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

Good morning. It's Friday, October 29th. It's the last trading day of the month. And we'll update you on what's going on in the financial markets as we start the fourth quarter. First off, let's face it. The equity markets have been exceptionally strong. This month, the S&P 500's up over 6%. Small and Mid-cap stocks have also been pushed higher too, making up for all the losses back in September. Year-to-date, rather amazingly the S&P 500's up over 23%. And if you took a broad measure of all the stocks as measured by the Russell 3000, the average domestic stock is up 21% year-to-date.

International markets have not been as good, but they've been positive. The international developed markets as measured by the EAFA (Europe, Australia, Asia and Far East) index are up about 13% year-to-date. And it's the smaller or the emerging market stocks that have fared the worst with China driving their stock market lower. Emerging markets stocks as measured by the Vanguard Emerging Markets Index are probably up about 3% or 4% as we sit here today.

Now, the bond market's a totally different story. While stocks have zoomed this year, interest rates have risen. And as interest rates rise, of course, prices are pushed down and we never expected a lot from the bond market this year. And the Lehman aggregate, now the Bloomberg Barclay's aggregate, which is the broadest measure of the bond market is down about 1.6% this year. Most taxable bond funds that you're likely to be invested in have come much closer to zero. For example, the Commerce Bond Fund is down a whopping 50 basis points. As interest rates rise more, the price depreciation of your bonds, more than offsetting the coupon, but basically bond investors have had something very, very close to about a 0% return.

Now what's driving the markets at the moment? Probably the biggest thing truly at the margin is the rollover in new COVID cases. We of course saw the Delta variant spike in the third quarter, which held back growth. You might recall that GDP was reported on a first estimate basis at only 2% in the third quarter, but this was entirely driven by the increase in COVID cases. Those have now rolled over by half. Hospitalizations are rolling over, and of course, new deaths are rolling over. Secondly, earnings are clearly driving the market. Earnings beats are still up.

Overall earnings for the S&P 500 are estimated coming in almost at an annualized basis of $215 per share. And of course, this has put the market at record levels. Now $215 per share versus a stock market that's getting to be very, very close to 4,600 as measured by the S&P 500 still creates a PE of 23 or 24, a rather expensive market, but we do expect earnings to grow.

Earnings have been basically fairly disparate as the quarters progressed. For example, some of the keynote companies like Apple, Amazon, and Starbucks have reported disappointments, while of course the energy companies have reported record earnings and all the disappointments have come slightly from different directions. For example, Starbucks' earnings miss was driven largely by the slowdown in China as their store sales in China have slowed materially. Apple's not from a lack of demand, but for the inability to get enough iPhones into customer's hands. They missed the revenues by about $6 billion. And then Amazon's are what you might expect. Rising wage pressure.

Nobody's hired more people than Amazon over the last year. There was a joke going around that perhaps they should implement the draft to bring in people for Amazon. We're literally talking hundreds and hundreds and hundreds of thousands of new jobs created, but of course the cost to Amazon has gone up, and then they're facing margin pressure. So it's a mixed bag in terms of earnings.

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Now, as we approach the end of the year, you basically have this push from valuation. Valuations are very high, but earnings are likely to grow versus this rising interest rate market. You don't hear much about it, but interest rates have been slowly creeping up. And around the world, they've actually been increasing a little bit faster. And importantly, they've been increasing in the short end of the market, meaning the short maturity. For example, the two-year treasury bond has nearly doubled in yield in October. It's gone from a minuscule 25 basis points to a whopping 50 basis points. And overseas, we've seen similar reactions, for example, in the Australian two-year and even Italian bonds and the Irish bonds and the peripheral credits have all seen their interest rates begin to rise.

Why is that? Because the European Central Bank and the United States, the Federal Reserve Bank, are about to slow their quantitative easing. They're going to start to reduce the number of bonds that they're buying, and this will likely put pressure on interest rates. And that's probably the market's biggest hurdle to overcome going forward is can they absorb a likely interest rate rise? Now growth's going to pick up in the fourth quarter, employment's going to pick up in the fourth quarter. We're going to hear from the Fed next week, importantly, on their reversal of the quantitative easing. And we're going to get the employment report next Friday. So there's going to be a lot of news to digest as we approach the Christmas season. And we'll be back in a couple weeks to talk about it.

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