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It Ain't Over Till the Fed Sings

Talk of Interest Rate Easing May be Premature

History is not entirely clear on the origin of the phrase, but one legend has it that in 19th century Britain, sailors who had gone ashore would not return to their ships "till the fat lady sings". The "fat lady" referred to the large boilers that propelled Britain's iron ships around the globe. When enough steam had built up in them, they whistled a loud tone signaling the ship's readiness to leave port and calling the sailors back aboard. It was a clear message that everyone understood.

More recently, despite the lack of a clear message from the Federal Reserve indicating a change of course, the investment world has been abuzz with anticipation that the Fed's rate hikes are nearly over and that a new easing cycle is at hand. While that may in fact turn out to be the case, it is too early to come to that conclusion. Inflation remains above the central bank's 2% target, and the Fed appears determined to stay on its tightening trajectory until it meets its goal. In other words, the Fed has not sung yet. Its decision-makers have not signaled their readiness to ease interest rates.

The Fed's Goal: Slow the Economy to Reduce Inflation

To Fed watchers, the latest interest rate hike in May came as no surprise. The quarter point rise in the Federal Funds Rate was the tenth increase in the last 14 months, and was prompted by persistently high national inflation figures. As measured by the Consumer Price Index (CPI), the national rate declined 0.9 percentage point from 4.9% in April, to 4.0% in May. This marks steady progress, but inflation is still above the Fed's 2% target.

Given sufficient time, the Federal Reserve's rate increases to date are likely to reduce inflation by slowing economic growth. There is often a lag of months or even years between the time that the Federal Open Market Committee (FOMC) changes interest rates, and the time those changes impact economic activity.

Considering the gap that still remains between real-life inflation and the Fed's target, one can reasonably assume that additional rate hikes are more likely than not. This is made all the more

probable when considering the Fed's rush to reach its target as soon as possible. To some extent, beating inflation is a matter of pride for the central bankers. They were partly responsible for stoking inflation in the first place. Now they need to demonstrate their ability to control inflation while achieving the Fed's dual mandate of price stability and maximum employment.

In May, chairman Jerome Powell stated that the Fed's actions could "bring some pain" on the U.S. population. In mid-June he added that "inflation pressures continue to run high and the process of getting inflation back down to two percent has a long way to go." More recently, at the end of June he said, "Although policy is restrictive, it may not be restrictive enough, and it has not been restrictive for long enough". These are clearly not comforting words that indicate a change of course from tightening to easing. They suggest that a hard landing, a recession, remains a distinct possibility for the economy as rates are ratcheted higher.

A hard landing, as the phrase suggests, would be painful for virtually everyone. Every aspect of the economy, including corporate earnings would suffer, as we have already seen. At the beginning of this year, Wall Street analysts expected full-year 2023 S&P 500 profits to grow by 5.6%. That figure has been revised downward through the past six months, and now stands at 1.1%. This significant decline in expectations is in large part due to the Fed's actions. For stock and bond investors, rising interest rates directly impact the value of their securities.

Predictions of a New Bull Market May Be Premature

With this as a backdrop, some market observers have nevertheless jumped the gun and heralded the end of "the bear market" and the start of a new bull market for stocks. Their biggest rationale seems to be that the S&P 500 has risen by more than 20% from its October 2022 low.

This casual definition of a bull market has been around for years. But, rather than being helpful to investors, it actually does them a disservice. It offers little-or-no value as a guide to sound investing. It disregards the many other factors that affect stock prices, including economic and corporate trends, as well as interest rate fluctuations. And it incorrectly assumes that a 20% rise guarantees further stock market gains, which it does not.

What transpired last year in the stock market looked and felt more like a correction than a whole bear market on its own. Admittedly, the qualitative differences between a bear market and a correction can seem esoteric or nuanced. But, investor sentiment offers helpful clues.

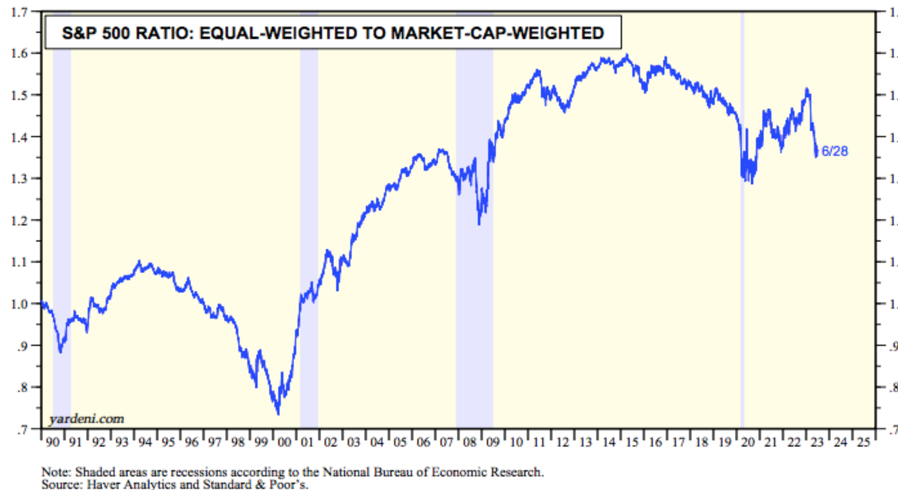
Bear markets are often rougher on the investor's psyche than corrections, and can end in panic, frustration, and exhaustion. Think of the 2007-2009 bear market when fear caused so many to liquidate their portfolios at losses of 50% or more. The same was true of the 2000-2003 bear market during which investor sentiment became so deflated by the market's 45% loss that many swore never to own stocks again.

