



Market Commentary
December 15th, 2023

English Version

Insigneo Weekly Dispatch

The Price of Perfection

A look at the Federal Reserve's recent decision on interest rates and the expectations that the market appears to be pricing in.

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The Price of Perfection

“It is a Pivot Party, everyone is invited, and the Fed just cranked up the music”. “A soft landing is in the bag for next year”. These were some of the comments that were floating around in the media on Wednesday after the Federal Reserve decided to leave interest rates unchanged and spoke of rate cuts for next year. Opinions like these were heard from multiple players across the industry, as investors continued to pile into the stock market rally on Wednesday and Thursday, betting that the Fed would be able to deliver a soft landing for the economy. We believe that a soft landing is certainly a possibility. However, achieving this outcome is incredibly difficult, something that the Federal Reserve has never been able to accomplish in its 110-year history. There is always a first time for everything, and this could possibly be the first time the Fed manages to stick a soft landing. However, taking a possible yet improbable event, that has never happened before, and betting that it is going to happen with nearly complete certainty is a very risky bet.

So far, 2023 has been a fruitful yet very bumpy ride for the markets. The S&P 500 rallied 10% to kick off the year, gave it all back by March, then rallied 20% by July, gave more than half of it back by late October, then regained it to present day. After the S&P 500 dropped close to 11% from its recent peak in July, a new rally took hold in November, pushing the index past its previous peak. Granted, the

Magnificent Seven stocks are largely responsible for this year's rally, skewing the index to the mercy of a handful of stocks. But even if we look at the Equal Weighted S&P 500, which smooths out the heavy influence of the Magnificent Seven, we see that the market still behaved erratically. In fact, its moves were even more drastic, dropping nearly 15% between July and October, then regaining this and more in a single month, 5% over the past 2 days alone. With this kind of volatility in less than one year, one would expect the CBOE Volatility Index, or VIX, to be high. After all, this index tends to be known as the market's "fear gauge", registering high levels during erratic and unstable markets. To provide some context, the VIX has historically tended to jump to levels of 30 or 40 during periods of high volatility. However, it is currently trading at 12, near its lows for the year and approaching its 5-year low near 11.5. The gauge moved higher earlier in the year, as would be expected when the market bounced around in the first quarter. After that, even though the market remained erratic, the VIX trended lower and never looked back. What could this mean? It could mean that despite the market's erratic behavior throughout the year, investors remain very complacent, betting that markets are going to continue moving higher, without giving much consideration to alternative scenarios.

This high degree of complacency is also being reflected in investors' expectations of Fed rate cuts for 2024. Wednesday morning, before the Fed's announcement on rates, the market was pricing in approximately 116 basis points of cuts for 2024.

Later in the day, after chairman Powell spoke and the Fed's dot plot showed that 75 basis points of rate cuts were being considered for next year, the market, instead of realigning its expectations closer to the Fed's, widened them, pricing in 140 basis points of cuts. In fact, over 100 basis points of these cuts are now expected to happen by the end of the first quarter. This behavior reminds me of a child that has been conditioned to, when getting what it wants from its parents, only asks for more. We all know what happens when that child is eventually told no...a tantrum ensues.

Admittedly, chairman Powell did change his tone on interest rates rather quickly, going from saying "We're not even thinking about cutting rates" on December 1st, to stating that the Fed was now discussing the timing of rate cuts, only twelve days later. Powell stated that he believes that "...the policy rate is at or near peak this cycle." However, he also said that inflation has eased but is still too high, adding that although headline inflation has come down, price levels have not, which means that people are still living with the effects of higher prices. He went as far as to say "...we still have a way to go, no one is declaring victory". This last statement attempts to lend the Fed a certain amount of flexibility, yet his actions, or lack thereof, were perceived by the market as a green light to buy risk assets. Many investors expected Chair Powell to provide some degree of pushback against the market's lofty expectations regarding the pace of rate cuts. The fact that his pushback was minimal, was interpreted by many as a

validation of these high expectations. In fact, rather than push back, Powell at times appeared to fuel investors' risk appetites, indicating that he was very pleased with the downward trajectory of inflation and the strength of the economy. Many in the market took the Fed's newfound optimism as confirmation of a soft landing, which would presumably lead to swift cuts in interest rates. Others pinned this optimism on politically motivated reasons. Whatever the reasons behind the Fed's change in stance might be, the reality is that it is likely to lead to more volatility as investors search for answers. What we do know is that the Fed does not want to repeat the mistakes of the 1970's when then chairman Arthur Burns cut rates to soon, only to have to reverse course shortly thereafter.

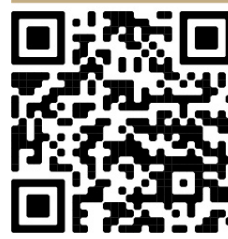
Most investors, us included, believe that the Fed is done raising rates. We have held this conviction for some time. However, as we have said before, we also believe that the market is being too optimistic in pricing in the currently high pace of rate cuts, as well as the probability of a soft landing. Let us explore three different scenarios. The first involves an important dynamic that is being overlooked by many, which is that financial conditions in the country appear to be tightening fast, potentially doing the job for the Fed in cooling off inflation and the labor market and pushing out the need for imminent rate cuts. Monetary policy acts with long and variable lags. Economic pain is currently being felt through the system, most prominently by low to medium income consumers. A recent report by JP Morgan pointed out that the average new car

payment in the country is over \$750 per month, and the average new mortgage payment is approximately \$2,800, meaning that the average American looking to get a new car and a new home needs to spend over 60% of his or her income to do so, based on median household income estimates (JP Morgan, 12/2/23). A second scenario involves an economic environment that proves to be much weaker than expected. Powell did state that he sees the economy weakening next year, maybe not contracting, but growing at a slower rate than in 2023. However, if the economy turns out to be much weaker than expected as a result of tighter financial conditions, the Fed could potentially be forced to cut rates at a fast pace, but for the wrong reasons. Not because of the soft landing that investors expect, but because the Fed would be looking to avoid a hard landing. A third scenario could involve "surgical" rate cuts, where the Fed begins to cut rates, then pauses as needed along the way, tailoring further cuts to data-dependent decisions based on economic conditions. This is a highly likely scenario, yet it is not the front-loaded, high-paced rate cut scenario and soft landing that the market is currently pricing in. In fact, none of these three scenarios would involve what the market is currently discounting as the most likely outcome.

It is true that other scenarios are possible, including the perfect yet improbable soft landing that is priced in. However, the investment world is one of probabilities. Given the low probability that the expected scenario of perfection occurs, and the

high probability that any of a myriad of other scenarios does takes place, we would heed caution ahead and would urge investors to take the proper precautions to protect their investments. Not by running out of the market altogether, but by exercising prudence, not be driven by emotions, and maintaining a long-term perspective. One of my favorite quotes from Warren Buffet says: “Be fearful when others are greedy, and greedy when others are fearful”. The market is currently quite greedy, and emotions are running high. These are the times when exercising discipline, maintaining

adequate prudence, and keeping a long-term perspective are key.



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