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Commerce Trust Market Brief with Scott Colbert
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Scott Colbert: Good morning. It's Monday, December 4th and the markets are about to open. We've all noticed that the stock market has been trending fairly well lately and of course, the big reversal came on or about October 27th.

Through October 27th, the S&P 500 (Index) was up 8.6%. Now we find ourselves up almost 21.5% as we sit here today, basically an additional 13% return just in the last month alone. Small-cap stocks were actually down through October 27th. The Russell 2000 (Index) was actually down 6% on a year-to-date basis, and today, we see now that small-cap stocks have rebounded and they're up by 7.2%. Again, another 13% swing in return. Even international stocks, which were up modestly, 3%+ through October 27th, are now up about 13% as well on a year-to-date basis.

We also saw an interesting symmetrical swing in the bond market where the Bloomberg Aggregate (Index) — the broadest measure of bond market returns — was actually a -2.5% return through October 27th, but we've now seen it swung to a positive 2.5% return as interest rates have declined fairly significantly since late October.

What's driving this big rebound in the markets? Simply put, it's a rolling over or a rapid cooling of inflation. On October 27th, we got the measure for personal consumption expenditures (price index, or PCE), the Fed's (Federal Reserve's) preferred measure of inflation, and it came in below expectations. It's been further compounded by a recent report that was also below expectations. And now, on a six-month trailing basis, the core PCE, the Fed's favorite measure of inflation, has fallen to 2.5%, after peaking at 5.9%.

Accompanying this lower inflation, of course, was then a decline in bond market yields. The 10-year Treasury had been about 5% yields in late October, and we see it today trading at about 4.3%. Most importantly, given the rollover in inflation, the market now believes — and we do, too — that there's absolutely no reason for the Fed to be raising rates in the immediate future. In fact, now the market is beginning to discount the potential for interest rate reduction as early as March of next year.

So, do investors feel great? They feel better, of course, the returns are up but they don't feel magnificent, because if we extend the view backwards for the last two years, the S&P 500 has yet to break into a new high. In fact, cumulative returns from January 1, 2022, to today are still negative on the S&P 500. They're deeply negative if we drop into small-cap stocks; they're down a rather amazing 14.5% cumulatively over this nearly two-year period. International stocks are down, and emerging markets stocks are down even worse than small-cap domestic stocks.

Probably what's most surprising is how deeply the bond market has been negative. Municipal bonds for this 23-month period are down a cumulatively 4%+ and in total the broad bond market, as measured by that Bloomberg Aggregate, is down a whopping 10.8% cumulatively over the 23-month period. In other words, a balanced portfolio (with an allocation of 60% equities, 40% bonds), which was deeply negative, a year ago has rebounded a lot this year, but a balanced portfolio would still be negative for this 23 month-period dating back to January 2022.

Are we out of the woods yet? Probably not, but there's certainly the possibility of a soft landing now that the Fed has stopped raising interest rates and likely might have some ammunition to help lower them next year and propel the economy along. Still, we know that interest rates will bite with a lag. We're about to go to print with our 2024 Market Outlook and we have several conclusions in there and I'll give you a hint preview at some of them.

Number one, we are worried about the higher interest rates. We know that there are some cracks in employment. We know that the deficits that the federal government has been running and actually accelerating, eventually will catch up with us and we've showed you the aggregate interest rate costs that the deficits are accumulating now and those will begin to bite and ratchet up with some time.

We do think that last year's market rebound or the rebound that we're having right now was purely in line and expected based upon the previous year's very deeply negative returns but as we just mentioned, the cumulative returns for the last two years are still negative. We know that the market, particularly the stock market here in the United States, has been driven by a very narrow set of stocks. And, of course, as the market narrows, that has typically been somewhat of a warning sign.

Perhaps one of the best opportunities for investors we see is the higher interest rate environment. We now know the broad market is yielding in excess of 5% and almost 6% and we have the ability now to lock in those returns for nearly a decade. This means that stocks would have to return more than that to make them an attractive bet and so the over-under for the stock market now essentially is 5% or 6%, not the typical 3% or 4% that it has been historically. We think fixed income makes sense, particularly on a risk-adjusted basis.

Finally, because interest rates are higher, the Fed does have some ammunition to propel the economy forward by cutting interest rates next year should the economy falter. We weren't so sure that was going to be the case when we started the year because inflation was still relatively sticky, but with the recent rollover in inflation and federal funds still trading (trending) north of 5%, we see that the Fed does have a modest amount of ammunition to help offset, basically, any stalls that we do see in economic activity next year.

We'll be back at the beginning of the year to discuss this Economic Outlook that we have for 2024 in detail and also discuss all the economic activity that's likely to take place between now and the end of the year.

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