PBS Ep112 2022 Economic Forecast in Review – Edited Transcript

Patti: Hi, everybody. Welcome to The Patti Brennan Show. Whether you have $20 or $20 million, this show is for those of you who want to protect, grow, and use your assets to live your very best lives. Joining me today is Brad Everett, our Chief Investment Officer. Brad, welcome to the show.

Brad: Thanks, Patti. Always fun.

Patti: Boy, this has not been fun, though. This year has been brutal. Let's do a recap of where we stand in the various asset classes, just to bring everybody up to speed. As of September 30th, the S&P 500 is down 25 percent. NASDAQ is down 32 percent. The Russell, which is small-cap stocks, is down 31 percent.

International equities, 29 percent loss, and the thing that really has made this year so difficult is that 20-year Treasury bonds -- guys, these are government bonds -- they're down 31 percent. So much for a safe haven, right? REITs, which is real estate, 31 percent losses.

Mortgages, 39 percent losses, and good ol' Bitcoin, oh, brother. That's down 66 percent. Brad, it's a really challenging environment. What do you think?

Brad: Yeah, there haven't been many places to hide. Cash is pretty unappealing, too, so where do you go?

Patti: Yeah, OK. Let's do this. Just for fun, let's go back to our podcast in February. At the time, we were asked by the Economic Development Council to give our outlook for 2022. Chris Davis, one of my favorite money managers out there, says that people give forecasts because they are asked, not because they know.

We were asked, and we gave our forecast. Today, we're going to give our little report card on how'd we do. How close were we? How cringe-worthy were some of the forecasts? What do you think, Brad? You up for it?

Brad: Yeah, let's do it.

Patti: Let's go back. We're in February. What was the topic that was on everybody's minds?

Brad: COVID. That was the first thing you heard every morning. That's really changed. It seems like we only have the mental bandwidth to keep track of one major news story at a time. In February, we talked about COVID as still the primary daily news story.

Then it became the Russian-Ukraine war, which was briefly interrupted for two weeks by the Queen's death, and we're back to Russia-Ukraine and inflation. At the time, we were noting in the podcast our roaring comeback from COVID.

We had just gotten info on a seven percent fourth quarter GDP growth right before we did the podcast.

Patti: Huge, right? If GDP theoretically is going to go up at three percent, to get a seven percent growth is awesome.

Brad: We're back. Everything's fine. Everything's over.

Patti: Totally.

Brad: Then the roaring comeback totally fizzled out. Now what?

Patti: Like a rock.

Brad: Yeah. We've had now two consecutive negative quarters of GDP, I guess, negative growth or positive drops, whatever, however you want to say it. They were minimal. They were about a percent and a half and then maybe another drops of less than one percent. Minimal drops, but drops, nonetheless.

Patti: It's interesting that we did go one quarter at 7.4 percent and then the very next quarter, three months later, we go to negative numbers. That had never really happened before. There were some indications on how people were feeling, the sentiment numbers, right?

Brad: Correct.

Patti: We talked about that in the podcast. I couldn't understand, at the time, why people were feeling so negative. The consumer sentiment numbers were at record lows, and continue to be at record lows when, at the time, unemployment was at three percent-plus, 3.7 percent and GDP was roaring ahead and the market had been doing so well, but people were feeling terrible.

Brad: Turning points of consumer sentiment from the bottom can also be turning points for the market. Following that, you mentioned in the podcast, a mismatch between the current status of the economy, low economic growth, versus these low consumer sentiment figures.

What gives? We wanted to look further into the historical relationship there between consumer sentiment, the economy itself, and to see if there's any relationship to stock prices also. There's some interesting stuff there. In a broad sense, a correlation coefficient is just an empirical measure of the relationship between two numbers.

You really need to consider a theoretical explanation to help figure out whether the correlation is actually correlation or if it's just a spurious correlation to some other factor or the difference between correlation, are they just related or is there actually some causality there where one is actually driving the other and the other one's responding.

It looks like they're tied closely together, but one's actually driving it or not?

