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COMMENTARY

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Investors Sell Stocks and Bonds Before Fed Meeting

- Market sell-off continues as investors sell both stocks and bonds.
- Fed comments after their meeting this week are very important for market direction.
- Given negative market sentiment, room for positive surprises grows.

U.S. equities continued their market sell-off as inflation concerns remain elevated and the perception grows that the Fed will need to get more aggressive to combat it. Because a more aggressive Fed raises the likelihood of a recession, investors have continued to sell assets. Though the market's mood is very dour now, the room for potential positive surprises grows. Even if markets continue their sell-off, history has shown that investment opportunities like these have proven positive for long-term investors.

Investors have become increasingly concerned that the well-documented inflation problems will impact economic growth. With inflation pressures as strong as they are, there is very little optimism that the Fed can help to cushion the blow and achieve a "soft landing," when the Fed slows the economy to mitigate inflation but does not trigger a recession. The fear has sent the major domestic equity indices into bear market territory, when the peak to trough decline exceeds 20%. Even traditional safe-havens have seen weakness. The bond market, where investors tend to gravitate towards during times of market uncertainty, has fallen as fixed income investors fear that last week's CPI report and recent survey data foretell even higher inflation readings. Gold has also seen a sharp decline, partially hurt by strength in the U.S. dollar.

With the financial markets expecting the Fed to be more aggressive to combat inflation and consequently push the economy into a recession, all eyes will be on this week's Fed meeting. While the Fed has telegraphed plans to raise interest rates by one-half of one percent, markets are fearful that the Fed may be more aggressive and raise by three-quarters of one percent. Helping fan this concern is the fact that the Fed is in its quiet period and cannot comment until its next meeting. While inflation concerns are worrisome, given the combination of a rallying dollar and weak equity markets, both of which can act like a rate hike, we don't anticipate the Fed being more aggressive this meeting. Instead, the Fed is more likely to guide investors to a potential three-quarter rate hike in July if inflation data worsens. Too much emphasis may be put on each Fed meeting right now as well. If the Fed raises rates more than expected in the next couple meetings, it may raise rates less in future meetings. The long-run interest rate could be more important than meeting-to-meeting increases.

While equity markets have pierced important levels, where can we get positive surprises to reverse course? First, the next inflation reports might suggest that last Friday's CPI report was peak inflation. We believe this is possible as supply chains further improve and consumer sentiment, and therefore spending, weakens. A shift away from goods purchases to services would also help. Second, the Fed may be less aggressive than the markets anticipate. The combination of a strong dollar, the already felt impact of rate hikes on the economy, and the stock market weakness could suggest to the Fed that economic demand has been reduced without having to raise rates. Third, the economy is able to withstand less monetary stimulus on the strength of a labor market with unemployment levels below 4% and greater than five million more jobs available than people looking for jobs. Lastly, while company earnings will likely be hurt by either higher inflation or slower economic growth or both, if strong corporate balance sheets, productivity gains, or a resilient consumer can help mitigate some of these concerns, the earnings picture may not be as bad as some fear.

In uncertain market times, the key question is should I invest and where? We continue to recommend a diversified allocation to help dampen volatility risk. For equities, valuations have improved dramatically since the beginning of the year. History has shown that long-run portfolio returns have been better when buying at lower valuations than at higher valuations. Within bonds, yields have surged on inflation concerns. However, fixed income typically offers defensive characteristics in times of market stress. Furthermore, if markets are correct and recession chances have increased or if we are close to peak inflation, yields should be falling (bond prices rising). Lastly, market timing and raising cash is not ideal. Market timing is difficult, and cash does not yield a dividend to cover high inflation.

Regardless of the situation in financial markets, always invest relative to your specific risk objectives. Don't be too aggressive or too conservative. Your financial professional can review your financial situation to help ensure your portfolio is aligned with your long-term risk levels.

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