Fiducient Advisors, Nonprofit Investment Stewards Podcast
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Second 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 cohost Devon Francis. It's the end of a quarter. And that means it's time for quarterly quick takes with Brad Long. He's Fiducient's deputy chief investment officer. As a reminder, these episodes are shorter than others, but loaded with super timely updates on the markets, the economy, and a lot more.

[00:00:53] Devon, how are things? Pretty good, Bob. Uh, I'm really excited to hear from Brad, as we know, it's been a very [00:01:00] tumultuous market environment so far this year. So I think that, uh, he'll share some quite interesting insights with us. Excellent, Brad, welcome to the show. We're glad to have you on again. Thanks Bob. Brad, why don't we begin with inflation, right?

[00:01:15] It's uh, we, we're seeing red hot figures, 40 plus year high in the US. What are your high level thoughts on the inflation front? Yeah, inflation. The most recent inflation figures came out and they were, they were pretty disappointing for the market. And really, for two reasons. One, the market's been trading around this idea of peak inflation.

[00:01:33] Really hoping that March was the top and, March at 8.5% was a, was a fairly high figure. Now we just eclipsed that with 8.6 here with the most recent CPI figures. The other, which is very much related to that, is markets have been looking forward to what they've been calling like the fed pause.

[00:01:51] So hoping that the fed can raise interest rates here, given inflation slowing, take a pause in the fall. With the most recent figures, [00:02:00] it's pretty clear that that is not gonna happen. The other thing is the fed is really fighting against the idea of inflation embedding itself into asset prices and they were hoping it would be transitory.

[00:02:13] And the most recent figures have really started to fight against that. And one of the ways to look at that is actually looking at what the Cleveland fed puts together. It's called the trimmed mean inflation. What they do is they take off the outliers, the things that have gone up the most and the things that have gone down the most, and look at the average, uh, within there.

[00:02:32] And they've been tracking that data since 1984 and that inflation is also making new all time highs. So, it really seems to be a broad-based inflation that's starting to embed itself into prices rather than what the fed was hoping for, which was more of a transitory inflation that they could then move through.

[00:02:52] And would you have any follow up thoughts on portfolio positioning that should be considered by investors? [00:03:00] Portfolio positioning around inflation, we talked about this a little bit last time. It's important to think about real returns in the long term but try not to be too reactionary to any one data point.

[00:03:11] So the key that we made last time, and it very much still applies today, is inflation as a headline figure is important. It's how we're consuming prices as, as, uh, as consumers in the US. But it's made up a lot of things underneath the hood, right. So simply trying to hedge against inflation by owning one asset, say like real estate or commodities.

[00:03:32] We think is a very narrow way to protect against inflation. And one of the things we talked about last time was actually kind of the shifting winds of inflation and somewhat of the agricultural impacts of the Russian Ukraine war, and also outside of geopolitical in Europe, but you know, hot and dry weather out of India and others.

[00:03:51] Since our last conversation, agricultural food prices at home, how the CPI measures it, are up over 12% since then. And up [00:04:00] 66% since you know, 2020 and COVID began. And so, when we think about portfolio positioning, we still believe to increase the likelihood of actually hedging against inflation. A broad basket still makes a lot of sense, cuz it increases the probability of catching those changing elements of inflation, not just taking one narrow bet.

[00:04:20] That's helpful, Brad. So let's talk a little bit about the fed, and you alluded to this, uh, a bit earlier, but the feds always played an important role, but that role now seems a bit outsized. It seems like the fed twitches and the markets react. Why do you think that is? Yeah, it's, it's a great point.

[00:04:39] And this is, I think the market is really trying to read tea leaves around inflation and the fed. And we talked a bit about this last time, but it's pretty clear to us that markets are somewhat addicted to accommodative monetary policy. So it started with Ben Bernanke and the global financial crisis with cheap money and quantitative easing, [00:05:00] but really accelerated during COVID and the G7 economies added over $8 trillion to their balance sheets through quantitative easing. And markets, risk assets and fixed income.

