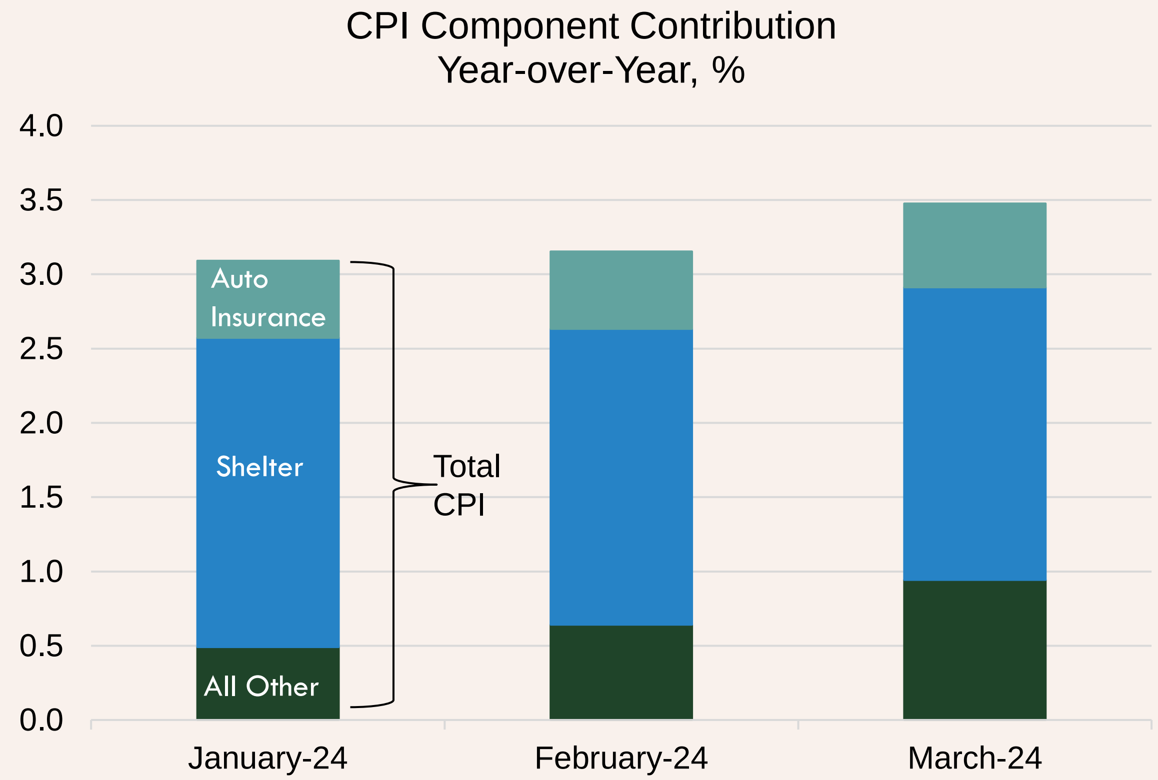
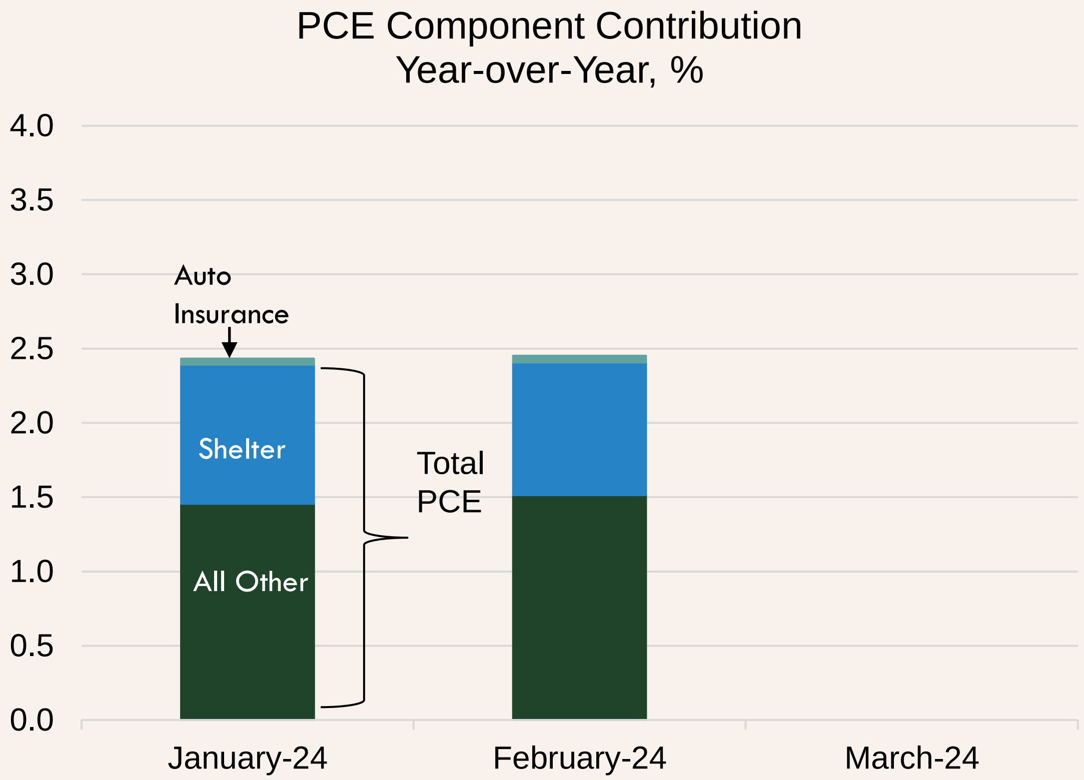
Data Source: Bloomberg L.P.; Federal Reserve Bank of St. Louis, President's Message: CPI vs. PCE Inflation: Choosing a Standard Measure

