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Commerce Trust Market Brief with Scott Colbert
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Scott Colbert: Good morning. It's Monday, March 18th and the markets are open. Stocks, as you know, have had positive returns so far this year. The S&P 500 (Index) is up 7.63%, smaller stocks are up, but not quite as much. The midcap 400 (S&P 400 Midcap Index) up 4.68% and the smallest stocks up a modest 0.89 basis points as measured by the Russell 2000 (Index.) International stocks are following a similar capitalization trend, with the largest stocks in the international developed markets (MSCI EAFE Index) up 4.44% and the emerging markets (MSCI Emerging Markets Index) trailing up only 1.42%, held back by Brazil and China returns.

The bond market hasn't fared too well yet year to date either as interest rates have basically been modestly moving higher as the year has progressed. The Bloomberg Aggregate, the broadest measure of the investment grade bond market, is down 1.72%, and even municipal bonds which of course haven't done quite as poorly as taxable securities, are still down a few basis points.

The big driver to the stock market returns has probably been about four things. Number one is a consensus view that has largely moved from recession to that of a soft landing. Number two is an amazing willingness to bid up almost anything AI (artificial intelligence) related. Number three are earnings that are coming in a bit better than expectations, and number four is probably this modest broadening out of the market. The S&P 500's equal rate of return is up about 4.5% so far on a year-to-date basis. While that's not as broad as we would like it, that is more broad than last year's very narrow Magnificent Seven stock market-driven returns.

On the bond market side, the focus has simply been two-fold. Number one, stickier and hotter inflation for the first two months of the year than the market was expecting. Then secondly, the fact that these higher inflation statistics have probably pushed out the timing of the first Fed (Federal Reserve) rate cut this year. Let's focus a little bit on this stickier inflation and how it compares to where inflation was at the end of the year, as well as how much this hotter inflation has likely pushed back the initial timing of a Federal Reserve rate cut. In terms of inflation, we've seen a bounce back on both the CPI (Consumer Price Index), the PPIs (Producer Price Index), and the personal consumption expenditure (PCE) indexes for the first two months of the year. Trailing inflation was, by and large, down to 3% or even closer to 2% by most broad measures.

For the first two months of the year, those measures are elevated. If we take just the first two months of the year, you can see across all four broad categories the core personal consumption expenditures, goods, housing, and a super core, which ex-outs food and energy and housing, have all jumped materially for the first two months of the year. The sudden rebound and somewhat stickiness to the inflation statistics, of course, has also pushed back the timing for likely Federal Reserve fed funds rate cuts.

At the beginning of the year, the markets were actually expecting the Federal Reserve to cut rates as early as March and as many as six, and perhaps even seven times as the year progressed. With these higher inflationary prints though, the timing has certainly been pushed back and today's expectations are that the Fed will start cutting rates in July and perhaps has as many as three rate cuts in them as the year would progress.

We believe after a very hawkish Federal Reserve meeting likely to be followed by a tough press conference this coming Wednesday (March 20th), that the market's expectations will still be around July for the first rate cut, but we doubt that the market will expect much more than two rate cuts by the end of the year.

Why are we still convinced that the Federal Reserve will be cutting rates this year? We've certainly seen some re-acceleration and growth and of course we've watched this rebound in inflation. It all comes down to housing, (with) housing being such a large component of the inflation statistics.

Historically, if you simply regress the average home price and where rents are, you can get a pretty good estimation of what owner's-equivalent rent or the contributors to housing inflation are likely to be. Already those statistics that are going into the CPI and the PCE are higher than we would expect by almost 2%, and as the year progresses, our forecasts are that they will fall by at least 2%. In other words, housing by the end of the year should be contributing about 60-70 basis points less inflation than it is currently today, which of course will help cool these inflationary statistics and move us much closer towards the 2% target than the current elevated 3% trailing inflation statistics that we see today.

We'll be back in several weeks to discuss this week's FOMC (Federal Open Market Committee) meeting, the outcome and how it's impacted your portfolios, and any potential changes we have in terms of our outlook for the financial markets.

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