FIDUCIENT Advisors

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First Quarterly Quick Take of 2022: Key Market Updates with Brad Long

[00:00:00] Welcome to Nonprofit Investment Stewards with Bob DiMeo and Devon Francis from Fiducient Advisors. Bob and Devon are passionate about helping nonprofit organizations prosper. Whether you oversee endowment, foundation, or retirement plan investments, this podcast exists to help stewards improve performance, reduce costs, and discover strategies that enable your charitable organization to prosper and advance its mission.

[00:00:26] Now onto the show. Hello, and welcome back to the Nonprofit Investment Stewards podcast. I'm Bob DiMeo, as always joined by co-host Devon Francis. A couple months ago, when Devon and I were planning our shows for this year, we thought it would be great to have what we'll call quarterly quick takes. And what do I mean by that?

[00:00:46] These will be episodes that provide listeners with super timely perspective on the markets, interest rates, global matters, and hopefully a lot more. Well, little did we know when on this, our very first quick take episode, [00:01:00] we'd be dealing with looming rate hikes, that the S and P 500 would have flashed into correction territory, and that Russia would have invaded Ukraine.

[00:01:10] It feels like we're launching quick takes in robust fashion. We'll jump to our guest in just a moment, but first Devon, how are you and what do you think about our new quarterly segment? Hi, Bob, I'm doing great as always, um, you know, this is working out kind of exactly as we had hoped. It gives us the opportunity to interact with our listeners who are overseeing investments and to help provide them really timely insights to real-world matters.

[00:01:36] And we certainly have plenty of those going on at the current juncture. Of course, we are thrilled to be joined on our quarterly quick takes by Brad Long. Brad is a partner at Fiducient and he serves as our deputy chief investment officer. Brad's been a guest on the show in the past. So we won't repeat his bio for you, but do know that Brad is very involved in crafting Fiducient's investment strategies for clients. [00:02:00]

[00:02:00] And he regularly provides advice and guidance to our nonprofit clients and to other types of clients as well. So, Brad, we're really excited to launch this new format with you. Welcome back to the show. Yeah, thanks so much for having me. Brad, great to have you on. And, and perhaps it'd be great to have you just share a little bit with our listeners and with investors about what the format will be like and what to expect from quick takes.

[00:02:25] Yeah. Bob, as we started talking about this, we thought we could flip, we could split it into three different spots. So first is the obvious, right? What's moving headlines? What are investors asking about? And kind of the questions that are on the top of everyone's mind. But we want to move through quickly and then get into maybe the non-obvious components of that.

[00:02:42] So the germane forces that are driving markets, our take and, uh, the take of other global market participants. And then finally, maybe end with a quick quip on something that's frankly not on the radar. It's a little bit off the beaten path. And if we raise the gaze from a little bit [00:03:00] beyond just our toes and try to look further down the road, things that are going to be coming that might be a big part of the discussion going forward.

[00:03:04] I like that. We'll raise the gaze hopefully, and it's probably as good a time as any to share that. None of what we discuss today represents a specific investment recommendation. One thing we know for sure is forecasts are just that and actual performance will differ.

[00:03:22] Um, but, uh, I guess it's time to get right into it. Great. So, Brad, I think, um, there's really nowhere else we could start other than Russia and Ukraine. Um, can you talk to, uh, what's going on and, um, the, the economic impact that you see that having on, you know, on our markets? Yeah, clearly a, uh, a key headline here.

[00:03:44] And you know, at the time of this recording, it's March 2nd and it's worthy to note, right? This is a very fluid situation. So, if you know, people are listening to this down the road, the facts and the circumstances could have changed, but nonetheless, you know what we know today, clearly a [00:04:00] horrible humanitarian event and one that is to some degree ushered us into a new era.

[00:04:07] And what we mean by that is, you know, Russia has moved its borders with force. That's the first time a country has done that since World War II. And it is a different paradigm shift that Europe is seeing today. And when we look at the impact there, and, and when we think kind of broader in markets and the shift that that occurs.

