Podcast Transcript: Rounding the Turn Toward a New Year

David Webb:

I'm David Webb, Director of Investments at JNBA Financial Advisors in Minneapolis, Minnesota. We're recording this discussion on October 5th, 2022. This morning, I'm joined by two long-standing members of our Investment Committee, Michael Bilotta and John Foster, also Senior Advisors and Investment Strategists.

John, in the next week or so, many investors across America will be receiving their quarterly performance statements in the mail. What can they expect to see in general?

John Foster:

Yeah, it's certainly been a challenging year, David, for both stocks and bonds, and very unique in that aspect. We're looking at a year where through the end of the quarter, stocks were down about 25% thus far in 2022, and bonds actually performing much worse than they have historically. In the last almost five decades, the worst year for bonds was a 3% loss. And year-to-date, through the end of the quarter, bonds had lost about 14%. So, both stocks and bonds performing poorly, and it's more been a year where trying to do less bad has been the objective versus any asset classes really performing well, as even things like gold that often benefit from the chaos are down in kind of the mid-single digits. So, certainly a year with all asset classes more or less out of favor.

David Webb:

Sure, sure. Thanks John. And I think for many investors that have built diversified portfolios, that goes against the grain of those portfolios having served them well over time. So, this year's definitely one that we're not seeing diversification maybe work as well as it historically has. Mike, can you maybe share a bit more? How rare is it to see both stocks and bonds down at the same time?

Michael Bilotta:

Yeah, it's not very common at all. Unfortunately though, we're seeing that this year, and John mentioned a couple of the points before, but bonds have only been down in four of the last 40 years. So, John mentioned back to 1994, which was the next worst time period, and they raised federal funds from 3% to 6%, so it doubled. This year, we raised fed funds from about 0.25% to 3%, which was 12 times the starting rate, and so what we've seen is a lot more of an exaggerated move down in bond values and so on. We've had down stock markets before and we've had, as I mentioned, a few years here and there where bonds have been down.

But going back to 1976, we've never had three consecutive quarters of both stocks and bonds being in negative territory. So again, I'm going to say this tongue in cheek, but we're privileged to live in a year where we've had some unprecedented things happen in the financial markets, and for balanced portfolios, this is the worst overall year, from a performance perspective, since 1932. Now, I say all of this simply to provide context. We go back to the, ”it is what it is”, but I think it is important to be able to put that into perspective as you relate that back to your portfolio or certain investment strategies and so on.

The silver lining in all of this as you try to take a bad environment and turn it positive, is that we've been able to do tax loss harvesting, both in equities, but also on the bond side, which in my 25-year tenure here, we've very rarely been able to do. And that's selling a bond investment, ETF, or fund at a loss, going back in and repurchasing something similar, and at this point, probably paying double or triple the yield. So, taking the proverbial sour lemons, turning them into lemonade, again here with the tax loss harvesting even on the bond side of the equation, but pretty rare combination that we've seen here in 2022, unfortunately.

David Webb:

Thanks for sharing that perspective, Mike. As we look forward, it seems like most investors are just highly focused on two things at this moment in time, inflation and earnings. We'll tackle the outlook for earnings in just a moment, but as it relates to inflation, what's the market currently expecting?

Michael Bilotta:

Yeah, you hit the nail on the head there. The prevailing themes this year are certainly inflation, and I guess 1A and 1B, inflation 1A and interest rates 1B, and then ultimately what that does to the economy, i.e., corporate earnings. And we're about to embark here in two weeks, maybe, on the next quarter earnings, and we'll talk about that, as you mentioned, in a minute.

But as far as inflation goes, there have been various reasons why this inflation bubble's been building for a while. It goes back to 2008 and '09 when the government, both the treasury and the Federal Reserve, started to be very stimulative with the economy. You've heard easy money, quantitative easing, those sorts of things. We moved into a period, about 10 years later, of ... or a little bit more of the pandemic and essentially spreading money all over the place there. We add that to the Russia/Ukraine conflict over in Europe, and so we've kind of had this perfect storm of things that were going to come to fruition at some point anyways. It's just, what exacerbates the situation? What was the catalyst to kind of tip the cart over? And so on. And that was probably here early this year.

