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SUMMARY

- Fed sends a mixed message: pause and forecast do not align.
- Market rallies on earnings potential and the end of rate hikes in sight.
- RiverFront's balanced portfolios are overweight stocks.

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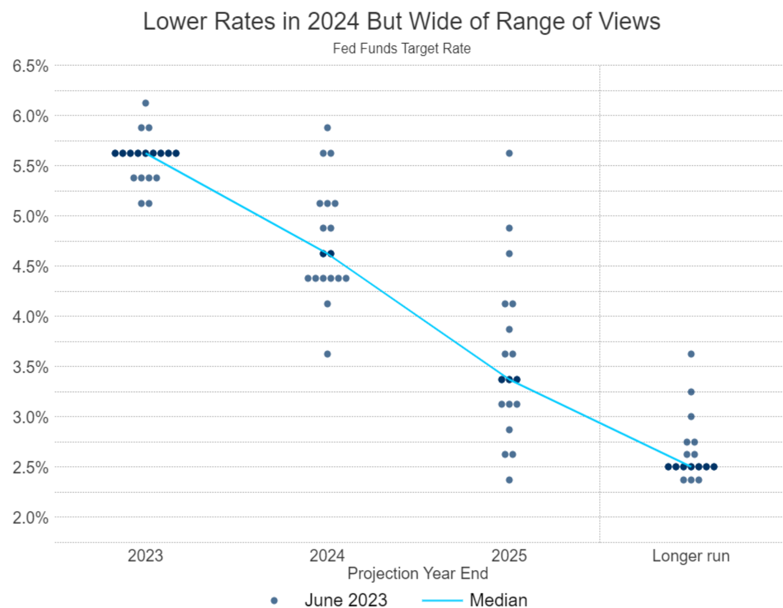
The Fed Did the Two-Step, the Market Does the Running Man

Financial markets have rejected the Fed's notion of a hawkish pause in interest rate hikes over the past couple of weeks, instead reflecting a dovish, more optimistic pause, in our view. Despite the Fed forecasting further rate hikes due to inflation falling slower than expected, financial markets see the end of the rate hiking cycle as stock markets look to 2024 earnings potential. RiverFront too has embraced this perspective as the economic environment has aligned more with our best-case scenario from our capital market assumptions published earlier this year. Hence, RiverFront's balanced portfolios are overweight stock exposure as we believe markets will broaden its leadership and trend higher, like the popular dance the Running Man.

Fed Sends a Mixed Message:

The Fed held the fed funds target range at 5.00-5.25% at its last meeting, while forecasting an additional 0.50% worth of rate hikes by the end of the year. The Federal Open Market Committee (FOMC) stated that it was willing to take a pause to allow the economy time to reflect the impact of its five percentage points of hiking over the last 10 meetings. However, in the next breath insisted that inflation was still too high despite continuing to fall. This mixed message by the Fed, dubbed as the 'two-step', left many scratching their heads, but we see two possible reasons for the convoluted message.

First, the US Treasury must replenish its coffers after nearly exhausting them during the debt ceiling stand-off. Thus, we expect the Treasury to refill them as quickly as possible in June and July, with additional issuance coming throughout the remainder of the year. It has been estimated by some market participants that there could be as much as a trillion dollars of issuance in the coming months. Just having the Fed pause its interest rate hikes for a month, allows the Treasury to issue at lower interest rates.

