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Five Minutes with Commerce Trust's Chief Economist – Scott Colbert
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Scott Colbert:

Good morning. It's Friday, April 8th. The markets are rebounding a little bit, as they have been for some time. But in general, all the stock markets are still down materially. They all began to decline last year sometime, the S&P was the last to hang on, peaked in January. Year to date, the S&P 500 is down 6%, small cap stocks are still down 12%, and emerging market and international stocks are still down 8%. Strangely enough, the bond market has had its worst performance ever for a quarter. It also is down 7%. So a balanced portfolio is likely be down somewhere between six, eight or 9%, depending upon how you have your stocks and your bonds allocate. What has driven this, of course, is a rise in short-term interest rates, as the Fed is embarked upon their interest rate hiking process.

The two-year treasury is up about 175 basis points. The 10-year treasury is up about 125 basis points. And basically across the entire interest rate spectrum, yields are somewhere between 2.5 and 2.7%. The return to the bond market, as measured by the Bloomberg Barclays Aggregate, is down 7% year to date. Now, the reason for all this, of course, is the surging (in) inflation, and this rise in interest rates puts pressures on stock prices. And the Federal Reserve has started to embark upon their interest rate hiking process. They are in the process of trying to get short-term cash rates, the so-called fed funds rate. And the fed funds rate, by the way, is the rate that a bank like Commerce, or Bank of America, or any other bank, can lend money to the Federal Reserve.

We have a checking account with the Federal Reserve, we can put money into it, they will pay us an interest rate. That interest rate right now is 1.5%. So they begin to raise that this year, and their target interest rate by the end of the year is somewhere between 2.5 and 3.5%. Let's call it about 3%. Let's let's assume that's where the cash rate ends at the end of the year. Well, what is a neutral fed funds rate? In other words, is 3% a neutral feds funds rate, or is it four, or five, or is it two?

The answer to that is nobody really knows, because the neutral rate is simply the rate that basically doesn't accelerate inflation any further, if inflation is at the target, but clearly inflation is not at the target. It's the rate that doesn't push the economy ahead further than it needs to grow, it doesn't push unemployment down. Over the long run since 1960 till today, so over that, and what is that? That's a 62-year time period, the average fed funds rate has been 4.9%. The average inflation rate has been 3.7%. So you'd say that the average fed funds rate has been about 1.2% higher than inflation. So I ask you, where do you think the neutral rate is for short-term cash? Well, as the Fed begins to raise rates, they hope to bring inflation down. So obviously, they hope to cross somewhere in the future.

I seriously doubt that inflation could be down to 3.5% by the end of the year. I think that they have to get short-term cash rates above whatever the trailing 12-month inflation rate to even approach whatever they considered be a neutral rate. And that's likely to happen sometime in 2023. And I think it's at a rate probably higher than 3%, but hopefully no higher than four or 5%, as they work their way into what they consider to be a neutral fed funds policy.

And then at some point in 2023, they're going to have to try and engineer, the Federal Reserve is going to have to try and engineer what you've heard is called a soft landing. Now, four times since 1960 the Fed has managed to engineer a soft landing when the economy's either been overheating, or the economy suddenly collapsed, and they've had to accommodate that. But in all those instances, the Fed had a couple things going for them. Number one, inflation had just barely moved up a bit. And in fact, in all cases, less than a surge from 3% from its trough to its peak, and the unemployment rate continued to decline. This time they confront a much more difficult situation with inflation having surged from 0%, essentially, to 7.9%. And of course, an unemployment rate that's near an all time low.

So let's just say historically (while) the Fed has never been able to engineer a soft landing trying to confront this type of inflationary surge. They can, if in fact, they can bring inflation down and unemployment doesn't grow very much at all. This isn't likely to happen, this potential recession is almost an impossible, impossibility to happen this year. It's out there somewhere after 2023. The average recovery only lasts seven and a half years anyway, since 1960. We are two years into this recovery, so that would tell you that on average, we only had five and a half years left to go. But it's a very delicate maneuver. The Fed is going to have to engineer and pull off in order to soft land this economy, and not pushes into a recession earlier than the average recovery.

So rather obviously, it's going to be a pretty tough transitional time for the financial markets going forward. As such, there's going to be a lot of rebalancing to do. And clearly we're going to want to approach this from the cautionary side, rather than the assertive or aggressive side. And as usual, we'll be back in a few weeks to talk about how things are progressing.

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