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Commerce Trust Market Brief with Scott Colbert
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Scott Colbert: Good morning. It's Tuesday, January 24th, and the markets have just opened. So far, we're off to a very robust and positive start to the financial markets for the year. The S&P 500 (Index) is up almost 4% year to date, and it's been a risk-on trade in general. Smaller cap stocks are outperforming large cap stocks. The Russell 2000 (Index) is up 6%. And when we move over to the international markets, large international stocks are up almost 7% and the emerging markets are up even more than 8%, driven particularly by the potential for the China reopening and the bottom of that stock market, which is up basically about 20% from the end of the quarter. Bonds also have participated in this rally. You might not believe that because short-term interest rates continue to rise, but intermediate and longer-term interest rates have actually fallen. The bond market is up nearly 3%, clawing back some of those large losses from last year so far, year to date.

So, what's driving all this financial market optimism? Well, clearly, it's a slowdown in the growth of inflation. The CPI (Consumer Price Index) peaked in June of last year at 9.1% on a year-over-year basis, and it's fallen already to 6.5%. And when you "ex out" (remove) food and energy out of the calculation, it's even fallen more. Now what's helping the inflationary rate fall as much as it is? Well, clearly, it's the decline in energy prices. We've seen oil prices go full circle. Prior to the beginning of the year in 2022, energy prices were about $80 a barrel for oil, and there's still just about $80 a barrel after having peaked at $125 a barrel. But behind that is a further improvement in natural gas prices. On average, natural gas prices both here and Europe are down about 50% from their average price during 2022.

So certainly, energy prices are helping pull inflation down. But beyond that, we also have cooling wage growth. Wages and salaries as measured by the Atlanta Fed Tracker, are down about 60 basis points from their peaks, and on an hourly earning basis, which is produced in every monthly employment report, wages and salaries have fallen about 1% now to about a 4.6% year-over-year pace. The Fed (Federal Reserve) would ideally like to see wages and salaries growing at about a 3.5% pace because they think with productivity, that's what generates about 2% inflation rate. And so, they'd still like to see some improvement, but nonetheless, there's been a large improvement already as wages and salaries have cooled. Now because inflation is cooling of course, this means that the Fed will not likely have to be as assertive as the market might have thought say, a half a year ago.

We expect the Federal Reserve to raise rates 25 basis points in February and no more than an additional 25 basis points as the year progresses. This, of course, will mean that short term rates went from last March of nearly zero to about 5%, and that's a large move on a relative basis. In fact, it's the fastest and largest Fed rate hiking process ever. This will lead to the slowdown and cooling of the economy. But the real question is, will it or won't it lead to a recession? In addition, financial market conditions remain very wide open. Credit spreads have actually declined so far this year along with the stock market rally, and the banking system is in tremendous shape with tremendous amounts of equity and very, very low charge-offs, which is atypical of what happens late in an economic cycle. In other words, the banks are in such a healthy mode, they're still extending credit at a relatively fast pace, and typically they have to pull back on this extension of credit late in an economic cycle, but they're in such good shape that they're still making loans.

And then finally, there's clearly the situation in Europe has improved materially with the lower energy prices. Recall that most of their inflation was driven by the Russian invasion of Ukraine and the spike in energy prices. As those have come down, it's quite possible that Europe avoids a recession. Add to that, the reopening in China, which is largely perceived to be deflationary and of course positive for growth in Europe and you can see how it's possible that both the United States and Europe avoid a recession this year.

Even with all of the initial positive start to the year though, there's still this overhang or worry that the markets do have because of basically two things. Number one, the yield curve remains inverted, and historically an inverted yield curve has almost always led to a recession. And secondly, even more gloomy in terms of the outlook for the next 12 months are that the leading economic indicators, 10 separate indicators, including that yield curve, are falling at a fairly rapid clip. In fact, just earlier this week, we saw that over the month of December, the leading economic indicators fell an additional 1%, and that means they're declining now on a year-over-year basis at about a 7 to 8% pace, which has also been a perfect indicator of a recession in general within 12 months. So, the big driver to the market this year is will we or won't we have a recession? And clearly there's a huge push and pull between the financial markets, which are rather optimistic at this point, and the leading economic indicators which are still falling.

So, we'll be back in a couple weeks to talk about how this tug of war is playing out as we work our way through this year.

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