5) In recent months, there has been a lot of noise surrounding the uptick in CPI. However, it's worth pointing out most of those increases can be attributed to just two factors: shelter and auto insurance. While the cost of auto insurance has also contributed to the rise in PCE, the overall impact has been minimal in comparison.





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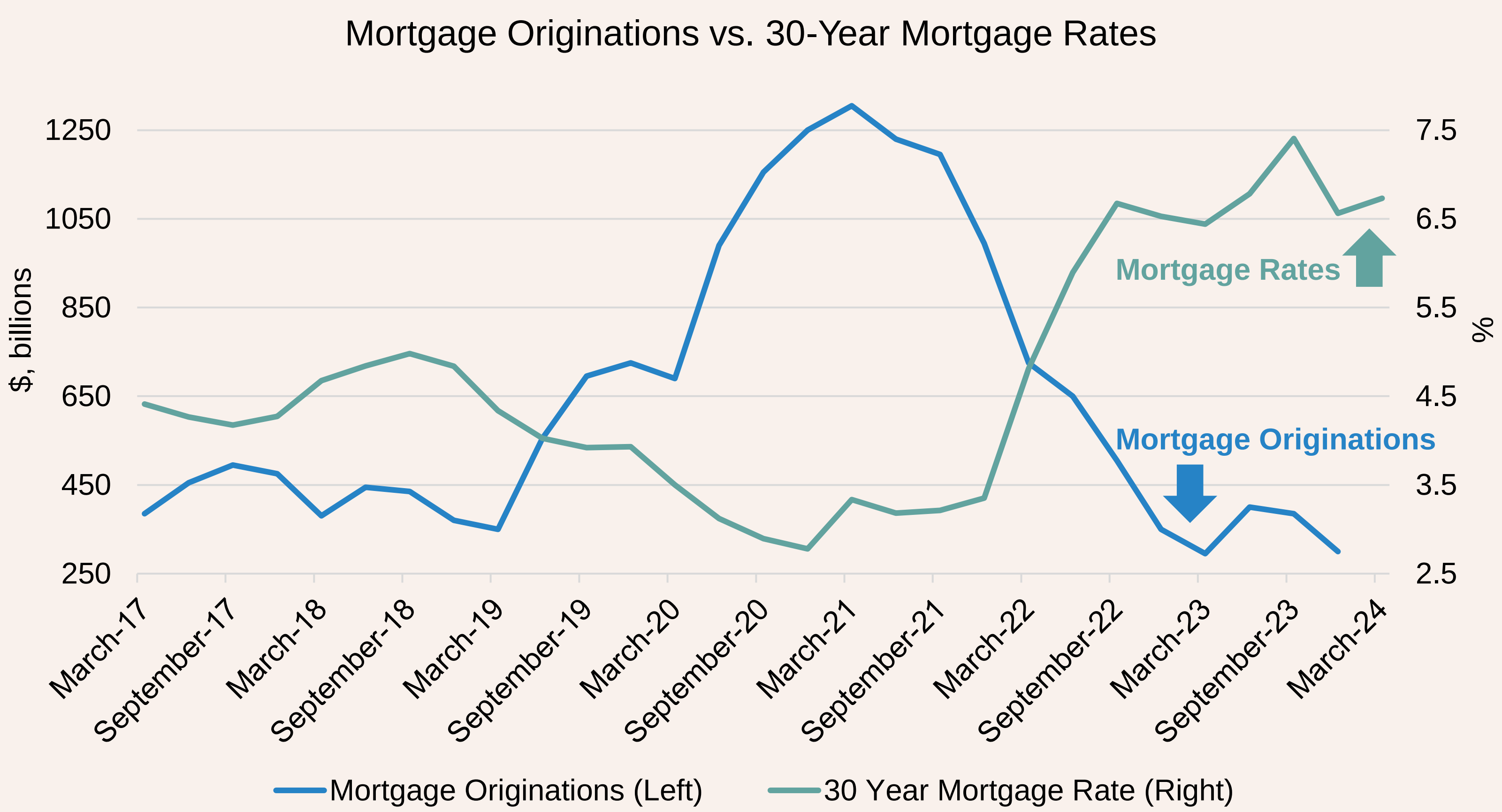
Data Source: Bloomberg, L.P.; U.S. Census Bureau; Bureau of Labor Statistics

6) Regarding the cost of shelter, we could be approaching the point where tighter monetary policy has accomplished most of what it can achieve. Higher mortgage rates appear to have helped tamp down a surge in housing demand following the pandemic; however, higher prices have persisted due to the lack of housing supply. Some economists are positing a new theory that higher interest rates could be constraining supply as homeowners with low mortgage rates are hesitant to move and swap their low fixed mortgage rates for higher ones. It's an interesting theory, but at this point it remains just that.



