Marketline April 2024

Stocks:

The stock market finally tripped in April, with the major domestic stock indices down 4% to 5%. Overseas, stocks performed slightly better, with negative returns in Canada and Mexico, though the FT-SE rose 2.4%. A big increase in interest rates was to blame for the poor behavior of US stocks (see *Bonds*, below), and that, in turn, was caused by persistent inflation, which is not only refusing to budge but became a bit worse here and there. Inflation is a major component in consumers' spending calculus, and we're just starting to see demand for discretionary items like Starbucks coffee drinks and McDonald's burgers collapse thanks to rising rent, electricity, insurance, and medical care costs.

Meanwhile, quarterly earnings reports are arriving thick and fast. This season is a mixed bag, with occasional "beats" – which refers to earnings greater than estimates – but largely numbers that are on the nose or slightly worse than expectations. Disappointments have been met with cratering stock prices, while on-target reports are not garnering much reward. Last month we complained about slim pickings on the buy side, but occasional stumbles due to earnings are making for better hunting lately.

We've received a few questions about upcoming elections and the markets. A reminder: there's virtually zero correlation between stock and bond market performance and political outcomes. The one outcome consistently rewarded by markets is a "divided house" with neither Democrats nor Republicans in charge. Soft seasonality does also exist, with slight differences among first-year returns, second-year returns, and so forth, spread across a Presidency – but profiting from that phenomenon is nearly impossible. The market is also almost impossible to surprise. If polls favor one party over another ahead of the election, that information is already baked into prices. The markets are constantly adjusting to account for uncertainty, so thinking that this thing or that thing will result in a big market move needs to be questioned: if you think so, then why haven't stocks already moved because of the fact you know? Billions of dollars stand ready to arbitrage facts at a moment's notice, effectively discounting the daily news and even looking beyond today to upcoming months.

Bonds:

After a short-term rally over the last couple of months, bond investors came to their collective senses, depressing prices and raising yields in April. The one-year bill rose from 5.02% to 5.24% while the thirty-year bond rose from 4.34% to 4.78%. That may not sound like much, but it amounted to a major correction five years and out. The culprit – as we mentioned above – was a poor inflation reading.

Of course, the probability of rate cuts by the Federal Reserve sank along with bond prices. Sentiment still indicates that we will see lower short rates this year. But behind the scenes is a new fact: the Fed's quantitative tightening (letting the bonds on its balance sheet taper off through maturities) has been tapered. Since 2008, the Fed managed to accumulate over $9 trillion in bonds on its balance sheet – the last $5 trillion or so for no particularly good reason. It has been letting those bonds come due without replacing them, first to the tune of $90 billion a month, then $60 billion, and starting in June, $25 billion. Tapering the taper is a nod to slightly weaker economic numbers recently. Hopefully, it is not a precursor to growing the balance sheet again, which amounts to unprecedented interference in markets, our economy, and risk pricing.

Commercial real estate deserves a mention here, because this long stint of higher rates is finally affecting values. Building owners are throwing in the proverbial towel, handing keys back to banks after defaulting on mortgages. All that low-interest financing is coming home to roost, as the new cost of obtaining a loan has skyrocketed. We could see a messy work-out before new owners step up. While I don't expect an economic disaster out of this, it's another factor contributing to volatility over the next year or so.

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