CETERA® INVESTMENT MANAGEMENT

COMMENTARY

December 6, 2022

Strong Economic Data Creates Fed Uncertainty

- With Fed officials in a blackout period, investors have switched their focus.
- A strong payroll and service sector report may cause a more aggressive Fed.
- Volatility will remain through this Fed rate hike cycle.

After declining 1.79% on Monday, the S&P 500 fell another 1.44% on Tuesday. Prior to this week, investors had been focused on what Fed officials had been saying. Officials had given investors optimism that Fed Fund rate hikes would slow from the current 0.75% meeting pace and eventually stop around a level close to 5% sometime next year. However, with the Federal Open Market Committee (FOMC) meeting next week, Fed officials entered a blackout period this past weekend, leaving investors to find something else to focus on.

On Monday, investors were given some good economic data when the Institute for Supply Management's Purchasing Manufacturers Index (PMI) Services was released. We like this index because it is forward-looking and one of the first economic indicators released during the month. This index is based on data compiled from purchasing and supply executives nationwide and gives us an early indication of what business leaders are thinking in the services industry. The November reading surpassed expectations and, instead of falling closer to contraction, it rose more into expansion. While good news for the economy, it doesn't fit with the Fed's objectives of slowing inflation.

Adding to investors angst, investors had brushed off a strong payroll report on Friday. Nonfarm payrolls grew by over 263,000, when many had expected the number to drop to around 200,000. So, while the manufacturing PMI has finally entered contraction, the service sector is doing well, and the labor market remains strong. This gives the Fed more room to raise rates, which thus increases the chance of recession and ultimately lower corporate earnings.

We expect more volatility leading up to next week. Next Tuesday we get more inflation data in the Consumer Price Index and the FOMC meeting concludes next Wednesday when they release a statement and Fed Chair Powell gives his press conference. We will also get the long-awaited Fed Dot Plot update which will show us where FOMC members see the Fed Funds Rate peaking.

Another tailwind perhaps is related to market technicals. The S&P 500's big decline on Monday pushed the index below its 200-day moving average, after it had closed above this level for three straight days. Prior to last week, the S&P 500 traded below its 200-day moving average since April. While there is concern that the Fed's aggressive polices have not made their mark on the economy quite yet, some investors may be simply profit taking after the markets sharp rebound recently.

As we continue through this Fed rate hike cycle, we expect volatility to remain. The Fed will not make policy decisions on a single data point, but investors will continue to price assets accordingly as data is released. Ultimately, the Fed needs confidence that inflation is under control. Stronger economic data could mean a more aggressive Fed, which increases the risk of a recession and lowers corporate earnings. The good news is that markets are forward looking and will eventually start to price in economic recovery, though timing is the big question.

While the employment and ISM services reports make the Fed's job more difficult, this doesn't change our thesis. If we have a recession, it may be a mild one due to labor strength and a resilient service sector. As is the case now, not all parts of the economy will have a recession at the same time – manufacturing and housing are weak and the service economy is still expanding.

As we go through this rate hike cycle, please continue to work with your financial professional to make sure you are properly diversified to help mitigate market volatility and your portfolio is aligned with your long-term investment objectives.

This report is created by Cetera Investment Management LLC. For more insights and information from the team, follow @CeteraIM on Twitter.

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