Podcast Transcript: What could recent market losses mean for the rest of 2022?

David Webb:

I'm David Webb, director of investment management at JNBA Financial Advisors in Minneapolis, Minnesota. We're recording this discussion on May 9th, 2022.

Joining me for the conversation are two senior members of JNBA's investment committee, Michael Bilotta and John Foster, both senior advisors and investment strategists.

John and Mike, there's been a lot of market volatility this year, and this past April was one of the worst months for global stocks since the pandemic began. So John, with rising inflation and interest rates, we really haven't seen investors being able to hide out in bonds or stocks from losses, and this clearly doesn't feel good for most investors.

Since the markets are now forecasting the Fed to continue to make many more hikes over the course of this year, can bonds still be considered an acceptable investment?

John Foster:

Hi David. I think, we've certainly seen a lot of volatility in both stocks and bonds this year and the bulk of that volatility to the downside. As we've talked about previously, the first quarter was the worst quarter for bonds in four decades, and in fact, the magnitude of increase in interest rates on both the two year and 10 year bond are about a one in 50 occurrence to happen within a quarter.

Certainly something that's very rare, but we do feel now that the bond market has priced in a good majority of what's anticipated from the central bank. To give you an idea now, yields on a two year treasury are sitting at about 2.6%, a five year 3% and a 10 year about 3.1%. All of those are more than double basically where they sat at the beginning of the year.

Just look in the last week here, we saw prior to the Fed raising interest rates by 50 basis points, a two year note yielded 2.8%. Since the Fed raised rates by a half percent and said, they're likely to do a half percent increase at each of their next two meetings, that two year note dropped from 2.8% to 2.6%.

So here you have the Fed raising interest rates and then rates actually dropping on two year notes in the bond market. We're seeing the bond market go and kind of suggesting at least that a lot of this is priced in already. As the Fed's moving interest rates higher, you're seeing bond yields actually start to stabilize, so that's a pretty good sign.

In addition to that, just pretty good yields out there right now. The corporate bond index yields 3.8% and a 30 year mortgage is sitting at 5.6%. We think that the bond market's done a lot of the heavy lifting to price in these rate increases, and that yields are going to be in that 4% range maybe for a bond portfolio moving forward, which is a reasonably acceptable return, especially considering how low interest rates have been for the bulk of the time from 2008 to now.

The bond market's done a lot of work to price in these rate increases, and we would expect a lot less volatility out of bonds moving forward.

David Webb:

Thanks, John. The key takeaway, it sounds like is after many years of investment purgatory, the entry point for bond investors is much improved.

John Foster:

Yeah, absolutely. We think it's a much better spot to be buying bonds and that returns can actually be pretty decent moving forward for bond investors.

David Webb:

Thanks for that perspective, John.

Mike, looking at the broad market in general, what would you share with investors who are wondering how unusual this environment is and what's our investment committee doing to navigate these waters?

Michael Bilotta:

Thanks, David. Coming into 2022, we knew that we were going to have a challenging year for all of the traditional measures. The first thing though, we were transitioning to a post-COVID economy where people have made the conscious decision that we're just going to get back on with life. We're going to go to restaurants again. We're going to travel again. We're going to start spending our money on the service side of the economy and less on the good side. What type of repercussions was that going to have for economic growth, either positively or negatively?

We also knew going into the year that inflation was a problem as it proved to be anything but transitory, which was the original thought last August, September, and that eventually it would start to come down. That may have been the case, except that everything was exacerbated by the Russia-Ukraine conflict, in that it really interrupted the supply chains of oil, natural gas, and a lot of the agriculture and commodities that go to much of the world for food production.

It was almost as if you had a powder keg of uncertainty, and as the Fed is going along and raising interest rates, as they have telegraphed and everybody knew they would, all of the data gets analyzed and over-analyzed to the point where you've got extreme volatility.

Now, if we backed up and said that we didn't have these unique factors at play, volatility is not really anything new to the market. For example, this is the fifth correction of between 10% and 20% since 2015. A 10% correction occurs once every 1.1 years, so once a year. A 20% correction occurs every three to four years.

So it's not as if we haven't seen this volatility before, but the last big correction we had was due to the pandemic, and so it feels like that one almost doesn't count per se. But again, even in a normal environment, we've experienced this sort of volatility before and tried to manage around it.

The one thing I know is, and we get it and it's never any fun, is that you don't know exactly where or when the damage is going to stop or that market's going to quit going down or what have you, and that's why it's important to keep flexibility.

David Webb:

That's great advice, Mike. Volatility, it's always with the markets. It pops up from time to time and it clearly is the price of admission to obtaining some of the higher, long term returns that stocks offer. I guess, still in the midst of this challenging environment, is there anything in the playbook for individual investors to consider, things that they can do to help alleviate maybe emotional decision making?

Michael Bilotta:

I think you made a very valid point there, and it is kind of the price of admission. The same types of allocations that allowed people to get the very positive returns that we've had over the last three to five years are the same allocations that from time to time will suffer the slings and arrows of a down market or a potential recession or higher inflation.

