WEEK IN PERSPECTIVE

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Reflation Narrative Repriced as Fed Strikes Less Dovish Tone

The S&P 500 (-1.9%) and Nasdaq Composite (-0.3%) started the week at record highs, but the benchmark index ended the week down 2% as value/cyclical stocks sold off after the Fed's policy meeting.

The Dow Jones Industrial Average (-3.5%) and Russell 2000 (-4.2%) succumbed to heavy losses of 3.5% and 4%, respectively.

From a sector perspective, the financials (-6.2%), materials (-6.3%), energy (-5.2%), and industrials (-3.8%) sectors dropped between 3-6%, while the information technology sector (+0.1%) managed to eke out a positive finish.

The FOMC made no changes to the fed funds rate or the pace of asset purchases, as expected, but the median forecast for the path of interest rates signaled two rate hikes by the end of 2023 -- the prior indication was leaving rates unchanged through 2023. Seven members expected a rate hike in 2022.

What's more, the Fed increased the interest on excess reserves to 0.15% from 0.10%, and the reverse repurchase rate was increased by five basis points to 0.05%.

Fed Chair Powell struck an accommodative tone following the FOMC policy statement, but St. Louis Fed President Bullard (FOMC voter in 2022), who was often seen as one of the more dovish Fed members, sounded more hawkish in a CNBC interview. Mr. Bullard said he was one of those seven officials who forecast a rate hike next year and said the Fed shouldn't be involved in mortgage-backed securities.

To be clear, the central bank acknowledged the rising inflation pressures in the economy, most evident this week in the hotter-than-expected Producer Price Index for May, but it remained assured that inflation will moderate and reach the Fed's longer-term goals.

In theory, raising rates modestly would help dampen inflation pressures without being overly restrictive for economic growth. The Fed also said it will provide advanced notice before announcing any decision to make changes to asset purchases.

The downside, though, was that the messaging from the Fed supported the burgeoning view that inflation rates, and growth rates, are peaking as the immediate effects from reopening the economy wear off.

The 10-yr yield decreased one basis point to 1.45%, respecting the Fed's view on transitory inflation factors, while the fed-funds-sensitive 2-yr yield jumped 11 basis points to 1.27%. The U.S. Dollar Index rose 2.0% to 92.32.

The unwind of the reflation narrative was further pressured by a series of other developments: commodities, ex oil, continued to pull back (copper futures dropped 9%); retail sales for May were weaker than expected; weekly initial claims unexpectedly increased; and JPMorgan Chase (JPM) and Citigroup (C) warned of lower trading revenue for the second quarter.

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