Fiducient Advisors, Nonprofit Investment Stewards Podcast
Episode 56, January 4, 2022

Markets And More – Quarterly Quick Take: 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, always good to be joined by co-host Devon Francis. This is our first episode of the New Year, and it's a great opportunity to thank our listeners for making 2022 a success. The show has gained a lot of momentum, and thanks to you, many of our episodes ranked in the top 25% of all podcast downloads.

[00:00:54] So thank you and best wishes in this new year. Yeah, absolutely Bob. Best time of the [00:01:00] year and really timing couldn't be better for this episode where we welcome back Brad Long. I think folks, remember Brad? He's Fiducient's deputy chief Investment officer, and this is our quarterly quick take show, but with a twist. Seeing that it's the beginning of a new year, Brad is going to update all of our listeners with Fiducient's outlook on how we might expect stocks and bonds to perform, whether we see a recession in the near future.

[00:01:24] What might happen to interest rates and a whole lot more that investors are thinking about. So Brad, thank you for joining us and welcome back to the show. As always, my pleasure. Hey, Brad, always great to have you here. So let's just jump right in. 2022 was very challenging for investors to say the least.

[00:01:42] And just to set the table, we're recording this show at the tail end of 2022, so be mindful of that depending on where the markets are while you're listening to this, but Brad, what key observations do you have to share looking back at the prior year? Yeah, I think it's pretty easy to say 2022, no matter where the next [00:02:00] couple of days end up.

[00:02:01] You know, it was a challenging year, full stop. It was a unique year in some ways by the, the magnitude and pace at which the Fed was intervening in markets and a very hawkish stance. It was also an unprecedented year in some ways with the volatility and drawdown that we saw in the fixed income markets.

[00:02:17] The unwinding of, you know, many things in acronyms, we've come accustomed to knowing things like SPACs and cryptos and others. But I also think it's important to put 2022 in context, not just from the January to December context, but also what does 2022 represent over a longer period of time. And you know, I say this somewhat ingest, but 2022 is a bit of the hangover year.

[00:02:40] And what I mean by that is we've been in this period of extraordinarily accommodative policies, monetary policies, fiscal policies, et cetera. And 2022 is the unwind of that. And so while it's been a painful year, it's also laying a better foundation for future earnings and opportunities [00:03:00] for portfolios. So, you know, just to give a little bit of context to that, from 1955 to Feb of 2006, which is when Ben Bernanke became the chair of the Federal Reserve.

[00:03:10] The average federal funds rate was 5.6%. If you look at that rate from when Ben Bernanke came into office, uh, to March of this year, the average federal funds rate was 1.1%, so almost five times kind of the air quote norm that you would expect. As we unwind that, it really does set a new foundation and it has a meaningful impact on what we'd expect going forward in markets and for returns.

[00:03:39] So, Brad, I know that you'll get around to sharing Fiducient's capital market assumptions with us, specifically how we expect stocks, bonds, other asset classes to perform. But first, let's talk broadly. What, what broader themes does Fiducient see driving the markets in 2023? So, you know, Devon, as we've talked about before, and I think many [00:04:00] listeners can appreciate, you know, our, our themes while, you know, certainly geared towards 2023, they may not uniquely live between January and December, right?

[00:04:08] The markets aren't necessarily aware of the Gregorian calendar and that it starts at one point and stops at another. But we do have three things that we think are gonna be really important for investors to consider in 2023 and beyond. So maybe starting with the longest term theme, and it's this theme of persistent volatility.

[00:04:26] So as I mentioned, we've now exited this period of extraordinary, uh, monetary and fiscal accommodation even up till early in 2022. And I realize it seems like many, many years ago, but it was just earlier this year, we were still in quantitative easing, and the Fed was holding interest rates. We have now exited that and exited with a lot of momentum and interest rates have gone up materially. Well, as we come out of this kind of zero bound interest rate period, we do think we're gonna revert back to historical norms of volatility.

[00:04:59] So that [00:05:00] means bonds are gonna be more volatile, stocks are gonna be more volatile, real assets are gonna be more volatile, and the cross interaction between those two are gonna be more important in the years going forward. So, if we look back over the last 10 years, you could, this is a little oversimplified, but you could say, I should have just owned the S&P 500.

[00:05:18] Or maybe just technology, or maybe even not just technology, but the FAANGs or a crypto stock, right? It was a, it was a period that was characterized by concentration as your friend, diversification is not, and anything that was benefiting from low interest rates, low volatility, low inflation, and low growth was benefiting right. Now as we exit that period of time.

