Conversations with Commerce Trust

Midyear Economic and Market Outlook: Is a Recession on the Horizon?

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David Hagee: Hello and welcome to Conversations with Commerce Trust, our show about the markets, investment themes, and economic insights that matter to you. I'm your host, David Hagee, Chief Investment Officer with Commerce Trust.

Today we're talking about our Midyear Outlook with Scott Colbert, our Chief Economist and Director of Fixed Income [Management], Brent Schowe, Director of [Investment] Research, and KC Mathews, Chief Market Strategist here at Commerce. Welcome back to the podcast, gentlemen.

Brent Schowe: Thank you, David.

Scott Colbert: Hello, David.

KC Mathews: Hey, David.

David: So, great to have you here. We're just about the halfway point of 2025. We got done just a week ago and published our Midyear Outlook, so I'd love to spend some time today unpacking that.

The Midyear Outlook is a recap of 2025 so far, but also offers insights as to where we see the economy going as well as markets over the balance of the year. The title of this year's Midyear Outlook is "A Cooling Economy Counting on Resilience."

So, let's start with why this economy is cooling. Scott, as I look at things, you know, the first half of 2025 has had a lot of transitions in there. Certainly, we had a new administration come in that has been very forceful in their first six months in office. Why don't we talk a little bit about why we see the economy cooling and what affects the new administration has had on it.

Scott: Well, certainly even prior to the administration, the economy had been slowing slightly. Nominal growth had been falling, and the reason for that, largely, is twofold. Number one, we've distanced ourselves, time-wise, materially from the huge stimulus offered during the pandemic.

And then secondly, you know, the Federal Reserve began to raise rates, you know, several years ago. Those higher interest rates are slowly but steadily biting into the cyclical growth in the country. So even prior to the administration, we were cooling a bit, but of course, administrative policy, particularly tariff policy, has, been a primary focus of the markets, the interest rates, credit spreads, and the stock market, and that's slowed economic growth further.

Imports are a subtractor from economic growth. And with the tariffs being thrown up, people rushed to import goods and services prior to the tariffs. That's beginning to reverse a little bit, but of course, you saw that first quarter growth came in basically effectively flat. It was even slightly negative.

That is reversing itself in the second quarter, but there's no doubt that, on a nominal basis, we're beginning to cool. Higher rates, distance from stimulus, administrative policy, and now the recent Israeli-Iranian war that we've got going on today for five consecutive days so far.

David: Yeah, that's a great point that, as we look at things, certainly a lot of turmoil in the world. But, you know, as we saw GDP (gross domestic product) come in flat for the first quarter, certainly businesses react to what they see as policy changes. And you saw a lot of front-loading of getting imports in before the tariffs came through.

You know, other areas that we've been focused on more recently have been around jobs. Looking back in the first half of 2025, what's been the big movement inside the jobs market?

Scott: Well, this all points a little bit to the resilience of the, you know, U.S. economy. As we have slowed, so too has job growth. But unemployment has been relatively consistent, around 4.2%, largely because, of course, we've also slowed immigration. And wage and salary growth is, you know, held up. Mostly because, of course, there isn't, you know, a tremendous number of people looking for jobs in general, relative to the size of the economy.

So we've seen, you know, continued positive progress on employment, but even that is tracking kind of the nominal growth as it begins to cool. In the Outlook, we show you a chart that shows you that job growth year-over-year has slowed.

That compares to a long-term average in the last expansion of about 180 (thousand jobs per month). So, you can see that we're already growing at about two-thirds the pace of the average expansion prior to the pandemic. But the key for economic activity and forward progress is positive job growth, and to the extent that we can continue to have that, there is no recession on the horizon. But it's troubling, of course, that job growth continues to cool.

David: You know, as we think about jobs, that's certainly one of the pillars that the Fed (Federal Reserve) is focusing on of their mandate. They have that twin mandate of full employment and inflation at 2%.

I would hope that's a 2% handle, not necessarily a flat 2%, but Brent, as we're thinking about inflation, you know, and tariffs, what do we think the impacts of tariffs will be on inflation?

Brent: Well, that's a good one, David. I think a lot of people are scratching their heads at that. I mean, we had in the previous administration, the previous Trump administration, and we had some mild tariffs. And the impacts there have been studied, and, you know, this is a whole different ball game. I mean those (tariffs) were quite mild compared to what we have now, and so how much of it gets passed through ultimately to the end consumer, because the "C" in CPI (Consumer Price Index) is "consumer," is yet to be seen.

