FED POLICY AND THE MARKETS

Implications for Investors

Another hawkish pause, with more hawkish expectations

Sept. 20, 2023

This week's Federal Open Market Committee (FOMC) decision to pause interest rate hikes didn't include many surprises, but there's no denying that the marginal shifts in the U.S. Federal Reserve's tone were hawkish, said Matt Orton, CFA, Chief Market Strategist at Raymond James Investment Management.

Markets had expected the committee members' projections of future interest rates, as reflected by the "dot plot," to move up in 2024 and 2025, but next year was marked up meaningfully from 4.6% to 5.1%, once again highlighting the notion that rates will remain higher for longer. Economic growth forecasts for this year and next also were marked up substantially. Most hawkish of all was the shift in real interest rates from the Summary of Economic Projections (SEP). Using policymakers' median forecasts of the core Personal Consumption Expenditures Price Index and the federal funds rate, the real rate would rise from 1.9% at the end of 2023 to 2.5% at the end of next year.

"This is important, and I believe it underscores the importance of focusing on quality across all investments going forward," Orton said.

Here are Orton's key takeaways from the Fed's interest-rate decision and economic forecasts on Wednesday:

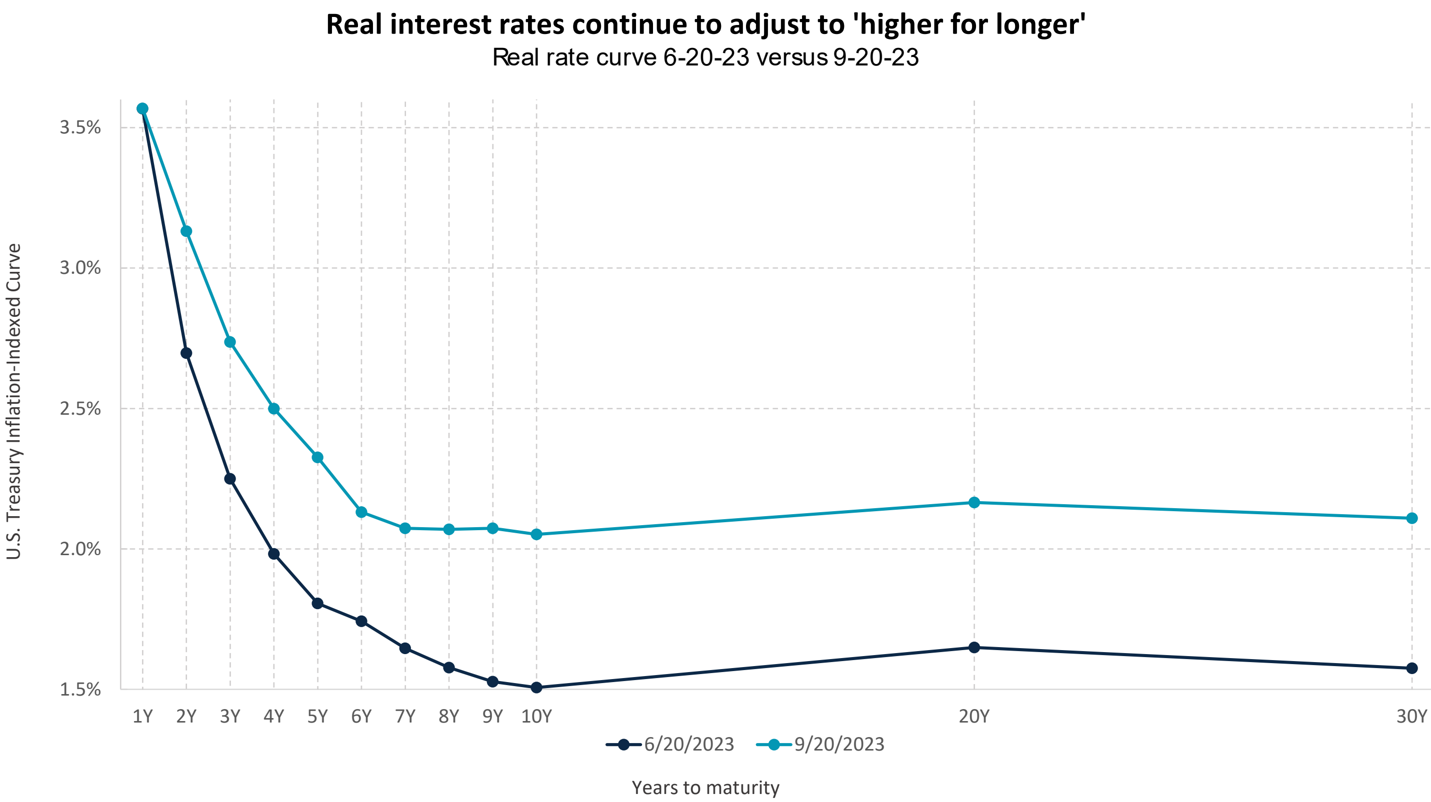
- The FOMC voted unanimously to leave the benchmark rate unchanged (as expected) in the target range of 5.25% to 5.50%, a 22-year high;
- The dot plot of rate projections shows policymakers still foresee one more hike this year, while 2024 and 2025 rate projections each rose 50 basis points (bps), a signal the Fed expects rates to stay higher for longer;
- 12 of 19 policymakers on the FOMC expect one more rate hike this year while seven favor holding rates steady;
- The committee's median projection for economic growth in 2023 jumped from 1.0% in June to 2.1%. Officials significantly reduced unemployment forecasts and now expect the jobless rate to peak at 4.1%, rather than 4.5%;
- The FOMC's statement repeats prior language saying officials are considering "the extent of additional policy firming that may be appropriate." The Fed acknowledges that job gains have "slowed" but said they "remain strong."

