KINGSVIEW
INVESTMENT MANAGEMENT

Nolte Notes

By Paul Nolte, CFA

April 11, 2022

It was a week for the news junkies. From the ongoing war in Ukraine to the confirmation of the first black woman appointed to the Supreme Court. Toss in some economic data, Fed speakers waxing on inflation, and the release of the minutes of the last Fed meeting, it was a week for the history books. The Fed indicated they would be reducing their balance sheet by $95 billion per month, a huge amount of money. However, in the context of what was added since the pandemic, that pace would take nearly 4 years to remove all the recent expansion. The Fed is looking to cut roughly 20% of the total economic growth of the US last year by 2026. On top of the balance sheet shrinkage, the Fed is expected to hike rates to begin quashing inflation that continues to perk along at 7%+ annually. Of course, the sanctions and reduction in trade of goods from Eastern Europe will likely exacerbate inflation. Next week starts the quarterly corporate earnings dump, with the banking sector beginning on Wednesday. The focus of analysts will likely be on top-line revenue growth, the impact of higher prices (passing them along or eating the costs), and labor issues. It should be another fun week on Wall Street.

The price level of the SP500 is back to roughly late August, having given up all the fourth-quarter gains of 2021. The good news is that earnings estimates continue to rise, as analysts have not reduced their numbers due to higher inflation, higher interest rates, or any economic slowing that may occur this year. Earnings last August were discounted based upon the prevailing interest rate for a 10-year bond of roughly 1.30%, allowing for higher prices. Today, those earnings are getting discounted at nearly a full percentage point higher, meaning stocks should be much lower to account for the higher interest rate. The higher interest rates go, the lower the market should trade, save for ebullient investors willing to buy stocks no matter the environment. At some point, interest rates will begin to bite, it is likely more when than if.

Those higher interest rates were not happening as much on the short-term bonds last week. As a result, the yield curve re-inverted and was once again (slightly) positively sloped. The bond model is still pointing to higher rates in the weeks ahead and the release of inflation data early in the week could color the interest rate market much of the remainder of the week. Another interesting “factoid” about the rise in interest rates, the yield on the 10-year treasury is not well above the dividend yield on the SP500. The difference of 125 basis points is the largest since 2018 and again in 2011. Since the financial crisis in 2008, the yield on the SP500 has consistently been above that on bonds, furthering the fuel to buy stocks and lending to the argument of “TINA” – there is no alternative… to stocks. We’ll see if that thought changes in the months ahead.

The rally from the pandemic low in March of 2020 has been highlighted by the strong and broad buying of the US markets. There has been a change since Oct/Nov of last year, with more stocks falling than rising and volume expanding on market down days vs. days when the markets rise. Both are an indication of a narrowing of leadership within the market. Unless/until the market internals flip around, it will be tough for stocks to sustain a long-term rally. Back on the interest rate theme, the higher rates are having an impact on growth stocks, which have been supported by low rates. As that narrative shifts, so too do investors – more toward dividend-paying stocks and even utilities. The utility sector typically follows bonds, so higher bond prices (lower yields) typically mean higher utility stocks. This time around, the falling bond prices (higher yields) have not seen a commensurate decline in utility stocks.

If we look at typical mid-term election year market cycles, the “bottom” in stocks usually happens in late summer or early fall. From there, markets usually rally into the presidential election. So far, stocks have been following the election cycle pattern this year.