The Fed has spoken … now what?

Tylar Lunke:

Hello everyone and welcome to a real time update from RBC Wealth Management. We're recording this on Wednesday, September 28th, 2022. My name is Tylar Lunke and I lead the Managed Portfolio Strategies team and I'm joined today by Janet Engels, head of the Portfolio Advisory Group. And we just want to say thank you to everybody for joining us today.

I know it's been a tough year for investors, both across equity and fixed income and negative news seemingly everywhere. It's tough to keep up on what's happening, but our goal over the next 10 to 15 minutes or so, provide some perspective on the markets, given we are back at equity market lows and we'll attempt to make some sense of the Fed, markets. Touch a bit on what to expect from here, and then close with some thoughts about what do we do now.

So with that, Janet, welcome. Always great to get your perspective and thanks for your time and we'll just jump right in. So like I mentioned, there's been so much volatility in equities, bond yields are higher, people are now talking currency. How does an investor make sense of all this news today?

Janet Engels:

Well, Tylar, thank you for having me again on this podcast. I would say, look, when we started the year, we talked about a year of shifting gears and shifting gears for us meant that we were going from strong economic growth to slower economic growth, from zero interest rate policy to something different from the Federal Reserve, and we were hoping to see a peak of inflation.

Those shifting gears just happen to be going very, very quickly now. And when we look at the landscape for equities overall, the range of outcomes, and quite frankly for fixed income as well, the range of outcomes has broadened quite a bit. And that has all to do with what is happening from a central bank perspective, not just in the United States, but from a global perspective as well.

Tylar Lunke:

So maybe talking a little bit more about central banks, that kind of leads us into the Fed and boy, they have been in the news and I think that's what's really driving things. So maybe put a finer point on what's causing some of these negative reactions.

Janet Engels:

Certainly, so we had a big FOMC meeting last week. That is the Federal Reserve in the United States. There have been central banks, as I mentioned, globally that have also been raising interest rates. We expected, there was no surprise that the Federal Reserve would continue to raise interest rates when they met and made the announcement last week. The movement was 75 basis points.

Again, highly anticipated. But what's changed and what really brought everything to the market's attention and caused a further downdraft in equity prices and a move up in yield was the fact that the Federal Reserve basically said they will stand resolute, in terms of fighting inflation. And when they gave their forward guidance, their forward guidance for where they would move rates was higher than what the market expected.

So what the Federal Reserve essentially said that by the end of this year, by December of 2022, we would see rates at 4.5%. That's their fed funds rate. And if we look out to 2023, they could see fed funds rates at 4.75%. That was way ahead of much higher than original street expectations. That had the impact of bringing up yields on the two-year Treasury as well as the 10-year Treasury. The 10-year Treasury just recently hit close to 4%, and again, starting the year at somewhere around 1.5 or 1.6%, that's a pretty dramatic move.

Tylar Lunke:

So it was more the statement about what they expect to see over the next few months and into next year. What do we see? What's our outlook from here and the impact of those rate increases.

Janet Engels:

So you have to get it back to public enemy number one, and we call public enemy number one what's happening from an inflation. So the Fed, as we mentioned, is focused on bringing inflation down. So they are willing, and they said to endure some pain if they can bring inflation down. So in the short term, pain to bring forward a much longer term better environment for the U.S. Economy, needing to get inflation under control.

So let's spend a minute just on inflation and should we be in the position of saying that inflation has peaked. And I think there's a consensus view that inflation has largely peaked, but the broader question is how quickly will it come down? So if you think of the key elements that have forced inflation higher, we think of the supply chain issues that existed. We think of commodity prices that went skyrocketing at the invasion of Ukraine by Russia.

We've seen that. You also think about monetary policy, the unprecedented monetary stimulus that was provided to the system during the pandemic. And you also think about fiscal stimulus, which was enormous. If you look at those four factors, you could basically say monetary policy has changed, right? It's starting to move higher.

The impulse from fiscal stimulus has started to wane, meaning it is not having that positive effect any longer on the U.S. Economy. Commodity prices have come down and we are seeing some evidence, in terms of the opening of supply chains overall. That's the good news. But the real question is, can we expect inflation to come down to that 2% level that the Federal Reserve would like to see?

Well, we will eventually, but it is a matter of timing. So quite frankly, we are in this tug of war between waiting for inflation to come down in their signs. It's starting to ease and the impulse from the Federal Reserve to ensure that they bring inflation down, even if it risks a recession in the U.S. economy.

Tylar Lunke:

So the Fed has that laser focus on inflation, fighting inflation, even if it inflicts some form of pain. But as we turn and think about what's priced into the market today, what would our view be on what we're seeing with today's market pricing?

Janet Engels:

Well, the market has priced in quite a bit. I think since the beginning of the year, the market has looked at these 40-year high levels of inflation, the most aggressive Fed tightening cycle since the 1980s. The Russia, Ukraine, and the skyrocketing and commodity prices. Supply chain disruptions, concerns about second-quarter earnings. So the market is already priced in quite a bit, but our view is as we are in these shifting gears, as we're in this tug of war, volatility will still be the order of the day for markets.

We believe that markets are trying to find some sort of bottom in here. Sentiment remains quite bearish at this point, which is usually a good sign, but we still have some headwinds, Tylar. We have the headwinds not only of looking for what the Fed will continue to do, but importantly, what drives markets. Earnings drive markets, and we're just on the cusp of the third-quarter reporting season. And there's some anxiety that companies will either guide lower either for the quarter, miss expectations or guide lower for 2023. It would not be surprising to us to see earnings estimates come down and that will have an impact on market valuations.

Tylar Lunke:

So certainly from a client perspective, volatility is never easy to endure. They always like certainty, but that's just not what comes with the market. So as far as what to do from here with that view, maybe that we'd kind of trade back a little bit further down. From here, what practical advice do we have for investors today? Should they take action or what's the prudent course from here?

Janet Engels:

Well, I think for the first time in a long time, there are opportunities within the fixed income markets. I think we've all been looking for higher yields. Now we have higher yields than we had before. So as I look at the market landscape, we think that there are some opportunities within fixed income for clients who are looking for levels of income.

That would be number two, number one, pardon me. Number two would be to say if we stay within volatile equity markets, I think we have to consider an investment time horizon, right? And as an investor looks out for the next three to five years, and we know that volatility is the normal part of any market cycle. It just feels very intense this year, because we've declined more than 20% and because we had a lack of volatility.

So we always look across our portfolios and say at times like this, quality is very important. Sticking with your discipline is very important. And then I think ultimately we are looking for opportunities in the market, particularly around growth stocks. Over time, those stocks have come down even more than the market, because they are impacted by higher interest rates.

Tylar Lunke:

Very good. So kind of three things that you're looking at there. Take a look at fixed income, think more about the longer term, and then seek out some potential opportunities. So thank you, Janet, for the perspective today. Certainly appreciate it. And we just want to make sure everybody is aware we will continue to provide updates and special reports as this narrative evolves.

Want to make special note of a market update that went out earlier this week. Talked specifically about the impact of the Fed. That piece is linked from the audio player for this recording. And then keep an eye out for additional content from across RBC and specifically within the Global Insights brand. So as a reminder, we do want to make sure if you have any questions about your investments, we would encourage you to stay in touch with your RBC financial advisor. Thank you all for the time. Take care and have a great day.

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