

PBS New Ep153 Mid-Year Outlook with Brad & Patti

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 none other than Brad Everett.

Patti: The reason that we are talking today is, I like to hold ourselves accountable -- Right, Brad? -- and you and I talked in January and gave our outlook for 2024. This is an opportunity for us to think about, "OK it is what it is. How did we do, and what do we think going forward?" It's an accountability check.

Brad: Right. Sure.

Patti: Good deal?

Brad: Great.

Patti: At the beginning of the year, everything was about the Fed and everybody, including us, thought, "Oh, yeah, the Federal Reserve is going to cut interest rates this year." Here we are in June. Hasn't happened. We don't know if it is going to happen. Some people say it's going to happen in September.

Other people say, "No, they don't want that for the optics because of the election." I heard somebody today talk about the fact that they're going to increase interest rates in December because, yeah, inflation has gone down from 9.1 percent. It bottomed out at three, but guess what? It's ticked back up to 3.4, and they don't want that.

Let's talk a little bit about where we are today and this concept of the Federal Reserve's influence on the economy, and the three things that we talked about before. **What's a hard landing? What's a soft landing, and what is no landing at all that we're hearing a lot about right now?**

Brad: Yeah, that's the debate. That's what we're all trying to anticipate and try to figure out what may happen. They're all like, "What is the ultimate result of the Fed raising rates to combat inflation?" You're right. There's three choices. The concept comes down to something very similar to actually landing an airplane.

A hard landing for an airplane is one that happens at very high speed. It's not technically considered a crash because it probably lands on its wheels, but it's stressful. The plane may get damaged, and passengers may get hurt. That's a hard landing in an airplane.

Patti: To relate that back to the economy, the passengers that we're talking about are people losing their jobs. Companies going under. That's what tends to happen when there is a hard landing in an economy.

Brad: Yeah. A hard landing in the economy is an extremely sharp slowdown. All those things happen quickly and severely, and it's probably from Fed intervention. They raise rates very rapidly, very high. What if they raise them too rapidly and too high?

The economy could contract all the way to a recession. Businesses would have to reduce their workforce, like you said. They might have trouble paying back debt. Then, depending on the surrounding circumstances, it just happens so fast that there's nothing that a central bank can do to stop it. It seems inevitable.

A more desirable outcome would be this idea of a soft landing. In which case, the central bank raised rates just slowly enough. You get inflation in range without sacrificing the jobs, creating the debt crisis. I don't think there's an official definition, but a soft landing could end in a mild recession, but not a severe one. The definition changes depending on who you ask. There's no official, I don't think, definer.

Patti: Isn't that fun? So much fun.

Brad: That's why the Fed's job is tough. You don't know ahead of time what the correct exact pace is supposed to be. You're just trying to absorb as much data as you can and trying to adjust as you go. It makes Jerome Powell's life a little bit difficult.

Patti: Even the data that he's looking at, boy, there's so many opinions as to whether or not it's even accurate or how it's being measured. Inflation, for example. Housing is a third of what goes into inflation, but it's not how much our homes increased in value. It's the owner's equivalent rent or something.

It's very interesting how you think it's so technical and they know so much. What I appreciate about their language is they're basically saying it's data-dependent. They're playing it by ear.

Brad: There's a lot of things to consider, far more than they even talk about when they address the public.

Patti: The other thing I think that a lot of people don't realize is that interest rates aren't the only thing that the Fed does to affect an economy. Maybe what they're doing behind the scenes right now or what they've recently announced...So they haven't cut interest rates, but they did announce the fact that this quantitative tightening or the quantitative easing...

What they were doing is they were tightening, which in English means they're going to get rid of some of the bonds that they hold on their balance sheet. Because of that, the longer-term bonds are probably going to go down. It's a way of providing liquidity in the market. Liquidity is everything. We have liquidity. We're spending money.

What they've announced is, in June, they're going to cut the sales, selling, from \$60 billion a month to \$25. They may not be cutting rates per se, but they are easing a bit. That's something that will influence. It's got to work its way into the economy. It's not going to happen overnight, but it does work its way into the economy.

Brad: A slow process, and they don't know until later how effective it was.

Patti: That's the problem. They don't know until after the fact. That's why this is so difficult to predict and so many different things are going to influence it.

Brad: Which I think is probably also how you get in the position of raising too fast, is because you're not waiting to know everything you need to know.

Patti: I think that people who are listening today recognize that they really increased interest rates crazy-fast, in a way they had never done before because inflation shot up so quickly. Originally, it was after the pandemic. The Federal Reserve's language at least was because of the supply chain problem.

