



Market Commentary

Weekly perspective on current market sentiment

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Last week's S&P 500 Index: +2.2%

Higher for longer

Key takeaways

- While inflationary pressures have eased significantly, “core” inflation remains well above the Federal Reserve’s (Fed’s) long-term target.
- We see the Fed being vigilant in its goal to lower inflation as we move into and through the early portion of 2024.

Our strategy has called for a high-quality, defensive portfolio posture since the first quarter of 2022. From that point until now, the Fed has raised the federal funds target rate from close to zero up to the current 5.25% to 5.5% range. Note that the S&P 500 Index (SPX) was at approximately the same level earlier this month as it was in March of last year (4,360). That was just before the second wave of the recent rally carried the SPX to the current level at the time of this writing (4,540). The SPX is a bit more than 4% higher than it was when the Fed first started its rate-hiking cycle. A number of persistent headwinds have caused the index to be volatile, but it has largely traded in a range over the last 20 months.

While inflationary pressures have eased significantly, “core” inflation remains well above the Fed’s long-term target level of 2%. Recent “core” Consumer Price Index (CPI) and Personal Consumption Expenditures (PCE) readings have been at or just below 4%. Core PCE is the Fed’s preferred inflation gauge. Recall that “core” inflation excludes the effects of food and energy prices that are volatile and tend to obscure the inflation trends policy makers are trying to track. Our analysis suggests that due to persistent inflation the Fed will likely need to leave the federal funds target rate higher for a longer period than many market pundits expect. However, an economic slowdown is taking place.

The combination of inflation and higher-for-longer interest rates generally tightens credit in an economy that already has weakened significantly. The problem is that while the economy continues to grow, wages are also likely to grow and increase core inflation. The economy needs to slow further to break this cycle of sticky inflation, high interest rates, and tightening credit. But, of course, as the economy slows further, it will approach a point of contraction. That’s why we believe the markets will remain volatile and why our positioning focuses on quality and playing defense. Patience is an investor’s best tool, in our view.

If inflation falls only gradually from here, the Fed will likely keep interest rates higher for longer. We see the Fed being vigilant in its goal to lower inflation as we move into and through the early portion of next year. While we do believe the Fed will eventually lower interest rates should the economy contract as we expect in the early portion of next year, we see the federal funds rate still likely in the 4.75% to 5% range by year-end 2024, higher than our previous estimate. We see the yield on the 10-year Treasury note also staying higher than our previous target, ultimately finishing next year in the 4.75% to 5.25% range as a second-half economic recovery and large U.S. government debt issuance combine to help to push rates higher.

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