**TRANSCRIPT**: Mid-Year Economic and Market Update - A conversation with Chief Investment Officer Charles Rinehart, CFA, CAIA, and Director and Portfolio Manager Brandon Zureick, CFA | Wednesday, May 18, 2022

**Charles:** I'm Charles Rinehart, Chief Investment Officer at Johnson Investment Counsel. I'm joined today by Brandon Zureick, Director of Johnson Asset Management and a member of our fixed-income strategy team. Brandon and I are gathered today to have a conversation about the markets and the economy, given the volatility we've experienced here in the first half, and I'll look forward into what we can do best to position our clients' portfolios for success in the remainder of this year and beyond. Brandon, thanks for joining me today. Wanted to start with some level setting. This year, 2022, particularly the first quarter, has been one of superlatives. Highest inflation rate in forty years. Best first quarter for commodities since Iraq invaded Kuwait. Bonds having their worst quarter since 1980. I think there's a lot of peaking, large amplitude signals happening in the market. As we sit here today, S&P 500 is down about 15%, Nasdaq down closer to 25% more in a bear market. But the thing that grabbed me most in this year so far: there were times, despite the market being down, where the aggregate bond index was down 5%, worse than the S&P 500 in a down market. We're not used to seeing that. I've heard you say, countless times, bonds are the ballast in the portfolio. Is the story broken, damaged? What's led to this unusual environment for the bonds?

**Brandon:** Sure. There are very few certainties in the world of investing, but one of them is that when interest rates go up, bond prices fall. The thing is, I'd say over the past couple of decades: we've really grown accustomed to interest rates moving in a slow, more methodical manner. And, the benefit of that is that as bonds produce income, they're able to soften the near-term price volatility in fixed income. The trouble was, interest rates rose very rapidly during the first quarter. So, we're seeing a magnitude of interest rate adjustment that we haven't seen in quite some time. And, the speed with which interest rates have risen has really made income a little less effective offset to price volatility. In fact, you use the superlative example. The two-year treasury was up 1.6% in the first quarter. That's the largest quarterly increase we've seen since 1984. The magnitude of the interest rate adjustment really hasn't been historically noteworthy. In fact, if you think about it, bond yields bottomed during this cycle, a lot around the similar levels where they bottomed in 2012. Assuming that today is some sort of peak, or at least near peak, in bond yields, they've peaked around where they did in 2018. The main difference, though, is that that happened over six years; most of the rate adjustment this time has happened over six months. So, it's the speed with which bond deals have adjusted that's been highly unusual. I would also add that there's a silver lining to what's been a challenging start to the year. We always like to say that the best indication of forward returns in fixed income is your starting yield. The good news for everybody is that we're seeing yields at, or near, their highest levels since the end of the financial crisis. So, we think the outlook for fixed income is brightening. Hopefully over time, as interest rates stabilize, that income that they produce can help re-heal or repair some of the negative returns we've seen so far this year.

**Charles:** Bond prices are down because rates are up, and rates are up largely because of what we've been hearing out of the Federal Reserve. Federal Reserve has been talking about inflation, and making some moves to combat inflation, for a while. It seemed like higher rates were more likely than not at the beginning of the year. A question I've been getting a lot is why not move to cash versus bonds in that environment?

**Brandon:** Yeah, sure. I'll give an analogy. We've largely thought that a portfolio without fixed income is a lot like driving without car insurance. You never set out in the morning planning on having an accident. It's always unforeseen. There are always unforeseen risks in the market in general. That's one of the reasons we've been reluctant to reduce fixed income exposure. We've really felt that would overexpose investment portfolios to those risks. Despite a pretty tranquil market environment over the past couple of years, the environment hasn't been without its own unique risks. We're thinking of everything from COVID waves to policy uncertainty, inflation's impact on the consumer, a war now unfolding in Ukraine, and even risk asset valuations. I think we've all grown accustomed to you telling us that valuations are historically stretched. So, that's been one reason we've been reluctant to underexpose portfolios to fixed income. The other reason is that the timing of that needs to be exactly perfect. We tend to invest more for the long term, and more for full market cycles, and tend to try to avoid the temptation to tactically trade. When we've looked at other prior examples of periods where fixed income returns have been negative, the thing that stands out is those are often followed by periods that are historically good. I'll give you an example. 1994: before this year was largely considered the worst year for fixed income in modern history. The Bloomberg Aggregate index was down about 3%. Well, the following year, that same index delivered 18.5% returns. As you can see, there's some asymmetry with this. If you exactly timed it right and sold bonds to cash to avoid that almost 3% loss, and you didn't get back in at exactly the right time to recapture the rebound net, you would have been worse off. So, really, it's the idea of making sure we're structurally balanced in our overall exposures and risk and also avoiding this idea of market timing or trading to guide our tactical decision making.

