



Insigneo Weekly Dispatch

# Higher for Longer

The latest move by the Federal Reserve and our thoughts on how to navigate the ensuing market environment.

**By Mauricio Viaud**

PM and Senior Investment Strategist  
Insigneo

## Higher for Longer

Higher for longer. This was the message from the Federal Reserve this week. The Fed decided to leave rates unchanged upon the conclusion of its meeting Wednesday afternoon, leaving the Fed Funds rate in the 5.25%-5.50% range. However, many of the participants in the meeting did change their projections for the level of rates. In fact, 12 of 19 participants expressed the view that there could still be another rate increase this year. This opinion was followed by the view that there could be fewer rate cuts in 2024 than previously anticipated. The head of the Fed, Jerome Powell himself stated that "...we [the Fed] intend to hold policy at a restrictive level until we're confident that inflation is moving down sustainably towards our objective." (Jerome Powell Press Conference, Bloomberg). He went on to say: "We are committed to achieving and sustaining a stance of monetary policy that is sufficiently restrictive to bring inflation down to our 2% goal over time." (Jerome Powell Press Conference, Bloomberg).

Let's remember that the Federal Reserve has the dual mandate of price stability and maximum employment. We continue to see that although inflation is coming down, it is doing so at a slower pace than expected, and unemployment remains stubbornly low.

In previous meetings, Powell had called for the need for flexibility and time to better determine economic conditions. This time though, he spoke many times of the need to proceed carefully, alluding to the strength of the U.S. economy. The economy is proving to be more resilient than the Fed expected, propelled by a strong labor market. This, however, is a double-edged sword, as a stronger economy could lead the Fed to be optimistic about the possibility of a soft landing, but at the same time is also the reason why it is nowhere

near ready to start cutting rates. In fact, the Fed upgraded its expectations of economic strength in the country, again, stating that it was surprised by the resilience of the labor market. Its forecast for Real GDP for 2023, which is the GDP figure that incorporates inflation expectations, was raised from a range of 0.7%-1.2% stipulated in its June meeting, to 1.9%-2.2% in this week's meeting. For 2024, Real GDP expectations were also raised, moving from a range of 0.9%-1.5% in June, to 1.25%-1.8% at present.

Tight labor markets are evidence of this economic strength. The most recent initial jobless claim data published this week showed unemployment claims drop by 20,000, down to a level of 201,000 claims. This is the lowest level seen since January of this year, a level that sits near 50-year lows. Even if we look at the 4-week moving-average version of the initial jobless claims metric, which smooths out some of its volatility, we see that this number dropped to a level of 217,000, the lowest level since February of this year. Digging deeper, continuous jobless claims, or claims by people who have been out of work at least a week or more, dropped to 1.66 million, the lowest level since January of this year. This means that less people are getting laid off, and when they do, many can find work again relatively quickly. In fact, slower hiring, rather than job cuts, has been a more prevalent route taken by many businesses to reduce costs. As of the end of last month, the unemployment rate stood at 3.8%. Evidencing the continued resiliency of the labor market, the Fed reduced its unemployment expectations for the year from 4.1% to 3.8%, and for 2024, from 4.5% to 4.1%. Stronger than expected employment has also led to higher-than-expected consumer confidence, as well as consumer spending.

As we can imagine, higher spending has also influenced inflation. The current inflation rate, as measured by the Consumer Price Index, or CPI, currently stands at 3.7%. Although this number is down

from the 9% highs seen last summer, it remains well above the Fed's long-term inflation target of 2%. From the two directives in its dual mandate, the Fed currently appears more focused on fighting inflation.

This makes sense, as consumers throughout the economy are feeling the pinch of higher prices. A recent report from CNBC published last week showed that even though some product prices have come down from the highs seen last year, other products and services continue to move higher. For example, the general cost of food rose another 4% from already high levels last summer. At the same time, rents for primary residences rose an additional 7.8% on a year over year basis. Rising oil prices are not helping either, and we expect these to continue to march higher, possibly into the \$100/barrel range for Brent crude, over the next year. The worry for the markets now is how prolonged the Fed's fight on inflation will be. In other words, how long will it keep interest rates at elevated levels in a bid to cool inflation. To this point, Fed officials are projecting rates to be close to 5.1% by the end of the year, higher than the 4.6% projected in June, not lower as many on Wall Street expected.

The logical question is, what does this all mean for the equity markets? Unlike many on Wall Street, we have not been proponents of the idea of the "Fed Pivot" in 2023. In fact, we have contended for the better part of the year that the Fed was not going to cut rates in 2023. To be honest, the Fed itself has been saying this same thing, and we have been around the markets long enough to know that it pays not to fight the Fed. Since Powell's press conference on Wednesday, the S&P 500 and Nasdaq Composite indices are down 2.2% and 2.5% respectively, as of yesterday's close. Judging from these reactions, it would appear that many investors are finally coming to grips with the idea that the Fed will not reduce rates this year and is not likely to do so until the second half of 2024. J.P. Morgan believes that rates cuts might not even be on the table until the 3<sup>rd</sup> quarter of next year.

So, how do we approach this uncertain market environment? We have been cautious on US equity markets for most of the summer and continue to do so. In a report titled “Our Views on the US Equity Markets and How to Approach Them” published in July, we stated that we continued to remain cautious and believed that prudence could prove to be the right strategy in this environment. Prudence means different things for different investors, and the tools used to achieve this are many. We have been advocates of repositioning portfolios to reflect quality-oriented traits, such as owning companies with solid balance sheets and strong profitability. This could be achieved through the repositioning of portfolios to ETFs such as the iShares MSCI Quality Factor ETF (QUAL). Other investors could consider buying put options or ETFs that are short the equity markets, such as the ProShares Short S&P 500 ETF (SH). To be clear, we are not advocating completely selling out of the markets, we are simply saying that tactically hedging market exposure could be a prudent strategy. To this point, it is of critical importance to keep a long-term perspective when investing. In a recent report titled “The Importance of Maintaining a Long-Term Perspective” we expanded on this idea and stated that, when we see a storm coming, we close the windows and bring in the dog, we do not sell the house and

move to another neighborhood. This continues to be our stance. Although we remain cautious on the direction of US equity markets in the short to medium term, we believe that tactically hedging exposures while keeping a long-term perspective is the best strategy through which to navigate an environment of higher for longer interest rates.

As always, it is important to consider that the investment ideas mentioned here can exhibit high degrees of volatility and are not suitable for every investor. These investments are best considered on a case-by-case basis, based on a particular investor’s willingness and ability to tolerate risk. If you need more information or would like to discuss these or other potential ideas in more detail, please do not hesitate to contact the Insigneo Research Team.



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