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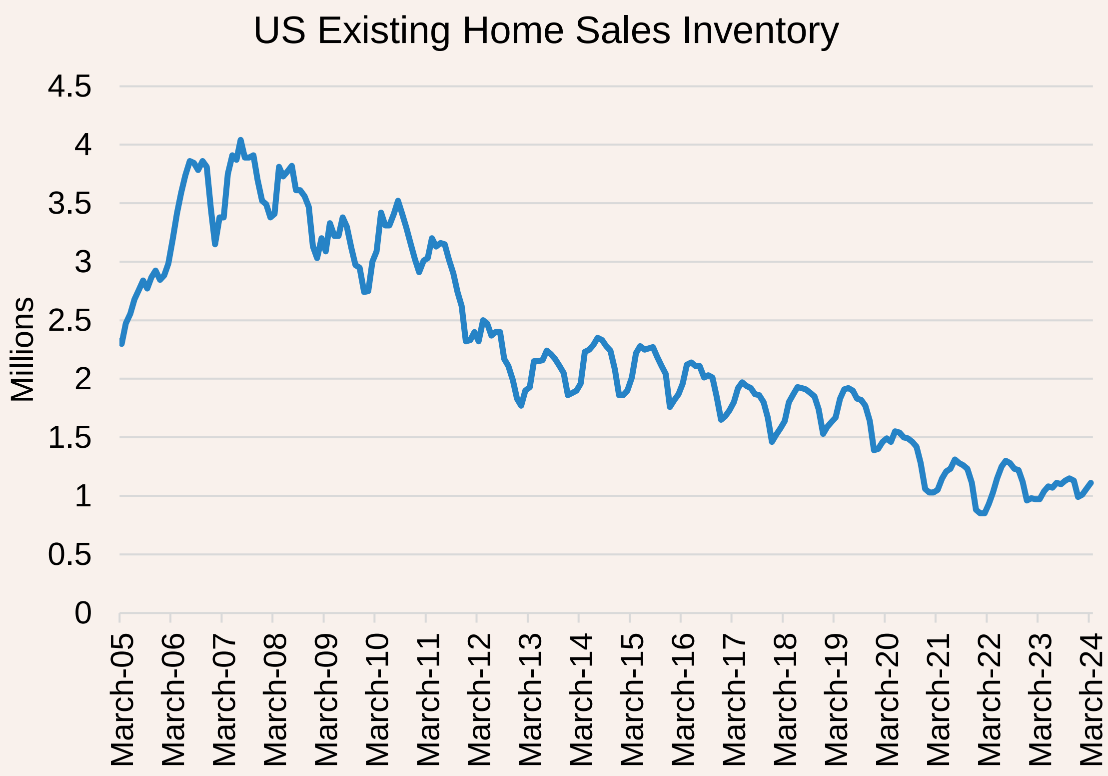
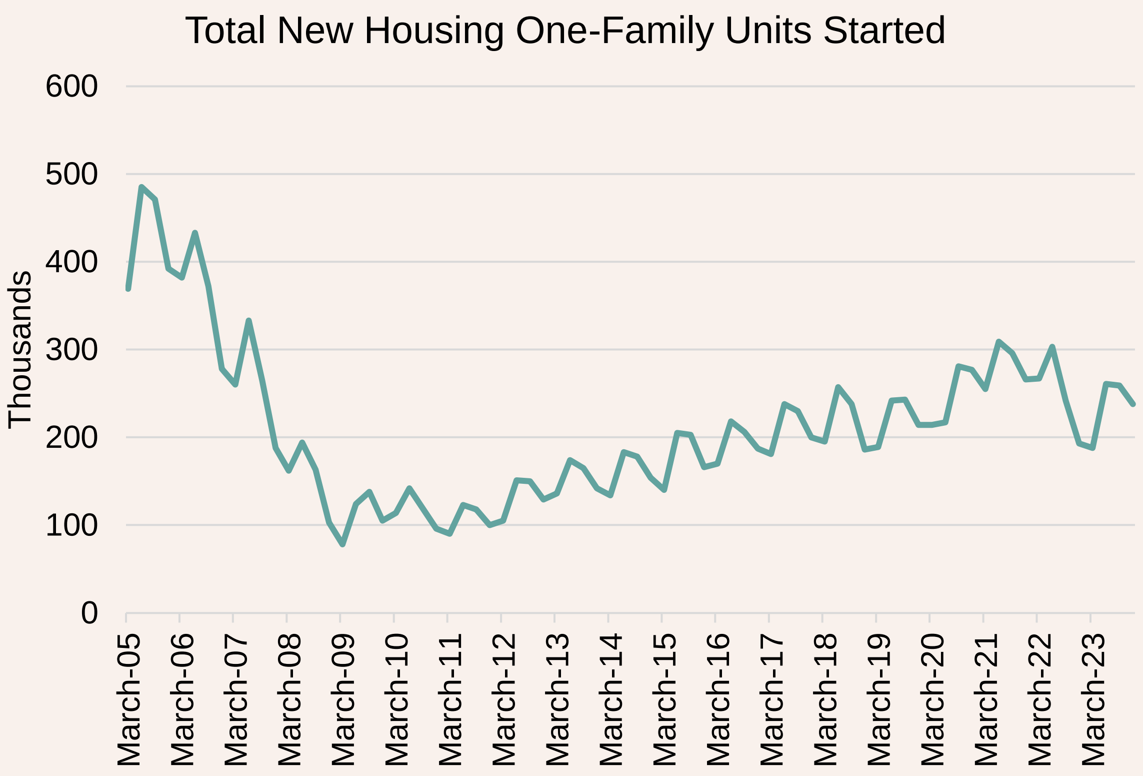
Data Source: Bloomberg, L.P.; Optimal Blue 30 Year Conforming Mortgage Rate; Inside Mortgage Finance (IMF)

