Nolte Notes

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June 6, 2022

"I see a bad moon arising, I see trouble on the way…I see bad times today." In what may have been the topic of discussion between the Fed Chief and the Commander in Chief, both did a little finger pointing. Sounding more like Laurel and Hardy (Another nice mess) than Creedence Clearwater, both had few answers to solve the inflation problem facing world economies today. Even Janet Yellen (former Fed Chief and current Treasury Secretary) admitted she was wrong about the path of inflation. Now that inflation is proving a bit more than transitory, the solutions are proving to be a bit tougher to figure out. Rate increases to slow economic growth is one tool of the Fed, but hikes will take time to impact the economy. Higher rates will not put food on grocery shelves and cheaper gas at the pump. Putting more money into the economy is not the solution either. Unfortunately, inflation will be with us for much longer than many expect as the global economy continues to "right-size" after coming to a screeching halt and restarting from a very different starting point.

The economic data of the week was the employment report, which was met with a bit of a yawn. Another 300k+ in jobs "created" (or re-created) and wages grew at a 5% annual clip. Digging a bit deeper, however, shows labor participation stagnant, time on unemployment jumping and the "goods producing" portion of the economy job growth slowing for the second consecutive month. As consumers shift their spending from "stuff" to "experience" the recent report supports that shift. Comments from airlines and hotels about lack of "space" indicate people are very comfortable moving about the country. The coming week investors will focus upon the inflation reports, which should remain around the recent high-water mark of 8%. If there is any potential consolation. It is that commodity prices, in general, have been stable over the past 6-8 weeks. This could provide a downside surprise to inflation. However, the combined still strong jobs data and higher than desired inflation rates mean the Fed is likely to hike interest rates again by 0.50% at both of their next meetings in two weeks and again in July.

After declining a bit over the past few weeks, interest rates are once again on the rise. The characteristics of the rise are interesting in that it is an across the board increase in rates, meaning the relationships between short and long-term rates remained stable. The bond model remains in negative territory, as the current price on commodities is above the average price of the past six months. The same is true on bond yields, current yields are higher than their average price. The bond model continues to point to higher rates and has been for much of the time since last Christmas. Rumors of a pause in the rate hiking cycle in the fall has boosted the markets. It is too early to decide if the rate increases are having the desired impact on the economy and the rates of inflation.

The volatile nature of the markets this year has masked some interesting underlying "strength" that could provide profitable whenever the current cycle of volatility begins to temper for more than a few days. The first is small cap in general and specifically the value side of small. Small stocks have performed a smidge better than their large cap brethren. However, small value is nearly six percentage points better than the SP500. The same is true of large cap. The SP500 is down just over 13% year to date, but the large cap value index is down just 5%, while the growth index is just over 22% in the red. This is a big shift since the end of the year toward value that has not happened much since the financial crisis, which began the growth "boom". The current market angst could mark the beginning of a shift away from growth and toward value. Less exciting is the domestic vs. international debate. Both developed and emerging markets are performing closely to the SP500 so far this year. Since the end of March, international investing has been holding up better than domestic. The best returns of the past 10 years may not be the best way to invest for the next 10 years.

Investors are trying to figure out how aggressive the Fed will be, how high interest rates will go and what further damage could hit the equity markets. There are good arguments for at least a short-term bottom in stocks. There are also just as good arguments for further market declines. This push and pull within the markets are what is creating the daily volatility that may stick around for a few more months.