Conversations with Commerce Trust podcast
July Episode: Midyear Outlook
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David Hagee: Hello and welcome to *Conversations with Commerce Trust*, our show about the markets, investment themes and economic insights that matter to you. I'm your host, David Hagee, Chief Investment Officer with Commerce Trust. Today, we're sharing our economic and market outlook for the second half of 2023. I'm joined today by Scott Colbert, our Chief Economist and Director of Fixed Income Management, and Tara McConkey, our Director of Portfolio Management (East Region) here at Commerce Trust.

Tara McConkey: Hello. Thank you.

Scott Colbert: Hey David.

David: So, the big question as we publish our 2023 midyear outlook is: Will we or won't we go into recession? It's been long anticipated that we will be going into a recession. The Fed (Federal Reserve) started to raise rates about 16 months ago. We've had a mixed bag on both inflation and jobs numbers. Scott, where do you think we're at?

Scott: Well, we're certainly in a firmer setting than most economists, including myself, would've predicted, say, a year ago, based upon an expected, aggressive and assertive Fed rate hiking process. With that said, it's also pretty clear, though, that nominal growth is cooling from its peak of a couple years ago. It continues to decline steadily, and even real growth adjusted for inflation has declined. It was 2.6% in the fourth quarter of last year.

It was 2% in the first quarter of this year, and right now, we're tracking it at 1.5% for the second quarter of this year. Will we get to zero, and will it turn negative? Our call is still that it's likely to happen and occur very, very late this year, or early next year. It might be pushed out for a number of reasons. As is typical, it takes a long time for these rate hikes, the quantitative tightening, to work their way through the system. As you said, we're only 16 months into the very first rate hike, which occurred last March (2022).

David: The question that's persistent here is that-- Can we go into recession with this jobs market being so strong? Last week we had a very strong 200,000+ print from the Bureau of Labor Statistics. As it sits today, do we think that jobs are going to be able to at least maybe cushion the blow of a recession, or even a soft landing here?

Scott: Yes, I think it's important to note that we've really never had a recession in this country unless we're losing employment. In other words, there's negative job creation, or there's more firings than there are hirings in a month. As you said, last month, we created, again, another 209,000 jobs. Remember, that's a first guess, a first cut, based upon surveying 22% of the employers in this country.

That's where that number comes from, and it gets adjusted over time. That's still as much job growth as we created in just about any month of the full recovery from the subprime crisis, all the way to the pandemic. It's probably the biggest potential reason we could avoid the recession and have a soft landing.

Job growth remains firm because, of course, businesses fired a lot of people during the pandemic, businesses recovered materially, particularly with all of the stimulus provided post the pandemic. Then the demographics would also argue we have very few new entrants coming into the workforce, much less than we used to have. It doesn't take a lot of extra employment to satiate all the needs for employment.

Still, though, I might mention that employment tends to fall fairly quickly just before the recession and, on average, doesn't start to fall materially until just a couple months before the recession. I like to say a recession sneaks up on you slowly at first, and then all of a sudden, I think someone said that about bankruptcy. I think that's also the same for a recession.

David: I think that's fair to say. The bigger driver here has been the fight against inflation, with the Fed raising rates. We touched on that earlier. The yield curve inverted about 12 months ago. What are we not seeing inside the economy right now, as it appears to be fairly resilient through the first 5.25% in interest rate hikes? What cracks are beneath the surface right now, that are giving you some cause for concern?

Scott: Well, certainly, it's this yield curve inversion and the fall of the leading economic indicators that, combined, are pointing most economists to this idea that you've probably heard it before, 8 out of 8, or 9 out of 9, or 10 out of the last 10 recessions have been preceded by this occurrence. In other words, short-term rates being much higher than long-term rates. Are there cracks showing that would counter the reasonably positive growth we've had so far? Sure.

Within the employment area, you've seen wages and salaries slowly decline, but not a lot. You've seen job openings come down from a huge peak during the pandemic. We've seen the quit rate begin to slow. In other words, the voluntary willingness of someone to leave a job. I think all those are pointing towards some slowdown in employment.

Of course, nominal employment has slowed. It was 400,000 per month last year, and it's already down to less than 300,000 per month now, this year. We are seeing the cooling. I'll call them small cracks, but again, it takes a long time, a lag time for these higher interest rates, and the quantitative tightening that most people don't talk much about, the Federal Reserve is doing, to slow economic activity.

David: As we're looking at the key driver for the Fed rate hikes, which has been inflation, this week, we're forecast to see inflation numbers come down to 3 (%) handle on those inflation numbers on CPI. Is inflation subdued, and what does that mean for the Fed, moving forward?

Scott: We have to remember that the most common inflation statistic is the CPI, the Consumer Price Index. It's the one we all gravitate towards and see. The Fed likes its own measure, called Personal Consumption Expenditures (Price Index), which is just a broader CPI, but let's focus on the CPI for a second. It did peak at 9.1% year over year in June (2022). It's come down a lot since June of a year ago.

The reason, of course, it's come down, is that food and energy aren't pushing up like they were, and goods prices now, on a year-over-year basis, are actually falling ever so slightly. We've managed to bring the CPI down – when we say we, the Federal Reserve, higher interest rates, and a little slower economic activity has brought inflation down – to 4% on a trailing 12-month basis.

We're about to drop off a very large inflation print from last June, when we get this July's print here, this week, on Wednesday, and you'll likely see nominal inflation down to 3.1%, maybe 3.2%. Huge improvement. The problem with this, still, is the core. The core inflation never jumped to 9%. It was only just over 6%, and now, core inflation is still 5+%, and it's still only likely to fall to 5(%).

