Investment Committee Video Discussion Transcript: What could 2022 mean for 2023 market performance?

JNBA FINANCIAL ADVISORS

Richard Brown:

I'm Richard Brown, chairman and CEO of JNBA Financial Advisors in Minneapolis, Minnesota. We're recording this discussion on January 11th, 2023. I'm with three senior members of our investment committee, Michael Bilotta and John Foster, both Senior Advisors and Investment Strategists, along with David Webb, JNBA's Director of Investment Management. 2022 was a frustrating year for investors with negative returns across almost all asset classes. Bonds were down and equities were even worse. So Mike, what happened, and what led us to where we are today?

Michael Bilotta:

Yeah. Thank you, Richard. It certainly was a test of people's resolve in 2022 as we were experiencing some issues that we hadn't in decades and then issues in combination with each other that had never been seen before. First of all, there's a quote that I couldn't resist. It was from one of our colleagues at NDR, Ed Clissold. He stated, "Most investors would say that in 2022, managing portfolios felt like parenting an infant. They needed constant monitoring, wild swings were absolutely exhausting, and they had to keep reminding themselves that it would eventually pay off in a few years. Despite the long days, 2022 felt like it was over before we knew it."

Now I don't know about that last part, but I certainly can agree with the first couple of points before it. We did have a very interesting year, a very trying year, and it was as a result of a few different items that had been coming about over the last couple of years, the first being the fastest inflation that we've seen in decades. And as a result of that, then the fastest pace of interest rate hikes by the Federal Reserve that we saw in decades mix; in a global conflict between Russia and Ukraine and bringing in other countries around the world and certainly in Europe; conflict that we hadn't seen the likes of since the Gulf War. And all of that really led to the perfect storm of uncertainty of people trying to position around this type of environment and again, not really having a playbook to deal with. And that of course extended into the equity and bond markets and volatility.

So this was all something that the market was trying to respond to in a quick fashion. It caused dislocations in the financial markets, any long duration assets, think intermediate to long-term bonds, think technology stocks, they really got punished as a result of this extreme rise in interest rates in a very short amount of time. And then that of course led to the financial markets. 2022 was only the sixth time since 1926 that both the S&P 500 here in the U.S. and the aggregate bond index declined in the same year. It was the only time in history where they fell by at least 10%.

So we had the S&P 500 down 18% on a total return basis. The worst year since 2008, the sixth worst year on record. Bonds were down by a little over 13%, by far their worst year on record by a long shot. And as a result, you can extrapolate then well a diversified portfolio 60/40 stocks bonds didn't fare very well either. And the performance once all was said and done, and I'm generalizing a little bit based on allocation, was that the average 60/40 portfolio fell 16% on the year. Also, its worst since 2008 and the fourth worst year on record, all things considered at the end of the day, end of the year, it proved to be very challenging in a number of areas.

Richard Brown:

Thanks, Mike. Challenging indeed. So let's move forward. As we look forward, what are a few key issues we expect will impact financial markets behaviors in 2023?

David Webb:

Richard, I think that's a great question and I think a lot of investors right now as they're reflecting back on last year and looking ahead are stuck somewhere between hope and fear. So we do know that markets tend to lead the economy and as such one might surmise that this year could be a rather bleak year for economic growth. That's what we're expecting today as we're looking at a lot of economic indicators, whether it's new job creation, which seems to be slowing. If we're looking at the services sector, which is now entered into contraction after 30 months. If we're looking at other leading economic indicators, there's an inverted yield curve out there. A lot of these signs portend that a recession is very probable. The odds are certainly probably greater than half, and there is a small chance that the Fed does thread the needle and we get a soft economic landing.

But I think investors should steal themselves for a year where the headline news might not be all that great as it relates to economic growth. So this matters really in a couple of different ways. I'd say the two things that investors need to be focused on for 2023, the economy, because the opportunity to create a robust stream of earnings is somewhat dependent on aggregate growth in demand. So if we see the economy not fall off a cliff, then earnings might hang in there fairly well. The Fed also matters quite a bit because the Fed determines the interest rate at which those earnings are discounted back to arrive at a sensible valuation for the market.

So as it relates to the economy, we're watching earnings very closely. This year I think the market is expecting margins to come in for a lot of companies that have had to deal with rising cost pressures and now are starting to see slow in demand. So this does matter quite a bit because even though stocks are discounted, they're not yet cheap. So that's one thing for investors to watch. I think Q4 earnings, which start pretty much at the tail end of this week and go for several weeks into this quarter will be very interesting to follow.