**Charles:** I heard you say a few minutes ago something to the effect of "assuming we're at or near peaks" in interest rates. I want to take the other side of that for a minute. What if we're not--what if the Fed has trouble getting its hands on inflation and they keep raising rates? Is it reasonable for investors to expect similar pain to what they've experienced already in bonds if that keeps happening?

**Brandon:** Yes, we're hearing that question often. I think it's a reasonable one to ask, and I think I've said unique so many times. But this cycle is certainly unique in that most of the rate adjustments are already priced into the bond market. So, we've really got a lot of cushion against further Fed increases. Really, the Feds only raised rates twice so far. One of them being 50 basis points. I think a benefit of that is that you've got a lot of cushion against further interest rate adjustments. When we think about what that full market cycle might look like, again, I'd go back to 1994 as an example. That is largely considered one of the most aggressive Fed tightening cycles in history, again, kind of before this year. The Fed raised rates from 3% to 6% in about twelve months. But, if we look a year out, the market is now pricing in a Fed at 3%. So, different starting point, but similar magnitude. In 1994, that 3% adjustment in a year, that was good enough to slow the economy down to the point where they very quickly had to start cutting interest rates because they had over-tightened or tightened so aggressively. So, we think it's reasonable that the market is pricing in nearly an entire rate hike cycle already before the Fed has really even embarked on it. That's the good news for investors: it doesn't mean that as the Fed continues to raise rates, their portfolios are going to go down in lockstep.

**Charles:** So, the market is already anticipating those changes and has priced in a lot of what's likely to happen already.

**Brandon:** Right.

**Charles:** Well, I think I want to have you put on your economist hat for a bit and circle back to some of the broader issues that are going on. We have this unusual continuation of COVID shutdowns in China. A lot of what started this inflation talk was supply chain disruption--seems like more of that's coming. And then, obviously, this tragic situation in Europe with the Ukraine invasion. How can we reasonably expect inflation to be something that the Fed can get a handle on? With that, won't we need to see pretty dramatic Fed policy in addition to what they've already done?

**Brandon:** Yeah. Another way to articulate that, too, that I've heard is just: what is inflation is more persistent than we expect? What's the Fed have to do, and what consequence might that lead to, in fixed income? Obviously, there's a ton of uncertainty in the inflation outlook. Inflation has been more persistent than we or many had expected. Part of that because a lot of the inflation we're seeing is supply driven, which, let's face it, is very difficult for either companies or the Fed to remedy very quickly. The point that I think I'd want to stress, though, is that if the Fed continues to tighten and feels the need to tighten very aggressively in response to more sticky inflation, that starts to increase the likelihood that the economy slows down. Then we start to increase the odds of a recession. So, from a bond investor standpoint, I think there's really one of two outcomes. One is that, naturally, the economy starts to slow and inflation starts to slow--helped, of course, by Fed tightening and quantitative tightening--the opposite of asset purchases that we're likely to see. The other would be that the locomotive is full steam ahead, and even though the Fed is tightening policy, inflation remains high. I think the Fed, then, will have to manufacture a recession to slow things down. Which, of course, then ends up being very bondholder friendly. It's almost the idea of killing the patient to treat the disease. So, we're very in tune with what's going on. I think it's going to be important to watch over the course of the next, say, twelve or eighteen months, how the economy and inflation reacts to Fed tightening. You pointed out, Charles, that a lot of what's caught investors attention this year has been the magnitude of declines in fixed income. But, I think the other thing that a lot of folks are talking about is the uniqueness of stocks and bonds both being down at the same time. So, we've talked a lot about the Federal Reserve: how that might affect the economy, stocks being down 15%. Does that mean that stocks are starting to price in a recession; what's going on in the stock market from your opinion?

**Charles:** Yes, it's an unusual year for stocks. I think it, in a lot of ways, is the flip side of what we've seen for the last several years. As interest rates were getting driven down in response to some of the fiscal and monetary responses to COVID, we did see certain pockets of the market really explode in their valuations. We've talked about it in these types of dialogues for years now, about market concentration, growth assets really being bid up to prices that we've never seen before, and just the sort of the 'trees grow to the sky' mentality in the growth sector of the market.

