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Investment Institute

Market Commentary

Weekly perspective on current market sentiment | March 22, 2023

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Last week's S&P 500 Index: +1.4%

Fed decision looms

Key takeaways

- We continue to believe a 25 basis-point (0.25%) hike in the federal funds rate will be announced today.
- But looking into the second quarter, the Federal Reserve (Fed) will also have to consider the disinflationary effects as recent bank failures roll through the economy and markets.

The good news is inflation, as measured by the Consumer Price Index (CPI), has dropped from a 40-plus year high of 9.1% in June of 2022 all the way down to 6% as of February of this year. The bad news is inflation remains far above the Fed's long-term average target level of 2%. So, 4% separates the current rate of inflation from the Fed's stated goal. Do we need to drop to 2% before the Fed stops hiking? The answer is likely no, but there needs to be continued progress pushing price pressures lower in coming months. Some of the shorter-term inflation data suggest the downward trends in Personal Consumption Expenditures Index (PCE) and the CPI have stalled recently. This would sync with what we have expected: an inflation rate that falls but not in a smooth, straight line. One could make an argument that anything between 2% and 3% (year-over-year CPI reading) would make the Fed, and financial markets, happy. But two things are almost certain: monetary policy changes work with a lag and our central bankers are attempting to take that into account at each policy meeting. The meeting this week is no different, even when considering the bank-related turmoil of the last 12 days or so.

Some market pundits have speculated that the Fed will pause and hold rates steady at this week's meeting given the market volatility and perceived uncertainty in some segments of the Financial sector. We disagree and continue to believe a 25 basis-point hike (100 basis points equals 1%) will be announced today. But looking into the second quarter, while the Fed may plan to continue to raise interest rates, it will also have to consider the disinflationary effects of unknown size as recent bank failures (and possibly future failures) roll through the economy and markets in the coming weeks and months. The issue of rates becomes a question of calibration, and that is likely to keep markets guessing.

Of course, Jay Powell & Company are paying close attention to financial market uncertainty, but they are also keenly focused on their mandate of price stability. The labor market continues to be tight, but wage pressures are easing relative to last year as the unemployment rate has drifted slightly higher than recent record lows. Now, considering the worries about the banking system, consumers and businesses could hoard cash, banks could further tighten credit standards, and small businesses may find it even harder to obtain loans. This all can potentially feed into disinflationary pressures affecting Fed monetary policy.

In the meantime, our portfolio recommendations continue to revolve around capital preservation and buying into quality segments of the equity market that reflect strong balance sheets, robust cash flows, easy access to credit, and diverse product offerings. The opportunity to take a more assertive posture will come, but based on our current analysis, now is not the time.

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Definitions

An index is unmanaged and not available for direct investment.

Consumer Price Index (CPI) produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

Personal Consumption Expenditures Index (PCE) is a measure of consumer spending and includes all goods and services bought by U.S. households.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

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