The second thing is the Fed, as I mentioned, and right now the Fed is becoming a little bit less hawkish, but they're still hawkish and they've talked about holding rates at elevated levels. And I think what the Fed is waiting to see is for the labor market to crack a little bit where the Fed doesn't want mass layoffs or anything to that extent, but they do want to see wage inflation come down. And an ideal scenario that would set us up for a soft landing would be job growth decelerates but doesn't turn negative and wage growth comes in, and wage growth has been decelerating for some time.

Job creation is still very healthy. So overall as we look at the labor market, we're a long ways away from maybe where the weakness would be significant enough for the Fed to pause, but it's moving in the right direction, which I think is key because it gives the Fed the ability to move a little bit slower and be a bit more data dependent as we move into the back half of this year.

The last thing I'll mention, as you can see in the chart here, a recession, if it does come to pass, could mean a break of the lows in the first half followed by a sharp rebound. Whereas if we don't have a recession, then that clearly means investors are probably going to see a stronger first half less volatility. And that's what you see in the blue line there. So we'll be watching earnings, we'll be watching the labor market very closely and all is not lost. As we've reflected a lot on 2022, we had a modestly growing economy. There were a lot of positives. China is now reopening. It's the world's second largest economy, and those consumers haven't spent anything for the last three years.

The labor market is starting at a very good position with unemployment and generational lows. So if you think about how bad the markets were last year with the backdrop of a fairly good economy, this year might be one of those things where the economy isn't so hot, but it doesn't mean that stocks might have a terrible year. I think investors just have to be prudent and disciplined and objective with regards to how they deploy capital.

Richard Brown:

Thanks David for sharing those insights. And yes, we will be watching. Okay. So the probability of a recession, or at the very least an economic slowdown appears to be rising. John, most investors might ask if that's the case, why not just avoid stocks and hide out in bonds and cash?

John Foster:

Yeah. Richard, I think that's a reasonable question certainly for investors to ask. Why not just hide out in bonds and cash if it does appear that a recession is on the horizon? And certainly I think this year, entering the year, it's the exact opposite of last year. If you think back to the beginning of 2022, there was a lot of optimism about equities and really that optimism faded quickly. We spent the bulk of 2022 underweight stocks or having a little bit less equities after a full year in 2021 where we had been in an overweight position or holding extra stocks. Right now in 2023, we're really going from underweight for the last 11 months of 2022 and moving equities up to what we'd call a neutral stance. And there's a few reasons for that, why we're getting a little bit more constructive about stocks.

First, both Mike and David mentioned that it looks like inflation has likely peaked. And the two big concerns last year were really inflation and rising interest rates. And as inflation is likely to peak and the employment market and economy soften, the Fed's likely to step aside. And four of the last five times that the Fed has gone from their last rate hike to their first rate cut, stocks have actually risen. So once the Fed gets off to the side here, there's a decent chance that stocks will rally. Another reason to be a bit more optimistic is there's just a lot of pessimism out there. When everybody's expecting bad news, it's easy to exceed those expectations. So you have a lot of people right now that are hiding out in bonds and cash and all it takes is news to be less bad and they'll have to look to shift some of those assets over to equities.

So we're getting a little bit more constructive just because it looks like the peak in rates and the peak in inflation is right around the corner. That said, the recession and the potential revisions downward and earnings as David was talking about, will probably lead to a lot of volatility this year. So while we're a bit more constructive, we do acknowledge that the year might be a bit bumpy, a bit challenging.

We'd also say that the equity risk premiums probably reduced. So over the last decade, if you think about stocks versus bonds, US stocks returned about 10% and bonds returned about 1%. So you really got a lot of excess reward for being in equities. If you think about that, moving forward with interest rates a lot higher, we might be looking at a decade ahead where you get paid seven or 8% to be in equities but are able to return around four to 5% in bonds. So that spread between what stocks will do and what bonds will do is likely to tighten.

Within stocks, we're really looking at overseas leadership now too. We've been in an environment where the U.S. has led for a long period of time and that looks like it's shifting. So last year the S&P 500 was down 18%, so U.S. stocks were down about 18%. Foreign equities were down 14. So we saw better performance out of foreign stocks than U.S., and a lot of that's due to the dollar peaking. So the dollar over the last three months has lost about 9%, and that's been consistent with when interest rates peaked, when the 10-year note peaked, the dollar peaked at about the same time. So a weaker dollar tends to be good for foreign stocks. And that's really continued here the first part of this year.

So far year to date, we've seen international up about four and a half percent US stocks up about 2%. So pretty good leadership here that's been consistent out of foreign equities. So we're really expecting a better year out of stocks just due to that peak in inflation, peak in rates. A lot of pessimism that has the bar set pretty low and easier to exceed here at the beginning of 2023. And then also leadership that's likely to come from overseas. It does appear that the dollar has peaked along with that peak in the 10-year note.