Supply chains started to open up. Things started to flow. It's supply and demand. The supply started coming in, but the demand was still really hot. Inflation went nuts. As a result of that, they had to increase interest rates really quickly. They shot up to close to 10 percent.

Brad: They've really paused for a while, which would lead to this third choice, which is the no landing scenario at all. The idea would be, without the Fed doing anything else from here, that inflation would drift close enough to where they're comfortable. You solve most of the problem but maybe not all of it.

You would have sustained higher interest rates. Rates wouldn't drop or increase. More than likely, they would just wait and let inflation dissipate. Maybe it gets stuck somewhere higher than where they would prefer. Maybe they feel like they've done 90 percent of what they wanted to do in terms of reducing inflation, but you still have an economy that's growing a little slowly.

You have this real, at the end, last mile trade-off where you're saying, "How much do we care about getting rid of this last bit of inflation that we don't like? Are we willing to put the economy into a recession now, knowing that there's only a little bit we really wanted to do, or do we just let it stay higher?"

Patti: What's interesting about that concept is the way the market seems to be perceiving this "higher for longer." Brad, you and I didn't talk about this, but I went on YCharts today. Wow. Look at this. In May of this year, stocks rebounded. NASDAQ went up seven percent in a month. The S&P 500 went up four and a half percent.

In the last 12 months, as tough as 2022 was, if you just take... This is another example of statistics and numbers. If we go year over year, which takes it from May of last year to the end of May this year, the stock market has gone nuts. It's up. NASDAQ went up 30 percent. S&P 500 was in the high 20s, etc. I don't know about you. This one surprised me.

I'm going to put you on the spot because we didn't talk about this. What do you think the number one sector in the market was in the month of May?

Brad: In terms of...

Patti: Performance.

Brad: Boy. Energy? Just as a weird guess.

Patti: Good guess. No. That's actually a really good guess. Everybody thinks it's got to be technology. It's got to be tech. Actually, it was utilities. How's that for an argument for diversification and not getting too cute? Utilities were up nine percent.

In the last 12 months, again, tech, tech, tech. Actually, it wasn't tech that was the number one sector. Actually, financials and industrials did better than technology in the last 12 months, trailing 12 months, May to May.

It's very interesting how our perception and what we hear about doesn't always translate to client statements and portfolios, etc. Hard landing, we get. Soft landing, we hope for. No landing is "Eh, OK."

When you think about what we're hearing about, we're hearing about no landing being more...Everybody's thinking, "Well, there's no reason for them to lower interest rates because inflation's getting there." If they lower interest rates, then inflation could kick up again. It's already kicking up a little bit. They don't want to do that.

If they increase interest rates, then they could push us into a recession. By the way, things are already slowing down. The good news is unemployment is great. Last year, in 2023 -- I'm getting into the weeds here -- the average monthly jobs number in 2023 was 250,000 jobs per month. That's really high. It's continued this year.

We've never had a period of time in this country where the unemployment rate stayed at four percent or below this long since the 1960s. We are a consumer-based economy. If everybody's working and feeling warm and fuzzy, they're going out and spending money. If they're spending money, then companies are making money, etc.

Brad: I guess maybe I would have a question for you. Maybe to change the subject a little bit, but I think it may tie. Interest rates are higher. The deficit's obviously increasing. Are they related, one? How related are they? Do you have any concern about the strength of the economy and currency from there?

Patti: That is a great question. Everybody's talking about this deficit and the impact of the higher interest rates and what is that going to do to the United States as the dominant economy.

We all know, in the last, certainly, the 5 years, 10 years, we diversify internationally. You know what? The United States has been dominant. We have been growing when other countries have not.

What does that really mean? A rising deficit typically is not good for an economy. It affects our currency in a very negative way. At what point are we going to break that historical whatever, that feeling that the United States is the only place to be?

Brad: Like the deficit-to-GDP figures or debt-to-GDP figure.

Patti: Exactly. We've seen other nations. Look at Japan. Look at other nations. They've got real problems with their deficits and their debt.

Brad: I guess, from our perspective, it almost seems like the spending itself is going to be nearly impossible to solve. Politically, it's easy to say there's a lot of things that are wasteful, but in reality, there's only a few major, major categories of spending that would really cause a dent in terms of the overall deficit.

I think they're things that no party would actually vote against. The military, Medicare, Medicaid, things like that, I just don't think either party would have the political will to reduce the spending on those things in a way that's significant enough that you would even notice that spending dropped.

Patti: Exactly. What you're saying and what I'm hearing also is we're going to have deficits for a while here. At some point, some people say, as long as the country, the GDP, continues to grow, then we can service the debt. Higher interest rates will have an impact, but we're still OK.

