Ropes Wealth Discusses Sticky Inflation, Slight Recessions, and Short Squeezes

"When the Fed taps on the brakes, somebody goes through the windshield."

In recent weeks, many noted economists and market strategists have resurrected this analogy to describe our current experience in an economy beaten up and out of balance from COVID, trying to drive forward, with a haphazard Fed at the wheel, seeing inflation in the road and using aggressive interest rate hikes to slam on the brakes. We the passengers are going through the windshield and onto the gravel of a recession. Or 'slight recession' as President Biden suggested would be the outcome this week.

While we all hoped for the best, the worst was revealed yesterday when the Consumer Price Index (CPI) once again surprised to the upside with a monthly increase of 0.4%, significantly more than the expected 0.2% rise. The annual pace of headline inflation did slow, barely, from 8.3% to 8.2%. This news came despite a meaningful decline in energy costs and other notable categories. Year-over-year, the core CPI rose from 6.3% to 6.6%, reaching a new cycle peak.

So, despite 300 basis points of tightening, price pressures – both on the consumer and producer side – remain elevated. As a result, it is hard to contemplate any course correction from the Fed who has committed time and again to use whatever tools necessary to cool inflation. For consumers and businesses, still elevated prices mean further pressure and pain to be felt in the marketplace. For the Fed, too-high inflation means there is significant work yet to be done. Therefore, Fed officials are no doubt poised for a fourth 75 basis point increase in the target rate come November, and likely an unprecedented fifth round 75 basis point increase in December. By then, the Fed funds target rate will be in a range of 4.50% to 4.75%, and mortgage rates could be close to 9%.

Against this backdrop of still too-high inflation, the latest FOMC meeting minutes show that while Fed officials remain committed to raising rates, they will continue to monitor financial market conditions for any outsized impact. Several Fed participants noted that, *"particularly in the current highly uncertain global economic and financial environment, it would be important to calibrate the pace of further policy tightening with the aim of mitigating the risk of significant adverse effects on the economic outlook."* In other words, the Fed recognizes they might need to deploy an air bag or two.

Stock markets were in a spiral all week, and then that inflation print came and markets plunged further in what would be a day of wild trading. Because as quickly as stocks fell by over 2%, they surged back and then some in the market's largest intraday point swing since the early days of COVID. Many speculated a short covering squeeze prompted the wild market action and point to the volatility as further evidence of the increasing short-termism of a vast amount of money in the market that moves around based on algorithms, quantitative strategies, and index rebalancing. Others warned not to be sucked into the calm before the coming earnings season storm, that the strong U.S. dollar has joined the pre-existing headwinds of logistical challenges and inflationary pressures in weighing on corporate profitability. Notably, JP Morgan's CEO Jamie Dimon continued to warn investors of an economic hurricane on the way, saying markets could be down 'another easy 20%' and cautioned the U.S. is likely to tip into recession in the next 6-9 months.

In a market that has become indiscriminate in its punishment, that is trading on how fast the Fed drives, we believe this earnings seasons will mark a pivotal moment for the outlook ahead. As CEOs make decisions about

the next 12-24 months, and update investors on the reality of the hardships they face today and their sense of how to manage those hardships for the future, we expect some more differentiation between and among the way individual companies are trading. We would welcome that development, as we have primed portfolios with quality investments and prioritized enduring business models, market leading brands and management teams who have been through challenging periods before.

Just like one of those CEOs, investors likewise face a pivotal moment as they make decisions about the next 12-24 months for their portfolios and consider whether to reinforce or alter their strategy. We are with you in that decision-making process and urge focus on your unique and individual goals and needs. What Jamie Dimon from JP Morgan or President Biden or the Fed or anyone else may predict is less important than what you know about your needs and comfort level for your strategy in the period to come. You are and always should be in the driver's seat.

Thank you for your interest in our investment commentary. If you would like to speak personally with a member of our team at any time, please click **here**.

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