

FCM Weekly Market Notes

The Fed Buys Bonds Some Time

The Fed did what was necessary given market pricing before this week's meeting. That stopped a lot of the bleeding in the bond market, but investors shouldn't expect much, if any, of a price rally from here.

The market reaction was more sigh of relief than price rally. The chart below is the week's prices for the ETF that tracks long bonds, illustrating that conclusion.

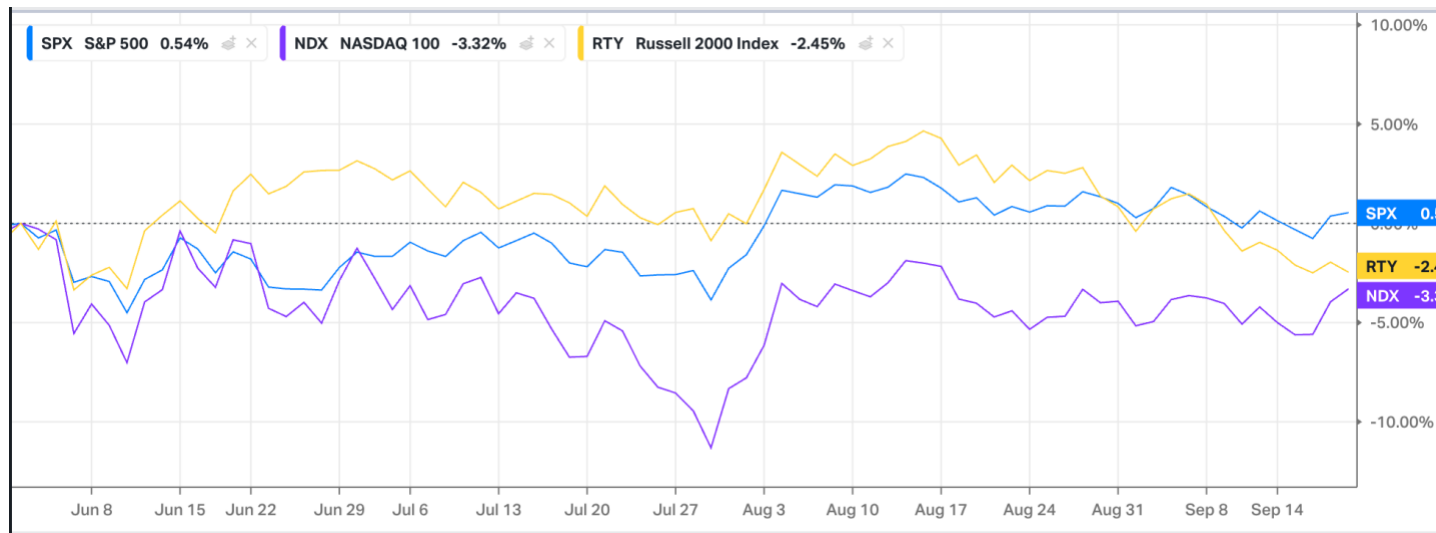


With the yield of the long bond now just a touch over 5.3%, some long end stability is a necessary precursor to calm in risk assets as well. And, in the same timeframe as above, stocks generally took the hike well after an immediate sell-off., closing at their highs for the week.



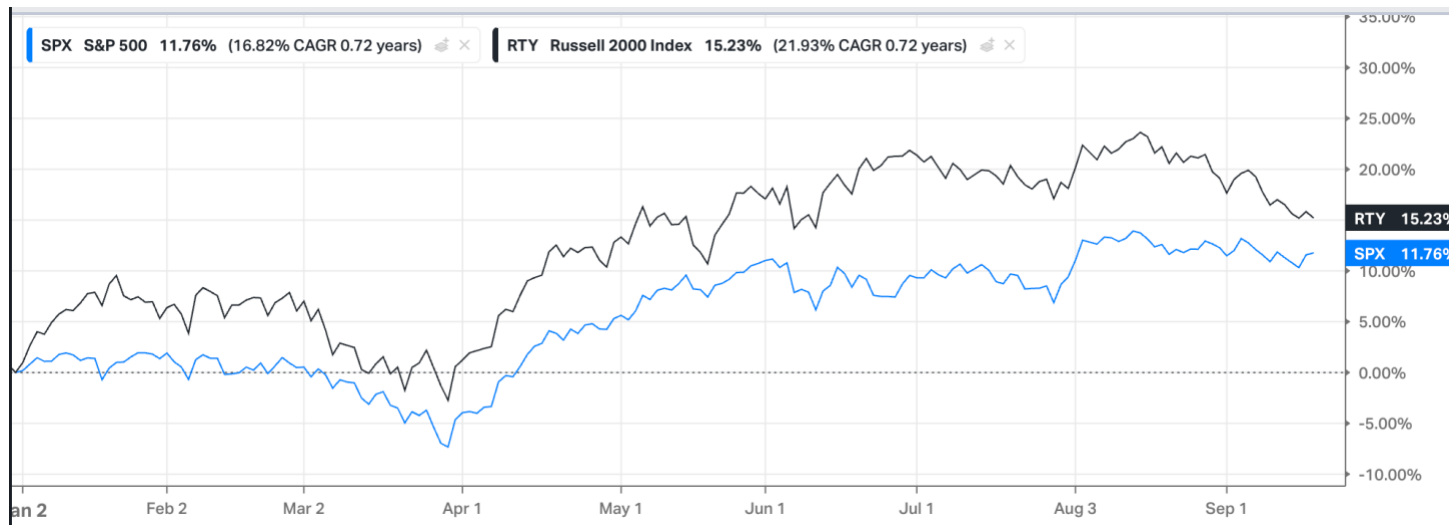
So will stocks to push forward with the Fed apparently on the inflation case? We think the odds are small, at least perhaps till the positive year-end seasonality (hopefully) kicks in. There are two reasons for that.

