Ropes Wealth Highlights What's Hot and What's Not

Like the record temps gripping the Northeast and Midwest, stocks have surged like our thermometers in recent days, buoyed by optimism that the more benign inflation data we received this week will spell an end to Fed interest rate hikes soon enough. It seems not to matter that the coming earnings season is likely to be ugly with deteriorating profits and weakening guidance. Airlines, hotels, and restaurants may be hit the hardest thanks to wage inflation, weaker consumer spending, and tough comparisons to last year when the pandemic reopening was in full swing. Tech is also sure to be in the crosshairs, which will test the year-to-date bounce back in the stock prices of bellwether companies like Apple and Microsoft. Then, of course, there are financial stocks, where the world will be watching the impact of the most recent banking crisis on balance sheets. Our view is that this earnings season may douse some cold water on the first quarter's market rebound so we urge you to brace for some of that volatility and keep a cool head, given that much of the bad news has been priced in after last year's market decline.

On the less hot side, we learned this week that the Consumer Price Index (CPI) posted its ninth straight decline, from 6% to 5%, driven mainly by a drop in energy related prices that are now compared with March 2022, when Russia invaded Ukraine and oil prices spiked above $120/barrel. However, with OPEC recently cutting oil production output, the comparisons may turn less favorable in the near term. Core inflation was less benign, increasing for the first time in six months thanks to higher prices for airline tickets and new cars. However, markets were optimistic as shelter costs, one of the largest contributors to core CPI, showed a loss in momentum with rents perhaps having peaked. Likewise, the Producer Price Index (PPI) also declined, with prices rising 2.7% versus the 3% expected, for the smallest gain since January 2021. The U.S. isn't alone in this progress on the inflation front as our European counterparts too have shown dramatic improvements this quarter.

Market players have been holding their breath waiting for this latest inflation data as an indication of whether or not the Fed can continue to raise rates in the wake of banking sector unease. To that point, the turmoil in the banking sector played a lead role in the minutes of the Fed's March meeting released this week. "*Recent developments*" in the banking sector were referenced at least 15 times while the likely effects on "*financial*" or "*credit*" conditions appeared nearly 20 times. The "*recent banking-sector developments*" led Fed staff to forecast "*a mild recession starting later this year, with a recovery over the subsequent two years.*" While the "*extent…was uncertain,*" Fed officials noted the developments "*were likely to result in tighter credit conditions…and to weigh on economic activity.*" The unanimous decision to hike 0.25% disguised more discrepant views. Several participants contemplated a pause because of the banking developments while some others tabled a preference for a 0.50% hike. While banking stress led many to lower peak rate estimates, the group still expected "*some additional policy firming may be appropriate*" because "*inflation remained much too high" and "the labor market remained tight." "In light of the highly uncertain economic outlook,*" the minutes noted, "*participants underscored the importance of closely monitoring information and assessing the implications for future monetary policy decisions.*"

To our mind, this progress in the March inflation data will reinforce the argument the Fed can take a pause, while the Committee assesses the full impact of earlier policy metrics on the broader economy and price pressures as well as recent banking woes. We are inclined to agree with Chicago Fed President Austan Goolsbee, who this week said "*prudence and patience*" is needed in assessing the economic impact of tighter credit conditions that are likely to stem from financial stress. However, given that the Fed was late to the inflation-taming party, holding onto "*transitory*" language for longer than was appropriate, we doubt a pause is coming. We suspect the Fed may err on the side of continuing to raise rates in May and beyond until the data clearly indicate a return of price stability is an

absolute, especially given the still solid nature of the economy and the consumer potentially offering a limited opportunity for further action. While that doesn't mean the Fed needs to see inflation reach 2% before backing off, it probably means the CPI needs to hit a number with a 3% handle before the Committee can hang the mission accomplished banner and move to the sidelines. Keeping in mind, though, that getting the last few percentage points of inflation out of the system typically induces the most pain for the economy.

If we are right, then unfortunately a recession is likely, albeit a short and shallow one. We may be starting to see the signs of that looming, as notably initial jobless claims reached a high this week at 239,000 reported. Although still at the early stages, the rising trend in jobless claims deserves close attention, since over the past 60 years every recession has been preceded by a steady increase in the number of initial jobless claims. Another warning sign is the malaise in small business sentiment which was reported near the lows for the post-pandemic expansion in March. The combination of high inflation, a labor shortage, a weaker sales outlook, and high interest rates has businesses skeptical about expanding their operations. The percentage of respondents saying now is a good time to expand fell to 2%, matching the lowest level since 1980. Similarly, the percentage of businesses saying they expect to increase employment or make capital investments over the next 3 to 6 months both fell to their lowest levels since 2020. Finally, this morning's retail sales report was grim, dropping -1% in March, as the consumer continues to tail off after an early January spending spree. There were declines in sales in most spending categories, especially gasoline, general merchandise, and electronics.

With stocks hot, but economic data not, there are reasons to be cautious in this period and take precautions for the future. Having some cash on hand in portfolios, invested in short-term Treasury bills or a government money market fund, makes some good sense. Likewise, it may be worthwhile to take required minimum distributions from retirement accounts at these now higher market levels. Diversification in global stocks is working well too this year, as global markets are getting a lift from a declining dollar and less aggressive central bank policy. Finally, embracing a portfolio balanced with high quality stocks and bonds, now paying some meaningful interest, is a way to be all-weather in these hot and cold times.

Thank you as always 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**.

The information set forth in this communication is presented by Ropes Wealth Advisors LLC ("Ropes Wealth") a wholly owned subsidiary of Ropes & Gray LLP. The contents are for informational and educational purposes only and are not intended as investment, legal or tax advice. Please consult with your investment, legal or tax advisor concerning any specific questions you may have. Ropes Wealth cautions the reader that past results are not indicative of future performance. The historical return of markets generally and of individual assets classes or individual securities may not be an accurate predictor of future returns of those makers, asset classes or individual securities. Ropes Wealth does not guarantee the accuracy and completeness of any sourced data in this communication.

Ropes Wealth Advisors LLC
800 Boylston Street Boston, MA 02199-3600