Ropes Wealth Studies Slowing CPI but Rising Risks

Markets floundered a bit this week with earnings season winding down and economic data delivering cryptic messages. Consumer price inflation was reported as expected, rising a moderate 3.2% since last year, though core inflation excluding food and energy costs reflected a 4.7% year-over-year increase. While we have come a long way since the 9.1% rate of inflation recorded last June, the fact remains that the Fed’s target rate is 2% so core inflation is more than double the Fed’s bogey. Despite all the efforts of the Fed, the battle for price stability continues, and the reality of higher rates for longer has investors on edge. It isn’t helping that the national average gas price hit $3.84 a gallon this week, crude oil rose over $84 a barrel, and we are not even in hurricane season yet.

This week also featured another prominent credit ratings downgrade, this time by Moody’s, that lowered its credit ratings on U.S. regional banks due to "growing profitability pressures" from interest rates and their exposure to commercial real estate. This news renewed the fears caused by the March 2023 banking crisis, sharpening worries about small and medium-sized lenders and their risk profile.

Notably, the New York Fed’s Quarterly Report on Household Debt and Credit revealed consumer credit card balances have topped $1 trillion for the first time ever—a dubious milestone. According to the details of the report, the number of credit card accounts also increased by over 5 million in the past quarter to roughly 578 million with total credit limits increasing by $90 billion to $4.6 trillion. Clearly, rising prices and waning stimulus and savings are prompting consumers to find alternative means to supplement still positive but slowing spending patterns. Credit card debt has been one such support, gaining 16.2% over the past year. Of course, relying on credit cards is not a sustainable solution, particularly as rising interest rates make it more costly for consumers to take on debt. According to the Federal Reserve, the average annual percentage rate on credit cards is now over 20%, the highest on record.

Which returns us to the key question of what exactly will our near-term future be: hard landing or soft landing? The economy has proven surprisingly resilient thus far, but the Fed still has work to do before policy has reached a sufficiently restrictive level. In fact, while some point to the ongoing strength of the labor market and the broader economy as evidence the Fed can achieve a soft landing, such strength may actually ensure an – eventual – downturn. After all, the longer this economic strength persists and the labor market fails to bend to tighter monetary policy, the stronger the required response to tamp down investment and consumption will need to be to achieve more benign wage growth and demand side price pressures, thus increasing the odds of a downturn in topline growth. In other words, market players should appreciate the somewhat smooth pathway and market response to the first 500 basis points of rate hikes, but they should not get complacent that such ease will continue.

Our expectation is that economic data will begin to disappoint after an extended period of outperforming expectations, especially given the lagged effects of Federal Reserve (Fed) tightening. With the S&P 500 trading at 19x forward earnings (and 21x trailing), a significant amount of good news has been built into the market. Keep in mind, the forward P/E multiple coming into this year was 16x. Two factors that drive P/E multiples are inflation and interest rates. But with headline inflation falling from 9.1% to 3% already, there is not much room for further multiple expansion as it will be a struggle for inflation to reach the 2% level in the near term. There is the potential that the twelve-month streak of decelerating YoY inflation could be temporarily interrupted by the recent rise in commodity prices and less favorable base effects. This means that earnings will need to have a healthy rise to propel the stock market higher. And with 10-year Treasury interest rates above 4% (and corporate yields even a disruptor in these places and spaces, betting that we are at an inflection point and predicting their future growth could be exponential.

higher), bonds have become much stiffer competition for the equity market. Therefore, a pause in the equity rally is more likely. And with once bearish investors now chasing the market's recent momentum and potentially ignoring risks on the horizon, the market could be setting up for some potential weakness in the months ahead. We are braced for this outcome: setting aside ample liquidity in high yielding Treasury bonds, allocating to the higher quality segment of equity markets, and rebalancing positions that have reached some steamy highs in favor of market segments offering more favorable valuations. As the Oracle of Omaha Warren Buffet once said, "stocks are still the best of all the poor alternatives in an era of inflation," and we agree, especially those that are carefully chosen and overseen and held in the right balance for your situation.

Thank you as always for your interest in our investment commentary. Please let your RWA team know if you have any questions or concerns. If you would like to speak personally with a member of our team at any time, please click **here.**

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