Patti: As you talk about correlation, I always think it's funny, Brad, when the year starts and the Super Bowl is played, and depending on who wins, that's going to determine how the stock market's going to do. How does that work? I forget.

Brad: [laughs] It's accurate, whatever it is.

Patti: Yeah. If the NFC wins, then the market's going to go up. If somebody wins, the market's going to go up. If somebody lose...It's just the weirdest thing in the world.

Brad: It's a data mining or data dredging. I guess if you look at enough data, you'll find something that seems to be tied to it.

Patti: Exactly. They're developing this correlation and said, "OK, because the Patriots won the Super Bowl this year, the market's going to be up." Not really. It just so happens to be a coincidence.

Brad: Yeah, the great example that always makes me laugh is you can always find studies that say how marriage makes people happier, right?

Patti: Mm-hmm.

Brad: Sure, on the surface, that makes sense, but that's really a misuse of statistics. The suggestion is that marriage makes people happier, but it's backwards. The fact that you're probably already a happy person makes you a more attractive potential spouse. Not the other way around.

If you're single at the bar, you're not like, "Well, they seem like a grump. All they need to do is get married to me and then they'll be happy, and it'll be so great," or probably get the opposite. You would say, "You seem fun. Let's get married." You would probably do it the opposite way.

Patti: That's a really good point. By the way, let's stay married in good times and bad because one way or the other, this is going to work out.

Brad: They're correlated, but the causality is not what you think. It's not marriage that makes you happy. It's you're more than likely a pleasant person to be around in the first place and probably a better chance of getting married if you're not a grouch.

Patti: It's an interesting way to make a comparison between economic activity in the stock market, but OK.

Brad: Same thing. Anyway, certain data points are usually characterized by whether they move ahead of a turn in the economic cycle, coinciding with it or after it. Consumer sentiment and stock market returns have always been considered leading economic indicators. You see changes there before you see changes in economic growth figures or GDP numbers.

A sharp upward change in either of them could pretend good news for the general economy. The question then becomes, are increases in consumer sentiment and the stock market causing the economic activity to increase? The answer might be different for both. Consumer sentiment calculations are totally based on survey data that asks respondents about expected financial situations, job prospects.

They're just really reading their feelings about the general economic situation, other questions. There is some causality there. A score above 100 signals a high confidence in the economy and is as a result of respondents' expectations of increasing their own spending.

You're actually asking people directly, "Do you anticipate spending more money in the future in the next 12 months than you are right now," or "Do you think you're going to spend less?".

Patti: When I think about that, Brad, it really makes sense because if someone feels like their job is on the line, that they could be losing their job with a layoff, chances are they're not going to feel warm and fuzzy about spending a lot of money in the future.

Whereas if things are humming along, they're feeling secure in their jobs, families doing well, they'll go ahead and make those purchases and that will translate because we are a consumer-based economy and to good GDP growth.

Brad: Consumer sentiment can be a self-fulfilling prophecy. If you're worried about losing your job, there's a decent percentage chance that you're actually right. You probably have a reason to feel that way. Your future income goes down and your spending goes down.

If you're feeling good about the future and you're committing to large purchases, the economy will churn as a result of all the citizens doing the same thing, on average, to increase economic spending. The stock market's also a leading indicator, but I don't know that the same causality is there.

The stock market is a discounting mechanism. If you anticipate stronger economic growth, you will express your opinion by buying stocks, which then proceeds to drive the stock market higher. Because you're anticipating economic growth, if you were correct, the stock economy will grow in the future.

If you test the correlation, you'd see these high correlations between consumer sentiment and the stock market, but it's actually their different relationships to the third factor, which is economic growth.

Patti: We must be clear in terms of how we define people. Sure, institutional investors, people like you and me, we'll look at the data, we'll look at the figures, and we'll make an educated guess on where we think the market's going to be in the future. When you think about consumers and the general public, I don't know that they operate that way.

I don't know that that's necessarily an indicator because, in fact, I would almost say, there's an inverse relationship because when people see the market going down, they're more likely to say, "Oh, no. I don't want to invest any more money because I'll just lose it."

