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Capital Markets Commentary

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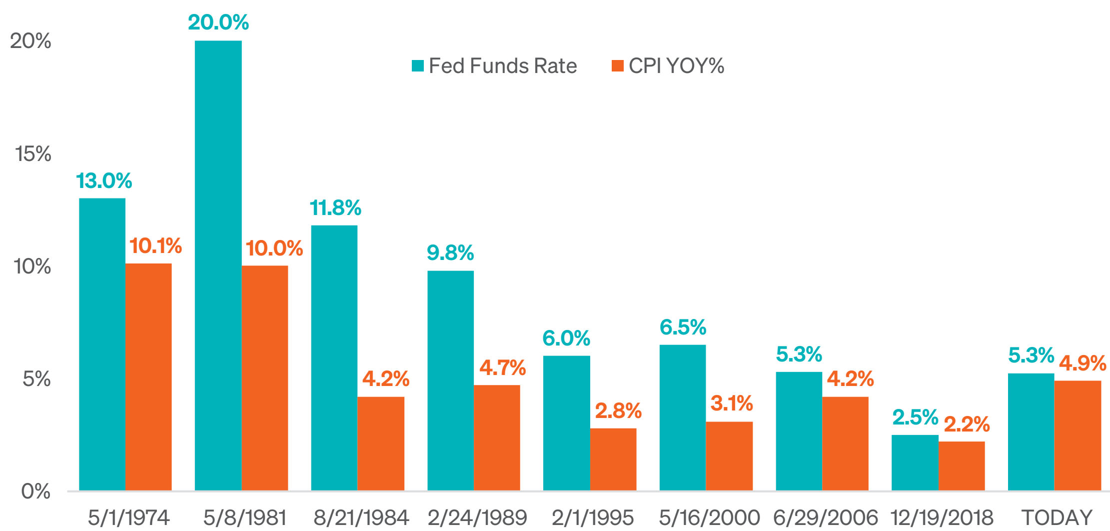
Fed Update

All eyes were on the May Fed meeting, where the FOMC raised the federal funds rate by +0.25% to 5.25%. It was the 10th hike in this tightening cycle and aligned with market expectations. While the Fed said they have not determined whether to pause future hikes, the Fed removed some language from their statement last meeting and provided more clarity about the outlook for investors. Fed Chair Jerome Powell said, "In determining the extent of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments." The market's interpretation of this statement was a shift in guidance, indicating the committee might pause future rate hikes and was welcomed by investors.

THE FED VS INFLATION

Historically Tightening Cycles End When Fed Funds Rate is Above CPI



SOURCE: STRATEGAS

The timing is significant because it is the first period in this cycle that the Federal Funds rate of 5.25% is now higher than the trailing 12-month year-over year CPI inflation rate of 4.90%. When looking at the past 8 tightening cycles going back to 1974, the Fed did not stop raising interest rates until the Federal Funds rate was higher than inflation.

First Fed Cut Historically Precedes Equity Weakness

It is also important to recognize that although Fed rate cuts are generally seen as a positive for equities, historically it has not happened quickly. When looking over the past 8 tightening cycles, the first interest rate cut has preceded equity weakness. According to Strategas, it took an average of 195 days for the market to reach its low and the S&P 500 Index dropped an average of nearly -24% over this time.

U.S. Economy Slowing

The U.S. economy continues to slow as GDP posted annualized growth of just 1.1% compared to an expectation of 2.0% in the first quarter. This decline was primarily driven by a reduction in business inventories, which is unsurprising as businesses continue to provide weak guidance to investors on their economic expectations. The Leading Economic Index also dropped 1.2% in March to 108.4, reaching its lowest level since November 2020. The ISM manufacturing Index increased slightly to a level of 47.1 but missed expectations of 47.5. The index experienced its sixth monthly contraction in a row. On a positive note, the ISM Services Index increased slightly to 51.9, beating market expectations, and was the fourth consecutive month of expansion. A level above 50 indicates expansion in the industry, where a level below 50 signifies an industry contraction.

Labor Markets

A positive sign is the labor market continues to be unfazed by the dimming economic outlook. Job growth continues to be vibrant as April's non-farm payrolls increased +253,000 compared to an expectation of +180,000 jobs. This growth was broad-based across industries. The U.S. unemployment rate fell to 3.4%, compared to expectations of 3.6%.

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