Nolte Notes

By Paul Nolte, CFA

April 4, 2022

The first quarter was a tale of two periods. The first two months, when the markets fell over 10% and then late February when stocks rallied back to within 5% of their all-time highs. With everything that has been tossed at this market, it is a wonder that stocks have done so well. Higher inflation, the invasion of Ukraine, a Fed hiking rates and some discussion of Covid have all cycled through the headlines during the quarter. The employment report on Friday was indicative of the shift in the economic landscape. Last year spending focused upon "stuff", as consumers remained in some semblance of "stay at home". Today, with most all mask mandates gone, people are looking to get out and about. The shift in spending has moved to "experiences" as people realize that life is indeed short. Employment gains were in hospitality, restaurants, and retail. The amount of time people are unemployed has fallen to just under eight weeks, a low not seen (outside of the pandemic) since 2000. There remains plenty of folks on the sidelines, judging from the very low participation rate. What comes next? Could be anything from a ripping rally or a decline to retest those February lows.

The economic data over the quarter has been overshadowed by the geo-political environment and the market reaction to all the news. The quarter ended with two-year yields above ten-year treasury yields for the first time since 2018. What happens next, within the equity markets, could be a rally. Historically, stocks do trade lower, but have finished higher over the ensuing year save for the year following the 2000 inversion. The volatility within the market was among the top 15 quarters since 1945. Here too, history would argue that stocks should be bought following these bouts of volatility, as they have generally finished higher a year later. Even after a big rise in interest rates, stocks finished higher a year later. Monetary policy is not yet tight, and rates have barely moved from the zero level and remain very low from a historical perspective. Will Fed Chair Powell be more focused on fighting inflation, or will he keep an eye on the financial markets reaction to higher rates? The answer could provide the road map for equities in the months ahead.

The bond market suffered worse losses than the stock market. Unusual to be sure, and the worst quarter for bonds in over 40 years. The Fed has signaled they will continue to raise rates through the year and want to see rates above 2% (now 0.50%) on short-term bonds. The long-term implications will be interesting if rates are able to get to those levels and stay there for a while. Interest payments on the huge amount of debt will begin to squeeze out other forms of spending. The "inversion" of the yield curve discussed above does start the clock on a recession countdown. The timing of any recession is less than certain, as it could be anytime over the next three years. The bond market is already expecting a recession AND a Fed that will begin cutting rates by 2024. If the market is to be believed, interest rates will not get too high and ultimately will reverse lower over time.

The "two-part" market, falling, then rising during the quarter, was also reflective of overall sector performance. Growth was under pressure from late in 2021 until the market bottom in February. From there, it led the market higher during March. This was in the face of higher rates, which are supposed to hurt the technology sector. A flatter yield curve is supposed to hurt financials, as banks usually make money on the difference between short and long-term rates. Financial were among the better performing sectors in the quarter. Energy, of course, led the way as prices rose dramatically. Can it continue or will consumers shift spending away from gas? Historically, higher energy prices do not last long as additional supply comes onto the markets at high prices. The other "odd" sector were utilities. As interest rates rise, utilities tend to perform poorly as investors flip over to the safety of bonds to get income. Typical relationships over the past quarter did not seem to hold given the economic backdrop.

Historically, stocks can continue their March rally into the remainder of the year, even as the economic headwinds build. Higher rates and rich valuations could temper those gains, so expect more back and forth in the markets in the months ahead.