



## Ropes Wealth Considers What Could Go Right (While Planning for What Could Go Wrong)

**WHILE WE KNOW FROM PAST EXPERIENCE** that the stock market and the economy do not move in lockstep, there is usually some correlation, which is why in the midst of a destabilizing and polarizing pandemic—and a period of intense political risk and social unrest—current market strength seems so unfathomable.

With the Fed delivering more stimulus than ever and promising to keep interest rates at zero, many attribute the surprising rally to a “never fight the Fed” bias, which has banished investor fears through the assumption that the Fed will vanquish every dip with even more stimulus. Low rates also “push” investors into stocks, because they nearly eliminate the returns available through fixed income.

### *But does Fed stimulus really have the power to support the broad economy?*

Unsurprisingly, the answer to that question is complicated. Fed stimulus is particularly helpful to very large publicly traded companies that can borrow by issuing bonds to the public market. Low rates also allow large publicly traded companies to refinance their existing higher-cost debt with lower rates, thereby increasing their earnings by lowering their interest expense. This results in the market assigning a higher price-earnings multiple to those enhanced earnings, allowing these companies to take advantage of the Fed’s activism in real time.

In contrast, small businesses that rely far more on sales revenue than capital markets to meet their funding needs have seen sales plummet due to forced lockdowns, consumer austerity, worker shortages and supply disruptions. They can’t turn to Wall Street

smoke and mirrors to make up for the shortfall. Thus, we experience the dichotomy that as the Main Street economy languishes, Wall Street soars to new highs.

Of course, the expectation is that ensuring the stability and strength of Wall Street unleashes the transmission mechanism for a Main Street recovery to take hold. And the strong rebound in economic data such as employment, manufacturing and home sales suggests that we are on the correct course.

But not all economic data is so sanguine. Consumer spending has moderated after a post-shutdown spike, consumer and business confidence remains on the downslide, and markers of deflation persist. And we just don’t know if the coronavirus and its attendant economic stagnation may be with us for years to come. Even if an effective vaccine is delivered to the broad population within the next year, the damage to the travel, entertainment, fitness and food service industries may be beyond repair. How long will it take for people to once again feel comfortable in large groups? The fear may linger long after the real danger is gone.

Cultural changes that have already taken hold may mean that office towers, retail chains and theaters may never recover. People and companies are becoming more comfortable with working from home, shopping online and avoiding crowds. While companies like Amazon, Zoom Video and Netflix are the obvious beneficiaries of these shifts, they neither employ the same number of workers nor those with the same set of skills for a seamless transition. For this reason, it is estimated that about a quarter of the 22 million “temporary” layoffs that began with the

first shutdown in March could become more permanent, lasting well beyond 2021.

During a time like this one, it is easy to focus on possible negative outcomes and weaknesses, and it is often useful to do so. We have done a lot of this type of “black hat” thinking, and it has allowed us to shape for our clients a portfolio that accounts for the myriad challenges that exist because of the pandemic. It has caused us to build into portfolios a hedged equity component, prioritize stock selection in our investment choices, and cycle up to quality or to segments with lower valuations that we deem less vulnerable to broad-based sell-offs. We have maintained a keen eye on the balance of equities and fixed income and cash, even as markets have drifted higher in order to remain diversified and aligned with your plan. We have also worked proactively with many of you to make charitable and family gifts in this period of market strength, to reserve cash for future expenses prudently, and to rerun financial projections with our financial planning team to account for scenarios like early retirement, reduced income, and extended support for children and parents.

### *But there’s another question we must ask, as well: What might go right?*

Effective vaccines will hit the market, widespread and safe administration will occur in due course, and life as we once knew it will return in many ways. While online shopping and remote work may be here to stay, those trends were already underfoot. A most likely scenario is that we end up somewhere between our habits formed pre- and post-COVID. The travel and hospitality industries

may face some headwinds, more from the lucrative business travel component than from leisure. But while the 9/11 attacks had a negative effect on global travel initially, it found its feet several years later. In other words, we adjust and we move forward as we have during countless periods of uncertainty before—whether due to war, taxes, inflation, banking crises, political crises or pandemics.

In the meantime, the \$3 trillion booster that the Fed has already applied, and the promise for unlimited doses for the foreseeable future, makes that rosy scenario a hard one to bet

against and, assuming we achieve a “CARES 2.0” in the somewhat near future, perhaps an impossible one to bet against.

