Commerce Trust Market Brief with Scott Colbert

August 26, 2024 – What Fed interest rate cuts might look like

Scott Colbert: Good morning. It's Monday, August 26th, and, of course, the financial markets are broadly positive on a year-to-date basis, masking some of the volatility we've recently experienced. The S&P 500 (Index) so far through last Friday is up 19.2%. Small-cap stocks, as measured by the Russell 2000 Index, are up 10.4%. Even the equal-weighted S&P 500 Index (S&P 500 Equal Weight Index) that we don't talk a lot about is now up a positive 11.5%, not up as much of course as the S&P 500, (which is) driven by those super mega cap names, but we're beginning to see a bit of a reversal that I want to talk to you a little bit about today.

Bonds have helped your portfolio too. Interest rates have declined slightly as the year has progressed. The two-year Treasury down from about 4.25% to 3.88% and even the 10-year Treasury falling five or six or seven basis points so far. The Bloomberg Aggregate (Index), the broadest measure of the investment-grade bond market, is up 3.6% now year to date, and municipals have also been pulled along positive. The Bloomberg Municipal Index up 1.3% so far this year.

These positive returns, of course, have masked all the recent volatility that I alluded to. The S&P 500 in the past month fell 8.5% and has nearly recovered all those losses. The equal-weighted S&P 500 Index fell, but actually has recovered now more than its losses.

So, what caused all of this market volatility? Well, initially it was sparked by a change in monetary policy at the Bank of Japan where they've hinted that they're going to be raising interest rates. This began then the so-called unwind of the carry trade because interest rates in Japan were going up and of course the Japanese yen was strengthening based upon those higher interest rates.

Secondly, it was sparked by weaker employment here in the United States. Initially in late July, we saw the initial unemployment claims jump significantly from about a 230,000 per week average to something closer to 250,000. And you might say, "What is a 20,000 increase in unemployment in a weekly basis?" But 20 times four, four weeks in a month, that's an increase of 80,000 people losing their jobs in a month. And of course, that has also been just about the same amount of reduced employment that we've seen because in the last employment report, we only created 114,000 jobs compared to the 209,000 jobs averaged over the past 12 months.

So, the combination of change in direction over in Japan plus the weaker employment reports here sparked a great deal of market volatility.

What changed the market's direction and what brought the markets back? Well, probably three things. The first and normally not the most important statistic to come out in a month was a very positive retail sales report, suggesting that the consumer was not nearly as worried about their employment situation as perhaps the slowdown in employment might've indicated. Secondly, we saw a drop in those initial unemployment claims, somewhat surprisingly, suggesting that the 250,000 per week loss of jobs was perhaps an outlier. And then finally, we've seen a massive Fed (Federal Reserve) pivot from one of restrictive monetary policy to flat out explaining to us that they will be lowering interest rates by the end of the year.

With all eyes on the Fed, what's going to push it towards either cutting slowly to start or a more rapid 50 basis point cut in September? We see three key economic reports as the likely "push" that would push the Fed towards either less or more accommodation. The first of course, is the unemployment report, which comes out in early September. The second will be the CPI (Consumer Price Index) report. Recall that the CPI has fallen all the way from 9.1 to 2.9%. In fact, with inflation as low as it is today and with the Fed having told us that they're moving from a restrictive policy to one that's more neutral, neutral policy would indicate probably perhaps as much as six interest rate cuts coming in the future. Finally, just before the September meeting, we're going to get the retail sales report and the market's keenly focused to see how the consumer is holding up.

We expect the Fed will be able to start with a modest 25 basis point reduction and probably continue that.

So, we'll be back in about three weeks to talk about the interest rate cutting cycle that we're about to embark upon.

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