Conversations with Commerce Trust podcast
January Episode: The Economic and Market Outlook
01/05/2024

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 reviewing our 2024 outlook with Scott Colbert, our Chief Economist and Director of Fixed Income Management, and KC Mathews, our Chief Market Strategist here at Commerce Trust. Welcome to the podcast, gentlemen.

Scott Colbert: Hey, David. How are you?

KC Mathews: Hi, David.

David: Guys, wrapping up 2023. I think there's a lot to talk about, and certainly looking forward into 2024, there's a good deal that we need to review here as well. Scott, we'll start with you. On the economic side, what are your thoughts about the 2023 economy as well as let's look forward a little bit into 2024? I'm thinking specifically around jobs and the consumer, but also this higher interest rate environment that we've been surviving through.

Scott: I think much to most people's surprise, the economy avoided a recession last year, and that was largely because job growth continued, and while we had higher interest rates, they didn't bite as harshly or as strongly as many expected. Going into this year, we still see forward momentum, but we still see an economy that's cooling as the higher interest rates today, with a lagged effect, continue to pull down economic growth.

The great news, though, is those higher interest rates have also helped cool inflationary pressures as well as time; time away from the pandemic that allowed all those backlogs and the jammed up order flow that we had, the bottlenecks, if you will, to clear. Our outlook for the economy this year is more forward progress, probably less likely from a probabilistic standpoint to have a recession, but yet an economy that continues to cool in the face of these higher interest rates. The best news of all is, though, because the inflation rate has rolled over as significantly as it has, it now provides the Federal Reserve (Fed) some ammunition to lower rates and continue the economic expansion.

David: Given the thought you just mentioned there of having a Fed pivot, what does that do for us on the housing market side, and what does that do for us on the job side? Today (January 5, 2024) we had another jobs sprint of 250,000+ jobs coming through, so a pace of three million a year. Does this accelerate jobs even further?

Scott: Any lowering of interest rates is likely to help spur along economic activity. Job growth has cooled, and it's cooled considerably, say, from the year prior, whereas job growth last year was about half that of the prior year. Frankly, the entire economic expansion that we had from the subprime crisis to the pandemic, job growth averaged about 180,000 jobs a month, so what we're getting basically is back to average and typical job growth.

I do think any pivot at all towards lower interest rates is likely to spur the economy along, but that pivot will largely be driven by not so much economic growth, but the outlook for inflation. Inflation on a trailing 12-month basis is certainly now much closer to 3%, and it was much, much closer to, say, 4% a year ago. On a six-month basis, it's approaching that 2% level that the Fed is targeting, and the Fed believes that they can probably get to that 2% level sometime during this year. If they can make it there, that's where that pivot occurs.

Now the market has already picked up on this pivot, and as KC will tell you, the market had a pretty good year last year. The financial markets are already anticipating the pivot. The pivot is likely to come. It may disappoint in the sense that it may not be as much of a pivot as the markets already expect right now.

David: Pardon the pun, but the pivotal question is, will the Fed pivot? If that happens, KC, what does that look like? Let's talk a little bit about 2023 as well. It's a market that we had fantastic returns of 26.5% or so on the S&P 500 (Index). International stocks showed some life at around 18% on the (MSCI) EAFE index, almost 19%. Maybe you could walk us through exactly what happened in 2023, and let's talk a little bit about that Fed pivot as well.

KC: You bet. 2023 was a good year for most asset classes, as most classes posted positive returns. It was no different in equities and equity subclasses. Last year, the narrative in the equity market was around the seven largest companies here in the U.S. called the "Magnificent Seven" or the Mag Seven. This group of companies actually posted a 75.9% rate of return in 2023. Now, what's important is these seven stocks have a large representation in many indices. The Mag Seven represents 28% of the S&P 500, and the Mag Seven represent 49% of the NASDAQ composite, which was up 44.7%.

Good returns across the board, even internationally, using the MSCI EAFE Index, as you cited, up 18.3%. Decent returns. The MSCI Emerging Market Index up 9.8%. Now, that Emerging Market Index is heavily dominated by China; about 30% of that index is China. China had a tough year. They had a tough economic reopening, and thus returns were somewhat muted. Overall, 2023 was a very, very good year in risk-based assets.