**Brandon**: Right.

**Charles:** That is where we're seeing the most pain today. I think it really does stem to everything you were laying out a minute ago; with interest rates so low, equity investors were empowered to buy really aggressive multiples to these growth assets. As that's come up, we're seeing that come down almost in proportion to where the benefit has been. So, we've talked over the years at nauseam about that Fang complex: to a stock, that grouping is underperforming this year. We've seen one of the biggest gaps in growth stocks--those high flying tech, consumer discretion communication services: internet, retail. That growth basket is underperforming more traditional economy--consumer staples, utilities--to a really wide degree. And, uniquely, this year, we've seen energy really carry the market in a way that a small sector typically has trouble doing. Energy stocks are up 50% or more with the way oil prices have moved. So, that's a dynamic with this kind of haves and have nots of growth really being beaten up. But, some of the cyclical stocks in the market holding in pretty well. That to me, and in our view of thinking in our investment teams, doesn't really signal that the stock market is latching on to recessionary fears yet.

**Brandon:** At certain point, though--historically, market weakness, that's been enough to cause the Fed to back away from plants of tightening: the so called Fed put. That's been in the news a lot lately. How do you think that's evolved? Is there a chance that, at some point, the Fed might lose its stomach to continue to talk tough on inflation and will bow to markets? What's your expectation of how markets can react to the Fed too?

**Charles:** Yes, I think we kind of have to take the Fed's word on this one. And, a lot of what they're broadcasting to the market is they're trying to accomplish real economic outcomes with what they're doing. The transmission mechanism for that is, unfortunately, a tightening of financial conditions, which includes lower stock prices. So, in some sense, what we're seeing is an indication that what the Fed is doing is working. I think that those dynamics of what we're seeing in the market, with those growth assets being hit the most, that's not the kind of weakness that we would expect them to react to. That's the patient reacting to the prescription to further your analogy. So, at this point, unless we see some real kind cracks in the underlying fundamentals, it's hard to say that the Fed is going to shy away when they're really trying to fight this inflation because, frankly, lower stock prices can help them do that.

**Brandon:** All right. So, if we're not seeing a near term recession, and you are telling us stocks are getting cheaper by the day, is now a buying opportunity? Could now be a good entry point to the market? I guess, in general, what's your outlook overall for stocks given kind of this uncertain, shaky environment?

**Charles:** Yes, it's cheaper by the day, it's true, but I think it's important that we keep in mind that we were starting from a historically expensive place. So, coming into the year, the PE ratio for the S&P 500 was around 21 times that's come down to closer to 17. Long-term averages are in the 15/16 range. So, still a bit of an expensive market. Despite how bad the pain has been for those growth assets, there's still a spread there that would indicate that has some room to go. As far as outlook, I think there are a couple of paths we can take. There are parts of the market that are holding up pretty well. I think that there's room for the kind of continuation of the trade we're seeing already, where these growth stocks continue to get beaten up, and the rest of the market holds steady. In order to see that, we're going to need to see earnings continue to be strong. The first-quarter earnings season for the market was, really, as positive as you could ask for: double-digit earnings growth, not a lot of negative revisions. Just in the last week or so, we're starting to see some signs of, maybe, some trouble and weakness on the earnings front. So, if that happens and we start to look at more of maybe the Fed pushes too far and pushes us past this off landing, I think there's a whole another dynamic to the market from here. But, the fortunate thing is, I think we're pretty well-positioned for either of those. If the market continues to be focused on inflation, then growth assets will continue to have the hardest time of it. That's not an area where we're really exposed in a meaningful way. If the economy starts to derail, and there starts to be real trouble with corporations, our quality bias is going to do a lot of good work there. We're not going to own the companies that are looking like they might go out of business if the economy slows. We're not going to own the businesses that have their profitability go negative. Just some of the natural biases in the way we pick stocks will help us carry the day there. So, I think there's a branching outcome--and there's a middle path, too, where inflation backs off and the Federal Reserve can moderate its message, and maybe we've just set the stage for another growth expansion. So, a lot of uncertainty in which way we're going to go. The good news is there's a lot that we've already done to get portfolios ready for that regardless of the path.

**Brandon:** So, what I'm hearing you say is that we would be reluctant to reduce our allocation to stocks before we became more certain a recession was going to happen. But, we're also a little bit defensive in our view, so now might not quite be a buying opportunity. We're kind of somewhere in the middle. What are the things that you're watching for signs that were going down? It feels like we're kind of at this fork in the road today. What are the signs that we're going down the recessionary path that might get you more defensive? Conversely, what are signs that could get you to feel a bit more optimistic to use this as a buying opportunity?