[00:04:26] It really makes us think of the days of globalization are at best waning, if not worst gone. And we're moving into more of a regionalization, if you will, which brings all sorts of nuances, including, you know, the potential greater volatility. It could include, uh, the potential for, uh, the, the, the difficulty of kind of transmission of goods and services and, and money across markets and regions.

[00:04:52] And so, you know, this, this act by Russia has really propelled us into what we think is a new era, but [00:05:00] it should, it should be worthy of note that when we come across events like this, like truly exogenous events that, you know, no one really has the predictive power of being inside of Vladimir Putin's mind.

[00:05:13] They're really hard events to try to trade around, if you will. And let me give you the two reasons why. The first is getting the fact pattern right. So, if you know that Russia invades Ukraine, then you know the US and EU and Japan's response. And then, you know, right, if you actually, if someone listening has the power of that prediction, please give us a call.

[00:05:33] We'd love to talk to you about it. But even beyond that, the market's reaction is a key consideration. And let me give you an analog about an exogenous event. So, you know, Devon, if it was 2019 and we're sitting here. I'd say, by the way in 2020, we're going to have 350,000 deaths in the United States. We're going to have high unemployment.

[00:05:54] We're going to enter a session and we're going to see a pandemic that is unseen in the modern era. What do you think the [00:06:00] S and P is going to do next year? Most people would probably not reply with yeah, it's going to be up to 18%. So not only getting the fact pattern right, but the market's reaction to it, is a really difficult thing for these exogenous events.

[00:06:13] And then the final thing I'd mention about kind of this macro situation here is not all terrible humanitarian events become terrible market or economic events. And history is actually a fairly reasonable guide here. We can look at, you know, the Gulf War in 91. You know, a year later, markets were up over 33%. Or the Gorbachev, also in 1991, a year later, markets were up almost 9%. And there are many others, the Iraq war in 2003, the previous invasion of the Ukraine in 2014.

[00:06:44] So it's important for us to understand and differentiate the difference between kind of a horrible humanitarian event and those that actually tip the scales towards economic recession and market reaction. So, can you help put things in [00:07:00] perspective and share with us, um, globally, what type of an impact does Russia have from an economic perspective?

[00:07:11] Yeah, I, I do think your, your point of perspective is probably the key one here and probably where we should start. So, Russia's the world's 11th largest economy, uh, by GDP. That's 1.5% of global GDP. So, it's a similar size to countries like Belgium or Netherlands. And while Russia is often thought of as a material global player, and they are the head of the security council of the United Nations.

[00:07:37] They are often kind of in the news as a strategic player, as a, uh, economic engine of global GDP. They are 1.5% of global GDP. So not to say that that's, not to diminish that, but just to set the facts. And then when we move beyond economies into markets and we look at the capitalization or the [00:08:00] value of the Russian market, and we use the MSCI ACWI, the all country world index.

[00:08:06] Russia makes up less than one half of 1% of the global market cap. So, I think it is important to understand, kind of get the, the expectation of what these markets are before we begin talking about the impact. And now we know impacts from events like this don't simply live in geographic borders, right?

[00:08:28] They are going to money and goods and capital, move beyond borders. So, when we start to talk about the impact, it's pretty clear that the cost of this action will be disproportionately what levied on Russia. The last time Russia partially invaded the Ukraine was 2014. At that period of time, their GDP fell by about 3%.

[00:08:50] The sanctions this time around that are being posed by the US, the EU, Japan, and others are far more impactful. So, we should expect an [00:09:00] economic scenario that's worse than what we would expect last time, especially the longer that this lasts. Um, the clear kind of second place and unfortunate, uh, impact here is Europe.

[00:09:11] It can likely come through lower GDP, higher inflation, since Russia is a key provider of natural resources, like natural gas, to Europe. So, through heating prices and others, they likely see higher inflation, especially countries like Germany who have built the Nord Stream 2 pipeline, which pipes natural gas directly from Russia to Germany under the Baltic Sea. German citizens are likely to see a greater impact there.

[00:09:36] And the ability to continue the sanctions as they've been placed today, it's really going to be an EU story because the EU is largely going to be the country or region that's most impacted economically. And it's important to remember for us as United States citizens, that it's not the United States of Europe, right?

