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After that strong start to 2024 equity markets are now facing magnified risks that includes resurgent inflation, weaker economic data, and increased tensions in the Middle East. There may be some turbulence ahead for markets as they navigate the risks and adjust to higher for longer interest rates.

By the end of March this year it was all blue skies ahead – interest rates and inflation were normalizing, economic growth was forecast to improve, unemployment remained low, and there appeared to be no obvious risks on the horizon (although on-going geopolitical tensions remained on the radar). But of course, in financial markets the unexpected is always close at hand.

Throughout the first quarter, economic data in the US and Australia kept indicating that inflation was not coming down as fast as markets had anticipated. While central banks had stated back at the end of last year that they now felt they had done enough work to tame inflation through the fastest and largest rate hiking cycle on record – and that the next move in rates would be downward – the expectations around when those rate cuts would start, moved around on a near daily basis.

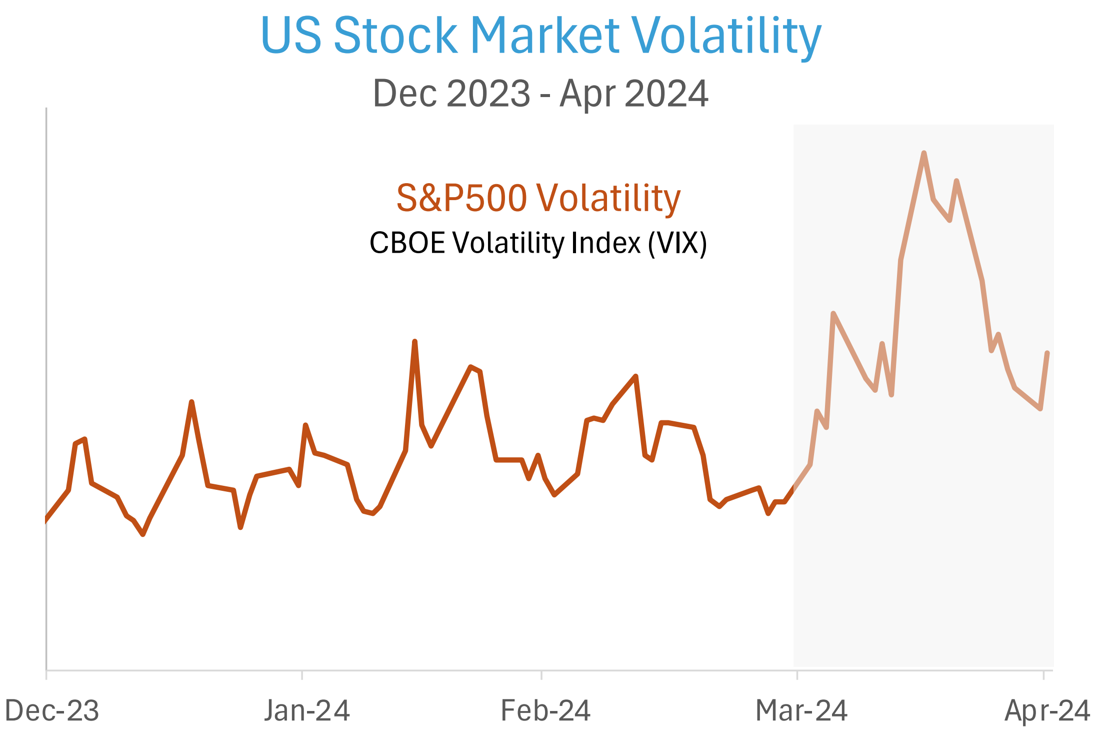
From expecting as much as three 25bps cuts in 2024 at the start of the year - starting as early as March - by the end of the quarter those expectations had changed to perhaps one 25 bps cut sometime later in the year. Longer bond yields kept slowly rising as the date for cuts kept getting pushed back, and bond indices – which had a massive rally at the end of the year - returned close to zero for the quarter.

But the equity markets ignored the signs from rising bond yields – corporate earnings were good, and even if rate cuts were being pushed back, the economy was generally in great shape. The Australian stock market returned a healthy 5.3% for the quarter, while global markets returned a stunning 14% – led by the US market and in particular the big tech companies that were investing heavily into future applications of AI. While data indicated that rates would stay higher for longer, the market still believed central banks would still beat inflation without a painful rise in unemployment.

