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Five Minutes with Commerce Trust's Chief Economist – Scott Colbert
10/1/21

Scott Colbert:

Good morning. It's Friday, October 1st. We've just started the trading day and there's a lot to catch up on. Maybe we'll review back over the quarter here just a little bit. But a lot of people would call this a quarter disappointing from a financial markets perspective; I would call it relatively transitory, as we are rotating from a reopening of the economy based upon a cooling of the Coronavirus and all the stimulus we've had, to one that's a more self-sustaining economic recovery.

But nonetheless, stock prices were depressed particularly in the month of September and the S&P 500 fell just a touch for the quarter. Small cap stocks did even worse and emerging market stocks were the bottom performers. But still on a year-to-date basis, the S&P 500 is up over 15%. Small-cap stocks, as measured by the Russell 2000, are still up 11%. International large-cap stocks are still up over 6% to 7%. And the emerging market stocks, held back by all the problems over in China, are only up 1% year-to-date.

The quarter also masks quite a bit of move in the interest rate level. The 10-year treasury started the quarter at just a little less than 1.5%. It ends the quarter at just a little less than 1.5%, but fell almost 30 basis points during the month as the Coronavirus cases around the globe surged and the growth forecasts were coming down.

Inflation peaked, probably, with the CPI coming in at 5.4% twice, and then most recently at 5.3%. And we've recently got in the Personal Consumption Expenditure indexes in just yesterday. The Personal Consumption Expenditure index is the inflation index that the Fed tends to focus on. It came in at 4.3% on a year over year basis. That's the highest inflation rate we've had since 1991. And on a core basis, it also equals the same amount of inflation that we had back in 1991. So that's 30 years ago, you have to look back to find inflation statistics like that.

What are we looking towards, though, going forward from here? I think the number one factor to focus on, still, is the Coronavirus. Now the Coronavirus cases bottomed in June, not only here in the United States, but globally. They rose rapidly in July and August, probably up by over 50% globally, up by a lot more than that here domestically. But in the last month they've been coming down and down and down. Down about 30 to 35%, depending upon where you live, what part of the world. That's probably the biggest driver of growth going forward, to the extent that it stalled growth from the third quarter, as we shut things down or had to socially distance where frankly, the ports in Vietnam and Malaysia literally came to a halt. As they begin to open up and bring back some capacity.

So we expect growth in the fourth quarter to increase from whatever it was in the third quarter. And there are a lot of guesses as to what it was. Probably in the low threes, high fours, something like that. But growth in the third quarter just basically gets transitioned probably to the fourth quarter.

Inflation is peaking. Now it's also a lot stickier than people thought. And it's a lot stickier than the Fed thought. And you can even hear it in their voice now, too. They've grown to realize that inflation is with us more on a going forward basis than they'd hoped. That has caused interest rates to rise. And that's probably the biggest risk to any economic outlook that we have, is how fast interest rates are likely to rise. Let's face it, the stock market is a bit of a levered investment. As those interest rates came down, you're willing to pay more and more for a dollar of earnings. And that drove stock prices up. So to the extent that interest rates rise, we would imply that generally the market has about a 10% delta. In other words, about 10% of the market move is driven by about a 1% change in interest rates. So as interest rates rise, probably over the last half of the year, or the last quarter of the year, and then in the next year, you're going to get some pressure on stock prices, offset, hopefully, by a lot of earnings growth.

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Now there's some wild cards in all of this mix, too. I think the biggest wild card in the near term is our own government. We've got to extend the debt limits. Fitch (a credit rating analyst) just put out a warning today that they're likely to downgrade the government unless they come to a quick agreement here on extending the debt limit. You might recall in 2011, that S&P downgraded our debt from AAA to Aa1 because of the same wrangling we had back in 2011.

You've got the situation in China. And clearly we talked a little bit about Evergrande the last time, but this is not going away. Evergrande, the largest or second largest property developer in China, is still under a great deal of pressure. And while we think that these problems are largely contained to China, to the extent that China slows, the rest of the world feels its impact. Clearly the emerging markets that supply almost all the goods and services right into the Chinese economy feel the slowdown. And as property becomes less and less important to China, prices might come down and hurt their growth. And at the margin, China has been the big driver of growth around the world.

And then the third probably biggest wild card I still think is inflation. How much will it cool and how much will it pull interest rates up? Housing prices have been driven up largely by lower interest rates. We've talked about stock prices being driven up. Even the inflation itself has been driven up by lower interest rates. And we do expect to see some pressure on interest rates. And so the speed or rapidity of how quickly this occurs going forward is probably key to the market's outlook.

So we'll think about that. We've got China to focus on. We've got inflation and interest rates to focus on. And we've got our own government to focus on. That still doesn't mean the outlook isn't awfully bright. We expect employment to grow. We expect growth to increase. We expect inflation to peak and continue to roll over. And hopefully the transition to a higher interest rate environment is rather moderate and slow, which affords us a rather positive outlook for the financial markets.

We'll be back in a couple of weeks to talk about the start of the fourth quarter and any changes we might have to our rather positive economic outlook.