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Commerce Trust Market Brief with Scott Colbert
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Scott Colbert: Good morning. It's Tuesday, October 10th, and the markets are open. Year to date, of course, stock prices are up. The S&P 500 (Index) is up 13.66% so far this year, and it's been the big index winner. Underneath, though, this large cap-driven S&P 500 return are much weaker returns. If we take the S&P 500 equal-weighted return —just the equal weight of all 500 companies— it's a barely positive 0.56%. The Dow (Jones Industrial Average), which doesn't have that huge representation of those seven mega-cap stocks that have driven returns this year, are only up 2.48%. When you get down to even smaller stocks, as represented by the Russell 2000 (Index), you're looking at barely positive returns at all.

Overseas stock prices are up but not up very much either. Large cap developed stocks as measured by the (MSCI) EAFE index are up 5.6% and emerging markets (as measured by the MSCI Emerging Markets Index) held back by China are only up about 0.5% so far year to date. Bonds aren't helping you out at all with negative returns. Cash has beat bonds so far year to date. The Bloomberg Aggregate (Bond Index) has fallen 2.36% through October 6th and the Bloomberg Muni (Municipal) Index is down 2.01% so far this year.

So, the theme on the markets recently has been what? Stock prices down and interest rates up, with bond prices falling. Driving this is largely good news from an economic perspective, which is thought to be bad news from a financial market perspective. Why? The good financial news probably increases the probability of a federal interest rate hike and, of course, the strong economic news also likely slows the disinflationary path that we've been on.

So, what's driving this rather strong economic growth? Well, first off, Commerce's estimate for growth in the third quarter is likely to be in the range of 3% to 4%, and that's nearly double the first half's growth rate that averaged at about 2%. Driving this growth of course has largely been strong personal consumption expenditures. You've heard that the consumer is about 65% of the economy and so far through the third quarter, personal consumption has averaged about 3.7%. We're also seeing exceptionally strong business investment, over 6%, and we're looking at strong residential investment as people continue to buy houses, again over 6%. Subtracting a bit from this growth is likely to be a lowering of inventories as we had some inventory accumulation in the second quarter and, of course, the strike ongoing with the automotive companies.

From an economic statistical point of view, we've had the purchasing manager index reports come out in the last month. Both the services and the manufacturing indexes surprised folks on the upside, and while we're still in contraction mode on manufacturing, it's barely weak. It's been negative now for 11 months in a row. The new employment side to the manufacturing purchasing manager index actually turned positive, and we continue to remain strongly positive on the service side and their employment prospects look positive as well.

Speaking of jobs, of course, we recently had our jobs report. We get the jobs report on the first Friday of every month. The Department of Labor puts out how many jobs were created in the prior month. This past Friday we saw that there were 336,000 jobs reported, higher than any of the 72 economists surveyed. This also pulls up the three-month moving average to about 267,000 jobs created per month in the third quarter.

Now this is a different trend than we had been seeing where we were seeing employment cool. For example, in the second quarter, employment growth only averaged 200,000 jobs per month. So, this is also a change in direction of employment. If employment grows, let's say employment grows 0.5% to 1% per year, on top of salary and wages, which seem to be growing at least at a 4% pace, that's basically 5% more money for consumption on a year-over-year basis. Adjust that for inflation, which is coming down, and you can see how growth remains exceptionally positive.

So why bonds now? Primarily three reasons. As these interest rates have climbed, the income from a bond and a bond fund has increased materially. That income largely can offset the price volatility of a bond, and rarely do we see bond prices perform on a negative basis in two consecutive years, and here we have an opportunity to buy bonds after potentially three negative down years. Secondly, because they generate this income, they're much less volatile than the market, about a third less volatile than the stock market, and they act as a diversifier, typically, oftentimes zigging and zagging, so they add diversification to your portfolio. Finally, the big reason is because interest rates have backed up so much and the Bloomberg Aggregate now has a yield in excess of 5.5%, that is likely to be very competitive over the next decade relative to the valuation of the S&P 500 today.

We've seen that the S&P 500 at these valuation levels have returned, over the next decade, a low of about 2% and a high of about 8%, and an average return based upon today's valuation of only 5% to 6%. The bond market with about 90% to 95% correlation, its 10-year return is very tied to its yield, and with a yield of 5.5%, it's easy to look down the road and see that bonds are likely to provide a return somewhere in that 5% to 6% range over the next decade being very competitive for the stock market. So, we're certainly not willing to give up on bonds. In fact, probably for the first time in 17 or 18 years, we see the bond market offering exceptional value even relative to the stock market.

Finally, we'd be remiss if we didn't mention all the activity in the Middle East that occurred over the weekend. The impact on the markets has been relatively muted with interest rates down a little bit, energy prices up, and amazingly, stock prices fairly resilient, both holding their values here in the United States and over in Europe. Of course, this is just an additional shock to the market that investors and diversified portfolios have to adjust to. We'll be back in the next several weeks to discuss all the financial market news and how it's impacting your portfolios.

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