When the market's going up and up and up, they are feeling warm and fuzzy. They are feeling wealthy. It's that wealth effect, and they are more likely to continue to want to invest. They love seeing those increases in equity values. I don't know that those investments into their 401(k)s and equities are making the stock market go up even higher. I do think that there could be a connection there.

Brad: Sure. What you're saying is what leads to momentum markets, where we can make the argument that institutions are probably a little more sophisticated than most individual income.

Patti: Sometimes.

Brad: They can, of course, make mistakes, but their process is probably more thorough, right?

Patti: Correct, right.

Brad: They are more thorough analysis of the fundamentals. When they decide, it changes the direction like, "This has gotten low, let's start buying there." Then you see individual investors pile on and that's when the momentum can really go.

Eventually, the institutional investors will say, "This is too high. Let's begin selling," and we could probably find exact numbers here, but they control a lot more money than individual investors. Their trades start to push the market down.

Eventually, individual investors catch up and they will pile in again on the way down as well. You can see these extreme highs and lows around what most people would argue as a more rational target figure, but then you can definitely go high and low in between.

Patti: Exactly. Let's go back to the original forecast and think about what we believed at the time and what has actually occurred. As I recall, when I was reading through the transcript, we weren't feeling that great at the time, were we?

Brad: Yeah, you think of a diversified portfolio and where you might switch and rotate and what looks maybe like a better option than what you have. At the time we were making the argument why would you want to sell stocks because bonds seem so unappealing. At the time, interest rates were very low.

The idea of going into bonds to earn one or two percent for three or four years didn't seem like a great idea. We had a hard time envisioning a scenario where stocks really got devastated.

Patti: Also, it's important to point out that, at the time, inflation already was beginning to rear its ugly head, even though the Fed hadn't done anything about inflation yet. We were beginning to see that in the bond market and interest rates were already floating up in anticipation of what the Fed was doing.

We didn't want to move into an asset class that probably was going to lose money. Now, stocks also tend to go down during these periods of tightening cycles. Yet, when you look at it longer term, stocks, equities tend to be a much better hedge against inflation.

Brad: It seemed like a rational response.

Patti: Exactly. In hindsight, I always want to make sure that we're doing the right thing for our clients, that we're positioning portfolios correctly, and if not, let's learn from our mistakes.

Brad: Historically, what you would have seen would be if you're worried about the stock market, you would see the flows out of the stock market and go into the bonds. This has just been so unique, where we were selling bonds just as quickly, and it was going into cash.

Patti: It's interesting. Eric and I did that podcast on inflation just before this, and we were talking about the matrix and the four different economic environments. Inflation on the one side, growth on the top. In three out of the four possible economic environments, equities, and even bonds, tend to do fairly well.

It is only in one environment where nothing works, and that is when inflation is high and growth is low, commonly referred to as stagflation.

Now, before we freak everybody out, this is not saying that we are in a period of stagflation like the '70s. In fact, that's what the Federal Reserve is trying to prevent. They have been very, very aggressive, in spite of the fact that, in February, we were talking about the Fed, and why weren't they acting? Why hadn't they increased interest rates?

In hindsight, maybe there is an argument to be made for the fact that they were really looking at the data and recognized that, while inflation was floating up, unemployment was still really high. They didn't want to increase rates and cause unemployment to go back from 6 percent back up to 10 percent.

That would not be a great outcome. That certainly would have pushed us into a recession. We had supply chain issues still occurring earlier this year. It's still occurring now, although it is dissipating.

Taking a more wait-and-see approach, while in hindsight, we can say, "Why'd they do that? Look at inflation and how high it is, these people, their wages are not keeping pace with inflation. Families are really getting hurt."

It seems to me -- and I don't know, you tell me -- that they're almost embarrassed. They want to say, "OK, we were a little late. We've got to nail this. We've got to nip this in the bud before it really stays high for a long period of time, and we get into that real stagflation period of time, where it becomes this self-fulfilling prophecy."

Which occurred at the end of the '70s and early '80s, which was really, really hard.

