

## Conversations with Commerce Trust Podcast

### July Episode: 2024 Midyear Economic and Market Outlook – July 2, 2024

**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 discussing our economic and market landscape for the second half of the year with Scott Colbert, our Chief Economist and Director of Fixed Income Management, and Tara McConkey, our Director of Portfolio Management (East region) here at Commerce. Welcome back to the podcast.

**Tara McConkey:** Good morning, thank you.

**Scott Colbert:** Hi, David.

**David:** So, Scott, I'm struck by sort of the Goldilocks situation that we've been in here. We've had an economy that's been growing nicely, and we've seen inflation subduing over the past, say 18 months or so. What are your thoughts on kind of where we've been inside 2024, and where we're going from an economic point of view?

**Scott:** Well, it's certainly working out a lot better than most people thought, say a year or two ago after the Federal Reserve (Fed) began to push interest rates up rather quickly and basically up 5.0 - 5.25% in a very short period of time. But we had a lot of economic momentum going into that.

But there's no doubt today that the economy is cooling. Economic growth last year for all 2023 was 2.5%. So far to start the first half of this year, it's probably closer to 1.75% (annualized) when we get the final numbers for the second quarter late in July.

Employment growth is also slowing. We created in the first five months of last year, 1.5 million jobs. We've only created about, I say only ... it's still a lot of job growth, but we've only created about 1.25 million jobs, about 17% fewer jobs so far this year compared to last.

And of course, wages and salaries have cooled a little bit and real growth is likely to decline. So, basically, we're in a cooling situation. But I think that it's largely the cooling from a very, very hot economy and we're in the process of transitioning, if you will, from basically stimulus-led, Fed-led, induced recovery from the pandemic towards one that's a much more self-sustaining economic recovery, which in the long run of course is the best thing for the country.

**David:** So, as we're thinking about a self-sustaining economic recovery, which we all can agree that that would be a nice move forward for us to get off the stimulus we're reliant on consumer spending. How is the consumer shaping up given that this job market is starting to wane maybe a little bit, asset markets really appreciating very nicely here?



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**Scott:** Yeah, consumer spending is slowing a bit from the surge post the pandemic. The only good part about this is that real incomes are starting to grow because inflation has declined so much, and in general, wages and salaries are still moving forward at about a 4% pace, which of course is higher than trailing inflation. But the consumer at the edges is starting to show some cracks as well. We've seen this in some of the retail statistics that come out in the equity market, as well as basically from a banking and financial perspective. Slow but steady increases in delinquencies, slight increases in car loan delinquencies, slight increases in home (loan) delinquencies, slight increases in credit card (delinquencies). And it does seem to be bifurcated as it usually typically is between the well-off and the not so well-off, with the delinquencies mostly rising for lower income type families.

**David:** Transitioning over to the stock market, people that have owned assets have done extraordinarily well. Maybe you could walk us through the first half of U.S. stock market for 2024.

**Tara:** Certainly, we saw the S&P 500 (Index) up roughly 15% for this first half of 2024. Probably one of the best, top three returns we've seen over the last couple of decades. So, very strong start to the year, certainly would love to annualize that number, but it has been a very narrow market. So, in the first quarter of this year, we did see a broadening of the market. We saw a lot of the S&P 500 sectors start to perform a little bit better. We saw mid-cap and small cap start to have some performance as well. Of course, by the time we entered the second quarter, things reverted back to that very familiar pattern of information technology and communication services.

It has been really an AI (artificial intelligence) driven market. And again, I feel like a broken record because I think the last time I was on, that's all we talked about too was AI. And the only thing this market really does seem to care about is AI. And it really doesn't matter if you're building the semiconductors, if you're providing the software, if you're doing the security, quite frankly, even utilities had this big run because all the electricity use from AI was going to really help them.

So, most companies are talking about AI, how to use it to be more productive, streamline inefficiencies, build processes, find solutions, that has been just huge over this first half of 2024. Just to give you an idea, Nvidia, which is the AI darling, was up 150% for the first half of this year that accounted for a third of that S&P 500's performance. Nvidia's market cap and market cap is shares outstanding times the price of the stock, grew \$1 trillion in 30 days. I mean literally unheard of, right? So, people are feeling good, people are making some money. Nvidia's is now over a \$3 trillion company, which is about the size of the U.K. (stock) market, so it is huge.

