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Investment Institute

Market Commentary

Weekly perspective on current market sentiment **August 23, 2023**

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Last week's S&P 500 Index: -2.1%

Adjustments

Key takeaways

- Inflation has largely erased wage gains received as the economy recovered from the pandemic.
- Higher inflation should lead to at least one further 25-basis-point (0.25%) Federal Reserve rate hike later this year.

The low labor unemployment rate in the U.S. has some investors wondering why we are calling for a recession to likely start at some point over the next 6 to 12 months. After all, in addition to a virtually 50-year low in the unemployment rate, recent retail sales data show the consumer is still spending. But we are seeing cracks in the labor market that lead us to believe the U.S. consumer, responsible for approximately 70% of domestic gross domestic product (GDP), will not be able to keep the economy from slipping into a modest recession.

A meaningful factor in this equation is the availability of credit. Interest rates have moved higher on everything from credit cards to home mortgages. In addition, at the same time, credit has been tougher to obtain as creditors have increased lending standards for consumers and businesses. The bottom line is it is much more expensive to borrow and spend and the U.S. economy generally runs on credit.

Consider that inflation has largely erased wage gains as the economy has recovered from the pandemic. As more workers have entered the labor market, businesses need fewer hours from existing employees. So, even though wages are rising, total labor income (measured as wages times hours) is falling behind. Consumers have increased borrowing as liquid household assets (think cash and other assets easily sold) have declined. That means more buying is fueled by credit.

The equity market cheers each decline in the inflation rate, but households have less to smile about. Their available cash is dwindling; gas, home, and food prices are rising again; and many other goods and services prices are still stuck at high levels. These developments led us to revise our 2023 inflation forecast higher from 2.9% to 3.6%. However, we do see inflation in 2024 ending the year below our previous estimate at 2.5%.

We believe this higher-for-longer inflation environment should lead to at least one further 25 basis-point (0.25%) Federal Reserve rate hike later this year, which would bring the federal funds rate up to the 5.5% to 5.75% range and higher than our previous projection. We also expect the Federal Reserve to keep rates higher for longer than many market participants expect. Should inflation eventually slow further and the economy experiences a recession as we expect, overall prices will likely still be well above 2019 levels, which will continue to be a negative for middle class consumers. We see the unemployment rate rising to 4.4% this year and 5.6% by year-end 2024, which will further impact stretched consumers in the mid- and lower-income brackets.

We continue to recommend that investors fade the rally and focus on quality, large-cap equities and high-grade fixed income. Now is not the time to take on more risk. We believe additional opportunities in equities will come at lower price levels over the next 12 months.

Risk considerations

Forecasts and targets are based on certain assumptions and on views of market and economic conditions which are subject to change.

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