Casey Mullooly:

Hello and welcome back to the Mullooly Asset Podcast. This is episode 410 and I'm your host Casey Mullooly joined by Tom and Brendan this week. 410, do you know where that zip code is?

Tom:

You mean area code?

Casey Mullooly:

Yes.

Tom:

410 would be Baltimore, Maryland.

Casey Mullooly:

That's right.

Tom:

Okay.

Casey Mullooly:

So this is the Baltimore Maryland episode.

Tom:

But what's 411?

Casey Mullooly:

411 is like information.

Tom:

Yeah. Committee info.

Casey Mullooly:

We were around for the pre area code days when you used to, when the phone numbers were seven digits. So...

Tom:

Yeah.

Casey Mullooly:

That is, just goes to show that, wow, maybe I'm getting old here. Anyway, like I said, we're recording this a couple days after the Fed met for their September meeting. To the surprise of no one they raised their benchmark interest rate by another 75 basis points up to 3%. The message was pretty much the same as they had in their Jackson Hole remarks run, which I know you and Tim did a podcast about and we've kind of been talking about the repercussions of that here for the last couple of weeks. So, more of the same from the Federal Reserve.

Tom:

I think they did a very good job in foreshadowing what to expect and so no one really should have been caught off guard and there were kind of like a bell curve of distributions. There were a few people out there that were saying it could be 50 basis points. There were a few people at the other end of the spectrum saying they should just do a hundred basis points, 1%, but most folks kind of got the understanding that it was going to be 75 basis points and as soon as the event is over people start looking ahead to the next meeting.

Okay, what are they going to do next? And so the talk at least after the Fed meeting from all the talking heads was they could see a terminal rate of somewhere in that four to four and a half percent range, say four and a quarter, which means that we would, if you want to be neat and tidy there would be another 75 basis point hike followed by a 50 basis point hike, but really who knows? That's the talk now, they could, all that messaging could change over the next couple of weeks.

Casey Mullooly:

Yeah. Bren, I know that we've looked at a chart that was put out by Bespoke Invest on Twitter about potential paths for inflation basically, and it looked at where the actual CPI has been and what would happen over the course of the next year or so here if certain rates of change in the month over month numbers occurred. So the change in the last CPI print was a 0.1% increase in the month over month and if that continues this chart from Bespoke projects that around the spring or late winter, February, March of next year we could see that terminal rate of a little bit over 4% actually be higher than the rate of inflation and that would basically mean job done by the Fed or...

Brendan:

It has in the past been the way that they've gotten inflation under control. I thought it was interesting to look at it illustrated the way that the chart laid it out because I think that maybe simplistically the expectation is that we need to see those numbers coming in on CPI, be negative for it to go down, but since it's a rolling number if we just see small increases and again, the number that freaked everybody out last week or the week before obviously I think it was more about the expectation and then the number being a little higher than expected.

But if those incremental increases are somewhat small then the overall rate of inflation that we use at least as a gauge of what's going on is going to drop, but it's going to drop instead of just getting like a minus 6% one month magically, it's more like turning a cruise liner or something like that where we're going to get these small increases that eventually mean the rate of inflation peters out and gets us to a point where maybe the Fed's hiking and things are normalizing on their own and hopefully at that point that's when they've got it under control.

Tom:

So to clarify what, the way Brendan just explained it is that this is a rolling 12 months number and so as bigger numbers from 2021 and 2022 start rolling off the rate of increase is going to, even if it continues to go up at a very small rate, eventually the interest rates are going to catch up.

Brendan:

And we don't necessarily, you don't want to start seeing dramatically negative numbers. That is a separate issue which has been the entire thing this year that we oscillate back and forth between which is we have to get inflation under control, but if we get under control too fast then we are in a recession and we don't want either of those things, but we have to tow the line to try to get to where we want to be.