To us, the real nuance is how to balance this vision of recovery with prices that already reflect optimism for a “what might go right” scenario. For this reason, we actually embrace some of the churn in the “richly” valued sectors of tech and health care in these early September days as part of a healthy rotation, and expect to see more of it as recovery hopes and prospects become more broad-based and valuation, not fear, once again drives the markets.

Our diversified approach is especially well built for these periods, when shifts in investor preferences create broad market participation across industries, sectors, geographies and styles. And with a record level of money sitting in cash and bonds, perhaps waiting to be unleashed, we urge you to consider what might go right, avoid “black-hat” thinking, and embrace and be empowered by the resiliency we have built into your long-term investment plan in so many ways.

## The End of the Preemptive Fed

At the recent annual Jackson Hole Symposium on August 27, Fed Chairman Powell confirmed rumors that the Federal Reserve would be revising their policy goals to allow for more flexibility in decision making, particularly when it comes to managing inflation preemptively.

As a brief refresher, it is worth noting that the Fed has two main goals (what they refer to as a dual mandate): promoting maximum sustainable employment and targeting a 2% inflation rate (price stability). Typically, the Fed would conceive of declining unemployment as a warning sign of inflation to come, and move interest rates higher to maintain price stability. Conversely, when unemployment was rising, interest rates were slashed to avert a deflationary spiral.

The problem was that all of these changes in interest rates were made in anticipation of inflation or deflation because of its historical correlation to employment, and not in actual observance of them. And interest rate increases made too soon because of wage inflation fears would ultimately choke off economic growth and employment, and widen an already devastating income inequality gap.

In recognition of these challenges, the Fed announced that it would “conduct a broad review of its monetary policy framework” in November 2018. Besides academic economists, the Fed consulted market economists and community representatives, and grappled with the obvious gaps in long-held economic theory. They gave weight to the premise that their policy must not be just to pursue maximum employment, but fight to maintain it. Sustained periods of full employment created lasting improvement in living standards and quality of life in low-income and minority neighborhoods. When the economy goes from labor slack to labor scarcity, poor neighborhoods transform from places where no one can find a job to places where opportunities compound over time. Without some wage inflation, the poor will never close the income gap.

And on August 27, 2020, the Fed changed; no longer will they have a clear target level of inflation. Rather, the board unanimously revised their policy goals to seek inflation that “averages” 2% over time, providing more flexibility for inflation to run above 2% for a moderate period. The hope is that this looser stance on inflation will maximize employment for all groups, including the socioeconomically vulnerable.

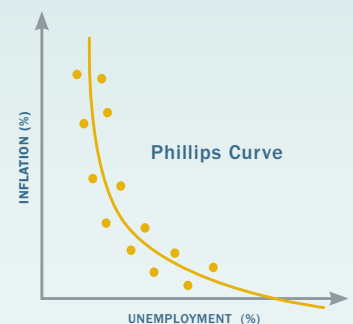
In their explanation of changes to the Fed’s long-term policy goals, FOMC participants explain, “The characterization of our maximum employment goal as broad-based and inclusive clarifies that the Federal Reserve seeks to foster economic conditions that benefit everyone. It also stresses the importance of understanding how various communities are experiencing the labor market when assessing the degree to which employment in the economy as a whole is falling short of its maximum level.”

In other words, the Fed will no longer choke off economic growth and declining unemployment by raising interest rates to fight an imaginary inflation phantom. They will assess the conditions and data of the time, and use their judgment to implement monetary policy in service of maximum employment and price stability for all.

Bear in mind that nothing really changes until the economy is strong enough to justify tightening. Even the old Fed knew the unemployment rate had to fall considerably lower than the current 8.4% before that happened. As a result, the only near-term influence this policy change will have is on expectations. Real success is likely five to 10 years in the future, when the economy is again at full employment and they must navigate how to keep it that way.

## Death to the Phillips Curve

First postulated in 1958 and named after New Zealand economist William Phillips, the **Phillips Curve** plots an inverse relationship between inflation and unemployment (i.e., a drop in unemployment would lead to an increase in inflation, and vice versa). While this correlation held up from 1960-1985, it has since weakened and has been almost nonexistent since 2008 as lower unemployment rates (pre-pandemic) have failed to spur higher rates of inflation.



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