FIDUCIENT Advisors

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

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, always good to be joined by cohost Devon Francis. It's the end of a quarter. And that means quarterly quick takes with Brad Long, Fiducient's deputy chief investment officer. A reminder, these episodes are shorter than others, but contain super timely updates on the markets, the economy, and more.

[00:00:53] Devon, how are things? Well, from a personal perspective, I'm great. Uh, the markets haven't been great. [00:01:00] Volatility has certainly continued since our last visit with Brad. So, let's just get right into it. I will make a mention first that listeners should not consider today's discussion to represent a specific investment recommendation.

[00:01:14] So Brad, welcome to the show. Thanks for coming back. Yeah. Thanks for having me. Brad, great to have you back on the show. And just for our listeners, the format here is basically threefold where we'll cover a headline story, what's going on right now, market economy, and such that would impact investors. Then what are the portfolio implications?

[00:01:35] And then finally, we'll conclude with a grab bag. This includes what might be around the corner for investors to be considering that's different than what they're seeing in the headlines. So, let's get started with, uh, Bob, the first thing you mentioned, the headline story. So, I think what everyone has been focused on is interest rates and inflation, and I guess inflation is sort of drifting [00:02:00] lower, but you know, at what pace? And, um, there's been, uh, a narrative of perhaps the fed pausing, uh, their, their rate increases.

[00:02:09] But you know, that may have been disrupted by the most recent inflation reading. So, what does that, uh, that pause narrative or the lack thereof mean for markets and for the economy? So just with that very simple question, Brad, take it away. All right. Well, if we can solve those two things, we can solve the world here, but, you know, look, the market has been focused on rates and inflation for good reason.

[00:02:32] It is kind of the, it's not just the, the topic de jure. It is the direction of kind of the future economy and markets. Now, I would say that last week, uh, you know, we got an inflation reading for the month of August, expectations were at 8%. It came in at 8.3, you know, the market sold off pretty heavily on that information.

[00:02:52] There has been somewhat of this myopic focus, you know, is it eight one or eight two on inflation figures? [00:03:00] Or this, this week the fed is looking to potentially raise interest rates. Is it 50 basis points, 75? 1%? Those things are important, but I think we're losing a little bit of the forest through the trees here. You know, one, we as investors know that we can't time these things. They are difficult to predict. And especially, in the short term, they can be a little bit more noise than signal, but it does give us an opportunity to zoom out a bit and just remind ourselves, why does the fed exist?

[00:03:28] Well, the fed exists for two explicit reasons. Full employment and price stability. We would argue that once you exit the econ 101 idea of that definition, we would say that there's a third definition in that the fed wants to keep the markets happy. But understanding those three prerogatives, it's

important to know, one, the priority of those three. And then two, the alignment of those three with one another.

[00:03:52] So for decades, we were able to prioritize really keeping the markets happy and full employment because we didn't have inflation. It was, [00:04:00] it was somewhat of a, of a lost word in the lexicon of investing. And so, by and large, anything that's full employment related keeps the market happy and the fed had an easier job.

[00:04:11] Well, now we have heavy inflation. And the fed is rightfully focused as that as their number one priority. And they need to be, right? Because the American economy, it's two thirds of it is based on consumption. And if the American consumer has falling real wages, so their wages are growing up but they're going up at a slower pace than inflation, then that leads to a eventual decline in the American consumer and the American economy.

[00:04:36] And so the fed is very much focused on inflation today and that's been a good thing, and those are misaligned. Largely what works against inflation also does not, uh, help both full employment and the markets. And so, as we think about kind of the contrast of these two things, if we look longer term, the fact that the fed [00:05:00] is focused on inflation is a good thing for the US economy.

[00:05:03] It's a good thing for the markets in the long term, probably one of the worst things is we could get stuck here at this mid-level inflation, say 5%, and just don't have a mandate to move lower. But it feels like a lot of pain in the interim. And so, I think the focus has been on rates and inflation for the right reasons, but I think the myopic focus on just kind of today, tomorrow, you know, next month where we're moving has maybe been misguided.

[00:05:29] We need to zoom out here and say first priority is getting inflation under control. Second priority is then we can grow both employment and grow our markets and portfolios after that. Well put, Brad. Let's talk markets then. And we saw quite a rally in stocks and we've seen quite a pullback and there's a thing called a bear market rally.

[00:05:53] And perhaps you can comment on what that is, are we in one? Does it mean to sell? What, what do [00:06:00] bear market rallies look like? Oh man, bear market rallies are kind of those, those ego crushing, maybe events, uh, in, in bear markets, in which the markets will rally pretty substantially off of what appears to be a trough.

