Seventy2 Capital
Wealth Management

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Market Commentary:
Don't Fight the Fed

Markets have shifted dramatically over the last year due to one primary theme: inflation and the Fed's fight against it.

We expect this topic to drive market movement in 2023 as well. The biggest question for investors today is whether the Fed will be able to pull off a "soft landing," a circumstance where the Federal Reserve increases interest rates enough to reduce demand and pull inflation closer to their long-term target of 2%, but not to a level that would induce a recession. We believe this is an overly optimistic view that is reflected in current market valuations but not supported by historical evidence. In most cases, the Fed has driven markets into recession.

CPI Inflation peaked in June at 9.1%. Much of this figure was driven by substantial rises in the prices of food, energy, used cars, rents, and wages. The last reported figure for CPI stands at 6.5%. Some parts of inflation are very elastic (adjust quickly) such as food, energy, and used cars. For example, container ships in 2021 waited outside of ports because they could not deliver goods on their intended schedules. Supply chain disruptions caused prices to rise substantially, and consumers were willing to pay more for the limited amount of goods available. Many of those freight queues and bottlenecks have been eliminated, increasing the availability of goods and decreasing their prices. Goods deflation is occurring in most industries and is likely to continue as companies offload excess inventory at sale prices. There are also inelastic areas of inflation, such as rents and wages, which take more time to come down. Employers and landlords are not reaching out to their employees and tenants to decrease wages and rents. Although the Fed's current actions are likely already enough to reduce inflation, that data will come on a lag. Their current rhetoric suggests they still have a job to do in tightening monetary policy.

Historically, the Fed overshoots. They raise rates and keep them up too long, damaging the economy and sending it into a recession. We think this time is no different. There are many leading indicators that already show that inflation has peaked, and the economy is likely to go into a recession (container freight rates, retailers' pricing power, U.S. Manufacturing PMI, U.S. Small Business Optimism Index).

Over the last few weeks, we have seen striking similarities between commentaries from strategists who downplay the risk of recession and forecast a soft landing and those of the past that deemed "this time is different" before previous recessions, including in 2006-2007. Until we see the Fed change course, our guidance is to stay defensive. The market has never bottomed out until the Fed has finished raising rates. Don't fight the Fed!

-The Seventy2 Capital Team
Commentary and Research provided by:
Michael Levitsky, CFA®, CAIA® - Director of Investment Strategy