Ropes Wealth Reviews the Reality of Rising Recession Risk

After four consecutive jumbo hikes of 75 basis points, the Fed scaled back the size of its rate hike and boosted rates by 50 basis points this week. The Fed's key interest rate is now in the range of 4.25% to 4.50%, its highest level in 15 years. The Fed maintained hawkish language that "ongoing increases" in the Fed funds target will be appropriate, despite recent signs that inflation is cooling. That hawkish bent was further reinforced by the Fed's projections that now show the Fed funds rate peaking in the range between 5% and 5.25%, which is higher than their last forecast. The Fed also lowered its 2023 GDP growth rate from 1.2% to 0.5%, just above levels that would be consistent with a recession. In addition, the Fed expects unemployment to rise to 4.6% in 2023, though inflation is expected to decline all the way down to 3.1%.

Powell remained steadfast in his hawkish messaging during the press conference, stating "we still have some ways to go" when questioned about future interest rate hikes and progress to reduce inflation. Arguably the most insightful question of the day came from *Wall Street Journal* reporter Nick Timiraos, who asked if the Committee might consider switching to 25 basis point hikes as soon as the next meeting as they probe what the peak rate should be. Powell answered that it was "broadly right" that this could be appropriate. He continued, "It makes a lot of sense, it seems to me - particularly if you consider how far we've come." But in no way did Powell signal an end to interest rate hikes, or a concern about recession risk.

As a result, markets were less than pleased and declined this week. Even though we had good news on the inflation front, with both the headline and core Consumer Price Index (CPI) declining to 7.1% and 6%, respectively, prices are still running hotter than we all would have hoped at this stage. On a positive note, used car prices, medical care, and airline fares were all down, and of course energy prices also had a notable drop. In fact, gas prices nationwide now average $3.25 per gallon, which is down 53 cents from the prior month. On the flip side, food and restaurant costs were higher, and shelter prices remain the largest contributor to the monthly CPI increase as rents remain sticky on the high side. Overall, this week's report confirmed that price pressures are easing some in the goods economy, though labor-intensive prices in the service sector remain stubbornly sky-high.

In other news, the Institute of Supply Management's Services Survey, which tracks activity across the largest swath of the U.S. economy, came in much stronger than expected. The pick-up in current business activity was the broadest of the year. Notably, though, spending on services appears to be trumping spending on goods. To that point, retail sales fell -0.6% month-over-month in November versus expectations for a -0.2% decline. Gasoline station sales inched down -0.1% while building material sales plunged -2.5% and auto sales sank -2.3%. Also hard-hit were furniture and home furnishing sales, electronics and appliances sales, and online sales. Bright spots were few and far between but included food and beverage sales and restaurant sales. With November typically denoting the start of the holiday shopping season, this report suggests the Grinch may be here as the resiliency of the American consumer is feeling the impact of the Fed's rate hikes. With credit card debt at record highs and the personal savings rate at multidecade lows, consumer spending may continue to weaken as confidence remains at depressed levels.

As we look toward 2023 and consider the outlook in light of the data and Fed developments, it is fair to say that outlook is mixed, and opinions abound on all sides as to how the economy and the markets will respond in the months ahead. Some economists think the Fed has already tightened too much. They compare the current period of high inflation to the price spikes that followed the end of wartime mobilization in the late 1940s when there was large fiscal stimulus, large excess savings, big labor market turmoil, and a shift in what people were buying. Inflation spiked then too, and then after surging for a year, came down on its own. Other economists see risks that inflation stays elevated unless the economy goes through a recession because the U.S. faces more persistent labor shortages and because wage inflation tends to be difficult to bring down without a downturn. They compare this period to the beginning of a wage-price spiral that took root in the late 1960s and early 1970s and believe the Fed will not repeat their past mistakes by cutting interest rates, but rather maintain rates at current levels and let the recession endure.

Both sides make compelling arguments and only time will tell. As a result, prudence and a healthy dose of caution is in order, and therefore we reiterate our commitment to an emphasis on higher quality, short- and intermediate-term fixed income with bond yields now higher, and diversification and balance between growth and value, large and small, and U.S. and overseas markets. There are times when market conditions call for extended positioning, but this is not one of them. We furthermore reiterate a focus on liquidity and cashflow planning as we block and tackle to manage through the next 6-12 months of what may be a bumpy ride, but one that will yield an economy and markets more grounded than before in their own self-sufficiency without the propped up and hopped-up adrenaline of unsustainable fiscal and monetary stimulus.

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