[00:06:15] Uh, but then ultimately it, it ends up being a bit of a head fake and the markets fall back either kind of meeting previous lows or making new lows. And so that's the idea of a bear market rally. They're not uncommon. They really happen in all bear markets to different magnitudes. Sometimes they're significant where it feels like, you know, the market goes up 10, 20, 30%, and then it could subsequently fall after. The question today has really been, Hey, markets really rallied recently, in the month of September, they've been pulling back a bit.

[00:06:45] Uh, depending on where you're looking or, or what market you were looking at, but are we in the midst of a bear market rally, or have we really met a trough? The hardest thing about bear market rallies is that they're even harder to call than bear [00:07:00] markets. Right? So, we don't advocate for market timing at all.

[00:07:03] In any circumstance, we think it's generally a losing proposition, but if you think about the math in a bear market rally, it works even more against you. So, let's just, let's use a hypothetical example. So, you started the year with a million dollars in the S and P 500, and this example applies to an endowment, an individual, a pension plan.

[00:07:24] Really, the math works across the board. Well, the S and P's obviously down year to date. And so, let's say your portfolio's at 840,000. The S and P's down 16%. Well, on average, and we're

gonna use averages here, cuz we certainly don't have a, a precise number. With bear markets, on average, since 1950, bear markets from peak to trough are down 38%.

[00:07:50] From the trough, on average, they tend to rally 36% one year forward. Now we know that 36 doesn't offset 38. We know [00:08:00] the math on that, but that is just the simple averages since 1950. So, most investors think, Hey, we're in the midst of a bear market rally. So, if we're down 16%, but ultimately, we're gonna go down 38%, you know, I should sell my portfolio and I'll save that difference in return.

[00:08:17] Well, if you, again, the million-dollar portfolio, call that $184,000 of what you could potentially save if the markets fall. Well, that's where most of investors stop the conversation, but we really think you need to take the next step and say, well, what are you wagering against that potential reward? And that would be, well, actually we've hit the bottom and markets rally that, again, on average, certainly no prediction of future results, that 36%.

[00:08:47] And that number would be around 300,000. Right? So, when you're trying to say, oh, well I could save 184, but I have to wager 300 to do it, the math starts to look a little bit more clearer on how [00:09:00] difficult bear market rallies are to time. So, if people are thinking about selling today, you really need one of three things.

[00:09:07] You need to have high confidence the market is gonna go down and we know that that's difficult to time. You need to have a view that it's gonna be far worse than it has been on average. You need to have a view that the return in the market from the bottom would be worse than it has in history. Or all three.

[00:09:25] And we think trying to get any one of those, nonetheless all three of those, right is difficult. So, timing bear market rallies is a, a process fraught with potential issues and one that we don't recommend investors take. That's helpful, Brad. Um, so let's, uh, in our threefold format, we talked about the headline story.

[00:09:47] Let's move on to the next big topic, which is portfolio implications. So, you know, I think we know the knock-on effects of rates and bonds. The last time we chatted with you, we talked about the impact on growth. [00:10:00] So today, let's talk about the dollar and what the strength of the dollar means for our client's portfolios.

[00:10:06] Yeah, the, the dollar is, is meaningful in the global economy, not just the US economy, and for a whole host of reasons. First, the dollar is the currency in which many goods are traded and priced in. And that could be in countries transacting with one another outside of the US, not just with the US.

[00:10:26] Also energy is priced in US dollars to think about oil or natural gas or others. Uh, many countries have currencies pegged to the US dollar. So, volatility in the dollar and especially a stronger dollar has a meaningful impact around the world. Today, and really since the GFC, so 2007, 2008, the dollar has been on a bit of a march higher.

[00:10:48] That has been because the fed has been very aggressive in raising interest rates. And so, the relative difference of investing in local government bonds. So, say if you live in Europe or [00:11:00] Asia versus investing in US dollar denominated bonds with higher rates, the US is more attractive. And so, generally investors wanna buy more of those, which means you buy more dollars, which means the dollar has been moving up.

[00:11:12] That's an oversimplified narrative, but one I think that helps paint that picture. Now that means that for anyone that owns anything outside of the US, that could be non-US stocks, really in most countries, uh, that could be Europe, emerging markets, et cetera. Those countries may have positive local returns, but have had negative experiences for investors because the dollar has been strengthening.

[00:11:35] And so the knock-on effects of a stronger dollar can be material in a number of different ways. Now, one of the things we know, just a product of I guess history, but also just generally of math, is that dollars don't grow to the, or I'm sorry, currencies don't grow to heaven, I think is how our CIO, uh, phrased it the other day is that we know that from here, it's unlikely the dollar's gonna continue its [00:12:00] relentless march over the next 10 years.

[00:12:02] And so when we think about the dollar today, it's been a pain point, but it also creates a source of opportunity because you know, many investors have looked in the rear view mirror and said most of my return has come here in the US and that's been the only place. Part of that has been the strength of the dollar.

