The Federal Reserve has many important responsibilities, but most investors focus on just two of them: managing inflation and promoting full employment. During the pandemic, the Fed pivoted sharply to favoring employment at the expense of controlling inflation, as it flooded the economy with cash to support CARES, ARP, and other fiscal policies. Last week, the Fed emphatically flipped those priorities: Fighting inflation is now the dominant priority. Although Fed Chair Jerome Powell publicly avowed that he does not desire to cause layoffs or a recession, his tone and his language clearly communicated his recognition that a “soft landing” will be exceedingly difficult to achieve.

The flip-flop was most evident in the Fed’s view of the labor markets. Since the onset of the pandemic, the central bank’s economists focused on recovering from the 25 million jobs lost due to economic shutdowns in the spring of 2020. That recovery has been robust, but even today the economy is still about 300,000 jobs shy of its December 2019 peak. Still, job growth remains very strong, with the number of job openings nearly twice the number of unemployed people; indeed, “quits” are at near-record highs as workers feel confident they can get better work elsewhere. Chart 1 shows these numbers.

In his press conference last week, Chair Powell ignored the “we’re not all the way back” narrative, and replaced it with its opposite: The labor market is too strong today, and all those unfilled openings suggest that demand for workers now exceeds our ability to supply them. The labor market needs a sedative, in his view: The current 3.6% unemployment rate is too low and the 5.4% increase in hourly wages is contributing to inflation. The Fed is now willing to accept some job losses – and a possible recession – to take a bite out of inflation.
A similar story is taking shape with respect to consumer spending. Here, too, the numbers can tell two different stories, as shown in Chart 2. For two years, the Fed (and most investors) had embraced the narrative that the surge in spending after the lockdown-induced 2020 recession was healthy, evidence that consumers were afloat and regaining confidence. What Americans no longer spent on experiences we instead devoted to improving the homes in which we spent so much more time, or procuring cars so that we wouldn’t catch germs on public transportation.

That narrative held water for a while. Retail sales had been growing at a rate of about 4% annually for more than a decade, as shown in Chart 2; the red line on the chart hypothetically extends that growth rate as if the pandemic had never happened. It’s reasonable to suggest that above-trend retail sales in 2021 represented a catch-up of sorts from the depressed levels of mid-2020; but what of the continued strength this year? Retail sales are still running well above trend at double-digit growth rates, straining our ability to meet this demand.

For two years, the Fed saw strong retail sales as indicative of consumers’ resiliency, and pumped up the money supply to ensure more of the same. Today, the Fed is suddenly concerned that demand needs to be restrained, lest overeager consumers drive inflation yet higher. What better way to rein in demand than to raise the cost of money? But with consumer sentiment already at dismal levels (Chart 3), what better way to nudge the economy toward recession?

When the Fed raised the overnight interest rate by 0.75% last week (rather than by the 0.50% it had previously signaled), it was communicating a sense of urgency. Chair Powell magnified this urgency by adding that another 0.75% increase is likely for July, followed by four more quarter-point hikes through the last few months of the year. All told, the Fed is now positioned to have raised rates by three full percentage points this year, triple the level it had anticipated in January.
The Fed’s change of course was in direct response to the “hot” inflation report the prior Friday, in which headline consumer prices rose by 8.6% from a year ago, a renewed acceleration after April’s number had hinted that inflation had already peaked. But two other figures released the same day cast the economy in a slightly different light. “Core” consumer prices, an inflation index which excludes food and energy, rose by only 6.0%, the second consecutive month of smaller increases. Chart 4 shows that while headline CPI rose in May, core CPI dipped. The chart also shows that producer prices moderated last month, which also portends better consumer price numbers in the future.

It's also important to note that retail sales for May were disappointingly light, dipping slightly from April as is evident at the extreme right edge of Chart 3; the dip may have been caused by higher prices, or perhaps by the end of Covid stimulus payments. Whether it represents the beginning of a trend is yet to be seen, but it does somewhat undercut the Fed’s concern that retail sales are too strong.

The combination of mixed data and a more aggressive Fed hike triggered strong reactions from both inflation hawks and inflation doves. The former is so concerned about rising prices (due to labor shortages, food and fossil fuel shortages stemming from the war in Ukraine, broken supply chains, and other factors) that it had lobbied for a steeper 1.00% increase. The latter group is worried that this month’s weak retail sales figure and the slight dip in core consumer price inflation indicate that the economy is already in a downturn and that inflation will heal itself, so the 0.75% hike was overkill and would cause a recession.¹

¹ Mr. Powell may have felt like Gerry Rafferty in the old Stealers Wheel song, with clowns to the left of me, jokers to the right, here I am stuck in the middle.
Perhaps the most important effect of the rate hike will be on the housing market. Already this year, mortgage rates have soared at the steepest pace in more than forty years (Chart 5). According to Freddie Mac, the average rate for a 30-year conforming mortgage was 3.1% last January, and is now 5.8%. While an increase of 2.7 percentage points may not seem to be much, it would increase the monthly payment on a $400,000 mortgage from $1,708 to $2,342 – a jump of nearly 40%. The sticker shock for first-time homebuyers is potentially devastating, perhaps pricing them entirely out of the market.\

Housing is a hugely important driver of economic growth, and the Fed’s campaign to raise interest rates threatens to send this industry into a stall or even a downturn. For consumers already unhappy with rising prices and slowing consumption, the fear of paying more for a home that is worth less money is truly frightening.

