Ropes Wealth Highlights an Evolving Situation

It's that time of year again: the "glistening autumnal side of summer" as Henry David Thoreau once described it. As we move closer to the start of September, with back-to-school shopping on our minds and Halloween candy appearing on our supermarket shelves, we must also brace for the seasonal market volatility that tends to accompany the change of seasons. Like clockwork, we are seeing the cracks start to form in the market's strong surge in the first half of the year. While stock performance has broadened in some respects from the domination of the so-called "Magnificent Seven" (Apple, Amazon, Alphabet, Meta. Microsoft, Nvidia, and Tesla) that led year-to-date gains on the AI theme, it is also weakening overall as anxieties are setting in over the nagging risk of recession that haunts the economic outlook. For example, the S&P 500's year-to-date gains have eroded by close to 5%, cutting the bellwether benchmark's rebound from +20% to +15%.

The market is squarely in the "good news is bad" and "bad news is bad" manner of processing economic data and headlines. For example, we kicked off the early part of the week with the good news that retail sales rose 0.7% in July, the largest monthly gain since January, and are tracking 3.2% higher from last year. Sales were strong across most categories, with restaurant, retail, and apparel sales jumping, while furniture and electronic sales weakened. Though a strong and resilient consumer is a good thing, the bad news is that they are financing their spending with increases in credit card debt, a massive increase in hardship withdrawals from 401(k)s, a drawdown in savings, and a last sputtering of state and local stimulus. With student loan payments ramping up and returning for many, coupled with rising prices and higher borrowing costs, pressure lies ahead.

Meanwhile housing starts rose 3.9% in July, pulling the annual pace up from 1.398M to 1.452M, a two-month high. Building permits also ticked up by a hair, pulling the annual pace up from 1.441M to 1.442M, also a two-month high. Industrial production rose 1.0% in July, surpassing the 0.3% gain expected and following a 0.8% decline the month prior. With these reasonably strong housing numbers, the retail sales strength described above, and labor market data that defies all signs of a slowdown, the Atlanta Fed notably revised its third quarter U.S. GDP growth estimate to a reading over 5%.

Which brings me to the bad news, because the stronger these data points are, the more the Fed remains active with interest rate policy in its quest for 2% inflation. On Wednesday, the Fed released last month's meeting minutes, which revealed a strong focus on inflation: *"most participants continued to see significant upside risks to inflation, which could require further tightening of monetary policy."*

Minneapolis Fed President Kashkari, a current-year voter, noted Tuesday, *"I'm not ready to say that we're done"* raising rates and believes the Fed is *"a long way away from cutting rates because core inflation is still around 4%."* Surprising economic resilience, evidenced most recently by July's stronger-than-expected retail sales data released earlier in the day, is *"a little bit of a double-edged sword"* because it raises the question of *"have we done enough to actually get inflation all the way back down"* or *"do we have to do more."* That said, Kashkari did suggest the Fed may find it reasonable to hold rates steady in September to get more economic data before hiking once again.

Against that backdrop, the 10-year Treasury yield surged this week to around 4.301%—a level last seen in October. Investors are clearly concerned the economy may be too strong for an inflation-focused Federal Reserve, potentially to the point where it may need to raise interest rates again, and certainly to maintain them higher for longer.

The economy may be far from out of the woods, despite all the talking heads arguing that solid U.S. economic growth, low unemployment, and resilient corporate earnings show that high interest rates aren't the speed bump they once were. While the mixed signals are hard to balance, and there is no question the economy has handled the rapidity of rate increases well, the next test is how it handles sustained higher rates. Without the potential for rate cuts in 2024, how will investors value stocks and how will consumers behave when the remaining vestiges of monetary and fiscal support fade? We will surely find out and are staging your allocation to be as resilient as possible with healthy allocations to bonds at these higher rates, high quality stocks and funds of stocks, and some increasing exposures to defensive market segments that will hold their value should the market cycle downshift further from here. We are rooting for market cycle momentum to continue, but want to be prepared if it loses steam, and ready for the opportunities that might come with that shift.

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