STREET SMARTS: MARKETS AWAIT FED GUIDANCE

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As the Federal Reserve heads into its July meeting, Phillip Nelson, NEPC's head of asset allocation, shares his insights into interest rates and monetary policy, the economy and the likelihood of a U.S. recession.

1. What is the market expecting from the Fed for its meeting today?

The Fed will likely raise rates by 25 basis points and that's largely priced in by the market. More importantly, everyone is looking to the guidance the Fed provides on the future path of policy changes.

We expect the Fed will be monitoring inflation on a rolling three- and four-months basis to evaluate the impact of monetary policy on prices. Should we see a stickier trend with inflation levels, one or two additional hikes by the end of this year may be warranted.

2. What is NEPC's outlook on the likelihood of a recession?

We didn't foresee a recession in 2023 and the market is coming around to our view. Our base case scenario is a soft landing engineered by the Federal Reserve. This soft landing is characterized by the Fed maintaining a restrictive monetary policy, but with the economy growing at a gradual pace.

For 2024, there's more uncertainty around the likelihood of a recession. The possibility of one will be tied to the pace of Fed rate hikes, path of inflation, and the extent of the flow of the lag effect of monetary policy into economic activity. That said, consumer spending appears resilient, and we are seeing some improvements in other parts of the economy such as housing. Such a scenario implies an elevated Fed Funds rate of above 5% through 2024.

3. What insights can we glean from the current earnings season?

We are full swing into the earnings season and the results from the banking sector make for an interesting data point. The collapse of Silicon Valley Bank had heightened concerns around the wellbeing of financial institutions. Now, the healthy results and guidance from the sector have led to these concerns dissipating.

As we had predicted, it appears the market has largely moved on. We continue to believe the banking system remains well capitalized.

4. Keeping in mind the current environment, what are NEPC's investment recommendations?

Against this market backdrop, we recommend investors reduce overweight exposures to the S&P 500, while maintaining positions in U.S. large-cap value. We also suggest investors increase exposure to U.S. high-yield bonds and broadly evaluate the risk-return benefit of fixed income. Lastly, we suggest holding greater levels of cash within safe-haven fixed-income exposures and urge investors to maintain higher levels of portfolio liquidity.

IMPORTANT DISCLOSURES

Past performance is no guarantee of future results.

All investments carry some level of risk. Diversification and other asset allocation techniques are not guaranteed to ensure profit or protect against losses.

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