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April 2024 Crescent Commentary

Financial markets gave investors a bumpy ride in April, driven by a few key factors. The first was conflict in the Middle East. The World Bank issued a report showing that if an outbreak of major conflict were to occur, it could cause a spike in oil prices that would result in an increase in inflation. Such a situation would create the need to keep interest rates higher for longer in order to contain inflation. As we've discussed in prior commentaries, popular and speculative investments crashed in 2022, and their recovery over the past year has been driven by the belief that interest rates would soon begin to fall. Any situation challenging that narrative would likely lead to challenges for popular and speculative investments, and we saw some of that in April.(1)(2)

Another factor driving April's stock market decline was persistent inflation. Inflation is the ultimate reason why the stock and bond markets crashed in 2022, and it's the reason the U.S. stock market has been nearly flat for 2 ½ years. One of the Federal Reserve's mandates is to maintain stable prices. For this reason, elevated inflation led the Fed to raise interest rates in order to contain inflation. Higher interest rates push all asset prices lower (interest rates act as gravity in relation to financial asset values. Higher interest rates reduce financial asset values, and lower interest rates increase values). Inflation fell through November 2023. Because of that, financial speculators started to bet that inflation would keep falling and the Fed would thus soon start to cut interest rates. This narrative led to a recovery of investments that crashed in 2022.(3)

But now we're starting to see inflation creeping back up and no longer falling to the Fed's target of 2%. This persistence of inflation is beginning to challenge the narrative that inflation will keep falling and the Fed will soon begin cutting interest rates. The reality of higher interest rates for longer is starting to sink in with financial speculators, and this is the reason we saw stocks decline in April.(4)

A third factor causing April's volatility was the GDP growth report for the first quarter. GDP growth is viewed as an important number because it shows how much our economy grew for the quarter. A growing economy is considered healthy, while a contracting economy is a recession. For the first quarter, the U.S. economy grew at a 1.6% annual rate compared to expectations for 2.4% growth – quite a bit less than expected. Yet while our economy grew less than expected, a key inflation measure followed by the Federal Reserve increased at its highest rate in a year. So for the first quarter, we had a situation of slowing economic growth paired with inflation that increased at a higher rate.(4)

The combination of low economic growth with elevated inflation gave rise to fears of a phenomenon not seen in the U.S. since the 1970s: stagflation. Stagflation is a word that combines stagnant with inflation, meaning stagnant economic growth combined with inflation. During the 1970s, stagflation wreaked havoc on our economy, and the havoc can be seen in investment market returns for that period: in 1964 and 1981, the Dow Jones stock index closed at the same level. So U.S. stocks essentially showed no growth over 17 years. This is why the specter of stagflation sent ripples through financial markets last month.(5)

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Of course, the circumstances today are nowhere near as bad as what our economy experienced in the 1970s. In the 70s, inflation reached double-digit levels and stayed at those levels until the Fed increased interest rates to double digit levels to bring down inflation. The double-digit interest rates led to a bad recession in the U.S., which finally pushed down inflation. With our current situation, we saw inflation peak in the high single digits in 2022, and it has fallen to its most recent level of 3.4% for April. So, the inflation situation we're currently dealing with is nowhere near as bad as what we saw in the 1970s. And as a result, the Fed hasn't had to increase interest rates to such high levels. For this reason, we would expect the economic impact of current higher interest rates to be more gradual and muted.[6]

As a result of the current mix of economic uncertainties, we maintain a cautiously optimistic viewpoint and recommend a balanced investment allocation. While we do recommend owning some investments perceived as having strong growth prospects, we recommend owning them in diversified amounts so that if the future does not unfold exactly as speculators imagine it, you as an investor won't get hurt. Offsetting these perceived growth investments, we recommend owning investments that have withstood the test of time and which generate steady cash flows and dividends. Investments in this category have been largely neglected over the past year during the return to financial market exuberance. One note: we use the term "perceived growth investments" due to the uncertainty and rapid change in industries currently perceived as high growth. It will be years before we know whether perceived growth turns into actual growth in profits.[7]

Thus far, our economy has remained strong in the face of interest rate increases. But it's important to note that interest rate increases always have a time lag in terms of their economic impact. For example, during the previous housing bubble, the Fed stopped raising interest rates in June of 2006. The full impact to our economy didn't become known until Lehman Brothers failed over two years later, spawning a domino effect of failing financial firms. As of now, the Fed stopped raising interest rates in the current cycle in November of 2023. Waiting over two years for the full economic impact would mean that we possibly won't know what happens until the end of 2025 or early 2026. The impact of higher interest rates on the current economy is also a unique set of circumstances which will follow its own timeline.[8]

Given the potential for different economic outcomes over the next several years, we think a balanced allocation gives investors the best chance of doing reasonably well no matter what happens. If economic growth continues, perceived growth investments would likely continue doing well. If growth falters, stable businesses generating strong cash and dividends will likely do well.

Now that we've covered recent financial market and economic events, we'd like to end with a brief Social Security topic. Social Security has changed a lot over the years and there are some features clients often don't know about. For married couples, it's often the case that one spouse earned more income through their career than the other spouse. In these situations, the second spouse may receive a larger Social Security benefit by receiving a spousal benefit from the first spouse. What many people don't realize is the second spouse can begin collecting social security using their own employment record first, and then begin receiving the larger spousal benefit once the first spouse begins collecting Social Security. Please contact us if you have any questions about this or other Social Security topics.

Sources:
(1) The World Bank
(2) CNBC
(3) The Wall Street Journal
(4) Reuters
(5) Fortune
(6) Statista
(7) RBC
(8) CNN

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