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**Investment Institute**


**Weekly perspective on current market sentiment** **February 15, 2023**

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Last week's S&P 500 Index: -1.1%

# Picking a fight

## Key takeaways

- The old market bromide, "never fight the Fed" is a tried-and-true piece of advice that, if followed, has largely benefited investors over many decades.
- The market has chosen to pick a fight with the Fed and downplay the deterioration in the economy and earnings. We have chosen not to participate.

Let's start with one of the conclusions: The stock market does not believe the Federal Reserve (Fed) when our central bankers tell us they have no plans to cut the federal funds target rate this year. Only recently, after the release of the robust January employment report, did the fixed-income market price in expectations that the "terminal rate" would reach 5% despite a concerted effort by Fed Chair Jay Powell & Company to hammer home that message for a number of months. The terminal rate refers to the peak level for the federal funds target in this Fed tightening cycle. At this point, after all the jawboning by the Fed, the market has continued to price in a small rate cut late this year and another early in 2024.

I am reminded of advice given to me by my father just prior to my wedding day: "You need to learn to pick your battles." Good advice indeed, even if it did take a few years to fully grasp his meaning. Market participants can apply that same bit of sage advice to heeding the message coming from the Fed. The old market bromide "never fight the Fed" is a tried-and-true piece of advice that, if followed, has largely benefited investors over many decades.

With the Consumer Price Index (CPI) still showing a more than 6% increase over the last 12 months, prices are anything but stable. While the trend is down and well below the 9.1%, 40-plus year high reading back in June of last year, inflation is still far above the long-term average Fed target of 2%. That means the U.S. central bank has more work to do as it has reminded us constantly and consistently in recent months.

The rule of thumb that it takes six to nine months for Fed rate adjustments to impact the economy implies that we are just now starting to feel the rate hikes announced at last year's September policy meeting or even as far back as the June 2022 meeting. In other words, there are a number of rate hikes in the system that have theoretically not even begun to affect the economy at this point.

As a result, we continue for now with our more defensive portfolio posture. We believe the Fed's rate hikes will result in a moderate recession that is likely to begin soon and last for a couple of quarters. On a year-to-date basis, investors have bid up the prices of stocks in sectors that are sensitive to an economic upswing such as Consumer Discretionary, Real Estate, and Financials. These sectors were among the worst performers in 2022. Our analysis suggests the market is ahead of itself in rewarding these sectors with notable outperformance thus far in 2023.

The market has chosen to pick a fight with the Fed and downplay the deterioration in the economy and earnings. We have chosen not to participate at this time but look to the second half of this year for better opportunities and brighter skies.

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Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Equity securities** are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities. **Sector investing** can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility.

**Definitions**

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

An index is unmanaged and not available for direct investment.

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