We saw also names like Broadcom, another AI darling, up about 60%. So, we've seen some very profitable companies. Some companies with real earnings and that has driven the earnings up over this last two quarters and likely for the rest of this year, we should see those earnings continue to rise from those top seven or so stocks.



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## Conversations with Commerce Trust Podcast

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**David:** I think that's an important note here is that as previous tech rallies have been based more on future earnings and not necessarily earnings in the present, where right now we've seen valuations move up a little bit and as you mentioned, some of that's earned on Nvidia where it's moving up a trillion dollars inside of 30 days. But this market seems to have some earnings to support where we're at right now. Really talking about the S&P 500 right there. What about the rest of the stock market, small cap U.S. smaller capitalization, U.S. securities as well as international, what are your thoughts around where they've been and where they're going?

**Tara:** Mid cap, small cap, international (developed), emerging markets, they've all had positive year-to-date performance. It's just paled in comparison to the S&P 500 and anything, of course with the heavy tech presence. We do anticipate mid-cap should start to pick up a little bit though it continues as I mentioned, kind of this large-cap growth market.

Small cap should perform if the Fed lowers rates for the right reasons, which would mean that inflation is under control, if we have a higher unemployment and also the Fed needs to reduce rates, small caps would not outperform. So, we are kind of taking a little bit of more of a backseat, underweight the small-cap area.

Emerging markets had a really strong second quarter. Most of that led by Taiwan, India, and a little bit in China as well having some strong performance though that seems to have burned off here a little bit. So, we would continue to favor the large cap market and a little bit more of the large cap growth market for the second half of the year.

**David:** Scott, I've heard it called the golden age of fixed income mostly by fixed income market commentators, but we do have abundant yield at this point. What are your thoughts on where we've been inside the fixed income markets for 2024 and where we're going?

**Scott:** Of course, the yields are nothing like we had back in the 1980s that many, many people remember.

**David:** That was the platinum age of fixed income.

**Scott:** That was the platinum age, that's right. Well, the good news is with the 10-year Treasury, call it at 4.4%, almost 4.5%; two-year Treasury at something closer to 5%. Even the treasury market is offering you a real return, meaning that the interest that you're earning is higher than the inflation rate. We haven't seen that for a number of years, basically since the subprime crisis that began in earnest in 2007. You're looking at 17 years where we've been in this interest rate desert, if you will, of having ultra-low interest rates to spark economic activity, post the subprime crisis.



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## Conversations with Commerce Trust Podcast

### July Episode: 2024 Midyear Economic and Market Outlook – July 2, 2024

So, the great news is the market offers you a real yield now and of course with a corporate bond on average, say yielding another 1% higher than treasuries, the corporate bond market's offering you real yields of maybe 2.5%, maybe even 3% of the Fed gets down to its inflation targets.

This a pretty reasonable rate. It's not something you're going to live off of your entire life, but at least it's a rational rate that provides a return that's likely to be at least half that of the stock market, if not perhaps a little bit more overtime. So, we think it's on a risk adjusted basis, it's an excellent opportunity that fixed income investors haven't had for quite some time.

**David:** As you dissect the fixed income market a little bit further, what areas of the fixed income market do we like, and we see as maybe a little more challenged?

**Scott:** Unfortunately, because the economy has done so very well and growth has been so strong, the riskiest parts of the fixed income market have performed the best, meaning high yield is beaten investment grade and investment grade is beaten government type bonds. There is less incremental earnings to be had going down the credit spectrum. So recently we've been basically focused on the investment-grade market, meaning those are credits that are BBB (rated) and better. (These are) usually large, well-known established companies as opposed to more speculative companies.

We've also begun to focus more on securitized type product. By securitized, I mean bonds that are backed by some type of asset or financial receivable to pay the bonds off so that you don't have to depend upon a company's credit rating. These are generally high quality, many of them AAA-rated securities that yield something that approaches a typical corporate credit.

Finally, mortgages don't do very well when interest rates are volatile. As they pushed interest rates up, of course, nobody wants to prepay their mortgage that extended those maturities exactly the wrong time if you're a bond investor.

Today, we think the mortgage market offers much, much better value and it does comprise a lot of what we call the index. If you look at the broadest index of the market, the so-called Bloomberg Aggregate (Bond Index), almost 30% of that index are mortgage-backed securities.