[00:09:55] It's the European Union, which is made up of 28 independent countries. And [00:10:00] so with different objectives and different approaches to working with their aggressor to the Northeast, I think that the EU is likely the region that is most likely impacted and, uh, going to have to bear the cost.

[00:10:14] Brad, that's great perspective. And as you mentioned, things may have changed by the time listeners are hearing this episode, but really appreciate the insights on, on Russia and the Ukraine and, and what that might mean for investors. Let's turn to equity valuations, particularly in the US, and earnings largely continue to impress, and curious if we're comfortable with stock valuations at this point?

[00:10:38] And, uh, what rising rates might do and alter views in any way? Yeah, earnings are certainly going to be, and we outline this in our 2022 outlook, they'll be a key contributor to the potential markets moving forward this year. The reason being is as the Fed moves in kind of a new era of less accommodation, rising [00:11:00] interest rates, quantitative tightening, the likelihood that valuations, meaning the willingness or ability to pay higher multiples for a business making the same amount of money.

[00:11:12] It's probably at the very best flat if not falling. And, and the reason is as interest rates rise, what happens in stocks is discount rates rise. So, the need for growing earnings is going to be important as we look at Q4 earnings, which are largely completed at this point in early March. You know, we haven't seen most companies beat on earnings, beat on revenue.

[00:11:35] However, those that did miss, for example, Meta missed in its earnings and the stock traded down materially around that. And we just think the misses in earnings, given the reliance on earnings growth this year, can potentially produce greater volatility. It doesn't necessarily mean that markets will be down, but it does mean that there could be greater volatility around these [00:12:00] events.

[00:12:00] So it is something that we'll continue to watch pretty closely as we go forward through the rest of the quarters. Great, Brad. And we'll come back to that in a moment in particularly active versus passive investing. But I'm curious, inflation is obviously another major theme here in 2022, and it feels like it's really not your father's inflation, if you will.

[00:12:19] That wage increases play just a disproportionate role in today's inflation, but certainly feels like it rhymes with some inflation components and elements of the past. So, we'd ask you, what's included on the list of assets that investors can own that could be considered inflation fighters, if you will?

[00:12:43] Yeah. Bob, your, your point is a great one, right? Not your father's inflation. There are some things that reflect historical bouts in inflation. So, for example, energy prices, many historical time periods in which we've seen material [00:13:00] inflationary environments. There has been a pretty meaningful contribution from energy.

[00:13:04] Now, we would argue that likely the component of CPI here in the US that's been impacted by energy in 2021, well, in the short term with some of the geopolitical risks and oil has been rising, it's less likely to continue at the same magnitude and pace where energy is leading the fray. So that's important for us as investors, as we think about our real returns, so returns minus inflation.

[00:13:29] What are other ways that we can think about guarding against inflation than perhaps just commodities or even oil? Well, one we can talk about, which is relative to Russia, right? Russia is a material agricultural provider around the world. They provide a meaningful amount of the world's barley. I believe they're one of the largest barley producers in the world and the third largest producer of wheat.

[00:13:51] So we can see agricultural inflation come here in the United States and around the globe. And also, Russia is a large producer of iron ore. Iron [00:14:00] ore is what goes in to make steel, right? So, steel prices could potentially rise. And that has many impacts across things like real estate, replacement costs are rising, et cetera.

[00:14:10] So you can see the drift here is that it shouldn't, when you think about an inflation fighter, you should think about it in a broad sense because inflation usually is not singular in its, in its components. It's usually from multiple perspectives. So having a broad portfolio with exposure to things like real estate, like agriculture, like commodities, or many other components can help broaden that diversification and frankly increase, hopefully increase, the likelihood of producing a positive real return.

[00:14:40] That's great. And probably also worth mentioning, it's sort of stating the obvious, but equities, I mean, they're real assets and generally, except largely in spiking inflation environments, have faired well. Yeah, equities are one of the best long-term inflation fighters. But as you accurately noted, in periods of [00:15:00] spiking inflation or materially rising inflation in short-term, they can be a little bit more choppy.