But the key is how you deal with that, and we all know there's no golden goose to all of this. What you try to do over time is increase the probability of success, and some of the ways to do it are the good old fashioned time tested elements of, and I know this is a cliche, but diversification.

There are different definitions of that, but the important thing is that when you're dealing with an environment that has such a wide variety of outcomes, it's important to be in all areas of the market, so you're ensuring that you're participating in whatever might be doing well at that particular time.

For example, here in 2022, as stocks have been down well into the double digits, gold and commodities are the only two major asset classes that are up on the year, and those are exactly two of the same asset classes that a lot of people didn't want to own any of over the last three to five years. Now, you wish you owned more.

It's important to be diversified. It's important to be flexible, to be able to adjust to the information as it comes out daily, weekly, monthly. Frequent review and rebalancing of the portfolio. It's possible in a volatile environment that makes no progress whatsoever from point A to point B, that if you're actively rebalancing, selling at a high point, redirecting dollars to something that's underrepresented, in a sideways environment you can actually have a very positive outcome on the end result.

Of course, the last thing is making lemonade out of lemons is the tax loss selling that can occur to create benefits down the road. In that, we can sell an investment that's at a temporary loss today, buy back something that's similar enough in value to where we keep the same exposure, and yet now, we have a buffer against future capital gains because we've just captured a loss that we can use. Essentially, we didn't alter the structure of the strategy of the portfolio at all.

So I know that these are the behaviors, but these are the things that we can control. There are a lot of other things out there that we can't, and that's where people spend a lot of their time, unfortunately, worrying about.

David Webb:

Sure, sure. Thanks Mike. Timeless lessons, indeed. John, I guess apart from trying to cultivate and practice healthy investment behaviors, are there some things that investors should not be doing that would otherwise undermine their ability to grow their wealth over time?

John Foster:

I think Mike really hit on the key point, David, and that's sticking to your strategy. All too often, whether it's because the market's doing really well and people want to chase returns and maybe get more aggressive, or get into areas of the market like over the last couple years where we saw technology or certain segments of the market do really well. People want to chase prices higher.

The same is true when prices are going lower. A lot of times, just because in the short run, it'll feel better to sell the things that are not working out, which this year happens to be most major asset classes as stocks and bonds have both performed poorly. So it feels really good in the short run to say, well, let me get rid of the things that are not working out in the portfolio.

But all too often, both stocks and bonds, which have long term positive returns, at about the time you get the most frustrated with them is often the time that they're about to head the other direction.

So it's really reassessing what you're trying to accomplish, and if what you're trying to accomplish or your time horizon hasn't changed, then usually your strategy shouldn't change either. It's staying disciplined and sticking with that long term investment strategy, and that's really going to give you the highest probability for success.

There's just no way to navigate all the squiggles exactly right, but long term that asset allocation's really going to drive 80% of that return, and so if your long term goals haven't changed, then the asset allocation should really look pretty similar.

David Webb:

That's great advice. Finally, just amidst all this volatility, could you share a few things that the investment committee is keeping a close eye on?

John Foster:

I think probably the biggest for the market right now, David, has got to be inflation. People are concerned about inflation and higher prices and the Fed is raising interest rates to combat inflation at the risk of slower growth in the future. I think in the near term here, if even over the next couple months, we add a couple of friendly inflation prints out of the CPI or other inflation readings, that would probably give the market some relief and a reason to rally. But certainly inflation's going to be good, a big part of the second half of the year here.

Michael Bilotta:

That's a good point. I think that also are the signs of a possible recession, and when I say that, I think that's what's kind of exacerbated volatility here as of late, is that the Fed doesn't have a very good track record historically of being able to raise interest rates and engineer a soft landing at the same time. Especially when we deal with a position like they've been in where interest rates have been almost zero for the last 12 years. They've been printing money, like it's going out of style, and then once you try to reverse course, it is a very tough balancing act.

So I think where six months ago, a recession was just one of the possibilities. Now it's becoming a bit more of a probability, and the question is if it's a mild recession or a very quick recession, that's part of the normal business cycle. Sometimes there's not a lot you can do to position around those, but it's something, if it turns into anything bigger than that, longer lasting and so on.

That would be along with stagflation, some of the things that we're paying attention to, but the important thing is in what we look for in our research and our models is we talk about all these varied environments, and at the end of the day, it doesn't matter what we or investors think should happen, want to have happen. Believe is the right course of action.

What matters is what's actually happening and to get in alignment with the trends and the data so that as the trends become a reality, we've already skated to where the puck is, so to speak, in our position accordingly. Just a couple of things there that I think are important as we meet regularly as an investment committee.

David Webb:

Thank you for the conversation today, John and Mike, and thank you very much for listening today. We hope you'll continue to visit jnba.com and tune into our other podcasts and videos where we cover both investment and financial life planning topics.

And thank you for your continued trust in JNBA, not just as your financial advisor, but also as your advocate. Please reach out if you need anything at all. You can find our contact information at jnba.com.

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