I look back because it's important to ... We look at, well, we could have seen this coming, but let me just give you an example. So, Fed Chairman Powell over time ... And I saw this yesterday and it was very interesting, because it does talk about how the narrative has changed in a short period of time. So, back in the fall, or summer of 2021, he said, "Inflation is expected to drop back to the Fed's goal of 2% to 3%. So to the extent it's temporary, it doesn't make sense to react." All right, that was just probably, what, 12, 13 months ago.

Fall of 2021, he said, "We should start seeing some relief in the coming months." So they haven't signaled anything yet. They, in fact, think inflation is starting to be more moderate in nature. November of 2021, time to retire the word transitory as it pertains to inflation. And then in March of this year, we need to move away from very low rates, so that's when things started to really cascade. And now, we've seen we need to do whatever it takes, even if it causes some economic pain, in order to bring inflation under control, and it just hasn't moderated to the degree that they would like to see it. For all intents and purposes, they are a little bit behind the curve, so I think they do think they bear some responsibility for getting us to this point, so they're likely to be a little bit more strong-handed.

David Webb:

So Mike, as investors have changed gears in terms of thinking the Fed is now going to be more aggressive with the rate-hiking campaign, do markets believe that they're going to get ahead of the curve here? What do expectations look like at this point in time?

Michael Bilotta:

Yeah, that's a really good point, David. The silver lining in all of this is that future expectations for inflation have not become unanchored. And what we mean by that is that people believe that inflation will be high and persistently high, so that they engage in a lot of behaviors right now to try to get ahead of it, and all that does is exacerbate the situation. So, when we look out one, three, and five years from an expectation standpoint, investors, the market, and so on really do believe that the Fed can get this back under control and closer to their target.

David Webb:

Thanks, Mike. John, it might be a little bit counterintuitive to most investors, but can you share your perspective on when it might make sense for investors to buy bonds, even if markets expect the Fed to continue raising rates? And maybe you could share also a little bit around what you're seeing out there in terms of investment opportunities for investors that have spare cash.

John Foster:

Yeah, David, I think what Mike was talking about with inflation expectations and where the Fed's at and their rate-hiking cycle really gets into where the bond market's at today. The Fed's gotten the Fed funds rate up to about 3%. Meanwhile though, today, two-year treasury notes about 4.2%, so the bond market's still expecting the Fed to raise interest rates by, we'll call it, a percent and a half. So, there's a lot of rate increases still baked into the bond market.

And bonds, for the first time in a long time, are providing really good returns. You can look at since 2008, really, when this war on savers began, the Fed funds rate has only been above 1% for about 12 months. So, we've had extraordinarily low interest rates for a very long period of time, and now you can buy a two-year treasury and it pays 4.2%. So, that shorter part of the yield curve looks real attractive from an income standpoint. But even more intermediate term bonds could rally, if the Fed comes up short. They're expecting the Fed to get to 4.5%. If the Fed doesn't make it, you could actually see a pretty big bond rally. And so we're starting to see that on days where economic news comes out a little bit soft, bonds are rallying pretty good. So, there's a chance in here that the Fed doesn't make it that high and that bonds actually, counter to what people are expecting, bonds start to rally from these levels.

David Webb:

That's a great point, and we've definitely seen that on a number of days more recently where bad news is good news as it relates to how the market reacts on a given day when we get some fresh economic data. So Mike, as the Fed has continued to raise rates, investors and just people in general are noticing, they're seeing a slowdown in certain areas of the economy. Housing is definitely the one that is on the top of a lot of people's minds, and many economists are even forecasting the labor market could soften a bit more into next year. So, as we are right on the cusp of entering into earning season where companies will report their third quarter results, what do you think we might be possibly seeing, and how could that affect financial markets?

Michael Bilotta:

Yeah, that's a great point, because up until recently, the 800-pound gorilla in the room, if you will, has been that the market has adjusted downward from a valuation perspective, and it has also adjusted downward prior to this point, factoring in an economic slowdown. But what had been holding in there was that corporate earnings and the growth of corporate earnings hadn't been taken down yet. So, when you try to reconcile that, you think, "Well, corporations are engaging in business in an economy, and if the economy is slowing to the point where it's not growing at all, or even contracting, how can corporate earnings continue to grow at the same level that they were predicted to at the beginning of the year?"

