Commerce Trust Market Brief with Scott Colbert

Stock Market Beats Expectations as Inflation Holds Steady

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Scott Colbert: Good morning. It's Monday, October 27th. The markets are open and trending higher. Driving the markets higher have been some pretty good news recently. There's negotiations moving forward between us and China with regards to tariffs, rare earth minerals. The stock market has been beating expectations. The CPI (Consumer Price Index) report that we just received was fairly benign, and energy prices are awfully well-behaved.

These positive reports of course, are boosting market returns. The S&P 500 (Index) so far this year is up 16.66%, and the average stock in the S&P 500 (as measured by the S&P 500 Equal Weight Index) is up about 10.75%. The Russell 2000 (Index), a measure of small cap (capitalization) returns, is catching up to the large cap stocks, now up 13.91% year-to-date. That's about as narrow as it's been since the beginning of the year. International stocks, though, have been the big winner, helped along by the lower dollar, with returns of nearly 30% whether you're a large or a small international stock (as measured by the MSCI EAFE Index and the MSCI Emerging Market Index).

And then the fixed income markets have been very positive too. The Bloomberg Aggregate (Index), the broadest measure of fixed income returns, is up now 7.41% year-to-date, helped along by what, the coupon, which is probably accrued to about 4% so far this year, plus lower interest rates, which have generated some positive price performance. Municipals, of course, have also participated, returning almost now 4% (as measured by the Bloomberg Municipal Index) year-to-date tax-free.

So while our government is shut down, they did bring back some workers to calculate the CPI. They needed to do this because they need the CPI report for September to calculate the year-over-year Social Security increase. Fortunately, the inflation statistics were relatively benign, and inflation is holding very steady at about 3%, whether on a core basis or on a total basis.

Now that the Federal Reserve has the CPI statistics, they have a really good shot at calculating what would be the PCE (Personal Consumption Expenditures Price Index) or their favorite inflation statistic. And that probably then came in at about 2.8%. And that's important information for them prior to their meeting this week. And of course, with this benign CPI report, the Federal Reserve is likely to lower rates because, of course, the tariffs are not impacting the CPI as much as initially expected.

Note that with a 3% inflation rate, this is somewhat below our expectations for a ramp-up in inflation because of tariffs and then a ramp-down. Effectively, the tariffs have had a very modest impact so far on inflation. And there are some offsets to whatever push the tariffs have put on inflation.

Let's take a step back to dissect the inflation statistics. Note that we can break the inflation statistic into two components. The service component, which is about 65% of inflation, and the goods component, the component that's being impacted by the tariffs. We would note that on a trailing 12-month basis, the service component is coming in at 3.6%, mind you, the lowest level since its peak of 7.6% post the (COVID-19) pandemic. And the goods are coming in at about 1.9%.

Now, for a while, we had goods inflation down to effectively zero post the pandemic, after having been run up consistently during the pandemic, particularly with the supply chain disruptions. But note that the goods prices are trending up a bit. But fortunately, goods are only 35% of the CPI, and of course, imported goods are only 11% of total GDP (gross domestic product).

Helping offset this push up in goods have been energy and housing. Note how well-behaved energy prices have been this year. Oil prices have only averaged about $66 a barrel, compared to 75 (dollars per barrel) last year, and the forward projection for energy prices is even lower next year. We have the futures market, where you can lock in prices for oil on a forward basis below $60 a barrel, and the EIA (Energy Information Administration) is out with their most recent estimates, expecting oil prices to perhaps push down to $50 a barrel.

Now, nobody's very good about predicting energy prices, but this is largely being driven because inventories are up. Current global production is about 107 million barrels a day, and consumption is about 104 (million barrels a day). Strong production out of the Middle East, as well as our fracking here, have generated basically excess surplus capacity. This has been absorbed in terms of inventory. Inventories are at record levels relative to where they've been during the pandemic. Currently, there's about a 30-day supply of oil around the globe.

And while we all see gas prices on a daily basis, home prices are still the biggest contributor to the CPI. Owner’s equivalent rent, which is about 25% of the CPI, is still clocking in at a relatively robust 3.8% pace. But note that since we know where apartment rents have been heading, as well as the median home price, we have a pretty strong predictive model that would suggest that owner’s equivalent rent is likely to fall next year by 100 basis points. You take out 100 basis points of the CPI. When it's a quarter of the CPI, that's a 25% reduction or a 25 basis point reduction in the overall CPI level.

So, with the very benign CPI helped along by lower home prices and energy prices, everyone is expecting the Fed (Federal Reserve) to cut rates. Probably by the time you're seeing this video, the Fed will have cut rates by 25 basis points, and the market expects an additional 25 basis point cut by the end of the year, as well as two rate cuts next year. That should drive the short-term interest rate down from something just over 4% to something closer to 3%, or a much more neutral posture.

Recall that the Fed is in the process of pivoting from basically keeping a slight tap on the brake to cool inflationary pressures in the economy and is now a little more concerned about weak job growth. Effectively, they want to take their foot off the brake and put the short-term interest rate in a neutral posture where it's not accelerating or decelerating economic activity.

Finally, it's a big week for the stock market. Five of those “mega seven” stocks are going to report earnings. Those five represent 25% of the market cap, with the Mag Seven (Magnificent Seven) representing 35% of the market cap of the S&P 500. Earnings expectations are very high, about 17% for these top seven companies on a year-over-year basis. And of course, that is about twice the earnings growth rate of the S&P 500 as a whole. But of course, we know that these top seven companies are also driving historical returns.

On a trailing one-year basis, these “mega seven” cap stocks are up 30%. And of course, the S&P 500 on a trailing one-year basis, ending the third quarter, is only up about 17%. So we can see how important the earnings of these companies are and how much they are key drivers to the S&P 500.

Finally, I would note that so far this year, most of the companies are beating both their revenues and earning estimates. 65% of the companies reporting so far through the quarter have beat their revenue estimates, and 85% have beat their earnings. This is the highest level of earnings beats in the last four years, also helping drive stock market returns higher. So that's a lot to digest, and we’ll be back in several weeks to update you on all the news and how it's impacting the financial markets.

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