

# How Much More Will the Fed Need to Hike if Inflation Remains Persistent?



## Nasdaq 100 Index Gains Almost 8% in May

Despite debt ceiling worries, weak market breadth, and stubborn inflation, the Nasdaq 100 Index rose 7.7% in May amid an artificial intelligence (AI)-related rally. The S&P 500 Index was also able to eke out a 0.4% gain but the Dow Jones Industrial Average Index fell 3.2%. US growth stocks (+2.5%) and US large-caps (+0.5%) were among the best performers while international developed equities (-4.0%) and US mid-caps (-3.1%) were among the worst. Bonds were lower as investment grade corporates decreased 1.8%, 7-10 year US Treasuries fell 1.4%, and high yield credits were down 1.2%. Commodities produced negative returns as crude oil declined 10.2%, silver was down 6.0%, broad-based commodities decreased 5.9%, and gold fell 1.3%.

### Exhibit 1: Trailing Returns as of May 31, 2023

Index/ETF	1-Mo	YTD	1-Y	3-Y	5-Y
<b>Equities</b>					
US Growth (IVW)	2.53%	13.99%	1.84%	10.85%	11.57%
US Large-Caps (SPY)	0.46%	9.68%	2.92%	12.85%	10.94%
US Small-Caps (SPSM)	-1.74%	-2.02%	-7.29%	13.54%	4.04%
US Value (IVE)	-1.87%	4.93%	2.90%	13.68%	9.08%
Broad-based Emerging Markets (IEMG)	-2.06%	1.88%	-7.16%	4.47%	-0.38%
US Mid-Caps (SPMD)	-3.14%	-0.23%	-2.64%	12.54%	5.66%
International Developed Equities (IEFA)	-3.98%	7.12%	2.87%	8.49%	3.07%
<b>US Fixed Income</b>					
Municipal Bonds (MUB)	-0.64%	1.68%	0.73%	-0.61%	1.72%
US Aggregate Bond Index (AGG)	-1.14%	2.64%	-2.18%	-3.71%	0.81%
Treasury Inflation Protected Notes (TIP)	-1.19%	2.40%	-4.29%	0.07%	2.51%
High Yield Credit (HYG)	-1.23%	2.66%	-1.51%	1.23%	2.16%
US Treasury 7-10 Year (IEF)	-1.44%	3.26%	-2.90%	-5.71%	0.78%
Investment Grade Corporate Bonds (LQD)	-1.76%	3.43%	-2.53%	-3.92%	1.67%
<b>Commodities</b>					
Gold (GLD)	-1.34%	7.47%	6.54%	3.82%	8.17%
Broad-based Commodities (BCI)	-5.87%	-12.06%	-23.45%	16.23%	2.64%
Silver (SLV)	-6.04%	-1.86%	8.93%	9.05%	6.93%
Crude Oil (USO)	-10.18%	-13.52%	-29.08%	32.77%	-10.97%

Source: FactSet. Data as of May 31, 2023.

