Commerce Trust Market Brief with Scott Colbert

From Inflation to Jobs: The Fed's Shifting Focus

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Scott Colbert: Good morning. It's Monday, August 25th, and the markets are open. So far this year, we've had exceptionally positive financial market returns. The S&P 500 (Index) is up over 10% now on a year-to-date basis. And even the average stock within the S&P 500 is up about 9% on a year-to-date basis. The Russell 2000 (Index), a measure of small-cap (capitalization) returns, has been catching up as well. It's a positive 6.81% now, not as far behind the S&P 500 as it used to be.

International stocks, though, have still been this year's clear winners. Larger-cap developed markets are up almost 25% (as measured by the MSCI EAFE Index) now year-to-date, and even the emerging markets are up nearly 20% (as measured by the MSCI Emerging Market Index) so far this year. Of course, about half of this foreign return has been driven by the decline in the (U.S.) dollar. But it's also been sparked along by what? Lower equity valuations overseas than here domestically, as well as some probable deficit spending, pushing some of these economies, value-oriented stocks along.

And the fixed income markets, as you know, are also positive now on a year-to-date basis. The broad market, being driven by slightly lower interest rates, is up 4.82%, as measured by the Bloomberg Aggregate (Index). And even municipals (municipal bonds) have now pulled barely positive on a year-to-date basis (as measured by the Bloomberg Municipal Index).

The biggest financial news recently has been (Federal Reserve) Chairman Powell's comments at the Jackson Hole Economic Symposium out in Wyoming. There, he suggested that the balance of risks is likely changing. Recall that the Fed (Federal Reserve) had been primarily targeting inflation. But of course, with the weaker job growth, they think that they might have to begin to ease interest rates just a touch to balance these risks out more evenly.

Now, these cuts in interest rates don't come as a huge surprise to the market. In fact, the difference between Treasury interest rates prior to his speech last Friday and where they are as I speak to you today are only a few basis points. The two-year Treasury has declined about six basis points down to 3.73%. The ten-year Treasury just moved four basis points, that's the rate that generally sets the mortgage market, from 4.33% to 4.29%. And the longest security, the 30-year Treasury, was least affected, only down two basis points. In effect, telling you that the forward market is largely discounting the thought that there will be an interest rate cut coming this September.

Now, there will be four big economic reports between now and when the Federal Reserve meets September 17th. These four key economic reports include the Personal Consumption Expenditure Index, the jobs report in early September, and one more PPI (Producer Price Index) and CPI (Consumer Price Index) report just before the Fed meets.

With regards to the Personal Consumption Expenditure Index, the Fed's favorite measure of inflation, they've been making good progress. Inflation based upon this measure peaked in February 2022 at about 5.6%, and it's fallen all the way to today's 2.8% rate. But note, over the past year, there's been very little progress made, and estimates are that the next print will be closer to 2.9% or 3% than it will be its low tick of 2.6%. As such, this is what gives the Fed a little bit of caution here to lower rates, because, of course, their favorite index for inflation isn't down to that 2% target just yet.

While inflation has been stubborn lately, the recent job growth rate has been cooling precipitously. Note the rapid fall down in monthly job creation post the pandemic, running this year at a miserly 85,000 jobs per month. It gets even a touch worse when you take a look at the trend in this year's job growth. Over the last three months, we've only averaged 35,000 new jobs created in this country, clearly below long-term average expectations. This, of course, is what's forcing the Fed to consider that the balance of risks has materially changed and they’re focused now on job growth, as opposed to solely being focused on inflation.

Despite the slowdown in job growth, surprisingly, the unemployment rate has held very steady. It's averaged between 4% to 4.2% over the last 12 months. How could the unemployment rate stay relatively steady while job growth has declined? The key to this is both immigration and demographics. From the immigration side, we know that it's clearly been limited over the past year.

From a demographic point of view, we now have the (baby) boomers who are retiring at about the same pace that 18- to 22-year-olds are now entering the workforce. In fact, over the next five years, the Census Bureau estimates that there'll be no aggregate growth at all in the workforce if it wouldn't be for additional immigration.

Furthermore, there are certainly some cracks appearing in the job market. While the initial jobless claims, that is layoffs, aren't really growing at all right now, we do know that job openings have declined precipitously from their pandemic peaks. We've also note that the quit rate, the number of people leaving their jobs, has also declined, indicating a desire to either stay where they're working or a recognition that there really isn't another job that they can quickly move to. And wage growth has clearly decelerated, also suggesting that the demand for labor is cooling.

Finally, just before the Fed meets, they'll also receive one more inflationary print, the CPI. The CPI, of course, has been rising recently, primarily driven upward by tariffs. The Federal Reserve is certain that tariffs are likely to push inflation up. They're just not certain how much, how far, or for how long. And will there be any contagionary-like effects? We would still estimate that there's going to be a slight rise in inflation as the year progresses, but then likely see it fall next year as the year unfolds. And we think that the balance of risks now has moved materially towards job growth, as opposed to what appears to be a rather subdued inflationary impact from tariffs.

So clearly, the Federal Reserve has a tough decision to make come September. Clearly, inflation has been a problem and remains somewhat elevated. At the same time, the sharp slowdown in economic activity and job growth puts these risks on a much more balanced basis. The market expects the Federal Reserve is likely to be cutting rates, with about 84% probability that there will be a rate cut coming in September.

Most of the Federal Reserve hasn't tipped their hand. A couple (FOMC voting members) clearly want a rate cut. A couple don't want a rate cut. So it's going to be a very close decision come September with a lot of data between now and this meeting. We'll keep you up to speed on all this new information and how it's impacting the financial markets.

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