Commerce Trust Market Brief with Scott Colbert
01/03/2023

Scott Colbert: Good morning. It's January 3rd. Happy New Year, everybody. The financial markets are open for the first time in the new year. We're going to try and cover four topics today. We're going to talk about [market] returns from last year. We're going to talk about the global economic outlook. We're going to focus a little bit on the United States as well, and then give you our outlook for stocks and bonds for the coming year. In terms of last year's returns, we know that they were dismal. The S&P 500 was down about 18%. The broad measure of the taxable bond market was down about 13%. Municipal bonds fared better, but they were still down 8.5%. This means that a 60/40 portfolio was deeply negative, about a negative 16% return, and we've only seen six or seven years like that since the end of World War II.

Value stocks outperform growth stocks. This is probably easily seen when you take a look at the Dow Jones Industrial, a more value-oriented index. It was down about 6% or 7%. Whereas the Nasdaq, a tech heavy index was down about 33%. For those of you with international exposure, somewhat surprisingly, international large cap stocks actually beat the S&P 500 for the first time in about 13 years. They were down about 14%. But emerging markets still lagged down nearly 20%, driven by lower Chinese returns. When we look around the globe, the setup this year is really just more of the same. What we have is the central banks battling an inflationary problem. Central banks continue to raise interest rates. We don't exactly know how high they're going to raise them or how quickly they will raise them. And we don't know how quickly inflation will react to these higher rates, slowing economic growth, hopefully bringing inflation down.

Over in the Eurozone, we don't think about it much, but inflation is still running a rampant 10%. It's even higher in Great Britain, and their short-term interest rates are still much, much lower than they are here. The ECB, the European Central Bank's overnight interest rate is only 2.5%. In Great Britain, it's 3.5%. And as most of you know here in the United States, it's 4.5%. And of course, now we aren't confronting quite as much of an inflationary problem. While it's still north of 10% overseas, it's down to about 7% as measured by the CPI here in the United States, and a more comfortable 4.7% measured the way the Fed likes to measure it, the personal consumption expenditure core index (PCE). The core PCE peaked February of last year at a 5.4% rate, and so if you ask the Federal Reserve, they've basically made about 70 basis points of positive improvement in the overall inflationary outlook.

Now, this leads us to the outlook though for the United States for this year, and it's still somewhat cautiously, I'll call it, rather than optimistic, it's cautiously pessimistic. We still have an inverted yield curve and we've had this inverted yield curve where short-term interest rates have been higher than long-term interest rates now for six consecutive months. We have the leading economic indicators still declining. On a year over year basis, they're down more than 4%, and on a six-month annualized basis, they're down about 7%. All three of those point towards an economic recession sometime this year. Unfortunately, our financial markets, even though they are down, aren't discounting entirely though the outlook for a recession. The S&P 500 index, having fallen 18% typically falls closer to 35% during recession, and of course the bond market may have fully discounted the rise in interest rates. They peaked several months ago. They've come down, but they've recently started to move up again as people worry how high interest rates will likely have to go this year.

The market's expectation, of course, is that Fed funds will likely peak sometime in the March to June time period at about 5%. In other words, the Federal Reserve (the Fed) may have two additional 25 basis point interest rate hikes left in them this year. With the Fed though still on the move raising interest rates and these leading economic indicators and the inversion in the yield curve pointing to a possible recession, we still are more defensive in terms of the way we're constructing the average portfolio. We're trying to hold back some cash. We're trying to be underweight stocks using that underweight for the cash allocation. We are fully weighted in the investment grade bond market, and we've actually been adding some duration back last year as the year progressed.

We're still a little bit short in terms of average maturity, but not nearly as short as we were last year, as we basically expect interest rates to peak probably sometime in the first half of this year, and then that's when we'll want to get even more assertive and possibly add even more maturity. We're not adding any additional credit risk at this time. We still have nearly zero exposure to high yield or emerging market type bonds. But those are likely to present pretty good opportunities as the year progresses. We'll also look to put that 5% cash to work back in risk assets at some point during the year, either when, A, we are convinced that there's going to be a soft landing, or B, when we see the whites of the eyes of a recession and probably find much better valuations than we find today.

And while we're still a bit defensive this year, it's important to note that it's very difficult to have two pretty dismal years back-to-back. When we look at the six or seven times at the stock market and bond market in aggregate have been down when you have a 60/40 portfolio, in five of those seven instances, the market rebounded the next year, oftentimes fairly significantly. Secondly, we know that we've had a yield rally, so to speak, and finally you can find real yields in the bond market. For example, cash yields now are up to about 3.9% and likely to go higher as the Fed continues to raise interest rates. A two-year treasury note has a 4.4% yield. And if you brought a broad basket of corporate bonds with, say an average maturity from three to seven years, the yields on that now are 5 3/8%. Even the yield on your stock portfolio is materially up. In 2001, the total yield was about 1.14% looking back on a 12-month basis. Last year, it was about 1.5%, and it's projected to be about 1.8% this year based upon the price of stocks.

And because of course, stocks have come down and we've had a year of progress, and the average trailing 10-year earnings of the market have increased now as we move forward a year, the cyclically adjusted PE ratio, the so-called CAPE ratio, has improved materially projecting positive returns of course to stocks over the next decade in the neighborhood of 5% to 7%. We'll be back in a couple of weeks to discuss how the financial markets have opened for the new year, how they're digesting the news from the rapid reopening of China, having gone from COVID zero to full on reopening of the economy. And of course, the impacts likely to the global economy from the ongoing Russian-Ukraine war.

Disclosures:

January 3, 2023
Commerce Trust is a division of Commerce Bank.

Commerce Trust
Banking | Investments | Planning™

1-855-295-7821 commercetrustcompany.com