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Investment Institute

Market Commentary

Weekly perspective on current market sentiment **December 13, 2023**

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Last week's S&P 500 Index: +0.2%

On hold

Key takeaways

- The market is pricing in around 125 basis points[1] of Federal Reserve (Fed) cuts by the end of next year.
- That is overly optimistic in our opinion. We do not think the Fed will deliver what the markets are pricing in.

While the financial media have been hyping the potential outcomes for this week's Federal Reserve Open Market Committee (FOMC) meeting, the markets have priced in a very low probability of a rate hike. We think it is safe to say the overwhelming majority of market participants are not expecting fireworks in any way, shape, or form this afternoon when the decision is announced. We view today's announcement largely as a reiteration of the stance our central bankers have been taking for some time, and we expect the federal funds target rate to be held steady at the current 5.25% – 5.5% range.

The FOMC will also release a new set of policy median rate projections (the so-called "dot plot") of Fed members along with this decision. While inflation has fallen to a lower level more quickly than the committee anticipated six months ago, the market will be looking at the updated estimates of where the target rate will be looking forward. The futures market has started pricing in a better than 60% probability of a rate hike starting in May of next year. By the end of next year, the market is pricing in around 125 basis points of cuts. That is overly optimistic, in our opinion. We believe the target rate will end 2024 in the 4.75% – 5% range. Back in September 2023, the median projection fell in the 5% – 5.25% range.

So far, the market has been pricing in meaningfully more rate cuts than the FOMC is projecting. We doubt the market's more optimistic view will change substantially in the near term. Nor do we think policymakers will lower their median projection in any meaningful way soon. It appears market participants do not believe this message that the Fed has been broadcasting for the bulk of this year: Rates will need to stay higher for longer to help weaken the labor market, slow the economy, and knock inflation down close to the 2% long-term average target level our monetary policymakers have set as a goal.

Of course, some progress on inflation has been made, and the labor market and the economy are gradually slowing. Last week the Fed released the latest Beige Book, which illustrates a wide swath of economic conditions in each of the 12 Fed districts. The report pointed to conditions reflecting a consumer who is pulling back and more price conscious, a labor market that is easing, credit conditions that are tightening (aka loans are tougher to get), and consumer delinquencies that are rising. The report also noted that the pricing power of companies is waning — a headwind for corporate profits.

Equity valuations are stretched. We believe earnings estimates for next year are too high. In our view, investors should not chase this rally and instead park funds in short-term fixed-income instruments that would be used to buy equities on noticeable pullbacks. The bottom line is we do not think the Fed will deliver what the markets are currently pricing in.

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[1] 100 basis points equals 1%.

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