[00:15:04] Certain equities like natural resource equities are those that are more linked to end commodities or goods, tend to do well. But over the longterm, and especially those that have a long-term portfolio allocation, equities can be a very meaningful inflation fighter. So, let's talk broadly about emerging markets.

[00:15:21] If we rewind the clock back to the beginning of the year, the conversation in many investment circles was focused on China. Obviously, that's taken a back seat to Russia given the current conflict. So how do all of these developments impact our broad thinking on emerging markets longterm? And how does China come into play?

[00:15:42] Yeah. Devon, it's a great question. It's a good reminder that emerging markets, while under one moniker, are a very diverse set of underlying countries and economies, et cetera. The, the, obviously we've seen Russia as an emerging country have very poor [00:16:00] performance as of late. On the flip side, we've seen Brazil, given higher energy prices, you know, the country's equity markets have been doing very well.

[00:16:08] So, it is a very diverse set of countries and economies under the hood. But nonetheless, China is such an important part of emerging markets. It accounts for well over a third of emerging market indices. And frankly, you know, we don't certainly have any geopolitical insight into China more than many others, but it seems like China's happy to be out of the limelight for a little bit.

[00:16:30] Given Russia stepping in and there's been no shortage of geopolitical tensions between the United States and the west really and China. And China's been trying to sneak their way through some of these conversations. Obviously, they're, they're decrying war as humanitarian elements, but they're also trying not to get too involved because you know, it's not too long ago, China was having its own sovereignty conversations about Hong Kong on their own station.

[00:16:52] China's long-term gaze is actually [00:17:00] not all that similar from Russia's with Taiwan, kind of multiple countries in one system. So, they're trying not to get into involved in too many conversations around sovereignty, but nonetheless, as we, again, move out of kind of the geopolitical sphere and back into the markets, you know, China is somewhat of an asynchronous economy.

[00:17:20] It's, it's a little bit in a unique phase and its own life cycle today. Recently, China's been decreasing their interest rates to becoming more accommodative, as opposed to most central banks around the globe are doing the opposite. And they have the ability to do that because they have modest inflation.

[00:17:36] They actually have slightly falling, but highly positive, growth in GDP. President Xi Jinping has, you know, is largely looking to move into the role of a new emperor taking on a third term in his party's election at the end of this year. And in doing so, has accelerated a number of infrastructure projects throughout the country to boost GDP.

[00:17:56] So China's in somewhat of a unique situation to try to [00:18:00] continue to grow its economy and support its markets, especially relative to other economies, those developed or even developing. So that continues to spike our interests in emerging markets. Not only broadly as a group of countries that have great economic and future potential benefits, but also in the shorter term, looking at the potential catalysts that can help drive that forward.

[00:18:22] And China's been a key one on those. Thanks Brad. Maybe it's a great time to jump to diversification and even a bit on active versus passive. I know when I was meeting with clients just before Russia invaded Ukraine, I was talking about inflation as such a big theme this year, and that's leading to a rotation in terms of growth and value and so on.

[00:18:45] And it probably is going to lead to a lot of gyration or volatility in the market. And I realized, hey, this is sort of a three-part rhyme, but anyway, I'm curious on your thoughts regarding value versus growth going forward,

and our prescribed [00:19:00] approach to diversification. Yeah. So, when it comes to, I guess Bob, your, your rhyme would be inflation, rotation, gyration, right?

[00:19:10] When we think about value versus growth. So, we talked about the potential inflationary impacts and what that means to the fed. The fed is likely going to be raising rates not too soon here in their March meeting. What typically happens during rate rising cycles is businesses that have very high or full valuations, as interest rates rise, discount rates rise, and those tend to sell off.

[00:19:36] We've seen a little bit of that. Even pre rate rise, you know, some of these higher flying securities are those that have done really well through the pandemic, have sold off coming into 2022 in anticipation of that. So, you have seen a bit of a rotation. The flip side on the value side is for every, we've read estimates.

