Casey Mullooly: Welcome back to the Mullooly Asset podcast. This is episode 389. I'm your host Casey Mullooly. We've got a good one here for you this week. We've got the whole team back. I think this might be a first with all four of us on the podcast. We've got Tom, Brendan, and Tim back. Tim, why don't you go say hello to everybody out there.

Tim: Hello. It's been a while. I don't know how long it's been, but I feel like it coming up maybe a year...

Casey Mullooly: Yeah, it might be.

Tim: ...since I've been on a podcast, so good to be back.

Casey Mullooly: Good to have you.

Brendan: Casey stepped into the host role. We're doing good, but obviously, now we have dual hosts, you guys going to duke out?

Tim: Now I'm going to let Casey host, but [crosstalk 00:00:41].

Tom: For this year.

Brendan: Yeah, Tom's the original [crosstalk 00:00:43].

Tom: I was going to say for the older folks out there, Tim has been wally pipped. So wally pipped got...

Tim: Not sure what that means.

Tom: Okay. So he was running from first to second, he got hit in the head by the relay throw and so, they put in some guy named Lou Gehrig to take his place and he played 2,700 games in a row.

Casey Mullooly: But who's on first?

Tim: So I got Drew Bledsoe'd?

Casey Mullooly: There you go.

Tom: Yes. Yes.

Brendan: More recent example.

Tom: Even better.

Casey Mullooly: We're going to talk about generally, what's been going on, it's been a pretty busy time of year in terms of news and especially here in the financial world. So the big news headline from last week was that the Federal Reserve raised their benchmark interest rate from zero to 25 basis points or a

0.25%, last week. This was in an effort to combat inflation. Everyone knows by now that inflation is it's highest level, it's been since 30 years. So some people were saying that the raise in interest rates is long overdue, but others are saying that hopefully the fed doesn't go too far, too fast. I think the latest predictions or the latest thoughts are that the fed is going to raise rates six or seven times this year. Eventually, they want to get to about 2.5% for their benchmark interest rate. So just wanted to address that first of all, and talk about their repercussions of that that we've seen so far.

Tom: Well, I think for folks that are sitting in a money market or short term bonds for the first time in a couple of years, they're actually going to get some cash flow out of this. They're actually going to see some yield where they haven't seen much at all for a while.

Brendan: Although, I wouldn't hold my breath if you have money at the bank in a savings account on them raising their interest rates anytime soon because we saw in the last hiking cycle that that ended in 18 and then was reversed in 19, that most, especially brick and mortar banks, never raised their savings account interest rates off of zero even though short term rates got to 2% I think.

Tom: This is how these banks make money and the money that's on deposit in a CD that is a profit center for the banks. And so, Brendan, you're right in the sense that the banks will be very slow to raise interest rates on deposits, but they'll probably raise interest rates very quickly on adjustable rate loans, like credit card loans and home equity loans and things like that.

Brendan: Of course. Yeah. That makes sense. I think if you're in money markets or CDs or short term bonds, those are going to move more freely with the market. It just seems like savings accounts have no attachment to reality whatsoever and the banks just keep them at zero no matter what.

Casey Mullooly: But they're quick to cut them on the way down. Like I remember in 2021, the fed cut rates, I got an email. It seems like the next day from my online bank, where it was like, "Hey, sorry, we're cutting your rates."

Tim: We hate to do this.

Casey Mullooly: Yeah.

Tim: At least there is another first place though.

Casey Mullooly: I mean, it's like the same you see with gas stations now, with gas prices.

Brendan: Crude oil goes to $130 two weeks ago when gas prices jumped 80 cents and then crude oil drops $30 in a week and gas prices are still the same.

Casey Mullooly: Right? It's like these companies are trying to make money or something. Another area that we've seen per it’s head up lately is bonds, which are related to the rising rate environments. We've seen some headlines about how bonds are actually not performing like they're supposed to. Basically, the basic relationship with bonds are when yields go up, bond prices go down and when bond prices go up yields go down. So bonds are a complicated investment and not a lot of people understand that. So...

Tim: I think that's the bigger point is that people might not understand what bonds are supposed to do because they are doing what they're supposed to be doing. The yields, the rates are going up, so yeah, the prices are going down. That's how it's going to work. If you're buying and selling these bonds, then you might be feeling the pain of these rates going up. But if you're just holding onto these bonds, the price fluctuation might not really matter that much to you and in the long run, you're going to be getting more yield with these higher rates. So it'll balance itself out over time. You just can't be buying and selling.

Casey Mullooly: Yeah. If you're a bond trader, then yeah, this is...

Tim: It is a tough time.

Casey Mullooly: ...hugely important into you and...

Tom: Nuclear winter for them.

Casey Mullooly: Right.

Tom: But let's talk about what happens if you're an investor in a short term, or maybe even an intermediate term bond fund, what's going to happen inside your fund? What happens to the yield? What happens to the price?

