Midyear Market Update: How has the first half of 2022 set the stage for the rest of the year?

Richard Brown:

I'm Richard Brown, Chairman and CEO of JNBA Financial Advisors in Minneapolis, Minnesota. We're recording this discussion on July 12th, 2022. 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.

David, John, and Mike, the first half of this year has been incredibly challenging for investors with negative returns across all asset classes. Hey, Mike, recently, we have started to see bond yields increase creating some good news in this environment. Can you help put some perspective in this for all of us?

Michael Bilotta:

Sure. Thank you, Richard. And boy, you hit the nail on the head when you talk about a challenging environment. It certainly has been that to start the year here in 2022. Before I talk about bond yields for a second, I think it makes sense to step back and just put in context, quickly, the environment during the first half, and then we can move on and talk about how that pertains to positives, at least as far as the bond market is concerned. Going into the year, it was inflation, and then it became the war in Ukraine, and then it became the Fed raising interest rates, turning into, are they going to be able to bring down inflation? Is it going to harm growth to the point where they're going to throw us into a recession or stagflation, which is even worse from an investment perspective? So those are all challenges in themselves. Mixing them all together, you've got a high degree of uncertainty, which, as the old cliche goes, the market very much dislikes uncertainty.

For context, it was the worst first half to start a year since 1970 for the equity markets. And for bonds, it was the worst half on record for the Aggregate Bond Index, which goes back to 1976. So when you put those two together, it's kind of basic math. You have the worst half of a year since 1970 for stocks, worst half ever for bonds, the traditional 60/40 – 60% stock, 40% bond portfolio – had the worst performance since 1932. So for those of you out there that are feeling it a little bit, we all are.

As Richard mentioned, there hasn't been any places to hide. It's been the first time since 1981 that all of the seven major asset classes, excluding commodities and gold, but U.S. large, small, international, emerging markets, treasuries, corporates, and REITs have all lost at least 7%. So that's clearly not a fun start to the year.

So now, as it turns into how it pertains to the bond market, the old inverse relationship, as the Fed raises interest rates, the value of bonds that are currently held at the time rates are going up, go down. So that's why the Aggregate Bond Index for the year is down 10.25% because the assumed interest rate increases the Fed was going to make throughout the rest of the year.

In fact, if you look at the Treasury yield curve, as soon as they think the Fed's going to raise rates, or as soon as the Fed announces they are going to raise rates, the yield curve adjusts immediately. And I think that's an important thing to remember is that upon the very first assumption of this hike cycle, the market will position itself for where they think the Fed will end. So every time the Fed raises rates, it doesn't mean there has to be a further hit to the bond market because the market's already anticipating that.

In fact, right now, if you look today, the Treasury yield curve is pricing in the expectation for 13 total rate hikes – 12 one day, 14 the next, but 13 in general – with each of those rate hikes amounting to a quarter of a percent. And that's between now and the end of the year. So if you add all those up, by the end of the year, the market's pricing the Fed funds rate at 3.25% or so. And the Fed's done six of those already, but the market's priced for 13. So that gives you an idea as to how far rates have already moved if the Fed's not even half done yet with where the market is positioned.

Now, the good thing, as it pertains to that, and we've seen it once or twice over the last couple of weeks, is if indeed the bond market perceives that the Fed is going to slow down, or pause, or not have to raise rates as much as anticipated, then the rates come back down, which means bond values go up. So the positive there is, basically, is that when we have some soft economic news and the market says, "Well, the Fed won't have to raise rates as much as they thought they were going to because they don't want to damage the economy," that could actually be a positive for current bond holdings. Now, on the other side of the equation is if they have to raise rates more than what the market has currently priced in, then you could be looking for further price depreciation ahead in bonds, but we don't think that that's necessarily going to be a big factor going forward.

A couple of the positives coming out of this, as it pertains to more specific portfolios, is for the first time, that I can remember, we've been able to very actively tax loss harvest bond holdings. And the advantage of tax loss harvesting any asset class, but bonds in this environment, we can sell a bond fund, buy something back that's very similar in nature, keeping the portfolio strategy in almost exactly the same place it was before we sold, and yet we can take whatever that loss was and bank that against any future capital gains that we might have as we trade – either later this year or in future years. So it's the very clear definition of making lemons, or excuse me, making lemonade out of sour lemons in this case.

Richard Brown:

Thanks, Mike, for sharing about the tax loss harvesting. Great insight. And it helps our clients and other perspective clients understand, truly, the value add that we can make a difference when looking at tough times like we are right now.

Many of us are flabbergasted at how the bond yields have come back and almost doubled. Can you share a little bit about that?