[00:19:55] These are not ours, but we've read estimates. For every 100 basis points [00:20:00] in move in interest rates, that gives banks 15 to 20% more earnings power just through their loan book, right? They're loaning, they're loaning assets at a higher rate. And so, they can earn more money over time. Financials and banks make up a much more material percentage of value here in the US but also indices across the pond here through Europe.

[00:20:25] And so we haven't seen a bit of that rotation, but nonetheless, timing some of these things, again, getting back to some of these exogenous events, there is really not a great mouse trap to timing value and growth. And both over time have positive economic value to portfolios. So, we think having a thoughtful and prescribed diversification across both brings the benefit of kind of when one's in favor, the other you know, uh, might be balancing that.

[00:20:54] And we do think that investors will benefit from a balanced approach to both. [00:21:00] To end, as you talk about both value and growth, I know on the active and passive front that we also believe in both practices there. I'm just curious, when we put on the cap of an investment committee member or other leader who oversees portfolios.

[00:21:19] What should we be thinking about now in terms of active versus passive? And are there any areas, particularly now, where we would favor active management? Yeah. Bob, as you noted, we think being pragmatic, not dogmatic, about active versus passive is the key approach. So, apply the, where we believe the opportunity is, is higher, right?

[00:21:41] So independent of skill, we think one could select an active manager that could outperform its index and also the payoff of being active. You don't want to outperform by a very small margin. You want to outperform by something that's meaningful, uh, worth your time. And if you don't have those characteristics, it likely makes [00:22:00] sense to reduce aggregate fees and own passive investments.

[00:22:03] Now in today's market, what's the shifting winds of increasing the probability of success and also the magnitude of payout? You know, we talked about rising inflation, that has a material influence on fixed income. You also have dis-aggregated global central bank policies, you know, historically they've all been moving in the same direction.

[00:22:23] Now we have the fed raising interest rates. We have the EU taking a different approach. We have China easing. The potential volatility associated with those markets we do think is a prime space for being an active manager within fixed income, not just from a risk management perspective, but even some that can be more dynamic and use volatility as an asset for bringing additional benefit to investors.

[00:22:47] That is a space that has even probably more tailwind today than it has in the past. And especially around risk management, we think will probably be a key variable going forward here. So, you've already [00:23:00] referred to the impending fed meeting a number of times. So, I'm going to go ahead and ask it.

[00:23:04] I won't hold you to it, but do you have a prediction what's going to happen at that fed meeting this month? Uh, I predict the fed will meet in March. No, just kidding. There's a fed watch tool put out on fed futures and it gives kind of the market’s traded predictions. It's pretty clear that markets are expecting at least 25 basis points.

[00:23:30] Prior to Russia invading Ukraine, the expectation, there was some expectation towards 50 basis points. I think, frankly, the preferred path the fed is going to be slow and steady wins the race, don't make the same mistakes of Ben Bernanke from communication to the markets and the taper tantrum. And also, some of these events, whether they be geopolitical, the transitory notion of inflation and what is transitory or what isn't, uh, the fed wants to be a steady hand in those.

[00:23:56] And then we would also argue the fed has a dual mandate. It's full employment [00:24:00] and price stability. There's probably a third implicit mandate, which is keep the markets happy. If the fed is moving at a faster pace at a greater magnitude, I think taking away the punchbowl, right, the stimulus that's been put in the system, think of it like insulin.

[00:24:14] We've been pumping the economic body with insulin. We're about to go through withdrawal. So, I think they want to do that in a pragmatic way. Now the one thing that we would say more than just the fed funds rate, which is probably the most discussed, is the move that we're also moving into a period of quantitative tightening.

[00:24:34] So remember, Ben Bernanke was the architect for quantitative easing from the global financial crisis. Another tool in the tool vault to bring stimulus to the market, which basically means the fed buys bonds in the open market. And it reduces the effect of interest, right? And stimulates economic growth and lending, et cetera.

[00:24:51] Now that the fed has stopped purchasing, there's two versions of quantitative tightening, QT, going forward. One is the [00:25:00] more passive way in which they just let bonds mature naturally over time. The other is the more aggressive way, which the bank of England is approaching, and they're actually selling bonds into the open market.