7) Moving away from theory and into actual data, the current strain on housing supply isn't an overnight development. Over the past decade, fewer and fewer existing single-family homes have been listed for sale while new construction of single-family homes slowly recovered from the 2008 financial crisis. At the same time, new households continued to form as Millennials and Gen Z began to reach adulthood. The pandemic didn't create the current demand/supply struggles in housing, though it likely did exacerbate fragile imbalances that had been brewing beneath the surface.





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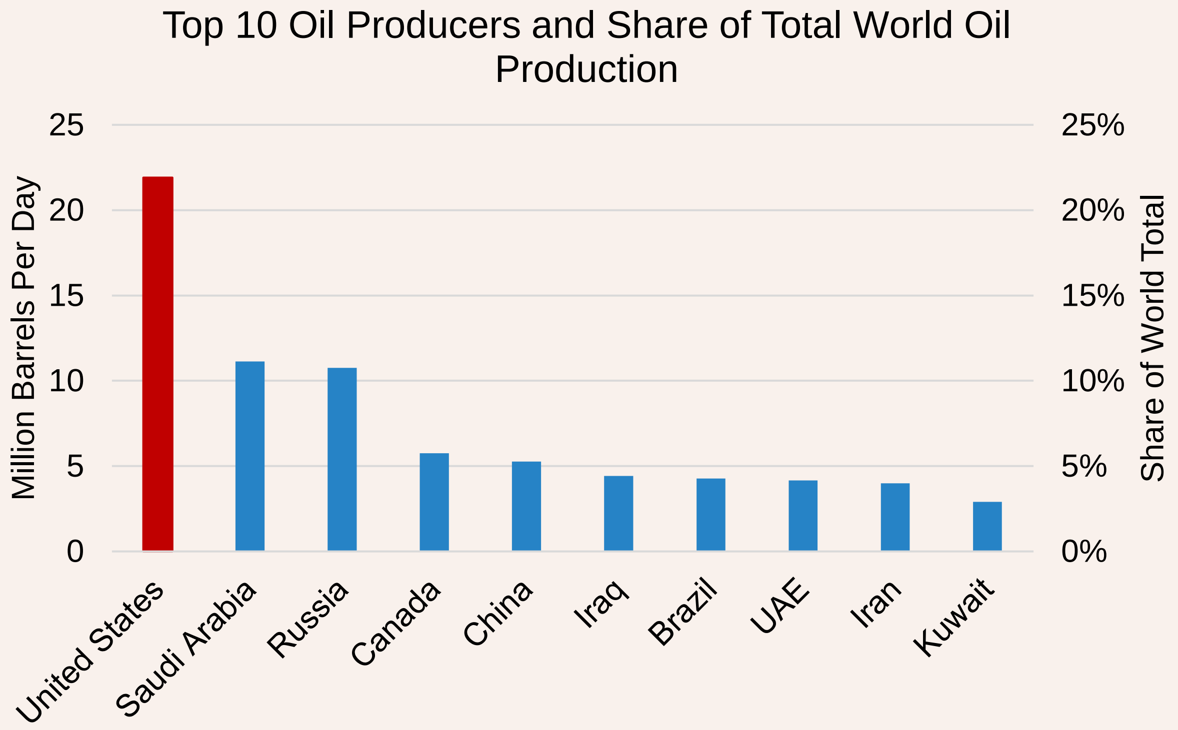
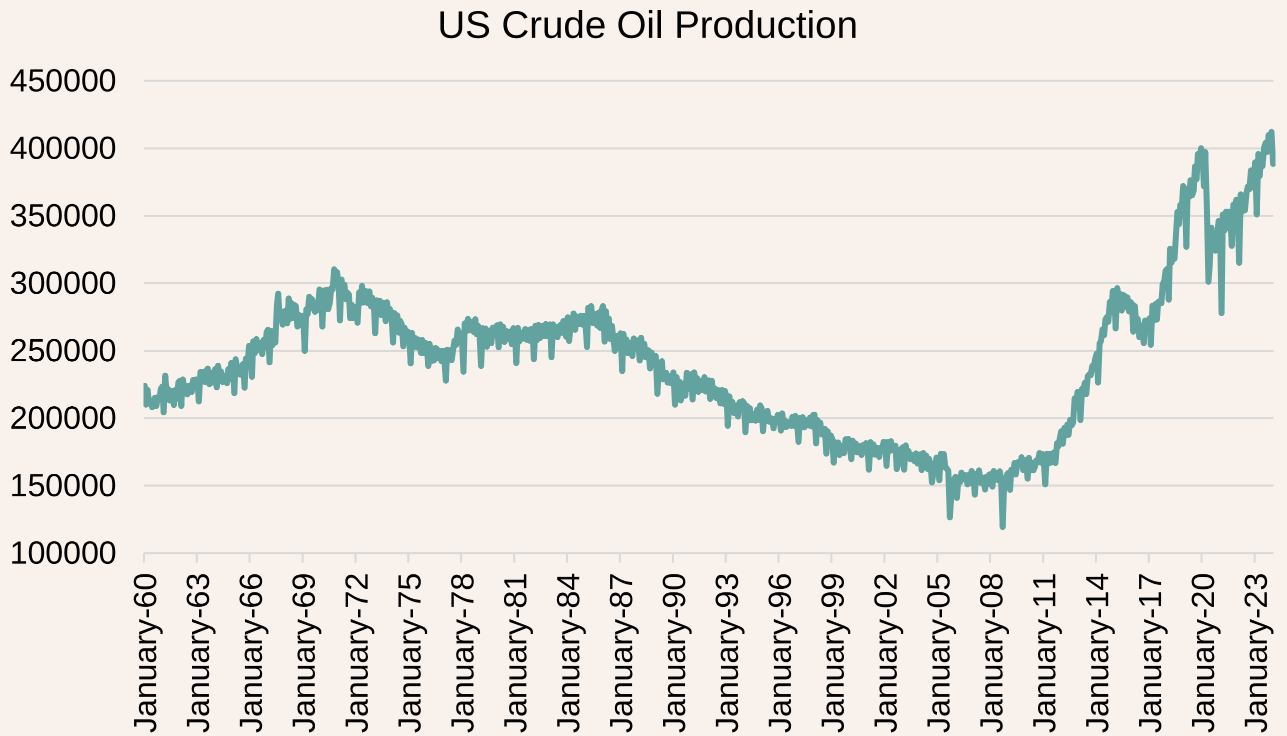
Data Source: Bloomberg, L.P.

