Podcast Transcript: Could the market make up ground as we head toward year-end?

David Webb:

I'm David Webb, Director of Investments at JNBA Financial Advisors in Minneapolis, Minnesota. We're recording this discussion on November 10th, 2022. I'm joined today by a senior member of our Investment Committee, John Foster, who is also an investment strategist at JNBA. Thanks for being here with me today, John.

John Foster:

Yeah. Thanks for having me, David.

David Webb:

John, recently we've talked a little bit about potential market moving news flow that might set us up for a year-end rally, and some of these events included the Fed decision a couple of weeks ago. We also had today's inflation print, a jobs report from a week ago, and then, of course, the midterm elections. I guess, as you think about all of these new pieces of data that the market has had to digest, which ones do you think are the most important ones that investors should be focused on here as we move into the final stretch of 2022?

John Foster:

Yeah, David. We are really looking at a variety of things that could be catalysts. Obviously, we've had both stocks and bonds under pressure all year and very high levels of investor pessimism, and oftentimes, when people are most pessimistic is when the market can really be set up for a large counter trend move, and even the smallest of positive news. Often, it's not the level of inflation or the level of unemployment or other things, but rather the rate of change. Are things trending the wrong direction, or are things trending the right direction?

And so a couple of things that we'd really had our eye on, we talked how a lot of times in midterm election years, the market will remain a little bit under pressure until such time as the market can successfully discount the outcome of midterm elections. And a lot of times that happens in August or September. This year, as close as midterms were, it obviously took a bit more time for the market to be able to understand, "Well, what are we dealing with moving forward?" Historically, the best outcome for the market has been a Democrat in the Oval Office and then a split Congress. That's been when markets have had their highest returns, and we're on track, it appears, for some sort of version of that in terms of having a Democrat in the White House and then a split Congress here.

That type of gridlock tends to keep the rules a bit in place that allows for more intermediate to longer term decisions to be made, so removing the uncertainty a bit from midterms here really then allows us to set up for what often is a real seasonally strong time for the market. This November timeframe through year end, the market tends to historically perform quite well.

David Webb:

I think those are great points, and I know some of the data we've talked about behind the scenes has been, even though the one year performance coming off of a midterm election going all the way back to 1950 has been about 15%, or about maybe twice what the market's done historically in any given timeframe, it's even stronger under a split Congress. Do we feel, John, that with the Fed continuing to raise rates that might dampen some of the normal seasonality that an investor might otherwise expect as a tailwind to their portfolio results?

John Foster:

I think it's really the Fed acting beyond what the market's expecting, David. I think that's really been the problem this year, as we've talked about. Inflation being the primary concern of the Federal Reserve, and the Fed being well behind the yield curve in terms of where they said rates were going and where they actually put rates. If we went back a year ago, the Fed had anticipated ending this year with a Fed funds rate of about 50 basis points, and now, lo and behold, they're going to end the year likely with Fed funds above 4%. They were off on what they were signaling to the market by a factor of eight, and that certainly created havoc in both stocks and bonds.

Well, now you have a market that expects Fed funds to peak out at about 5%, and the Fed's below 4% today. So there's a lot of wiggle room still to the upside for the Fed to do what appears like 50 basis points more in December without it roiling the bond market. In fact, today we finally got the first friendly... These inflation days, they have not been friendly to the markets, in that inflation had been coming in hotter than the market wanted. Now today, we finally had a bit of a break in inflation, where inflation came in a bit under expectations.

It kind of lit a fire under both stocks and bonds with the 10-year yield today dropping by about 30 basis points, and stocks, as we speak, rallying the most they've rallied since April of 2020. So a big move up for stocks, a big move down in yields, and all it took was one friendly inflation number because everybody was positioned on the other side of that. Everybody had been waiting for inflation to cool, and now we're finally seeing some friendlier inflation data and markets acting accordingly as everybody was kind of positioned for that hotter inflation, higher interest rate trade and now finally leaning the other way.

David Webb:

Yeah. It's definitely striking, John, how ugly sentiment got, where people just felt like they couldn't catch a break with some of the fundamental news, but especially on inflation. I mean, jobs have held in pretty good. Inflation, we've talked a little bit about it being in the process of peaking, and today's inflation print is clearly a step in the right direction, coming in below the consensus. I guess, with valuations now having reset, and I mean, this is the flip side of the market selloff, prospective returns should be higher for investors. Clearly, on the bond side, they're going to be making well more than they did at the beginning of the year, but how does a JNBA Investment Committee think a little bit about timing? Are we to a point now where the valuations and the sentiment are enough where, assuming you don't need liquidity as an investor, you can kind of close your eyes and look through the valley here? Do you feel the market's gotten to that point yet?

John Foster:

Yeah. I certainly think we're far enough into it. If you went with, today, a base case that the Fed rate increases act with a leg, as we've talked about, where typically, nobody knows the amount of leg, but call it three to six months. Rates that are being raised today won't impact the real economy for a few months out, so if you go with some sort of base case scenario that we do end up with a mild recession the first half of next year, the average bear market with the recession lasts about 15 months. We're 11 months into the current one, as it began January this year. Here, we're sitting in November, so you're definitely well into it, where you're likely closer to the bottom than the top.

Now, for equities, though, equities have never bottomed before the recession began, so there could still be, depending on the exact timing of everything, a bit more volatility ahead for equities. What's interesting to note on bonds is fixed income actually will bottom about four months ahead of a recession beginning, and so if you put some sort of time horizon of Q1 of next year, let's say, on the prospects for recession starting, that would probably mean that yields have peaked or that the bond market's actually peaking right around now, if history's any guide.

We think, certainly, to be invested in bonds and then expect yields to hang in there, that would be a very rational expectation based on history. Whereas equities, you're far enough into it where if you buy stocks today and you wait three to five years, you'll probably be real happy with your decision. As far as hitting the exact bottom, though, there's a chance that still is in the future, depending what happens with the economy from here.

David Webb:

Sure. Well, I think that's a great point, and I'm glad you shared it, John. I definitely know, and we've talked about this ad nauseam, inflation peaks are just wonderful things for forward looking returns. It's amazing how well this market has dealt with this bevy of bad news over the last four to five months. It was really just the first half of the year that the market kind of went into a free fall. It's been choppy since then, but it's been largely flat. That just echoes your earlier point about the market sort of being a wonderful discounting machine in terms of looking around the corner and anticipating what's next.

I appreciate you sharing some reasons for optimism today and appreciate the very good discussion, John, and thank you very much for listening in today. We're grateful 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 more information and our other podcasts at our website at JNBA.com.

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