Commerce Trust Company
Wealth | Investments | Planning

Five Minutes with Commerce Trust's Chief Economist – Scott Colbert
08/03/2022

Scott Colbert: Good morning. It's August 3rd. The markets are open. Stocks are up today, and interest rates are up just a touch. Stocks continuing with the rebound that basically started in mid-June, and the bond market continues to do a bit better materially since mid-June.

What is really driving this rather strong rebound that we've had in financial assets? The S&P 500 in its bottom, including dividends, was down 22.5% this year. And as we sit here today, it's only down... I say, only... down 13.5%. It's recovered 40% of its losses.

Well, the big rebound has largely come from basically a cooling in inflation expectations. And where is that all coming from? Well, number one, commodity prices have begun to roll over, the broadest measure of commodity prices, the Goldman Sachs commodities index, is down about 19% from its peaks. And of course, we've all seen it in the energy market with gas prices, in general, over $5 a gallon, and now in many places, less than $4 a gallon. The price of a barrel of oil has fallen from basically $122 high this year to about a $91 or $92 price per barrel, as we sit here today. So, the cooling of inflation expectations is basically the start of the market's recovery.

Secondly, earnings for the S&P 500 have come in stronger than expectations. There was a lot of worry and angst about earnings in the second quarter, mostly because of course, rising commodity prices, rising labor costs, and a strong dollar were likely to pinch earnings. And they did certainly, and companies lowered their expectations, but still more than two thirds of companies are beating their expectations, which is better than average. And we've had about 51% of companies report. So, the earnings have helped rebound the market materially.

Probably the biggest, most recent driver to the rebound in the stock market was the Powell Federal Reserve conference post the most recent Federal Open Market Committee meeting. Chairman Powell walked an exceptionally fine line between being an inflation hawk, where inflation is still job one. And the Fed is intent to bring core inflation down from its current 4.8% pace to something less than 2(%). If you're interested, average inflation since 2000 has been about 2%, and so this is why the Fed wants to bring it down to this 2% range. But basically, Powell was able to suggest that there is a modest opening for a soft landing down the road where inflation can continue to cool, and the Fed would not have to raise rates high enough to push us into a recession.

As such, we know that financial assets don't do very well in recessions. And even at this point, now that they're only down about 12 or 13% on the stock side and only down about 8% on the bond side, we are taking this opportunity, or this relief rally, to basically reduce some of our risk exposures. And in general, you will find that most of the portfolios that we're managing are now underweight stocks.

Of course, we've also been, as the year progressing, improving bond market quality. And you'll find that most of our portfolios have very little exposure to high yield or emerging market or basically what we would consider the more credit-sensitive markets and basically want to reduce those types of exposure. And we are still running bond durations of about 85% that of the market. In other words, we still don't have as much sensitivity to the interest rate rise as the market has. Those three key things are what has created basically a rather defensive situation for a market that still has yet to adjust to whether or not we won't end up in a recession.

Now, of course, we've talked about this for quite some time. We are quite clear that we are not currently in a recession. We don't have recessions when we're growing jobs. We do view the probability and possibility of recession continue to grow, but it's still out there somewhere on the distance, but we're taking this as basically a bear market rally to reduce risks, take advantage of this bounce back in returns to basically set portfolios up for what's likely to continue to be a fairly rocky ride as the Fed raises interest rates. Between now and the end of the year, there are still three Fed meetings. The market's expectations, they're kind of torn between 50- or 75-basis points at the next meeting, but between all three of them, the market's average expectation is to put short-term interest rates at 3.5%.

With the 10-year Treasury clearly right now at about 2.8%, if it doesn't continue to move up along with those shorter-term interest rate hikes, that only inverts the curve further, adding to the likely probability of a recession. Now, of course, we don't know exactly how this will play out as the year progresses, but we think it's much more important to play this from a defensive side rather than an offensive side. And we'll be back in a couple of weeks to talk about how the markets are adjusting to all of the recent news.

Commerce Trust Company
Wealth | Investments | Planning

invest, you should inform yourself and be aware of the risks. The risk of loss from investing in securities and other investments can be substantial. You should consider whether investments entered into directly by you or on a discretionary managed basis through Commerce Trust Company or elsewhere are appropriate for you in light of your investment objectives, financial circumstances, tax status, your tolerance to risk, investment time horizon, and your investment experience. Past performance is no guarantee of future results, and any opinions and other information in the commentary provided as of this date are subject to change. Diversification does not guarantee a profit or protect against all risk. Markets, economic forecast and aspects of specific investments can change from time to time based on a variety of individual interrelated or complex factors.

This disclosure statement cannot present all the risks and other significant aspects of investments, economies, or markets in which you may elect to transact from time to time. You should therefore carefully study investment arrangements in advance of making decisions about investing. Providing this information, which may be a value to you, or others does not detract from an investor's responsibility to take all such steps and make all such inquiries as may be necessary to ensure a full understanding and familiarity with any potential future investment. If you are in doubt about the risks involved in trading or investment arrangements or have not understood any aspect of this risk disclosure statement, you should seek independent professional advice. Please also note that Commerce does not offer tax, legal or specific estate planning advice. And while we may provide information or express general opinions from time to time, such information or opinions are not offered as professional tax or legal advice.

August 3, 2022
Commerce Trust Company is a division of Commerce Bank.