While most economists and investors have heretofore focused on the supply side of the economy since the pandemic began, it is becoming increasingly clear that excessive demand is a problem, too. The Fed is aiming to restrain demand just enough to match supply constraints, but not so much as to cause a recession. The Fed has some leeway here; Wall Street’s forecasters are now expecting about a 1.0% to 1.5% GDP growth rate for the year, following a brief decline in the first quarter due to higher imports and inventory depletion (which, in turn, was a byproduct of disrupted supply chains and parts shortages).

Events around the world also bear upon the U.S. economy, of course. Europe, in particular, is dangerously close to slipping into recession. The war in Ukraine has severely cut into the Continent’s food and fuel supplies, raising prices and creating shortages. Also, the U.S. dollar has been strong this year because the Fed has been ahead of its global counterparts in raising interest rates. That has weakened European purchasing power, cutting into demand. The European Central Bank is thus caught in a difficult dilemma: Should it raise interest rates to preserve the purchasing power of the euro, or should it cut rates to help keep the economy from falling into recession? Regardless of which path Europe chooses, the impact on the American economy will probably be negative: Either lower demand or higher import prices would likely adversely affect European sales of American-made products.

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\[2\] This calculation assumes a $400,000 mortgage in both the January and June instances. But home prices have increased about 10% since year-end; taking this into account, a mortgage on the same property might now be $440,000 and the monthly payment $2,576. With both a higher purchase price and a higher interest rate, the monthly payment on the same property with the same loan terms would be 51% higher today than it was just six months ago.
The Fed’s surprisingly steep rate hike comes at a time when demand is already showing initial signs of slowing, corporate layoffs are beginning to rise (a little, and from very low levels), export revenues are threatened by events overseas, and consumers are feeling awful. To ratchet up the pressure on inflation now is unequivocally to raise the probability of a recession. Despite that risk, the Fed’s new trajectory shows that it intends to keep interest rates high for the next two years (Chart 6). As a soft landing becomes more difficult, investors must address their portfolio positioning.

Markets are often described as anticipatory in nature, and stock prices are already down more than 20% this year. So perhaps investors have already “priced in” a recession, in which case it might be time to be thinking about the economy emerging from a recession that hasn’t even begun yet. Indeed, futures prices in the Treasury debt markets suggest that investors are beginning to anticipate lower interest rates in 2024. This positioning is consistent with a view that the incipient recession will be short and shallow.

A stock price fundamentally consists of two factors: earnings per share, and the price an investor is willing to pay for a dollar’s worth of earnings. For the algebraically minded, \( P = E \times \frac{1}{P/E} \). By examining these two factors separately, we can assess what stock prices are telling us today about investors’ expectations. Chart 7 shows the expected earnings per share of the S&P 500, and Chart 8 shows the one-year forward price/earnings ratio of the index based on expected earnings.

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**Note:** Each dot shows one Federal Open Market Committee member’s expected level of the overnight Fed Funds interest rate for the year.

**Source:** Federal Reserve
The evidence is powerful: Stock prices have dropped this year entirely because of valuation, not fundamentals. Market earnings expectations continue to rise, but the value of a dollar of earnings has plunged as interest rates have risen.\(^3\) If investors begin to contemplate a fall in corporate earnings – if Chart 7 turns downward – then stock prices could see another downward leg: Investors will pay lower multiples for lower earnings. The pain isn’t over yet.

Sooner or later, however, all bear markets end. Consumer demand will abate, layoffs will rise and then fall, and prices will stabilize as supply and demand come into a new balance. When those things happen, depressed stock prices will understate the future potential of earnings. A new bull market will begin, and it will overtake the January 2022 highs. But that’s getting ahead of ourselves: First, we need to address how to position portfolios to carry us through the remainder of the bear market.

We think recession is inevitable, and possibly already here. The retail sales report earlier this month provided the first government-collected data hinting that consumers are resisting higher prices; this corroborates with reports from Walmart, Target, and other retailers that demand has shifted from discretionary items to basics, and from top-shelf brands to lower-priced alternatives. Consumers are tightening their belts. As they do so, companies up and down distribution chains are starting to suffer from compressed profit margins. The housing market is beginning to show the pressure, too, as the May data for housing permits and starts missed investor expectations.

We don’t often make wholesale changes to our clients’ portfolios, and we aren’t doing so now. We invest in solid companies that can stand the test of time, and we are conscious of tax issues as well. But we do shift our positions to reflect both evolving fundamentals and valuations. A month ago, we had been anticipating sustained higher inflation with continued economic growth; today, we think the Fed’s new stance will stem inflation but cause a shallow recession.

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\(^3\) P/E ratios typically move in the opposite direction as interest rates. The inverse of a P/E is a company’s earnings yield, which is analogous to a bond’s coupon yield; when interest rates go up, so too do yields of risk assets, driving their prices down.
Against the backdrop of a slowing economy and increasingly cautious consumer sentiment, we have tipped more defensively in our stock selection. In our bond portfolios, we have upgraded our credit quality in anticipation of a weaker economy. These changes are at the margins; we know that our economic and market views may turn out to be off base, so we build resilience into every portfolio through a diversified selection of securities that will behave well in a range of economic outcomes. As always, patience and fortitude are the most valued attributes we seek today.

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