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Mitch on the Markets

Portfolio Manager Investing Insights

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Will the Fed Raise Rates Again? Does it Really Matter?

For the better part of two years, the Federal Reserve has been the center of attention for investors and market watchers. The most important question every few weeks for many investors was, *will the Fed raise rates again, and if so, by how much?* The Federal Open Market Committee (FOMC) meetings were, for many, the single most important factor determining the fate and direction of stocks.[1]

Today, the debate centers around whether the Fed will raise rates at their next meeting by 25 basis points. Beyond the next meeting, investors are trying to forecast whether rates will hold steady at 5.25% - 5.50%, whether they may tick slightly higher, or whether the Fed may eventually start cutting rates.

But at this point, I'm not sure these particular details matter all that much to the economy or stocks, as I'll explain below. I think it's time to shift focus.

The stock market may be the clearest indicator telling investors it's time to move on. As seen in the chart of the S&P 500 below, the Federal Reserve has raised rates by a cumulative 275 basis points since September 2022. In that time, stocks have rallied considerably, rising nearly +20% from the October lows (as I write). If interest rate increases and monetary tightening really mattered as much to the markets as many purport, shouldn't stocks have continued to struggle over the last seven months?

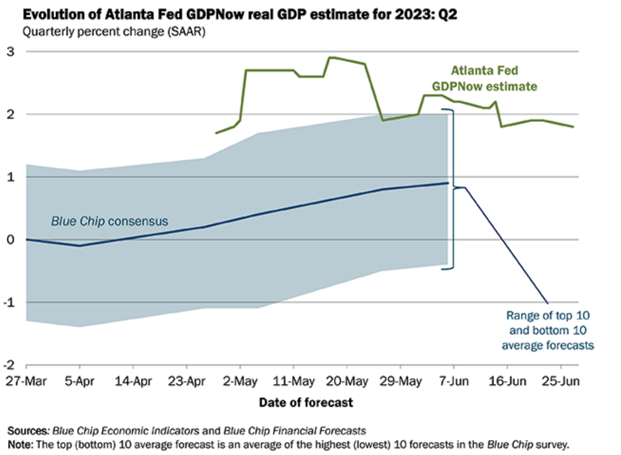
S&P 500 from January 2020 – Present

Source: Federal Reserve Bank of St. Louis[2]

In my view, the message here is that stocks are now looking past remaining Fed decisions for 2023, and investors may be starting to price-in expected economic and earnings growth well into 2024.

Now, there's a reasonable argument that stocks' rally to date has been too narrow – focused only on mega-cap names that play into surging enthusiasm about artificial intelligence. But this argument has weakened as breadth expands and more stocks begin to participate in the rally. Small-cap stocks as measured by the Russell 2000 are also up double-digits from October lows, for instance.

What will matter most to stocks from here, in my opinion, is how U.S. economic growth in the coming quarters measures up to past and current expectations. The broad consensus is that a recession is looming, but just about everyone has been wrong about this point so far. As seen in the Q2 2023 GDP forecasts from the Atlanta Fed (GDPNow) versus the top and bottom 10 economic forecasts (chart below), the U.S. economy is likely going to outperform what almost everyone expected in Q2. This outperformance has been happening for almost a year now.



Source: Federal Reserve of Atlanta[3]

Markets tend to respond positively to 'better-than-expected' scenarios, and vice versa. If the U.S. economy continues to expand even just modestly in the second half of the year, supported by a resilient jobs market, falling inflation, and steady consumer spending, then I would expect this market rally to continue apace – perhaps even more strongly than many expect.

Conversely, if the U.S. economy sputters in the second half or early 2024, and suffers a recession that is deeper and longer than economists are currently anticipating, then I would see a case for the market retesting October's bear market lows. I certainly would not rule out this possibility, but I also think it's the least likely to occur.

The final scenario is the possibility that a U.S. recession is more of a 'garden variety' economic contraction – a slight pullback in output coupled with modest increases in the unemployment rate, say to 5% - 6% or so. If that were to be the case, I would argue that the stock market would not be negatively surprised. This is the type of recession I think was already baked into stocks' decline in 2022, so it would just be the realization of what stocks were pricing in for the economy last year.

Bottom Line for Investors

As laid out above, what I think matters most for markets today is whether a U.S. economic recession turns out to be worse, better, or largely in line with what investors, economists, and market watchers are expecting. The only scenario I see as negative for stocks is if a downturn is deeper and longer than expected, which I also do not think is likely. Any other outcome – even one where the U.S. economy enters a mild recession – should not have a meaningful negative impact on stocks.

