# How far will the Fed go to bring inflation down to 2%?

Q3 Market Commentary

**Hezel Gadzikwa**
Senior Associate
hgadzikwa@syntaxdata.com
October 2023

Syntax

# How far will the Fed go to bring inflation down to 2%?

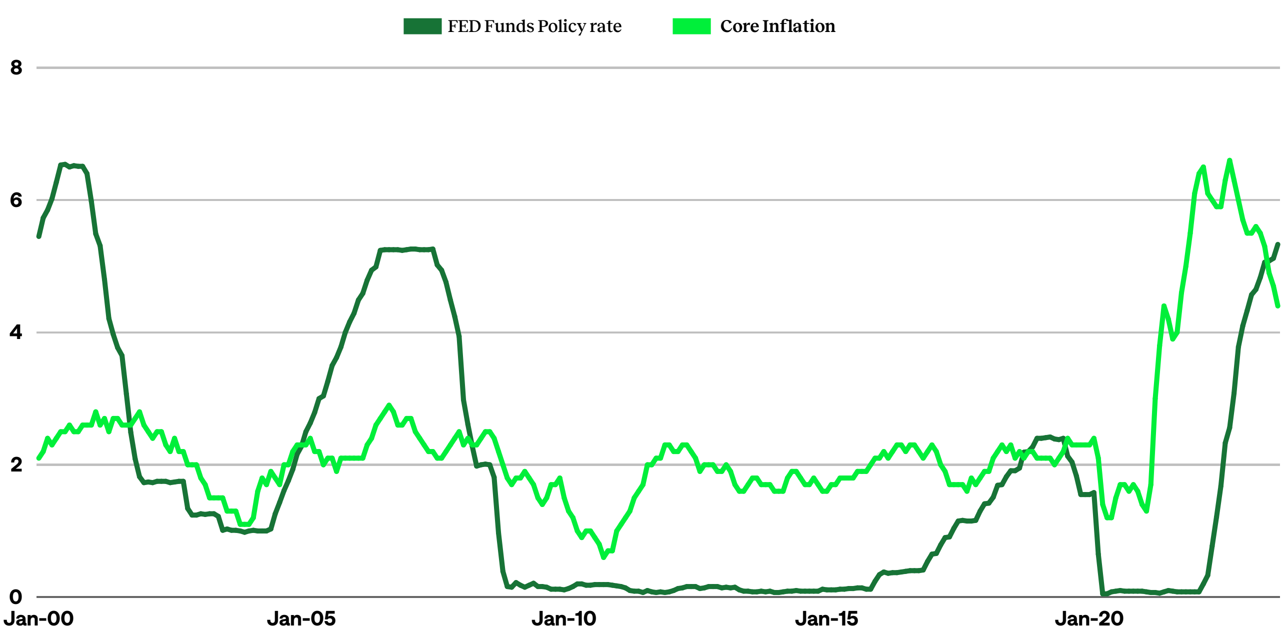
## Q3 Market Commentary

**Hezel Gadzikwa**
Senior Associate
hgadzikwa@syntaxdata.com
October 2023

- The Fed confirms that "the Committee is firmly committed to returning inflation to its 2% objective."
- A "soft landing" may be possible, but the economy faces headwinds from rising energy prices, returning student loan payments, and auto strikes.
- Energy stocks, up 4.0% in Q3, provided some much-needed fuel to the S&P 500, helping offset losses in other sectors for an overall return of -3.3%.

During its recent meetings, the Federal Open Market Committee (FOMC) repeatedly stated its commitment to achieving its 2% inflation target. The question remains: how far is the Fed willing to go to fulfill its mandate? The Fed has demonstrated a willingness to take uncomfortable measures to maintain price stability, raising interest rates from 0.25% - 0.50 % in March 2022 to 5.25% - 5.50% in September 2023. Correspondingly, overall inflation has dropped from 9.1% in June 2022 to a month-over-month rate of 3.7% in August 2023, while core inflation fell from 5.9% in June 2022 to 4.3% in August 2023.

### Exhibit 1: Fed Funds Rate and Core Inflation (FRED) (%)




Source: Federal Reserve Economic Database | St. Louis Fed.

