1919 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

December 19, 2022

The Fed Speaks, the Market Falls

Financial Markets

U.S. financial markets fell for the second consecutive week. The Dow declined by 1.66%, the S&P 500 by 2.08%, and the NASDAQ by 2.72%. Investors can point to many reasons for the selloff. One is that the market was just taking a break from the 14.1% gain the S&P 500 had since October 12th. We doubt this was the main reason. The most likely explanation is the Fed's interest rate projections and hawkish comments following the conclusion of the Open Market Committee meeting last week. On Tuesday, investors were encouraged by the CPI report showing signs that inflation was falling. Markets started on a powerful rally early in the day, but fell to a moderate gain by the end of trading. Later in the week, the Federal Reserve proved that central banks still rule the waves. They raised interest rates by 50 basis points which was exactly what the market expected. So, why the dramatic fall? Blame it on the Dot Plot.[1] The plot showed that some felt inflation would persist at a higher level and for a longer duration than the market expected. Former Fed Chairman Ben Bernanke explains in his recent book, *21st Century Monetary Policy: The Federal Reserve from the Great Inflation to COVID-19*, how there are two kinds of forward guidance, cleverly named Delphic and Odyssean. It will not surprise readers that Delphic is changeable, while Odyssean is not. He points out that Delphic is quite changeable, even at short notice. It appears as if investors chose to believe the opposite.

Investors are clearly moving towards the recession camp.

Economics

The economy is slowing, and this is what most investors wanted—until it happened. The U.S. and global economies are showing some signs of weakening, and may be a post-pandemic labor rebalancing. Investors are concerned about rising layoffs. That is a red flag in normal times, but it comes after a rapid hiring spree, particularly in technology. Supply chains are normalizing after a prolonged period of disruptions. That may help the economy grow in a non-inflationary way, because efficient supply lines help to hold down prices. It is our opinion that if the Federal Reserve continues to hike the policy rate to bring down inflation, a recession in 2023 becomes likely.

Conclusion

The U.S. economy is showing signs of weakening. Employment is slowing, an earnings slowdown appears imminent, and, perhaps, we will be faced with higher rates for longer. But the economic environment can change rapidly, and monetary policy can adjust. It takes a while for monetary policy to work, but, just like forward guidance, it can have a large psychological impact on both investors and business leaders.

Next week we will not publish, but we wish all of our readers a very happy and safe holiday season.

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[1]The dot plot **shows the estimates by the Fed's 19 policymakers for interest rates at the end of 2022, along with the next several years and over the longer run**. The forecasts are represented by dots arranged along a vertical scale.

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