Legacy Trust

Investment Perspectives

Focus on the Federal Reserve

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Key Takeaways

- Equity markets have been positive but volatile so far in 2023, with further sideways movement expected
- All eyes are on the Federal Reserve, as the path of interest rates is a major uncertainty that the market is still attempting to price in
- We expect 2023 to be a positive year for stock market returns but we believe a sustained rally isn't likely to find its footing until the Fed pauses in its tightening cycle

On the heels of a tumultuous 2022, 2023 has gotten off to a good start but has already brought a slew of confusing indicators for investors that make it difficult to judge the path ahead. Many pundits seem convinced that a recession is the natural next step following multiple years of growth, but the data is still far from convincing. Consumer activity remains robust and should cushion any downturn.

January brought a strong equity rally on the heels of a historically challenging 2022. After months of market declines, equities were higher in January, with the S&P 500 making a +7.8% gain from its December low. Technology and growth stocks, which had been beaten down disproportionally throughout the last calendar year, led the market gains in January. Investors were more optimistic about increasing deflationary signals in the economic data as the Fed appeared to be approaching the end of their hiking cycle.

The timing and pace of Fed action moving forward remains a major question for investors and for market performance. Consumer sentiment has been strong and investor surveys have shown increased bullishness thanks to a very robust U.S. jobs market, China's economic reopening after years of failed zero-Covid policy, a softening of the U.S. dollar, and better-than-expected economic conditions in Europe as the region proved more resilient to energy disruption than originally expected following Russia's invasion of Ukraine in February 2022.

Economic data in January continued to point toward a disinflationary trend, with December's Consumer Price Index report largely in line with expectations and with the headline number posting the smallest one-year rise since October 2021. Q4 GDP was better than consensus expectations and, while housing data has weakened, there appear to be signs that buyers are still engaged despite higher mortgage rates.

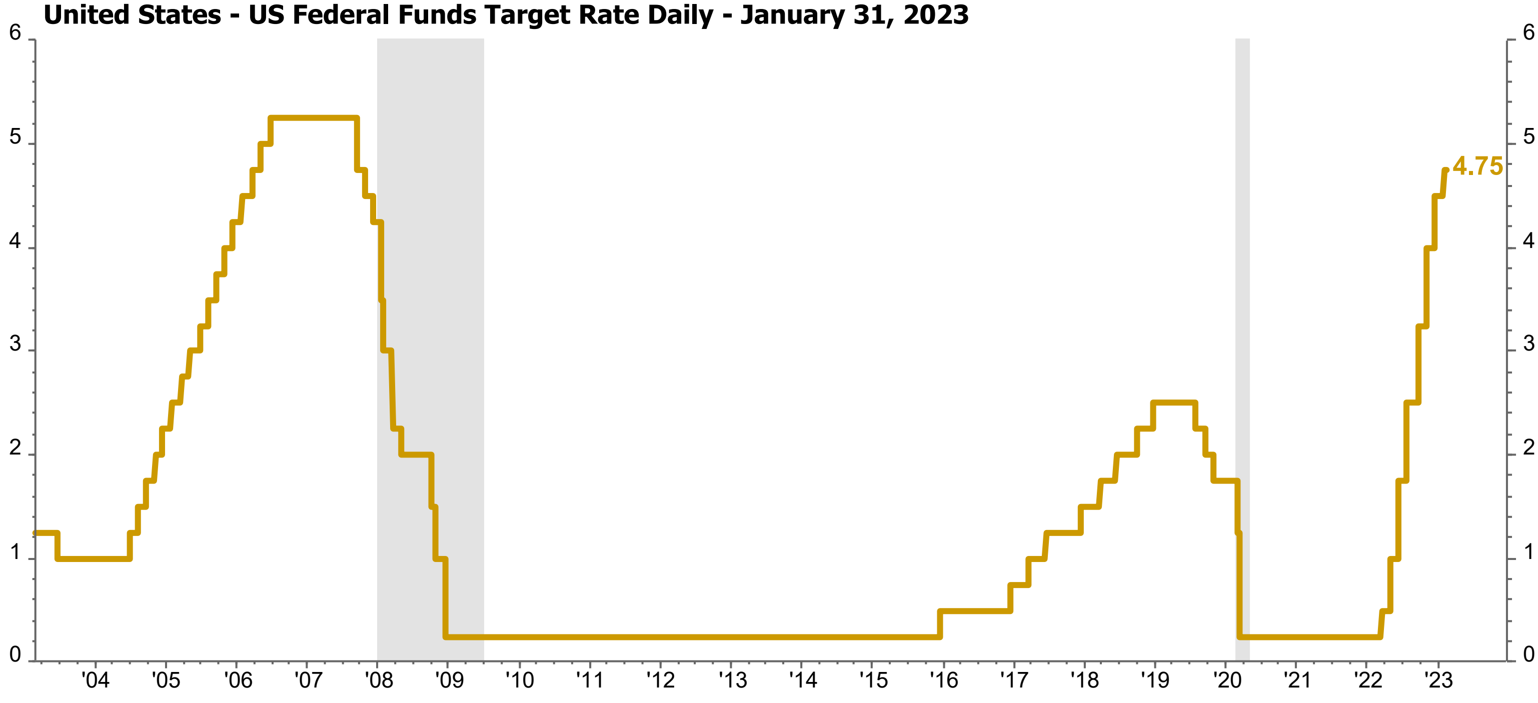
February has brought something of a reversal of January's market trends, as economic data has continued to appear robust to the point of raising concerns about a more aggressive Fed path than originally thought. Recession risk remains but appears to be low given the robust labor market and solid consumer spending trend.

While these developments are generally positive for U.S. economic growth, they also generate inflationary pressures and could lead to additional Fed interest rate hikes in the near term. In an increase from year-end projections, investors now expect three additional rate hikes in March, May and June with a terminal Fed Funds rate of 5.25 - 5.50%.

While additional rate hikes and further uncertainty about Fed posture are likely to be overhangs for markets in the short-term, we believe that once the Fed is able to pause and shift posture from their current tightening perspective, it should pave the way for equities to fully price in expectations and be able to begin a more sustainable rally. We still expect 2023 to be a positive year for stock performance and see significant opportunities ahead.

The yield curve remains significantly inverted, indicating that the markets expect the Fed to cut short-term rates before too long. Until the Fed confirms market expectations we are likely to continue to experience sideways equity movement. Fortunately it appears that we are normalizing toward an economy that doesn't look too dissimilar to 2019 pre-pandemic conditions, which were positive and growth-oriented. We still see substantial growth opportunities for our economy and markets going forward once we move further past the pandemic imbalances.

United States - US Federal Funds Target Rate Daily - January 31, 2023



Source: FactSet Research Systems