Commerce Trust Market Brief with Scott Colbert

October 28, 2024 – A look at the market's momentum and potential risks

Scott Colbert: Good morning. It's Monday, October 28th and the markets are trending higher as we await this week's inflationary reports, as well as reports on third quarter GDP (gross domestic product). And then of course next week's eagerly anticipated election results, as well as a Federal Reserve (Fed) meeting that meets two days after next week's election.

From a top-down perspective, the economic climate remains a relatively benign, but it seems to be hiding some of the risks in the market. We certainly have solid economic growth, low unemployment, resilient profits up almost 10% now year over year, as measured by the S&P 500 (Index), downward biased inflation, and a Fed that's poised to continue cutting interest rates.

This does tend to mask though the underlying risks that have basically built as the years progressed. These include very high domestic U.S. stock valuations, very concentrated indexes as exhibited by the mega cap seven (mega-cap stocks known as the Magnificent Seven), a possible election surprise that the market hasn't discounted yet, and of course, investor complacency that shows up when companies either exceed or disappoint on earnings.

Two examples of this include Tesla, just last week up 22% on optimistic earnings projections, and ASML, the company that builds all the machines that make all these very important chips that we're buying down 16% based upon lower projected orders.

In terms of those robust returns, of course, the S&P 500 is up about 23% so far this year. Midcap stocks (as measured by the Russell Midcap Index) trail the S&P 500 (but) are still up 14.8%, and the Russell 2000 (Index), a measure of small caps, are up about 10.1%.

The international markets, of course, remain positive. Large cap international stocks as measured by the (MSCI) EAFE Index are up 8.1%. Emerging markets (as measured by the MSCI Emerging Markets Index) have done even better, up about 13+%, driven by the recent resurgence in the China stock market.

This masks, though of course, a bond market that has basically disappointed a bit as interest rates have remained relatively high all year. The Bloomberg Aggregate (Bond Index), the broad measure of investment grade credits, is only up 2% year to date. Basically, underearning the yield that it's providing. And then the Bloomberg Municipal Index of broad-based return of municipal bonds only up 0.8%

Clearly, it's been a year with stocks grossly dominating bond market returns. And of course, underneath these large stock market returns is somewhat of a broadening out of the market since July 16th when the market became exceptionally convinced that the Fed would be cutting interest rates. And we can see that the average stock as measured in the S&P 500 (Equal Weighted Index), has actually beaten the (S&P 500) index, the concentrated index, by about 1% or 2% since that turn on July 16th.

Of course, that takes us to what's been going on recently. One of the more important things underlying this market's positive return has been a slight reduction in the outlook for the number of interest rate cuts coming to the market as the year progresses and into next year.

When the Federal Reserve cut rates last September 18th, recall that they reduced them by 50 basis points, the market was very optimistic there would be a number of rates cuts coming, including as many as seven by next June. The market has backed away from that, and you might take that as a negative, but it's not because the market has backed away from this because they've recognized that the odds of a hard landing or in a recession seem to have diminished. Now, looking at the market, the market is only expecting four rate cuts coming.

We'll know more about this when the Fed meets next week. But before the Fed's meeting next week, we will have statistics on inflation and employment growth. This week, we will get the Fed's favorite measure of inflation, the so-called PCE (Personal Consumption Expenditures Price Index), which we believe will come in at about 2.1% on a year-over-year basis down from last month's reading closer to 2.2% or 2.3%. And we've already gotten the CPI (Consumer Price Index) this month, which has fallen to 2.4% on a year-over-year basis from last year's 2.5%.

On Friday, we'll also get employment reports. Employment of course, has been cooling. In 2023, job growth averaged 251,000 jobs per month. This year, job growth is averaging 200,000 jobs per month, but still higher than the long-term average that we had from the post sub-prime crisis to pre-pandemic.

We still expect to see positive job growth of around a hundred thousand jobs, but there will be a great deal of adjustment trying to ferret out the impact of those hurricanes. Nonetheless, whatever the job number is, it's not likely to dissuade the Federal Reserve next week in their rate cutting path forward.

This of course brings us to the stock market and how it typically behaves after the Fed begins to reverse pivot and adjust interest rate policy. Historically, there's been one of two outcomes. Either the stock market ends up materially higher or it ends up materially lower. In other words, there's really no average result once the Fed begins to reduce interest rates.

Three times we can see that the Fed has engineered this so-called soft landing since 1983 as they've lowered interest rates, and this of course generates a positive market return. Three times, of course, the Fed has been a little late to the party in cutting interest rates and we ended up in a hard landing where no matter how much accommodation they gave us, and we still ended up in a recession. And this of course drives stock prices lower. Over a 24-month period of time, you can see that the difference in the outcome is rather striking.

So, while this week, we're going to work our way through some inflation statistics as well as an employment report. Next week's probably even bigger as we work our way through Tuesday's election and Thursday's Fed meeting, and we'll be back in several weeks to discuss the outcome of all of these events.

October 28, 2024
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