Commerce Trust Market Brief with Scott Colbert

October 7, 2024 – Economic fundamentals provide boost to market returns

Scott Colbert: Good morning. It's Monday, October 7th, and the markets are open. Financial assets, of course, have shown you exceptionally positive returns so far this year. The S&P 500 (Index) hit new records last week up 21.9% through the year. Midcap stocks (as measured by the S&P 400 MidCap Index) are up 13.4%, and small cap stocks (as measured by the Russell 2000 Index) trailing those are up 10.3%.

International stocks are also positive. The large cap markets (as measured by the MSCI EAFE Index) are up 11% and the emerging market stocks (as measured by the MSCI Emerging Market Index) are up resounding 17.6%, quickly catching up to the S&P 500.

Finally, in the fixed income area, total returns to the broad bond market as measured by investment grade securities (Bloomberg Aggregate Bond Index) are up 3.4% and municipal securities (as measured by the Bloomberg Municipal Index) up about 2.3%.

There are two things to note in all those return measures. Number one is a modest broadening out of domestic stocks. The average stock in the S&P 500 (Equal Weight Index) is now outperforming the (broader) S&P 500 itself. Since July 16th the difference is about 3%, meaning that the average stock is beating the overall index now.

Secondly is the big jump in emerging market returns driven primarily by the big jump in Chinese stock prices. Since the Chinese government has unveiled stimulus measures, basically aimed at driving up stock prices and improving home prices, we've seen a marked increase in (emerging markets) equities. The Chinese stock market was flat for most of the year but is now up a whopping 39% on a year-to-date basis.

So, what's driving all these positive returns? Well, basically it's the economy that continues to do exceptionally well. Recall that we like to talk to you about the economic cycle with four letters, C-O-P-E. "C" standing for cyclical stocks, "O" standing for orders, "P" standing for profitability, and finally at the end of the cycle, how is ("E") employment trending? Clearly, the most recent statistics have shown you that we're still in the middle of this economic cycle and nowhere near its end.

We know that the cyclical part of our stock market has been pushed back. These would be auto stocks and steel stocks because of the higher interest rates. But new orders, particularly on the service side, have been rebounding recently. Last week, we got the Institute of Supply Management's New Order Index, and it's showing a marked expansion. And while new orders in general have been cooling, this rebound on the service side is very promising.

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You move from orders then to profitability, and there the story gets even better. Almost all of second quarter profits have been reported by the S&P 500, and we've seen a marked jump in profitability, not typical late and an economic cycle. In fact, profitability overall has jumped from 6% on a year over year basis to something closer to 12% when we measure operating earnings from the second quarter of 2023 through the second quarter of 2024.

GAAP (generally accepted accounting principles) earnings are also trending positive as well. Those are operating earnings, of course, adjusted for one-time charges. They're now increasing at about an 8.8% pace compared to essentially a flat pace earlier in the year. So, we've seen the new orders rebound a bit, profitability accelerate; What has it meant for employment?

Well, last month's September employment report showed the job growth, at least on a first-cut basis, was approximately 254,000 jobs. That was up materially from the previous two months and with revisions now we have employment growth that averaged over 180,000 jobs for the last quarter. On a year-to-date basis, job growth has been just a bit better than 200,000 jobs per month, and of course, 200,000 jobs per month is better than the entire economic expansion from the subprime crisis (2007) to pre-pandemic (2019).

So, all this indicates is that the economy is definitely cooling. It's slowing, but it's not even coming in for a landing. It's really just moving down towards a cruising like speed.

Finally, not all the news is perfect, of course, with the stronger economy and the higher level of growth, a higher number of jobs created, we've also seen a push up in interest rates, ironically, since the Fed (Federal Reserve) cut short-term interest rates 50 basis points on September 18th. Since the Fed reduced the short-term cash rate by 50 basis points, we've seen the 2-year Treasury and the 10-year Treasury rise by approximately three-eighths of a percent.

The irony of this though is, as the Fed was cutting rates and economic news was still reasonably positive, the odds of a recession have declined, and as such have actually pushed interest rates up a bit. The 2-year Treasury and the 10-year Treasury now are about 35 basis points higher than they were, subtracting a little bit of the return from the bond market on a year-to-date basis.

This is clearly a lot of financial market news to digest as we work our way through the most volatile month, which is typically October, into the election cycle. We'll be back to discuss all the year-end market activity coming our way and how it's impacting your portfolios.

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October 7, 2024
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