[00:05:43] We do think that that idea of kind of volatility of asset classes and concentration is shifting and it materially influences the way that we allocate portfolios, which we'll talk about in a moment. The second major theme, which we think is gonna be certainly present in 2023, is moderating inflation. [00:06:00]

[00:06:00] So the Fed is a target of 2% on inflation. Who knows it precisely when or if, uh, inflation will get to 2%? It's unlikely that it's gonna fall straight to the fed's target in 2023. But the good news for investors is that we don't have to get to 2% for markets to begin to appreciate the direction of inflation.

[00:06:21] We just need a path towards lower inflation, not necessarily 2% today. And even recent figures, uh, in inflation are looking encouraging, right? The November figures that we're looking at month over month, they rose far less than they have in the past. Only up 0.2% on core prices if you exclude energy and food.

[00:06:41] There's a little bit of noise in there with, uh, shelter. CPI actually calculates it with a pretty funny figure, which we've talked about before, called owner's equivalent rent. That has actually still been increasing in CPI yet house price, housing prices have been falling, and so we do think that we can see a path forward to moderating [00:07:00] inflation.

[00:07:00] The point, important point there though, it's not simply a, a linear path down. It's gonna be a bumpy road, you know, month over month it's gonna be up or down. But the key thing is the direction the, and what that brings is it allows the Fed to step out of the way of markets. They've been very influential in markets this year.

[00:07:20] Actually, there's never been a period in economic history where after the markets have pulled back, you know, call it 15% or more, where the Fed has been actively raising interest rates and the markets have bottomed and begun rising. Now, that's not a natural law of physics. It could certainly happen this time, but it does say to us that the Fed needs to really step out of the way before the markets can find their bottom.

[00:07:45] And that gets to our third theme is the bear market bottom. Now, I think. Anyone that's read our content, listened to this podcast, knows Fiducient at all, we're not market timers, right? So by saying we have a theme on 2023 for a bear market bottom, we're not saying. [00:08:00] precisely on January 15th, it's gonna happen.

[00:08:02] That is, that is not the case. What we are saying is that we see the cards playing where they're, we're building a better foundation for 2023 to be a better year for markets and for risk assets than 2022. And we're preparing for that. We don't need to be precise and get the exact date right, but we want to think about how we build portfolios around that eventual outcome.

[00:08:22] Cuz markets will rebound. The question is when. And we're starting to see the tea leaves for that and building around it. So those are the three things we think are really gonna drive in 2023. And I know you've shared with listeners before, Brad, uh, I think on this podcast, certainly in some of your other, uh, collateral, that when the market does rebound, a good portion of that forward 12 month return comes within that first month.

[00:08:51] So I think it's 35% of that first year's rebound return happens in the first month. So, if you're not invested at that time, you miss [00:09:00] out on, on a big, uh, portion of the upswing. Exactly right. There's, there's, there's a high cost to trying to time markets and being wrong. And so, obviously staying invested is a far more profitable proposition than trying to time markets because rarely can you sell, buy, and do it with enough size in your portfolio to make a meaningful difference, and then repeat, have a repeat performance of success.

[00:09:25] So staying invested is, you know, function number one. But function number two is then, you know, looking to optimize the portfolio based on what the marketing is giving us today. And what they're, what the market is giving us today is far more interesting than what we were getting at the end of last year.

[00:09:41] That's helpful, Brad. So, so let's jump to Fiducient capital market assumptions. And, and just before we do that, I'll just provide a reminder of the process that we engage in with clients on an annual basis here at Fiducient. So, basically, Brad and our research analysts and [00:10:00] all these folks who are working in terms of developing capital market assumptions and so on.

[00:10:05] They each and every year, towards year end, they are developing our forward-looking assumptions on what will stocks earn, what will bonds earn, what will real estate and so on earn? What will the correlation among asset classes be and the volatility and such? While they're doing that, we end up taking that information, sitting with clients.

[00:10:23] Generally in our first quarter meeting. Could be January, February, checking in with a client, what's going on in your world? If it's a university, what's changed? What's happening with enrollment, other sources of revenues, that kind of thing? But what's happening in your world from a liquidity, from a risk perspective.

[00:10:39] We marry that, if you will, with our capital market assumptions. We generally develop a new, I'm doing air quotes, 10 year strategy or game plan. We manage to that risk return budget that we've settled on throughout the year. And then what do we do next year? The whole thing all over again. The research [00:11:00] develops capital market assumptions.

