Commerce Trust Market Brief with Scott Colbert

August 5, 2024 – Equity sell off and recession fears

Scott Colbert: Good morning. It's Monday, August 5th, it's about noon, and the markets are awfully rocky, having been pushed around by a weak employment report last Friday. Through July 31st, stock market returns were exceptionally positive. The S&P 500 (Index) was up 16.7%, just five calendar days ago. Small cap stocks, as measured by the Russell 2000 (Index), were up 12.1%, having broadened out materially, once it was pretty clear that the Fed (Federal Reserve) would ultimately lower rates sometime this year. And international large-cap stocks (as measured by the MSCI EAFE Index) were up about 8.5% through July 31st. The bond market was positive, but it's even more positive today. Why? Because this weak employment report has roiled the stock market and pushed investors towards the bond market. Since July 31st, the S&P 500 is down about 5.7%, small cap stocks are down nearly 10%, international stocks have fallen 6.2%, and the bond market (as measured by the Bloomberg Aggregate Index) has rallied about 1.7%.

So, what's causing all this market turmoil? First, let's focus on the S&P 500. Through July 16th, when the market peaked, the S&P 500 was up 19.7%. Let's face it, that surprised just about everybody that the market could move so forcibly forward, so fast. In fact, when you look at the oscillator, the Relative Strength Index, you can see that the relative strength was peaking out at about the highest levels that the market really ever attains.

The good news is the market hasn't broken through its long-term trend resistance. Its 200-day moving average is still down about 300 (basis) points from where stocks are trading today, but even if the market bottoms somewhere around its 200-day moving average, which we expect it might, that's still a positive return on a year-to-date basis from the stock market.

With the stock market having given back a lot of its gains so far this year, what about treasury rates, and returns to the bond market? The two-year Treasury began the year at 4.25%. It peaked at about 5.04% in April, but now has declined all the way to 3.91%, as we sit here today, based upon these recent weak economic reports. The 10-year Treasury followed a similar path, peaking also in April, and having rallied now on a year-to-date basis. It's about eight basis points lower than where it started the beginning of the year.
This has moved bond market returns from the negative side, as interest rates (yields) rose, to the positive side. Through April 30th, the return to the broad bond market, as measured by the Bloomberg Aggregate, was actually down 3.2%. Today, the total return to the broad investment-grade bond market is actually a positive 3.3%.

So, what's pushing these markets around so much? Well, basically, it's a cooling of economic activity, as signaled by the most recent employment report. Last month, it appears that employment only grew by about 114,000 jobs, down quite a bit from where we were growing jobs for most of the year. In fact, if we annualize that 114,000 jobs report for the next quarter, the third quarter of 2024, you're looking at job growth that's just about half what it was the first quarter of the year.

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In addition to this slowdown of employment growth, we've also seen some other cracks appear in the employment landscape. Initial unemployment claims have been rising a bit. The quit(s) rate has been falling, and in fact, now is lower than it was pre-pandemic. Job openings have declined, even though they're still slightly higher than pre-pandemic. And hourly earnings have fallen quite a bit. In the last employment report, the average hourly earnings growth on a year-over-year basis fell to just 3.6%. It had peaked at 5.9%. So, effectively, we've seen quite a slowdown in wage growth.

Now, of course, the market is worried that this slowdown in employment growth will lead us towards a recession. And recessions in this country have historically coincided with the first month that we actually lose employment. We view this as just a fairly typical slowdown that one might expect after having had such robust employment growth.

Where does that leave us today? Well, it certainly leaves us with an economy that is cooling. It leaves us with tightening financial conditions as the S&P 500 falls, as inflation falls, and yet the Fed remains with their 5.25-5.50(%) restrictive fed funds policy. We think it most likely leads to some material interest rate cuts, as the year progresses.

The market is now projecting as much as a 50-basis point cut in September, as well as an additional 25-basis point cut in November and December. We would tend to agree with the markets. Why? Clearly, the bias to higher inflation has diminished, and the bias towards weaker economic growth has increased. This suggests that we ought to have a more neutral monetary policy, rather than the restrictive one we have today.

In the long run, the fed funds rate tends to be about 1% higher than trailing inflation. The CPI (Consumer Price Index) on a year-over-year basis has fallen to 3% and will likely fall further as the year progresses. With Fed funds at about 5.38%, this affords the Federal Reserve, even as we sit here today, the ability to lower rates about six times, or down 1.5%, and just bring the fed funds rate down to neutral. We think that's likely to happen as the year progresses, and this will be more than enough to keep our economic momentum moving forward.

We'll be back in a couple of weeks to discuss all the recent market volatility. We'll find out if the markets settle down a bit, and we'll certainly know more about the direction that interest rates are likely headed as the year progresses.

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