Ropes Wealth Frames GDP, the Fed, and 4%

The U.S. economy grew at a 2.4% annualized rate in the second quarter, accelerating from a 2% pace the quarter before. Economists had expected growth to slow slightly to a 1.8% rate. Key drivers of activity were business investment, government purchases, inventory investment, and consumer spending, though consumption grew at a much weaker 1.6% pace than the steamy 4.2% rate posted in the first quarter.

This latest evidence of the economy's resilience came a day after the Federal Reserve said it had taken its benchmark interest rate to the highest level in 22 years. With this latest move, the Fed's benchmark interest rate has risen 5.5% in just 16 months. Despite this historically rapid runup, the economy continues to chug along, stirring investors' hopes the Fed may succeed in suppressing inflation without causing a damaging recession. Powell was asked about growing optimism for a soft landing and said: "We do have a shot, and my base case is we'll be able to achieve inflation moving back down to our target without the kind of really significant downturn that results in high levels of job losses that we've seen in some past instances." However, the Fed left the door open for further rate hike(s) before year-end, although the pace (every meeting vs. skip-reengage) remains unclear: "We have to be ready to follow the data. And given how far we've come, we can afford to be a little patient as well as resolute as we let this unfold," Powell said. Today’s data releases added to the Fed’s case as the PCE measure of inflation rose 3% year-over-year in June, slowing from the 3.8% reading in May. The core measure, excluding food and energy, rose 4.1%, again down from the 4.6% rate the prior month. Likewise, personal income growth (a key indicator of wage inflation) rose just 0.3% month-over-month versus 0.5% in May. Inflation is clearly moving in the desired direction, and the Fed has the data to warrant a pause and allow the historic policy moves they have already made to take shape over the coming months, but they remain concerned about taking their foot off the brakes too soon.

As a result, good news has taken on a sour tone, because it is feeding investor anxiety that the Fed will continue to boost interest rates. To that point, the 10-year U.S. Treasury yield hit 4% on Thursday, as stocks faltered despite the strong GDP print and other good data like solid durable goods orders and declining initial jobless claims. Investors were also taking stock of how much stocks have risen in 2023, and profit-taking as the S&P met some technical resistance at the 4,600 level. Finally, investors were reacting to reports that the Bank of Japan is considering lifting its cap on long-term rates, which could put a dent in Japanese demand for U.S. bonds and spike yields even higher.

The punchline of this kind of data and reading the tea leaves of the Fed is that investors may face a new regime in which central banks will not quickly ease policy in a world shaped by supply constraints – notably worker shortages. They may be forced to keep policy tight to lean against inflationary pressures. Economic relationships like steady growth and low inflation during this era of the ‘Great Moderation’ will break down. The shrinking supply of workers in several major economies due to aging, among other factors, means a low unemployment rate is no longer a sign of the cyclical health of the economy. Broad worker shortages could create incentives for companies to hold onto workers, even if sales decline, for fear of not being able to hire them back. This poses the unusual possibility of “full employment recessions” in the U.S. and Europe. That could take a bigger toll on corporate profit margins than in the past as companies maintain employment.

This is also why sources of structural change like artificial intelligence are so prized in this moment. But there are other trends to watch closely as well: the transition to a low-carbon economy, a fast-evolving financial system, and geopolitical fragmentation, among others. Investors are more confident to “pay up” for companies positioned to be a disruptor in these places and spaces, betting that we are at an inflection point and predicting their future growth could be exponential.

Every truth has two sides, Aesop said for a reason. We urge your best course to stay committed to your high quality, diversified stock holdings, and hop into some of the best yields on quality bonds in over a decade. Work closely with us to define cash needs for your six- to twelve-month period ahead and be disciplined about those reserves given how far and fast we have moved since last year's market lows. Consider appropriate profit taking in some stretched segments and offset those gains with lingering losses from 2022 before the market rebalances for you on some shift in short-term investor sentiment. Finally, we recommend you take stock of your stocks, so to speak, and let's together make a shift in our reviews away from discussions of the Fed and more toward a discussion of how our portfolios are investing in these transformative themes and companies of our futures.

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