[00:11:01] We check in with the client on unique circumstances. And next year develop a new, uh, 10-year game plan. So, with all that said, Brad, I wish we could do a drum roll here. Let's get into some of the numbers and some of the expectations, and perhaps we can start with the outlook regarding inflation. So, we'll have to work on that drum roll another time.

[00:11:21] Cause I think that'd be a great idea. Inflation, as I mentioned, is a, is a key input, right? So, as we're looking at inflation over this 10-year period, we do see inflation moderating in a meaningful way, but again, staying kind of, it's gonna be a bumpy road to get there and it's gonna remain elevated.

[00:11:38] You know, we do have a lot of macro drivers that are driving inflation. There are inflationary drivers and deflationary drivers. The primary inflationary drivers over the next 10 year are threefold. globalization, the transition from brown to green energy, that's gonna be fairly expensive and inflationary.

[00:11:55] And 90% of the world's population still lives in an emerging market today and [00:12:00] consumes like an emerging market. As those consumers either move into the middle class or start to consume like developed country consumers, that will be inflationary for both goods and services. So, on a long-term level, those are all inflationary impacts.

[00:12:15] The flip side is technology is deflationary, right? We can do more with less over time, and we do have slowing demographics. China is commonly, uh, cited. Japan is commonly cited. Sometimes, the United States for aging demographics and working cohort of populations. So those are deflationary, right? So those are the two primary forces.

[00:12:32] So we don't see hyperinflation as being a primary concern, but we don't see inflation dipping back to the kind of benign, you know, sub 2% over the next 10 years. And so that is also reflected in our allocations, both in real assets and our fixed income allocations. And what are your thoughts on the equity landscape?

[00:12:51] So equities is a very unique point in time here, and as you look at the landscape, there's quite a bit going on underneath the hood. So, for example, in the United [00:13:00] States, we entered 2022 and equities had very full valuations historically and on a relative basis. As we've come through, the year end markets have pulled back.

[00:13:09] The US has actually, it's come down in valuation, no question, but it's come to call it average valuation. So the US is definitely priced for a soft landing. If you look at international, say, developed and emerging international, international markets started the year round average, right? So they were less expensive, but they are now priced for a meaningful recession.

[00:13:31] Right? So the different markets are telling investors different things, which creates opportunity. There's anomaly there, and the truth probably lies somewhere in between. So, over the next 10 years, given the retreat in valuations and lower valuations in aggregate, there's no question our forecasts are increasing, but they have increased disproportionately for some of our international and emerging markets.

[00:13:54] Now, that being said, there are perhaps elevated risks associated [00:14:00] with those markets today, whether that be the expansion of a ground war in Europe for the first time since World War II, whether that be new policies coming out of Asia, primarily China, whether that's kind of Taiwan or Xi’s third term, or COVID zero.

[00:14:14] So there are a number of things that are taking hold, right? So as we're building our equity allocations, we're aware of opportunities, we're aware of forward valuations, but we're also aware of these exogenous risks. So when we think about the net change year over year, our, our forecasts are higher.

[00:14:31] But as I mentioned, it looks like you would want to dive head first into a lot of international markets. We're actually using a lot more humility in those markets and holding our position today. Now that's an overweight. We, we like those assets. We want to maintain exposure to those assets, but we're doing it in a risk-adjusted way and being cognizant of some of these other exogenous factors.

[00:14:53] That's helpful, Brad. So what does that mean from a, a return expectation perspective? So Bobby, so [00:15:00] you mentioned at the outset we have a 10 year forward looking forecast. So let's just use equities and US equities as an example there. Coming into 2022, our 10 year forward looking forecast, and it's our median expectation, right?

[00:15:12] We don't expect precisely this number, but it's, it's where all else equal what we would expect. Uh, we are at 5.9% on the S&P or on US all cap companies. Now that is low in historical context, it's low for our forward forecast and it's because we had those full valuations. Now, as valuations have pulled back, even in the US, from those full to median valuations or average valuations, we actually expect on a 10 year forward looking basis, a 6.7% rate of return on all Cap US.

[00:15:43] So that's a pretty meaningful move over a 10-year period. Annualized almost 1% more year over year. Now, international and emerging, as I mentioned, those valuations are even less expensive. So, for international developed, we went from 7.7 to 8.9. So, a, a [00:16:00] 1.2% increase. So again, even more meaningful, uh, here than the US and then in emerging markets from 9.6 to 10.8, right?

[00:16:07] So certainly, uh, reflecting those, those more attractive valuations and a meaningful pickup, uh, here year over.