Brendan: Well, the best indicator of what a bond fund is going to return over time, since it owns a group of individual bonds that's always changing, is the starting yield. And so for people who are going to have money and fixed income, something like the aggregate index for bonds, the most recent clip on the yield that I saw was two and a quarter percent now. So on a go forward basis, that should be the expectation for returns over the next five to seven years, since it's an intermediate term bond fund. And that's a lot better of an outlook than we would have gotten by looking at the same, by looking at its yield a year or a year and a half or two years ago, even though.

Tim: I think that some people, when they think mentally that they have bonds, that's "safer part of their account" and they forget that stuff like this can happen to it, it's not that your money is not invested, it's not out of the market, it's in the market, it's out of the stock market. You look for the diversification from stocks to bonds because bonds hold up well generally when stocks are doing poorly and vice versa. So you look for that offsetting nature, but there's always this scenario sometimes where, stocks aren't doing great and bonds are also not doing great, so kind of double, double whammy there.

Brendan: Have some numbers on that. I've read this from piece that Michael Batnick put out from Red Hole 12 management, and he looked back and saw that since 1976, the S&P 500 and the aggregate index have only both clients for consecutive months 10 times.

Tim: Wow.

Tom: That's not very often.

Brendan: And so the idea that this maybe feels worse than it otherwise might because this stuff with inflation and interest rate rates that we're seeing feed through to bonds happens to also be coinciding with a two, three month stretch at the beginning of the year here, where stocks are also down. Normally, we would expect the bonds to have held up during that period of time, hasn't been the case so far this year. It's actually never been three straight months for those two to consecutively decline. And I think we looked like we might be on our way towards that for the first time in history, as recently as last week, but stocks have turned around a bit now and so yeah, that relationship is when you expect to play out the way, the way that most people do over longer periods of time, but it doesn't rule out these stretches where they're both down and for whatever it's worth, it doesn't rule out stretches of time where they're both up also, which happens very frequently, more frequently than these consecutive month declines. And so we, I think, benefit from that relationship more often than not.

Tom: I think it's also important to remember that if you have money in a short term bond fund, or even in an intermediate term bond fund, the fund manager is constantly reinvesting dollars in the newest yields that fit that portfolio. And so as yields go up, you're actually going to see some cash flow or more cash flow than you did in the past with these. And so, especially in short term bond funds, we don't want to predict what they're going to do, but I think they'll do a better job in terms of holding their value and providing some cash flow more than they did in the past.

Casey Mullooly: Do you think that that's what's in play here as I know we've seen rates move up. We're talking small percentages here, but they're big increases. Do you think that this is the first time that the fed has raised rates in two years and everyone's pricing in the six or seven more expected rate hikes this year and it's kind of moving too fast because of that?

Tom: Possibly. It's possible. The fed has been, and I know I sound like a broken record because I say this all the time, but the fed has been more transparent with every passing month. And this is a comment that I've made going all the way back to Ben Bernanke that they've been very, very transparent and more so every time. Today we had fed governor Charles Evans come out and say, he's totally comfortable with 25 basis point increases each step of the way, but he's also open to a 50 basis point hike. He also that he does not believe, and I've got to believe he's not the only one at the table, that the fed is not going to raise rates to put the country into a recession, which is something that a lot of people are just, instead of taking this step by step, these traders, they jump to step 17 in the process because they want to plan for the worst possible outcome. So a lot of different opinions make a market.

Casey Mullooly: Yeah.

Brendan: We also saw back in the last hiking cycle, bonds as measured by the aggregate index do just fine and the stock market too, for whatever that's worth, and you can go back and look at the table tantrum in 2013 as well. And there were a lot of people at that time when the fed was talking about ending quantitative easing and all that, which didn't actually bear out for another several years, but people were talking about that, that was the end, and that if you were holding bonds, you were fool and go forward returns from 2013 onward have been very good and especially considering how low interest rates have been over that period. So how little that you got from dividend yield or from interest alone on the bonds, returns had to be, I think, better than expectations then because people were banking in apocalypse for bond holders.

Brendan: And again, we say this on podcast videos all the time, but it's just bears remembering that bad year in the bond market is like a bad afternoon in the stock market. Bonds are down 5% this year as measured by the aggregate index. We've seen percent daily moves as recently as the COVID crash and maybe even last year included, so that happens.

Tim: I think certain indexes in the stock market were up 5% or 6% last week.

Tom: Right. Yeah.

Casey Mullooly: Alone.

Brendan: Or let alone if you're dealing in individual stocks or something, like if you're out there doing game stop and AMC 5% is like, that's nothing.

Tom: Premarket

Brendan: Bitcoin, for that matter, crypto, right?

Casey Mullooly: Yeah. So you got to remember why you're owning the bonds, the bonds tamper down the volatility and the portfolio and usually, more times than not will offset the stock side of the portfolio.

