Truist Advisory Services, Inc.

Market Perspective from the Investment Advisory Group

Fed conundrum and financial stress support continued defensive tactical posture

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What happened

Markets have been under pressure on the combination of the Federal Reserve (Fed) raising rates and renewed stress in the financial sector. PacWest fell more than 40% as it considers a possible sale, and First Horizon's stock also declined sharply after a merger deal with TD Bank was mutually terminated.

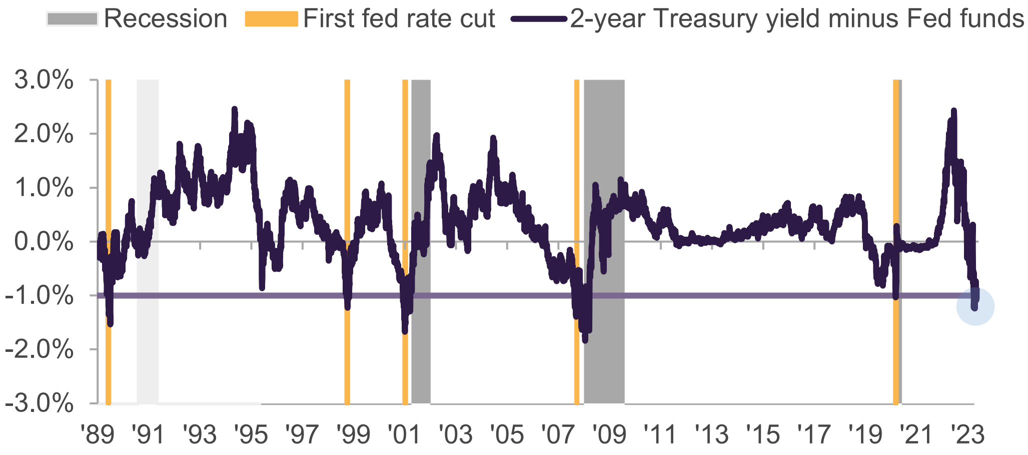
Our take

It is unusual to see the Fed raise rates during a period of stress in the banking system. But the scar tissue left behind by the elevated inflation of the past few years has created a conundrum for the Fed. That is, with inflation well above target levels, the Fed is hesitant to cut rates and risk that inflation does not come down towards its 2% goal. The tradeoff is a degree of short-term economic pain.

What's also unusual is the 2-year U.S. Treasury yield, a proxy for where the market believes short-term rates will be in the future, is more than 1% below the Fed funds rate. This is the market saying it ultimately believes the Fed will be pressured to cut rates.

This 1% threshold was first breached in March for only the sixth time since 1989. In all prior cases, the Fed cut rates during that same month or the next. Instead, this time, the Fed raised rates in part due to core inflation that is still running above 5% versus an average of 2.8% during the five prior periods. This point illustrates the Fed's conundrum.

2-year U.S. Treasury rate goes 1% below Fed funds



Data source: Truist IAG, FactSet, Haver. Past performance does not guarantee future results.

Past performance does not guarantee future results
Investment and insurance products:
- Are not FDIC or any other government agency insured
- Are not bank guaranteed
- May lose value

TRUIST Wealth

Notably, recessions occurred sometime over the next year following all other times the 1% threshold was breached except 1998. This is consistent with our *House View* of elevated recession risks later this year as the lagged impact of rates filter into the economy. Moreover, lending and credit conditions, the lifeblood of the economy, are only expected to become tighter, especially given recent bank pressures.

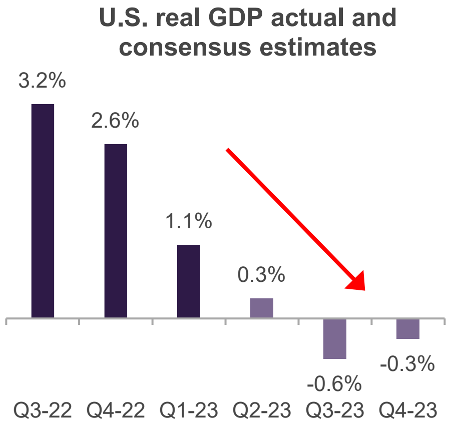
Market reaction

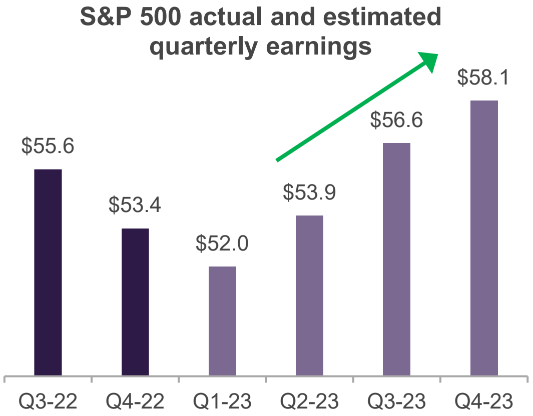
Prior to the setback, the market was trading at elevated levels and vulnerable to bad news.

- The S&P 500 traded up to 4186 on May 1, near the very top end of its recent multi-month trading range of roughly 3800 – 4200.
- The volatility index, a gauge of fear in the market, reached 15.5, the lowest since November 2021, suggesting a degree of investor complacency.
- And at an 18.2x forward P/E, the S&P 500's valuation reached near the top end of its range of the past 25 years, outside of the pandemic and technology overshoot.

While the S&P 500 has pulled back about 3%, and other segments, such as small caps and financials, are down much more, we still view the near-term risk/reward as less attractive for risk assets. If anything, recent events in the banking sector will further weigh on economic growth, market valuations remain elevated, and earnings remain at risk.

Indeed, despite the anticipation of an economic slowdown, the consensus expects S&P 500 earnings to rebound to a record high in the second half of the year. We see a disconnect and view it as likely that earnings projections will eventually need to be revised lower.


U.S. real GDP actual and consensus estimates


S&P 500 actual and estimated quarterly earnings

Data source: Truist IAG, FactSet. Bloomberg consensus GDP estimates quarter-over-quarter SAAR

Bottom line

The additional rate hike by the Fed, at a time when economic growth is already set to slow and banking concerns linger, makes for a challenging backdrop for risk assets. Therefore, there is no change to our strategy. Within the context of a longer-term asset allocation plan, we still advise taking less risk relative to targets.

We are underweight equities alongside an overweight to fixed income and cash. We continue to advise an up-in-quality portfolio bias, with an emphasis on U.S. large caps within equities and minimizing credit risk within fixed income. We also remain underweight financials as we expect the sector to be challenged as the economy weakens.

Disclosures

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S&P 500 Index is comprised of 500 widely held securities considered to be representative of the stock market in general.

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