However, the Fed has a challenging task ahead as they continue to address inflation. Despite the addition of 187,000 jobs in August, increased labor participation led the unemployment rate to rise by 0.3%, bringing it to 3.8%. The healthy job market, which was starting to soften, added 338,000 jobs in September - a sign that the economy may be more robust than expected, and that inflation concerns may therefore persist despite high rates. This concern appears to be reflected in the bond market as yields continued to rise during the quarter as the Bloomberg US Aggregate index, a measure of the broad US fixed income market, lost 3.2% for the quarter.

All of this may come as unwelcome news to investors, as the Fed could hike rates further. In the September FOMC meeting, the Fed left policy rates unchanged but hinted that additional rate hikes could be on the horizon. However, the Fed must balance this against three sources of economic headwinds: surging oil prices, the return of student loan payments, and the United Auto Workers strike.

Crude oil, priced at $76.87 per barrel at the beginning of the year, has been increasing, and central bankers are now predicting that the current price could rise beyond $100 per barrel as supply has decreased and geopolitical tensions flare. This will put additional pressure on consumers' discretionary income: although energy is not a part of the core CPI that the Fed uses to make policy decisions, it remains a significant component of household expenses, influencing how much consumers are willing to spend in other areas.

Meanwhile, starting on October 1st, 27 million student loan borrowers will be affected by the resumption of loan payments.[1] On average, they will have to make an additional monthly payment of $200-$300. These payments add to an already precarious household balance sheet scenario: the Q2 2023 report on Household Debt and Credit revealed that credit card balances increased by $45 billion.[2] Additionally, the Conference Board Consumer Confidence Index has declined for two consecutive months as consumers continue to navigate the ever-changing financial landscape.

While the supply chain issues driving inflated car prices for the past few years are largely in the rearview mirror, extended strikes by the United Auto Workers Union against GM, Ford, and Stellantis, three of the biggest car manufacturers in America, place additional pressure on the auto industry, its large network of suppliers on household budgets. A reduction in supply could raise the prices of used vehicles, putting more pressure on inflation and leading the Fed to overtighten monetary policy if inflation remains stubborn.

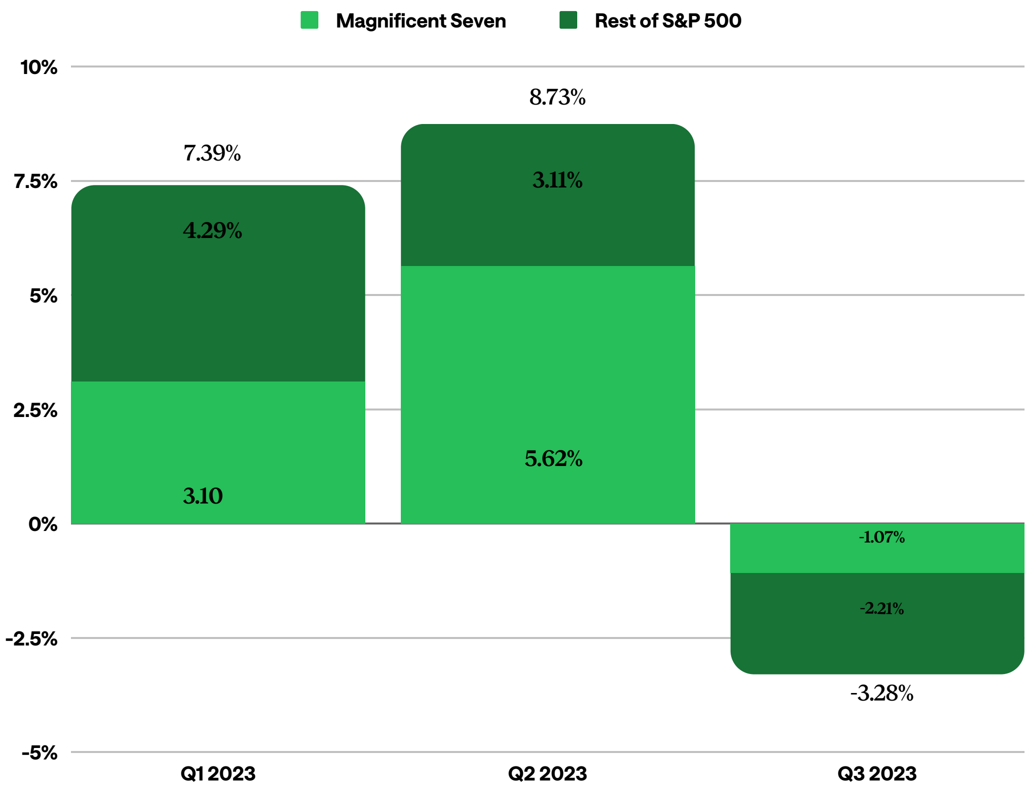
While there is a broad consensus within the markets that a soft landing, which has been rare historically, is within reach, these factors could steer the Fed off its course. The consensus remains that we might experience extended periods of higher rates and that the highly anticipated rate cuts may be delayed into the second half of 2024.

