Commerce Trust Market Brief with Scott Colbert
10/30/2023

Scott Colbert: Good morning. It's Monday, October 30th, the markets are open and trending higher. So far this year, the S&P 500 (Index) is up 8.66%, but that masks what the average stock is doing. Value stocks are down on a year-to-date (YTD) basis, the average S&P 500 stock is down on a YTD basis, small cap stocks are down, emerging market stocks are down, and large cap international stocks are positive, but not positive by a heck of a lot. Even bonds aren't helping your portfolio down about 2.5% as measured by the Bloomberg aggregate, and muni (municipal) bonds are down a similar amount.

Let's talk a little bit about stock prices and interest rates. It's been an interesting year because most of the returns in the stock market accrued over the first seven months, while the 10-year Treasury was relatively unchanged. For the first seven months of the year, the S&P 500 was up more than 20%, but in the last three months, it's given back more than half of those gains. Why is that? We think primarily it's because of the change in interest rates. The 10-year Treasury started out the year at 3.87%, was still less than 4% by July 31st, but in the last three months, the 10-year Treasury has moved basically from about 4% to almost 5%, or an increase of over 1% in yields. You say, "But 1% doesn't sound all that much." I want you to think about the difference between a million dollars earning less than $40,000 a year, and today, with risk-free rates having risen to where they are, a million dollars now earns almost $48,000 to $49,000 a year, creating quite a bit of competition for the stock market.

We mentioned that third quarter growth (Gross Domestic Product, or GDP) was exceptionally strong. As first reported, growth increased in the U.S. at a 4.9% pace. That's a real pace adjusted for inflation. That's about 2.5 times faster than the first half (of 2023) —growth rate of about 2% or 2.1%. Driving this growth is basically good old-fashioned consumption, with consumption growing at 3.9% pace, but was also added to with an inventory accumulation that isn't likely to be repeated in the fourth quarter.

Driving this real growth though, in addition to just nominal spending, was a lowering in inflation. The Fed's (Federal Reserve) favorite measure of inflation was just reported, and core PCE (Personal Consumption Expenditures Prices Index) for the third quarter was reported to continue to fall. In fact, on a trailing six-month basis now, core PCE is down to 2.8%. The Fed's favorite measure, on a trailing 12-month basis, it's 3.7%. Both of those numbers are materially lower than the start at the beginning of the year, and quite a bit lower than their highs reported back in 2022. Clearly boosting growth has been this fall or rollover in inflation. There's one other part that we don't talk about a lot that's also boosting growth, and it's deficit spending.

I'd like to talk a little bit about deficit spending, which accelerated materially last year from the previous year. When we talk about growth, it's hard to separate actual growth from deficit spending. Nominal growth, as measured by total GDP output, has increased basically from about $21.3 trillion, during the year of the pandemic (2020), to $27 trillion today. Underneath that, of course, has been a growing budget deficit. On average, per year, each year was pushed forward by about 9.3% deficit spending, with cumulative deficit spending over the last four years approaching $9 trillion. Of course, this is relative to about $96 trillion of total cumulative economic growth. Another way to say this is basically if it weren't for deficit spending, growth would have been 9.3% per year slower than it was. Now, it's not unexpected that we'd have deficit spending during the pandemic, but of course, it was the highest amount of deficit spending we've ever had.

When we compare this to the subprime crisis (2007-2010), relative to the size of the country or relative to GDP, it was about 33% more deficit spending. I don't want to get carried away with the deficit and the nominal amounts because they are kind of scary. The biggest worry, though, with regard to our deficits, though, is the increase in interest expense that is likely to come along with it. Interest expense two years ago, to manage the entire budget when interest rates were nearly zero, was only $440 billion. Last year, it was $660 billion. It's projected this year to be closer to $880 billion.

Ultimately, this begins to crowd out domestic spending. Of course, it likely means that budget deficit spending can't continue at this pace. It's also our strongest argument probably going forward — other than the fact that the Fed has been raising interest rates— to suggest that the economy is likely to cool next year.

Finally, there's going to be a great deal of economic data to digest this month. We're going to get home prices on Tuesday (Oct.31). The Federal Reserve meets on Wednesday (Nov. 1). On Thursday (Nov. 2), we're going to get the Institute for Supply Management's manufacturing and service side indexes, which are very coincident indicators of economic activity and have been cooling lately. Most importantly on Friday (Nov.3), we're going to get the jobs report. Recall last month, jobs surprised on the upside, with a strong 336,000 job report. Everybody is expecting that job growth to cool, but if it doesn't cool, that likely raises the probability of an eventual increase in interest rates at some point, perhaps in December or January of next year.

We'll be back in a couple of weeks to talk about all this economic data, and how it's impacting your investment portfolios.

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