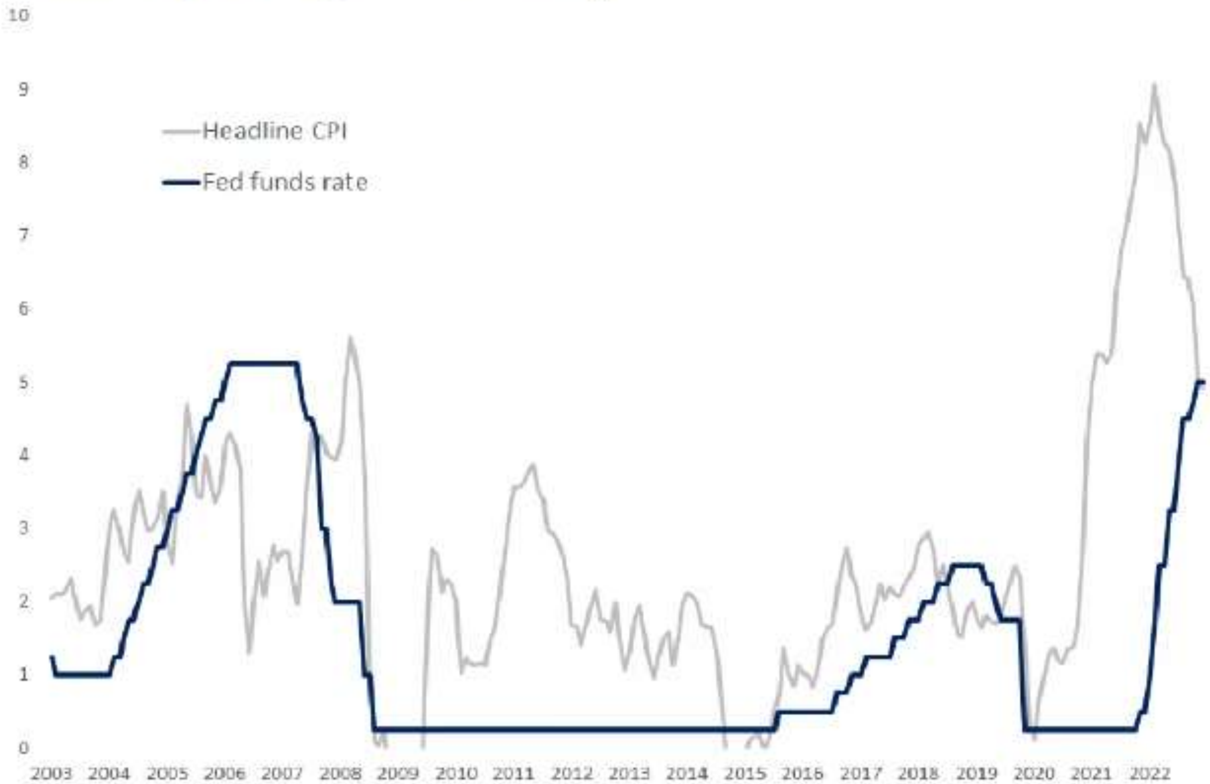
Monday, May 15, 2023

Good afternoon:

Markets were mixed last week as inflation data continued to show improvement while debt ceiling debate concerns swirled. The consumer price index (CPI) for April came in at 4.9%, slightly less than the 5.0% expected, and below last month's 5.0% reading. This was the smallest annual increase since April 2021 and the tenth straight month of improvement since inflation peaked in June of last year at 9.1%. Gasoline prices rose from March, but food prices dropped. Annually, food inflation is still high at 7.1%, but it is down from 13.5% in August. This declining trend further supports the position that the Fed has paused and will not need to hike rates further in this cycle.

Although May inflation data will be reported prior to the Fed's June FOMC meeting, the April CPI data makes it less likely the Fed will choose to raise rates. Historically, the Fed has never ended its rate hikes before its policy rate exceeded the rate of inflation. With headline inflation now at 4.9% and the Fed Funds rate at 5.0% - 5.25%, a June pause would not break that precedent. However, a pause does not mean that rate cuts are coming soon. Inflation is still way above the Fed's 2% target, and the stress in regional banks has not spread to other parts of the economy, which would justify a quick pivot to an easing posture.

Moderating inflation gives Fed room to pause



Source: Bloomberg

Meanwhile, investors and market strategists are forced to again turn their focus to Washington where the all-too-frequent debt ceiling issue has once again caused concerns that our elected representatives are playing politics as our nation’s debt moves closer to the precipice of a default if no deal can be reached. Denmark and the United States are the only two countries in the world that have a statutory limit on the total amount of debt that can be issued at any given time. The U.S. debt limit was hit earlier this year and the Treasury projects it will need to borrow more money by June 1st to meet its obligations. Since 1960, Congress has raised the debt ceiling 78 times, an average of more than once per year.

Although both sides are still at odds over spending, meetings are scheduled to take place tomorrow after Treasury Secretary Janet Yellen remarked over the weekend, "I am told they have found some areas of agreement." If past is prologue, an eleventh-hour agreement will very likely be reached and the fear of a default will subside. However, the anxiety of such a high-stakes game of chicken is apt to cause further volatility as we get closer to the end of May if no deal is reached.

Underpinning all these concerns is the clearly slowing economy as it lags the dramatic increase in interest rates over the past year. Earnings growth is slowing, and many believe this negative momentum will push the economy into a recession. The bigger question may be whether this slowdown will be mild or severe and how much of this, if any, is already priced into current equity valuations?

These specific topics will be discussed by Federated Hermes' Chief Equity Market Strategist Phil Orlando in our exclusive client call on Friday of this week. We will be sending out the email invitation again today, as well as later in the week and encourage you to join us to gain some additional perspective on these interesting and challenging times in the financial markets.

Have a great week!

Mark and Jeff

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