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Five Minutes with Commerce Trust's Chief Economist – Scott Colbert
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Good morning. It's Tuesday, June 28th. The markets are open, and they have a positive tone today as they've had for the past week. As we sit here on a year-to-date basis, the S&P 500, though, is still down about 16.5%. And that's almost the same for almost any other major market index. For example, the international large cap indexes are down about 16-17% and even emerging market stocks are down about 16-17%. You might have hoped that a balanced portfolio would be doing a bit better because it had bonds, but of course, bonds this year have had a tough year, as well as interest rates have moved up materially. The average bond fund is still down around 9-10% as well. So, a typical balanced portfolio that might have something like 60% stocks and 40% bonds is likely to be down in the 12 or 13 or 14% range so far on a year-to-date basis.

Now this has all primarily been driven by the higher interest rate environment that we're confronting. Of course, the federal reserve has raised interest rates from basically zero to almost one in three quarter percent as the year has progressed. And the average 10-year treasury rate last year in 2021 was about 1.42%. And of course, today, 10-year treasury rates are just above 3% or more than double from where they were last year. And so largely most of the adjustment in stock prices and bond prices is simply the mathematical result of a higher interest rate environment. Unfortunately, we're also cooling, the economy clearly is cooling, growth in the first quarter was negative and growth in the second quarter is likely to be barely positive. As nominal growth, top line growth, has cooled from about 11.8% in 2021 to something closer to 8% and probably falling towards something like a 6%, 7% pace as we end the year. And of course, it's being pinched by higher and higher inflation. The CPI [Consumer Price Index] now on a trailing 12-month basis is 8.6%, up from 8.3% the last time we might have talked.

So, what is Commerce Bank and Commerce Trust trying to do to adjust to this kind of changing market? Well, the first thing we believe is that obviously as interest rates have risen and as the economy cools and as inflation has remained stickier and stickier, the probability of a recession out there somewhere in the future has begun to increase. As such, typically in a recession, a stock portfolio will fall 34% or 35%. And of course, I just mentioned the S&P 500 is only down 16% or 17%. So, what we're trying to do is take some risk out of the portfolio to the extent that the probability of a recession is likely building.

How are we taking those risks out of the portfolio? Well, we're trying to reduce the average balanced portfolio. We're trying to take a bit from the stock side and move it into the cash. We're making all this into the strength of the recent market build up. In other words, we're making these trades with the

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recent stock market bounce back. So, most of our portfolios are likely to see some cash by the end of the quarter. On the bond side, we remain short duration, which of course is defensive as interest rates rise, shorter maturity portfolios tend to do better. And then most significantly we are reducing the amount of high yield exposure the average client might have in their portfolio. In some cases, we're even taking it down to 0%, other clients want to have some exposure. So, it just kind of depends on a client-by-client basis. But nonetheless, you can see that we're clearly taking some risk out of the portfolio on the bond side, by reducing this high yield exposure. What are we doing with those proceeds? We're actually putting them into a short-term Treasuries, and just trying to batten down the hatches of your portfolio, to the extent that there's a probable or possible recession out there.

Now we could be wrong about the probabilities of recession rising. The market could be wrong about a recession entirely and we certainly don't see the recession in the near term because number one, short term rates are still much lower than long term rates. Number two, the leading economic indicators are still increasing, but they're increasing at a slower and slower pace. And clearly, the biggest element that helps us remain optimistic is that we continue to create jobs. And historically, until we begin to fire people or actually lose employment, we haven't historically had recessions.

But all of this is tough on the equity markets and that's why we are taking some of the risk off the table right now and selling back into some strength as the market bounces off of its near-term bear market bottom. We'll be back in a couple weeks to discuss these changes that have all been implemented in June, how this has adjusted to your portfolio, and of course the changing market as it accrues.

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