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Investment Institute

Market Commentary

Weekly perspective on current market sentiment **April 19, 2023**

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Last week's S&P 500 Index: +0.8%

Splitting hairs

Key takeaways

- Our expectation that the Federal Reserve (Fed) will not cut rates this year is a key reason we believe the economy will slow further and eventually tip into a recession later this year.
- Some investors may be focused on whether the Fed will hike interest rates 25 basis points (0.25%) one or two more times. To us, that is splitting hairs.

The debate has been "raging" in the financial media for the past month or so. And granted, there is a lot of time to fill each and every business day on financial-oriented cable television. The big issue is whether the Fed will hike rates by 25 basis points at the May and June Federal Open Market Committee (FOMC) monetary policy meetings or if the central bankers will be finished with their aggressive rate-hiking agenda after one more increase. Note that our call is for a 25 basis-point hike at both the May and June meetings. After seeing the Fed hike the federal funds target rate from virtually zero in early 2022 to the current 4.75% to 5% range, it seems this debate would be better spent on another topic: Just how long will we be at the "terminal" rate?

The Fed has made it clear that knocking inflation back close to the long-term 2% goal is job one. Our strategy is based on the foundational belief that the Fed will give up some growth (and even help trigger a recession) to get inflation down to the desired level and will not ease rates until it is clear the goal will be achieved. We do not believe that the Fed will cut rates this year.

However, per Bloomberg data, the fed funds futures market is currently pricing in a series of rate cuts that could start as early as September (49% chance of a cut at the time of this writing). The same data suggest the probability of a cut at the November FOMC meeting is 69.3% and is higher still at the December meeting (72.8%). We think rate cuts will not occur until 2024 as further inflation deceleration becomes more apparent and the Fed is more confident its goal is close at hand.

Our expectation that the Fed will not cut rates this year is a key reason we believe the economy will slow further and eventually tip into a recession later this year. Given that, we further believe that earnings estimates on the Street are still too high, even after taking into account recent consensus adjustments to the downside. As a result, we believe the S&P 500 will likely trade in a range with the upper end near current levels and downside support near 3,700 or just below. Bond yields also are likely to trade toward their highs of the past few months in our view. We would not chase the recent rallies in stocks and fixed income but would patiently put money to work as prices trade toward recent lows.

For now, we continue to recommend a more defensive posture focused on adding to high-quality equity and bond positions as prices fall. Some investors may be focused on whether the Fed will hike rates 25 basis points one or two more times. To us, that is splitting hairs, and we choose to focus on the slowdown in the economy and earnings and the opportunities any downside in equity and fixed-income prices might offer toward the lower end of their trading ranges.

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