[00:05:10] They've kind of marched up along with it. And so they've really enjoyed the accommodative stance. It's clear the fed, the fed is clearly no longer accommodative. They are increasing interest rates. We just, uh, started quantitative tightening, the evil cousin of quantitative easing. And so, markets are trying to now assess, okay.

[00:05:30] If you know, if we're gonna carry the analogy of addiction, we've already checked ourselves into rehab here. We know that we're in a period of, of increasing interest rates. But how long and how much? So we're trying to, you know, kind of pick at the doctor and say, Hey, how long is this going to take? That's where the market has been.

[00:05:49] So hyper focused on the fed's actions in trying to understand what is the aggregate impact on prices and how long can we expect this to persist? [00:06:00] So the fed has a dual mandate of full employment and price stability. Could you comment on each of those? Yeah. You know, the, we had a bit of this discussion last time and, and the narrative has really shaped up around this.

[00:06:16] So yes, they have a full employment and price stability mandate. We also mentioned last time and that still remains the case though. It's certainly fallen in the list of priorities. We would say that there's an implicit third, which is largely keep the markets happy. Well, if you think about the Fed's role in the global economy and for, uh, citizens here in the US, inflation is a key priority.

[00:06:40] Cause if we have inflation that's at recent levels, say almost 9%, wages really can't keep up with that. And so, if inflation was to persist at this level, then real wages over time, you're just gonna be in theory losing a little money every year. And that's obviously not what the fed wants for the economy or for the consumer. [00:07:00]

[00:07:00] And so inflation has become priority number one. Their hope is that by slowing the economy they can reduce inflation, but keep positive economic growth. So that would be the soft landing. And with our three priorities, as I would call them, full employment, price stability, and keeping the markets happy.

[00:07:18] The third is what they would be sacrificing there. Right? They're saying, hey, we'll slow the economy, but not to stalling speed. We'll get inflation under control. And the collateral damage will be kind of markets in the short term. And they're fine accepting that. What the recent conversation in markets has been, and especially in May and with the recent CPI, uh, repricing, is the question is okay with inflation being priority number one.

[00:07:42] Is it not just markets that will be the collateral damage, but will it also be the economy? Meaning will the Fed have to hike the economy into a recession in order to tame inflation? And so, with those three mandates in mind, again, two explicit and one implicit, [00:08:00] the pecking order has been, is, is coming more clear.

[00:08:04] And the fed is certainly deprioritized the market, but it might actually have to work against the economy in order to get inflation under control. And so there's, there is that shifting interplay between those three. Brad I like your three-legged stool analogy. If you will. I remember being in a printer shop one time and it said you can have quality, speed or good price.

[00:08:26] Pick two of the three. So it seems like, uh, as, as you're mentioning, the fed is, uh, letting the markets do what they will while they work on other matters. And that leads us to the point of valuations. And so far this year, it's been really unusual and really challenging for investors because we've had this uncommon occurrence of seeing both stocks down double digits and bonds down double digits.

[00:08:48] Tell us what Fiducient's thoughts are on valuations and as well, please share a bit about our intra-year capital market assumption updates. Yeah. So Bob you're right on the valuation [00:09:00] side, right? As prices come down, all else equal, our outlook is going to be better. It's valuation based. And so, you know, if we can buy a dollar for 75 cents or 50 cents, right.

[00:09:10] That's going to, uh, only be beneficial in the long term. And so, as prices have retreated really across many global assets, that's within fixed income. Uh that's within global equities, you know, our outlook has subsequently changed, especially on the fixed income side. If you think about where we entered the year, we had an extremely low outlook on fixed income.

[00:09:31] I mean, we even wrote a research paper talk about, it was entitled, fixed income complacency, in which, you know, we were saying, look, there's low opportunity and high risk. What are the things that we can do to potentially modify allocations with that set of circumstances in mind, but as interest rates have changed and the fixed income market has changed.

[00:09:51] So is the outlook. If you think about our fixed income outlook, it's actually doubled since the end of the year. Now that's doubling off of a very low base. We had [00:10:00] about a 1.7% 10-year return on fixed income when we entered 2021 and we're saying, Hey, this is gonna be a really hard asset to continue to own over the next 10 years.

