Commerce Trust Market Brief with Scott Colbert

September 26, 2024 – Market reaction to the Fed's decision on interest rates

Scott Colbert: Good morning, it's Thursday, September 26th. The markets are open and trending higher. Returns this year for financial markets have been exceptionally strong, driven most recently, of course, by a cut in short-term interest rates. So far this year, the S&P 500 (Index) is up 21.5% through last night's close. The Russell 2000 (Index) is up about 10.4%. In other words, smaller cap stocks doing about half what larger cap stocks have done. International stocks have done pretty well with large cap international (as measured by the MSCI EAFE Index) up about 12%, 11.7% to be specific.

And even interest rates having fallen a bit now, have provided positive returns from the bond market, 4.4% return to broad investment grade securities (as measured by the Bloomberg Aggregate Bond Index) and municipal bonds (as measured by the Bloomberg U.S. Municipal Index) have returned about 2.2% so far year to date.

Once the market recognized the Fed (Federal Reserve) would be pivoting towards a lower interest rate environment, we've seen a broadening out of the stock market. While the S&P 500 sits at a new record high, it was back on July 16th that the market made up its mind that the Federal Reserve would be cutting rates. Since that time, the S&P 500 is up to a new record high up 1.48%. But the broader market, when you take a look at it as measured by the average stock price in the S&P 500 is actually up 3.79% since July 16th.

Why is this important? Well, most people aren't over concentrated in those mega cap stocks that have done so very well. Most of you have exposure to mid-cap stocks and small cap stocks as well as international stocks. And it's this broadening out of the market that's benefiting the average investor's portfolio.

So, while obviously the lower interest rate environment has been good for stocks, what's it done to bonds? Here's the ironic situation. Since they (the Fed) cut rates last week, interest rates (bond yields) have actually moved up just a touch. And you might say, how could that possibly be? And the answer is, if the lower interest rates are going to lead us towards a soft landing, that means that interest rates probably don't have to come down much more than they already have. In fact, with the 10-year treasury rate hovering around 3.8%, that would suggest that cash rates ultimately might make it as low as 2%. We actually think that's fairly optimistic.

The difference between cash rates and the 10-year treasury has historically averaged about 170 basis points over the last three decades. So essentially what we're suggesting is the bond market has already discounted most of the soft landing and probably doesn't have a lot more to give us from this point forward. Now, while the bond market doesn't have much more to give us in terms of positive price performance, clearly yields are up and the average investment grade portfolio is probably yielding somewhere around 4.5, perhaps even as much as 5%.

So, what does this all mean going forward? Well, clearly inflation is quickly approaching the Fed's target. This will give the Fed ongoing opportunity to continue to cut rates on a going forward basis. Short-term interest rates are likely to decline by at least 150 basis points over the next six, seven, or eight months. The market thinks at least that much will happen and perhaps even more.

And of course, the reason the Federal Reserve is cutting rates is because they're a little more concerned now about economic growth and job growth than they are concerned about the inflationary environment.

Taking a look at job growth, we can see that there are some clear cracks in the employment landscape. We've seen a slight increase in the newly issued unemployment claims. We've seen job openings decline. They're about a third down from their peaks. We've seen the quit rate slow down, meaning people aren't leaving their jobs. And when it comes to actual nominal job growth itself, we've seen a marked slowdown. So far this quarter, we've only averaged about 115,000 jobs per month created, and that's about half the pace that we had in the first quarter. And of course, this year's average pace of job growth is materially lower than it was in 2022 and 2023.

But fortunately, we believe the Fed has a tremendous amount of ammunition to provide to continue to propel economic activity forward. In fact, second quarter growth was just confirmed today at a solid 3%, and we think that we're growing probably at a two plus percent pace, almost at 3% pace as well in the third quarter.

So quite obviously, there's a lot to digest with the Fed pivoting towards a lower interest rate environment, stocks at record highs, and interest rates oddly backing up just a touch, despite the fact that short-term rates are coming down. And we'll be back in a couple of weeks to discuss what the Fed is likely to do in November, just post the election, and where we think the best opportunities are in the market.

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