First, while most commentary myopically focuses on what has just happened and extrapolates from there, a bigger picture suggests there should be some tempered enthusiasm going forward. Over the past three years, the Nasdaq has nearly doubled while the S&P is up over 74%. But since June, most stocks have gone nowhere.

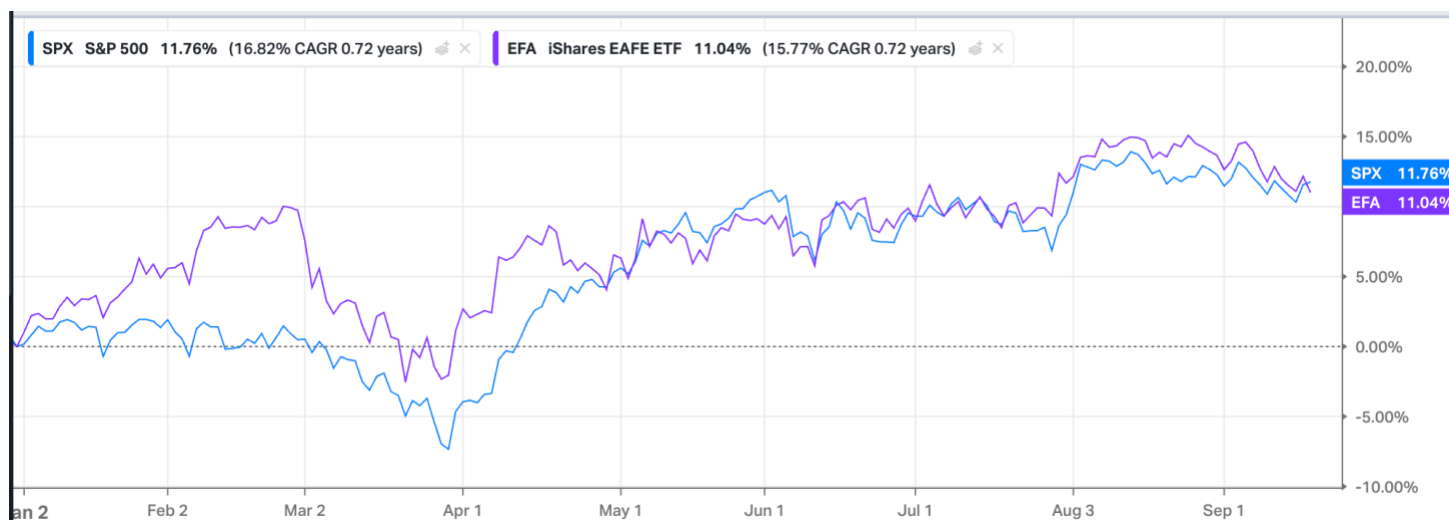


Second, any argument for strong performance from here has to consider the fact that the liquidity environment will almost certainly be less supportive, as we pointed out [here](#). The market is now pricing in almost even odds that we will end the year with an additional 50 basis points of hikes.

And asset prices have reacted rationally to the prospect for higher rates. Small cap stocks, highly sensitive to interest rates, are rapidly shedding the out-performance that they put in most of this year.



Similarly, international stocks are now under-performing the S&P after a very strong start to the year as the dollar has strengthened in anticipation of a hiking cycle. We would lighten up or avoid exposure in both market segments.



All of this argues that we are into, or entering, a market regime where capital appreciation is less likely. We like to think of the market as providing “available alpha”. Coming out of the rate hiking cycle of 2022, liquidity conditions eased



rapidly and investors were treated to a target-rich environment where alpha and high returns were highly available.

If that era is over, squeezing out positive gains is a better framework than hoping that some driver of strong gains will emerge even as conditions tighten. Choices like covered call strategies as opposed to outright ownership of underlying indices are likely to out-perform even in a market that can eke out some positive performance if not just tread water.

Lastly, we have seen a lot of market pundits praise Warsh, label him a “hawk” and conclude that his promise to return to the 2% inflation target might just be credible. We continue to be doubtful. First, pipeline inflation pressures with diesel prices at an all-time high, won’t abate soon. Second, a true effort to return to 2% inflation will of necessity involve a slower growth trade-off and damage to risk asset prices. The willingness of the Fed and markets to absorb that in the current political era should be suspect.

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