[00:12:17] So if the dollar were to be flat or maybe even weakened over the next 10 years, again, we're not trying to time currency, that provides a lot of opportunity outside the United States. So, I think the knock-on effect of the dollar, it's very material today, but again, gazing a little bit longer in our arc.

[00:12:35] We think it provides some unique opportunity. Right. It's funny. Uh, you talk about the dollar. I was reading the Wall Street Journal this morning, and you know how when you're reading articles about an acquisition or expenditure, what have you, it'll always say, oh, 7.2 billion Euro, and then Perens, and you're looking for a different, and now the dollar and the Euro and the Perens are the same.

[00:12:56] It's just, uh, it's different. Yeah. So, uh, [00:13:00] let's stick with portfolio implications and talk about higher rates, which really have been a forerunner of bad news, but there's a flip side to that. Can you talk about some of the benefits of higher interest rates? So, it it's an interesting one that we've been talking about internally because you know, one of the benefits we have at Fiducient is we a multidisciplinary practice.

[00:13:18] And what I mean by that is we work with families and nonprofits and pension plans and defined contribution plans. But one of the lessons we can take from our pension work, which very much work explicitly on, how much do I owe to achieve something? They talk about that in the terms of liabilities.

[00:13:39] And how much do I have in, in assets and dollars to apply to that? And they call that their, their funded status. Well, pensions are really the only industry that talk about liabilities and, and assets in that funded status way. But if you talk to most pensions, they would say, yeah, it's been pretty ugly out there, but we're better than we were when we [00:14:00] started the year.

[00:14:01] The reason being is interest rates have moved up at a greater magnitude than the market has gone down. And what that means is their funded status by and large, it obviously depends on the pension, has gone up, meaning they're better than they were before. We can apply that concept to really any series of cash flows, whether you are Mr or Mrs. Smith.

[00:14:23] And you're trying to retire over the next five, 10 or 15 years. You're an endowment and you're trying to achieve a certain type of spending. The reason, one of the reasons we've talked about for years, low interest rates and QE as financial repression is because it's difficult to achieve objectives with very low rates.

[00:14:42] Now, rates have gone higher and that's been painful in the short term. We appreciate that, full stop, but what it means also going forward is a larger percentage of your portfolio is now earning something that's meaningful and, and in a meaningful way. And so, if we [00:15:00] apply kind of the math of pensions to other parts of our investing groups, we can really see that while balances may be down, as rates have come higher, we may actually be in a better position than we were when we started the year.

[00:15:15] So, exiting financial repression feels hard. It feels bad, but going forward, again, looking through the windshield, not the rear view mirror, actually we think that's going to be a benefit long term to all investors, individuals, pensions, endowments, et cetera. That's great. That's very helpful, Brad. So let's shift to the third leg of the quarterly quick take stool.

[00:15:39] And that is this grab bag where Brad attempts to share insights about what's around the corner. What should investors be thinking about? And one thing maybe we can get your input on are the midterm elections. They are fast approaching, and should they matter to investors? I'm generally a seller of [00:16:00] elections in markets, right?

[00:16:01] There's so much swirl there and there's not a whole lot to glam onto. You know, if you think about what elections really do to markets is they, they invite uncertainty. And I would argue markets dislike uncertainty even more than they dislike bad news. At least with bad news, you know, you can work the math on it and tell you, okay, here's how bad it is.

[00:16:24] But uncertainty, it tampers animal spirits, if you will. So, for stocks, that might show up as lower multiples. So, the willingness to pay, what you're willing to pay for a business, and the economy, it can show up as less capital expenditures or less hiring, et cetera. But you can actually see it in the data, you know, in years of midterms or even general elections, they tend to be lower returning years than non-election years.

[00:16:45] And it's because of that higher uncertainty. So, as we look to unpack this year's midterm elections, coming into the year, it felt like, and practically, there was quite a bit on the table. However, [00:17:00] Democrats who obviously lead here in the US today have been more successful with recent legislation than I think many had expected kind of coming through 2022.

[00:17:10] So examples of that, corporate tax increases, prescription drug negotiation plans, green energy transition, and capital moving that direction. A lot of that came through the inflation reduction act or IRA. Those were all independently, not just in one big package, things that were on the table and up for debate.

[00:17:29] And so if you're voting, you know, in your local election cycle for, you know, a Senator or a Congressman, those are big things on the table, which kind of by and large have been removed, not completely, but at least reduced to some degree. Another example of that would be the introduction of the China Competition Bill. China-US relationships, uh, the interaction between our two countries is important.

[00:17:51] And that's another one that was kind of sitting out on the table. So, if we look at what the stakes are, and again, this is not to undermine, you know, elections [00:18:00] can be very emotionally charged and have a lot of high emotions as you're talking about certain political issues. We're just digging straight into the market.

