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

Hello, everybody. It's Wednesday, July 20th. The markets are open. Fairly mixed today, not really up or not much down. You've probably noticed that months to date, the stock market is rebounded. The S&P 500 is up 4%. Of course, stocks were down materially for the first half of the year, the S&P 500 down about 20%. Now, of course, we're sitting here today and it's down about 16%. Interest rates have plateaued. They peaked out at about three and a half percent on the 10-year Treasury. They've come down to 3%, but bonds returns are still down about 10% on a year-to-date basis. Municipal bonds have fared better, down about 8(%).

With the recent bounce back in the market, the key question we're getting from our clients is, is this the calm before the storm or is this the start of some material rebound in financial assets? To answer that, we essentially are kind of putting probabilities on three different economic scenarios. Number one, and the best one for financial assets would be for the Fed to engineer a so-called soft landing. Now, a soft landing is pretty tough. We know historically they have not been able to do it.

When I say they, the Federal Reserve has not been able to engineer a soft landing when either you've had an inflation surge above 4%, or you start with a less than 4% unemployment rate. So, what needs to break in the right direction to find a soft landing? Number one, inflation needs to roll over fairly significantly in the back half of the year. Can it? We'll see. We definitely think it will begin to decline, but we'll roll over aggressively, assertively, we'll find out. The Fed would probably have to pause or indicate that it's going to pause somewhere in its interest rate hiking process before it gets to the year end.

Right now, the markets are betting that the Fed will take interest rates from about 1.75(%) today to about 3.5% at the end of the year. So effectively, the Fed would basically have to tell us they're probably not going to push us towards 3.5% to get this soft landing. We certainly have to see continued employment growth, and we think that's quite possible that while there's a slowdown in employment, we continue to get employment growth. And then finally, we would need to see some re-steepening of the curve.

And you might say, boy, why would you want the 10-year Treasury to go up? Well, basically the 10-year Treasury is reacting to the economic outlook. To the extent that things look worse and worse, the 10-year Treasury is rallying and coming down in yield. And to the extent that things look better and better, the 10-year Treasury is gradually rising to basically slow the economy down, but not slow the economy down so much that it pushes it into a recession. So, that'll be a soft landing. What are the odds of that? Like I said, the Fed has never been able to do it in the past.

It's quite possible that it can. Everything this time seems to be different than the last time, but we put that possibility or probability at about 25%. Could there be a hard landing? Which would be a near term disaster for financial assets because as we said, in a recession, stocks fall 35% on average, not just the 16% that they're down so far. So basically, a doubling of the losses. Well, we're about to get our second quarter GDP print. It's likely to be negative. We'll have had two consecutive negative quarters of growth.

But to have a hard landing, you're going to have to have no rollover in. I think that's entirely unlikely. Clearly, the commodity price indexes are down. You've seen gas prices decline, used car prices for four consecutive months are down, housing prices, while continuing to rise, affordability issues are pushing back on new purchases. So, we find it very difficult to believe that inflation won't begin to roll over, at least somewhat. The Fed would have to be even more assertive probably than they currently are, indeed indicate that they're going to have to raise rates more than the market indicates.

And finally, we need to see job losses and we need to see them now, if we're going to have a near term recession. We don't find the probability on any of this to be very high at all, and we put the probability of a very, very near-term recession in very low, zero to kind of 10%. The most likely outcome, of course, is that there's a recession somewhere down the road, but not just yet. The yield curve with the 2-year Treasury just somewhat inverted to the 10-year Treasury typically tells us that a recession on average is down there, but it's 18 months away.

We'd have to see job losses eventually. But right now, we've told you we don't really see any of those. We'd have to see stickier inflation than the Fed wants, but some rollover in inflation, and I think that's probably the most likely scenario. There's a lot of parts to core inflation that are likely to remain sticky. Even if we start to get energy prices to break the right way, even if some of the bottlenecks get better, the biggest component in the CPI is housing. Housing costs get absorbed with a lag into the CPI. And of course, we all know that housing, in fact, just today, we got the medium price of a home at a record high.

It's up about 40% from where it was three years ago. And that increase in home prices have barely been absorbed yet by the CPI. And then finally, eventually, ultimately, we need to see the unemployment rate rise. Near term with job openings at 11.3 million job openings and new entrants into the unemployment lines of only about 240,000 people per week are exceptionally low numbers of newly unemployed and it's a high number of job openings, this number, these two need to compress and compress and compress, and that clearly will take some time.

So, I think that the probability of soft landing: that's a tough one. Hard landing near term, almost impossible to see that, but a recession on the horizon. As such, if the highest probability is an eventual recession, financial stocks don't do terribly well into recessions, we're likely to continue to get more defensive. The two key defensive measures that we're likely to take are to begin to push back on our overweight devalue stocks and move them back towards growth stocks because growth stocks typically do better in a recession.

And of course, the biggest thing we can do is to push down some of our stock allocation and push it back towards bonds, which are behaving much more like bonds used to behave. That is an asset that defends you into a recession as opposed to what they've done so far this year, which is increase or basically decrease in value as interest rates have risen. Now there's a lot to unpack here. The Federal Reserve will be meeting here in one week and we'll be back in a week or two to talk about all the changes that are going on.

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