Ropes Wealth Renders a Review of Recent Data & the Market's High Hope

A run of solid economic data updates helped cure some of investors' Federal Reserve-induced pessimism, lifting markets to their highest levels in roughly two weeks. Investors had been in a funk earlier this week after Fed Chair Jerome Powell warned that two more rate hikes may be needed this year to contain inflation. Today's Personal Consumption Expenditure release did little to change that outlook with core PCE coming in at 4.6% excluding the food and energy components. This matches the level we have seen for the last six months, showing progress has clearly stalled out and the Fed must remain active to bring inflation back to their 2% target. With that, concerns over high interest rates choking off growth have eased in the face of fresh evidence of the economy's resilience.

Why the optimism? The Commerce Department revised its first-quarter GDP growth estimate to 2% from the previous figure of 1.3%. Analysts hadn't expected such a major revision to the upside. Meanwhile, the Labor Department reported weekly initial jobless claims fell to 239,000 from 265,000 the week before. These numbers came after separate reports earlier this week showed consumer confidence and durable goods are holding up far better than expected. In addition, reports that 23 major U.S. banks had passed the Fed's annual stress tests further buoyed the market. After three bank failures this year, one wonders at the quality of those tests, but I digress.

Reflecting on the strong consumer confidence data, Dana Peterson, Chief Economist at the Conference Board said, "the expectations gauge continued to signal consumers anticipating a recession at some point over the next six to 12 months." The board's expectations index has been below 80, a level associated with expectations of a recession within the next year, nearly every month since February 2022. And despite the revision to GDP, the 2% expansion in the first quarter was still a step down from the 2.6% annual rise in the previous three months.

If there's a dark lining to the otherwise silver cloud of recent economic news, it's that investors appear all but certain the Fed will hike rates again in a month. Which was exactly what Fed members continued to communicate in their public remarks. At a central bankers' meeting in Sintra, Portugal, Fed Chair Powell sounded a familiar refrain saying that more tightening is ahead. Powell said, "Although policy is restrictive, it may not be restrictive enough and it has not been restrictive for long enough." He gave a little more color than in his Congressional testimony last week, noting, "I wouldn't take moving at consecutive meetings off the table at all." He cited core services ex-housing inflation as a focus and noted the correlation with wage growth. Powell said they need to see better balance between supply and demand in the labor market, "We need to see more softening in labor market conditions." As for the prospects of a recession, Powell said it was not in his base case but that there is a "significant probability" of one occurring. For her part, ECB President Christine Lagarde was equally hawkish and said, "We still have ground to cover." She was joined in this chorus by Bank of England Governor Andrew Bailey and Bank of Japan Governor Kazuo Ueda.

In the regime now forming — the post-COVID era — stock valuations, inflation, and interest rates are all higher. Supply is being constrained by demographic trends (aging populations and fewer workers), decarbonization, and deglobalization, all of which are inflationary. Going forward, the Fed is more likely to be in a position of having to fight inflation rather than bolster the economy, a less friendly scenario for financial markets.

That said, equities historically have been the highest-returning asset class over the long term, and we see nothing to alter that precedent. However, higher stock valuations than at the start of the prior regime plus higher interest rates mean less return from markets broadly. We see more dispersion in earnings estimates, valuations, and stock returns — and this suggests a greater opportunity set for active stock pickers. It also suggests emphasizing careful

security selection as your main tool to drive strong returns, rather than being overextended in allocation. This is important because the world isn't exactly a bastion of stability right now and with cash and bonds so attractive, maintaining balance is prudent. Either the market upswing will broaden beyond a handful of tech names, or the handful of tech names will trim back some of their meteoric rise and trade back with the rest of the market until we slog through all the resets of this post-COVID era renewed and ready for the future. We think the latter scenario is most probable but propose that we can still have solid returns stemming from good selection work and careful allocation management.

Best wishes to you and your families as you celebrate Independence Day this weekend. As President Abraham Lincoln once said, "My dream is of a place and a time where America will once again be seen as the last best hope of earth." We may have more work to do on that dream as recent events remind us, but remember too what Superman Christopher Reeve said, "once you choose hope, anything's possible!"

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