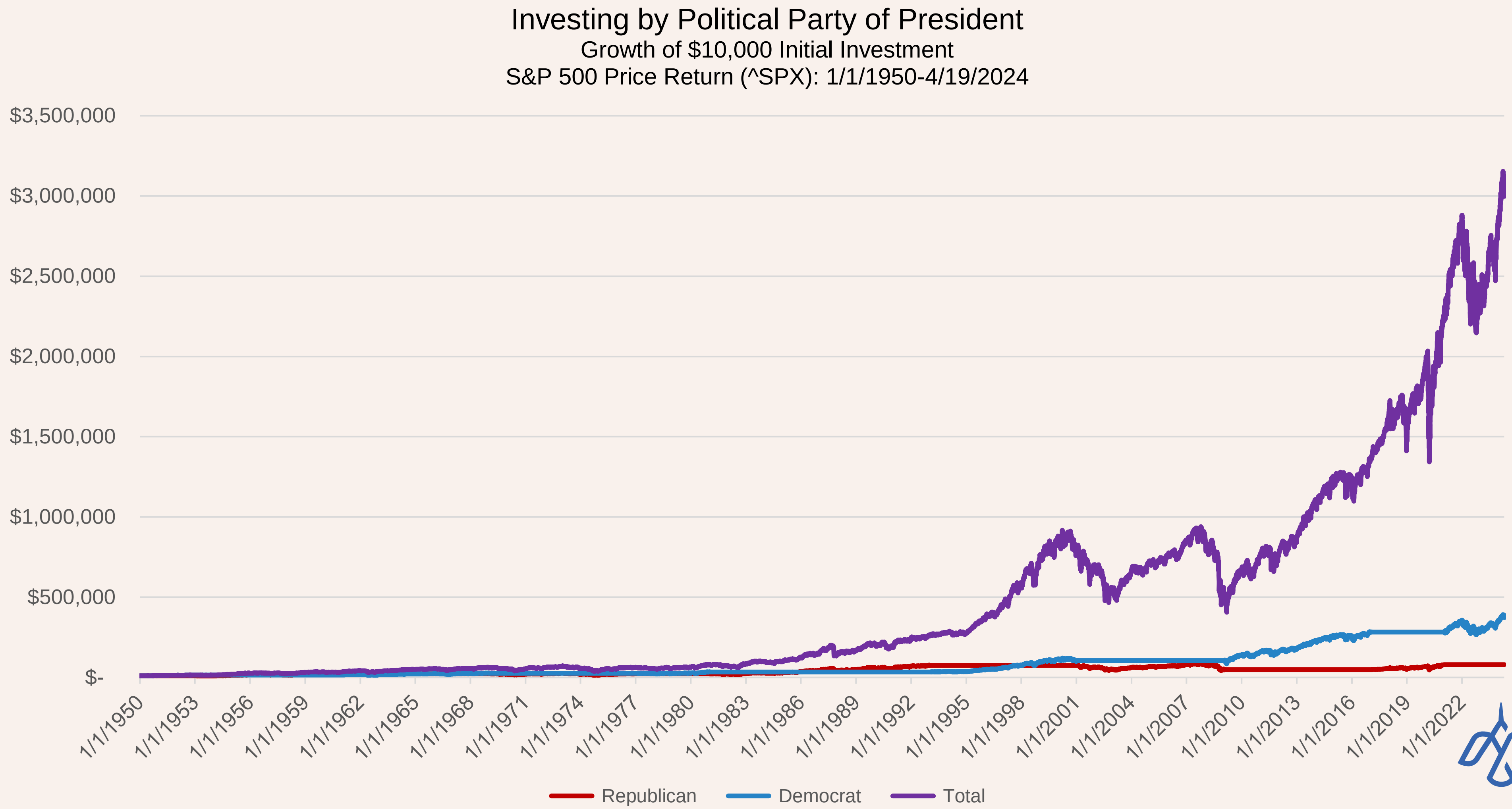
8) In recent months, the price of oil and gasoline have ticked higher as tensions heightened in the Middle East. Unfortunately, there is little the Federal Reserve can do to combat rising prices caused be geopolitical events. Fortunately, as we've highlighted in past issues, United States oil production in near record levels, making the United States the worlds largest oil producer… larger than Saudia Arabia and Russia's output combined.