That's the goal, get the economy to continue to grow, which, again, goes back to the Fed and goes back to policy. We've got an election coming around. What's that going to do, etc.?

For now, I think the biggest concern, of course, is Social Security and Medicare is a huge chunk of what the federal government spends money on. To your point, Brad, that is not something that is going to change anytime soon. Neither party, neither candidate is even talking about it.

Brad: You wouldn't be able to campaign on cutting any of those things.

Patti: It's not a popular thing. They probably wouldn't get elected. Let's talk about the markets and household net worth. We're at a point where household net worth in America is at an all-time high, consumer spending, etc. Let's talk about the economy in general and what we can expect or what we're thinking about going forward.

Brad: I guess there's a lot there. [laughs] It's interesting. I think a lot of net worth is more mindset than actual spendable cash. There's a lot of net worth in houses. There's a lot of net worth in retirement plans. In reality, there's not a tremendous amount you can do about that. On a year-to-year basis, I don't know that that will fund the economy. Long-term, that's great news.

Patti: It makes people feel more comfortable. There's the wealth effect.

Brad: Consumer confidence is through the roof still.

Patti: They go out and spend money. I think the key here is the unemployment rate and the fact that, as long as people are working, they are spending money. We are a consumer-based economy.

There are two things to consider when it comes to employment. There's the labor supply, which because of the pandemic, the labor supply crashed.

There were companies who were screaming, "We need workers. We need workers." They couldn't get enough help. Labor supply has improved tremendously, mostly because of immigration because that seems to be a big reason why it's getting better, but the participation rate is still below where we were before the pandemic levels.

The participation rate is basically because a lot of people are retiring. That's a factor. When people, as we know, because we work with those people, they tend to be more worried about their spending because where am I going to get my income?

Where's my salary coming in? That might have an impact on the economy.

Brad: It seems like there's such few things that actually influence GDP growth. It's labor force. Can the labor force grow? Then you've got, it's comes down to a demographic question. Can we replace workers faster than they retire? In reality, like immigration is part of that conversation too.

Patti: If I can interject, Brad, it's not only can we replace the workers, but can we replace the people, right?

What's happened over the last 70 years, for example, on a worldwide basis, the number of babies being born has been cut in half. In today's environment in the United States, or actually globally, it takes 2.1 babies per female to keep your population exactly the same. In the US today, we're not having as many babies as 1.7 now.

Brad: It's a pretty big gap.

Patti: It's a big gap. That's got important implications. Especially for our future, on many different levels, we're not going to get into the weeds on that, but it is a factor in terms of GDP and growth. Where's the growth going to come from if we don't have enough as many people buy ?

Brad: That's the only other input is just productivity. It's workforce and productivity...

Patti: I'm so glad that you brought that up, because let's think about that. That's the big AI hype, right?

Brad: Yeah.

Patti: Productivity, right, that we're going to be able to do so much more in so much less time. By the way, does that mean that half of the workforce is going to lose their job? I don't know. Robots are the big thing right now.

Brad: That can always happen in the short term, right?

Patti: Mm-hmm.

Brad: Until that workforce is put to a different productive use, you can say like, what, it just frees them up to do something else instead, but until that person is trained to do a different job or finds the right company that can use their skills, There's always some kind of frictional period there where a new technology could very well displace a lot of people, but so far, 2024, it's always happened that those people have, again, found some productive use and economy as needed them to do something else instead.

Patti: It feels so much like the 1990s with the onset of the Internet, and everybody was freaking out, that it's going to replace all these jobs, and our economy is going to go down, and just people learned how to do different stuff.

New industries were created. This thing called an iPhone, came as a result and the apps and etc. Artificial intelligence is just another dimension of that. People are predicting that it could actually be even more significant than the Internet. I think it's interesting, even internally, we're experimenting with it. It's pretty amazing.

What is also interesting to me is already we're seeing industries and jobs popping up. For example, did you know that there is a new title called "Prompt Engineer"? It's somebody who knows how to use artificial intelligence, these ChatGPT or whatever, and knows exactly how to frame the questions to get the answer.

Brad: They're just better at asking questions. We probably ask questions like we would a Google search engine or something.

Patti: Google. Exactly. That's very interesting. Okay so transitioning a bit here, this is the midyear. It is what it is. Markets are doing just fine, thank you. We are in the middle of the year. We've got six months left. What do we think about the rest of it?

Brad: It's interesting. I think it comes down to which of those landing scenarios. It doesn't have to be bad. The no landing scenario probably changes a few things, but it doesn't have to be terrible. Again, I think it's just so nuanced. Even in any of these scenarios, there's things that would work, and there's things that won't.

