Podcast Transcript: What could the economy's mixed messages be trying to tell us?

David Webb:

I'm David Webb, Director of Investments at JNBA Financial Advisors in Minneapolis, Minnesota. We're recording this discussion on August 24th, 2022. I'm joined today by a senior member of our Investment Committee, John Foster, also an Investment Strategist at JNBA. Thank you for being here with me today, John.

John Foster:

Yeah, thanks for having me, David.

David Webb:

John, inflation has been the topic du jour for some time. More recently, bond yields peaked in June as investors shifted their worries away from inflation towards a possible growth slowdown. Can you take a moment to explain what's been happening lately and how does it affect the market?

John Foster:

Yeah, David, I think inflation really now for a year has been on everybody's mind. Going back to last summer, we talked about the big word with the Fed was transitory. And then as inflation persisted for really now over a year, it became a problem for the Fed and something that the Fed has had to deal with by raising interest rates. And we're seeing signs, at least, and we talked about this over the last few months, that inflation might be cresting here over the summer, peaking over the summer. And we've at least seen signs now that that may indeed be the case. Prices at the pump have come down a little bit. Energy's been a big component in all of this. I filled up my car for less than $4 a gallon for the first time in a long time recently, so I know everybody can relate to that. But even the CPI in July was down to 8% from 9% year over year.

So we've seen a little bit of fall off in inflation and if that becomes a trend, I think that'll give the market a bit more confidence that inflation is indeed peaking, and probably be a good thing for consumer sentiment too. People are really starting to use revolving credit more. More money's going on credit cards as wages just aren't keeping up with the cost of living right now. So everybody's feeling the pinch due to inflation. And while 8% is still very high, if year over year lower inflation becomes a trend, I think that'll be a welcome sign for the market and for the Fed that reversing all these fiscal and monetary policies that are in place to offset Covid, those have now been reversed. It should mean lower inflation and we're starting to see signs that that inflation is coming down a bit.

David Webb:

Yeah, it's pretty amazing how fast sentiment shifted there. So we saw a terrible month first for stocks in the month of June, and then the market had a monster rally in July that spilled over into the beginning half of August. So the last few days have been a bit bumpy, but from the perspective of the JNBA investment committee, is it still premature to dial up risk now that things seem to be shifting a bit on the margin?

John Foster:

Yeah, I think a bit premature to dial it up. We spent 2021 kind of overweight equities with an extra helping in what we really viewed was a risk on environment, a favorable Fed. And the Fed's still a bit in the market's face. Fed policy acts with a lag. The Fed's raising rates. They're likely to raise rates at least a couple more times it would seem. And so you still have fiscal and monetary policy that's in reverse, and the market's still going to have to deal with that.

But the market, the S&P 500, at its peak was down 24%. It's cut those losses in half. So to your point, we have seen a very big rally, but it was from a very oversold condition though too. At the end of June, the market was extremely oversold. Investors were very pessimistic. And so some of this favorable inflation data, a little bit better earning season, we've seen some optimism creep back into the market. But we're really playing things pretty neutral here, not overweight stocks, not underweight stocks, but in a mode of wait to see what happens next, because there's certainly outcomes that could break either way here.

David Webb:

Right. Even looking at our Bloomberg terminal today, it was pretty amazing to see that the odds of a potential recession have shifted down from north of 40% to just about 30% here over the next 12 months, which means the odds of a soft landing are possible where I think investors, when things got pretty rough in June before the pendulum swung in the other direction, they had been thinking that basically a recession was fully baked into the cards. So it still does look like we could thread the needle. So, what should investors be doing then, John? How is JNBA positioning for this type of environment?

John Foster:

These are times where it's really important to remain disciplined. We saw that just over the last month here, where investors that were not engaged in the stock market would not have experienced that rally that cut equity losses in half. On the flip side, though, you don't necessarily want to chase the rally like that because if you put money back in, the market could easily reverse, but we view it, to your point, two outcomes that could occur that are probably pretty even in terms of their probability, which is why we're staying disciplined, but neutral on our outlook for stocks and bonds.

One outcome would be, to your point, the Fed threads the needle perfectly, the lows are in for the market, and we're off to the races from here. We don't see an earnings recession, and stocks continue to work their way higher and the lows will be in from June. The other outcome would be though when this happens somewhat frequently, when the Fed's behind the curve and raising rates aggressive, the Fed continues to hike to offset the inflation and then eventually the economy breaks. You enter some sort of recession that we'd view as mild, just because employment is so strong right now. Unemployment sitting near all-time lows. And so from a strong employment position, we imagine that the recession would be fairly mild, but some sort of mild recession, some contraction in earnings. And then maybe the market, this would merely be a bear market rally and the market could break lower.

So we're really looking at the inflation data. Can the Fed maybe move on hold economic data? Does employment remain high? Are employers going to hang on to workers, and then earnings to see, okay, where might the market go next? And then that'll dictate do we get back to an overweight position in equities like we were in 2021, or do we still need to be a bit more cautious moving forward? So, the next few months here will really be critical, I think, to decide are the lows indeed in and the market's going to work higher, or are these rate hikes going to lead to more economic problems and eventually earnings will contract and maybe the market will go back down to the lower end of the range where it was here just about six weeks ago.

David Webb:

Very helpful insights, John. Thanks for the great discussion today. And thank you very much for listening today. We're grateful for your continued trust in JNBA, not just as your financial advisor, but also your advocate. Please reach out if you need anything at all. You can find our other podcasts as well as our contact information at jnba.com.

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