[00:10:12] Now, we're looking at almost three and a half. And depending on what market opportunities are presenting themselves and fixed income, uh, yields continue to rise that could continue to rise as well. So valuation in fixed income has moved markedly in a good direction. Now on the equity side, there's no question.

[00:10:28] Things have gotten cheaper. And earnings have still remained fairly robust. Q1 earnings are done, around 80% of companies beat on earnings, which is, which is good. The incremental though is, is the earnings outlook still looks a little too rosy. It hast adjusted to recent market conditions and expectations remain high.

[00:10:48] So when we think of the opportunity within equities, yes, there's no question that incrementally, it has gotten better from the beginning of the year. But usually in periods of stress, periods of market drawdowns, you don't just [00:11:00] drop down to the average and then bounce right off of it. And today, when we're looking at say like the forward PE metrics on a 10-year basis, we're just below average.

[00:11:09] So it's not like we've moved into this extraordinarily cheap environment, but yes, things have definitely incrementally gotten better. So, we've seen a significant rotation from kind of transformational growth stocks to companies with current earnings. What do you think the driving force is behind this change in sentiment?

[00:11:30] Yeah. I mean the fed kind of not to make everything about the fed, but coming back to the idea of what the fed is doing in the real economy, as they're increasing interest rates, that increases the cost of doing business. And if we just rewind the clock a few years ago, inflation is low. The cost of doing business, meaning, debt is low.

[00:11:52] Investors were prioritizing growth. If the economy's growing at a modest pace, you wanna be investing in businesses [00:12:00] that are gonna outgrow the economy and use that as a way to return good investment returns to investors. And so, investors were willing to pay up for future growth, but because things were so cheap, meaning the cost of money was so cheap.

[00:12:13] Businesses could have very little or no earnings, but they could fund their businesses with very cheap cost of capital. And so, they had a long runway to be able to do that. And they could kind of spend over time and that's kind of the venture capital model, right? You promise for very high growth, but in day one or year one, you might not even have earnings at the end of the day.

[00:12:34] Now as the cost of capital, as the fed has increased interest rates, that has changed that equation marketably. And investors are saying, you know what? I would rather take earnings today and more modest growth in the future than no earnings today and a promise for growth in the future, because that runway is so much more narrow.

[00:12:53] Given the cost of doing business is so much higher. So that has absolutely been kind of a wind shift [00:13:00] for investors and, the easy expression of that is growth versus value, but it's, it's come up in a lot of different ways in venture capital, in growth equity, on the private side. You can see it in the debt markets as well, across high yield or other lower quality businesses with less strong balance sheets.

[00:13:16] So that has been a very marketable change and it's really been driven bottom up from the fed. Thanks Brad. So let's just follow and finish with a few grab back questions we'll call them. I'm looking at unemployment claims that are near 50 year lows. So employment is very, very robust yet consumer sentiment.

[00:13:35] If you look at the Michigan survey, is at an all time low. Usually people feel really good when jobs are so strong. What's your take on this? Yeah, it, it's a great question, Bob. You know, I would say consumer sentiment is one of those things where measuring emotions in the market is pretty difficult to do.

[00:13:55] And the, the Michigan index has others. You can look at flows, data is [00:14:00] another version of sentiment. It's not a precise measure, but it's pretty clear. Investors are, are fairly gloomy. Part of that is likely obviously market action and, and activity. More investors, more citizens, individuals today are investors in the market than have ever been before.

[00:14:18] You know, if you think of the proliferation of Robinhood or fractional shares, you know, typically investors that or individuals that wouldn't have been investors in the market or lost capital if markets were down, they're now in the fray. So that sentiment has been low. Trying to unpack kind of where we are as a, as a society around exiting COVID and mental health, right.

[00:14:40] I'm sure that there's some, uh, some component there, but the dichotomy of wages and kind of wage growth and unemployment being all very robust and sentiment being extremely low is, is a pretty rare divergence. And I do think not again, bringing it back to the fed, this is probably where the fed is gonna be most targeted.

[00:14:59] [00:15:00] They're willing to take lower sentiment market returns that are down, but they do actually wanna slow wage growth. They wanna slow employment and labor because that is one of the underlying fundamental drivers of inflation. And so, my guess is, and again, this is, you know, we don't have a magic or crystal ball on this.

