Q2 Market Podcast Transcript: Feeling Comfortably Uncomfortable

Cärin Viertel:

Hi, I'm Cärin Viertel, Director of Client Services at JNBA Financial Advisors in Minneapolis, Minnesota. We're recording this discussion on Wednesday, May 3rd, 2023. I'm here with two of my colleagues and fellow members of the Investment Committee, Mark Rosenkranz, an Investment Strategist, as well as John Foster, an Investment Strategist and Senior Advisor on our team. John and Mark, we are getting into the mid second quarter of the year and there continues to be a great deal of discussion not only on earning season, but also whether or not the Fed will continue to increase interest rates. To provide a bit of context for this current environment, recap of us key events that have happened year-to-date in the markets.

John Foster:

Yeah, Cärin, I think there's been a few things going on. Probably one of the biggest benefits that asset prices had coming into the year was just really negative sentiment about stocks, about prospects for higher inflation and prospects for higher interest rates. So we kind of entered the year with the bar set very low as far as expectations go, and things have probably been a little bit better than expected. Earnings momentum has kind of troughed out a little bit and companies are starting to report not really great results, but better results than people have been expecting. And that's allowed stocks to rally a bit here as stocks are up about 8% to begin the year. And then interest rates really kind of peaked out on longer dated bonds, going back to the fourth quarter of last year, we saw a 10-year treasury near the end of last year hit about 4.4% and it's down about a full percent, and 3.4% today and lower rates are good for bond prices. And so, we have higher income due to higher interest rates. And then we have prices that are a bit more favorable as rates have peaked out a bit and that has the bond indices up about 4% this year. So pretty good start to the year for both stocks and bonds with just all that negativity setting the stage for just incremental improvement leading to a bit better results. Later today, we expect the Fed will probably hike rates one quarter of a percent, but that may be at or near the end. One thing we've talked about is the Fed really more or less follows around the two-year note over time. Last year they were chasing at higher all year having to raise rates to catch up to the two year. Today, a two-year note is sitting at 3.9% and Fed funds is at 5 talking about raising it to 5.25.

So the two-year notes pointing to the Fed being very close to the end of this rate cycle and the prospects that at some point in the next couple of years they'll have to reverse to catch it to the downside. So overall, I think things are looking a bit better, but obviously still we have banking concerns. Last year higher interest rates had bond prices down 13%. Banks own a lot of bonds and that has their balance sheets not as solid as people would like them to be. And so, we've seen some turmoil with the banking sector, especially in regional banks. And so, that's certainly been a concern. And then obviously the lag that higher rates have still has that recessionary concern out there as well.

Cärin Viertel:

Thanks, John. Definitely lots to talk about and how bonds have affected different parts of the market. Mark, do you have anything to add here?

Mark Rosenkranz:

Yeah, I think when you look at this year, it really kind of started in 2022 where the Fed decisions and the interest rate hike we've seen have really been a main driver of both stock and bond performance for coming up on 18 months now. And as we kind of approach the end of this hiking cycle, whether it's today or whether it's in the next meeting or longer, the market start to see some light at the end of the tunnel. And I think for good context is we're definitely entering an environment it seems where it's that proverbial bad news is good news.

And you look back to earlier in March when we saw some of the banking collapses, since that point we've seen 10 of the largest stocks in the U.S. actually increase north of 10%. And that's the kind of takeaway is any type of cracks beginning to emerge signals to the Fed that maybe it's time to start taking the foot off the gas in terms of rate hike cycle and it's actually being positive rewarded by the market. So it's a bit of an interesting dynamic, but it all comes back to the Fed's decision making process.

Cärin Viertel:

Thanks Mark. So given that, what areas of the market or the economy is our Investment Committee focused on as we look forward?

Mark Rosenkranz:

So I think John touched on the main areas, but I'd say when we kind of look at the big picture, two of the larger stable points of the economy, which is really led to some resiliency, is unemployment near all-time lows and corporate profit margins near all-time highs. So really we're kind of trying to pay attention to those long-term drivers, anything that could kind of impact those numbers and how it relates to changing fiscal and monetary policy. Corporate earnings were about halfway through Q1 results like John said, so far it's looking pretty solid off of fairly low expectations. That's a number that's going to start to look towards the end of 2023 and even in the next year's numbers. So, we're razor focused on how the corporate profits are doing and what they're seeing out of the consumer and other businesses.