1 https://www.nytimes.com/2023/09/15/business/economy/restart-student-loan-payments.html
2 https://www.newyorkfed.org/microeconomics/hhdc

## The Market Reacts

Excitement over the perceived benefits of AI has propelled the growth of Big Tech companies and led to market growth. In our Q2 Commentary, we covered how the "Magnificent Seven" of Apple, Alphabet, Amazon, Microsoft, NVIDIA, Meta, and Tesla accounted for over a third of the S&P 500's 7.4% return in Q1 and almost two thirds of its 8.7% return in Q2. In Q3, however, the story began to shift as market breadth expanded; these seven stocks collectively returned -1.1%, while the whole S&P 500 declined 3.3% (Exhibit 2).

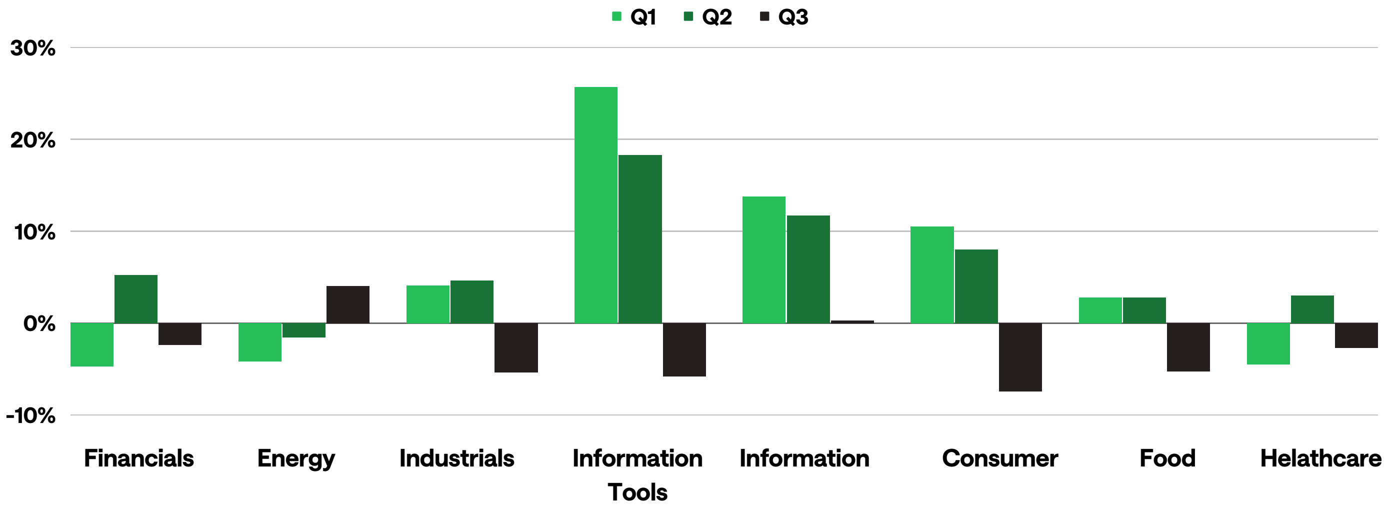
### Exhibit 2: "Magnificent Seven" Contribution vs. Rest of S&P 500




Total Return of the "Magnificent Seven" (Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla) and rest of S&P 500 in Q1, Q2, and Q3 2023. Performance does not reflect fees or implementation costs as an investor cannot directly invest in an index. Source: Bloomberg, Syntax

The market as a whole fell 3.3% in Q3, in large part due to a falloff in Information Tools and Information stocks, which carried the market in the first half of the year. Despite negative topline returns, breadth expanded slightly in Q3: while 35% of stocks outperformed the market as a whole in Q1, falling to 32% in Q2, this number has risen to almost 42% in Q3.

