FED POLICY AND THE MARKETS

Implications for Investors

A hawkish pause, but not a pivot

June 15, 2023

As expected, the U.S. Federal Reserve (Fed) held its policy rate unchanged on June 14 after 10 consecutive increases. It also wasn't surprising that this was a "hawkish" pause, though the degree to which officials updated their projections caught many investors off guard, said Matt Orton, CFA, Chief Market Strategist at Raymond James Investment Management. The new Summary of Economic Projections (SEP) now shows a median terminal rate of 5.5% to 5.75%, meaning that the Federal Open Market Committee (FOMC) is penciling in two more quarter-point rate hikes.

"It should be crystal clear that the Fed remains biased to tighten monetary policy further, and I believe it will remain data dependent," Orton said. "To come to fruition, the steeper dot plot in the SEP will depend on data coming through in line with Fed forecasts."

Orton's key takeaways from the Fed's messaging:

- **A high degree of conviction**. Of the 18 policymakers, 16 foresee at least one more 25-basis point hike as appropriate, and 12 penciled in rates at or above the median range. This highlights that most agree further tightening will be required to bring inflation on a sustainable path toward 2%. There were also no dissents to the statement, which sends a strong signal that hikes would resume as soon as July.
- **A pause doesn't mean a pivot**. Any hope of rate cuts in 2023 and into the start of 2024 should be extinguished (if they haven't been already), Orton said. "The market has been offsides all year with respect to the economic narrative and expectations for rate cuts," he said. "We've finally seen the market come to the Fed, and I don't know why we wouldn't take the Fed's message that more rate hikes are very likely at face value going forward." Fed Chair Jerome Powell's comments during the news conference were more dovish than the very hawkish statement, and he did emphasize that the dot plot is "not a plan," but Orton said he couldn't wrap his head around the insistence that we're done based on the current data. "I now expect one more rate hike and then the actual pause," he said.
- **Economic message was marginally positive**. The SEP showed upgraded projections for growth, labor, and inflation that are broadly consistent with a view of greater economic momentum and resilience. "This more sanguine view of the economy is one that I have shared all year," Orton said. "It also gives more ability for the economy to weather an additional hike or two."

The market reaction was interesting. With the median dots shifting higher, we saw a whiplash between the release of the committee's statement and Powell's news conference. Thirty minutes after the release, Powell's comments were fairly dovish. The reaction of equities was generally encouraging, and it's a reminder of the strong momentum behind the recent rally, Orton said.

"Some consolidation would frankly be a helpful reset for overbought sentiment and short-term internals," he said, "but it's clear that many market participants are hearing less of 'continued hikes will be required to continue fighting inflation' and more of 'the Fed is close to stopping rate hikes and we need to put some cash to work.' "

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That was somewhat evident when digging beneath the surface yesterday, where technology stocks, particularly those in the artificial intelligence (AI) trade, rose meaningfully into the close while cyclicals and small caps broadly lagged. Energy, materials, financials, and industrials were all in the red while information technology was up more than 1% within the S&P 500 Index largely due to strength in semiconductors. Orton said he couldn't explain why a leader in AI technology would be up nearly 5% when the rate backdrop continues to increase, but he said he takes that as an opportunity in higher-quality parts of the market that have lagged.

"The changing negative correlation between the Nasdaq Composite Index and rates is important to watch, especially as real yields keep pushing higher," he said. "This can continue in the short term, but I worry that investors are starting to overstay their welcome. I have been encouraging risk management and adjusting position sizes among the big winners."

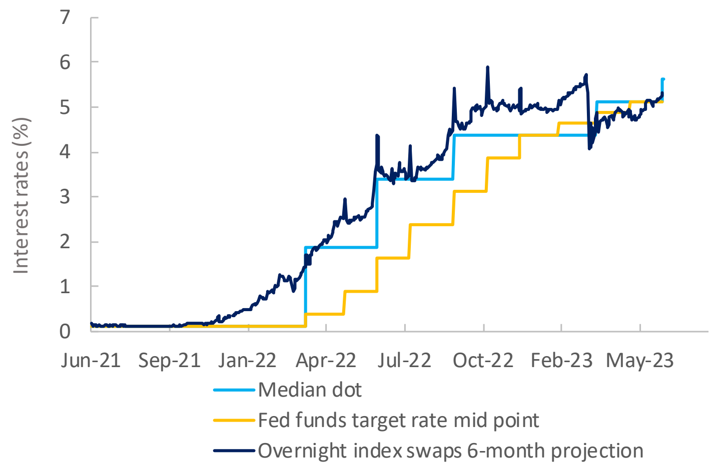
While we are likely to see one or two more rate hikes, this is a critical time to consider what to do with cash in money market funds, Orton said. Those have dramatically underperformed the market, and he said there is mounting evidence that the economic outcomes will be more benign than the doom and gloom so many predicted at the start of the year.

