IM&R Economic and Market Update:
The Fed Takes a Breather

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WEALTH ARCHITECTS

On March 16, 2022, the S&P 500 stood at 4,357. Then, starting from zero, the Federal Open Market Committee (FOMC), raised the Fed Funds rate at 10 consecutive meetings, reaching 5-5.25% in May.

During this timeframe, the S&P 500 went on a rollercoaster ride, bottoming at 3,577 on October 12, 2022. Fast forward and the S&P 500 has gone full cycle, entering a new bull market (rising 20%) and closing at 4,369 on June 13, 2023, only 12 points from the beginning of the hiking cycle.

Now, for the first time in over a year, Chairman Powell and Company have taken a pause, signaling that Fed leaders would prefer to wait to evaluate the impact of past increases on the economy as well as recent banking failures on credit conditions.

So, is the U.S. Federal Reserve tightening cycle over? Maybe not. The FOMC participants' assessment of appropriate monetary policy (the "Dot Plot") points to two more rate hikes before year end and a terminal rate of 5.6%. And, according to current federal fund futures pricing, there is a 74% chance this is a "hawkish skip" and there will be another rate hike in July. Regardless, the real story is that the tightening cycle is close to the end.

In the Federal Reserve press release, the members stated that economic activity has continued to expand at a modest pace, job gains have been robust, the unemployment rate has remained low and the U.S. banking system is sound and resilient. However, inflation remains elevated, and tighter credit conditions are likely to weigh on economic activity.

The headwind of inflation pressures continues to recede. The Bureau of Labor Statistics May Headline Consumer Price Index came in at 4.0%, cut in half from one year earlier when inflation soared to 9.1%. The Core CPI (ex food and energy) has been stickier but dropped to 5.3% from 5.5% the previous month. May's reading marks the 11th consecutive month that inflation has slowed and is the lowest 12-month change since March 2021. The core CPI decelerated and is the lowest 12-month reading since November 2021. And the CPI is likely to decline further in June due to favorable base effects when last June's 1.3% monthly increase rolls off the calculation.

The economy continues to avert recession, as strong job growth and excess savings still support consumer demand. But recession risk remains possible amid the lagged impact of the Fed rate hikes, tightening credit conditions and weakening corporate profitability.

When looking at prior Fed cycles, the amount of time between the last hike and the first cut is variable, with unemployment as a key determinant. History shows that more often than not, Fed tightening cycles have ended in recession an average of six to seven months after the last rate hike. Regardless of whether the rate hike in May was the final one of this cycle or whether the Fed has one or two more to go, history would suggest a recession may start in early 2024.

As long as inflation stays above the Fed's interest rate target of 2%, the Fed will remain vigilant on monetary policy. We have been positioning our portfolios to weather higher rates for longer, and have been in short duration fixed income securities. As the tightening cycle ends, we will look to lengthen maturities closer to our strategic targets. We are at our long-term strategic weights in domestic equities, have increased our exposure to international equities and remain well diversified.

We believe that investors who stick with their investment strategy and maintain a diversified portfolio will be well positioned for the current market environment.

Sources: Federal Reserve Board, NDR, Future Capital, Goldman Sachs, Blackstone, MFS