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Five Minutes with Commerce Trust's Chief Economist – Scott Colbert
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Scott Colbert:

Good afternoon. It's Friday, January 28th, and the markets have closed for the week, down once again. Fourth consecutive decline for the stock markets this year.

As we sit here one month into the year, it feels a little bit like the Tale of Two Cities. "It's the best of times and it's the worst of times." In terms of the best of the times, the real economy is doing exceptionally well. Economic growth last year was up 5.7%. Job growth, we literally created 6.4 million jobs. Of course, the unemployment rate has fallen to 3.9%. Wages and salaries have grown at about 5%. About the only thing holding the real economy back is inflation. Of course, inflation has grown faster than people expected.

This year should be another good year, though, for the economy. While we don't expect to see 5-plus percent growth, it wouldn't surprise us to see at least 4% growth. As job growth is likely to be closer to 2% and 3%, wage gains of 4% and 5% this year, as well, provide a lot of economic stimulus as we progress through the year to make forward progress.

The worst of the times, though, seems to be focused in the financial markets. As we've grown so quickly, we mentioned inflation, of course, has risen relatively dramatically. The Federal Reserve was even perplexed, was hoping to see it (inflation) roll over by now, but yet it hasn't. They've even admitted that they were probably wrong about the transitionary status, and likely to be sticking around. They want to take action, and they're going to be forceful this year about trying to push back with their monetary accommodation, taking some of this stimulus away.

The market had been discounting a few months ago perhaps two rate hikes this year, and then it was three, and now it's probably closer to five. Even today, a major bank came out and suggested perhaps there is a rate hike coming at every central bank meeting, and there are seven of them left this year, which, of course, would drive cash rates up from zero to maybe as much as 1 ¾%

As such, the S&P 500 peaked basically the second day of the year, third day of the year, on January 3rd, and it's fallen about 10%. Small-cap stocks and technology stocks, the NASDAQ, sniffed this out earlier, though. Back in November, they peaked, and small cap stocks are down almost 21% now, as measured by the Russell 2000. And the NASDAQ Composite is down about 15% or 16% as well.

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What does this mean for the markets? Well, historically, the markets are now in what you would call a technical situation where they're below their long-term moving averages. And we've seen this three times since 2008, essentially when the market bottomed in the last recession, in March of 2009, in the last recession, and have made a lot of forward progress. It's hard to believe, but as we sit here today, the S&P 500 is up 14-plus percent over a trailing 10-year period, and it's still up 30% from its peak prior to the pandemic.

So as the market breaks down and moves through its moving averages, it typically has to settle in, and this takes a while. This takes a process. Bottoming is a process. It typically takes an entire quarter, and of course, we're only about a month into this.

The good news is, is that we think that this is a correction in the midst of an economic expansion, and that's a lot different than a bear market that accompanies a recession. So, in other words, while we expect to see the markets pull back, we also expect to see them bottom, and then we eventually expect to see them make some forward progress.

Our equity team still thinks that stocks have a chance to be up by the end of the year. On average, one year after the Fed begins to raise rates, stocks are up, on average, 5%. Two years into a rate-hiking cycle, they're actually up 10%. What could make stocks do this? Well, earnings are still growing very rapidly, valuations are getting better, and eventually the market will over-discount the amount of Fed accommodation that they're going to take away. So we're still optimistic that the market can pull out a gain for the year.

It's been a tough year, too, for bonds as well, because, of course, interest rates are moving up. The two-year Treasury is up about 40 to 50 basis points, and the 10-year Treasury is up over 25 and almost 30 basis points year to date. Of course, bond prices move inversely to the changes in interest rates. They're down as well.

So it's been a lot of tough financial market news, but a lot of good economic news so far to digest. We'll be back in a week or two to talk about whether we're any closer to a stock market bottom. I think we will be. We're likely to try and work through this in the first quarter, and then we'll try and build a base and finish out the rest of the year, in what's going to amount to basically a very strong year for the economy, but a much tougher year, finally, for financial markets.

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