Brad: Yeah, I remember when inflation first started to tick up, the phrase they kept using was "base effect," that inflation had been so low that we're just being deceived by the number, because it wouldn't take much of a change in prices for inflation to look high. Prices have been so low for so long.

Patti: That's interesting, yeah.

Brad: The strategy changed shortly after our last podcast.

Patti: Hey, they heard the podcast, and they said, "OK, Patti and Brad said we got to get going here," so they went going.

Brad: That's probably it, yeah.

Patti: Good for you, good for me. Now, here we are. They've been doing what they've been doing. Mary Daly was on this morning on CNBC, and she basically told all of America that they're going to continue.

They're going to still be very, very restrictive and they're going to continue to increase interest rates until they have several months of low inflation, down towards that two percent target, and they're not fooling around.

This is something that we're going to have to understand, we're going to have to live with. Mortgage rates have doubled. Housing has stopped dead in its tracks. There's very little activity. The builders that we have as clients are really hurting. They're very worried about the next year to two years.

I think we've got to get used to these higher interest rates for a while. Now, what does that really mean for stocks and bonds and cash equivalents and portfolios? Does that mean that we're stuck with these very, very low returns or no growth for the next year to three years?

Brad: I guess it could take that long. It's hard to project how long it would take. I think, going back to the sentiment, I don't know how much good news it would take for all that cash that's on the sidelines to come into the market. You've got bonds that look incredibly appealing priced to buy.

Stocks look like an incredibly appealing price to buy, if you have cash, how do you not, unless you need it soon? I would think it wouldn't take much in terms of some good news from any of the various fronts for people to maybe be willing to kick some money in.

Patti: You know, Brad, that is a really good point. You look at the last two days. We are recording this on October 5th. The last two days in the market, the market's up seven, eight percent in two days. It's crazy. A lot of it had to do with this number that I never knew about, to be perfectly honest with you, called JOLTS.

Basically, what it measures is the change in labor. It's not like things are wonderful. It was just less bad, and the market goes up 800 points. It really is, it goes to exactly what you were just saying. We just need a little bit of good news, and all that money that's on the sidelines...Believe me, there's a ton of it.

For the previous podcast, we were talking about the amount of liquidity that is still in the system. Because of COVID, what the Federal Reserve did, and the fiscal stimulus, there was an additional $2.1 trillion added to balances in people's savings accounts, business accounts, etc. That's on top of what they normally would have saved.

Now, that has come down to 1.3, but that's 1.3 trillion with a T. I think that things, as they begin to get a little bit better, the news becomes less bad, there is an argument to say that maybe the worst is already in. Maybe people, as they begin to see that there's light at the end of this tunnel, that they want to hop on the train before it leaves the station.

Brad: Yeah, I think it makes sense to me to be optimistic always as an investor, but as an argument against being a pessimist, if you go back to the beginning of the year and look at your traditional defense mechanisms against chaos, and if you were normally pessimistic or defensive, I don't know that they would have served you better.

Gold hasn't done very well. Bitcoin got a lot of press as a good hedge for the dollar and against inflation, and that obviously hasn't worked. Cash is, I guess you haven't lost money, but it certainly hasn't gone very far.

Patti: No, and I think that's a really important point that we need to bring out to everybody listening today. Cash, it's stable, but I wouldn't call that safe. If inflation is running at nine percent, and you're getting one percent, you've lost eight percent in purchasing power.

I’ve got to tell you, that isn’t coming back. That doesn't fluctuate like bonds and stocks do. Be careful about how you perceive where your alternatives might be, because that may not be a good long-term decision, especially now.

Brad: Absolutely.

Patti: I think that it's easy in hindsight to say, "Oh, we should have seen this coming." To me, of all of the crises that we've had and talked about over the many, many years, certainly, that I've been doing this, and the crises in the last 15 years, I don't know why this bear market doesn't bother me as much, Brad. It just doesn't.

It just feels like the normal business cycle. Let’s really take a look at the opportunities that are being presented. For those of you who are listening, if you do this yourself, please, please, please look at your portfolios, especially your non-retirement accounts.