Emerging markets, as Tara mentioned just recently have been improving a bit. Believe it or not, over half of them are investment grade credits. They have a lot of duration as in a lot of maturity, and of course if we think rates are high, you want to grab a lot of that maturity and importantly, as we think the dollar begins to loosen up a little bit or weaken up a little bit as the Fed lowers interest rates. This is very positive for emerging market credits.



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### July Episode: 2024 Midyear Economic and Market Outlook – July 2, 2024

**David:** The other asset class that we want to discuss today is alternatives. We're broadly characterizing this as sort of hedge fund, real assets, private debt, and private credit. Tara, where are you seeing the opportunities right now inside the alternative space?

**Tara:** Right now, we would look to hedge funds, absolute return hedge funds as an alternative to your traditional asset classes of stocks and bonds, a good way to further diversify and mitigate risk. These absolute return hedge funds tend to show steady growth over long periods of time with limited volatility. We also favor hedged equity strategies, which have been competitive with the broader market, but also provide some downside volatility.

We also find some interesting opportunities in the private equity and private credit markets; however, these assets are fairly complex, can be illiquid and have some very strict eligibility requirements. So very important for any potential investor to talk to their financial professional about these types of assets.

**David:** I think having a discussion around private credit, private equity as well as the hedge funds space could be very important for portfolios as we think about it, both the hedge funds offering that different type of risk inside the portfolio and a nice diversifier as you mentioned, but really from maybe a return enhancement point of view, having a conversation around what sort of private equity and private credit, should you be eligible, could make sense inside a portfolio.

Lastly, just want to touch on as we enter the third quarter here, geopolitical risks. Certainly, we have an election inside the U.S. in the second half of 2024, and there's plenty of issues down ballot on that. Additionally, we have about 50% of the world's democracies going into election this year. We've seen results so far that have been polarizing. They have not been surrounding the center. Tara, what are your thoughts on how this affects the U.S. market?

**Tara:** As you mentioned, we have seen Europe just went through elections in majority of the countries and it seemed to be kind of more of a right tilt to those markets, and that's going to cause some uprisings probably, and how things are managed in those countries and how that would affect the U.S. is really going to come down to this next election.

Historically, the presidential election year tends to be positive for the market, tends to be slow in the first half and then really pick up in the second half. Majority of that is because people who are voted into power is what the people wanted and therefore are happy and the market tends to reflect that. But this is going to be a pretty volatile year trying to outguess what's going to occur here over the next several months.



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**David:** Scott, the persistent question that I get is around U.S. deficits. Certainly, we're past the stimulus at this point, but we're still deeply in deficits when it comes to our fiscal positioning inside the U.S. government. What are your thoughts around the risks inside the U.S. economy as well as the risks specifically with this deficit spending that we're seeing?

**Scott:** Well, you talked about the political risks and of course the financial markets have done quite well and largely seem to be looking past any political risk. One of the bigger political risks, although you wouldn't overtly suggest that it's political, is our deficit. U.S. government deficit, as most people know, is approaching 1.2 times the size of our country (in terms of U.S. gross domestic product). That's the largest deficit ever, including the deficit that we ran up during World War II. And as interest rates begin to rise and they of course are up, and that debt rolls over and has to be repriced, all those treasury bonds that were issued when interest rates are low are coming due now. Those interest rate costs are squeezing discretionary spending.

So, from a political perspective, I think the biggest risk that our economy faces on a going forward basis is this continued deficit spending and it's very difficult to get under control because of course nobody's really in charge. While the president can veto congressional budgets, Congress tends to want to spend, and of course the president doesn't like to disappoint, so our budget deficits are large.

I think that's the biggest risk that the financial markets, and frankly our country faces going forward, is how do we get a handle on this deficit spending? They've gotten a better handle on it overseas, over in Europe. We need to start focusing internally here because a lot of the oomph that we've had post pandemic of course has been stimulus driven, and we really need to transition now towards a more self-sustaining economic recovery that's not dependent upon government stimulus.

**David:** Well, thank you for the interesting discussion today. I really enjoyed it. To download the 2024 Commerce Trust Midyear Economic and Market Outlook, please visit [www.commercetrustcompany.com](http://www.commercetrustcompany.com).

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July 2, 2024

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