The Weekly Market Update – 9/25/23: A September Fed Pause, But Interest Rates Remain Elevated

Major Indices (Price Returns)	Close	Last Week	Quarter-to-Date	Year-to-Date	Trailing 12-Months	All-Time High	% to High
S&P 500	4,320.06	-2.93%	-2.93%	12.52%	9.23%	4,796.56	11.0%
Dow Jones Industrial Average	33,963.84	-1.89%	-1.29%	2.46%	7.79%	36,799.65	8.3%
NASDAQ Composite	13,211.81	-3.62%	-4.18%	26.23%	11.81%	16,057.44	21.5%
Russell 2000	1,776.50	-3.82%	-5.94%	0.87%	-3.67%	2,442.74	37.5%
MSCI EAFE (USD)	2,064.71	-2.06%	-3.14%	6.21%	12.18%	2,398.71	16.2%
MSCI Emerging Markets (USD)	964.24	-2.11%	-2.55%	0.82%	-3.01%	1,444.93	49.9%
Bloomberg Commodity Index	106.22	-1.16%	4.68%	-5.83%	-12.67%	237.95	124.0%
Barclays U.S. Aggregate Bond	87.24	-0.50%	-2.84%	-1.85%	-5.06%	112.07	28.5%

Source: FactSet

As expected, the U.S. Federal Reserve Bank (Fed) left its federal funds (overnight bank lending) interest rate target unchanged, and also signaled that interest rates could remain higher for longer. Changes were evident, however, in the Fed's Summary of Economic Projections (SEP), which records individual economic forecasts of 19 Fed Board members and bank presidents. The September SEP showed a stronger GDP (gross domestic product – the value of U.S. goods and services produced) growth number than was estimated in the prior SEP (June 2023). The September median GDP estimate for 2023 is 2.1%, up from 1.0% in June, and the 2024 median GDP estimate moved to 1.5% from 1.1% prior. In addition, while the 2023 estimated year-end fed funds mid-point target range was unchanged at 5.6%, the 2024 estimated fed funds level was revised higher to 5.1% from 4.6% in June. From the current actual fed funds target range of 5.25% to 5.50%, the SEP reflects Fed expectations for one more 0.25% interest rate increase this year (two 2023 Fed meetings remain) and then 0.50% of rate cuts next year (the June SEP estimated 1.00% of rate cuts in 2024). The Fed projections of higher GDP growth, along with rate cuts next year, tell us that Fed voters believe that an economic "soft landing" (no recession) remains achievable and, along with improving (lower) inflation, could support lower fed funds targets because rates could move from restrictive (slowing economic activity) levels to a neutral range. In our opinion, that view offers only one path for potential lower interest rates next year, while a second, more negative path to lower interest rates remains possible. The second path would be a weaker economy caused by today's higher interest rates, and a slowdown in consumer spending in the months ahead. Cracks in consumer strength have emerged in recent weeks, including higher credit card balances and payment delinquencies (New York Federal Reserve Bank), and slowing monthly nonfarm payrolls gains and job quit rates (Bureau of Labor Statistics). In addition, many consumers must navigate the resumption of federal student loan payments in October and recent spikes in gasoline prices. If recession odds increase, the Fed may respond by cutting the fed funds target sooner than expected. While a recession would likely continue the trend of lower inflation, economic weakness would clearly pressure corporate earnings.

A September pullback in equities adds to the August decline. After last week's decrease, the widely followed, large-company S&P 500 index was down 4.2% in September, and since setting a 2023 closing high on 7/31/23, was down 5.9% (as of 9/22/23). This is similar to a 6.9% pullback over four weeks earlier this year (2/15/23 to 3/20/23), following concern about regional banks losing depositors. The current decline has been more gradual, so far covering eight weeks, but also comes amidst an increase in interest rates. Since 7/31/23, the U.S. 10-year Treasury yield (a proxy for U.S. long-term interest rates) has moved to 4.51% from 3.95% and is at the highest level since July 2007. Higher long-term interest rates can create a challenge for equity valuations as the present value of future cash flows is lower in an elevated interest rate environment. In our view, equities could remain under pressure if long-term interest rates move even higher. The S&P 500 remains up 12.5% year-to-date.

As September and the third quarter come to a close this week, a federal budget agreement remains at an impasse. With the House of Representatives needing to approve 11 separate appropriation bills this week to keep the government funded, a shutdown appears increasingly likely. A potential outcome is to pass a few of the 11 bills and extend the remaining bills with a continuing resolution. Contentious negotiations often lead to market volatility.

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