I guess, maybe as an example, we fuss with the no landing scenario. Let's talk it through. Let's say there's no landing. Inflation goes down a little bit, but that would suggest probably that rates stay higher for a longer period of time. Probably, how does that flow through?

Patti: As we brainstorm this, remember that people and markets don't react to things whether they are good or bad. It's are they going to get better or are they going to get worse. Don't you think that, to a certain extent, people get used to these higher rates? They just go ahead and live their life and do what they're going to do?

Brad: I think the landing scenario is nothing probably really got that much better or that much worse. Doesn't that seem like that's what that one is? Rates don't change much. We just keep cruising. The economy's growing but not that fast.

What does that look like for clients? If rates stay higher, probably doesn't mean a whole lot to short-term bonds, but you can imagine maybe rates on the longer end of the curve go up. There's been maybe a push like we've had a conversation with a lot of portfolio managers about, now being the time to add duration. It's been this time to add duration for six months.

If we get this no landing scenario, I don't think we would want that much duration. How does this flow through to what we're trying to do for clients? I think that's one of the things. I would tend to stay short until the prices adjust there.

Patti: It's so interesting. I'm so glad that you brought that up because we have so many people who come in here, want to talk to us, recommend us to your clients, etc. They talk about their opinions and what they think is the right thing to do.

Isn't that wonderful, that you just brought that up? We may or may not agree. We've got to understand what the goal is for each client. Duration is something that is really important. It's not just maturity. What is duration, Brad?

Brad: Duration is partially about maturity, but it's also a way to average out. The maturity is not the only time you get money from a bond. You also get money in six months from now. You get money in whatever, depending on how the bond's laid out.

Maybe you get annual coupon payments. Maybe it's six months, whatever. Maybe you don't get any coupon payments. It's just a zero-coupon bond.

Duration is a measure of the weighted average of when all these payments come in. I guess there's another complicating factor. A floating-rate debt, if interest rates go up, the value at the end may go down, but your payments have gone up. Duration actually could be pretty short, but I think we're maybe getting too silly there.

Duration is a measure of when all these payments come in. You could actually have a portfolio with a very long-duration bond. If the coupon's high, the maturity could be long, but the duration actually could be much shorter.

Patti: The bottom line is it's measuring the sensitivity of a bond to rising interest rates or lowering interest rates, how much it fluctuates in price on that given day, in that given month.

For example -- again, I like to use examples -- if you've got a bond that's got a duration of five, if interest rates go up one percent, the price of that bond goes down by five percent.

Brad: Yeah, pretty good average.

Patti: Now it's worth 95. However, you've got to keep in mind that it's earning interest. If the interest that you're getting is three, your total return for 12 months is about -2.

Brad: Maybe you lost two percent.

Patti: It's not like it's crashing, that kind of thing. Duration is an important measure of the sensitivity of the price. That's how we manage risk. We want to watch and be aware of that. You can go long. Why would you go long duration? What would you be thinking about if we did what those managers suggested that we should do? Let's go long on the duration. What happens?

Brad: By doing that, you would be hoping to, so-called, lock in to higher rates. If rates drop, which...Again, that's a choice too. I guess that was the point in picking this no landing scenario. Really, there's three different scenarios that, obviously, we work through. We say, "What happens if this happens? What happens if this happens? What happens if this happens?"

Is there anything that's a good idea across all three? Is there anything that's a bad idea across all three? Is there something that we should moderate and say, "Let's have a little bit of this and a little bit of that, just in case it's a great idea in this one but a terrible idea in this one. Let's just make sure we don't totally screw it up"?

The idea of going long duration is the hope that either, A, rates stay the same and you can just lock into this high coupon payment, or that rates actually would drop and then you would have the capital appreciation at the end.

Patti: Just as the value of that bond went down five percent, you could get another five percent on top of the interest that you got for the year. That's pretty good. I will tell you, honestly and truly, that in the last few months, all these conferences, basically people are saying that's probably where the easy money is going to be made, is in a bond portfolio.

You and I both know people don't want to be investing in bonds because they didn't do what they were "supposed to do" in 2022. That's why we have to take every day, every month, and understand what's happening, do that scenario that you just did, to make sure that people are going to be OK no matter what happens.

I'm going to add flyer in here. The market went up a lot in 2023. Earnings came in.. People

were surprised. The market was surprised. Everybody thought -- I say everybody -- the talking heads, the analysts, the traders thought that earnings were going to get slaughtered because of the higher interest rates these companies were having to pay.

