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Commerce Trust Market Brief with Scott Colbert
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Scott Colbert: Good morning. It's Monday, December 5th, and the markets are open. I think everyone's noticed that there has been a large rally in risk assets. The S&P 500 has recouped about half of its losses for the year, up about 14% since early October. Emerging markets and international stocks have fallen [followed] suit as COVID restrictions have eased in China, helping drive emerging markets up 14.7% from their bottom, and international stocks have performed in lockstep, plus they've had the additional help of a falling U.S. dollar. Credit spreads have also improved, falling about 25 basis points from their wides in the year. And this of course, with falling interest rates, has helped drive bond market returns up. Still deeply negative on the year, but much better than their lows towards the end of September.

Now this rally across the board in all risk assets has pretty much been driven simply by four things. The number one and biggest item that's helped drive stock and bond prices higher has been cooling inflation, and cooling inflation that's cooled faster than the market's expectation. Top line inflation was 9.1% in June. It's fallen to 7.7% and expected to fall in the range of 7.2 or 7.3% by mid-December. So that's a whopping 140 to 170 basis point (bps) drop in top line inflation, driven primarily by energy prices and of course some falling goods prices. More importantly though, when you X food and energy out, and that's what like the Fed likes to do because they don't really control energy costs and they don't think they have much to do with controlling food costs either. Core inflation has fallen either as measured by the CPI, or the Fed's preferred measure, core PCE, or personal consumption expenditures. And in fact, core PCE peaked at 5.4% early in the year and is now down to 5%. So, the Fed would tell you they probably made about 40 bps of positive improvement or lowering inflation as the year has progressed.

Secondly, of course, we still have a growing economy. The third quarter GDP offset the slightly weak negative first two quarters. There are a lot of folks concerned that we were already in a recession. We of course had suggested that we really weren't. In fact, while the economy isn't up much this year, adjusted for inflation, it's still positive, and of course it's also growing on a positive basis in the fourth quarter.

Now the third thing is that because inflation is cooled, the expectations for short-term rate hikes have also declined. The market used to think that the peak Fed Funds Rate would be about five and a quarter percent in June, and that's come down a full 25 bps since we last talked. And Chairman Powell helped confirm a little bit of this slowdown, or at least reduction in the interest rate hiking process when he suggested last week that they're likely to slow the rate hiking process in December, and the market has moved to a 50-bps rate hike in December from an original 75 bps thought. That will still take short term rates though up to four and a half percent by the end of the year.

Finally, the midterm elections have come and gone, and while the Republicans of course were disappointed in their showing, a split Congress is generally favorable to the markets. Less legislation is basically more of the same, and the markets prefer a stable outlook rather than one where legislative priorities are relatively uncertain.

Now, that still doesn't mean that next year is all roses. Clearly the forward indicators still point to a recession. The leading economic indicator is down 2.7% on a year over year basis, and on a six-month rate of change basis, it's falling as bad as it did in early 2000 and late 2007. Both harbingers of a recession.

Why is the market so nonplused, if you will, about a potential recession for next year? Well, I think it's largely an optimistic outlook that there's still some small chance for a soft landing. The reason for that small chance for a soft landing is that job growth continues to remain very, very firm. We've grown jobs this year by four million, which is an increase in the total labor force by about 2.9%. Add to that the fact that most people are getting about a 5% wage increase and that's almost 8% more money moving through the economy.

We're just not sure how much the higher interest rate level will bite and slow growth next year. Now, we know historically the Fed has had a very, very tough time, soft landing the economy under even the best of circumstances. And they've never managed this softly on the economy when they had to fight an inflationary surge that was over 4%, or frankly, after they were after they pushed rates up by 4%. But that doesn't mean a soft landing is not out of the question. And that's what this equity market and risk rally are basically looking forward to.

Now, we're about to bring our forward thoughts together in an outlook for next year with our financial and economic outlook. It'll go into publication about mid-month, and you should be receiving it either in hard copy or via email. And we'll be back next time to talk and review our prognosis for next year.

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