[00:18:09] We've removed a lot of that from the table. So really what remains? I'd say there are three ticket items that we'd say are kind of still sitting out there for midterm elections. So, it's technology regulations, tougher competition on China and measures there, which we talked about briefly, and then crypto regulations.

[00:18:27] So for the markets, the former two are the most impactful to say, like headline prices and indexes broadly. In the US, tech is still the largest sector by far. China is the world's second largest economy on its way in the next decade to being the first. It's a material producer of goods globally and here in the US, both on consumption and production.

[00:18:49] And so the change of either regulations around those two topics would probably be the most meaningful and important to markets broadly. Now, crypto regulation could be [00:19:00]

extremely important in that bubble of crypto, but its knock on effects at kind of the broad index, think of S and P 500 level, would be somewhat de minimis, right?

[00:19:11] So there are these pockets of areas that could be impactful in the coming election. But again, it's not something that we think are that we should try to time or, or, or, or guess, you know, kind of, who's gonna take which seats and how they're gonna vote when it comes to a certain regulation. So by and large, elections are important, but we think the stakes have been somewhat lessened here as of late.

[00:19:33] And then there's a few pockets where it could be most meaningful going forward. So, the last thing that we wanted to chat with you about is this concept of recency bias. And, you know, it seems to me that the overarching theme in markets is that once inflation slows, growth will be slow, but the fed will become accommodative again.

[00:19:53] And we'll be back off to the races with stocks and bonds moving up like the last decade. What's our long-term view here? [00:20:00] Yeah, it's, it's an important one, Devon, because the markets by and large, if you look at kind of long term break-evens for 10 years or more, you're kind of betting that, Hey, the, the volatility that we've seen, it's transitory and then the playbook that we've seen over the last decade.

[00:20:20] So, kind of think of, think of growth, think of areas of the market that has succeeded over the last decade. They'll just kind of go right back to what we've experienced. There's a lot of risk in kind of that recency bias. And just assuming what has happened in the recent past is what is gonna happen in the future.

[00:20:39] The reason we would point to that is, is threefold. If you look at let's just call it post-GFC. So, 2007 forward. We've been in an era of maximum accommodation, right? Where a very accommodated fed, both through quantitative easing and low, uh, fed funds rate, we've been in an era of kind of [00:21:00] minimum volatility in which markets have really, on historical averages, been extremely low from a volatility perspective.

[00:21:09] And we've been in an era of maximum liquidity, right? Where not only the fed has been an active participant, but many, uh, new buyers, retail buyers, et cetera, have been coming into that market. If we now step back and say the next 10 years, right?

[00:21:26] What does that mean? It's more likely that we're in an era of lower liquidity, I wouldn't necessarily call it minimum liquidity. From an accommodation perspective, it's possible, but less likely that we're gonna go straight back to the, uh, effectively zero barrier of interest rates and, you know, the fed buying every bond they can get its hand on.

[00:21:48] And then therefore, by extension, is it more likely we're gonna be in a minimum volatility environment like we have been in? Or a maximum volatility or a higher volatility environment going forward? So, the idea of [00:22:00] recency bias is trying to learn from kind of our past experiences, especially those most recent, and not be anchored to those.

[00:22:08] And we've talked a lot in our process, our capital markets processes. We try to look, again, through the windshield, not the rear-view mirror, and what is gonna be most beneficial to helping our clients prosper in the future is to not be overcome by that recency bias. And we do think that if you simply just take what has done well in the last decade, and just copy and paste that into the next decade.

[00:22:33] You would probably be poorly or sorely surprised with what those outcomes are. And so being able to think kind of dynamic and think about where markets are shifting to and opportunities as a result of those somewhat secular shifts, we think it will be important going forward, but we think it's a risk that many are just associating last decade will equal next decade.

[00:22:56] And that's a big debt. [00:23:00] Thanks. That's really helpful, Brad. Uh, you know, we really appreciate you joining us. You are always such a sage voice in the room and you offer great perspective. So, thank you for taking time out of your busy day. And I'm sure that our listeners are appreciative as well. Uh, folks, if you want to obtain a lot more information, uh, from our research team and, and other folks like Brad, you can visit our website fiducient.com and, uh, check out the insights tab where you'll find white papers, the blog, other episodes of this podcast.

[00:23:32] So, Brad, thanks for joining us. Thanks so much, Brad. I too wanna thank you. Very, very helpful as always. And to our listeners, remember to have a plan, especially in turbulent times like this. It helps to take almost a clinical approach. We use what we call and we've referred to it many times here on the podcast.

[00:23:51] The three levers exercise with our clients of inflows, outflows and required return, then dictating [00:24:00] how you construct a portfolio. If you need help with any of that, reach out to me or to Devon on LinkedIn, or use the email that appears in the show notes. So, to all your good stewards, thanks for investing time to help your nonprofits prosper.

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