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

Good afternoon, it's Wednesday, May 25th, and the markets have closed. So far, the S&P 500 is down about 16.5% year to date. The Dow has been the big winner with less technology and more value orientation only down 11%. Small cap stocks and tech stocks are down about 20%, but small cap stocks and tech stocks peaked back in November, and from their highs are down almost 30% now from their peak-to-trough.

Basically, the key question that we're getting here at Commerce Trust is "When will the stock market bottom and what are you looking for to see that a bottom is in place?" To answer that question, we have to go back to the beginning of the year and say what was the market set up for and what expectations weren't met that drove stock prices materially lower?

We would say there were probably five things that the market was expecting that didn't happen and we're disappointed. Number one of course, most people didn't expect the Fed to begin to raise rates even until June, and then it was going to be a gradual rate adjustment thereafter. They really didn't expect that Russia would have a full-on invasion of Ukraine even though the troops were massing at the border. There were bottlenecks but they were beginning to clear in the economy. We were expecting inflation to peak probably earlier at a lower level than it actually did. And there was absolutely no thought of a recession. We were about two years into an economic recovery with still a lot of stimulus momentum, job growth and forward progress yet to be made both here and around the world.

Looking back on it of course, we know that this hasn't quite worked out, primarily driven by the Russian situation and of course surging inflation. The Fed basically is going to be driving short term cash rates up more than twice what the market expected. The Russian invasion of Ukraine has created sanctions, additional bottlenecks and has been much more disruptive than the previous incursion that Russia had in Ukrainian territory back in 2014. Inflation has taken a while to peak. We think that it's probably peaked in late April here early May, but we don't know for sure, and it certainly was at a much higher level than the market expected. And then finally, while there was absolutely no thought of a recession to begin the year despite the fact the market thought that the Fed would be taking some of the punch bowl away and raising rates and that things would slow. We were only into essentially the second year of a strong economic recovery, and there was still marked expectation for forward progress. Certainly, today those recessionary fears have increased.

So, what is it going to take to help us find a stock market bottom? I think the first thing we have to recognize is will there or won't there be a recession? If there is a recession, on average the S&P 500 is down about 35% into a recession, but it's important to note that the stock market tends to predict two recessions for every one that occurs. When they're wrong about the recession the bottom is typically down around somewhere about 25%. Of course, we've mentioned that we're down about 20% so far peak-to-trough on the S&P 500. So, if we are correct in our thought that there is no recession on the horizon then we're much, much closer to a stock market bottom.

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Why are we so certain that there's no recession on the horizon? Probably three things. Number one, the leading economic indicators are still growing on a year-over-year basis. It's important to note that the stock market is one of those leading economic indicators, but it's often psychologically driven, and we think missing the point this time. Number two, the yield curve is still exceptionally steep. Short term cash rates are 1%, 10-year Treasuries are 2.75%. The yield curve is a near perfect indicator of a recession, but we're nowhere near inverted yet. And the number three thing would be when we grow jobs in this country we don't tend to go backwards, and job growth has still been very, very strong. Now, if you tell me by July or August that we're actually firing people and the net job gains are actually negative then I will tell you we're wrong about our recessionary fears. The stock market typically smells or sniffs out a recession six months prior to recession. That would tell you that we're very, very close to the start of the recession, and we really don't see that in the economy right now.

So, what is it going to take to bottom the stock market? Probably three simple things. 1) The market has to overestimate how high short-term rates are going to go. The market's estimate right now is about 3.25–3.5% as being the peak short-term cash rate. I don't really know whether that's going to be too high or too low, but we're working our way towards getting at least a reasonable discount rate that we can then undershoot in the sense that the market, or that the Federal Reserve may not have to raise rates quite as high. 2) The market has to be overly pessimistic about inflation. The market still largely underestimates the inflationary statistics. For example, the last one that came out, the last inflationary print was 8.3%, the market was only expecting 8.1%, so that basically has to reverse. 3) And then finally, I think the market has to come to the conclusion that there really is no recession as opposed to being more like 30 to 40 to 50% certain that there's probably a recession on the horizon. When those three things are in place, I think we can find ourselves a stock market bottom.

All this is very fluid, it's quickly moving, and we'll be back in a couple weeks to discuss how the market has changed its thought process.

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