[00:16:17] So Brad, obviously an interesting landscape on, on the equity front and equally interesting probably on the fixed income front. Uh, you know, we're in a very different interest rate environment than we were a year ago. What are our expectations for fixed income? I mean, if equity's interesting, bonds have been extraordinarily interesting.

[00:16:37] It is. It's been an incredible change year over year. So if we rewind the clock to the beginning of 2022, fixed income globally was fairly unattractive. We had negative interest rates at many parts around the world. Our 10 year forward-looking forecast on US bonds was 1.7%, [00:17:00] even with a modest rate of inflation.

[00:17:02] That's pretty much a negative real return, you know, which led to some of our year over year allocation shifts. We, we wrote a, uh, research paper in the beginning of the year called Fixed Income Complacency, navigating Today's Fixed Income Market. Now, you fast forward to today. We're light years different now.

[00:17:20] Appreciate that we got from there to here through a lot of pain in the fixed income market and a retreat in bond prices. But in doing so, forward-looking yields, which is the primary component of forward-looking bond returns have increased meaningfully. So again, end of last year, US bonds 1.7%. 10 years forward. Today, you know, 2023 going forward.

[00:17:44] A 5% rate of return. You know, that's a over 200% increase in return expectations, and that is extremely meaningful. And hence the title actually of our 2023 outlook. We titled it Goodbye TINA. Tina stands for There [00:18:00] is No Alternative. And it was this idea that extraordinarily low bond returns. We're forcing investors to own basically anything other than bonds, equities, or real assets or commodities or cryptocurrencies, et cetera.

[00:18:11] That shift that I just mentioned in US bonds is really reflected across many other bond categories, whether that's high yield bonds, global bonds, municipal bonds there has been a rerating and a material move upward in expectations for forward-looking returns. And frankly, that's a very healthy thing for markets on a go forward basis.

[00:18:34] That's helpful, Brad. And then why don't we shift towards real estate and then other alternative asset classes like private equity and hedge funds and such? Maybe you can share your thoughts and, and our outlook there. So, real assets in our view, you know, they've, they've always been an important part of portfolios.

[00:18:53] But you know, as we talked about moderating inflation, we don't think we'll fall from the kind of [00:19:00] 7% rate of headline inflation. We are today down straight to 2%. So that bumpy road along the way means things like real assets, like marketable alternatives or things that don't necessarily or directionally correlated with the market can play a meaningful role.

[00:19:15] So, broad real assets, that's a mix of things. Treasury inflation protected securities, commodities real estate, global infrastructure, et cetera. At the end of last year, you know, we had a, uh, 4.7% 10 year forward looking view on broad rail assets. That is actually increased to 6.8%. Part of that is some of the sub-components have become more attractive.

[00:19:40] Part of that is that continued bid for inflation, which we talked about. over the longer term, creating more, uh, appetite for owning those type of assets. So broad real assets and real assets, the complex in general, remain a very important part of portfolio construction. And as inflation kind of has a bumpy road to finding its long-term, [00:20:00] reasonable level, we think that they'll continue to play an important role.

[00:20:04] And is it time for some of the alternatives to have their day in the sun? You know, private equity, uh, probably has a sunburn at this point. It's had to stay in the sun for a very long time, you know, not, uh, moving away from the jests. Right? Private equity valuations haven't been as reflective as public pullback and valuations today.

[00:20:23] But again, private equity tends to be a very long-term view. You buy that position, you hone it for 10 or more years so you're not, you're, you're less beholden to, you know, today or tomorrow as, uh, entry multiple. That tends to be a far more secular view. And so yes, private equity, our outlook on private equity has increased as generally asset prices have fallen cuz all else equal, if you buy something for less, you have an opportunity to sell it for more and that's better for return.

[00:20:57] Marketable alternatives is another interesting space, so that's our [00:21:00] glib word for, call it hedge funds or things that aren't necessarily directionally correlated with the market. My comments previously on higher volatility across asset classes, bonds, uh, real assets, equities, et cetera, that creates greater opportunity for some of these strategies that can take advantage of, you know, they're more nimble and take advantage of some of those positions.

[00:21:23] And the idea that volatility will just be present, right? Higher volatility. It also means that having some things that aren't necessarily just one for one exposure in equity markets can be really meaningful to helping clients achieve their objectives and goals. So we do think that there continues to be, but it may be even more of a, an opportunity for marketable alternatives to play a role in portfolios.

