DIAMOND HILL

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Are Markets Facing the Interest-Rate Music?

Apr 2024

Global markets declined overall in April as geopolitics further intensified, inflation remained sticky across major global economies, and central banks remained committed to keeping interest rates at their current high levels for the time being. In USD terms, the MSCI ACWI Index declined -3.3% as economic data continued painting a mixed picture.

The US reported +1.6% annualized growth in Q1 — well below the +2.4% expected — while the personal consumption expenditures index (the Fed's preferred inflation measure) rose from +1.9% in Q4 to +3.1% in Q1 and from +2.5% in February to +2.7% in March. US wages rose, too, according to a measure the Fed keeps an eye on. Though the GDP report seemingly points to a slowing economy, the numbers beneath the headline paint a slightly different picture — with the trade deficit and inventories dragging while demand remains undiminished. The combination of relatively robust data seemed to force investors to quickly adjust their 2024 expectations, with a sharp reverse from broad expectations for several (as many as six) rate cuts to maybe just one or two. Federal Reserve head Jerome Powell also admitted rates would likely need to stay higher for longer — in the wake of which markets globally declined, including European markets.

Interestingly, we may be on the precipice of diverging monetary policy: The European Central Bank, which, like the Fed, held rates steady in April, has begun signaling it may cut rates as early as this summer. A significant reason for the potential shift is inflation, which seems to be moderating faster in Europe than in the US — eurozone inflation fell to +2.4%, and German inflation fell to +2.3% in March. Inflation is also moderating in the UK, prompting growing pressure on the Bank of England to consider rate cuts sooner rather than later.

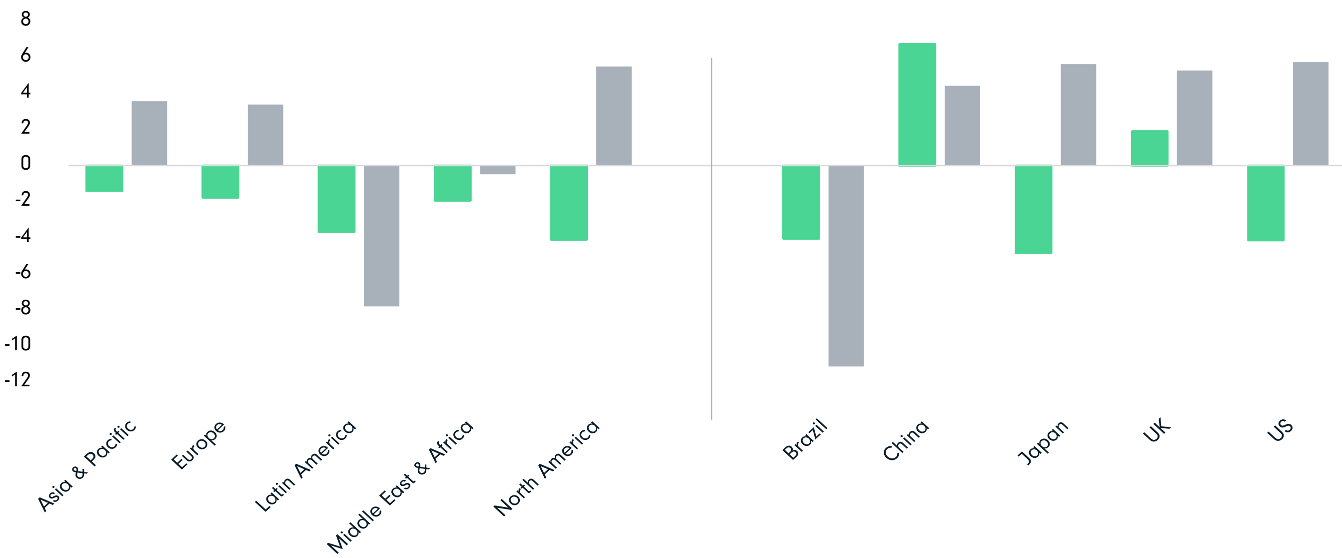
Notably, the sharp reversal in investors' expectations prompted the US dollar to strengthen relative to global currencies, particularly the Japanese yen, which fell to its weakest level relative to the dollar since 1990. On the heels of the Bank of Japan's long-awaited exit from its negative interest rate policy, it now faces accelerating inflation tied to a weak currency, which could prompt it to raise rates more and faster than it planned. Several Asian countries, especially Indonesia, faced sharp currency pressures from the strengthening dollar — forcing Indonesia's central to raise interest rates to defend the weakening rupiah.

Further complicating the global macroeconomic picture are rising commodities prices — especially oil — amid ongoing Middle East tensions, which ratcheted up in April as Iran launched a massive (if ineffective) drone attack against Israel, and Israel responded with its own missile attack. Simultaneously, war continues between Russia and Ukraine, and geopolitical tensions between the West and China continue, with Taiwanese companies making concerted efforts to shift supply chains away from their heavy reliance on China. All global shifts whose full implications have yet to play out but will likely have meaningful effects on global supply chains and trade patterns.

Regionally, stocks in the Asia and Pacific region led global stocks, falling a moderate -1.4%. China was a significant contributor, rising +6.7% in April and taking year-to-date returns into positive territory, up +4.4%. Factory activity expanded for a second consecutive month, while GDP grew a more-robust-than-anticipated +5.3% in Q1 as industrial production expanded. However, the economy remains a mixed bag as consumption remains weak, and the real estate sector shows few signs of recovery thus far. Other Asia and Pacific countries were in the red, notably Indonesia (-8.5%), Korea (-5.8%), Japan (-4.9%) and Taiwan (-2.3%).

European stocks were also down relatively less, falling -1.8% and led down by major economies Germany (-3.7%) and France (-2.8%). The UK had a positive month, rising +1.9%. The Middle East and Africa region fell shy of -2.0%, with Egypt's market the biggest decliner, -11.8%, as the country faces ongoing currency and shipping crises. Unsurprisingly, Israel's market fell a sharp -7.1%, while South Africa was the region's sole country in the black, up +2.8%. Latin American stocks broadly declined, with the region delivering -3.7% returns. Brazil's year-to-date decline continued, falling -4.1% in April. Colombia (-4.4%) and Mexico (-3.7%) were also in the red for the month. North American stocks declined the most, with the US down -4.2%.

Exhibit 1 — February Returns for Major Markets (USD) (%)



Source: FactSet, as of 30 April 2024.

At the sector level, non-US technology stocks declined the most (-5.9%), followed by discretionary stocks (-3.0%), as investors seemed to seek relative safety in less growth-oriented sectors. Real estate was also down (-2.4%) as rates look poised to remain higher for longer. Energy turned in the best month, up +2.5% amid rising oil prices, while utilities (+0.1%), communication services (+0.1%) and materials (+0.0%) were flat.

Markets seemed to finally respond to headlines, which, depending on one's lens, haven't shifted all that materially but have undoubtedly remained sober at best — particularly on the geopolitical front. Though it's hard to envision headlines improving significantly in the near term (again, especially geopolitically), it is precisely such uncertainty that can produce an interesting investing environment — particularly for bottom-up, value- and fundamentally oriented investors who are willing and capable of doing the deep research necessary to identify high-quality companies trading at interesting valuations.

MSCI ACWI Index measures the performance of large- and mid-cap stocks in developed and emerging markets. The index is unmanaged, market capitalization weighted, includes net reinvested dividends, does not reflect fees or expenses (which would lower the return) and is not available for direct investment. Index data source: MSCI, Inc. See diamond-hill.com/disclosures for a full copy of the disclaimer.