Podcast Transcript: Some Potential Upsides to the Fed's Recent Rate Hike

JNBA FINANCIAL ADVISORS

David Webb:
I'm David Webb, director of investments at JNBA Financial Advisors in Minneapolis, Minnesota. We're recording this discussion on June 21st, 2022. Joining me for the conversation is John Foster, a senior advisor and investment strategist, and also a senior member of JNBA's Investment Committee. Thanks for being here with me today, John.

John Foster:

Yeah. Thanks for having me, David.

David Webb:

John, the Fed hiked rates last week by the largest amount in nearly 30 years. What opportunities have opened up for savers who, for the better part of the last decade, had grown accustomed to staring at paltry yields?

John Foster:

Yeah. David, I think the Fed, in their fight against inflation, they're what we would call behind the curve. They've really been following around for about the last two decades now, the two-year note. And the two-year note's all the way up at 3.2% for a two-year treasury.

And the Fed, even after the rate hike, is sitting at about 1.5% on Fed funds. And so there's no surprise that rates are going higher because the Fed is simply trying to get Fed funds close to that two-year treasury.

And they still probably have about 150 basis points of hikes to go to get there. But it's really had very little impact on the bond market. So, in the last two Fed meetings, the Fed has hiked interest rates by 1.25%. But a 10-year treasury is only up about 0.15% or 15 basis points while the Fed's done those hikes.

So, the bond market is well priced in these rate hikes. The good thing for investors though now is that these higher yields, you have a two-year treasury at 3.2%, the five-year at 3.4%, and a 10-year at about 3.3%. And so after savers forever got punished with paltry yields, we're seeing yields on bonds go up, better opportunities for investors.

And with Fed funds going up now and that'll impact very short-term interest rates, that'll actually help money markets and savings balances be able to earn better yield than we've seen in the past too, where there's really been this no alternative with bonds. And then that have been forcing money chasing returns in other asset classes, whether that be stocks or cryptocurrencies or other things, but money was forced out of cash to seek return elsewhere.

David Webb:

Right. So this is just one of the things that in talking with investors, we hear a lot is just how bonds can be priced to do fairly well, even with the anticipation of the Fed hiking rates.

So it sounds like definitely there's some opportunities for people that have spare cash that don't necessarily want to put it in the market to look at a variety of alternatives given their time horizons. Is that a fair assessment?

John Foster:

Yeah. Correct. And something that just hasn't been available really almost since 2008, when the Fed first began cutting Fed funds down to below 1%. So we're finally seeing yields that have a crooked number in front of them with 3% across the yield curve and then mortgages and other things even higher yet. So, a good opportunity to actually earn money in fixed income for the first time in a while.

David Webb:

Sure. And it's really the fears over inflation and the Fed being a little bit behind the curve that has led to investors worrying about how far they might need to hike rates. And that's no doubt the primary reason behind this market's volatility and just sort of the negativity that we've seen surrounding stocks in the last three months or so since the Fed really did begin to hike at a much more aggressive pace.

So if stock investors really haven't begun to capitulate yet, and from everything we've seen, people are experiencing higher levels of anxiety around stocks, but it doesn't feel like everyone's just thrown the towel in and I guess, John, what do we need to see? What do investors need to see for the drumbeat of all this negativity surrounding stocks to now begin to ease?

John Foster:

Yeah, I think there's a few things that are really starting to work in the favor of investors. And then there's maybe one or two things that maybe will still play out here as we move through the year, but sentiment's gotten very negative.

People were excited about stocks coming off the lows in 2020, into 2021. Now obviously investor sentiments gotten negative, which actually sets the table pretty well for better performance moving forward. Valuations have gone from expensive on equities down to about average. So certainly we're seeing better valuations in the equity market.

And then just kind of overall market seasonality will be a bit more favorable here in the second half of the year being as it's a midterm election year.

Probably the biggest challenge is we've seen earnings estimates come down here for the second quarter to about 4%, but the second half of the year earnings estimates are still for earnings growth of about 10%.

And that just might prove to be a bridge too far. And a lot of that might actually play out here in the next month or so as companies release earnings and then talk about their forward guidance. And perhaps those second half estimates would come down, but that would probably be the last thing to really maybe set up for a good buying opportunity in terms of an unknown out there that would then become a known.

Right now, peak to trough, the market's dropped about 24%, a typical bear market with a recession. And we haven't had a recession yet, but a bear market with a recession is 30% in the last nine months and we're six months into this.

So from a duration standpoint, a sentiment standpoint, a valuation standpoint, things have gotten a lot better for equity investors and we're probably nearing a pretty good entry point here. The one thing might still be though earnings estimates coming down that would then be kind of all the negatives could then be known perhaps.

David Webb:

Sure, sure. And that's very helpful perspective. I guess before we go, John, are there other silver linings in the current environment or additional developments that you haven't shared that might unfold in the back half of this year that you could offer that the JNBA Investment Committee feels might be a little bit underappreciated in the current environment?

John Foster:

Yeah, I think there's a few things. I mentioned seasonality. A midterm election year will typically have a choppy flat to slightly negative first half of the year. And then about August seasonality tends to turn positive as people start to handicap election outcomes and move beyond that.

There were a lot of negative factors, really the first half of this year. Higher rates, high inflation, the onset of war. And as those kind of fade and the Fed gets closer from behind the curve to more neutral on policy, the rate hikes will be behind us.

Inflation is showing signs at least of peaking here over the summer months. And so that could perhaps go from a negative to seeing some better inflation prints. And then there's things even in a rocky environment that our frequent review of portfolios can provide.

Things like tax lost harvesting to lessen investors tax burden and really set people up for good net after tax returns when the market does return to posting positive returns.

David Webb:

That's a great recap of many of the things we've talked about. Thanks so much for the conversation today, John, and thank you very much for listening in today. We hope you'll visit jnba.com and tune into our other podcasts and videos where we cover both investment and financial life planning topics.

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