The other area we're kind of trying to pay attention to is broader economic indicators. The Fed has made it very clear they're watching unemployment and inflation very closely and any type of sentiment indicators, any type of changing business environment, manufacturing output, home sales, anything that kind of trickles back to those two main drivers of unemployment or inflation are going to be key drivers for any decision-making policy. And then last but not least, not only monetary policy, but there is some fiscal aspect to play. There has been a lot of talk about the debt ceilings and debates within Congress and Senate. It is coming up on election year, so we might start to hear a little bit more noise. But really when it comes to fiscal policy, absent to a large debt crisis so to speak, it comes back to those two main pillars of unemployment and corporate profits and any impacts of those are going to be more felt either by Fed decision making policy or by market participants applying valuations to what they see on the environment.

John Foster:

Yeah, I think, too, Mark, when we think in the last 10 years, portfolio returns were really all coming from stocks. You look at the last decade, stocks globally did about 9%. Bonds did about 1%. So, if you were invested, you really had to be in stocks to make money. And the other big trend really moving forward now is competition from higher yields for capital where all of a sudden now you can make 5% on a treasury bill, 4-5% on a corporate bond, 5.5% maybe in a mortgage fund.

There's opportunities out there to earn income on your cash for the first time in 15 years. And I think that competition's probably going to have equity flows not as robust as they were the last decade. And so looking forward, it might be where stocks return 7, 8, 9% over the next decade, but bonds return 5. And so, you're not going to have that same differential where there was only one game in town for the last 10, 15 years and that was equities and now investors have options. And really for most diversified portfolios, that's a good thing. You can get a similar to maybe even better return even if the stock market doesn't perform as well, because you're not just making money from stocks, but you're making money from stocks and bonds for the first time in well over a decade.

Cärin Viertel:

So John, given that diversification is a pillar of how we invest clients' portfolios, how are we currently positioning portfolios going forward?

John Foster:

We really spent the last year in what we'd classify as a bit of an underweight or a bit of a cautious stance towards stocks where the combination of higher inflation, higher interest rates had us not wanting to take extra risk as we've kind of seen this earnings picture trough out a little bit, we have gotten more constructive this year on the stock market and gradually gotten back towards what we'd call a neutral to slightly constructive stance on stocks. We had a top to bottom 28% pullback in the stock market and we had basically a 15-month bear market from kind of top to bottom as well where the market really sat 20% or more off its highs for an extended period of time. And that kind of led to all that pessimism that I mentioned earlier, and people are still relatively pessimistic, yet stock prices are grinding their way higher here.

And so we think there is a chance that equities can surprise people and do a bit better than expected. So we've gotten a bit more constructive as the Fed nears the end of its cycle on stocks. Same time though too, we want to make sure that all dollars in portfolio are earning yield. For a long time it was really when you looked at fixed income return of the capital instead of return on the capital, and now it's far more focused on getting a reasonable yield on all your dollars. We can be in an invested money market now and make 4.5%. So, I think it's really running that allocation where we feel comfortable with the risks we're taking and the yields we're getting on the bond side. And after a bear market, we're gradually becoming more constructive on equities.

Cärin Viertel:

Thanks, John. Mark, do you have any other comments to add on positioning of portfolios?

Mark Rosenkranz:

No, I think John kind of described the sentiment well, a term we've kind of thrown about a little bit lately is we're comfortably uncomfortable. And when you look at the last even two plus years, there's been a lot of headlines and a lot of things to pay attention to from the pandemic, to reopening the economies, to fiscal monetary policy. There's just been a lot going on and I think when we kind of zoom out a little bit and kind of focus on what we're looking for to drive longer term performance is really trying to incorporate all the new information we're receiving on the daily headlines and trying to blend that with what impact the long-term focus and our long-term drivers.

Cärin Viertel:

Thank you, Mark. Thank you, John, for the conversation today. And thank you very much for joining us. We hope you'll visit jnba.com and tune in to 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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