Wall of Worry

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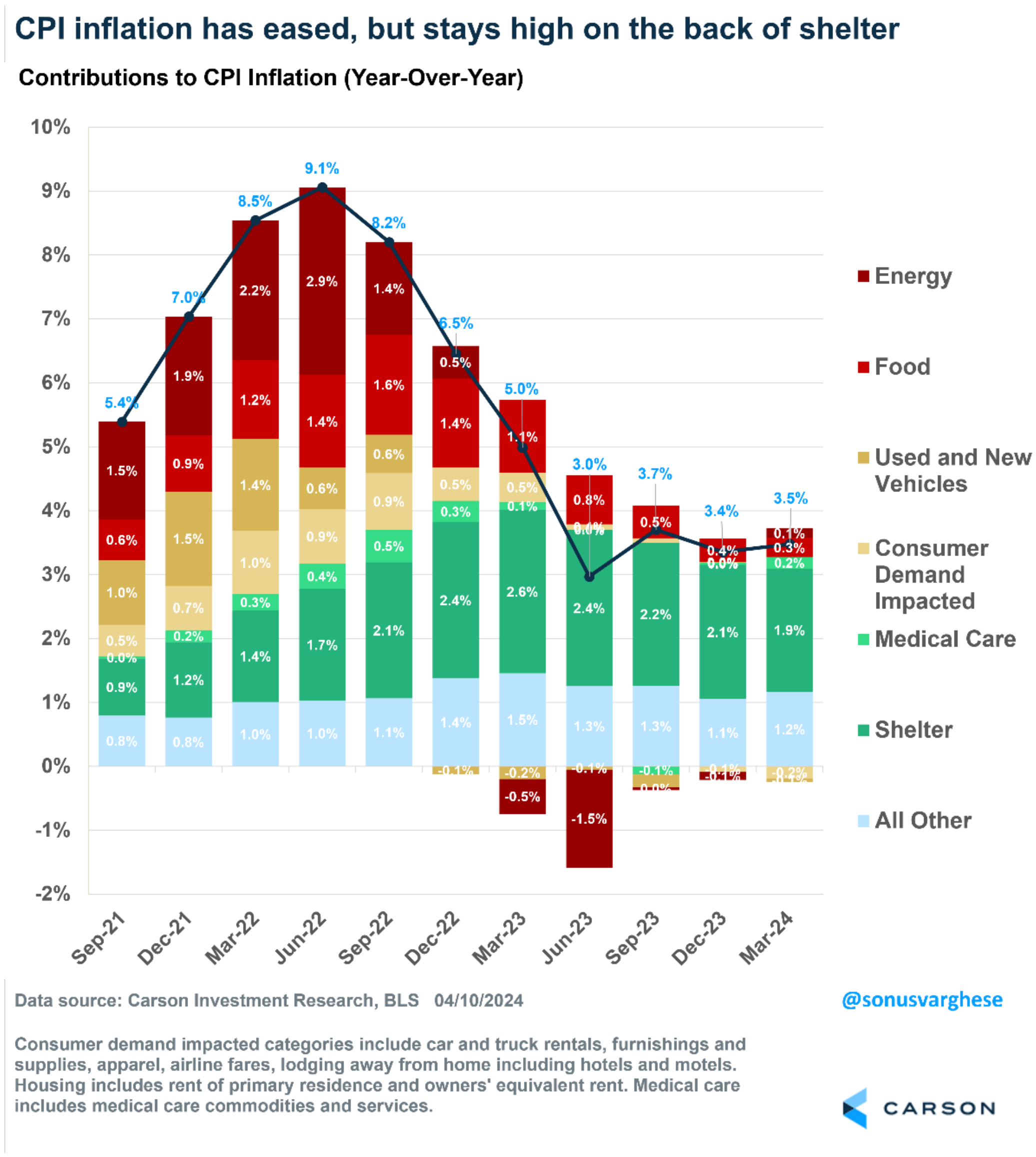
The financial markets got off to a great start in 2024 as U.S. stocks raced to near 10% gains during the first quarter. As you may have noticed, however, things have hit a bit of a lull these past few weeks, and last week's inflation report did nothing to help. March CPI (inflation) was reported at a 3.5% annual rate, which was higher than expected and likely closed the door on a June interest rate cut by the Fed. So, is it time to worry about inflation again?

While I'm inclined to say no, market participants are clearly worried. They don't want to hear about how much interest they're earning or be reminded of the fact that their wages have gone up. They want price rises to stop, or to actually go backwards, though that is highly unlikely to happen. But the bottom line is that the economy is too good to expect a rapid cooling off anytime soon. When people are working, people are spending. And almost everyone is working.



When you look at the chart above, what do you see? I see progress, and a significant amount of it. Trying to battle inflation is a messy process. We should consider ourselves fortunate that headline inflation has fallen from over 9% to nearly 3% without the need for some sort of catastrophic event happening in the economy or the labor market. Both are still strong. For a while there, it seemed like the only way out of the spiraling inflation we were facing was a recession. But despite the Fed's best efforts to slam on the brakes, we skirted an economic recession and continued to add hundreds of thousands of jobs each month. Almost no one thought we could disinflate and create jobs at the same time - yet that is exactly what has happened.

So maybe we will never get to that 2% inflation rate that seems to be the target on everyone's mind. Personally, I see that being a very tall task given the strength of the consumer and labor market. So, unless auto insurance and shelter costs reverse their upward trend, investors might just have to get used to the idea that 3% inflation is the "new normal."

Adding to the angst surrounding the latest CPI report is all the geopolitical stuff happening around the world. These types of events often trigger a panicked response by investors because of their high level of uncertainty. But you might be surprised to know that it rarely pays off to make portfolio changes in reaction to this sort of thing.

First off, we don't know what's going to happen. And the more we read about a brewing crisis, the more our minds go to worst-case scenarios. But most importantly, while we might be right about our own predictions, we could be wrong about the reaction in the stock and bond markets. Consider today: stocks are up (marginally), while bonds and oil are down. This is the exact opposite of what I, and many others, would have expected for today given the events of the weekend. Now that could all change just by the time I'm done typing this, but like I said, you never know how the market is going to react. Consider some past market reactions to major geopolitical events, many of which might surprise you:

- In the 6 months following the onset of World War I in 1914, the Dow dropped more than 30%. The market even closed for six months. But in the following year, it rose more than 88%, which remains the highest annual return on record for the Dow.
- Hitler invaded Poland on Sept. 1, 1939, beginning World War II. When the market opened on Sept 5, the Dow actually rose almost 10% in a single day.
- The Dow Jones lost only 1% and remained surprisingly calm during the 13-day period of the Cuban Missile Crisis in 1962.
- The stock market opened up 4.5% the day after the assassination of JFK, and went on to gain more than 15% in the following year (1964).
- Stocks fell sharply after the 9/11 attacks, dropping almost 15% in less than two weeks following the tragedy. The economy was already in a deep recession and stocks were still falling from the technology bubble, but within a couple of months the stock market had gained back all its losses from Sept 11.
- The U.S. invaded Iraq in March 2003. Stocks rose 2.3% the following day and finished up the year with a gain of more than 30% from that point on, though this followed the end of a brutal bear market.

You can see that markets have a mixed record when dealing with international conflicts, and there is no blueprint or road map for investors to follow. And obviously none of us have any idea how this situation in the Middle East is going to play out. About the only thing we do know is that we're likely to see a fair amount of market volatility over the coming days/weeks as investors digest new information, and we'll be sure to keep you updated on both the risks and opportunities that may arise as a result.