

Will Higher Rates End The Rally?

Economic Perspective

Well, the Fed finally hiked interest rates! After three years of frustration waiting for stubborn inflation to come down, new Fed Chair Kevin Warsh raised interest rates by a quarter-point at the September FOMC meeting. The inflation hawks cheered while the economic bears jeered the move. Will inflation finally come down, or will the high rates bring the economy down? The impact of the hike remains uncertain over the short-term, but we believe flashes a warning signal to both the stock market and economy over the intermediate to long-term. Core inflation remains well above the Federal Reserve's stated 2% goal, with August CPI up 3.4% from a year earlier. Energy prices have added another layer of uncertainty - keeping headline inflation high and volatile. The Fed is trying to 'thread the needle' by raising rates to moderate inflation without causing a recession. This underscores the difficult balance of its dual mandate to support economic growth without persistent inflation. With interest rate levels across much of the yield curve up about 100 basis points (1%) from one year ago, we ask: has the bond market already done the Fed's job for them? Isn't hiking rates duplicative? Our investment team understands what the Fed is trying to accomplish but warns it needs to be careful. Thankfully, the U.S. economy entered the third quarter with decent momentum. Second quarter GDP numbers were upwardly revised and grew at a 2.2% annual rate, following 2.5% growth in the first quarter. Beneath the surface, the GDP data was even more impressive after factoring in a 1.1% headwind from trade (which would have resulted in 3.3% growth!). Business investment, particularly in technology and artificial intelligence (AI) infrastructure, remained an important engine of economic activity and growth during the quarter, but also worrisome should that concentrated cap ex spending slow down. Sustained growth also becomes less clear when analyzing the state of the consumer. Personal consumption recently expanded at its fastest pace in six quarters. However, consumer credit (debt) leapt and has continued its ascent for almost two years now. I think we all know how consumer discretionary income will be impacted if rates stay at higher levels. At the same time, the labor market has clearly cooled. September payrolls increased by only 29,000 and the unemployment rate edged up to 4.2%. Importantly, July and August employment numbers were also revised lower. We believe that uncertainty in the labor market could result in a Fed wait-and-see approach for upcoming meeting(s) as they await confirmation of a slowdown.

Market Perspective

The third quarter produced a meaningful divergence beneath the headline market results. The S&P 500 gained 2.3%, while the Nasdaq Composite advanced 2.6%. In contrast, the Dow Jones Industrial Average declined 2.3%, and the S&P 500 Equal Weight Index fell 1.9%. The significant gap between the cap-weighted S&P 500 and its equal-weighted counterpart highlights how concentrated the market's gains have become, with a relatively small group of large technology companies accounting for a disproportionate share of the market's performance. In addition, sector performance reflected a significant rotation during the quarter. Energy, Information Technology and Health Care were the three best-performing sectors, gaining approximately 17%, 7% and 6%, respectively. On the other end of the spectrum, Utilities, Industrials, Real Estate and Consumer Discretionary were among the weakest-performing sectors. Utilities declined approximately 12%, Industrials fell 10%, Real Estate declined 6% and Consumer Discretionary dropped 5%. Finally, we experienced a notable development in performance dispersion between large and small companies. During the quarter, the Russell 1000 was favored over the Russell 2000, as large cap stocks continued to outperform their small and mid-cap counterparts. We view this as typical market behavior given the uncertainty.

Looking Ahead

While the overall market continues to benefit from strong corporate earnings and profit margins, a resilient consumer and substantial business investment, the divergence beneath the surface is worth watching. Our investment team believes the combination of elevated valuations (a 21% premium to historical price to forward earnings), market concentration and shifting sector, size and style leadership reinforces the importance of stock selection rather than simply relying on broad market exposure. Our outlook remains constructive, but disciplined. Strong market fundamentals should provide a solid foundation for the market going into midterm elections. However, the wild card remains the future trend in interest rates and its potential impact on the economy. Our experience suggests we may be near the peak of higher interest rates and that they may be range bound going forward. If true, and rates begin to decline in the coming months, this could set the stock market up well for 2027 as we transition from an earnings-driven stock market to a valuation multiple (price-to-earnings) expansion-led one. Time will tell but, in the meantime, we will maintain our disciplined approach.