While food and energy helped drive it way up, food and energy have helped bring it back down below trend, but the Federal Reserve is still focused on the sticky core. Now, if you'd like to ask, and maybe this would've been your next question, are we making progress on the sticky core? I think absolutely. This is the wild card going forward, and there are some clear cracks showing up, in even core inflation.

Housing is the biggest component of it. Rents, of course, we've seen slow down. While housing has had a bit of a rebound recently, it's tough to see nominal home prices increasing materially when interest rates have jumped so very much, with a 30-year mortgage now, up to about 7+%, even a 7.5% rate, with the 10-year treasury, now at 4(%), we're likely to see a material slowdown in home price appreciation.

Right now, housing or shelter as a percent of the CPI is coming in at 8% year over year. We think that begins to decline, and that also will help bring down core inflation. If we bring down core inflation quicker than nominal growth falls, you can have your soft landing. That's a mouthful, but just think about it. If growth will fall slower than inflation falls, then we have a chance for a soft landing, and oddly enough, the positivity or the chance of this core inflation cooling in the second half of the year is pretty strong.

David: As we look into the markets, clearly, we think the heavy lifting's already been done by the Fed. Maybe some base effects kicking in, especially on the housing side that, as you mentioned, that second derivative of growth is just slowing. It's still maybe not contracting, in terms of home prices.

What does this mean for fixed-income returns? We walked through 2022, very tough year, as we had a broader reset in interest rates, been a positive year, so far, in 2023. What does the balance of 2023 look like, for both the broad market as well as, more specifically, some credit issues out there?

Scott: Of course. We do think that the Fed raises rates one more time in July. They'll have a meeting July 26th. They will tap the brake again, another 25 basis points, and push basically short-term rates in that 5.25% to 5.5% range. I think they will certainly pause at their September meeting, because there is no August meeting, and then that leaves November as a wild card. I'm optimistic that they won't need to hike rates in November, and that this is hopefully the last rate hike.

As such, the opportunity for fixed income looks pretty good, despite the fact that bond yields have been backing up for most of the year, we still have small positive returns to the broad bond market. As of this morning, Monday, July 10th, we had the Bloomberg aggregate up 77 basis points, and most bond funds are outperforming the aggregate by a little bit, and municipal bonds are also in positive territory.

I think this sets us up for a very nice second half of the year, with interest rates peaking, and perhaps coming down a little bit, to finally give us some diversity away from the stock market, which, of course, has been on a tear and I think Tara is likely to talk about that in a minute.

David: Thanks, Scott.

Tara, let's transition to talk a little bit about the equity markets. It's been a strong start to the year, we're up on the S&P 500 (Index) just a little short of 16%, been a different market for us. It's less broad-based than we had grown accustomed to during the quantitative easing years. What do you think about this market moving forward? Maybe talk a little bit about the markets, how they've been so narrow recently.

Tara: Sure. Certainly, the equity markets defied the odds of three bank failures, recession fears, rising interest rates, tensions with China, higher inflation, to have a really strong first half. Most of that first half was led by the mega caps and technology. The technology laden index of the Nasdaq (stock market) was actually up 32% in that first half, a lot of that being driven by artificial intelligence, or AI, commonly referred to, that tends to be across the board.

We've been in a very narrow market, with only about 25% of the stocks in the S&P 500 actually outperforming the index. (The) market broadened a little bit in June, but really, we'd need a much stronger rally from here, for this to improve. We really need to see earnings growth, which is likely to be very difficult in this environment, due to higher inflation, wage pressures, et cetera, really hurting the margins.

While technology was the clear winner in the first half and is likely to probably moderate here, as we go forward, given the skyrocketing returns we've seen, I will say we are closely monitoring that developed international equity space, as we do believe the high dividends and relatively cheap valuation might lead us to start bringing in our underweight to developed international.

David: Tara, I've been struck by this market. We have this very narrow leadership, about seven stocks accounted for about 90% of the S&P 500 return. As we look at Apple, it crossed over the $3 trillion mark. Apple, at this point, is larger than the smallest 2,000 stocks inside the Russell indices. Is this sustainable, and how is AI playing into this whole piece? I know AI is maybe not a pure Apple play there.

Tara: We saw, after the first quarter earnings report, really, the mere mention of artificial intelligence, again AI, seemed to add several percentage points of return to stock prices. We had another big winner for the first half, was Nvidia, which also joined that trillion-dollar market cap, was up almost 190%. Nvidia is, of course, a clear AI winner that does graphic processing units that power the chatbots, like ChatGPT. AI will likely live up to its expectations and a lot of the hype, but it's going to be a long process to get there.

AI is certainly going to increase productivity, which will dampen, probably, pressure on inflation. It'll certainly improve and increase medical breakthroughs, likely to help solve some of the biggest issues, with hunger, global warming.

Big question is, really, how much do you pay for it, and how much do you pay for these companies which we work through. Downside to artificial intelligence is the information's only as good as it receives, right? There's likely to be misinformation or, quite frankly, just bad information. You could see a potential increase in cyber-attacks, and probably, I think, the thing that worries a lot of people about AI is certainly being replaced by these AI robots, certainly to hit the lower paying jobs, which would worsen that income inequality.

David: I'm certainly struck by the amount of cross currents that we're talking about now. The fixed-income market is clearly signaling recession. The equity market has had robust returns this year. As you mentioned, Tara, AI has really powered the U.S. stock market up. International stocks, we are getting more constructive on, and from a valuation perspective they're very attractive, but they have almost virtually no AI exposure in there.

As we move through this second half of 2023, a lot of things to keep your eye on, I think, paramount inside the U.S. market is going to be focusing on whether the economy continues to deteriorate, like Scott mentioned, and as you mentioned Tara, whether the promise of AI is going to be fully priced into this market for the back half of 2023. Certainly, an interesting time to be observing the economy, as well as the markets. Thank you both for joining us today.

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