Can the Fed Talk Down the Market?

What we saw:

Q4 2023 found the S&P 500 Index up 11.7%; this is well above the average return for a typical quarter (about 3.0%) and the average return for a typical Q4 (about 5.0%) over the past 50 years[1]. While October was negative, the market grew in November and December, marking a strong close to the year. It appears the catalyst that started the market rally was the Federal Reserve (the "Fed") meeting that ended November 1st. While the Fed's decision to hold the Overnight Federal Funds Rate steady was not a surprise, equities gained considerably following the news. Fed Chairman Jerome Powell did not definitively say that the Fed was done hiking rates, but the stock market certainly reacted as if he did. Powell has continued to try to rein in the market's optimism, but in Q4 at least, the market was not listening.

In our opinion, that was the theme of the stock market for 2023. There has been more optimism around the Fed's plans than the Chairman or any other member of the Fed has given explicit reason to believe. Take the end of 2022 for example. The conventional wisdom in the stock market at the time was for the Fed to cut rates by mid-2023. Alternatively, the Fed's dot plot, a chart updated quarterly that records each Fed official's projection for the federal funds rate, projected no rate cuts but rather several hikes. The dot plot ended up being right.

The other major non-event in Q4 was the recession that did not happen. Going into the quarter, there was continued fear that a recession would take hold in the U.S. While there are still some that believe a recession is coming, it no longer seems to be the general consensus. In our view, the concern for a potential recession diminished after the October 7th attacks in Israel, likely because the fear and urgency of war overshadowed continued recession concerns. In addition, this shift may also stem from the fatigue of expecting a recession that has yet to materialize.

Recessions have traditionally been identified by two consecutive quarters of negative real gross domestic product ("GDP") growth. Despite this occurring in the first half of 2022, the National Bureau of Economic Research ("NBER") did not declare it an official recession. The NBER's official recession definition is "a significant decline in economic activity that is spread across the economy and lasts more than a few months[2]." Our best guess is that the negative real GDP growth was not severe enough on its own and not accompanied with other negative metrics like rising unemployment, so the NBER decided it was not "significant." Further, annualized real GDP growth has been north of 2% since the first half 2022 and market participants may now believe that after waiting an entire year, the recession is not going to happen.

1. *Morningstar Direct. S&P 500 quarterly total return 1974-2023*
2. *https://www.nber.org/research/business-cycle-dating*

What we're watching:

As we look forward, the Fed's dot plot suggests 3-4 cuts during 2024 while the market expects 5-6. We believe the theme of market optimism relative to the Fed's tone will continue. Of course, a recession is still possible, but appears less likely due to inflation receding, potentially in response to the Fed's rate hikes, without a corresponding rise in unemployment. Unemployment in the U.S. ended the year at 3.7% compared to 3.5% at the end of 2022. We are not convinced the stock market would react negatively to a light recession at this point. It would significantly increase the likelihood of the Fed being accommodative by cutting rates, which may be more bullish than a light recession is bearish.

Of course, there are plenty of opportunities for negative catalysts too. If inflation does not continue to subside, we could see the "higher for longer" talk from the Fed that would signal fewer or no cuts for the year. The longer rates are higher, the more likely some sort of debt crisis could become an issue similar to the Silicon Valley Bank fiasco. It's also possible the debt challenges in China could start to spread.

There are two major wars going on in the world right now, namely between Russia and Ukraine and between Israel and Hamas. In our opinion, neither war has had a major impact on the U.S. stock market thus far. There is certainly potential for a negative catalyst to come out of war, but we believe the largest potential threat to the stock market is a conflict between China and Taiwan. That is due to the large role both play in global trade, especially within technology components. While we will continue to monitor these geopolitical tensions, it is lower on our set of concerns going forward.

Another major event in 2024 will be the presidential election in the U.S. At this point, we do not anticipate the election will have a major impact on the stock market. By the end of Q1, the Republican primaries will become more clear, but again the impact of any result there is, in our opinion, likely to be small.

Overall, we do not know where the market is heading, but we will be paying close attention to any change in the general tone of market participants, inflation, and what the Fed is saying as the first quarter of 2024 unfolds.

Should you have any questions or want to discuss potential investment options, please call 1.877.524.9155 or visit SRHfunds.com for more information.