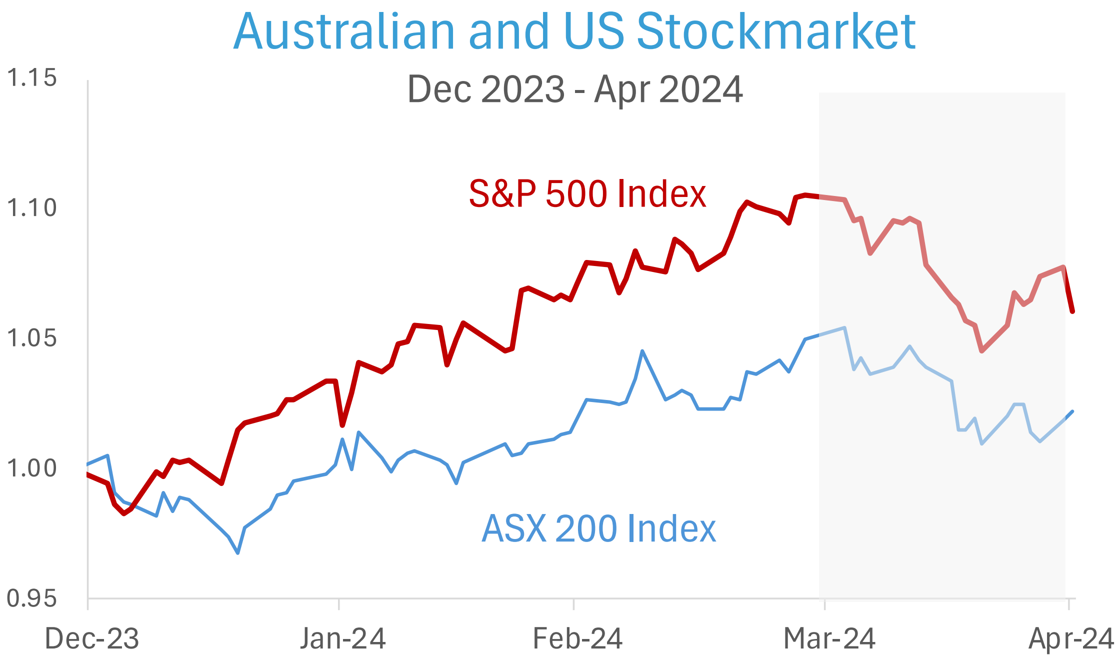
But after that strong start to 2024 equity markets are now facing magnified risks amidst signs of resurgent inflation and weaker economic data. By mid-April, data from both the US and Australia had inflation coming in higher than expectations - strengthening the case for delayed rate cuts and raising fears of potential rate *increase*s, should inflation continue to stick. Market commentators have moved from the hard landing scenario of only a year ago, to a certain soft landing only a few weeks ago, and now a possible "no landing" scenario, where higher interest rates could be required to bring inflation back to the target band.

Furthermore, risk-off sentiment has dominated in April as Iran launched hundreds of drones and missiles against Israel, in an unprecedented attack that came as a response to an Israeli raid on the Iranian consulate in Syria at the start of the month. The ramifications for oil prices amid further military escalation in the Middle East have weighed heavily on market sentiment.

A gauge of the turbulence in markets can be seen in the Volatility Index, or the VIX, which represents the implied volatility of the S&P 500 Index. The VIX is sometimes referred to as the "fear index", and one can see in the chart below that while volatility has remained low throughout the first quarter it has spiked in recent weeks.



Consequently, stock markets have been unsettled by this turbulence. The chart below shows the US and Australian markets since the start of the year. In April the ASX 200 Index is down 2.9%, while the S&P 500 index which represents the US stock market is down 4.1%. Of course, one needs to keep recent market turbulence in perspective – over the last 12 months the Australian index is up over 9%, while the US index is up 21%.



More recent news indicates that this period of turbulence in the markets may be dissipating. The dangerous back-and-forth between Israel and Iran appears to have ended - at least for now - when Israel destroyed part of a long-range air defence system in Iran, without retaliation. The strikes were a delicate balance between escalating the conflict further and inaction but did signal that Israel could launch precision strikes against strategic locations. The design of these targeted strikes – and Iran's muted response – indicates that neither side wants a war.

In Australia, the stronger than anticipated first quarter CPI results did push back market expectations of the RBA cutting rates to the end of the year or even early 2025, but this had minimal impact on the market. While the CPI was unwelcome news, it was still consistent with inflation coming down.

In the US - In a widely anticipated move - the Federal Open Market Committee opted to maintain its Fed funds interest rate at its current target range between 5.25% and 5.5% at their May 1st meeting. While the Federal Reserve signaled fresh concerns about inflation, the Chair said that it was unlikely that the Fed's next move would be to raise interest rates, saying they would need to see persuasive evidence that policy is not tight enough to bring inflation back toward its 2% target.

The last few weeks has reminded us that turbulence in markets – while never pleasant – is a part of the investment journey. We don't expect the recent volatility to be the last we will see this year – clearly risks remain, around both geo-politics and higher interest rates. But risks and uncertainties are a part of any journey, and until there is compelling evidence indicating otherwise, one should not change the path initially set out to reach the destination. When it comes to investing, the same is true as in flying – in times of turbulence please remain seated.

Dr Steve Garth
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