David: As we talk about that, we had this market leadership with the Mag Seven do they become the Lag Seven, as you put it earlier today, in 2024? What about sectors? What sectors are we watching out for in 2024?

KC: That I think is the big question is “Will the Mag Seven become the Lag Seven?” We don't think so. We like those stocks. What we do think at Commerce Trust is the market will broaden out. The reason we think that is, I looked at the fourth quarter, and looking at the S&P 500, 90% of the S&P 500 stocks moved above their 50-day moving average. That's the first time we've seen that since June of 2020. Our expectation is maybe the leadership of the market might change. Right now, we still like domestic large cap because of the risk-return profile.

Given Scott's assessment of the economy and his forecast, if we see some uncertainty with a slowdown, perhaps a recession, we want to be in domestic large cap. That will give us more downside protection. For 2024 is decent returns in the stock market because what we know is once we see peak rates, and Scott tells us he's a fair amount of confidence we've seen peak rates when you look at the 10-year Treasury rates peaked in October, same thing with T-bills in October of last year. Our research suggests that once we see peak rates, risk-based assets perform well for the next 12 months.

David: Let's talk a little bit about the things that we should be attentive to. As I look forward into 2024, it's a year of the presidential election inside the U.S. Interestingly enough, 40% of the world's democracies are going into an election inside 2024, so certainly something that we're keeping in mind. Additionally, is it time for international to finally see their day in the sun? They've lagged for almost 15 years with some episodes of outperformance there. Then finally, a recession isn't completely off the table, but what would we see if we saw a recession, or this Fed pivot happen inside markets?

KC: Okay, got a number of questions there.

David: That was a long question, KC. A lot to unpack there.

KC: We'll tackle them all. What's interesting is international equities, the valuation is waving a white flag. Look at me. What I did is I looked at just valuations, domestic versus international, using the S&P 500 for domestic valuation. Today, that index trades at a 19.5 times forward PE (price to earnings), and I use the MSCI All-Country ex-US Index, which is everything but the US, that valuation PE stands at 12.9. Clearly, looking at valuations alone, you would say, "Well, we have to buy more international,” but then-- you got to put the pieces of the puzzle together. The next step is to look at earnings, and earnings growth is much more attractive here in the US than globally.

I think there's a reason why many international markets trade at a discount valuation because earnings growth just isn't there. Yes, at some point in time, we might need to look at international, we want to remain diversified and have international in our portfolios. We're just underweight, and that has benefited our clients. At least for the first half of this year, 2024, we want to be in domestic large caps to protect us on the downside. Like you said, what if, what if you see that slowdown and recession? Again, we think domestic large caps will perform best.

David: Let's talk for just a quick minute about the presidential cycle. We have this election coming due this year. How should we be thinking about that in the context of the equity market?

KC: The team here at Commerce Trust spent a lot of time looking at this. Let me start with what a presidential election introduces into the market is nothing more than volatility. We can go back and look at GDP (gross domestic product), and stock prices, and performance. We actually did this going back to 1947. Guess what? You have good years and bad years regardless of what political party is in power. That's not really the issue. It's more about in a presidential election, you have all this uncertainty and markets don't like uncertainty.

David: Scott, given that we have this Fed pivot that may or may not happen inside 2024, how are you thinking about fixed income markets?

Scott: We're very positive on fixed income on a relative basis. Number one, of course, with rates higher today and inflation cooling, it's likely to generate a positive real return just like it did last year. Just from the start, it helps to anchor portfolio returns, reduces risk. Secondly, in general, in almost every circumstance we can find, if the Fed is lowering rates, you want to be long duration, you want to be long maturity. It's very difficult to fight the Fed. Rates tend to go up as the Fed pushes rates up and rates tend to come down as the Fed pulls rates down. It's just that simple. We want to anchor those portfolios with longer maturities.

The bigger question within fixed income is how much credit risk you want to take. We certainly like the market from a risk perspective a little better than we might have last year, with the exception that valuations have improved. Credit spreads are below average, meaning the average corporate bond now gives you a little less relative yield to treasuries than it did even the previous year. We're still a little cautious on taking too much credit risk. We want to basically stay in that intermediate quality range, up in quality, say, from the junk levels, but not too far down in terms of the investment grade.

