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2024 First Quarter Newsletter and Outlook

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For the first quarter of 2024, stocks made money, long term bonds lost money, and very short-term bonds made money. MCS clients were mostly positioned in US Treasury Bills (which are very short-term bonds) and made money.

Through March 31, stock indexes put up excellent gains, ending high on AI and the effervescent hopes of a soft landing (where inflation and interest rates continue a decline which in turn fuels stock and bond price gains). Gold was up too, but it wasn't investor demand pushing up gold prices; it was central bank and retail buying of physical gold.

The much-ballyhooed story—'The Fed will reduce short term interest rates 6 times' (January), er, make that 3 times (March) starting in June, er, we mean July—was smacked down by worse than expected April inflation reports that translated to "Hey, further reductions in inflation aren't going to be easy, so don't even expect 3 interest rates cuts this year![1]" Bond bulls, those betting on lower rates, watched their heavily promoted soft-landing story crack on hard inflation data.

As I write this on April 15, bond and stock prices are dropping as yields spike upward. Since most investors are far more interested in stocks than bonds, they typically fail to appreciate the relationship between the stock prices and interest rates.

> *Bond price declines, a reflection of rising interest rates, can often (but not always) offer an early warning of lower stock prices to come.*

For the first quarter of 2024 (if MCS clients' investments were treated as one large portfolio including their cash), on average clients gained 1.1%, after fees. For comparison purposes, the S&P 500 Total Return Stock Index (S&P 500) gained 10.6%, and the Bloomberg Barclays Aggregate Bond Index lost 0.8%. The range of MCS individual client returns was from a gain of 3.2% to a loss of 1.4%[2]. The clients who fared the best and the worst were overweight in long held, low-basis stocks. While the market in general (and oil stocks in particular) gained, some stocks like Apple (AAPL) and Nike (NKE) did not do well in the first quarter.

Those 'in the know' really do not know that much.

Since the beginning of the Pandemic, my view has been that the markets do not fully understand the complex dynamics unleashed during and in response to the pandemic, in part because there is no comparable historical economic data. Full disclosure: I don't fully understand it either. The Bloomberg article headline, 'US Insight: 60,000 Headlines, 99 Indexes Say Fed to Cut in July' is a powerful reminder of how buying into a story and its repetition influences both policy and our views of reality. Unfortunately, reality in the form of actual inflation data intruded on the carefully crafted story. To the Fed's credit, it has maintained that any cuts are data dependent – if the data changes enough, the Fed will change its collective mind about when and if interest rates will be cut.

Larry Summers, PhD, former President of Harvard[3], has had some of the best insights into how the economy and inflation evolved during and after the pandemic. He opined *a month ago that markets need to consider the probability (15-25%) that the next Fed interest rate move may need to be HIGHER and not lower. Now that would be a gut punch to financial markets!*

The tremendous uncertainty is also recognized by JPMorgan Chase CEO, Jamie Dimon[4]:

> *Chief Executive Jamie Dimon warned that U.S. interest rates could soar to 8% or more in coming years, reflecting the risk that record-high deficit spending and geopolitical stress will complicate the fight against inflation.*
>
> *Huge fiscal spending, the trillions needed each year for the green economy, the remilitarization of the world and the restructuring of global trade—all are inflationary," Dimon wrote in an annual letter to JPMorgan Chase shareholders released on Monday.*
>
> *…Dimon said his bank is preparing for a range of scenarios where interest rates could drop as low as 2% or head to "8% or even higher," based on where the economy is headed. The 10-year Treasury rate recently was 4.42%.*

UBS is now suggesting that the Fed hiking rates to 6.5% next year is a potential outcome that should be considered.

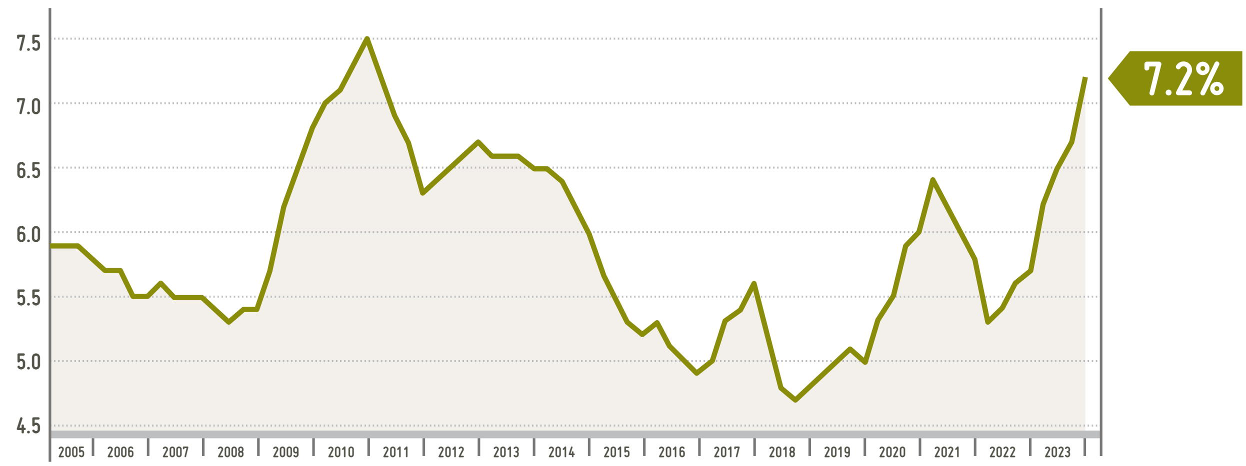
Rising Interest Rates Mean Trouble for Investment Real Estate