Data Source: YCharts; U.S. Energy Information Administration

9) During presidential election years, we are often asked about the potential for volatility depending on which party controls the White House and/or Congress. To be blunt, if an investor were only invested when their preferred party controlled the White House, they would have sacrificed a lot of performance. As the chart below highlights, since 1950, a $10,000 investment only allocated to the market during a Republican presidency would have grown to about $80,000 today. The same $10,000 would have grown to about $370,000 if an investor were only allocated when a Democrat was in the White House. But an investor who stayed invested during both Republican and Democrat administrations would have seen their $10,000 grow to nearly $3,000,000!



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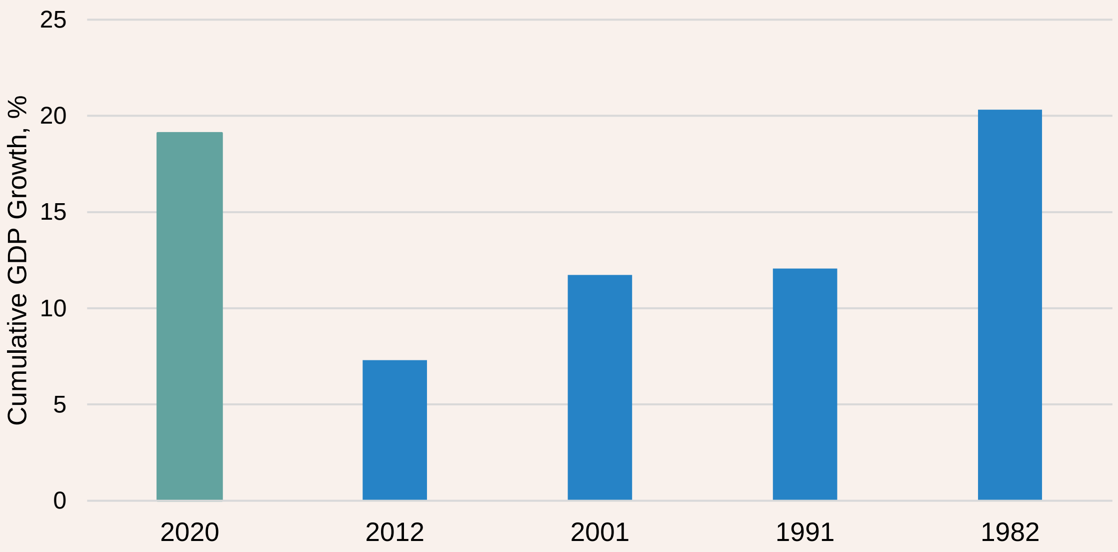
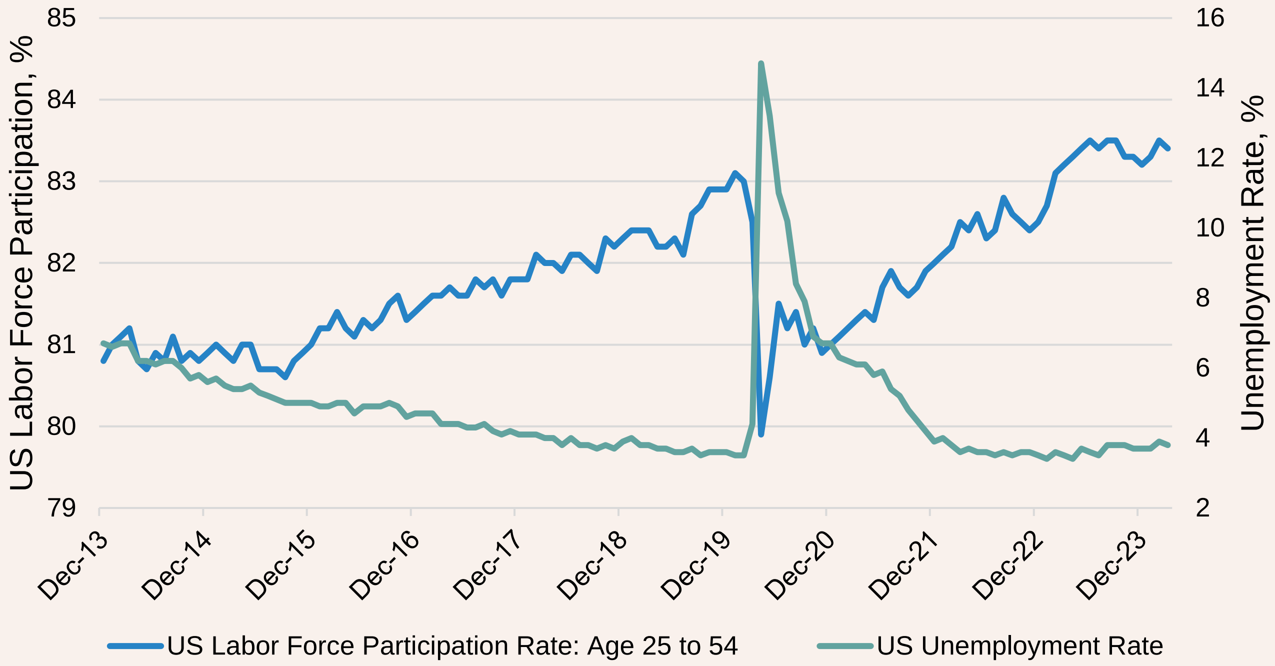
Data Source: YCharts