Casey Mullooly:

Yeah. I know there's been a lot of comparisons between the seventies and early eighties economy. During that time period the Federal Reserve was trying to balance growth and fighting inflation which led to them doing this on off policy of cutting and then raising and then cutting and then raising again and Volcker came in basically and was like we're getting inflation under control and we're going to, it basically just that's our sole focus for right now. And we're kind of seeing the same thing from Powell right now where it's like the labor market is continuing to be good. That is their dual mandate technically is to promote price stability and balance unemployment and what they've signaled was employment is good so we're going to focus on inflation for right now so-

Brendan:

Right, it's kind of the house money that allows them to play and try to do what they can to get inflation under control so even if we see, I guess those were like the spooky words this week that have people freaked out, is the tough talk on that front, meaning if Powell's comments were like, yeah, we might even see an increase, a small increase in the unemployment rate as a result of what we're doing and we don't really care that much. And I don't know if that's true, I guess it depends on to what degree, because I don't think that if it started to go up dramatically as a result of what they're doing and everything else happening that they wouldn't be there to be accommodated, but they at least have to talk that way for now. I guess the thing we don't have to do is get sucked into every single word that they say about this one way or the other because I think that they can change their mind at any point in time based on what's happening.

Tom:

And they've done that before in the past.

Casey Mullooly:

I also think it's to your point about it gradually coming off, it's going to be a collection of data points and not just one data point in time where people, I think that's kind of what people were looking for in the summer rally here that we saw in the markets, people were, they saw one kind of good inflation reading and just projected that out into the future so it's going to be a collection of data points and kind of a slow grind down versus this big drop.

Tom:

They talk about how market participants now, whether it's stock market or bond market, how market participants are freaking out and ripping their hair out over a 75 basis point hike. There was a Fed meeting, I think at the end of 1979, where Volcker raised Fed funds rate by 400 basis points in one meeting and then over the next two meetings raised it another 600 basis points from 79 into 80.

Brendan:

It's relative though because if 4% on what he was hiking on top of is probably the same on a percentage basis increase versus 75 off of what they were hiking from-

Tom:

They're off a very low number.

Brendan:

So it feels the same despite the numbers being larger. I agree with the broader point that we shouldn't be freaking out over that, especially when this was as telegraphed as could as have the last couple of hikes been, none of them have been surprising.

Tom:

So to that point, Volcker never gave press conferences and they never made an announcement. It was at the end of the day, end of the training day, the market closed at 3:30 those days, it was starting tomorrow Fed funds rate is going to be here and all the banks afterwards would raise to a point over that and that's how you knew that the Fed was changing rates. Then at least Greenspan, when he came along, he would have some kind of statement that it would take people to the next Fed meeting to translate what he was trying to say. Starting with Bernanke and then Yellen and now Powell, the fact that they have these press conferences, it's glorious to at least be able to ask them questions and get a somewhat straight answer.

Brendan:

You even get the, it seems like at least over the last couple months you get the unofficial update from the Fed the day before with the one reporter at the journal who seems to just get the info from the Fed and announce that, it's like their soft announcement before they announce it to maybe try to get the market to not freak out. Doesn't seem like it's actually helped the last couple times, but it does seem like, drawn a blank on the guy's name, but he seems to have to report the day before.

Casey Mullooly:

Sir Nick Timiraos.

Brendan:

Yes.

Casey Mullooly:

I think, I'm not, not sure if I'm saying that right, but-

Brendan:

Yeah. He's had the stories multiple times this summer, part of what was positive for the market over the late summer months was not only the data that was coming in on inflation, making people wonder if we were maybe getting some progress on that front, but we had the earnings come in and earnings were still really good for most companies and that's like the next shoe to drop that all the doomers have been talking about is just wait for the earnings. All these numbers are baking and forward earnings. If the earnings are lower then look out below and so far it hasn't happened. I mean, obviously you're going to have specific instances of companies struggling and having bad quarters and then turn around and blaming it on the global economy like FedEx, but so-

Casey Mullooly:

I wasn't going to say it.

Brendan:

I'm just so it's very easy in this environment when your company's going to miss for a quarter to come out and just be like, yes, supply chains, inflation, yada, yada, instead of just owning up to the fact that you might have had a bad quarter and we've seen it from other retailers too, with inventory issues, it's like, and I'm not the sort of-

Tom:

Both Walmart and Target fell in that bucket.