## Exhibit 3 - Sector Perfomance Tables Q3




Total Return, Q1, Q2, and Q3 2023. Performance does not reflect fees or implementation costs as an investor cannot directly invest in an index.
Source: Syntax

Consumer Products and Services, which outperformed for the year's first half, significantly lagged in Q3. Financials, which had recovered in Q2 after a stumble driven by Q1's regional banking issues, also lagged in Q3. Both sectors continue to adjust to the possibility of prolonged periods of strict monetary policy.

Meanwhile, surging oil prices led energy stocks, which had a lackluster start to the year, to a comeback in Q3. With more supply issues on the horizon, oil prices will likely keep rising, which might lead the energy sector to outperform in Q4. Strong performance from companies like Chevron Corp (+8.2% in Q3), Exxon Mobil (+10.6%) and ConocoPhillips (+16.7%) helped mitigate losses from other sectors.

Looking more broadly at Syntax's suite of benchmark indices (Exhibit 4), Q3 performance was unusually consistent across size segments, though small cap continued to underperform large cap and mid cap, as we noted in previous quarters. The Stratified Weight approach, designed to diversify exposure to business risks, underperformed its cap-weighted analogs by less than in previous quarters as markets broadened.

**The Magnificent Seven?**

| | Q3 Return |
|---|---|
| Alphabet | +9.2% |
| Meta | +4.6% |
| NVIDIA | +2.8% |
| Amazon | -2.5% |
| Tesla | -4.4% |
| Microsoft | -7.1% |
| Apple | -11.6% |

Total Return, 6.30.2023 - 9.30.2023.
Source: Bloomberg

**Exhibit 4: Index Performance**

| Index Name | Ticker | Q3 2023 | Q2 2023 | Last 12 Months |
|---|---|---|---|---|
| **Syntax US LargeCap 500 Index** | **SY500** | **-4.52%** | **8.86%** | **19.69%** |
| Syntax US 1000 Index | SY1000 | -3.18% | 8.62% | 21.03% |
| Syntax US SmallCap 2000 Index | SY2000 | -5.89% | 4.68% | 8.45% |
| Syntax US 3000 Index | SY3000 | -3.16% | 8.43% | 20.46% |
| Syntax US MegaCap 200 Index | SY200 | -4.11% | 9.94% | 22.01% |
| Syntax US MidCap 400 Index | SY400 | -4.29% | 6.11% | 15.82% |
| Syntax Stratified LargeCap Index | SYLC | -3.95% | 3.86% | 15.37% |
| Syntax Stratified MidCap Index | SYMID | -4.86% | 4.98% | 18.27% |
| Syntax Stratified SmallCap Index | SYSC | -7.20% | 2.71% | 8.50% |

Total Return, 9.30.2022 - 9.30.2023, Q2 2023, and Q3 2023. Performance does not reflect fees or implementation costs as an investor cannot directly invest in an index. Source: Syntax

### Conclusion

Persistently low unemployment highlights that the US economy continues to be resilient in the face of sharp interest rate measures from the Fed. The Fed has been effective in its approach as strict monetary policy continues to impact the spending habits of consumers, which has helped bring inflation closer to the longer-term target of 2%. However, challenges still remain as the economy faces headwinds tied to the impacts of higher energy costs exacerbated by the geopolitical turmoil in the Middle East, the scheduled restart of student loan payments, and the ongoing automotive strike. These inflationary pressures, along with the new reality that interest and mortgage rates may remain elevated for a prolonged period of time, raises questions on whether the Fed can avoid a recession or engineer a soft landing as it tries to achieve its dual mandate of price stability and low unemployment.

## Important Disclaimers