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2019 Outlook: Conversations with Commerce Trust
Overview Transcript

Chris Schildz: Welcome to Conversations with Commerce Trust. A podcast where various specialists discuss the latest research, insights and market news.

This is Chris Schildz with the Commerce Trust Company and we have Scott Colbert with us today. Scott, welcome to the new year. Scott is our Chief Economist for Commerce Trust Company and Scott, you have a unique role here. You get to see more of our clients face to face than maybe any other person in the organization. There's a little bit of angst out there with the recent correction and the volatility. What have you seen out of investors and what did they tell you when you go to your investment summits throughout our locations?

Scott Colbert: Well, they're anxious, they're worried, they're all are living through the stock market correction that started in October and mostly they want to know, you know, if and when the stock market is going to bottom. And then secondly, is all this turmoil going to lead to a recession. As are probably the two biggest concerns.

Chris Schildz: And you said it, the recession word, the r word, six months ago, maybe not much of the economic lexicon whatsoever and discussions on the economy. Here it is now. what, how far out is recession? What do we say about the possibility?

Scott Colbert: Well, oddly enough, it's not like a lot has changed over the last six months and it usually doesn't because the economy is kind of like a super tanker and it takes a lot to move it around. But clearly the forward indicators, it faded a little bit. There's heightened tensions from the trade tariffs that weren't nearly as important at the beginning of the year. You've seen stock prices fall and anytime you see prices fall, you know, it raises the anxiety level, it’s raised the volatility level, hurt credit spreads. So, you know, clearly, you know, financial conditions have deteriorated. And the question that everyone now has is, is this a harbinger of a recession next year. Our thought process is, it really isn't, for a number of reasons.

Number one, interest rates are already lower and lower interest rates generally then help push you forward, they don’t pull you back. Number two, energy prices were already low and falling and going into this morass, not as a result of the fall in stock prices and lower energy prices, never accompany a recession. It's almost always higher energy prices, accompanying a recession. Third, you've seen a Fed that was basically, I won't say they're on autopilot, but for sure their dot plot and forward forecasts for rates was essentially to raise rates, you know, another three or four times next year. Back in October, back in the third quarter. And they've since now had to basically back off of that forecast which ought to also help propel the markets forward and help the equity markets find a bottom. And then the last thing I'd say is, financial conditions are awfully good in the banking and financial system. We of course work at a bank charge offs are near all-time lows, and it's not just this bank, it's every major bank in the country. Folks when they're working, pay their bills and their bills are being paid on time, their outlooks are positive because they're fully employed. So we're pretty, pretty certain that there isn't a near term recession on the horizon.

Chris Schildz: Scott, hearing from your comments that it sounds to me like the economy still has legs. We have a chance for record territory later on this year. I assume you still believe that that's in place in is quite a possibility.

Scott Colbert: Yeah. We're nine and a half years into this economic positive economic cycle on the longest economic recovery we've ever had between their sessions though has been 10 years. We're just now a chip shot away, another six months away, even five away from, you know, having the longest economic expansion and we think that's easily doable. How much longer will it continue after that? You know, that becomes more of a guessing game because basically nobody has crystal balls that look out for, for years, but we think there's still quite a bit of room to run basically given the financial conditions that we have. Number one, the leading economic indicators, they only got back to where they were prior to the last recession about a year and a half ago. And typically you get about six years of recovery once they recover, once these leading economic indicators recover, so take a year and a half off of that and you get four plus years of potential recovery.

Secondly, you know, inflation and the Fed funds rate are right on top of each other and typically by now the Federal Reserve will be more restrictive in their monetary policy having short term rates basically at least two or two and a half percent higher than the inflation rate to push us into a recession. And right now they have short term interest rates that are essentially just on top of the recession. And then the third thing is the sheet, the yield curve while it's flat now and calling out a clear warning signal that things could slow, the link of the recovery is directly proportional to the time that you have a positive slope yield curve. And we've had a slope yield curve or positive slope yield curve, meaning short term rates are lower than long term rates for a considerable period of time. And that ought to propel us forward for still sometime, so we actually don't see a recession in the near term at all and think that it probably has several years to go before we were onto rocky territory.