"Once again, I'm surprised that the market continues to push back against the Fed," Orton said. Pricing on Fed funds futures barely budged despite the hawkish tone. Perhaps it was U.S. Federal Reserve Chair Jerome Powell's more balanced tone during the news conference – there were many references to the need to "proceed carefully" – but he was still quite resolute on inflation.

"If anything," Orton said, "his tone gives me a bit more confidence in expecting no hike in November, assuming core inflation continues to move in the right direction (and the slow downward trend in the labor market continues). I also would add that the 12-to-7 breakdown in favor of one more hike this year is hardly a promise that the FOMC is going to go ahead and hike. It simply points to the Fed's resolve to depend on data in its decision-making. With 2-year rates at the highest level since 2006, I believe the risks are skewed lower while longer-dated rates likely remain firm, particularly with the supply of bonds with long maturities set to reach all-time highs amid no clear evidence of a rollover in data."

Understandably, information technology, communication services, and consumer discretionary underperformed following the FOMC's announcement. And Orton said the prospect of higher for longer – particularly higher real rates – will continue to put pressure on parts of the market that are trading at extended multiples. There are certainly companies in each of those sectors that are high quality and remain important to hold in portfolios, but he said this just emphasizes why it has been so important to take some profits on your biggest winners this year. On the other hand, the backdrop of higher rates, coupled with a stronger economic backdrop, should support a much-needed broadening of the market. Energy remains quite attractive given compelling valuations, the potential for earnings acceleration, and a positive correlation between industry stocks and real rates, Orton said. Also on display following the FOMC meeting were the defensive characteristics of healthcare, which outperformed the broader market by nearly 100 bps.

"The main takeaway from this Fed meeting is the need to be selective and to lean into quality across the market," Orton said.



Source: Bloomberg, as of 9/20/2023

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Definitions

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%.

Core inflation is measured by the Personal Consumption Expenditures (PCE) excluding Food and Energy, Price Index, also known as the core PCE price index, is a measure of the prices that U.S. consumers pay for goods and services, not including two categories – food and energy – where prices tend to swing up and down more dramatically and more often than other prices. The core PCE price index, released monthly by the U.S. Department of Commerce Bureau of Economic Analysis, measures inflation trends and is watched closely by the U.S. Federal Reserve as it conducts monetary policy.

Correlation is a statistic that measures the degree to which two securities, sectors, indices, or other forms of activity that are being measured move in relation to each other.

Defensive stocks provide consistent dividends and stable earnings regardless whether the overall stock market is rising or falling. Companies with shares considered to be defensive tend to have a constant demand for their products or services and thus their operations are more stable during different phases of the business cycle.

The 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.

Extended is a term used to describe an investment, industry, or sector with performance that has substantially moved away from a longer-term average in a short period of time.

The federal funds rate is the target interest rate set by the Federal Open Market Committee of the U.S. Federal Reserve. The target rate, also known as the benchmark rate, is the Fed's suggested rate for commercial banks to borrow and lend their excess reserves to each other overnight.

The Federal Open Market Committee (FOMC) consists of 12 voting members: the seven members of the Board of Governors of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and four of the remaining 11 Reserve Bank presidents, who serve one-year terms on a rotating basis. The FOMC holds eight regularly scheduled meetings per year at which it reviews economic and financial conditions, determines the appropriate stance of monetary policy, and assesses the risks to its long-run goals of price stability and sustainable economic growth.

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.

A multiple, sometimes referred to as the price multiple or earnings multiple, is a measure of a company's value based on the ratio of its current share price to its earnings per share. This ratio is known as the price-to-earnings ratio, or P/E.

Quality investing is a strategy that seeks to invest in companies with low debt, stable earnings, consistent asset growth, and strong corporate governance, as reflected in financial metrics such as ratios of return to equity and debt to equity, as well as to earnings variability.

A real interest rate is an interest rate that has been adjusted to remove the effects of inflation. Once adjusted, it reflects the real cost of funds to a borrower and the real yield to a lender or to an investor. A real interest rate reflects the rate of time preference for current goods over future goods. For an investment, a real interest rate is calculated as the difference between the nominal interest rate, which is not adjusted for inflation, and the inflation rate.

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.

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.

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