Chances are, you've got some pretty decent tax losses. By all means, between now and the end of the year, grab those losses. Those are tax deductions can actually be converted into real cash next April in the form of deductions and a check from the IRS.

Look at your portfolio. If you have tax losses, do some tax loss harvesting. Rebalance your portfolio. I can't think of an easier, better way to get some lemonade out of this lemon.

Patti: Let's give the viewers and listeners some of our inside baseball. Why don't we talk a little bit about what we're doing here at Key Financial, just to give them some insights into what we're thinking and how we're approaching this really chaotic period of time.

Brad: Yeah, I guess from the top down, we always have to invest with the idea that this could happen in the next month, always, forever. If you're 60 years old now, you're going to live through this same thing for different reasons 7 to 10 more times, if not more.

I think you must expect that this could happen at any time, and knowing that, be prepared for contingencies. We always start with a financial plan. When do you need cash flow? How long can this money really go with the cycle before you need to spend it, or convert it to something else?

That's a huge factor that goes into how you're even going to be invested in the first place. There's always been historically very large stretches where very major, major indices have not performed very well. You've had entire decades on the S&P that's made no money at all.

I only bring that one up, because that's the one that has done so well in the last 10 years, but in those times, when the S&P has not done well...Now, again, to back up, in the short term, like this last nine months, everything can go down together, they can go up together.

Over long periods of time, that seems to stretch out. They spread apart and indices go on their own valuations and their own fundamental factors. If you go back to the last decade of the S&P, the first decade of the 2000s, the S&P made about half a percent.

Patti: The entire time.

Brad: Yeah, for a 10-year period, a total of a half a percent. Not a great return if that was your only investment. Again, invest with uncertainty and invest that chaos will come. Small-cap stocks were up almost 60 percent for the decade. International stocks, non-US stocks, were up, not a lot, but almost 30 percent. The AG was up almost 100 percent and almost doubled over the decade.

Patti: Wow.

Brad: A normal 60-40 diversified portfolio that included a healthy chunk of the S&P. You certainly wouldn't have known to avoid the S&P. As long as you're invested across the globe in the different types of asset classes, a 60-40 portfolio chugged along at about six, six-and-a-half percent.

Patti: Not bad.

Brad: Yeah, it's not great, but it's certainly not dead money.

Patti: The other thing to keep in mind is during that decade, inflation was very low. The real return on that portfolio was about five percent. Again, pretty decent, given what was going on during that period of time.

Brad: Yeah, which explains why the AG outperformed basically everything.

Patti: We didn't know that at that time. Nobody knows going into any decade or any day of any year, what's going to happen in that year. We didn't know that Russia was going to invade Ukraine, and we don't know what's going to happen in the next three months.

The key here is to understand that and have a little humility and be everywhere all the time, and over time, you'll do well. Now what we tend to do is we tend to overweight certain areas. For example, we have underweighted international equities. Why have we done that?

We don't really know what's going to happen, but if you look at the United States and the fact that we have water pretty much all around us and we got to two very friendly countries above and below, chances are we may not have the same threats that Europe is facing with Russia. We don't have to worry about some of the things that they're worried about.

Even the energy. They are energy dependent on Russia. We are not. While we are affected by that, we are less affected by that. We want to keep that in mind as we look at our portfolios and we have. We're positioning things accordingly. Currency is such a big influence on returns with international securities.

The dollar is at record high. Everybody wants the dollars. Understandably so. That will affect the performance of international stocks. I can speak for myself. I don't consider myself a currency expert. I don't know about you, Brad. How do you feel about currencies these days?

Brad: No, it's not on my business card that I'm a currency expert.

Patti: You got a lot of things on that business card, by the way. This guy is unbelievable.

Brad: Currency expert is not one of them.

Patti: Currency is really tough and yet it has a major influence in terms of return. Hey, let's accept the fact that it's not an area that we work in and have a lot of knowledge in and it's a day-to-day phenomenon. We have just pretty much given that to the experts.