Unlike stock prices, which can defy higher rates with rapidly growing earnings (or the promise thereof) or meme investor enthusiasm, prices of investment real estate are anchored to the realities of interest rates and rental income.

The income from real estate is expressed as a yield, called the cap rate (capitalization rate). It's calculated by dividing net operating income (rent minus operational expenses) by the market price of the property. A property with $50,000 of net income and a sales price of $1,000,000 would have a cap rate of 5% ($50,000/$1,000,000 = 5%). When interest rates rise, cap rates rise as well, which reduces the value of real estate.

Figure 1

NY City Apartment Cap Rates



Source: Bloomberg

The Cap Rate on NY Apartment buildings declines from 7.5% in 2010 to as low 4.7% in 2018 and then back to 7.2%. The table below shows how Cap Rates change building market value for an equal amount of income.

Table 1

NY City Apartment Cap Rates

As cap rate increases, market value decreases

Income	Cap rate	Market value
$50,000	4.7%	$ 1,063,830
$50,000	5.0%	$ 1,000,000
$50,000	6.0%	$ 833,334
$50,000	7.2%	$ 694,450

Now, imagine that an investor bought in 2010 and refinanced the apartment building as interest rates declined. By refinancing, investors can take money out of the property with no tax consequences at the time. The building is worth $1,000,000 when the cap rate is 5%, and the investor gets a loan for 80% of the value, or $800,000. When cap rates increase to 7.2%, the investor's equity has been wiped out ($50,000 / 7.2% = $694,450). This leaves the investor under water, with an $800,000 mortgage on a property worth less than $700,000.

The most troubled real estate investors are those that consistently refinanced their properties to pull money out, as interest rates declined, thus maintaining a relatively high to loan to value. Like previous real estate downturns, the distressed sellers set new lower comps for the market.

Commercial real estate has suffered badly because the pandemic drained demand for offices as employees shifted to 'work from home,' while higher cap rates put further pressure on property values. Buildings are being returned to the lender after the owners lost all their equity[5].

While real estate investors will have their property value smacked hard by 'higher for longer' interest rates, so long as they have low fixed rate mortgages and positive cashflow, they won't be forced into selling. It simply becomes a lousy investment that requires a lot of work.

I was recently talking to a doctor who is a partner in a medical building. He was bemoaning the fact that they had missed the sell window when the cap rate was 4%. To explain his sense of loss, a cap rate going from 4% to 5% reduces the building value by 20%! They are trying to increase rental income, which is not easy. At a 5% cap rate, they need to increase net income by 25% to get back to a 4% cap rate.

Table 2

Valuing Investment Real Estate

(Simplified: interest rate variable only)

Building Value $	Net Operating Income $ (NOI)	Cap Rate	Comments
1,000,000	40,000	4%	Historically Low Cap Rate equals Every Investor is a Genius
800,000 20% decline	40,000	5%	Cap Rate Normalizing This will be painful
1,000,000	50,000 25% increase	5%	25% NOI increase: This is not so easy

Single Family Homes, a Different Story?

In a higher-for-longer interest rate environment, given the poor outlook for *investment* real estate, you may wonder whether home prices will fall as well. After all, home affordability has dropped significantly. See Figure 2 (on page 5).