## Fed to Either Skip or Hike Small in June

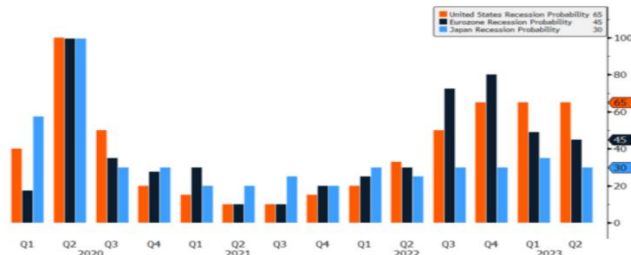
At the May FOMC meeting, the Federal Reserve raised interest rates by 25 bps, leaving the funds rate in the 5.00–5.25% range. Though at their highest level in 16 years, rates may have to be increased further to bring inflation back down to the 2% target. In relation to “spikeflation,” where inflation periodically increases, returns to normal levels, then spikes again, April’s PCE data (the Fed’s preferred inflation gauge) indicates inflation’s stubbornness and could be associated with the beginning of a spike. All measures came in hotter than expected and rose from the prior month. Additionally, the current fed funds rate remains below Core CPI which historically suggests a decrease in interest rates will likely have to wait until inflation eases further. Moreover, the implied fed funds rate at the end of 2023 has recently moved back to levels last seen since SVB’s collapse given investors’ confidence in the Fed to provide liquidity to the banking system. At its 5% predicted level, this implies as much as 125 bps less in rate cuts than what was expected in March when bank fears were at their highest. The labor market is also showing strength according to the latest JOLTS Job Openings report which showed an increase after two consecutive monthly declines, and the economy has indicated signs of growth via GDP and the Chicago Fed National Activity Index. Fed officials have expressed uncertainty regarding additional rate increases in the most recent FOMC minutes. As of May 14<sup>th</sup>, market participants were calling for a skip rather than an all-out pause in which the Fed would pause raising rates in June and likely hike again in July. However, after stronger than expected data was released in the past two weeks, a 25 bps hike in June has been somewhat reconsidered. Though Cleveland Fed President Mester stated she doesn’t support a pause in June, Fed Governor Jefferson and Philadelphia Fed President Harker are advocates of a skip which will allow the Fed more time to assess future data. Overall, their common messaging seems to be keeping interest rates higher for longer.

## The Case for International Developed Stocks

The MSCI EAFE Index valuation is relatively cheap compared to history as it currently trades at a twelve month forward PE ratio of 13. This is also approximately five valuation turns lower than the S&P

500's forward PE of 18. As the Fed gets closer to reaching the peak fed funds rate, the dollar is predicted to weaken thereafter which may also bode well for international developed markets. Moreover, the probabilities of the Eurozone and Japan (black and blue bars, respectively) experiencing a recession have come down in recent quarters and remain lower than that of the US (orange bars) based on economists' expectations.

### Exhibit 2: Recession Probability Forecasts



Source: LPL Research, Bloomberg as of May 11, 2023.

### Will Cheap Stocks Outperform Again?

The 1970s saw multiples waves of “spikeflation,” and stocks with low P/E ratios outperformed stocks with high P/E ratios in such an environment. Given still-elevated inflation, bad relations with China, and deglobalization, is the US headed for a similar landscape where such stocks will again outperform?

### Exhibit 3: US Stock Market Performance by P/E Ratio



Source: Ken French Data Library, CRSP database, Twitter @JeffWeniger. Data from December 31, 1969 through December 31, 1979, File #0177.

### How Much More Will the Fed Need to Hike if Inflation Remains Persistent?

While leading indicators and the yield curve continue to signal a recession is near, other indicators relating to GDP, housing, and manufacturing appear to be approaching a bottom or have started to improve. Additionally, recession risks have been well communicated for months, unspent stimulus from the pandemic is keeping the consumer strong, and recent AI breakthroughs have sparked optimism given potential productivity benefits. However, we don't think it is likely that AI saves the economy from a recession. What markets may be experiencing is a rotation away from value and back into growth because the profit cycle has declined, and AI may just be the excuse to rotate back into growth stocks whose earnings are higher than the market. We also forecast the consumer's spending power to dry up in Q1 2024. Despite this, we do think markets can rally 5-8% with the debt ceiling seemingly under control and light positioning—market breadth is at its lowest in 20 years, and allocations to T-Bills/money market funds have soared. We wouldn't chase the market, but instead we would buy the laggards that are sensitive to growth, such as mid-caps, inflation-linked assets, energy, and commodities, which haven't yet benefited if the recession is punted down the road. International developed stocks are also attractive given they are sensitive to growth, have cheaper valuations, and are further behind the inflation and interest rate cycle. We feel there is a rotation away from the US that could last for several years. So what's the next big catalyst? The June FOMC meeting. Will there be a skip, or will the Fed hike given inflation continues to surprise to the upside? Recalling how long duration bonds and unprofitable tech fared last year, as well as regional banks in Q1 2023, we feel the Fed is comfortable with pockets of recession occurring as long as the market is flirting with sizable YTD returns. Ultimately, we think the fed funds rate needs to increase further for inflation to get back to 2%.

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