

## [Featured Insights]

### **Labor Data and Fed Policies Shape Market Trajectory Amid Inflation Risks**

The most favorable scenario for the stock market in the short term was viewed as the possibility of the Federal Reserve cutting interest rates by 50 basis points without igniting concerns over economic growth. This outcome was successfully managed by Fed Chair Powell, and the equity markets responded positively.

In the months ahead, labor market data is expected to play a crucial role in determining the direction of equity markets, especially over the next three to six months.

The forthcoming data, expected by the end of the upcoming week, will be critical in sustaining current stock valuations. For market conditions to hold, the unemployment rate needs to decrease, and job creation must remain above 140,000, with no adverse revisions to previous reports.

In addition to labor data, several other factors are being closely monitored to gauge growth trends. Earnings revision breadth, often used as a key measure of corporate outlook, has remained flat for the S&P 500 and shows negative trends for the Russell 2000 small-cap index. Seasonal influences are likely to put further pressure on this metric in the near term. Furthermore, the ISM Purchasing Managers Index has not shown a significant rebound after nearly two years of sluggish activity. Additionally, indicators like the Conference Board Leading Economic Index and Employment Trends have continued on a downward trajectory, which aligns with typical patterns observed late in the economic cycle.

The larger-than-anticipated interest rate reduction by the Federal Reserve has provided extra time for higher-quality stocks to remain costly and offered some support to lower-quality cyclical stocks. However, to maintain these market conditions through the year's end, labor market data and other economic indicators must improve.

It's also important to highlight that the budget deficit in August exceeded projections by nearly \$90 billion, bringing the total year-to-date deficit beyond \$1.8 trillion. While this fiscal policy has been supportive of economic growth, it has led to increased competition for resources in the private sector and financial markets. The Federal Reserve's decision to implement a 50 basis point cut, rather than the 25 basis points expected, is likely linked to its responsibility in assisting the Treasury with financing the government. Contrary to common belief, both the Federal Reserve and the Treasury benefit from allowing inflation to run at higher levels, as deflation poses a greater threat to those with large debts.

This also illustrates why a recession, despite being seen by some as a potential remedy for high inflation or elevated prices affecting 80-90% of Americans, is considered the worst possible outcome. A recession would likely trigger concerns about debt deflation, which, once initiated, becomes difficult to reverse. The Federal Reserve is fully aware of this risk, as was emphasized in Ben Bernanke's well-known 2002 speech titled "Deflation: Making Sure It Doesn't Happen Here." In this speech, Bernanke outlined a range of monetary and fiscal tools the Fed could deploy to prevent deflation.

There has been long-standing coordination between these policies. For example, gold has consistently outperformed most other assets, including the high-quality S&P 500. Since Bernanke's speech in 2002, when gold was priced around \$300, it has risen to approximately \$2,600 today. In an environment where government intervention supports the economy through high fiscal spending, low interest rates, and unconventional financial measures, the purchasing power of the U.S. dollar has decreased significantly more than traditional inflation indicators would suggest.

In response, inflation hedges such as gold, premium real estate, and certain stocks have thrived. Cryptocurrencies, a more recent hedge against fiat currency devaluation, have shown remarkable growth over the past decade. Meanwhile, lower-quality cyclical assets—such as commodities, small-cap stocks, and commercial real estate—have underperformed, both in absolute terms and when adjusted for declining purchasing power.

In the short term, these trends are likely to continue unless there is a change in investor sentiment regarding the sustainability of current fiscal and monetary policies. To see a reversal, either organic growth in the private sector must accelerate—leading to a shift back towards lower-quality cyclical assets—or a recession must occur, resetting asset prices to levels from which the market can expand more broadly.