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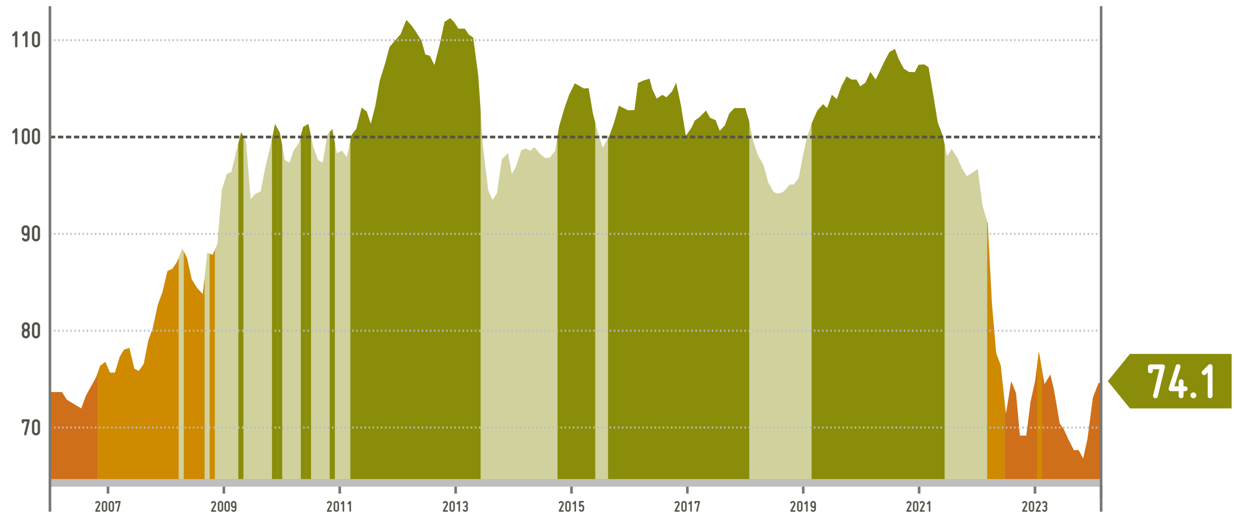
Figure 2

Home Affordability

Lower means less affordable



Source: Federal Reserve Bank of Atlanta

My current view is single family residential real estate can maintain its value better than other real estate, because the situation is very unlike the real estate crash of 2008 in eight important ways:

1. Tighter lending standards - Unlike 2008, lenders are not making junk mortgage loans (small down payment, drive-by appraisals, low teaser interest rates that quickly adjust higher) to unqualified buyers. Today real estate borrowers put more money down, typically 20%, and are well qualified, income-wise.
2. Low fixed rate mortgages - Homeowners have benefited from 10 years of super-low fixed rate mortgages; payments are low and people are not moving[6].
3. Work from home - This has reduced supply of 'for sale' real estate by reducing the need or desire to move for a new job.
4. Supply - The supply of homes for sale has decreased faster than the demand decreased, despite higher interest rates. Unlike 2008 when people were forced to sell, current homeowners are not defaulting. (Note: In other countries, like Canada, where mortgage rates tend to be adjustable, defaults are a problem.)
5. Employment - The jobs market remains tight, meaning there is high demand for workers.
6. Builders - It is not easy or cheap to increase the supply of homes in already developed areas.
7. No forced selling - The 2008 collapse in home prices due to imprudent bank lending cascaded through the financial system, severely damaging consumer balance sheets. Consumer purchases make up 70% of the economy, thus the impact was very large. In this environment, the home values are stable and well supported by demand due to short supply.
8. Rentals - After the 2008 crash, institutional investors bought up distressed homes by the thousands from banks and turned them into rentals[7]. The rise of short-term rentals (Airbnb) further reduced supply.

Now many qualified homebuyers, who held off buying believing the often-forecasted imminent recession would reduce housing prices or that mortgage rates would soon decline, are throwing in the towel and buying. They know that they can always refinance their mortgages if rates decline.

Table 3

Stock, Bond, and Real Estate Yields

As of April 12, 2024	Short-Term Bonds 6 mo. UST	Intermediate-Term Bonds 10 yr. UST	Long-Term Bonds 30 yr. UST	Stocks Earnings to Price Ratio or Earnings Yield	Real Estate Cap Rate on Publicly Traded REITs
Current Yield	5.34	4.52	4.63	4.09	5.7
Potential income growth	No	No	No	Yes / High	Yes /Moderate
Potential income decline	No	No	No	Yes / High	Yes /Moderate
Yield required to be attractive	5.34	6.0% +	6.5% +	6.0-7.5% +	6.0 -7.5% +
Comments	Lower Short-Term yields reduce required attractive yields and vice versa	Current yields already assume that short-term bond yields will fall rapidly. If inflation remains sticky (or worse, rises), short-term yields will not fall enough to meet expectations, and the yield on all the above will rise, depressing prices. Stock yields are more variable because the income can grow. Note: Major geopolitical events, like escalating wars or a financial crisis, can push required yields much higher.			

Note: The '***yield required to be attractive***' is an example of what rates would need to be under current circumstances for MCS to consider investing. In the red highlighted areas, rates need to increase significantly to make it worth taking the risk.

The Silver Lining – Yep, there is One.