So, you know, the idea that also that consumers can substitute for other goods. And how much is the importer going to absorb? How much will other businesses absorb? And so, it's a very tough call. At the high end, we would say it could add as much as maybe another percent over a cent and a half. I think at this point we'd be surprised if it got that high to add to the CPI that's already in the mid-twos.

If you saw a four-handle on the CPI late this year, I think that would come as a surprise. But it could get into the threes again. But again, this would be probably short-lived as people adjust, as businesses adjust, and then we move along to the next thing.

David: So, as we start to look forward here on inflation and jobs, are we anticipating that, as Brent mentioned, to have a little bit more inflation trickle through, or is this going to be sort of a non-event here?

And then finally, let's talk about how that ties back to the Fed, right? You have full employment, but you might have a window for them to start to cut rates a little bit further.

Scott: I think Brent hinted that, you know, we're more likely to see the "under" on this inflationary impact than the "over" because the response so far has been, that the exporters have lowered their prices a bit because they're being tariffed. The importers are eating some of their margin. The sellers are eating some of their margin.

And the consumer, as Brent said, has choices, and they don't have to buy French wine. They can buy something else that might not be tariffed. So, the impact to the CPI looks like it's going to be rather modest. However, that has put the Federal Reserve on hold because they're not exactly sure how much of it gets pushed through. And of course, whether it's transitory or a one-time temporary blip in inflation. And they (the Fed) don't want to be caught flat-footed like they did, you know, post the (COVID-19) pandemic.

But I do think that eventually the Fed will see that it's not as inflationary as expected and begin to slowly but steadily reduce interest rates sometime towards the end of the year. But it also depends, as you said, upon the employment situation. To the extent that employment weakens faster than people are expecting, that also could pull forward any potential Fed rate cut.

We're going to get a good handle on this on Wednesday. We're going to see the Fed dot plot post their June meeting and see what the median expectation is, from the Federal Reserve's point of view, for rate cuts as the year progresses. Our guess is that, at most, there will be two rate cuts by the end of the year.

David: So, the big question that culminates all the economic activity that we've seen is, will we or won't we go into a recession? As we looked at the betting markets surrounding that question of "will we or won't we go into a recession?"

When tariff talk really hit the crescendo in the first weeks of April, it appeared that there was about a one-in-two shot, or a 50% chance, that we were going to go into recession. What are our thoughts for a recession for 2025?

Scott: We've been pretty consistent that we didn't think we were going to have one. Largely because, as a middle market bank, we were touching lots of middle market businesses and consumers, and frankly, you know, everyone was in a pretty healthy shape going into this slowdown. That doesn't mean we're necessarily right, but I think the market's kind of come our way.

You've noticed, of course, that the stock market is back to positive territory. Credit spreads have compressed considerably, and this is even in the face of the recent situation developing between Israel and Iran. So we think, you know, that economic growth will continue. But of course, at a slower pace, and we are five and a half years into this recovery.

The average economic recovery post-1980 has been about nine years. Post World War II, it has been about seven (years). So, you know, if you're in a Shakespearean play, you're clearly in the third act and moving towards the fourth. So, you know, the expansion is probably more than halfway through its cycle, but nonetheless still has several innings to play out to, to mix a metaphor there.

David: Sure, as we look forward, that's a great point to bring up, that typically a recession is accompanied by some sort of energy price shock. And as we look at the geopolitical events unfolding, especially the Iran-Israel conflict, that seems to be growing, 20% of the world's oil floats through the Strait of Hormuz every single day. (EIA- The U.S. Energy Information Administration). So, if you took that oil off offline somehow, someway, through that widening conflict, that could be maybe some of that energy shock that could push us over into a recession. So, something for us to keep our eye on.

Certainly, something very tangible for us for 2025 has been the (U.S.) dollar decline. KC, we've seen this. The dollar against a broad basket of currencies declined by about eight to nine percent over the first half of 2025. How has that affected markets?

KC: Well, two ways. One would be, domestically, when you look at exporters like industrial companies, their products become cheaper around the world. So right now, when you look at sectors of the S&P 500 (Index), industrials lead the way up almost 10%. There's some positive there.

