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Commerce Trust Market Brief with Scott Colbert
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Scott Colbert:

Good morning. It's Monday, October 24th and the markets are open. We thought we would touch on four topics today, 1) where the markets are on a year-to-date basis, 2) how the economy has behaved so far this year for the first three quarters, 3) the outlook for the economy next year, and the growing odds of a recession, 4) and then finally touch on the midterm elections and their possible implication and impact to the financial markets.

In terms of the markets so far, the S&P 500 year-to-date is down just a little bit more than 20%. International developed stocks are down about 25%. Emerging market stocks are down almost the same.

Parts of the market that have done better than average are fairly narrow. Energy, the biggest, positive contributor, the XLE SPDR, which is comprised of course, of our largest energy companies, are up almost, it's hard to believe, 60%. Master limited partnerships, which are the pipelines that push the oil around this country, are up about 30%. Value stocks have outperformed growth stocks. The growth stock index is down almost 30% and the NASDAQ is down about 30%, whereas value stocks are only down about 15 or 16%.

And of course, shorter bonds have done better than longer term bonds. If you took three-to-seven-year treasuries, they're down about 10% year-to-date. If you just move out the curve a little bit and take seven-to-10-year treasuries, they're down almost 18% year-to-date. It's quite likely when you open up your portfolios as of 9/30, that you're down at least 15%, and probably close to 20% year-to-date on average.

In terms of the economy, there's no doubt we've been cooling. The first two quarters growth this year was barely negative. Third quarter growth that will be reported this week, is likely to be relatively positive. And on a cumulative basis, it's important to remember that on a trailing one-year basis, nominal growth was more than 9%. And real growth, when you adjust for inflation, is still positive. So, to the extent that you might have heard that we're in a recession, we don't find that to be likely.

Going forward however, while growth has been cooling over the first half of the year, we think it's likely to cool even further next year. Most economists' forecasts are now probably more than 50/50 for a recession next year. The two key drivers that are bringing economists to this conclusion include the leading economic indicators, which are now deeply negative on a sixmonth annualized basis, and of course now, negative even on a year over year basis. And this continued so-called, inversion of the yield curve, where short term treasury rates are higher than long-term treasury rates.

When we look back, say go back to 1980, the leading economic indicators, when they go negative on a year over year basis, have almost always indicated there was a recession going forward. But twice the leading economic indicators went barely negative in 1996, during basically the run up to the long-term capital crisis and the Russian default, as well as in 2016 when we had the peripheral debt crisis in Europe. So, I would suggest that the leading economic indicators have been very good. But they've also called two recessions perhaps out of the last five, that didn't actually occur.

More troubling, of course, is just simply that the yield curve remains inverted. The two-year Treasury is at four and a half percent. The 10-year Treasury is at 4.1%. Since World War II, the last eight recessions we've had, this has been a perfect indicator of a recession with about an 18-month lead time. The two-year Treasury went higher than the 10-year Treasury in early July, and so you add 18 months to early July. And you could see easily how the average person might think that we'd be in a recession sometime next year or at least by the end of the year.

Even if we have a recession, we think this is likely to be a fairly moderate recession, much like the recession in 1990 during the first Iraq War, or 2000 when we took an economic hit. Largely because the banks and financial system are in such good shape and the average consumer's in pretty good shape. And corporate America is in very, very good shape, with healthy earnings. It will take quite a bit to slow this economy down, and because this won't be a financial recession or a leverage recession where basically borrowings are imploding, we think it's likely to be a more-mild recession than not.

Finally, of course, we have elections coming up, the midterm elections on November 8th. And many of our clients are asking, "What will the likely implication of either a Democratic win or Republican win do to their portfolios?" The good news is, in the long run, it doesn't seem to matter a heck of a lot. Under Democratic administrations and Republican administrations since the end of World War II, the returns to the market have been almost identical. We do find though, that either a split house or a Republican legislator versus a Democratic administration have generally resulted in higher market returns than not. The worst returns are when one party is in control of both the administration and the legislative bodies.

There are some both cyclical and secular reasons to basically maintain the course. Number one, markets tend to bottom more than not in October. And the most positive seasonals to the market are October through May. Secondly, the year after a midterm election, the last 19 times we've had a mid-year election, the markets have actually been up, in all 19 of those years. And third, Goldman Sachs has a very nice piece out that shows you how difficult it is to time the markets.

When the S&P 500 has fallen 25% – and it's done that eight times since World War II – on average, one year later, the market is up 27%, and was up seven out of eight times. So, we'll be back in a couple of weeks to update you on where the financial markets are, any impacts that the midterm elections might have had, most importantly how all this is factoring into our investment outlook.

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Commerce Trust is a division of Commerce Bank.