I think people sometimes forget, those traders sometimes forget that there are human beings that are pretty smart and probably understood that earnings were going to be affected. They made different decisions so that their earnings wouldn't be as affected. In 2023, earnings didn't go down. They were flat, surprising everybody. The market went up.

Now, here we are in this no lowering of interest rates etc. We've got one more thing that could affect what happens for the next six months. That is this wonderful thing that happens in November.

Brad: I forgot about that.

Patti: Everybody wants to forget about it. Knowing what we know and, more importantly, knowing what we don't know, which I think is just everything...There's so many people who are over their skis. They're so confident. That, I think, is where really big mistakes happen.

Again, having said that, we've got this election. We understand that markets are going to do whatever they're going to do. We know, because of the election year podcast that we did earlier in the year, that, on average, markets lose about 14 percent. They have a drawdown. Then they go back up. By the end of the year, nobody knows what happened.

In an election year, they tend to go down more. Here we are, in June of 2024. Historically, which we always have to say is no guarantee of what you could expect in the future, it isn't working out that way.

Typically, the first half of the year is terrible in a year of the election. I don't know about you, but 10 percent is pretty darn good. We're not doing historically what we've always done. What do we do now?

Brad: Nothing.

Patti: Very good.

Brad: An election's a weird one. I think the volatility stems from maybe...It's important to vote, obviously. I don't know that it's important to vote based on what you think will happen to the stock market, given who gets elected. I think there's very little correlation there.

Patti: Excellent point. I think it's really important for us to really drive that home. The President of the United States, historically at least, really didn't influence stock prices.

Brad: No. I think you're in the middle of a business cycle that goes 15 to 20 years. At best, you'll be the President for eight years of that. You're just going to be sitting in the seat, watching it go down or watching it go up.

I think there's maybe other things that they should spend their time talking about, but it's an easy thing to take credit for. You come in. The market goes up. You can say it's because of you.

Patti: I think it's so interesting that the perception out there, generally speaking, is that the markets do really well when a Republican is in office and it doesn't do so well when a Democrat is in office. It actually, historically at least, has been the opposite.

Brad: It's also close enough that you would never make that bet. You would do yourself a real disservice if you took your money out during one party's being in office and left it in when the other one...It wouldn't make any sense to operate that way.

Patti: I think it's also so important, when we talk about, first of all, historical statistics, etc., there are not that many periods of an election year, etc.

Brad: There's only been so many elections. You just don't have enough data.

Patti: I thought it was interesting. Hartford came out with a great statistic about markets three months ahead of time, from the three months ahead of the election to the election, versus the three months after the election.

The three-month average return in that particular year was a whopping 1.5 percent. After the election, three months after, the rate of return, historically at least, was five percent. There were two major exceptions to that average.

The first one was when Obama got elected in 2008. We were in the midst of a wicked financial crisis. The market went down. The other one, I think, is also really important for us to keep in mind, not that we're going to do anything.

It was in the year 2000, when Al Gore basically campaigned against George Bush. The election was contested, and it went to the Supreme Court. From the date of the election to the date that the Supreme Court ruled that Bush won the election, the market plummeted. Nobody knows. Given what's happening in our country today, let's pray to God that doesn't happen again.

Brad: I think an election always leads to uncertainty. The market doesn't like it. Then as soon as you know who the president is going to be, then everybody just starts buying again and off you go.

Patti: Lives their life, exactly. The takeaway from this: it's mid-year, this is our mid-year outlook, and we don't know what's going to happen. What is the takeaway from this?

Brad: I heard somebody at a Fellows Conference a few years back say the answer to every great question in investing is always, "I don't know. When do you need the money?"

I think once you know that, you can prepare your portfolio for all kinds of scenarios. We don't know what's going to happen. We can't. I think you can arbitrarily assign probabilities to different things or we can go through the scenario analysis and say these are the things that could possibly happen, but we may miss one.

Once we have the client's plan, anybody's plan laid out, that gives us a lot more confidence to not worry so much about making macroeconomic calls and making bets on an election, or bet on the direction of interest rates. We can prepare, knowing what asset classes make

sense for that investor. We can go from there. That's a fundamental truth that we hope will last forever.

Patti: Absolutely. Fantastic. It's personal. Let's make sure that this is personal. There's rules of thumb out there. There's historical statistics, etc. It doesn't matter. What matters is what are you comfortable with and when are going to need the money.

Thank you, Brad Everett. Best chief investment officer out there. Thanks to all of you for joining us. My name is Patti Brennan. We are Key Financial, financial management with wisdom and care. I really appreciate you joining us today. If you have any questions, go to our website at www.keyfinancialinc.com. Take care.