Podcast Transcript: Market Update: Out of the Woods?

David Webb:

I'm David Webb, Director of Investments at JNBA Financial Advisors in Minneapolis, Minnesota. We're recording this discussion on February 8th, 2023. Today I'm with a longstanding member of our investment committee, John Foster, also a Senior Advisor and Investment Strategist.

Thank you for joining me here today, John.

John Foster:

Yeah, great to be here, David.

David Webb:

John, after a very challenging 2022 for investors, both bonds and stocks are off to a solid start despite what one might consider to be mixed earnings results and a still hawkish Fed. In your mind, what gives?

John Foster:

Yeah, David, I think it's been certainly a solid start to the year and really a good fourth quarter last year. We had sent around a piece in the fourth quarter of last year just talking about what had been a really challenging environment, but how negative sentiment had gotten on equities. People had set the bar really low, and in that piece we had talked about how better news on the inflation front and a little bit of a friendlier Federal Reserve could very well lead to a big rally, and we've certainly seen inflation come down a little bit. We've seen the Fed really kind of come close to the end of their tightening cycle here, only doing a quarter point hike here at their meeting last week. And so a bit more accommodated Fed, a bit friendlier inflation data, all on the back of extremely negative sentiment, really set the stage for a big rally here, and we've seen equities finish the year out strong in 2022 and really start 2023 strong where stocks are about 15% off their lows now. So a real nice rally for the equity market, but certainly likely to be some volatility yet ahead.

David Webb:

Thanks, John. I know at the investment committee level, we've talked quite extensively about all the things that no one really expected that are sort of coming into play now. I think in particular, Europe is a bright spot, and everyone was expecting that to be quite weak. Even now China is reopening, which is sort of stimulating the global market. So the Fed does continue to remain hawkish, as I mentioned earlier. Just last week, they hiked their short-term rates by another quarter of a point to 4.5%, which is great for savers and stocks rallied nicely after the meeting, but I guess what are your thoughts in terms of do we need to see the Fed pause in the rate hiking campaign before stocks can find a firmer footing, or does it seem like we'll still have quite a bit of volatility this year until we get sort of the all clear?

John Foster:

Yeah, I don't know if we'll need to see a pause per se. Certainly it's helped here that they've slowed their pace. As I mentioned, we've seen a real strong rally in equities and that's happened while the Fed's been raising rates, so I don't know if we necessarily need to see the Fed pause but certainly show that they're coming to the end of this tightening cycle, and it looks like that’s where they’re at.

We talked a lot in 2022 about the Fed really being behind the curve and chasing that two-year treasury note higher pretty much all of last year or all of last year. The two-year note, which the Fed tends to follow, was higher than the Fed funds rate. Well now today the two-year note’s at 4.4%, and the Fed funds is at 4.5%, and so the Feds finally caught up and passed by the two-year note, which really to us as an investment committee signaling that we’re very close to the end of this tightening cycle.

On top of that, we talked about how before the rate hikes end, the 10-year note will usually peak. The 10-year note got up to about 4.3% October of last year, and that's down to 3.6% a day. So we've seen the Fed continue to raise rates, but they've now raised the Fed funds above the two-year rate, which shows that they've kind of finally caught up to the yield curve, and we've actually seen longer term rates come down, so certainly signs are all pointing to the Fed being very close to the end of this cycle.

David Webb:

John, I think that's a great point. As we think a little bit about where expectations were when sentiment was pessimistic as you described, a lot of investors expected the Fed to hold rates at a higher level once they achieved it, and now the markets are actually expecting cuts. I guess one of the things that I know we've thought a lot about is just that there's an entirely big difference between both pausing on the rate hiking cycle and actually cutting rates. The worry would just be if we need to cut rates, then maybe something's wrong, and maybe we've entered into a recession, but the latest quarterly GDP figures were outstanding, the last jobs report was just an amazing report, and earnings aren't really falling all that much, although they're down a little bit year over year. So I guess what really, at this point, could throw a monkey wrench into the best laid plans of most investors as it looks like the economy has a little bit more momentum that when maybe what people expected, not all that long ago?

John Foster:

Yeah, I think the economy certainly to this point's been resilient. A lot of people thought we'd perhaps see a recession in 2022, but some of the longer-term indicators too are still pointing in that direction. We've now had an inverted yield curve for the better part of a year, which is usually a fairly accurate predictor of economic recessions. It's really going to come down to how does the consumer hold up as we've seen the biggest reversal ever in fiscal and monetary stimulus when you combine the two. We had all the COVID measures that were pumping fiscal stimulus into the economy, and then on top of that, we had interest rates set at zero. And this is really a gigantic adjustment to higher interest rates and taking away a fiscal stimulus. So far it's held up pretty well on its own, but I think time will tell if the economy can avoid recession or not, as Fed policy tends to act with a lag and right now, really some of the Fed raised rates for only about nine months here, and it's usually considered six to 12 months that there's a lag to monetary policy, and so we're just now seeing some of the early effects of higher rates really impact the economy. I think still a recession could throw a monkey wrench into it.

Obviously, we have an ongoing war, heightened geopolitical risks with China, and then how well earnings hold up on the back of higher rates and maybe less demand from consumers. We're still expecting a volatile year for equities, but we've really gone from a very oversold condition with a lot of negative pessimists, a lot of pessimism on the stock market, to now people viewing that glass as half full versus half empty, and then higher equity prices that ensued. I think with earnings growth expected to be flat and a bit of volatility ahead, for now, the equity market's perhaps a bit stretched and will maybe struggle from these levels to get decent gains, but time will certainly tell, and certainly not out of the woods yet as far as the economy's concerned.

David Webb:

Sure, sure. Thanks. Well, it has been amazing to see how well markets have held up in the aggregate over the last half year as we've had just a move from basically free money or zero interest rate environment into what is far more of a normalized status quo today. Thanks, John, for the great discussion, and thank you very much for listening today. I hope you will visit jnba.com and tune into our other videos and podcasts where we cover both investment and financial life planning topics. 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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