"I see scope for modestly higher yields given the incrementally more resilient economic picture," he said. "The Fed's willingness to remain engaged with additional hikes means the curve is likely to remain sticky at deeply inverted levels for now, and this gives investors time to put together a plan and to look for opportunities in the market to strategically deploy capital."

Accordingly, Orton said he continues to advocate for leaning into higher quality and low volatility companies, many of which have lagged the AI-fueled rally. If the increase in breadth continues, these companies will benefit the most as the market of stocks catches up to the stock market, he said. And if the market starts to consolidate, he said he would expect profitable, high free cash flow companies with stable earnings growth to outperform.

The market comes around to the Fed

Overnight index swap projections catch up to FOMC dot plot projections



Source: Bloomberg, U.S. Federal Reserve, as of 6/14/23

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Definitions

A policy rate is an interest rate set by a central bank or other monetary authority to influence the evolution of an economy's monetary variables such as consumer prices, exchange rates, or credit expansion.

Hawkish, dovish, and centrist are terms used to describe the monetary policy preferences of central bankers and others. Hawks prioritize controlling inflation and may favor raising interest rates to reduce it or keep it in check. Doves tend to support maintaining lower interest rates, often in support of stimulating job growth and the economy more generally. Centrists tend to occupy the middle of the continuum between tight (hawkish) and loose (dovish) monetary policy.

The Summary of Economic Projections (SEP) is produced following meetings of the Federal Open Market Committee and includes meeting participants' projections of the most likely outcomes for real gross domestic product growth, the unemployment rate, and inflation for a forward-looking three-year window and over the longer run.

The terminal rate is the rate at which the U.S. Federal Reserve stops raising the federal funds rate in an attempt to bring down inflation. The federal funds rate, known as the fed funds rate, is the target interest rate set by the Federal Open Market Committee of the Federal Reserve. The target is the Fed's suggested rate for commercial banks to borrow and lend their excess reserves to each other overnight.

The U.S. Federal Reserve dot plot is a chart summarizing the Federal Open Market Committee's (FOMC) outlook for the federal funds rate. Each dot represents the interest rate forecasted by one of the members of the committee.

Basis points (bps) are measurements used in discussions of interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%.

Overbought is a term used to describe a security or group of securities believed to be trading at a level above its or their intrinsic or fair value.

Internals refer to quantitative market indicators that investment professionals monitor to spot trends and forecast movements within securities markets. A subset of technical indicators, internals include a number of formulas and ratios, such as the number of stocks moving in the same direction as a larger trend, the ratio of securities with rising and falling prices, the ratio of new highs to new lows, and price and volume indicators that are seen as indicators of overall market sentiment.

Cyclical stocks have prices influenced by macroeconomic changes in the economy and are known for following the economy as it cycles through expansion, peak, recession, and recovery.

Correlation is a statistic that measures the degree to which two securities or sets of data move in relation to each other.

Real yield curve rates, commonly referred to as "Real Constant Maturity Treasury" rates, on Treasury Inflation-Protected Securities (TIPS) at "constant maturity" are estimated by the U.S. Treasury from the Treasury's daily par real yield curve. These par real yields are calculated from indicative secondary market quotations obtained by the Federal Reserve Bank of New York. The par real yield values are read from the par real yield curve at fixed maturities, currently 5, 7, 10, 20, and 30 years. This method provides a par real yield for a 10-year maturity, for example, even if no outstanding security has exactly 10 years remaining to maturity.

A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity. Investors and market analysts watch certain yield curves for signs of inversion, when yields for longer-term debt instruments fall below yields on short-term debt with the same credit quality. Inversions are watched as potential signs of a weakening economy and in certain cases, a harbinger of recessions.

Position sizing refers to the number of shares or other units of a particular security held by a portfolio, investor, or trader. Investors adjust position sizes through buying or selling securities in an effort to control risk and maximize returns.

An overnight index swap is a hedging contract in which a party exchanges a specific cash flow with a counter-party on a specified date and uses an overnight rate index such as the federal funds rate as the agreed-upon exchange for one side of the swap.

Indices

The S&P 500 Index measures change in stock market conditions based on the average performance of 500 widely held common stocks. It is a market-weighted index calculated on a total return basis with dividend reinvested. The S&P 500 represents approximately 80% of the investable U.S. equity market.

The Nasdaq Composite Index is the market capitalization-weighted index of over 2,500 common equities listed on the Nasdaq stock exchange.

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