I think that's where our number one priority is, high quality, longer duration, fixed income assets. Secondly, as the year progresses and if we can totally put the potential for a recession behind us, then we might consider adding to the higher yielding, riskier sectors of the bond market. I think that we'll have enough equity exposure, and we have full equity exposure now. That probably likely provides quite a bit of a risk to a portfolio as we work our way through, as KC just said, an election year and one where basically we don't have the all-clear signal just yet.

David: Finally, the asset class we haven't spent any time on has been in the private market side of things characterized by hedge funds as well as private credit, which is a new version of lending out there or a version of lending that's got some emphasis more recently. Then also private equity, which certainly captured a lot of people's headlines and thoughts over the past decade or so.
I'm struck by whenever interest rates went up dramatically, that really slowed down the initial public offering market as the liquidity event that a lot of these private equity funds used to get returns to shareholders. Really a very, very tough year in 2023 for the private markets. KC, how are we

thinking about private markets, both private credit as well as hedge funds and private equity for 2024?

KC: Let me start with hedge funds. Hedge funds is a very broad term. There are many different sub-asset classes under that umbrella. For the most part, if you look back at 2023, hedge funds, especially what Commerce Trust gets into, multi-strategy and hedged equities, they did what we expected them to do. They mitigated risk. Multi-strategies, which is just what it is, a number of different strategies tied up in a bow, it did north of 6%. It beat bond performance, was a risk mitigator. Hedged equity, it'll never outperform on the upside broad equity indices, but many of these hedged equity products were well up over 15% with a fraction of the risk. They did what we expect them to do. In 2024, if you have volatility, I would expect these type of asset classes, risk mitigators, to play out well in clients' portfolios.

On the private side, yes, with higher interest rates, you saw merger and acquisition activity dampen, the initial public offering market dampen, buyouts, all that, I think, just slowed down dramatically. It doesn't change our outlook on private investments. Whether it's private credit or private equity, these can play a role in a client's portfolio. I'm in Scott's camp: I think rates are going to come down. Then private equity, private credit continue to do well and add value in clients' portfolios in 2024 and beyond.

David: Thanks, gentlemen. I think it was a really good discussion today. Certainly, our outlook (is) we are cautiously optimistic on the equity markets and feel like we can earn a nice return there. Certainly, we're confident we can earn a nice return inside the fixed-income markets.
As we think about that in the context of portfolios, especially with the potential of a Fed pivot coming through, Commerce Trust has made the move where we had a 5% cash position inside most of our portfolios for the balance of 2023. In December, we made the move, given that we see a clear path forward for real returns inside fixed income, (and) we are optimistic about the returns we could be receiving out of the equity markets. We allocated that 5% cash position back into both fixed-income and equity markets as we are fully invested starting off 2024.

Thanks for the interesting discussion today, gentlemen. To download the Commerce Trust 2024 Economic Outlook, please visit www.commercetrustcompany.com.

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.

interests, or profitability of any investment strategy or market activity. And information provided may not be relied upon as such.

You as the investor, are fully responsible for any investment transaction you choose to enter into, including determining whether such investment is appropriate in light of your investment objectives and personal circumstance. And you shall not have relied on any of the proceeding or following information from Commerce as the basis for any investment decision. This material is not intended to replace the advice of a qualified attorney, tax advisor, or investment professional.

In considering whether to trade or invest, you should inform yourself and be aware of the risks. Past performance is no guarantee of future results. And the information in the commentary provided is subject to change based on market or other conditions. Diversification does not guarantee a profit or protect against all risk.

Commerce Trust does not offer tax, legal, or specific estate planning advice. And while we may provide information or express general opinions from time to time, such information or opinions are not offered as professional tax or legal advice. Commerce Trust does not provide advice relating to rolling over retirement accounts.

Commerce Trust is not a municipal advisor under Section 15B of the Securities Exchange Act and therefore does not offer advice or recommendations concerning bond proceeds or other municipal advice, subject to this section. Any data contained herein from third party providers is obtained from what are considered reliable sources. However, its accuracy, completeness, or reliability cannot be guaranteed.

January 5, 2024
Commerce Trust is a division of Commerce Bank.