Brendan:

Really, really difficult, really difficult to plan given that we went from a place of extreme shortage to access and not having enough to make sales and seeing all the demands slip through your fingers to the opposite this summer. So tough world for those retailers to exist in and the fact that they had excess inventories weighed on earnings earlier this summer, but people were looking at as the harbinger of the recessionary times that Target missed on earnings and has a glut of inventory. I don't know, I mean maybe it's just been a difficult environment and it doesn't mean anything about the economy overall that Target had a bad quarter. It could be company specific and not a broader thing and just in general, you look at the technicals, you look at the fundamentals so far earnings I think broadly have been mostly okay to good, better than expected.

Tom:

And the forecasts for the next quarter and the next year seem to be okay.

Brendan:

Right.

Casey Mullooly:

Yeah. I know we've talked about it quickly before on a couple previous podcasts, but this being a midterm year, Tom, I know we talked about this a couple of days ago, just kind of off the cuff, but wanted to share some numbers here. Ryan Detrick over from Carson Group shared that this year looks a lot like 1962 with there was a new democratic president, it's a midterm year, there were some supply chain issues going on that year too. The S&P in 1962 didn't bottom till October, October 23rd, but from that point on until the end of the year there was a 19% rally. And that has kind of been the story for a lot of these midterm years. Another popular follow here from Twitter, Eddy Elfenbein shared that in actually all of the midterm years dating back to 1962, the story has a lousy first three quarters, and then a very good fourth quarter with the average drop in the first three quarters being 6.2% and then the average fourth quarter return is again, 6.2%.

Tom:

Going back to 1962 so we've got 60 years of data. The only time, well, I guess it's not 60 years because it's every four years is a midterm election so 15 years of data, but the only time that didn't, that formula or that recipe didn't work out was actually in 2018 when we had the opposite where we had a decent year through the first three quarters and then everything just fell out of bed. In the fourth quarter of 2018 the market was just terrible and went down 20% to-

Casey Mullooly:

Yeah, in the last month of the year.

Tom:

Christmas eve, yeah.

Casey Mullooly:

Yeah.

Tom:

So you can kind of take these straw arguments, these historical things. We sat with a client yesterday and we said, hey, look, we don't expect history to repeat, but it often rhymes. And so these are things that we like to keep in our back pocket to remain optimistic and hopeful, but we don't want to bank on these things happening.

Casey Mullooly:

Yeah. It's definitely not a rule and there's very few rules I think when it comes to investing. But I think in a world of Bren, like you said all the doom and gloom it's important to keep this context and share it when we do come across data points like this. So I know you also have an article from the journal that you wanted to talk about regarding mortgage rates and the crazy spike we've seen there and how a lot of... Could you share the numbers and specifics with us.

Tom:

Sure. Okay so shifting a little bit more towards real estate and it's easy to find plenty of doom and gloomers as Brendan calls them online who say just wait, besides earnings one of the next shoes to drop in this economy is going to be housing. And housing was just a big bubble waiting to burst. And I think a lot of people are playing the last war or the last battle that happened with real estate. You go back to 2005, 6, 7, where we had this tremendous run up and everybody could own four houses and there were liar loans and no money down and all those crazy things and that led to the implosion of 2008, 9 for the real estate market that continued into 2011. Things are a little different this time. So I'm just going to read this quote that I pulled out of the Wall Street Journal and I retweeted this, this afternoon.

Nearly nine out of every ten first lean mortgages, so primary mortgages, nine out of 10 of them have an interest rate below 5%. More than two thirds have a rate below 4%. According to mortgage data firm Black Knight, 83, about 83% of these mortgages are 30 year fixed rates. And so it's going to be hard to find people who are going to be forced sellers in this market in 2000 8, 9, 10, even into 2011 there were plenty of people who became forced sellers. They couldn't afford to pay their mortgage anymore because their rates increased. Well, they had an adjustable rate mortgage, 83% of these people don't. They also had dropping home values so they couldn't refinance. They didn't have equity. I mean, they were totally in the road runner cartoon so Wile E. Coyote had gone off the cliff and now he was going to go down 500 feet.

So little, I would say a totally different scenario this time around. I'm not going to make a prediction about home prices or the real estate industry, but it seems to me that there's going to be a lot of people out there who would like to upgrade to a new home or bigger home or whatever, but they've got a mortgage that they're paying 3% interest on and right now if you're looking to get a new mortgage, you're looking at six and a quarter, six and a half, maybe depending on your credit score, maybe even higher than that so I think this is going to be a speed bump for real estate. I just don't-

Brendan:

It's going to make a weird market. It's like we have a thinly traded security.

