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Market Commentary

Weekly perspective on current market sentiment **May 3, 2023**

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Last week's S&P 500 Index: +0.9%

The calm before the storm

Key takeaways

- Stocks and bonds have rallied nicely since Mid-March.
- But it would be a mistake to be complacent about the risks that we see arising in the months ahead as the economy continues to slow and eventually slips into a moderate recession.

Equity markets have rallied nicely since mid-March. Over the same period, bond prices have risen as the yield on the 10-year Treasury note has fallen from approximately 4% to 3.5% and both investment-grade and high-yield fixed-income spreads (aka, yields relative to U.S. Treasuries) have narrowed. In other words, many investors have a reason to be happy with the performance of their portfolios over the past seven weeks or so. However, we think it would be a mistake to be complacent about the risks we see arising in the months ahead as the economy continues to slow and, in our opinion, eventually slips into a moderate recession.

Bank-related news has been on and off the front burner since early March. At least in the early portion of this week, bank news is again dominating financial headlines. While there may be more regional bank failures in the near to intermediate terms, the bigger takeaway from these struggles is the tightening of credit conditions and the spillover effects on the overall U.S. economy. The bottom line is loans are tougher to get, especially for consumers and businesses that do not have a stellar track record. The U.S. economy is reliant on the availability of credit to fuel growth. Spending is what drives growth, and the ability to obtain loans and credit is what lubricates the U.S. economic engine. We believe it is correct to assume that tightening credit conditions will quicken the economy's deceleration and ultimately result in a recession that happens sooner than might otherwise be the case.

In addition to tightening credit conditions, another key area of concern is the likelihood that the Federal Reserve keeps interest rates higher for longer than most market participants currently expect. The federal funds futures market is currently pricing in one last 25 basis-point (100 basis points equals 1%) rate hike this week and then rate cuts starting in September and occurring at each Federal Open Market Committee (FOMC) meeting through January 2024. Our projection calls for another 25 basis-point hike at the June meeting, and we do not believe the Fed will be cutting rates this year. The tone of today's FOMC statement following this week's meeting and Chair Jerome Powell's post-meeting press conference are likely to reiterate the position that the Fed does not see rates being cut this year.

We believe the financial markets are not fully considering these and other potential risks. We also continue to see the S&P 500 Index trading in a 4,200 – 3,700 range this year. Given that the index is trading near the top end of our projected trading range, along with the complacency we see from markets about potential risks, we see downside for equities in the near to intermediate terms. As a result, we have taken measures to reduce equity exposure and reiterate our defensive posture (see our April 21 *Institute Alert* for details). Recent market action could very well be the calm before the storm.

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