Michael Bilotta:

The how it pertains to then the positive is, right now, we're looking at much higher yields. So if people were to buy into bonds today, the total bond index is averaging about 3.4%. 10-year Treasury is at 3%, and it was as high as 3.5. Even muni bonds are averaging almost 3%, which, if you count the taxable yield, that puts it at about 4.5. And then even looking lately CDs, and so on, even short-term in nature, are somewhere between 1.5 and 2.5%. So clearly, as it pertains to the attractiveness of bonds, as we sit here today in July, very much higher yields and more attractive yields today than what we saw six months ago, meaning bonds can actually play a much bigger role again in portfolios going forward as far as either return or downside buffer is concerned.

Richard Brown:

Thanks, Mike. And thanks for making our sour lemonade a little sweeter. We appreciate the perspective.

John, as we've discussed in our Investment Committee, earnings season is upon us. What could we expect to see in the coming weeks, and how could that affect where the markets go from here?

John Foster:

Yeah. Thanks, Richard. As we've talked about, earnings season always gives investors a glimpse into corporate profitability as well as a lot of times what the forward guidance is on those earnings. And if there's an area where maybe we think expectations might still be a little bit too high, it's with second half earnings. So, for the second quarter, earnings are expected to grow about 4% year-over-year, but then, Wall Street analysts have earnings growth accelerating to double digits the second half of the year. And we just think that double digit growth might be a bridge too far. So, we could see companies come out and bring down earnings guidance.

The challenge, though, is always understanding what the market has priced in as Mike had mentioned earlier. We've priced in a lot of rate hikes. We've obviously priced in some economic weakness with the market. The stock market began the year trading at about 22 times earnings. It's at about 17 times now. The long-term historical average is 16. So, clearly, we're pricing in lesser outcomes for the equity market, as well as corporate earnings, but they could be coming down here, as far as estimates are concerned, the second half of the year.

It's also, though, very challenging to time your way around that. This is now the 11th bear market since World War II or in the 12th. Prior 11, on average, 12 months after the bottom stocks were up 40%. And so a lot of times, you get into this, and even though you might expect a little rockiness or maybe still negative developments ahead, what you cannot do is miss that turning point because stocks usually perform very well once the market does turn, and you just don't want to miss out on the rebound when it comes. And so we expect that there could be some bumpiness here during earnings season, but we also know that once you're in a bear market, you want to also be thinking about that recovery because that 12 months after the bear market ends, you don't want to miss out on what usually are some of the best returns that investors end up receiving.

Richard Brown:

Thanks, John. Very helpful insight.

David, some industry experts say we are in a recession, and others predict that we could be entering one in the next 18 months. What is our Investment Committee focused on as we look towards the end of the year?

David Webb:

Sure, Richard, great question. I think, certainly, most individual consumers are feeling some of the stress out there, whether they're at the gas pump, or the grocery store, or even looking at their utility bills. So, as we think about whether or not a recession is on the way, or if we're in a mild one right now, technically, a recession is really just a decline in economic activity for two consecutive quarters. And oftentimes, it's going to be accompanied by a rise in unemployment. What we're seeing today is the job market is very healthy. And the market right now, if we look at what's getting priced in, you can see that about 40% of all investors, the way they've positioned their portfolios, are expecting a recession in the next 12 months. If we look out two years, the vast majority of Wall Street is expecting a recession.

So, we don't think that's entirely crazy, but we do think that a mild recession is probable, and it's probably already, for the most part, priced into the market. A mild recession is not all that bad. Earnings might decline maybe on the order of 10%. And as John mentioned earlier, right now, Wall Street's a little bit more optimistic. So, as we move into the back half of the year, what we're looking for is more of a clear break in inflation. And all leading indicators around inflation suggest it is in the process of peaking today, but we're looking for more of a clear break in inflation that's accepted by the public. We're starting to see that in terms of expectations for future inflation. Those are now starting to fade. Oil, interest rates, and the dollar are just a few of the factors that, over time, as those become greater headwinds, they do tend to weigh on corporate profits.

It takes a while to filter through. We're starting to see that happen here. Commodities have come off the boil. Energy is now in a bear market. It doesn't feel like it because it's still up year-to-date, but oil prices are down more than 20%. Most metal prices are down 10 to 40% since May. And interest rates, while they're still elevated, the 10-year Treasury, for instance, has come all the way down from 3.5 to below 3%.

So, the market is a pretty good forecaster of whether or not a recession is on the way. That's one of the primary things we'll be looking for. So, in terms of finding a good entry point to step back into the market, we feel we're a lot closer to the bottom than the peak at this juncture. We're watching leading indicators. Most of them are softening, but most of them are still positive, which suggests there will be some economic growth. The few that we're really concerned about most would be housing, autos, some of the areas that are financed, where higher interest rates hurt, affordability. Those will be some of the areas we're watching in the year-end, Richard.

Richard Brown:

Thank you, David, John, and Mike for this great discussion today. And thank you very much for listening today. 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 only as your financial advisor, but also your advocate. Please reach out if you need anything at all. You can find our contact information at jnba.com.

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