Well, over time, we've started to see some of those expectations get taken down for a number of companies, and so on. So, the key will be when we get to the report of earnings, and most of the earnings aren't going to be very good, but the market doesn't necessarily care about good or bad. What it cares about is, is the number you're reporting better than what was expected or is it worse? And I think we'll start to see a situation where those companies that disappoint are going to get punished fairly severely, and those companies that actually do manage to, or have managed to, guide lower and get expectations more in line with what's reasonable, those companies can certainly hold their own and even do fairly well. But that is going to be the next leg, either up or down in the stock market, as a result of what happens in the coming weeks with earnings, for sure.

David Webb:

And I think as we've seen last quarter, a number of companies, even though they issued negative guidance overall, investors were pleasantly surprised that things weren't as bad as expected. In recent weeks, I know our Investment Committee has talked about this a lot. But companies do definitely seem to be battening down the hatches somewhat in terms of hiring freezes or even partial layoffs, so that maybe not every company in the corporate world is making the same adjustment at once, such that maybe we see a bit more of a modest slowdown, more akin to like a mild recession as opposed to something more devious.

So I'll ask this next question, John, and I know it's an impossible question to answer, but I'm going to do it anyhow. For investors that have now seen the market slide more than 20% year-to-date, is it possible to call the bottom? I know everyone wants to know when is this going to be over, but is it important to even try to do so? Can you share your perspective on us with that?

John Foster:

Yeah, David, I think calling a top in a market or calling a bottom in a market's always next to impossible. But what I think you can do is kind of look at what's happened historically and get an idea, are we closer to the top at times, or are we closer to the bottom, based on a variety of factors. Obviously, we've seen sentiment go from people being really optimistic about equities at the start of the year to now being very pessimistic. And usually you need a lot of pessimism to form a bottom, so we're certainly, on the scale of investor sentiment, a lot closer to the bottom than we are the top.

From a drawdown standpoint, the typical bear market with a recession, the stock market will drawdown by about a third. We've drawn down by a little bit more than a quarter from the top to the bottom, so that would say too that you're probably closer to the bottom than the top. And then maybe from an amount of time standpoint, the average bear market's nine months. We're now entering the 10th month of this bear market. The average bear market with a recession will typically go a bit longer than that, closer to 15 months, so somewhere between three and six quarters, call it, is the amount of time a bear market takes, and we're over three-quarters into this bear market. So, people are far more pessimistic. We've drawn down about what you'd expect to see.

And then from an amount of time standpoint, we're kind of right in that range, so we're certainly probably at the beginning of maybe a bottoming process. But to call it the exact bottom, when we still expect maybe some earnings revisions to the downside, and Fed policy that often acts with a leg, and the Fed is still raising rates here in the month of September, there could still be a little bit more economic weakness, a little bit more time to go. But definitely from our vantage point, we're much closer to the bottom than we are the top.

And then when the market does recover, on average, over the next 12 months after a bear market, returns are in the 40%-plus range. And so you certainly want to start getting into that timeframe of saying, "We're closer to the bottom and we got to stay the course, we got to stay committed," but then also position for the eventual recovery on the other end, because that's where returns can be quite powerful the other direction.

David Webb:

Well, gentlemen, this has been a great conversation thus far, and I know we've covered a lot of ground. Is there any parting wisdom you'd like investors to recall as we continue into the last few months of what's been a challenging year?

Michael Bilotta:

Sure, and I know this will sound a little bit cliche to a certain extent. First of all, look, this year hasn't been any fun. It's been challenging. It has been very difficult from a navigation standpoint, I think we would all agree. With bull markets, they never feel like they're going to end on the upside, and on the downside, bear markets also feel like they're never going to end. And yet, through a global depression, a couple of world wars, September 11th, the financial crisis, a global pandemic, all of those things that one would argue would be a lot more challenging than what we're seeing today, bear markets have always come to an end. And on the other side, to John's point, the recovery is often pretty swift and plentiful on the upside, but you have to be there.

So, the parting wisdom is more, this will come to an end. We will end up on the other side of this. We will get back to making better returns again. Unfortunately, the price of entrance into getting those outsized returns is that sometimes you have to go through these periods right now that prove really challenging and nerve-racking, and we understand that.

David Webb:

Well said. Thank you, John and Mike, for a very insightful discussion today, and thank you very much for listening. 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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