[00:25:10] But clearly if you have more sellers, you might have more price pressure. But the thing that I think the market is under appreciating is, we've read estimates actually largely from Ben Bernanke's, um, most recent conversations that if the fed were just to let maturities uh, mature, or bonds mature over time, that implicitly is an additional 25 basis points raise over time.

[00:25:33] So quantitative tightening is going to have a similar effect as interest rates, but I think the market is largely under appreciating that. So, we do think that, you know, there's likely to be a rate rise. But we don't, we don't think that the market is fully appreciated the potential impact of the Fed's new era.

[00:25:53] Brad, as we wrap things up or get close to wrapping things up, what else is out there that may be on your [00:26:00] radar and just might not be obvious to investors at this point? I would say two things quickly in summary. One, since we're talking about the fed and it feels like this is going to be a continuing conversation, earlier in the segment, we talked a little bit about history and using history as a guide for potential future outcomes.

[00:26:19] We've read a lot of investors using past rate rising cycles as an, you know, an analog for the future impact. We think that that's a pretty bad mouse trap to try to think about future return. And we'll give you the quick reason why. So, since the 1980s, there's been seven rate rising cycles. And on average, the Bloomberg aggregate, the broadest fixed income index, actually returned positive 3.9% during those rate rising cycles.

[00:26:50] So one could look at that and say, oh great. I don't really have to be worried about rising rates. I can continue to move on. Now, the difference there is you need to understand that the [00:27:00] average starting yield across those past seven rate rising cycle was 6.7%. We do not have the luxury of 6.7% rates or yields on fixed income today.

[00:27:14] So we don't think that using the analogy of history to predict forward and fixed income today is a very prudent path on future prediction. So that's one. The second is when, you know, we again increase the, uh, the arc of our gaze a little bit more, and we, you know, we moved beyond March fed meeting. The international longshore and warehouse union, that is a mouthful, but the ILWU is a union that stretches from the Southern tip of Moscow all the way up through Alaska, including Canada. If anyone remembers back to 2015, when we had a supply shock, because we couldn't get goods into the Western border of the United States.

[00:27:57] Uh, and some people couldn't get Christmas gifts that year. [00:28:00] It's because that union went on strike. Well guess what? We've already got supply chain issues from the pandemic and those contained linger. The ILWU's contract is up on July 1st of this year. So, we might be finally fixing a bit of our supply chain issues here only to have kind of this left tail event potentially come in.

[00:28:21] Now, hopefully it's a great resolution and it never really hits the radar. But when we think about setting expectations for inflation going forward, we do think it's one people should have on their, on their view. Brad, thank you so much for joining us today. You have provided such expertise and such great insights, and we really appreciate your time and your energy.

[00:28:43] Alright, thanks so much. So, if folks would like to learn more, if this episode just serves to what your appetite and you're anxious for more information, there is so much on our website. Go ahead and visit it.

Fiducientadvisors.com. You can check out the insights [00:29:00] tab and through that tab, you'll be able to access white papers, the blog and other episodes of the podcast as well.

[00:29:07] And I too want to thank Brad. I think this will be a fun and informative quarterly segment. So, thanks so much, Brad. And as Devon mentioned, Fiducient has some great resources. To me, it feels like 2022 is going to be a strap on your helmet kind of year. And I would only say if you oversee an endowment, foundation, or some other pool of investments, you might be feeling a little uncomfortable right now.

[00:29:29] Maybe you're not sure how the portfolio will perform in a downturn. Or perhaps you're concerned about cost or governance issues. All I can say is that if you oversee investments and have any concern, we encourage you to check out the resources or to contact me or Devon to talk about it. You can reach us at the email in show notes or through LinkedIn.

[00:29:51] So to all you good stewards, thanks for investing time to help your nonprofits prosper. We'll connect with you soon on the next episode. Thank you for [00:30:00] listening to the Nonprofit Investment Stewards podcast. Click the subscribe button below to be notified of new episodes and visit Fiducientadvisors.com for more information.

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[00:30:24] Always seek the advice of qualified professionals familiar with your unique circumstances.