



Ropes Wealth Reviews Pivots, Pauses, and Payrolls

True to form, the Fed delivered its fourth consecutive 75 basis point increase on Wednesday. The Fed's key interest rate is now in the range of 3.75% to 4.00%, which is its highest level since 2007-2008. On the bright side, this is likely the Fed's last hike of such magnitude for this tightening cycle, as explicit language was added in the FOMC statement acknowledging the lag effect with which monetary policy impacts the economy. During the post FOMC news conference, Powell said that smaller sized hikes may come as soon as December, and for a brief moment, it felt like the notion of a Fed pause or pivot might be forthcoming.

Not so fast.

Following the statement release and meeting, Powell delivered the bombshell news to the markets that smaller sized hikes were not at all a signal of a pause or pivot. In fact, he said it would be "very premature to be thinking about pausing" rate hikes. Don't think about the pace of hikes, said Powell—what matters now is how high rates go. They will go higher than the Fed previously thought, he said, and they will stay higher for longer. The Fed has not done nearly enough yet, he added. Inflation is still way too high and core inflation shows no sign of coming down. And the Fed is not worried about overtightening—policymakers know how to correct that if it happens. He said the Fed worries—a lot—about not tightening enough (or cutting too soon) because inflation would then become truly entrenched.

What does this mean for interest rates? Powell concluded that the policy rate needs to rise above the core inflation rate, because if the real policy rate is negative, clearly policy is not tight enough. Economists think at best the core Consumer Price Index (CPI) will downshift to 5.5% in the second quarter, so it would seem likely a fed funds target rate of 5.5% is likely. Contrary to market opinion, we are unlikely to see rate cuts next year. The Fed will want to feel confident that core inflation is coming down toward its 2% target in a sustained way.

What about the impact on the economy? Powell admitted that a recession is more likely than not but indicated it should be a mild one. Powell said his belief in a soft landing is due to the fact that the labor market is still extraordinarily tight, and consumer spending is well supported by high saving. He emphasized a mild recession, if still accompanied by high inflation, is unlikely to move the Fed off its stated path.

And the impact on markets? Powell just reiterated his message: rates will go higher than previously envisaged and stay higher for longer; the Fed is not afraid of tightening too much, it's afraid of tightening too little or loosening again too soon; and no-one should doubt the Fed's determination to bring inflation down.

The Fed that used to prioritize asset prices now will lean against markets to bring inflation under control. That's indeed a pivot. Just a different kind of pivot than markets expected.

October's strong market gains are being reduced by this week's action. This morning's payroll report noted 261,000 job gains in the month of October and a 7.7% annualized wage increase that reinforces the Fed's position that wage inflation is showing no signs of relenting. Job gains were driven by hires mainly in the leisure and hospitality sectors, manufacturing, healthcare, and business/professional sectors. The unemployment rate ticked up modestly from 3.5% to 3.7%, but most economists expect that number to surge higher in the coming months and overall job growth to come to a standstill. This earnings season showed us that many companies are not

planning on replacing existing workers who leave, and tech companies particularly battered by current market conditions are picking up steam in announcements of hiring freezes and layoffs.

While pivots, pauses and payrolls are incredibly important to the short-term performance of your portfolio, we are encouraged to see the markets have found some footing, albeit at these much lower levels. This earnings season has demonstrated a weakening demand environment, high input costs (including labor), the effects of the strong U.S. dollar and the impact of the Fed's aggressive rate hiking cycle. Of note is the breadth of hits in terms of industries—with not only technology feeling the pressure, but also housing, autos, communications—and especially those segments of consumer/retail that were the biggest beneficiaries of the stimulus-fueled early stages of the pandemic. With that, we see continued benefit from a stance of caution and quality, as we have not seen the worst yet in earnings declines. A time will come for optimism about a path forward from the economy and market's recent troubles, but it is not time yet.

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