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Commerce Trust Market Brief with Scott Colbert
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Scott Colbert: Good morning. It's March 7th and the markets are open. Today, the markets are digesting. Federal Reserve (Fed) Chairman Jerome Powell's testimony in front of the Senate. I thought it might take some time to digest exactly what the Federal Reserve told the U.S. Senate and to take it apart and see what it likely means for the financial markets.

Number one, we heard from the Fed today that although inflation has been moderating, the progress towards 2% (the Fed's long-held inflationary target) has a long way to go. Now, this surprised the market a little bit because, you know, inflation had been decelerating pretty considerably in the back half of the year. In fact, the CPI (consumer price index) had fallen from 9.1% to basically 6.4%, making good progress. But the Fed was probably focused more on this thing called core personal consumption expenditure, which had fallen from about a peak of 5.4% to 4.4% by the end of the year. In other words, the Fed felt that they had made about 100 basis points of progress on their inflation on their favorite inflation measure. Unfortunately, in January, this measure reversed a bit, and trailing 12-month inflation, as the Fed likes to measure it now went up from 4.4% to 4.7%. So, the Fed is emphasizing still that they think they have a long way to go towards 2%, probably longer than the market was anticipating.

Second, the latest economic data have been stronger than anticipated. Well, what economic data are they talking about? Probably simply three things. Number one: employment growth was very robust in January. We added over half a million jobs. And this broke a trend, a downward trend where for the five previous consecutive months, the newly employed folks had been declining for five consecutive months. This was a big rebound. Now, the seasons are quirky in January, and we'll have to see if this falls through to February. Secondly, spending was up. Retail sales actually broke a downward trend. Past two months they had been down, and they popped up. And then finally, we're looking for some hints that employment growth is likely to cool. And so, to look at that, they look at the new initial jobless claims. These are produced weekly, but initial jobless claims, in other words, despite all the fact that you're hearing about that, there are some tech layoffs, net-net, newly unemployed people are nearly at an all-time, not an all-time low, but a low for this particular cycle. So, the Fed would like to see some increase in unemployment, but we're not really seeing any of that. So that's the stronger economic data.

Number three, if this data remains strong, they could accelerate their pace of rate hikes. What does that mean? Well, for three consecutive meetings now, the Fed has been slowing its pace of rate hike. Recall back in November, they bumped rates up 75 basis points, in December 50 and in January 25. That's why the markets were anticipating a gentle two additional rate hikes - two gentle 25 basis point rate hikes this year. Well, based upon this stronger economic data and of course, this recent Fed testimony, the market now is expecting four additional rate hikes. And they're equally split on whether or not in March – when the Fed meets on March 22nd – whether the Fed will raise rates 25 now or 50 basis points. The two key pieces of information that are going to push the Fed towards 50 basis points or keep it at a 25-basis point path, will be the employment print that we get this Friday. And so, we'll see whether job growth cools and the CPI print that we get on March 14th, we'll see if inflation gets back on that downward trend. To the extent that it doesn't, there's a high probability that the Fed could basically boost rates by 50 basis points. The markets aren't expecting that yet. They think it's a coin toss, but that would be tough on the markets.

Number four, to achieve their price stability, it's going to require a restrictive stance for some time. And secondly, history indicates against loosening policy too soon. So, in essence, the Fed is simply saying this when they look back in history and they let the inflation genie out of the bottle in the seventies, they basically reversed policy three times on their way to tighten, tighten, tighten. They're not going to make the mistake this time. They're basically going to keep rates high and keep them longer until they see the whites of the eyes of this disinflationary trend firmly in place. The market, even today, still anticipates the possibility of a rate reduction by the end of the year. At the beginning of the year, they're expecting two rate reductions. But I don't think the market is still picking up on the Federal Reserve's resolve. And to the extent that they remain and keep rates higher, longer, even when they're done, and they get to their terminal policy, this also plays into whether we will or won't have a recession. In the last three recessions, they kept rates up there and they kept them steady for eight months. If they wanted a soft landing, on average, they had to start lowering rates within three months. So, to the extent that they hold rates higher, longer, this also raises the possibility of a recession.

And then finally, they simply reiterated, don't doubt our resolve. They want to get inflation down to 2% because they think that is the maximum way of maintaining the most employment and the most growth in the future. Unpacking that, it simply means this, they are willing to risk a hard landing to get to their 2% rather than a soft landing that would maintain employment at a higher level now. But to the extent that they would have to get tougher later, they think that might hurt employment in the longest of runs. So, I think all of this pushes us towards higher interest rates for longer.

We'll be back in a couple of weeks to digest the most recent economic news and how the markets are behaving.

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