Five Minutes with Commerce Trust's Chief Economist – Scott Colbert
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Scott Colbert: Good morning. It's Tuesday, July 5th. We thought we would take the time here to recap the market's first half and talk about our outlook for the second half. Clearly stock prices are down basically 20%. S&P 500's down about 20%. International emerging stocks down a little bit less than that. Small cap stocks down a little bit more than that. The bond market, fortunately, is only down half what stocks are. The Bloomberg aggregate, the broadest measure of bond prices is down about 9.8% so far. Year to date, municipal bonds have fared just a touch better.

And of course, commodity prices have surged over the course of the year, peaking sometime in April to May, and they've begun to move down ever so slightly. What has driven the markets lower this year? Well, clearly, it's the surge in inflation. It's the Fed's reaction to that surge in inflation as they begin to raise short term rates. And it's the fear of a probable recession that has begun to increase. Is there a possibility of a soft landing? Absolutely, but historically, the market knows that any time the Fed has had to try and fight a 4% inflation surge or try and soft land the economy when the unemployment rate was already lower than 4%, they haven't been able to do that successfully.

And of course, if there's a recession, and we've mentioned this several times, the stock market isn't down on average, just 20%, it's down closer to 35%. Credit spreads tend to widen, high yield securities underperform, and the only safety is generally treasury bonds. And we have seen a small flight to safety as treasury interest rates peaked not too terribly long ago and have come down quite a bit since their highs in June. What's it going to take to bottom this stock market and allow us to make some forward progress over the second half of the year? Clearly inflation has to begin to wane.

Top line inflation, as measured by the CPI is peaked so far at 8.6% up from 5%, just a year ago. Unfortunately, on July 13th, when we get the next inflation report, we're likely to even see higher inflation. It's possible that it's 8.7% or 8.8%, so that broad measure isn't giving the market much hope. But when you take a step back, there are some positive signs. When you look at the core personal consumption expenditure, the inflation rate that the Fed thinks is the best and broadest measure of inflation in the economy, it peaked at 5.3% and is down to 4.7%.

And even those commodities that have been pushing prices up and up and up, have begun to show some signs of moving down. The Commodity Research Bureau's broadest measure of commodities are down about eight and a half percent from their peaks in May. When you look solely at industrial products, they're down about 11%. Copper, one of the bleeding edge indicators of economic activity has fallen almost 30%. And this might surprise some of you, but energy prices peaked at $120 a barrel for domestic oil here, West Texas intermediate, and those are down to $99 a barrel.

As we sit here today, you've probably noticed some decline in the gas prices. The market also has to overestimate how assertive the Fed is going to be. And we're going to have to get some sort of signal from the Federal Reserve that they're not going to be as tough as the market expects them to be. The Federal Reserve begins to indicate that they might not have to take rates up that much, then there's the possibility that stocks can bottom. And of course, the market has to start to just reduce its overall probability of a recession.

The latest largest survey of 49 economists, 70% of them expect a recession sometime next year. One of them expects a recession this year. Is there any good news in all of this? Well, clearly the biggest and most positive news that our country has is that employment still continues to grow. We're still down 800,000 jobs from the previous peak in employment. And even though the unemployment rate is at 3.6%, we're slowly pulling people back to work. And in fact, this Friday, we're going to get an employment report. It's expected to be positive 200,000 to 250,000 jobs. And even the unemployment rate might decline.

There are still a tremendous amount of job openings. There are 11.4 million job openings, which is about 4 to 5 million more job openings than there were prior to the pandemic. We've talked about the possibility that inflation will begin to roll over that top line, ugly 8.6% number still very sticky in people's minds, but we might see a fairly rapid rollover. Valuations in the stock market are much, much better, and they're better in the bond market, of course, too, as interest rates have risen, the PE on the market is down to about 16. It was more than 20 at the beginning of the year.

And the longer term cyclically adjusted PE ratio that Shiller is so famous for has come down materially suggesting that 10 year returns to the market, while very anemic at the beginning of the year, have improved materially somewhere in that two and a half to 8% range over the next 10 years. So valuations are much better. And of course, when things look the worst, they can also start to break positively. We saw that of course, with COVID. The very quick reaction to that. Supply lines seem to be improving. The stock of chips over in Korea seems to be growing.

The Russian war in Ukraine, of course, is still weighing on the markets, but even that can begin to normalize and perhaps allow us to make some type of forward progress. And of course, the stock market can bottom, all of a sudden. It has broken through this down 20%, twice already and bounced off the bottom. But essentially, we're going to have to see the probabilities of a recession begin to decline to basically try and find this stock market bottom, as it's possible, that things break on the positive side. Now, there's a lot to unwind over the second half of the year, and we'll be back as events unfold to talk to you about it.