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Investment Institute

Market Commentary

Weekly perspective on current market sentiment | June 22, 2023

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Last week's S&P 500 Index: +2.6%

Hawkish pause

Key takeaways

- Economic data over the last month or so continue to reflect good levels of consumer spending and a still-tight labor market.
- But the Federal Reserve (Fed) made it clear that it will hike rates if inflation does not continue to track lower in the near term. A tight labor market doesn't help.

The Federal Open Market Committee's (FOMC) June meeting has now come and gone, and investors largely got what they expected: central bankers who are still concerned about inflation staying higher for longer. That means interest rates are likely going to be higher for longer. Many investors seemed to be slow to come to grips with this likelihood as, until just a couple of weeks ago, federal funds futures contracts were pricing in a high probability that the Fed would be cutting rates at the last three meetings this year (September, November, and December).

But the economic data over the last month or so continue to reflect good levels of consumer spending and a still-tight labor market. Granted, the last U.S. employment report showed the unemployment rate jumping up to 3.7% in May, a level that is just above the 50-year low of 3.4% recorded in April of this year. Even if the unemployment rate went up a few tenths of a percent from here, the labor market would still be in good shape relative to history. And U.S. consumers with money in their pockets tend to go out and spend it. However, the Fed wants us all to spend less, which decreases demand relative to a given supply. When demand falls, inflationary pressures tend to subside to some extent.

That has largely been the case with manufactured goods. The widely followed economic gauges tracking the manufacturing sector show this segment of the economy to be in at least a mild recession (contracting). Of course, in the heat of the pandemic when we were all trapped at home and not going out to movies or our favorite restaurants, American consumers stepped up and bought all sorts of goods. Online retailers and those delivering those goods were thrilled while eateries and your favorite neighborhood watering hole were either shut down or seeing a severe drop in customers (and profits).

But now the shoe is on the other foot. Service-oriented businesses like restaurants and air travel that were shut down or severely cut back on during the pandemic are in high demand. Workers may not be as hard to find as a year ago, but most employees are seeing their wages rise. And employers want to hold onto their workers. That means boosting pay to (rising) competitive levels. Wages are typically the biggest expense for any employer, big or small. The Fed closely watches rising wages as a tight labor market puts upward pressure on inflation as companies try to pass along these higher employee costs by ultimately boosting prices to customers.

The bottom line is inflation remains well above the Fed's long-term average target rate of 2%. The FOMC made it clear that it will hike rates if inflation does not continue to track lower in the near term. The June policy meeting inaction may be only a pause in the hawkish path of rate hikes the Fed has pursued over the last 15 months. We favor continuing to play defense.

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