On the other side, in general, it'll be negative for stocks. And that's why you see, even though domestic stocks, using the S&P 500 as a barometer, is up 2.4% year-to-date, but international stocks, after almost 15 years of underperformance, now rise to the top. Using the MSCI ACWI (All Country World Index) ex U.S. Index, an index of international securities, it's up 15.6% year-to-date, driven primarily by the dollar weakness. So, there's some pros and cons with dollar weakness.

David: You know, the other thing that I'm struck by over the course of the first half of the year is, we mentioned the crescendo in tariff talk in the first couple of weeks of April. We experienced an extraordinary amount of volatility.

You know, as we look forward, what are we anticipating for equity markets for the balance of 2025?

KC: Well, it's interesting, David. As we know, every cycle has some similarities for the economy and financial markets and some nuances. And with tariffs and administration changes, what we do know is, you're going to have an increase in volatility.

So, the good news is we look back in history to find clues of what might happen in the future. We know in President Trump's first term, we had a trade war with China, a smaller scale than what we have right now. But guess what? We had volatility just like we're seeing in 2025.

So, what we do know is, we would expect some increase in volatility as we work out these trade policies, and that's exactly what we're seeing. But the good news, I think our conclusion at Commerce Trust is, just like in President Trump 1.0, companies find a way to navigate these tariffs, manage their margins and profits. And we still see corporate earnings growing in the six to nine percent this year, this calendar year, which, in turn, should support stock prices and give us positive returns in like the S&P 500 domestic stocks for 2025.

David: So, the other side of that coin is, as we looked at fixed income markets, Brent and Scott, what do we see in there? You know, we have certainly less volatility there, but it's still been a bit of a ride.

Brent: Yeah, it has, David. I mean, we were approaching, if you're looking at a 10-year Treasury bond, for example, we were approaching something along the lines of 5%. It was in the high fours in January. And then when we got the peak tariff concerns in that early April period that you mentioned, we had yields fall all the way down to nearly 4%. And now we're kind of in the in between those at four and a half. So there's been a bouncy ride.

I think it's important to note, though, that you know, we were talking about the Fed earlier. And their focus is certainly across the entire yield curve, but what they can really control is the short end. And as Scott mentioned, we're thinking maybe two rate cuts this year.

The long end is going to do what it's going to do, and what it tries to do is sniff out things like longer-term inflation. It's sniffing out deficits at the federal level. And so, the long end could be, you know, a little bit higher. The 30-year bond is at 5%. So, we're encouraging investors to, you know, pay attention to what the Fed's doing.

Scott: Brent, you grew up as a municipal (bond) analyst at our firm. What do you think about muni (municipal) bonds?

Brent: Yeah, I'm a recovering muni bond analyst, Scott, but I do certainly pay attention there. They're kind of a conundrum this year though, they're the weakest performing part of the bond market. They're actually slightly negative on a year-to-date return basis. A lot of that is a little bit kind of inside baseball because of supply and demand issues during this season.

You know, during the April tax period, things can get a little bit funky in muni bond land. But right now, yields are quite attractive. You can get a 10-year AAA muni approaching almost 6%, if you do the tax adjustment, if you're in the highest tax bracket. So, we think that represents really good value because, as many of us know, munis are certainly a less risky instrument than some of the corporate bonds out there. So, we think they represent really good value, and it's a good window of opportunity compared to other fixed income asset classes that have rallied quite a bit post the tariff talk.

David: Yeah, I'm struck, in general, that as we talk about the equity markets and the fixed income markets, there's beginning to have a bit of parity between the markets in terms of our expected returns, right?

So for stocks, we've had two great years in '23 and '24 (2023 and 2024), up 20% on the U.S. markets, 20% plus. This year, we're anticipating more subdued growth, but with that, we're seeing fixed income markets it's offering the possibility of mid-single-digit returns, but of course with two-thirds less risk. So, it reminds us that, amidst this uncertainty, we continue to hold to our core belief that asset allocation is the primary driver of returns. With that, gentlemen, thank you for the interesting discussion today.

For more on this topic, please visit www.commercetrustcompany.com for additional commentary and to be able to download our 2025 Midyear Outlook, "Cooling Economy Counting on Resilience." If you've enjoyed what you've heard, you can subscribe to our show on Apple Podcasts, Spotify, Amazon Music, or wherever you get your podcasts from.

Thank you for joining us on Conversations with Commerce Trust, I'm David Hagee, we'll talk again soon.

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