Ropes Wealth Contemplates the Good Amidst All the Ugly

The Federal Reserve raised interest rates by three-quarters of a percentage point (75 basis points) this week, the most at any meeting since 1994, and exactly the move Chairman Jerome Powell was dismissive about after the last meeting in early May. As a result, the target for the federal funds rate is now 1.50% – 1.75%, and it's headed considerably higher. At the post-meeting press conference, Powell made it clear that the Fed doesn't expect 75 bp rate hikes to become "common," but a rate hike in the 50 – 75 bp range should be expected at the next meeting in July. Notably, every single Fed policymaker thinks the fed funds rate will finish this year above 3.00%. For 2023, the median policymaker projects the funds rate will finish at 3.625%, before gradually starting to decline in 2024 and beyond.

The Fed downgraded its real GDP growth forecast for this year to 1.7% versus a prior estimate of 2.8%. Growth in 2023-24 was also revised down. Meanwhile, the Fed increased its estimate for PCE inflation this year, to 5.2% from 4.3%. The Fed also removed language from its last statement that it expects the "labor market to remain strong" in recognition that this path of fighting inflation requires a set of policies that may generate higher unemployment – and possibly a recession. As for quantitative tightening, the Fed will stick to its current schedule of reducing the balance sheet by $47.5 billion per month until September, when that pace will double.

The combination of this aggressive interest rate hike, a weak May retail sales report showing the bite rising prices are already taking out of consumer spending, and last week's 8.6% CPI inflation print has sent markets spiraling. As major stock market indices notched declines of -25% or more by Thursday's close, the average rate on a 30-year fixed-rate mortgage rose to 5.78%, the highest level since November 2008 and well above the 3.11% recorded near the end of last year.

The breathtaking market declines we are experiencing belie just how much perfection was formerly factored into stock market prices. But with so much appreciation erased, and our hopes of a triumphant economic rebound from a pandemic dashed, where do we go from here?
Time and again, markets have clawed back from setbacks, and we believe this time will be no exception. When and how quickly will be a function of the correction of past policy mistakes, an easing of exogenous shock factors like the pandemic and Russia-Ukraine invasion, as well as the wherewithal and fortitude of all of us, as both consumers and investors.

We suspect that inflation will peak and turn downward from these 40-year highs soon, though perhaps not quickly enough to facilitate a sharp reversal of all the damage that has been done. Consumers will ebb and flow. Demand will be blunted some by higher prices, depleted savings, and rising interest rates, but supported by pent-up demand, higher wages, stable employment, and solid household net worth with resilient real estate as its centerpiece. Washington will continue to flounder, the Fed will push forward, and a recession will ensue. And yet, we suspect that recession will be shallow and short-lived.

Consumers and corporations are not overextended in ways we have been in the past, and therefore these pressure points, while painful, will slow but not stop activity. The economy will return to the solidly low average rate of growth we had before: below expectations and historical trends, but reflective of our mature economy and demographics. Therefore, we see the potential that stock markets will move forward and retrace back to our recent highs before they move in search of their next catalyst for another level up.

The timing of this turnaround could be weeks or months, but we do not believe it is years away. After all, this is not an outlook for some dramatic intervention or catalyst; rather, this time, we believe the market will be spurred by the unremarkable yet persistent force of the consumer and those companies that best serve our needs and wants. The trick will be to focus your portfolio on those hearty brands and businesses that we all can't live without.

For a measure of reassurance, it is worth noting that bear markets do tend to come and go quickly according to market history. Going back to 1929, the average length of time bear markets have lasted is 324 days, or around 10 and a half months. The longest bear market was triggered in 2000 by the collapse in tech stocks, which was exasperated by 9/11 and the Enron scandal. The shortest bear market, at 33 days, occurred in 2020 due to the pandemic. Since the Great Depression, S&P 500 stocks have lost 35.7% on average during bear markets, the worst being the rout between 1930 and 1932, when stocks fell a whopping 83%. On the flip side, the market contracted "only" 19.9% during a three-month period in 1990 when Iraq invaded Kuwait and oil prices increased.

Only time will tell the length and ultimate severity of this downturn. As always, we urge you to focus on the underlying quality and character of your investments, and less on the "market" or "macro" forces driving headlines and volatility. We believe the consumer, and the investor focused on fundamentals, will ultimately be the source of our economic and market recovery from this challenging period, and that remains our singular focus on your behalf. In contrast to other periods when there have been fiscal or monetary "big bang" catalysts, this recovery may be a slog, and will take focused, fundamentals-driven, back-to-the-basics investing and discipline to drive toward the achievement of your objectives.

Your Ropes Wealth Team

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