**Charles:** Yeah. I think we're still in a place where we think a neutral stance is appropriate. There's just a lot of uncertainty. So, if we're buying at the margin in this environment, it's really to kind of rebalance portfolios and get things back in alignment. As far as data that still has yet to come in, I think the longevity of this bout of volatility matters. I think if we continue to see this volatility into the third and fourth quarter, that's something that we need to take note of and say maybe that means we're not trending in a good direction. Conversely, there is a point where things get cheap enough that we'll just have to be opportunistic on the buying and we're not there yet as I mentioned earlier. On the flip side, I think any change in tone from the Fed in response to good economic and inflation news would be more of an "all clear" signal, and something that we would look to get positioned for another expansion in the economy. So, policy signals are one place we're going to be watching. Further volatility and maybe cracking underlying economics is another thing that we'll be watching closely.

**Brandon:** Sure. And, I guess as someone who follows the economy closely, we're certainly very regimented in our approach to what we watch for signs of a recession. Just to leave everyone with a couple of those key indicators that we're thinking about: definitely, the yield curve has historically been a pretty powerful signal. That's one we've gotten some questions about because the yield curve has flattened pretty considerably. That tends to be something that happens well in advance of an actual recession--that's twelve, eighteen, twenty-four months. So, that indicator, in and of itself, has gotten our radar up for an economic downturn; the things that we're really honed in on are the labor market. It's hard to see a recession, or cracks in the economy, without seeing some weakening in the employment outlook and we still have rock bottom unemployment. There are many more job openings than there are unemployed people. So, it seems as though it would take some time to work off some of the excess in the labor market, but that's certainly something we're watching closely. And then, of course, inflation. We talked a lot about how the Fed's reaction function to inflation will be important in the idea of tightening the slowdown versus overtightening to really dent demand to help subdue more persistent inflation. So, it's a simple list of indicators for us at this point, but we'll certainly share that information as it starts to come in.

**Charles:** Yeah, I think that's really critical because it would be unlikely for us to get to a materially defensive or underweight equity position without feeling pretty convicted that the economy was headed for some rough waters. One thing, if I could maybe take a bit of a divergence for a minute, and talk about why we're not chomping at the bit to make big asset allocation changes. This is an environment where our firm's quality mantra and discipline really will do a lot to benefit portfolios. Our idea here is that it's very difficult to time the market value volatility spurs. The next bear market is always kind of intrinsically unknowable. If we knew when it was going to happen, that would change the timing of the event. If we can just focus on what we can predict, which is how the best stocks will perform relative to others when that volatility comes, we can build in a level of protection into portfolios that doesn't require this timing facet to be right all the time. We've done that this year, we continue to do that, we will always do that. It's not because we think the economy is getting better or worse, it's just because we think it's the best way to build portfolios. So, on both the stock and bond side, I think that quality focus is really critical this year.

**Brandon:** That's so important to point out. I think it's so important to recognize that we don't have to be market timers or we don't have to rely on short-term trading. It's "all quality, all the time." That's the bedrock of what we do.

**Charles:** So, maybe to end this, let me circle back to the beginning. We talked about some of the risks in the economy. We talked about how challenging the Federal Reserve's policy has been on the bond market. I think my big question is: this year’s asset allocation, your mix between stocks and bonds, hasn't been the way to get protection in portfolios. Thankfully, it's been this quality bias that we have. But, if there's a next leg to this, if the economy starts to go off the rails and we find ourselves in a recession and the equity market is still heading down, what can we expect from bond protection and portfolios in that environment?

**Brandon:** Absolutely; I alluded to it earlier that, just in and of itself, the outlook for fixed income returns has brightened, naturally, with the increase we've seen in yields. But, in a challenging environment, we've heard a lot about the death of the bond hedge. it's not hedging equity market volatility. Well, as rates rise, it also affords fixed income the ability for interest rates to decline, which then can soften further decreases. I heard you say that a lot of the risk asset or equity market volatility was more valuation-oriented and, possibly, that's the reason why, across the globe, valuations have corrected, stocks have corrected, bonds have corrected--pretty much everything except commodities have corrected. But, the next chapter of weakness, where we start to introduce fundamental uncertainty, I'm very optimistic that bonds will act like bonds again, and ultimately deliver that tried and true offset. You could see some pretty historically "good" bond returns, even without volatility, but you could see some very good years, especially if there was a catalyst, to get folks more concerned about the economy or even company fundamental.

**Charles:** Great. Well, Brandon, as always, I have found this time together to be useful and engaging. We hope it's been helpful for you as well. As always, we're here to answer any questions you may have. As a follow-up, please reach out to your portfolio manager. Thank you for your continued trust and confidence, and it's a pleasure to be of service.

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