Commerce Trust Market Brief with Scott Colbert
Sticky Inflation, Slowdown in Job Gains, and the Recent Fed Rate Cut
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Scott Colbert: Good morning. It's Friday, December 12th, and the markets are open. Of course, this year they've generated exceptionally positive returns. The S&P 500 (Index) is up 18.75%. Small-cap (capitalization) stocks on a relative basis are almost keeping up as well. They're up 17.6% as measured by the Russell 2000 (Index). The average stock though, in the S&P 500, is still underperforming (as measured by the S&P 500 Equal Weight Index), only up 12.79% so far this year, showing you that the S&P 500 returns are still being dominated by those large mega-cap stocks that you all know about.

International stocks, both large (as measured by the MSCI EAFE Index) and emerging market stocks (as measured by the MSCI Emerging Market Index), are up around 30% so far year-to-date, having been boosted by that 10% decline in the dollar. And the fixed income markets are soundly positive, too, with the interest rates having come down a bit this year as the Fed (Federal Reserve) cut short-term rates three times. The Bloomberg Aggregate (Index) is up 7.04% year-to-date, the broadest measure of investment-grade credits. And the Bloomberg Muni (Municipal) Index is up 4.05% with those tax-free returns.

The biggest news recently has been that the Federal Reserve has cut short-term interest rates. You can see that during the pandemic, of course, the Federal Reserve cut short-term interest rates to nearly 0% and then pushed them up about 5.25% as inflation took hold. But more recently, the Fed has been lowering rates starting last September and now cumulatively have lowered rates 1.75%, with a target top-end fed (federal) funds rate now of 3.75%.

The yield curve has responded accordingly as well, with shorter-term rates having come down this year. The 2-year Treasury now is down 70 basis points on a year-to-date basis, and the 10-year Treasury has also followed suit, down about 41 basis points so far this year. Now, while the Fed cut interest rates at this past meeting, there certainly is a bit of disagreement on the committee about how much and how fast they need to cut interest rates.

The reason for this, of course, starts with inflation, and inflation still remains relatively sticky, having been boosted a little bit this past year by the tariffs, only offset by slightly slowing service inflation. You can see that by either measure, the core CPI (Consumer Price Index) or the core PCE (Personal Consumption Expenditures Price Index), the Fed's favorite measure of inflation, inflation is much closer to 3% still than it is 2%.

When we dive into those inflation statistics. About 65% of it is driven by the service side of the economy, and housing falls into the service side, being the vast majority of the CPI. You can see that the service side has been cooling, and we expect with moderating home prices as well as moderating rent rolls, we expect to see the service side of inflation continue to fall.

The goods prices, though, have been the sticky part, boosted probably by the tariffs having risen from about 0% a year ago to about 1.9%. But we do believe the tariff impact is likely to be one-time, and eventually sometime next year, perhaps as early as April or May, we are likely to see inflation start to cool once again.

But while inflation has been sticky, there's been a clear deceleration in the job market. You can see that over the past several years, job growth per month has been declining. That is typical as a recovery expands. But the recent slowdown in job growth is rather alarming. So far, this year, with revisions, job growth is less than 50,000 per month compared to a longer-term average of something closer to 180,000 jobs created per month.

And why is this alarming? Well, you can look at the following chart and see that basically when job growth begins to go negative, historically a recession ensues. Now, this time it could be different. We've seen different things coming out of this pandemic. The inversion in the yield curve did not lead to a recession. The collapse in the leading economic indicators post the pandemic did not lead to a recession. And this might be one of these other situations, because of demographics, we have very minimal job growth for a period of time, yet no recession.

But this is why it's alarming to the Fed, and why they were still willing to lean towards lowering short-term interest rates a bit to protect against this cooling in the job market. So, all in all, the Fed basically is trying to put short-term interest rates at what they consider to be a neutral posture, one where they're neither accelerating the economy nor decelerating.

So what should we take away from this Fed meeting? Well, we think there are four key points to note. Number one is the growing dissension within the committee on whether or not to cut short term rates at all. Two members voted to keep rates the same, while one member voted to increase the rate cut by 50 basis points.

Secondly, while the Fed is not of clear mind as to what to do with short-term rates near-term, all members are biased towards easing eventually. They're just not sure how much they need to ease and how fast they need to do it. Thirdly, while the Fed believes that it's pretty close to neutral, it's still probably on the higher end of the range of neutrality.

Now, no one knows what a neutral fed funds rate, the fed funds rate that neither accelerates or decelerates the economy. But basically, when you look at the longer-term dot plot expectations of the average Fed member, we believe that short-term rates are likely to be closer to 3% in the long run than they are today's 3.75%.

Finally, we expect the Fed to be on hold for a period of time now. They will be digesting though some new employment statistics next week as we catch up on the government statistics from October and November. But to the extent they're not exceptionally weak, we expect the Fed to be on pause for a period of time, just balancing the nearer-term inflationary pressures versus the long-term slowdown in employment. So we'll be keeping you up to speed on all the financial news and how it's impacting the financial markets.

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