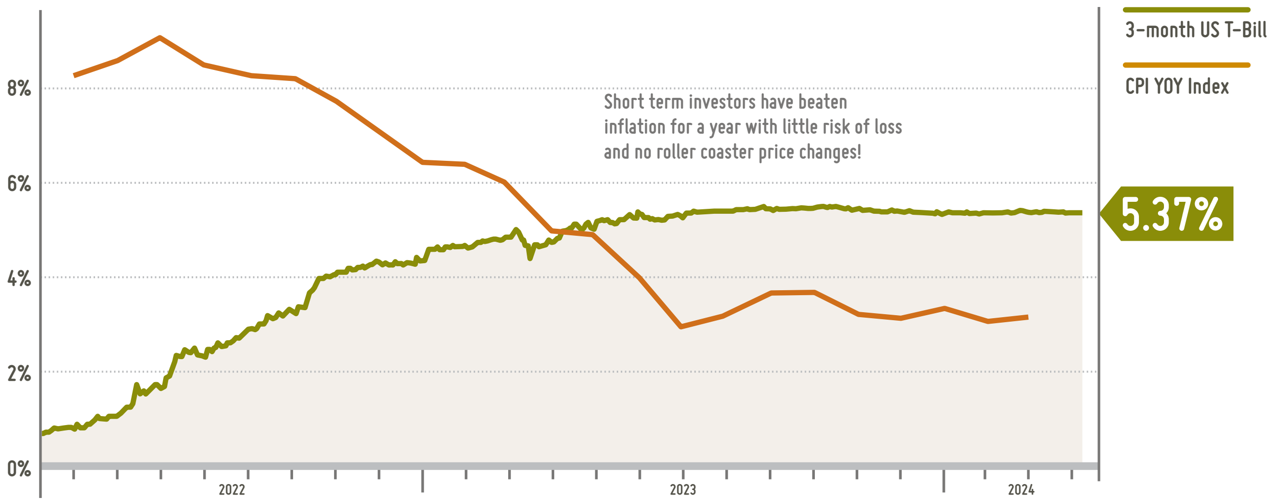
Other's Interest Rate Pain is Your Gain.

Current interest rates have been a huge boon for retirees and conservative investors who need a secure source of income. Chasing the latest stock market craze may be entertaining, and even rewarding, but it is unpredictable. MCS clients have been beating inflation with T-Bills for almost a year. Not so for long term bond investors who have lost money.

Figure 3

Investors are Beating Inflation with Low Risk

3 mo. US Treasury Bill (5.37%) vs. Consumer Price Index (3.15%)



Source: MCS, Bloomberg

Bottom Line

Currently, short-term investments are very attractive on both an absolute (higher yield than other high-quality investments) and risk-adjusted basis (far less risk than competing investments). The main risk and advantage of short-term investing is the yield can quickly change lower or higher depending on the circumstances. The potential for losing or gaining principal value is very low.

To take more risk and lock in long-term interest rates now requires long-term yields to be higher than short-term yields. These conditions do not exist at the present time. This could happen in two ways: by long-term yields rising above short-term yields or short-term yields falling below long-term yields.

Regardless of which way long-term yields beat short-term yields, the odds are it will make for a volatile event.

We're ready to take advantage of it. As always if you'd like exposure to stocks without waiting for the interest rates to change more favorably, please call me at 541-345-7023 or email me at michael@mcsfwa.com. There are more nuanced interest rate scenarios where stocks could also perform well.

Endnotes

1 https://www.wsj.com/economy/central-banking/wall-street-fed-rate-cuts-f6c154d7

2 MCS Family Wealth Advisors (MCS) consolidated client returns are dollar-weighted, net of investment management fees unless stated otherwise, include reinvestment of dividends and capital gains and represent all clients with fully discretionary accounts under management for at least one full month in 2024. These accounts represent 99% of MCS's discretionary assets under management as of 03/31/2024 and were invested primarily in US stocks and bonds (1.2% of client assets on 03/31/2024 were invested in tax-exempt municipal bonds). The Stock Index values are based on the S&P 500 Total Return Index, which measures the large-capitalization US equity market. The Bond Index values are based on the Bloomberg Barclays US Aggregate Bond Index, which measures the US investment-grade bond market. Index values are for comparison purposes only. The report is for information purposes only and does not consider the specific investment objective, financial situation, or needs of any recipient, nor is it to be construed as an offer to sell or solicit investment management or any other services. Past performance is not indicative of future results.

3 https://en.wikipedia.org/wiki/Lawrence_Summers

4 Wall Street Journal, April 8, 2024. https://www.wsj.com/finance/jamie-dimon-warns-u-s-might-face-interest-rate-spike-83789da7

5 https://www.costar.com/article/1384869720/more-office-building-landlords-are-giving-properties-back-to-lenders

6 https://www.wsj.com/economy/housing/baby-boomers-big-homes-real-estate-inventory-3a047cb6

7 https://www.cnbc.com/2023/02/21/how-wall-street-bought-single-family-homes-and-put-them-up-for-rent.html

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