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Wealth Management
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July 2024 Crescent Commentary

During the month of July, we saw financial markets react to potential imminent interest rate reductions. It began with the July inflation report, which showed that monthly consumer prices fell for the first time in four years. And at the end of the month, it concluded with the Federal Reserve stating that it could cut interest rates in September. Market forces started pushing interest rates lower as investors began to anticipate a formal rate cut in September.[1][2]

And the decline in market interest rates had an immediate impact on financial markets. Historically, declining interest rates have benefited dividend-paying investments. The main reason for this is that dividend-paying investments can act as an alternative to bonds. When interest rates decline and bonds pay less interest, dividend-paying investments become more attractive as an alternative to bonds. And in July, we saw an almost immediate adjustment in the stock market as traders started rotating out of stocks not paying dividends and into stocks paying dividends.[2]

When we look back over the past two years of interest rate increases, we can see that higher rates have had their intended effect of slowing economic growth and reducing inflation. The all-important question looking ahead is: what additional impacts will we see from higher interest rates? As Warren Buffett has said, “you can’t just do one thing in economics”. Yes, higher interest rates have slowed the economy and reduced inflation. And they have also led to bank failures and signs of stress in markets that relied on cheap credit. As we mentioned in past Commentaries, private markets such as private REITs and private equity have recently showed signs of stress.[2][3][7]

There may be other challenges that surface in the future as a result of higher interest rates. This is part of the reason the Fed will likely begin lowering rates in the near future, now that we’ve seen a good trajectory for falling inflation. In many ways, our economy did become dependent upon cheap financing over the past 15 years, and we probably do need to begin lowering rates again to prevent an adverse economic impact. If the Fed begins lowering rates, that will certainly help stabilize the signs of stress we’ve seen in private investment markets and the banking sector. As for the full economic impact of higher interest rates, there’s always a time lag between interest rate changes and the full economic impact. It will likely be another year or two, and possibly longer, before we know the full impact.[4]

Given this uncertainty, it’s important to invest in a balanced manner that both captures opportunities and protects from risk. Right now, we think financial market participants are too focused on gain and not enough on risk, which will likely cause challenges at some point for investors who aren’t adequately diversified. There are some caution signs we can point to with the stock market as a whole. For example, the five largest companies by market value currently make up more than a quarter of the value of the U.S. stock market. This is a level not seen in at least the past 37 years. This basically means that the stock market as a whole isn’t adequately diversified at this time.[5]

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When any or all of these five stocks inevitably encounter challenges, it will have an outsized impact on the stock market. Historically, we've seen the stock market as a whole remain flat for a decade or longer as a result of major components becoming overvalued. Another caution sign to point out is the neglect of sound, dividend-paying stocks. At mid year, dividend-paying stocks were the most neglected that they've been on record. This situation reflects the intense speculation and irrational exuberance currently seen in portions of the stock market. And again, it points to the fact that many investors appear to be currently focused too heavily on gain and not enough on risk management. Historically, dynamics like this have preceded stock market rotations out of risky stocks and into dividend-paying stocks. As we mentioned earlier in this Commentary, we may be seeing the early stages of this now.(6)

Given the current dynamics, what should an investor do? We know that trying to time the stock market doesn't work. The largest ever study of investor behavior looked at investors in an allocation of half stocks and half bonds. Those investors who tried to time the stock market over a twenty-year period earned only a 2.6% annual return. Investors who remained invested at all times over those twenty years earned a 6.8% annual return. Instead of trying to time financial markets, our approach is to develop balanced allocations with diversified amounts of investments viewed as growth investments, underpinned by a strong weighting of stable, dividend-paying investments.(5)

The fact is that the opportunity going forward is in the high-quality investments currently being neglected. That's where the value is. Investments tied to artificial intelligence (AI) have gone up over the past year mostly on speculation and hype. Now that they've gone up, many investors are overconfident. The very same investments crashed in 2022, but no one wanted to buy them. If investors were confident in their assessment of the future of AI, they should have bought those investments in 2022 when they crashed. Instead, many were selling. And now that those investments have gone up again mostly based on speculation, many investors are interested in buying again. Unfortunately, this is the opposite of how you succeed at investing over the long term. To succeed, we must buy low and sell high, rather than sell low and buy high.(8)

The final piece of the puzzle takes us back to interest rates. As we mentioned earlier, we still don't know whether the ultimate result of higher interest rates is a soft landing where our economy keeps growing unharmed, a hard landing where we experience a recession, or something in between. Investing on the expectation of any one of these scenarios alone doesn't make sense. Rather than being optimistic or pessimistic, we prefer to be realistic. Being realistic means diversifying portfolios so that our clients have the best chance of succeeding no matter what happens. That's what we'll continue to do.

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Forbes Best-In-State Wealth Management Team 2024

Sources:
(1) Reuters
(2) The Wall Street Journal
(3) Barron's
(4) Board of Governors of The Federal Reserve System
(5) RBC
(6) Factset
(7) Business Insider
(8) CNBC

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