This is also why I think the outcome of the next few Fed meetings is largely inconsequential, and why I think investors should move on. Whether the Fed raises rates by another 25, 50, or even 75 basis points is not likely to alter the direction of the U.S. economy in the next year, which I think means investors should place focus elsewhere. Earnings forecasts for 2024 are a good place to start.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Wall Street Journal. June 21, 2023. https://www.wsj.com/articles/forget-the-fed-and-focus-on-the-economy-b56eb562?mod=markets_lead_pos1&mod=djemMoneyBeat_us

[2] Fred Economic Data. June 27, 2023. https://fred.stlouisfed.org/series/SP500

[3] Federal Reserve of Atlanta. 2023. https://www.atlantafed.org/cqer/research/gdpnow

Weekly Market Update

Important Market News We Think Worth Considering

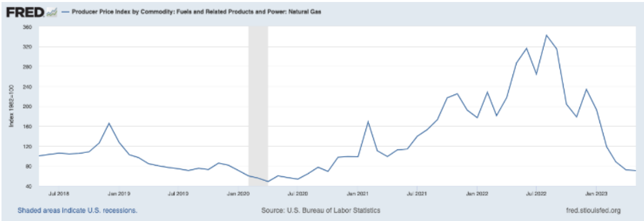
STEADY INVESTOR WEEK

- **U.S. consumer update**
- **Producer price index for natural gas**
- **Strong travel demand**
- **Reasons more people are working in their 80's**

Summer Shopping Bargain in the U.S.

Any time a consumer encounters a 50% discount deal on a desired item, excitement usually ensues. And that's what's happening with natural gas right now. Last summer, natural gas prices jumped to their highest level in over 10 years, as Europe moved to replace Russian gas supplies with liquified natural gas from the U.S.—spurring intense new demand that put upward pressure on prices. This summer, natural-gas futures for July delivery ended this week at $2.603 per million BTUs, a 60% discount from last year's prices. August futures weren't much higher, at $2.668.[1]

Producer Price Index for Natural Gas



Source: Federal Reserve Bank of St. Louis[2]

Readers may wonder, how does cheaper natural gas factor as a summer shopping bargain? The reason is that lower natural gas prices should lower electricity bills for millions of American households, especially as hotter temperatures are likely to keep air conditioners on for long periods of time. Analysts forecast that natural gas prices are likely to move higher as higher electricity demand accompanies higher temperatures, but not by much. The amount of gas storage is over 15% higher than the 5-year average for this time of year, which should be a supply cushion as demand ticks higher. Another beneficiary of lower prices is many companies that rely on natural gas for production, like makers of chemicals, fertilizer, paper, steel, and even cat litter. Many companies have reported an easing of cost pressures as a result of lower natural gas prices, which should boost profit margins this summer.

Strong Travel Demand Bolstering the Aviation Industry

The post-pandemic travel surge is real, and it's bolstering demand for planes. According to the Transportation Security Administration, about 2.3 million passengers have passed through U.S. airports every day in 2023 (on average). That's about where things were in 2019, and recent deals at the Paris Air Show indicate that plane makers and airlines think strong demand will continue. For one, Indian budget carrier IndiGo made a record 500-jet deal with Airbus, which isn't scheduled for delivery until 2030 – at the earliest. This long-term outlook is a clear signal that executives and industry watchers think travel demand is here to stay, and will likely only increase in the coming years as developing economies usher more people into the middle class. On the other side of the supply–demand equation is Airbus and Boeing, the two titans of the aviation industry. The problem is that these two companies have limited ability to quickly ramp up production, given supply constraints of engines, chips, and workers. This poses a 'good problem' for the industry, given the 1,429 year-to-date orders of Airbus and Boeing jets, which is more than the 1,377 posted for the entire year in 2019.[3]

An Unexpected Way to Spend Your Twilight Years

Many people dream of spending their 70s and 80s near a beach, lake, grandchildren, a golf course, or all of the above. Some would rather keep working. According to the Census Bureau, about 650,000 Americans over 80 were working last year, which is nearly 20% higher than levels 10 years ago. Of course, part of the reason for the jump is that there is simply more 80+ year-olds, i.e., members of the baby boomer generation. But others have re-entered or stayed in the workforce for other reasons, namely inflation, stock market volatility, and perhaps above all, a simple desire to work and contribute. In some cases, jobs taken by 80+ year-olds are simple ones, like being a greeter at a store or running a help desk at a nursery. But federal data show that 80-somethings are more commonly found in professional, managerial, and financial jobs than they are in the service sector.[4]

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[1] Wall Street Journal. June 28, 2023. https://www.wsj.com/articles/cheaper-natural-gas-prices-in-store-this-summer-71272a10?mod=djem10point

[2] Fred Economic Data. June 24, 2023. https://fred.stlouisfed.org/series/WPU0531#

[3] Wall Street Journal. June 24, 2023. https://www.wsj.com/articles/demand-for-airliners-soars-we-cannot-make-planes-fast-enough-5758d02e?mod=djemRTE_h

[4] Wall Street Journal. June 25, 2023. https://www.wsj.com/articles/the-reasons-more-people-are-working-in-their-80s-34f11699?mod=djemRTE_h

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