COMMERCE TRUST COMPANY CHIEF ECONOMIST COMMENTS ON RECENT MARKET VOLATILITY

By Scott M. Colbert, CFA®

The one-day closing of the stock market exchanges Wednesday during the George H. W. Bush state funeral did little to curtail all the recent volatility in the markets. So analysts did their best to explain the current correction.

As economists are prone to do, they can tie everything back to the classic yield curve that most of us probably ignored during our school days when we were deciding on other careers.

That said, the yield curve is as good as any place to start citing economic statistics during this fluctuating market, now in a full correction, even for those who failed to grasp much from this standard interest rate sign post.

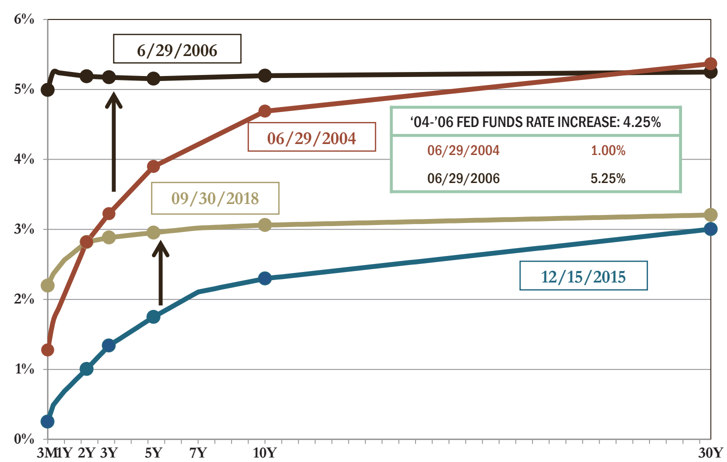
The big yield curve question for economists at the Federal Reserve (Fed) and at the various economic think tanks is this: What does the current yield curve flattening and potential yield curve inversion mean?

The signposts here are easy to read. Historically, a flattening of the yield curve has been associated with a slowdown in growth. And secondly, an outright inversion of the yield curve, which means that shorter-term rates are higher than longer-term rates, has preceded every post-World War II recession that we've had.

So, what do we, and perhaps most importantly the Fed, make of the recent flattening? We think it's a warning shot for economic caution, but not the definitive sign of an impending recession.

We believe that it's clearly a warning sign that growth is likely to cool next year, and that secondly, if the Fed does not slow the rate-hiking process, it risks a more material slowdown here domestically than it likely wants. Continued rate-hiking indirectly prolongs the protracted slowdown across the emerging markets as recognized by their falling stock prices, weaker currencies and a rather obvious drop in most commodity prices, like oil.

Treasury Yield Curve – Last Fed Tightening Cycle Relative To Today's Curve



Source: Bloomberg

Still, the flatness of the yield curve in this cycle is not likely as strong an indicator of recession for the following reasons. And we think the Fed believes this to be true as well.

Number one, our longer-term rates have been held down by the quantitative easing that the Fed embarked upon during the financial crisis. All told, the Fed bought approximately $3.3 trillion of government securities, primarily treasury bonds and some government-guaranteed mortgage backed securities. Fed studies have suggested that this perhaps lowered longer-term rates by as much as 1% more then they would've fallen during the financial crisis. And since the Fed has just begun to reverse the quantitative easing process, they feel like their expanded balance sheet is still holding down longer-term rates materially.

Secondly, it's rather obvious that most interest rates overseas are exceptionally low still today. The next six largest government borrowers are on average paying only a little over 1% to borrow money for 10 years. Among them are Japan, whose 10-year rates are effectively zero, and Germany, which pays a mere 0.25% for a decade's worth of debt. These lower rates and our relatively wide interest rate differential have attracted foreign monies. This added demand keeps our rates low and strengthens the U.S. dollar for the same reason.

Finally, demographics -- not just here but overseas as well -- argue for slower growth and higher demand for longer-duration fixed income assets. This has rather obviously already played out in Japan, is playing out in Europe right now (Italy's demographics are just behind Japan's) and is starting to impact the fixed income markets here as the boomers continue to retire and the average population's age increases.

Fortunately, the Fed has gotten the message and has already given indications they may pause after one more quarter-point bump in short-term rates (their ninth total in this cycle). The ensuing pause should provide enough time and ultimately confidence to allow the risk markets (stocks, junk bonds, etc.) to bottom out and eventually lead longer-term rates higher. And as risk appetites and rates recover, it will provide an all-too-clear signal that we could afford one or two more rate hikes this cycle to get rates back to a positive real yield in the short end of the market...the so-called "neutral rate". That is a rate that is viewed to be neither stimulative nor restrictive in terms of economic growth. Just where the Fed would like to land.

Commerce Trust Company is a division of Commerce Bank.

ABOUT THE AUTHOR

SCOTT M. COLBERT, CFA®

Executive Vice President, Chief Economist and Director of Fixed Income Management

Scott is the chief economist and director of fixed income management with Commerce Trust Company. He joined Commerce in 1993 and has investment responsibilities for over $19 billion in fixed income assets. Scott directly manages the Commerce Short-Term Government and the flagship Commerce Bond strategies. Scott received his bachelor of science degree in nuclear engineering from the University of Cincinnati in 1986 and received his master of business administration from Xavier University in 1988. He has been both a director and president of the Chartered Financial Analyst Society of St. Louis.