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Five Minutes with Commerce Trust's Chief Economist – Scott Colbert
2/18/2022

Scott Colbert:

Good afternoon. It's Friday, February 18th, and as we all know, there's a heck of a lot going on in the financial markets. Year to date, the S&P 500 is down about 9%. Large-cap stocks, particularly in the tech sector, are down closer to 15 as measured by the NASDAQ 100, and small-cap stocks are down about 10%, somewhere in between the large cap stocks and the NASDAQ stocks. But oddly enough, small-cap stocks have been in a little bit of a stealth rally. They peaked back in November of last year, fell almost 20%, but are actually higher today. We see that as the first sign of light at the end of a correction tunnel to perhaps provide some expectation that stocks will bottom over the next few months.

Now, interest rates haven't helped you much either. The bond market, no place to hide. Interest rates have jumped materially this year with the 2-Year Treasury going from about 75 basis points to about one and a half percent. And the 10-Year Treasury essentially hanging in there right around 2% now, up about 30 to 40 basis points from where it started the year. The Lehman, which is now the Bloomberg Barclays aggregate, is the broadest measure of the U.S. bond market, and it was down 3.85% year to date as of yesterday. It's rallying a little bit today as the stock market fell just a touch, and there was a small flight towards quality.

So, there's been no place to hide really in the equity market, no place to hide in the bond market. Why all the trouble in the financial markets, if in fact the economy's doing pretty well? And the economy is doing pretty well. We're going to grow jobs at about a 2% pace. Meaning there'll be about 2% more people working, wages and salaries are likely to grow 4 to 5%, 2% plus 4 to 5%, that's an extra 6 and a half to 7% more money coming into the economy as the year goes on. There's still some deficit spending. There's still some pent-up demand. There's still some inventory that we have to restock. So, it's quite easy to see that growth, after adjusting for inflation this year, is likely to be perhaps as much as 4%. Remember, we grew 5.7% last year and 4% is still a very, very positive number.

So, what's the problem if the economy's doing so well, what's holding back the financial markets? Well, we think it's basically three very straightforward, simple things. Number one, of course, it's inflation. Basically. It's become the headline story. CPI's (Consumer Price Index) up 7 and a half percent year over year, and it's not so much that inflation is holding back the market, but it's the likely repercussions from that inflation in terms of where will interest rates be to combat this inflationary surge say a year forward? And the Federal Reserve has clearly become more hawkish, and that's number two, the interest rate hike that is likely to follow the surge in inflation.

When we began the year, we thought that the Federal Reserve might raise rates four times at about every other meeting and probably reverse their quantitative easing sometime as the year progressed. Well, they've ended their quantitative easing sooner than the market's expected. They're going to end that additional quantitative easing in March and they're going to start to raise rates fairly assertively and the market is discounting now six rate hikes, probably bordering on a seventh rate hike. It wouldn't surprise us at all to see the Federal Reserve is going to have to raise rates at every meeting. So, you have inflation and you have this rise in interest rates.

The third thing of course is the geopolitical situation, which only gets more tense. The Russia Ukraine situation feels like a powder keg. That's basically out of our hands and very, very hard to discount and hard to handicap, but likely to overhang the market and create a risk-off type posture. Stocks typically don't do well when the Fed's raising rates. They of course don't do well when there's geopolitical turmoil. So, we think that probably the opportunities to get back into the stock market assertively and aggressively will occur sometime as valuations open up over the course of the year.

What are we doing to help your portfolios though through this rocky time? Well, number one, of course, we have shortened your bond portfolio's maturity protecting against that interest rate hike. That's working out pretty well. We've added some credit exposure to get some extra yield to make up for the ultra-low treasury interest rates. That's worked really well last year. It's been about a push this year in terms of value added or value subtracted. The biggest thing we have done so far this year, though, is we have subtracted from the growth sectors of the portfolios and pushed them more towards the value sectors of the market. The biggest and cheapest valuations are overseas in the international markets and emerging markets, and typically the value sector of a portfolio withstands an interest rate rise better than the growth sector of a portfolio. And so that's probably been the biggest defensive change we've made.

Now, as the year progresses, we're going to have better earnings. So, valuations are likely to come down and stocks will be looking better and better. Hopefully there'll be some progress made somehow or another over in the Ukrainian Russian situation. And eventually the market will over-discount how hawkish or how tough the Federal Reserve will have to be. And we do think by the end of the year, we'll clearly see some signs that inflation is coming down and probably provide us an opportunity to take a more risk-on posture. But for the next three, six, nine months, it's pretty easy for us to see that you probably ought to pull back some of the assertiveness of your portfolio and stay a bit defensive, looking for better valuations as the year progresses.

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