Ropes Wealth Reminds Readers "Don't Fight the Fed"

The late great Dr. Martin Zweig, a renowned investor who was well known for calling the 1987 market crash, coined the phrase "Don't fight the Fed" in 1970. In his book, Winning on Wall Street, he talked about the relationship between monetary policy and stock market returns. Of particular note was the trend in interest rates and, specifically, the Federal Reserve's ability to either tighten or ease the Fed Funds target rate. For years, investors used the phrase as a mantra about the importance of staying invested when the Fed was behind the markets, acting as a safety net from downturns.

Today, "Don't fight the Fed" has a new meaning, as the central bank is under pressure to raise interest rates aggressively, due to inflation trending a 40-year high even as the economy struggles to get back on its feet after a global pandemic. As a result, much economic debate centers around whether a future recession is likely.

History's lessons about the impact of Fed rate hike cycles suggest a recession is more likely than a soft landing. In fact, there were 10 recessions associated with the past 13 rate hike cycles, and only three soft landings. Exacerbating the risk of a downturn is the Russia/Ukraine war, more elevated inflation than we have experienced in a long time, polarized and paralyzed fiscal policy, and a backdrop of a still ongoing pandemic.

Has the inflation story been overplayed? Consider this week's stunning admission from U.S. Treasury Secretary Janet Yellen when interviewed by CNN's Wolf Blitzer about her comments from 2021 that inflation posed only a "small risk": "I think I was wrong then about the path that inflation would take… As I mentioned, there have been unanticipated and large shocks to the economy that have boosted energy and food prices and supply bottlenecks that have affected our economy badly that I didn't -- at the time -- didn't fully understand, but we recognize that now," she said.

While goods inflation has come off the boil recently, falling from a peak annual growth rate of 12.3% in February to 9.7% in April, core services inflation is increasing at a 4.9% annual rate, the fastest since 1991. This dynamic is likely to continue to play out, given recent data underscoring a clear shift in consumer preferences from goods to services spending.

And now there are signs that real demand destruction is underway.

Consider that the backlog of unsold homes has risen for four consecutive months. In fact, the increase in the backlog from 6.9 months to 9.0 months inventory is concerning, as there has never been an inventory backlog of nine months or more without a recession near or underway. Consider, too, that the personal savings rate has collapsed from its pandemic peak and fallen to 4.4%, the lowest since September 2008. While that reduction has coincided with relatively strong consumer spending, it is concerning to see borrowing has also picked up markedly, with a spike in revolving credit now at its highest level since 1996.

And while this morning's jobs report showed terrific growth of 390,000 jobs in the month of May, a 3.6% unemployment rate, wage growth slowed to a 5.3% year-over-year rate. Those income gains are just not cutting it and as a result, consumer confidence is faltering here. And it's not just consumers that are feeling the heat of high inflation and weak growth as CEO confidence has plunged as well. Notably, this week J.P. Morgan Chase CEO, Jamie Dimon, told analysts and investors to brace for an "economic hurricane" caused by the Fed and the Russia-Ukraine war. For his part, Elon Musk announced plans to cut 10% of his work force this morning because he has a "super bad feeling" about the economy.

That said, stocks have priced in a lot of this negative news. Yet we want to be realistic with you that another down leg is possible as that recession risk forms more clearly and if earnings growth expectations falter more from here. While a recession may be short and relatively shallow by historical standards, it is still a challenging environment and especially so after years of compounding market gains and low volatility.

Therefore, we urge you to once again remember this is not a market likely to reward excessive risk-taking, nor is panic an investment strategy. We continue to recommend adhering to the disciplines of diversification and quality, as well as the power of periodic rebalancing (which instills a process to buy low and sell high versus trading on emotions). We will be with you every step of the way as we manage to the other side of this period when corporate fundamentals take over the spotlight from the Fed, and the risks and opportunities are more in balance than they are today.

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