The Fed Spooks Investors

Article by: Nick Stenger, *Chief Executive Officer, Financial Advisor*
Phone: (630) 912-8295 | Email: nick.stenger@stengerfamilyoffice.com

During last week's Fed meeting, Powell kept rates unchanged but announced that the government will continue its plan of quantitative tightening by shrinking the size of the Fed's balance sheet. Powell maintained that target inflation should be 2%, far from its current level of 4%. Equity market investors were surprised by the news and the S&P 500 Index traded down 7% from its summer peak of 4,600 points. We weren't overly shocked by the selloff because the bond market tends to be a leading indicator of stock price movement. Long term bonds started trading off in March and left fixed income investors with massive continued losses even as many financial professionals have recommended adding duration, a move we've adamantly disagreed with.

Data show high quality stocks actually produce relatively strong performance across an entire hiking cycle. What matters most is not rate hikes, but the direction of long-term yields. The yield curve is still inverted (long term bonds pay less interest than short term bonds), a potential sign that rates will be lower in the future than they are today. While we agree rates in 2025 and beyond are likely to be lower, we disagree with the belief that rates will be cut in 2024. Because of this, we could experience some continued choppiness the rest of 2023 as investors swap long term assets for short term assets. During rising rate environments, investors favor current income and profit over future estimates. That's why so called "safer" stocks rallied and growth stocks tanked in 2022. This year, the opposite is true - growth has recovered substantially while value stocks have been flat. We expect the value trade to reverse for the rest of 2023 as investors come to grips with the potential of higher rates for longer.

We've also argued stocks are most at risk in the short run because of a potential Black Swan event rather than an earnings decline. Bearish market pundits thought 2023 would be a blood bath for earnings and they were wrong, earnings have actually be strong for the first and second quarters. Q3 and Q4 also look strong, which is why we haven't recommended panicking out of stocks. On the other hand, we believe fixed income could continue to represent a major risk to investors. The Fed only controls short term interest rates. Bond markets control long term rates. Losing money on medium- or long-term bonds doesn't require the Fed to keep raising rates, but rather for the yield curve to normalize. Normalization of the yield curve would happen if the U.S. economy avoids recession.

Its possible the U.S. economy avoids recession depending on which data points you follow. Despite popular opinion, a recession is not simply defined as two consecutive quarters of declining GDP. Rather, a textbook recession considers unemployment and personal income alongside GDP growth. In past recessions, higher rates have played a large role in triggering economic collapse because companies and consumers had a lot of leverage. So far, higher rates really haven't impacted top companies and wealthy U.S. families. We do expect a continued gap to emerge between the top 50 stocks in the S&P 500 Index vs. the other 450. Similarly, we see a widening gap between top and bottom income earners. As usual, government mistakes are hurting small business and poorer families the most. For example, many millennials simply can't afford to buy a home because increased money supply the past 3 years and 8% mortgages have increased prices and rates at the same time. Retired Baby Boomers with no debt and money in the bank aren't affected by the higher rates, which is why we haven't seen a massive drop off in consumer spending, despite Fed tightening.

In the end, the Fed will break something. As an investor though, it's nearly impossible to time the market around a potential breaking point. Rather, we have to use basic math to determine if the market is under or overvalued. Stocks were overvalued in the late 90's, undervalued in the aftermath of 08 & 09, overvalued in 2021, and we think undervalued today. Further, FactSet research reported September 22nd that Wall Street analysts are now projecting a 19% increase in the S&P 500's level the next 12 months. FactSet's data show technology, consumer discretionary, real estate, and communication services leading the earnings pack the next year with defensive sectors like energy, utilities, and consumer staples trailing. Remember, the market's level is always a math equation, which is why we've urged you to stay the course while remaining aware of the potential doom and gloom stories that could emerge the next few months.

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Stenger Family Office LLC. 400 E. Diehl Road, Suite 550, Naperville, IL 60563