

Is the Fed Too Late or Still on Target?

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JULY STARTED with a return of market volatility, although markets finished the month on the upside. The volatility began primarily in the tech sector as the “Magnificent 7” stocks — along with most other stocks in the Nasdaq index — sold off. Despite the sell-off, the rotation into small cap and value-oriented stocks was significant, limiting the downside move and accounting for the recovery at the end of the month. The markets look for reasons to correct throughout the year, a reminder of how sensitive the public markets can be to economic reports as opposed to investor expectations.

Relative to the uptick in volatility, there were initial concerns that the economy may be slowing more than the Federal Reserve had predicted or intended with its restrictive interest rate policy. That accounts for the more substantial market moves than we had become accustomed to year-to-date. The poor jobs report at the outset of August indicates that the economy was slowing more significantly than initially thought, putting the “soft-landing” scenario in jeopardy as unemployment increased to 4.3 percent — the highest level since 2021. The markets corrected significantly August 5 on the news, continuing a peak-to-trough decline of 8 percent in the S&P 500 index. The financial markets would prefer softer labor market to ease inflation, but not so soft as to raise the specter of a recession. With the subpar job report, the risk of a recession increased — or at least the perception of risk — and volatility returned. Economic data also created doubt about what the Fed might do about cutting interest rates. In the previous six weeks, the U.S. Government’s 10-year Treasury bond moved from a yield of 4.45 percent annually (beginning of July) to a current yield of 3.9 percent. As slower economic growth was being priced into the markets, investors flooded the bond markets, driving bond prices up and yields down, leading to a significant decline in interest rates, including mortgage rates.

More recent data is causing a swift rebound from the August 5 sell-off. Retail sales are more robust than expected and inflation data is benign. The most ideal scenario for the economy and markets is the combination of low inflation, low interest rates, and low

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unemployment, which would allow the economy to continue growing. Throughout the rising interest rate cycle that began in January 2022, the economy and markets have been resilient. The inflation data looks increasingly promising, and the Federal Reserve is eyeing an interest rate cut in September of as much as a half percent. The main question in today's financial markets is whether the "soft-landing" scenario is still most probable or if the economy will slow more substantially as the Fed begins to loosen its interest rate policy.

Given the market volatility over the past six weeks, and considering the current pressure on tech stocks, the rotation to small cap and value stocks, and declining interest rates, portfolio diversification is paying off. Bonds have started to move in a positive direction and other investments in a diversified portfolio have benefited from sector rotation. Given the uncertainty of the economy and interest rate policy, there is no substitute for diversification. It has proven beneficial through the recent correction, serving as a reminder to limit concentration in a long-term investment portfolio.

Going forward, expect the markets to be sensitive to economic and inflation data. Volatility could continue, though there is longer-term opportunity as interest rates look to be on the decline and cash balances are still relatively high.

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