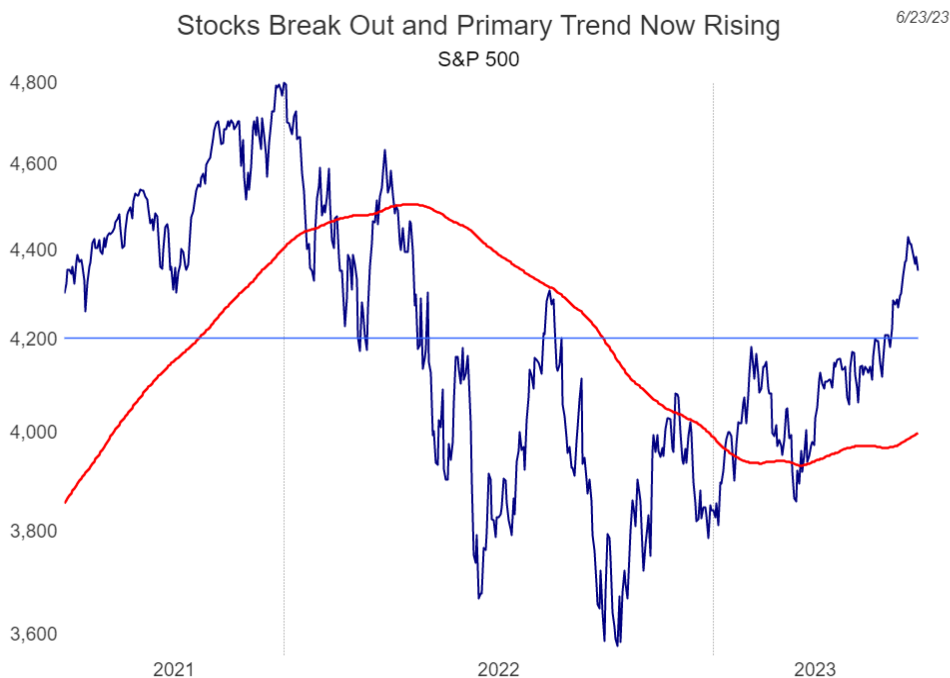


Source: Refinitiv Datastream, RiverFront. Data as of June 14, 2023. Chart shown for illustrative purposes.

Additionally, we believe that the hawkish pause by the Fed was a compromise. It appears to us that the leadership wanted to pause, and it was communicated to markets by vice-chair Jefferson just prior to the quiet period before the meeting. Looking at the Fed's forecasts for the fed funds target rates, as shown in the dot plot on the previous page: two members wanted to hold rates at current levels through year-end, while 16 other members project between one to four more 0.25% hikes. We believe that the pause was a compromise by Chairman Powell and Vice-chair Jefferson with the remaining members, hence the mixed message.

Markets Rally:

The logical question is: 'why would equity markets rally after such hawkish commentary from the Fed?' We believe that the stock market is now more focused on 2024, when the Fed itself expects some rate cuts (see the chart above) and earnings are expected to grow. As of June 23, 2023, the S&P 500 is trading near 20 times consensus estimated operating earnings for 2023 of $218.22. Analysts are forecasting 12% earnings growth for 2024 at $244.81 with $230.04 earnings coming in the next 12 months. Assuming no further multiple expansion and continued strong labor markets, we believe recession worries can be pushed farther out, and the S&P 500 could potentially trade to 4900 in 2024. With that perspective, it is not difficult for us to imagine the market looking past the Fed's hawkish communication.



Source: Refinitiv Datastream, RiverFront. Data as of June 23, 2023. Chart shown for illustrative purposes.

It is important to remember that markets do not go up in a straight line but the definitive breakout above 4200 appears to be a good starting point. Acknowledging that there will be some setbacks, we believe the primary trend has turned up as can be seen in the chart above.

Overweighting Stocks:

Despite the Fed sending a mixed message and doing the two-step, like the popularity of the dance, the Running Man we are siding with markets in our belief that the breadth of the rally will broaden, and stock markets will trend higher. Consistent with this view, we recently increased our exposure to stocks across our balanced portfolios, focusing on segments of the market that we believe will benefit from broadening leadership beyond technology. The portfolios accomplished this by adding equity exposure both domestically and internationally, as we see all central banks getting closer to the end of their rate hiking cycles. Currently, the portfolios favor stocks over bonds by roughly 6 to 9 percentage points relative to their respective benchmarks. We view the recent additions to the portfolios as one of a few tactical moves we make in a typical year, as the improving trend-line tends to foreshadow attractive future equity returns.

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All charts shown for illustrative purposes only. Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

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Index Definitions:
Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

Definitions:
The Federal Reserve System (FRS) is the central bank of the United States. Often simply called the Fed, it is arguably the most powerful financial institution in the world. It was founded to provide the country with a safe, flexible, and stable monetary and financial system. The Fed has a board that is comprised of seven members. There are also 12 Federal Reserve banks with their own presidents that represent a separate district.

The term Federal Open Market Committee (FOMC) refers to the branch of the Federal Reserve System (FRS) that determines the direction of monetary policy in the United States by directing open market operations (OMOs). The committee is made up of 12 members, including seven members of the Board of Governors, the president of the Federal Reserve Bank of New York, and four of the remaining 11 Reserve Bank presidents, who serve on a rotating basis.

Federal funds, often referred to as fed funds, are excess reserves that commercial banks and other financial institutions deposit at regional Federal Reserve banks; these funds can be lent, then, to other market participants with insufficient cash on hand to meet their lending and reserve needs. The loans are unsecured and are made at a relatively low interest rate, called the federal funds rate or overnight rate, as that is the period for which most such loans are made.

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