Tom:

Very weird market.

Brendan:

The [inaudible 00:18:00] spread is going to be a mile wide.

Tom:

Yes.

Brendan:

So you have people who want to sell and then you're going to have people who want to buy, and they're not going to agree upon what it's all worth because the new buyers are going to have a massively higher interest rate than they might have a year or two ago and the sellers want to get as much money as possible to be compensated for the fact that they're going to be giving up a two or 3% mortgage and shifting to something different so I think we've seen that in the home sale data. Sales are slowing down, but I don't think that, that's necessarily indicative of housing prices also going alongside them. It just might mean that there's a lot less activity happening as a result of what interest rates are doing.

Tom:

I tend to agree.

Casey Mullooly:

Right. So we're not going to see these big drops in home prices like we did back in 2008, 2009, but we might just see a slowdown of activity and not as rampant as a housing market as we've seen for the last two or three years, but it's not going to be a crash. It might just be a prolonged slowdown. Is that basically...

Brendan:

Well, the crash happened last time because what Tom said people had to sell. Right now it's like you might want to move, but if you take it to market and you get prices that you don't like you can just say, all right, we'll stay. And as long as you can make the payments then nobody can force you out of there. That's the deal that you cut. So the homeowners have a say in whether the real estate market tanks or not, whether they're willing to accept what they believe is 90, 80 cents on the dollar for the asset they're trying to unload. That's got to be their prerogative and people are going to sell because of life circumstances for sure. But the idea that people are going to be doing as much as we saw in 2020 or 21 in the real estate market, I mean, probably not with interest rates as they are.

Tom:

Yeah. It's going to be a different set of circumstances and so I think the message is kind of in the same vein as Brendan was talking about earnings and earnings expectations I think folks kind of look at the past and try and pull a play out of an old playbook and say, okay, this is probably what's going to be the next problem is going to be decreased earnings expectations or poor earnings reports. For the same reason I think there's people out there who are saying that real estate's going to be weak. I don't necessarily know if that's the case for the same reason that people are saying we're definitely going to have a recession. How do you know? If you look at the corporate balance sheets have never been better. If you go back 75 years now the individual consumer has never had a better looking balance sheet and the banks are in fantastic shape in terms of their lending guidelines and so these things don't normally happen when we're in a recession or about to go into a recession.

Brendan:

People just want it to be binary, though. We can exist in a world where people who bought homes in the last couple of years don't make the kind of gains that people who bought a few years before that did in real estate, but also don't lose their houses in a housing crash. We can just be somewhere in the middle. And honestly, I would say that, that's probably more likely than either end of the spectrum, but people want to make those extreme proclamations and then reap all the fame for being right, but doesn't need to be that way.

Tom:

We had a client call in a couple of weeks ago who was looking at buying a second home, vacation home and he said, I'm just nervous because of what's going on in the market and what's happening with interest rates and mortgages and things like that. I said, if this is a vacation home just forget about all of those details and tell me how you're going to feel 10 years from now and he's like, "Thank you. You're right." So it's a vacation home. Don't worry.

Brendan:

Right. Of course, it would be great if you made money on something like that also, but it's not necessarily the investment aspect when it comes to something like that. It's like can you afford this within the confines of your financial situation and is it going to bring you enough joy that it's worth the dollars you spend on it? In that case, great. If anybody's telling you what they think the ROI over the next year, two or three on a piece of rental real estate is going to be I think they're a quack just like I think we got quacks on TV saying the same kind of stuff about the stock market.

Casey Mullooly:

Yeah. Agreed, agreed on all fronts there. I think there's been a lot to talk about here so far in 2022. We'll definitely keep doing what we've been doing and sharing our thoughts and what we're seeing out there when it comes to what the Fed's doing, what the economy's doing, what the market's doing and trying to put it all in the context of how it affects you, our listeners. So that's going to do it for episode 410 of the Mullooly Asset podcast. Tim was on last week and the Jets won. I don't know if there's a correlation there. He's not on this week so that might spell some bad things. If they lose we'll get him back on for next week.

Brendan:

Yeah. Good call. Good call.

Casey Mullooly:

Thanks as always for listening and we'll see you on the next one.

Speaker 4: