Investment Committee Video Transcript: Where is the recession everyone has been talking about?

Richard S. Brown:

I'm Richard Brown, Chairman and CEO of JNBA Financial Advisors in Minneapolis, Minnesota. We are recording this discussion on July 12th, 2023. I'm with three members of our investment committee, Mark Rosenkranz, an Investment Strategist, and John Foster and Michael Bilotta, both Senior Advisors and Investment Strategists. Michael, let's start with you. In the last six to 12 months, we've seen a lot of headlines and concerns around when an eventual recession may arrive. On top of the continued recession concerns, in 2023, we have had headlines around a national debt ceiling debate, fears of potential banking crisis, and there are still ongoing concerns about the Fed's interest rate hiking cycle, yet the markets continue to rally. If you narrow it down, what are the two main themes that have driven market performance year to date?

Michael Bilotta:

Yeah, Richard, I think two of the biggest factors in what we've seen with the market to date is... Or that have led to the performance of the market to date are the resiliency of the economy and a strong consumer, and then the second would be kind of the narrow leadership pulling the market along with it. And whether that's something that's healthy, or not healthy, or whatever, and that can be debated, but the first with the consumer... Households are the least leveraged debt wise since 1991. And in addition to that, they've had a lot of excess cash sitting around from the pandemic that they would've liked to have spent but weren't able to, and that was in the trillions of dollars. You add that to large cost of living increases with social security, and a reprieve on student loan payments, you just kind of have a recipe for people, if they felt secure enough, to open up the pocketbooks and spend.

So even though we had really inverted yield curves, Powell last August even said, "We plan on keeping at it until the job is done, and the plan of hefty rate increases will bring some pain to households and businesses." Basically telling you right there, we're willing to cause a recession to get inflation under control, it just hasn't transpired quite that way yet. And that's let consumer spending, and even a housing market stabilize after showing some signs of weakness over the past couple of months. We have to differentiate a little bit between the backward looking or lagging indicators, meaning what has happened, and the coincident indicators, what's happening now. And most importantly for argument's sake, the leading indicators, what are the things that signal where we could be going in the next three to six to 12 months? But at least to date, that's really given investors a sense of security that the consumer's alive and healthy. And because we are a service-based economy, we can plot along here with maybe subpar growth, but growth nonetheless.

The second is the narrow leadership of the market so far this year, and if you look at it, it's been talked about quite a bit, but the seven mega-cap technology names, names that you would all recognize, as of mid-June, represented 28% of the market cap of all 500 S&P companies, and 17% of the earnings. So they did contribute a healthy clip, but for argument's sake, not almost a third. And through the end of June, if you look, these seven companies were up 63%, the S&P 500 was up 16, so still a very healthy number there. But if you take out those seven companies, and just look more at the broad market, you'd have 5% return. So I guess, if you're a passive index investor in the S&P 500, it doesn't matter, you just care that it's going up. You don't really concern yourself with why or what's causing it, but I do think there is some, I guess, attention that needs to be paid to whether the rally's broadening out or not, or how far these companies can continue to carry the market essentially by themselves.

The last time we saw leadership like this was around 2000, and those companies were... Microsoft was one of them, but GE, Intel, Exxon, and after that not so good. And so from that perspective, is that going to happen again? I don't think so to that degree, but it certainly does bear watching if those companies or that sector starts to show some weakness, does the whole market go down with it? So I think those are the two biggest things, and there's numerous, but for the years so far would be the resiliency of the economy, and then the narrow leadership still supporting the market kind of by itself.

John Foster:

Yeah, I really think too, Richard, Mike mentioned this narrow technology led leadership in the market, and it's really been a year where what did the worst last year has done the best this year. And what really held up well last year, which was dividend paying and value stocks, while the market was off about 20% last year, dividend paying value was down about 5%. Well, those stocks are only up about 5% this year. While technology last year, you look at the Nasdaq, it was down by about a third, and that's also rallied by about 30% this year. So whatever did the best last year has been the worst this year, and whatever did the worst last year has been the best so far this year. So it's really kind of been the polar opposite of 2022, the first half here of 2023.

Richard S. Brown:

So really, really hard to predict. So John, within the surprisingly resilient environment Mike highlighted, what are some of the opportunities the investment committee is seeing in the markets, and how has that changed recently?

John Foster:

Yeah, and I think within the markets, there's a couple things that we're finding attractive. First off, for the first time in a long time, you're not forced to own stocks if you want to get return. We have a bond market right now, where over the last 18 months, the Fed fund rate has gone from 0.25% to 5.25%. So all of a sudden, you can buy money market funds that yield close to 5%, treasuries that yield 4 to 5%, depending on the maturity. A 30-year mortgage is 7%, so you can buy mortgages, corporate bonds. So forever, there was no alternative to stocks, stocks actually had chance for capital appreciation, and paid more income than bonds. Well, now all of a sudden that's changed, where the S&P 500 yields less than 2%, and there's a bevy of opportunities in bonds that yield in the 5, 6, 7% range. So fixed income is way more attractive than it used to be.

And this should really help more conservative investors get higher returns the next 10 years, even if equities don't do as well, because they're getting so much more yield on fixed income than they used to. The other is probably some of these areas that have been left behind. Mike talked a little bit about how the leadership's been very narrow and very concentrated in technology. Well, small cap has been largely left behind, a lot of dividend paying quality companies have been left behind the first half of the year in this rally, and we started to see it in June, and it's carried a little bit over into July here. We're seeing a broadening out of that rally. We're seeing small caps start to behave a little better, we're seeing value companies do better. So it wouldn’t surprise us to see this rally broaden out and include more than just technology, mega cap growth companies, but pull small along with it, and a bit better performance out of value here the second half of the year.

Michael Bilotta:

You know what's strange, John? Is those mega cap technology names, it's almost as if post-COVID, investors started to look at those as the safe havens or the companies that can grow no matter what, because they did it through the pandemic, but people have to look at what was their business model, and what were they providing during the pandemic that let them grow to that degree? And now I guess here in 2023, what gets picked up is now the phenomenon of AI, and artificial intelligence, and those companies being involved to that degree, but they really almost have become more the defensive names for people to, at least in their mind, go to when times are a little bit uncertain. And that typically hasn't been the case historically to this degree, so it's a bit interesting to see.

John Foster:

Yeah, and I think too, the balance sheets, Mike, you think about most of these technology companies, they carry little to no debt, whereas a lot of more old school industrial companies or consumer staples, well, they've used both debt and equity financing. So technology companies are largely unimpacted by these higher interest rates because they just don't have debt, they have to worry about refinancing. So I think people flock to them because one, they've been able to grow even in slower economic environments. But then two, you don't have to worry about refinancing if you don't have any debt.

Richard S. Brown:

So true. Very good information, guys. So Mark, I can't believe we're already in the beginning of the second half of 2023. What is our investment committee monitoring?

Mark Rosenkranz:

Yeah, I think everyone here has done a good job of highlighting all the things that have changed over the last six to 12 months. It never feels safe to say, but it feels like we're in a bit more of a normalized environment. A lot of headlines have come and gone, whether it's a banking crisis, whether it's a debt ceiling, a 100 basis-point rate increases, it feels a little bit more of a day to day. And in that environment, we're allowed to focus on a lot of the things the Fed are stated they're watching. Things like unemployment, things like inflation. We got another good CPI print this morning. Things like corporate earnings, consumer activity. These are the things that, as Mike pointed out, have really driven the first half of the year, in terms of holding in there. And in a more normalized environment, it can start to come down to how markets perform can be driven by how businesses and individuals are spending and investing their dollars.

So it feels a little bit more business as usual than maybe the last six months, 12 months, even a year or two. We know how quickly that can change, we're always being vigilant, but that's right now what we got top of mind.

Michael Bilotta:

Yeah, we certainly had a bull market that climbed the proverbial wall of worry that first half of the year, that's for sure.

Richard S. Brown:

And based on those comments, how are we currently positioning portfolios?

Mark Rosenkranz:

Yeah, so overall, as long as economics continues to hang in there, we're willing to give equities the benefit of the doubt. At the same point as John pointed out, equities aren't the only show in town anymore, and there is some compelling yields on the fixed income environment. So adding that altogether, right now at JNBA, our portfolios are slightly overweight equities and slightly underweight fixed income. And within our equities overweight, we have a slight bias towards value and quality. We think that sets the stage where we continue to be rewarded, as long as the economic activity hangs in there. And there's still some upside opportunities for that value and quality segment, but it does add some decent downside protection if we start to see some weaknesses start to emerge. And furthermore, if things start to deteriorate even further, we'd look to be opportunistic and lean on the better yields we see in the fixed income environment.

Overall, it's been a very strong year and we're looking to be opportunistic, and continue to keep eye on things and how they're progressing. But we want to recognize that we are still below even 2021 highs that we reached, and there is still some opportunities, depending on which asset class you're taking a look at.

Michael Bilotta:

To that last point a little bit, I think we would be remiss if we didn't at least talk a little bit about or mention a couple of the concerns. The market is calm until it isn't. And at that point, the more complacent investors have become, the more overbought the market becomes. And one could argue it is right now, at least in many areas, and with volatility at extremely low levels, all it takes is something sort of dropped into the middle of all this that wasn't expected, and all of those things get thrown to the side, and the market will react accordingly. So a lot of the Fed rate hikes still aren't fully felt yet, the Fed will probably raise rates another 0.25% at their next meeting, although that's not a foregone conclusion with today's inflation print. But I think we just have to, again, very to Mark's point and what John mentioned. Monitor very closely the trend in the data that's starting to happen and not as much what has happened.

Mark Rosenkranz:

Yeah, I think that's well put, John, and Mike, I think the last two, three years have taught us how quickly things can change, and something that you wouldn't even be on the top of mind becomes the only thing that matters on any given month or year.

John Foster:

And I think too, it'll all come down to 2024 and where earnings are able to come in. I think this year, everybody was expecting earnings to be flat to negative. Earnings have been flat to negative, but the market expected that, perhaps got too pessimistic on how low they might go, and we've had a good first half of the year based on things holding in there. Not necessarily great, but relative to expectations, things look all right. Well, people are expecting earnings growth in 2024, and so it's really going to come down to, is there an economy that can give us earnings growth? Or is that going to be too far for an economy that still is dealing with rate hike adjustments and a Fed that's trying to slow what was an overheating inflation situation? And so I think that's the big question really, to keep an eye on here as we work through the second half of the year. Are we going to have to bring down earnings estimates for next year? Or are we able to have an economy that's going to allow earnings to get back to growth?

Richard S. Brown:

Yes, great conversation. And what we have all learned is the markets do not like uncertainty. So we'll have to watch, and be careful, and be diligent. So I'd like to thank you, Mike, Mark, and John for this great discussion today. And thank you very much for joining us today. We 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 only 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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