Chris Schildz: Now we do have a new variable injected into this right now and it's the partial government shutdown. You see any impact from that long-term going forward?

Scott Colbert: You know, I look back on this and there's been several, seven partial government shutdown since I've been here the 30 years at the bank. They're almost always a hard to see in retrospect as having had any material impact. I will say those seven previous partial shutdowns generally accompany a debt ceiling so that we have this finalized terminus to get this thing put together because nobody wants to default on the debt. And that brings everyone focused like a laser beam. This one doesn't have that and this one is probably likely to last quite a bit longer. It's pretty clear we have a fairly unique president and we have a new democratic congress and between the two of them I think they could butt heads for quite some time. So there's potential to have this be a little bit more damaging than the typical government shutdown might have been historically. Yes.

Chris Schildz: The other part of the economy are tariffs. We haven't heard as much about that in the past. And of course this year we've heard a lot.

Scott Colbert: Tariffs, largely been, pretty much being reduced and reduced and reduced are almost nonexistent during most of our financial lifetimes. And the administration has reintroduced them as a tool to help us minimize or at least stop the acceleration in the trade deficit with China. It is true, we import a heck of a lot more from China than we export, but the number is really relative to the size of the total economy still are fairly modest. They sound big because we import $500, $600,000,000,000 of goods and services from China. But that represents less than 3% of our economy. We're clearly taxing it, which affects the consumer because you're going to have to pay more for this and affects the manufacturers because they have to pay more for this and affects the Chinese manufacturers because they're going to have to accept probably less to continue to sell into the market and it is a tax and it's probably not, it can't be positive for economic growth. In essence, what you have is you have a modest war going on where we feel like we can hurt them more than they're hurting us because we export so much less to China then we import from them. But it's still a lose lose situation. It's just a question of who loses by a less amount right now.

Chris Schildz: Changing gears just a moment. Will the Fed be under any kind of pressure this year? We had four rate hikes last year. Will they ease up on that sequence a little?

Scott Colbert: Well, the Fed's been raising rates now, in earnst, since December of 2015. It's hard to believe, but we're three years into this rate hiking cycle. Now, they have paused along the way and they've gone very slowly, but last year they got their four rate hikes in, at every other meeting, kind of like they expected. In the past, the Fed can typically raise rates about 10 times or 2 1/2%, quarter on quarter point moves before they slow the economy enough that they have to stop, perhaps even reverse direction or at least pause. And this was the ninth. This past rate height was the ninth rate hike in this cycle. So, on a nominal basis they're close to doing what they normally do. And so it wouldn't be shocking to see them pause. Secondly, clearly the outlook for economic growth has diminished. We grew 3% this year, maybe 3.1% when the numbers are counted and next year we're only likely to grow 2%. So clearly growth is slowing. So it's, it's quite likely that they'll have to pause in their upward movement, but we think that the economy's going to have enough forward momentum, the stock market won't bottom, the credit spreads will improve, but the Fed is likely to still be able to raise rates around midyear if our forecast is correct for no recession next year.

Chris Schildz: Scott it feels though with all this activity and volatility that the paradigm is broken somehow it's different than it was before. Do investors ask that question is this different as we head into 2019?

Scott Colbert: Well, what's different is we've had a very benign and slow recovery that was accompanied by unusually low volatility in financial markets. We almost forget that we've had the longest bull market without a 20 percent correction ever. So it's gone on now for March of '09 to essentially today because technically we only fell 19.9%. So we're in the middle of the longest bull market we've ever had, but late in an economic cycle, you always get upticks in volatility and you know a heightened sense of anxiety. So I wouldn't say this is any different at all. And of course the Fed has raised rates nine times and we did just say that on average they only make a 10 before they, before they impacted the economy enough to, to slow things down. So it's, you know, it's, I think we're now back to basically a much more normal market and it's what you'd expect late in an economic cycle.

Chris Schildz: Another term the Fed likes to use this normalization of rates. Are we there yet? What kind of grade do you give the Fed on the last few years?

