Commerce Trust Market Brief with Scott Colbert

June 3, 2024 – What's the current state of the U.S. Economy?

Scott Colbert: Good morning, it's Monday, June 3rd, the first trading day of the month. With five months already in the history books now, it's pretty clear that the S&P 500 (Index) has been the big winner so far this year, up 11.3% so far year-to-date. Small (cap stocks as measured by the Russell 2000 Index) and mid-cap stocks (as measured by the Russell Mid-Cap index) are positive but haven't participated nearly as much, up about 3% to 6% so far (respectively). International stocks are also positive, the large ones doing better than the small ones in a similar fashion, large-cap international up a bit over 7%, whereas emerging market stocks are up about 3.5%.

Somewhat surprisingly, interest rates have continued to push upwards this year, despite the fact that the Federal Reserve (Fed) has done absolutely nothing in the short end. The 2-year Treasury and the 10-year Treasury are both up about 60 basis points, which has pushed the return to the bond market, as measured by the Bloomberg Aggregate (Bond Index), the broadest measure of investment-grade securities, -1.64% so far year-to-date. Munis (municipal bonds) are also negative, but not quite as much, because municipal interest rates haven't risen quite as much as Treasury rates so far this year.

We're in the process of beginning to write our midyear economic outlook, and as we're looking at it, the three big questions that we're getting from clients have to do with: 1) How strong is growth, and perhaps are higher interest rates actually better for the economy; 2) What is the trend on inflation, and will it fall low enough so that the Federal Reserve can eventually cut rates; then 3) will we or won't we have a hard landing? Of course, we think we're in the process already of a soft landing as we sit here today.

In terms of addressing the first question, are higher interest rates actually pushing the economy forward, we come clearly in the camp that no, they are not. First off, the average household has a lot more debt than they do cash on the balance sheet, particularly those of lower income. People with high incomes who have the most cash don't have as much propensity to spend their extra earnings.

Clearly, it can be seen when you look at nominal growth, it's been cooling ever since the Federal Reserve has been raising interest rates. Nominal growth now is down to about 5.4% on a year-over-year basis. What has re-accelerated is real growth, but this is the good kind of re-acceleration because it's come from inflation falling faster than nominal growth. Essentially because inflation has cooled so quickly, there's more left over at the end of the year. Let's not be fooled by thinking that higher interest rates are a positive for the economy. They're clearly working; they're cooling economic growth.

While it's pretty obvious to us that higher interest rates are not accelerating the economy, what are they doing to inflation? To look at inflation, we took a long-term picture and looked back over the decades. You can see that it's been pretty clear that inflation rate, whether it's the CPI (Consumer Price Index), or the personal consumption expenditure (Price Index, or PCE) that the Fed likes to look at has been coming down by decade. Of course, it's rapidly increased post the pandemic with all the fiscal stimulus, the ultra-low interest rate environment, and all the problems that we had breaking our supply lines during the pandemic.

Has anything though really changed? We see two things that might have changed a bit. Number one, China clearly helped accelerate the deflationary trends post-2000, becoming basically the world's backseat or backyard manufacturer. To the extent that companies now are trying to diversify up their supply lines, I think that the deflationary forces from China probably aren't quite as great as they used to be. Secondly, the ultra, ultra-low inflation that we have experienced for about the last 15 years prior to the pandemic was largely driven by the subprime crisis and the deleveraging of the American economy.

I don't think that we're about to go through one of those again as well, so basically for the last 20 years, we had some extra help getting inflation of these ultra-low rates from China and the subprime crisis. To that extent then it's going to become a little tougher probably to get inflation rates back to 2% (the Fed's target inflation rate), but the Federal Reserve is making progress because they have a slightly restrictive monetary policy, keeping short-term rates higher than trailing inflation.

This year so far, the CPI has fallen to 3.4% and the PCE has fallen to 2.7%. The big drivers to this inflation have been housing and transportation services. We clearly see that housing is cooling a touch as affordability is basically at rock bottom levels and interest rates are high with mortgages hard to come by. Even on the transportation service side, we have seen some cooling. We expect some progress towards the end of the year, perhaps enough progress that the Federal Reserve can finally begin to lower interest rates, probably after the election.

Finally, then, we get to the big question, will we or won't we have a recession? We think the answer to that is we've already passed the will we or won't we part. We've already landed. We've already seen the slight reacceleration in real inflation. With employment likely to move forward, we see a long expansionary runway, particularly now with lower inflation, the Federal Reserve now has some ammunition to come to the economy's rescue should it slow down materially or begin to falter. You'll be seeing these issues addressed in our midyear outlook and we'll be back in several weeks to talk about the markets and how they're impacting your portfolios on a going-forward basis.