[00:21:48] So Brad, what does this mean in terms of portfolio implications? So we've talked about our revised capital market assumptions, you know, increased return expectations across the board, but do you anticipate [00:22:00] any shifts in portfolios perhaps to the underlying types of strategies that we're using? What does this mean for investors?

[00:22:07] We do. So, if you take kind of all of that, right, and we build to the punchline, there's really two things we're trying to primarily accomplish. So one is we want to build greater resiliency in our allocations. Part of that is just the natural uncertainty of the future. That's no different today than it was a year ago.

[00:22:26] But we do think that volatility will be higher. So, building greater resiliency in portfolios is one objective. The second is, again, preparing for the markets to bottom right? Set another way that we will get through this slump that markets will rebound, that prices will go up, that risk assets will rise, right?

[00:22:43] That is a change from where we are today, and we don't have the power of precise prediction, but we have the power of preparation, right? So we want to do that and do that in a meaningful way. And then we're doing all of that with humility, right? We're doing it in a risk aware fashion. So when you think about what that means for individual asset [00:23:00] classes, you know, bonds and equities and real assets, et cetera.

[00:23:03] Year over year we're pretty meaningfully moving up our exposure to US bonds and intermediate bonds, not just necessarily short duration bonds, reflecting those higher yields that I mentioned. All else equal, higher yields is better forward return, but with recharged yields, we also think that fixed income will begin to play its more historical and traditional role of a diversifier from risk assets.

[00:23:22] So if we go into recession, which we don't know if we will, or if we see greater volatility in markets in 2023, we think fixed income can actually play a, uh, a hedging role relative to risk assets, not necessarily what it has done in 2022, which is, you know, kind of be down as much or maybe even more than risk assets.

[00:23:44] You know, the other is when we think about the opportunities within global equities you know, much of the success over the last 10 years, as I mentioned, could be categorized by S&P large cap growth, right? A narrow band of certain securities. And then also [00:24:00] historically, when markets rebound, certain assets tend to perform better than others on the way up.

[00:24:05] So for those two reasons, both valuation, uh, kind of preparing for market bottom and historical kind of break of where we think we've been in the past, and we're actually overweighting small cap securities here in the US at the, I guess you'd call it, at the expense of, uh, large caps, which we think is taking advantage of current attractive valuations.

[00:24:27] Some of that shift in recent sentiment that we've seen and preparing for a market bottom here in 2023. So those are the primary shifts that we'll be seeing in portfolios. And then a lot of smaller shifts kind of under, under the hood. So, you know, slightly increasing our exposure to, uh, credit within fixed income, uh, slightly increasing our exposure to, to real estate given the pullback in those markets.

[00:24:51] But those are far more modest than the, than the changes I mentioned previously. Brad, so helpful on all these fronts. Are there any [00:25:00] other practical tips you'd like to add or, or just anything you'd like to underscore at this point? I think the primary thing as we look to 2023 and beyond is, it's important to have patience, right?

[00:25:15] If we think about where we are in the economic cycle and the unwind of where we've come through, right, the, the, the proverbial hangover year of 2022, we want to start 2023 on a good foot, and everybody wants, including us, would love to see the markets rebound with extreme resiliency on January 3rd and be off to the races.

[00:25:35] That might not happen. It might take a couple of months, it might take a couple of quarters. We do feel fairly confident we're closer to the end than we are to the beginning of, you know, this recent bout in volatility. But it's important to remember that as we begin our conversations in March or April or May, if that's not necessarily the case, faith and patience, you know, we'll let our [00:26:00] capital market work.

[00:26:00] And context work for us over the years or over the year, but we shouldn't expect it kind of day one. And I realize in today's world, everybody's looking for instant gratification and we may or may not get it, let's hope. But if we don't, it shouldn't surprise us. Well, thank you so much for joining us today, Brad.

[00:26:20] You always are a wealth of information and knowledge, and for folks that are interested in learning more or perhaps reading our 2023 Outlook Goodbye TINA, which Brad already referenced. You can find all of that info on our website, Fiducient.com, and we'll also provide a specific link to that outlook in the show notes.

[00:26:39] So Brad, thanks so much for joining us. It's been a pleasure as always. Thank you. Brad, thanks so much. I think it's good. Uh, goodbye TINA. Hello, old friend, diversification. So, uh, welcome back, but thanks so much, Brad. Uh, last year was absolutely a challenging year, and this year might bring more challenges, as Brad points out. If [00:27:00] you oversee investments and you have concerns or you have questions, know that you can always reach out to me or Devon via LinkedIn or at the email address that we include in the show notes.

[00:27:10] 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 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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