Nolte Notes

By Paul Nolte, CFA

KINGSVIEW
INVESTMENT MANAGEMENT

April 25, 2022

When the drill sergeant says to “jump”, you say “How high, sir?” When Fed Char Powell says, “we’ll be raising rates.” The markets are asking “How high, sir?” The answer to “how high” has changed a lot over the past six months or so. It was originally, don’t worry, inflation is merely passing through, to gradually over time, we’ll get rates to “normal”. Today it seems the sky is the limit. While entertaining a half percent hike in May, the door seemed to have swung open for a three quarter (75bp) hike during the summer. The Fed still has not begun to shrink their balance sheet and have only hiked rates one time. In stark contrast to March ’20, when everything got tossed at the markets to prevent a melt-down, today the specter of higher inflation for longer is only just beginning to worry Fed officials. Of course, the markets are up in arms. Mortgage rates have swung from roughly 2% at the start of the year to over 5% today. The SP500 has dropped 10%, while the (seemingly) more rate sensitive technology sector has dropped nearly 20%. Without lifting as much as a finger, the rhetoric from the Fed has forced rates higher and done much of the heavy lifting. The formal announcement in May is likely to be anti-climactic.

There was very little over the past week, economically speaking, that moved the markets. It was truly all about the Fed. Earnings were all over, with some notable misses from Netflix (falling 33% on losses in subscribers) and some beats from Kimberly Clark (on higher revenue). The coming week will have some potentially market moving data, from personal spending to the Fed’s favorite inflation indicator. The good news will be the Fed officials will be in their “quiet period” ahead of their May 3rd/4th meeting, so no discussion of higher rates coming until then. This week could be the lull before the storm, as the Fed meeting will be followed by the employment report and inflation data the week after. Keep an eye on commodity prices, as they have flattened out over the past few weeks and oil prices have dropped nearly 10% from their early March highs.

Interest rates have jumped dramatically from the beginning of the year. Long-dated bonds have fallen nearly 20% since the beginning of the year. Even short-term bonds have dropped over 3%. Without a real hiding place in bonds, what are fixed income investors to do? Contrary to recent belief, interest rates will not be rising to the sky, they will be coming back down again…at some point. The significant increase in yields could be creating at least a short-term buying opportunity. While many of the models remain negative, the rise in yields has pushed some of the “momentum” type of indicators to levels not seen in 30+ years. Investors are so bearish on bonds that it may be a good time to tip-toe into bonds and lock up some better yielding securities than what was available at the start of the year.

Before Chair Powell began chatting on Thursday, the markets were looking pretty good and potentially starting to “repair” from the decline earlier in the year. However, Thursday and Friday saw a dump of everything, with stocks declining by a 10 to 1 margin vs. stocks that were rising on Friday. These tend to be “capitulation” moments in the markets and can mark at least a short-term bottom. It doesn’t mean the markets will bounce immediately, but a few more weak days that could push the markets toward the March lows on very strong volume. That high volume would mean investors are selling at any price, having reached a pain point that they do not want to hold stocks. Again, this could mean at least a short-term bottom for the markets. There is a “flow” in the markets. Higher commodities are pushing up interest rates, which in turn, create a drag for stocks. IF (yes BIG IF), commodity prices can moderate or even decline some in the weeks ahead, it is possible that the worst in the inflation data would be behind us.

A potentially calm week for stocks as Fed speakers will be quiet ahead of their meeting the first week in May. Earnings and interest rates should remain at the forefront for investors. The 3% interest rate level on the 10-year treasury is likely to be a key level for both bond and stock investors, as it marked the high point prior to the start of the last big decline in yields.