Richard Brown:

Thanks, John. Great information. So given all that's been shared, what specific items or trends are the JNBA Investment Committee focusing on to navigate whatever 2023 has in store?

Michael Bilotta:

Yeah. That's a great question. I think it's one or two data points does not a trend make. So I think what we're really paying attention to here, certainly over the first month or two of the year is the same things that were dominant last year, inflation. Is inflation truly continuing to come down and given that trajectory, at what point during the year may we get to where the Fed's comfortable that they can slow down or stop altogether? They did in December slow from 75 basis points to 50. So they began that. But what they've been desperately afraid of is going back to the last regime of inflation, is that they stop, inflation comes back and it's even more perverse than it was the first time. So they want to be extra sure that they're seeing multiple data points of both inflation and the economy before they really slam on the brakes and either stop altogether or possibly, and this is a whole different issue, but go the other way.

That goes to my next point is are we going to experience a recession? Are we already in that process? Is it going to be mild? Is it going to be severe? What are the repercussions? Where are the places to hide out? That sort of thing, because I think that that's the next domino to fall in all of this is how much of an impact does all of this interest rate tightening have on the economy? And then from a portfolio perspective, and I don't want to be too exhaustive, I'm sure John and David have a couple ideas in here too, but a continuation of what John talked about before is, is international in emerging markets as asset classes going to take the reins and keep them for a period of time from a risk return perspective?

We've seen fits and starts here and there where it does gain leadership and then something happens. It was COVID in 2020, it was the rise of the dollar last year. Things that put the breaks on that a little bit, but we really do feel as do a lot of the major institutions and research firms that international emerging markets are going to be one of the better places from a risk return perspective over the next three to five to 10 years. So validation of something like that will be important, but those are only a couple items that we're paying attention to. I know there are others, and John or David can probably talk about a couple of those.

David Webb:

Well, I would certainly echo Mike's point about international being an attractive area for investors with a very long-term horizon. I think just given the dominance of the U.S. over the last decade, it's put valuations at a relative level at pretty extreme comparisons versus their international brethren. But in terms of more like 2023, what would be a couple of good ideas. I think dividend paying stocks do very well in an uncertain environment. They tend to do very well when you see protracted inflation.

And if you think about this year being a volatile market, as we've talked about a little, dividend paying stocks offer a cushion to investors that is a lot less volatile than the price component of stock fluctuations. So for those interested in dampening volatility as well as reducing downside risk in the portfolio, I think those could form a large chunk of one's stock allocation in an environment where they're somewhat nervous and you can play both offense and defense with that type of stock category.

And then lastly, I just think now that we've got a normalized type of environment, again, where the cost of money is no longer free, government debt ceilings, government deficits are going to be back in the news quite a bit. And for investors that are a little bit worried about how that might play out, gold has been an effective hedge in the long run, really against monetary excessiveness that that might not be sustainable.

So our ability to service government debt is somewhat dependent on the relationship between the growth in incomes and the level at which interest rates are set at. So as long as the Fed keeps hiking, that might represent more of a challenge. So investors that do have a healthy chunk of their portfolio in stocks might want to consider some of those hedges.

John Foster:

Yeah. One idea Mike and David too, that I maybe add is moving down in company size. We've had this period where mega cap stocks have really performed well. Multi-trillion dollar companies like Apple, Google, Amazon, we know the household names, and we're really at an extreme right now of valuation difference between large caps and small caps. So moving down in company size as small-cap stocks tend to lead coming out of a recession. So it might be a little bit early right now as we're maybe just heading into that, but with a major gap in valuations between large and small, and large-cap stocks now starting to lag a bit, small-cap stocks are starting to look more attractive and when the turn comes could perform really well.

Michael Bilotta:

Yeah. One additional item, and I'd hate to miss this because it's been such a hot button over the last year plus is the role of bonds in the portfolio. And after a year like 2022, people may feel like I never want to own another bond again because wasn't what I thought it was going to be. It didn't play the role that I thought it was going to and so on. Well, that's all because interest rates were at zero and there wasn't anything there to provide ballast to when the contribution really was flat.

Well, now we have interest rates at three and four and five and 6%. So kind of of that return of the diversified 60/40 portfolio, we're starting to see some articles catch up to that. But even as recently as last month or the month before, you'd hear, “oh, the death of the 60/40 portfolio.” And is that going to provide investors with the return that they need going forward? Well, I would argue now is a much better time going forward for a strategy like that than it was a year ago.

Richard Brown:

Great insight, and again, a terrific conversation. 2022 was a challenge, we look at 2023 as a great opportunity. Thank you, David, John, and Mike for this great discussion today. And thank you very much for joining us today. I hope you will visit jnba.com and tune into our other videos and podcasts where we cover both investments and financial life planning topics.

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