We give that to the money managers in the form of investing in global investments, global mutual funds, and ETFs. That way, they can make the call, how much is in the US, how much is international etc. How about the old growth and value question? What do you think about that?

Brad: Yes, that's a tough one because growth has obviously taken far more of a beating than value has so far this year. Looking forward, you would say, growth maybe has a little more room to recover. On the other hand, if you're entering an environment where rates stay higher, value seems to be more appealing.

It's so old school, but so many analysts still value companies with a discounted cash flow model. The higher rates are, the more you're discounting future earnings. Those future profits that are promised from growth companies that maybe don't exist yet.

Growth is, in a lot of respects, investing in companies that aren't very profitable or maybe they're not even profitable yet on the hopes that they will have incredible profits 10 years down the road. If you're discounting that over 10 years, it comes to a much smaller number when the interest rate's higher.

Companies like Johnson & Johnson and Procter & Gamble and things like that that sell products at the grocery store. They're making money this year. They'll make money every quarter for the rest of eternity. They're not so susceptible to changes in interest rates because their earnings are not distant.

Patti: They are much more resilient during recessionary periods of time and certainly coming out of recessions. That's been clear. You go back and look at history, etc. That tends to favor dividend-paying stocks, things of that nature. Those are the tilts that we can make, and we have made.

Again, we're not market timing. We're not doing that. We're just trying to apply some common sense to what's happening in the world around us, and then actually doing something about it, which is really what it's all about.

Ultimately, the goal to me and to you, Brad, is to make sure that the sum of money that people have is preserved and invested for growth over time that exceeds inflation and provides the cash flow that they're going to need for the rest of their lives.

The cash flow they need for the next year to three years is one thing. The cash flow that people are going to need 10 years from now, that is quite another.

Brad: That's not invested in the same way.

Patti: Exactly. That's important. That's why, again, to your point earlier, that financial plan is really important. I don't know how people do it without it because we know every year how much a client's going to need and when we've got to set aside money for Jessica's wedding and when that next car is going to be needed etc.

We're literally sending out money on a monthly basis to our clients. We've invested accordingly. We get it. We're not going to fool around with the shorter-term needs because that's important.

We can't project. We can't predict. We can give our outlooks. We can give you our opinions, but that's all they are. Nobody knows for sure, so let's not get too cute. Let's make sure that our clients are financially secure for the rest of their lives. What do you think?

Brad: Love it. It makes sense.

Patti: Love it? Good deal. Moving forward, we don't know what's going to happen. We believe that most of the worst is already in. We believe that there are reasons to be optimistic going forward. This is a cyclical thing. Yes, inflation has gotten higher than anybody would want, and it has stayed higher longer than anybody would hope for, but the Fed is now on it.

That makes me feel like eventually, this is going to get better, and when things eventually get better, so do stock prices, so do bonds, so do asset values, and people can go back to living their lives. We are probably going to have a recession. I would say probably the first quarter of next year, we'll be in a recession officially.

Not the worst thing that could happen. They happen every five years or so. At least, that's what's happened in the past, and that's probably what's going to happen in the future. Again, it's part of the business cycle. Unemployment's going to go up, so for those of you who are working, just be ready for that.

I think that it's OK to be more conservative if you're working, and you're not quite sure about your job prospects going forward. Keep a little bit more in cash. Increase that emergency fund. That's important, because you don't want to be a position where you have to raid your 401(k) to pay the mortgage, for example.

Just be prepared all the time. I know, I can speak for Key Financial. We are. That's for sure, right?

Brad: Yep.

Patti: All right, well, Brad, thank you so much for joining me today, and thanks to all of you for listening to these podcasts. We sure hope that they're helpful to you and help you make better decisions for yourselves and for your family.

Feel free to share them. Feel free to go to our website. There's lots of white papers on the website. Log on, get the white papers. There's a lot of intellectual content that goes even deeper than what we've done today.

In the meantime, I hope you have a great day. Thanks so much for joining us. I'm Patti Brennan, Key Financial, wealth management with wisdom and care.