[00:15:22] Is that if the fed is successful in doing that, then wages and labor and unemployment will likely follow sentiment and can slow into the future. So, one of the things that we haven't touched upon, but obviously is weighing heavily on the markets, is the war in Eastern Europe and growing sanctions against Russia.

[00:15:42] Can you talk a bit about the impact? Um, not only on Europe, but also beyond European borders. Yeah, the, the impact on Europe is pretty acute. You know, since our last conversation, sanctions have only continued to grow, uh, the EU has really stepped up at its own cost to [00:16:00] continue to sanction Russia's actions and doing so through.

[00:16:03] Uh, less purchases of natural resources. That has a really direct impact on inflation and inflation pressures in Europe, uh, slowing economies there, Germany has been particularly impacted, which we talked about a bit before. But maybe since we've been talking about low consumer sentiment, we can flip the script a little bit and say, what has been good out of, the, the horrible, uh, actions that Russia has taken in Europe.

[00:16:27] And frankly, it goes back over to Asia with China. So, China has had similar conversations around sovereignty with Taiwan that Russia has had with the Ukraine. Russia's actions and the world's response has probably done more to protect Taiwan and its sovereignty than anything else done in the past.

[00:16:48] And it's really united NATO, it's united the proverbial west. And if we were to just simply replace Russia for China and Ukraine for Taiwan and apply the exact [00:17:00] same sanctions from the EU and the US and Japan, China is a much, much more material global player in the economy and goods, uh, that are sold and shipped.

[00:17:10] And so we wouldn't be considering recession. We would probably be guaranteed a recession in those. And I know we don't use the word guarantee, uh, lightly, and we certainly wouldn't know, but it'd be far more probable than we would have some negative outcomes on that end. So, the good maybe out of the silver lining from that is that you know, perhaps it's dissuaded other countries from taking similar actions.

[00:17:33] That's super helpful, Brad, thank you. One final question. We like to ask this on each of our quarterly quick takes. What aren't investors talking about or thinking about that perhaps they should be? Oh man, with the number of phone calls we've been getting, there's not a lot that people aren't thinking about, but you know, we did briefly mention last time, the international longshore warehouse union, the ILWU, you know, their, uh, negotiation deadline is July 1st.

[00:17:59] [00:18:00] They have not come to a decision. There's been some disagreements around automation at ports, which unions are, you know, that union is broadly against. So, the last thing, uh, officials really want is when you've got a red, hot inflation number, you get a, you know, the largest, you know, longshore union strike, uh, in the nation.

[00:18:16] So that remains outstanding. The two other things we'd continue to point out there. We mentioned quantitative tightening last time. It feels like the market is underestimating the influence of lower liquidity in fixed income and the potential risk that that can provide. And then lastly would be around earnings.

[00:18:32] Earnings expectation by analysts for the calendar year of 2022 are still pretty rosy. If you look at the back half of the year, expectations are still in the nine or 10% range for earnings growth. Even though when we completed the first quarter, you know, we've had just over 9% growth, so full, uh, meeting expectations for their remain of the year might be challenging.

[00:18:54] And that's something that is likely gonna have incremental headline impacts as we progress through the next coming quarters. [00:19:00] Thanks so much for joining us today, Brad, and for your expertise and your insight. If listeners want to obtain more information, there is a ton on our website

Fiducient.com. If you look at the insights tab, you'll be able to access white papers, our blog, and other episodes of this podcast.

[00:19:19] Brad, thanks so much. Great having you on the show. Thanks Bob. So, I also wanna mention that most of our new business for endowment investment consultant comes by way of request for proposals from a nonprofit, could be a hospital, university or another charitable organization. With all the market volatility that Brad referenced and all the uncertainty out there, RFP activity has been spiking.

[00:19:43] To that point, listeners can always feel free to reach out to me or Devon via the email on the show notes or through LinkedIn. 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 listening to the Nonprofit [00:20:00] Investment Stewards podcast.

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[00:20:23] Always seek the advice of qualified professionals familiar with your unique circumstances.