Last year, we did not see any of this. In fact, by the end of the year, the most intrepid risk-taking investors were chanting "buy the dip". That is not the kind of sentiment we typically hear at the bottom of a bear market from almost anyone, even risk-takers. It is more characteristic of a correction, or an intermediate phase of an ongoing bear market.

At the end of the day, calling the end of a bear market and declaring the start of a new bull market without considering key fundamental factors, fosters unsound investment conclusions. These in turn have the potential to impact the financial well-being of millions who rely on the stock market to save and to invest for their long-term goals.

Narrow Breadth Suggests That a Bear Market Persists

Another difficulty with the "new bull market" viewpoint is that the rally since October has been narrowly based. Investors have flocked mostly to a handful of the largest and most liquid household names in the hope of riding these momentum stocks higher. Market breadth, or the number of stocks going up versus the number of stocks remaining flat or going down, is very small and has been most notably confined to the collection of companies commonly referred to as the FAANGMs, short for **F**acebook (Meta), **A**pple, **A**mazon, **N**etflix, **G**oogle (Alphabet), and **Mi**crosoft. It is the rise of the FFANGMs, and a few other mega-cap technology names, that has prompted declarations of a new bull market.



This chart from Yardeni Research highlights the narrowness of the market. The ratio of the equal weighted S&P 500 to the market capitalization weighted S&P 500 (the index that is normally quoted) shows that most stocks in the index are on a weakening trend to the end of June.

There is some irony in the current strength of the FAANGM group. High interest rates are normally a headwind to technology stocks. The tech sector tends to be dependent on debt, and higher priced debt means higher interest expenses and potentially lower profit margins. These six mega-caps have gone against that notion for the moment partly because of their leadership in the developing field of Artificial Intelligence (AI). Investors rightly see AI as one of the biggest trends of the future. These are also names that investors quickly recognize and trust, making them a natural go-to in challenging market times.

A Portfolio of Six Stocks? Consider the Risk.

However, from a prudent portfolio management standpoint, six stocks from the same sector cannot constitute a well-diversified portfolio for risk mitigation purposes, no matter how strong their price performance may be. Additionally, five of these mega-caps are more volatile than the general market. Their median beta, a measure of volatility against the S&P 500 Index, is 1.225. This means

that on average they are 22.5% more volatile than the S&P 500 Index when moving either up or down.

When the stock market is rising, a concentrated portfolio of six high-beta growth stocks, such as the FAANGMs, can work very well - the portfolio has the potential to outperform the market by a substantial margin. But on the downside, a 22.5% loss beyond the S&P's own declines can feel painful. Based on historical betas, last year's decline of 24% in the S&P 500 Index from December 31, 2021 to October 13, 2022, had the theoretical potential to produce a decline of 29% in the FAANGMs. In fact, this group declined by a median 33% in that period, with the most dramatic declines coming from Meta and Netflix, which fell by 73% and 61%, respectively.

Initial Investment	% Loss	$ Loss	Balance in Account	Return Needed to Recover
$1,000,000	-10%	($100,000)	$900,000	+11.11%
$1,000,000	-20%	($200,000)	$800,000	+25.00%
$1,000,000	-30%	($300,000)	$700,000	+42.86%
$1,000,000	-40%	($400,000)	$600,000	+66.67%
$1,000,000	-50%	($500,000)	$500,000	+100.00%

When a portfolio loses a significant portion of its value due to concentration, downturns in the overall stock market, or from company-specific factors, restoring that portfolio to its original value becomes a Herculean task, as this table illustrates:

This mathematical reality highlights the importance of finding a balance between risk and return when constructing a portfolio.

Navigating the Waters

With these considerations as a backdrop, the number of attractive stocks meeting conservative investment criteria has become very small.

In a stock market that is characterized by narrow breadth it makes little sense for long-term investors to chase a handful of high-beta stocks as those stocks rise to loftier valuations. That is especially true when one considers that rising interest rates in the months ahead pose clear risks to those same stocks, and to the stock market as a whole.

With no clearcut end to the Fed's tightening cycle we can expect more headwinds for the economy, for corporate profits, and for the markets. This makes it important to invest prudently and to prioritize capital preservation over short-term gains.

Until the Fed sings, we should not assume that a change of course from tightening to easing is in the offing for the central bank, or that a nascent bull market for stocks is in the works.

V. Henry Astarjian

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