Scott Colbert: Yeah, by normalized they mean to get rates at what would be the rate that wouldn't accelerate or decelerate the natural economy. They think, you know, we have the ability to grow at about 2 to 2.2% a year without generating any inflation. So basically they're looking for that short term rate that would afford us that type of growth rate without pushing us faster or, or keeping us slower. They can also relate that to inflation, trailing inflation. Historically the Fed funds rate the rate that we're talking about, but that is able to change on a quarterly basis has been, has averaged about 1 ½% over trailing inflation. They think the real rate, the normalized rate, is much lower today because largely they'd caught the inflation gene, they bottled it up mostly.

Technology keeps inflation low, cargo container ships help keep inflation low, access to foreign markets, labor. All of these things, the Amazonation of the world has a pushback on inflation. So they believe that probably normalized rates are probably about something closer to 2 ¾ - 3% if trailing inflation is 2. So they're not yet back to what they consider to be normalized rates, but they're much closer and really they're willing to admit they're not even really sure what a normalized rate is. Nor is the rest of the market. My hunch is, is actually a lot lower than people think because I've always suggested why should cash give you a real yield? In other words, why should cash be an investment and generate an excess return over and above inflation? It ought to just be a store of value. Think about it, but they've got short term rates right now about 2-2 ¼%. That's exactly where cash is. You’re not going to make any money holding cash, but you’re not gonna lose any, which seems to me to be a fairly normalized rate for short term interest rates.

Chris Schildz: Interest rates throughout the world, globally speaking. Are they behind us? Are they following the same sequence of events? Where's the rest of the world in relation to the.

Scott Colbert: Well, I hate to say it. I think most of us know it. That the rest of the world has had a subpar recovery relative to our subpar recovery. So they're still struggling over in Europe because, for a number of reasons, they weren't able to take the action that we took to make economic progress quicker. Japan is still struggling with inflation year zero and even China is cooling after having grown at a very high single digit pace for a number of years. It's the law of big numbers now in China. Essentially their GDP is approaching 12 or 13 trillion dollars, so they just don't have the ability to grow as fast as they used to. So things are more punk overseas, there's no doubt about it and it's helped keep interest rates obnoxiously low, if you will. It'd be really interested in earning a coupon on a bond. You have a hard time when the next six largest borrowers on the planet are only paying around 1% to borrow money for 10 years. Those six borrowers are Germany and Great Britain, France, Spain, Italy, those types of folks, they're borrowing money and exceptionally low rate.

Chris Schildz: If that's the state for interest rates. Let's go to inflation for just a second. It's pretty much subdued in the United States. You have a probably a pretty good picture. Commodities are different than they were even six months ago. What do we have to look forward there?

Scott Colbert: Well, you, it felt like we were, there was a little inflationary pressure building. The number one driver, the Fed believes the number one driver for inflation is primary wages, wages and salaries, and to the extent that they're growing at about 3% and say, well, Geez, that’s 3% inflation, but businesses are productive. They don't just give you your 3% raise without trying to get a little more out of you. Productivity is typically run at least one percent in this country, meaning you get, you know, get an extra 1% out of your workforce every year. So that generates something closer to 2% inflation rate and that's exactly where we are, spot on, with trailing inflation is about two percent. The Fed was worried that with unemployment, a 50 year low 3.7% and wages and salaries accelerating some and we were late and economic cycle that perhaps inflationary pressures were going to build. But clearly the cooling overseas, cooling here domestically, the drop in the stock market have all put those inflationary pressures aside. You can see it directly when you look at the price of gas and the, and the demands, the supply and demand for what amounts to a very volatile commodity. So, inflationary pressure, at least for the foreseeable future can be kind of set aside for a bit.

Chris Schildz: Scott, I'm going to line this up with a very important question that people are dying to know the answer to. What does the Commerce Trust Chief Economist think about today's, Alabama/Clemson football game and does it have any bearing on the economy depending upon who wins?

Scott Colbert: I doubt that has much bearing. I think the bank from its perspective is probably a lot more focused on the Chiefs. You know, the championship game coming up on Sunday. So I wouldn't, I wouldn't have know. Ithink it used to be that if the NFC won, we had a good year for, for stocks. I think we should still be rooting, I guess for an NFC team.

Chris Schildz: Thank you for listening to this episode of Conversations with Commerce Trust. For more research, insights and market news, visit www.commercetrustcompany.com