10) One of the biggest complaints about the economy right now is that it's too strong. This is likely as strange a sentence to read as it is an unusual one to type. By our measurement, the current economic expansion that began in 2020 is one of the best over the past forty years through the first fourteen quarters. Today, the unemployment rate remains below average, the participation rate amongst prime age workers has surpassed pre-pandemic levels, and consumer spending remains firm. We believe fully employed US consumers have little reason to change their spending patterns. Though, perhaps what's good for the economy could be challenging for the Federal Reserve.

Cumulative GDP Growth to Start Economic Expansion
(Through First Fourteen Quarters)

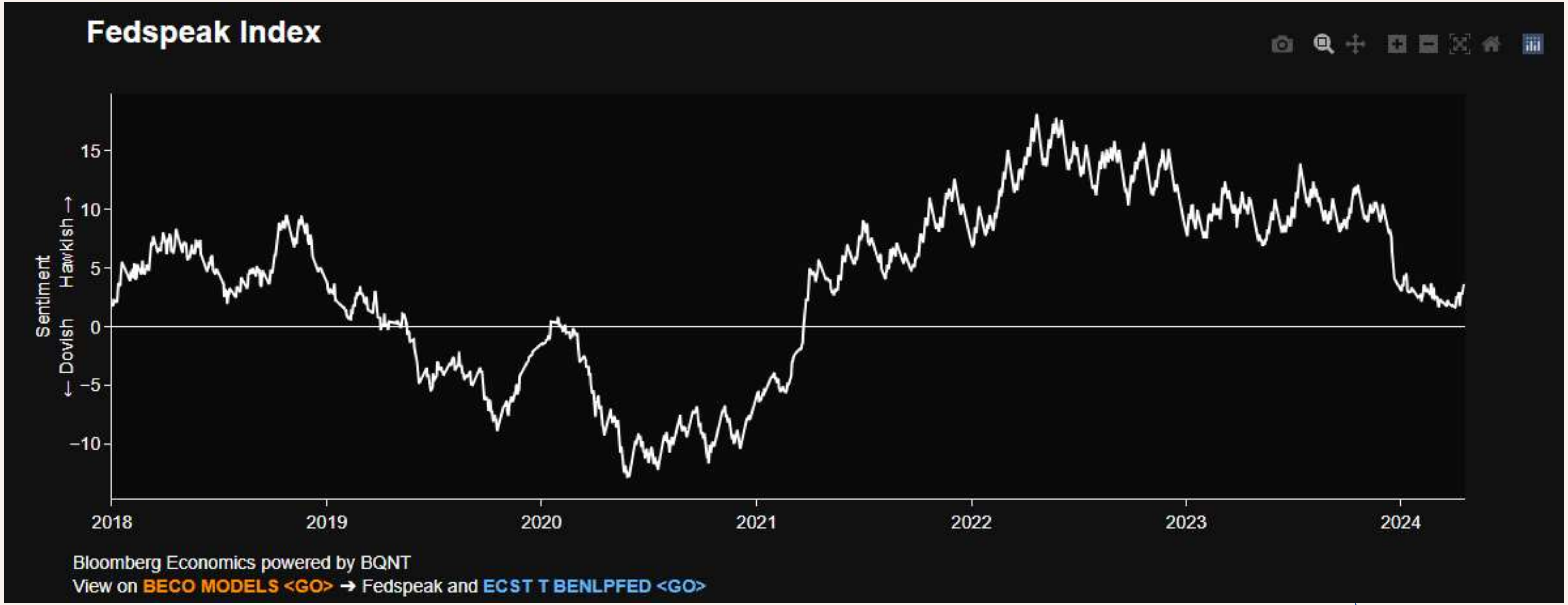


U.S. Labor Market Remains Strong



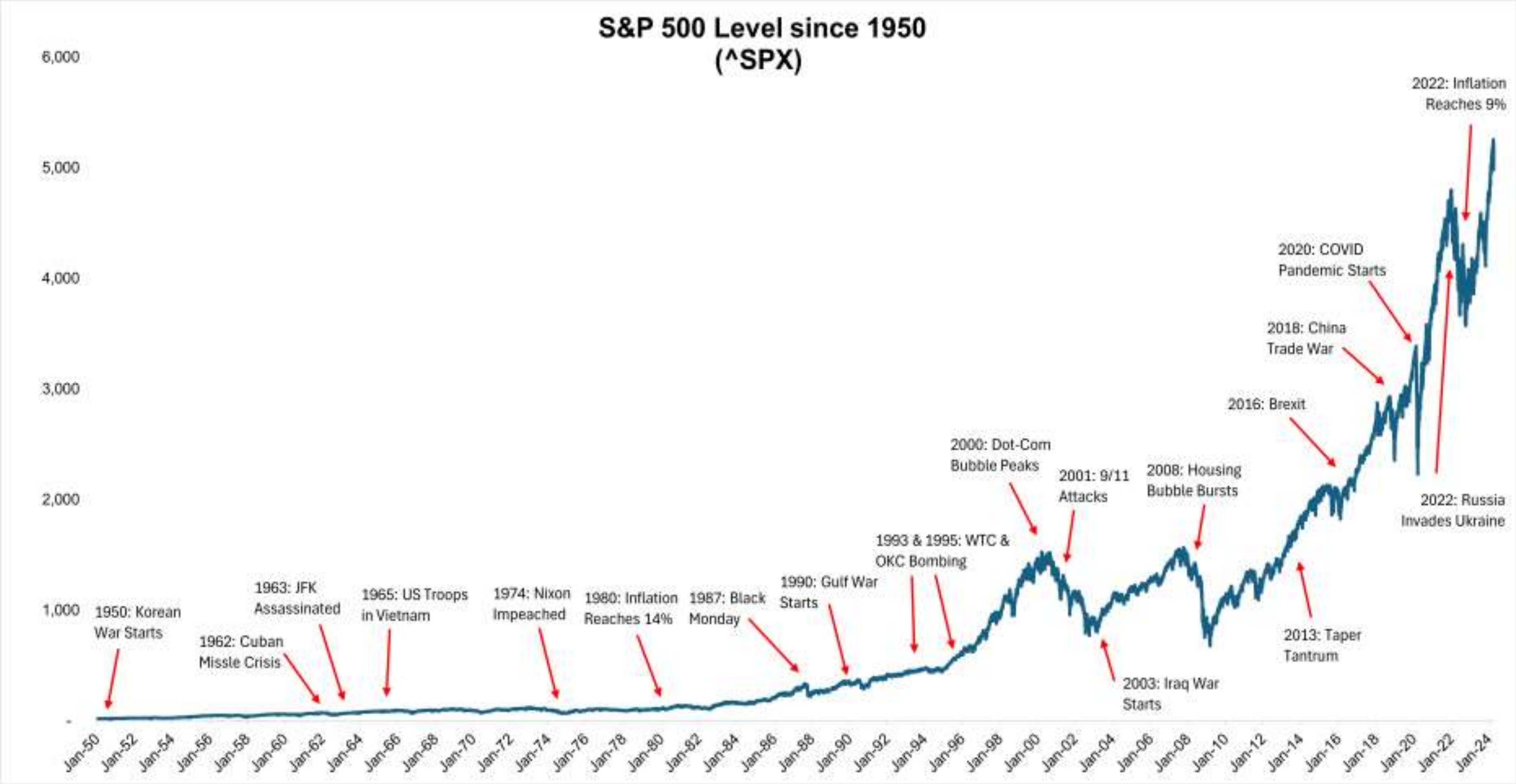
Data Source: YCharts; National Bureau of Economic Research

11) Economic resilience has led forecasters to revise calls for an economic ‘hard landing’ in 2022, to a ‘soft landing’ in 2023, to ‘no landing’ in 2024. Accordingly, interest rate cut expectations have been heavily repriced as the year has progressed. In recent comments, Federal Reserve Chairman Jerome Powell indicated current policy may just need additional time to work rather than immediate interest rate change. Since the beginning of April, Bloomberg’s Fedspeak Index has begun to move from neutral levels back towards ‘hawkish’ sentiment. In our opinion, this move could provide a potential catalyst for markets should there be any signs of economic or inflationary cooling in the months ahead.



Data Source: Bloomberg, LP.

11) One thing that will never change: markets crave the ‘known’ and hate the ‘unknown.’ The recent repricing of interest rate cuts, geopolitical conflict, and equity volatility have presented the market with a litany of ‘unknowns’ to worry about. While unsettling, it is important to remember this is not the first (nor will it be the last) time that the market has had to fight through causes for concern. In the chart below, we highlight various market and geopolitical ‘unknowns’ from the past. While past performance provides no guarantee of future results, one ‘known’ we take comfort in is the fact that markets have historically rewarded investors who have been able to look past prior short-term unknowns.



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Data Source: YCharts

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