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March 2024 Crescent Commentary

During March, financial markets continued to focus on what the Federal Reserve will do with interest rates. This focus played out through large swings in both stock and bond markets during times when Fed Chair Powell spoke, as well as during the release of inflation data. Financial markets have had a particularly acute focus on inflation and interest rates for two reasons: 1) the high inflation we've experienced over the past two years, and 2) the higher interest rates induced to reduce that inflation. But the fact is that financial markets have experienced swings in response to expected interest rate changes for the past ten years and more.(1)(2)

Before we get too far into this topic, we should stop to ask why interest rates matter for financial markets. Well, interest rates act as gravity to lower the value of all financial assets: public, private, real estate, stocks, bonds, privately held businesses, etc. Higher interest rates translate into lower asset values, and lower interest rates translate into higher asset values. Additionally, lower interest rates act as a form of stimulus and higher interest rates act as a form of stimulus reduction. Lower interest rates allow businesses and consumers to borrow and thus spend more money, which boosts the economy. This is why interest rate expectations move financial markets.(3)

While financial market swings in response to interest rates have intensified over the past several years, we can see these swings going back at least the past decade. For example, in May 2013, the Fed started to talk about the possibility of raising interest rates – the Fed had reduced interest rates to near zero to pull the U.S. out of the Great Recession, and by 2013 our economy had strengthened enough for the Fed to determine it could be time to scale back stimulus. Within weeks, world stocks fell 10%.(1)

More recently, let's fast forward to 2018. Fed Chair Powell publicly stated that interest rates were well below the level appropriate for the current strong economy. Following these comments, U.S. stocks declined 20% through the end of the year. In a bizarre twist, Powell appeared to get cold feet and actually reversed his position a few months later, which led to a recovery in stock prices. Then we went through Covid in 2020, which again led the Fed to cut interest rates to zero, fueling speculative investment euphoria through the end of 2021. At that time, it was clear that we had an inflation problem, and the Fed announced it would begin raising interest rates to reduce inflation. As a result, both the U.S. bond market and U.S. stock market crashed over 20% through the end of 2022.(2)

2023 began the year similar to how it ended 2022, with speculative and popular investments in a crashed position and dividend paying / stable investments holding up quite well. Then in March of last year, we experienced the failure of a few prominent banks. In another one of the most bizarre financial twists of the past few decades, the bank failures actually led to a recovery in the most speculative and popular investments. This recovery continued through this past February. The reason bank failures led to a recovery in popular / speculative investments is that speculators / traders started to bet that the Fed would have to cut interest rates sooner rather than later as a result of economic weakness they thought would stem from the bank failures.(2)

And this takes us to the present time. We're now in the position where speculative and popular investments crashed in 2022 as a result of interest rate increases. Then they recovered over the past year as a result of expectations that the Fed would have to cut interest rates as a result of bank failures. But instead, the economy has remained strong, and recent inflation data has come out stronger than expected. So rather than needing to cut interest rates sooner, the Fed is now in a position where the economic data call for higher interest rates for longer. At some point these two sets of facts must reconcile. Mathematically, we know that speculative assets are worth less when interest rates are higher. We saw the impact of this in 2013, 2018, and 2022 when popular and speculative investments did poorly when interest rates moved higher. So either interest rates will have to move down, or speculative and popular investments will need to move down.

And this is the reason why we think it's important for investors to diversify today. In our last Commentary, we talked about "lost decades" in the U.S. and Japan, which were times when investment markets were flat for a decade or longer (34 years in the case of Japan). The big driver of these lost decades was popular and speculative investments that made up a disproportionate share of investment markets. When those popular and speculative investments crashed or stalled, it caused markets to stall for a long time. Investors who didn't diversify away from what was most popular and who did what everyone else did got burned. The good news is that investors who remained disciplined and diversified did fine during those times. For example, the most recent lost decade in the U.S. was 1999 to 2013, when the U.S. stock market was flat for over 13 years. For the decade 1999 to 2009, the U.S. stock market fell over those ten years. But specific industries actually showed a gain. For example, healthcare, industrial, and consumer staples industries all showed a gain over that decade when the U.S. stock market declined.[4]

So while it's fine to own growth-oriented investments which are very popular at the moment in the U.S., it's important to own them in diversified amounts so that when something bad happens, it limits your downside. This is why we currently recommend a "barbell" approach to asset allocation where an investor owns some growth-oriented investments, but also owns plenty of stable, dividend-paying investments to balance out the risk. Investors overly exposed to popular investments are dependent upon low interest rates for success. In our opinion, if your investment process depends upon what happens with interest rates, you're doing it wrong. What you want to own are investments that have the best chance of doing reasonably well no matter what happens with interest rates.

Now moving on to a different topic, and that's to remind you about the projected sunsetting of the current estate tax exemption. As part of the Tax Cuts and Jobs Act of 2017, Congress increased the estate tax exemption from $5 million to its current level of $13.6 million for 2024. For married couples, the current exemption is $27.2 million. The exemption will revert to $5 million ($10 million for married couples) at the end of 2025 if Congress does not act. For families and individuals looking to take advantage of the higher estate tax exemption of $13.6 million, the clock is ticking to take action and eliminate the possibility that the exemption reverts back down to $5 million. If you'd like to learn more about this, please contact us.

Last but not least, we're excited to announce that we welcomed Randi Walker, CFP® to our team this month. Randi joins us as a Senior Financial Associate. Randi's main role will include assisting Carsten and Paul with financial planning. Randi will also reach out to you to gather information to update your financial plan, as well as to schedule your meetings and calls with Carsten and Paul.

The Crescent Group: Paul Hendershot | Carsten Frederiksen, CFP® | Lindsey Vickers, MBA | Randi Walker, CFP®
Forbes Best-In-State Wealth Management Team 2024

Sources:
(1) Reuters
(2) CNBC
(3) Harvard Business Review
(4) Richard Bernstein Advisors