Brendan: I wish there were a better solution that offered a more perfect hedge to stock market risk, but I'm not sure that short intermediate term high quality bonds, I'm not sure that that can be improved upon, that's obviously something that we consider when we're building portfolios and I've yet to see something that does a better job than that in terms of hedging the downside risk that we all worry about, but also surviving, let's say the upside risk. There are things that you can do that better hedge the downside than bonds might since they're not perfect as we've seen so far this year, but what are those things then do, when the market is off 20% on the year?

Casey Mullooly: Right.

Brendan: And do you want to own them when that's happening? Because if you can't own them during those periods, then how are you going to know ahead of time when to own them when the market's going to go down?

Casey Mullooly: Right. So along the same lines as what we've been talking about is another headline that we've been seeing and that is the yield curve is going to invert, is close to inverting. Some durations may have already inverted, but a lot of the news articles that we're reading and you might be reading too, are saying that the yield curve is inverting, which means that a recession is coming.

Brendan: When?

Casey Mullooly: Right. Well, that's the catch. So the yield curve has inverted before every recession dating back to 1950, but the kicker is that it doesn't predict when it's going to happen. The range is anywhere from six months to 24 months. In many instances, the yield curve inverting has correlated with other major economic changes or major economic events and we're going to talk about a couple of those instances. Another article referenced 1973 and also, the yield curve inverted in 2019 and then the COVID pandemic happened in 2020, but the COVID pandemic didn't happen because the yield's curve inverted.

Tim: The yield curve should have given us a heads up that the pandemic was coming. What the heck? I should have known.

Casey Mullooly: Yeah, should've known.

Tim: I think it's important, like you said the word correlated there and these things happened around the same time, but it doesn't mean that they caused those recessions, right?

Tom: And I think that's the sin of having too much data with these things. In 1973, when the yield curve inverted, I was not in the market by then but...

Casey Mullooly: What?

Tom: Yeah I know. They weren't even tracking the twos tens

Casey Mullooly: One year.

Tom: Yeah. So the one year rate was over the 30 year rate at that time. They even had 40 year bonds back then, which they no longer have. So there's a lot of faulty data. I would say that an inverted yield curve has predicted 80 of the last 10 recessions or something, you know how people joke about that, so it happens, but like Tim was saying, it may not trigger an immediate recession.

Brendan: Yeah.

Tom: It just happens to be a handy bit of data.

Casey Mullooly: Right.

Brendan: I think everybody inherently knows that we don't have one thing that tells us when stocks are going to go down or when a recession is going to happen but the...

Casey Mullooly: We don't?

Brendan: The allure of finding that thing so that you can obviously reap the benefits of not having to sit it through market downturns or endure a recession is just too great because we, despite knowing that it doesn't exist, we continue looking for it and I don't think that's ever going to stop, and in fact, I have another example that I wanted to share that reminiscent of the yield curve. So pre 1957, the dividend yield on stocks was always higher than the interest rate that bonds paid because people wanted more compensation to bear the risk of owning stocks. So this was virtually like 99% of the time, stocks yield did more than bonds.

Brendan: And when that relationship changed, it was the signal to get out of stocks and they would fall not long after that stocks, as a signal, we're overvalued by that metric. So this worked flawlessly from 1900 to 1957 and then in 1957, they changed and nothing happened and the stock market went up. And for 95% of the time since 1957, the relationship has been reversed and the stock market has obviously done great since then, because it's such a long time horizon. So just going to share that we come across these things for periods of time that seem to be the answer in terms of being able to time the market based on an indicator and some of these things are going to work until they don't, and we don't know when that's going to be. So maybe the yield curve continues to nail it, but it's definitely not something that I would be willing to hop out of the market based upon, because I think the downsides to doing that are vast.

Casey Mullooly: Well, the article from the journal actually looked at the last five instances that the yield curve inverted the twos and tens and there were five instances in 1989, 1998, 2000, 2006 and 2019. So over the last 30-ish years, there's been five instances and it looked at the S&P 500's total return from when the yield curve inverted until a recession started. And the average return over those five instances is 10.4% just because the yield curve inverts, stocks can still go up in that time period. It doesn't mean that yield curve invert, it's time to get out. That's what...

Brendan: Right. Well, and the longer the runway is before a recession actually does happen, and the more the market performs in the interim, the further it has to drop to validate your decision to get out based on whenever the curve didn't invert, if you decided to hop out at that point in time. So you got to keep that in mind too. The market could do so well in the interim that when it falls, it barely makes a difference based on where you got out if you chose to act on something like that.

Tom: We've had plenty of instances over the last 30 years where we've kind of gone into what people will call a rolling recession in the sense that it almost goes sector by sector, real estate doesn't do well, then manufacturing doesn't do well, and we see a market that goes sideways to down a little bit, but it doesn't go through a typical recession where the market's down 30% or 35%, something like that. I think the article that Casey's point to from the Wall Street Journal gave a really good rejoinder in the sense that it said, "An inverted yield curve may signal that the economy is getting later in the cycle." Which I think makes a lot more sense because bankers start to wake up and say, "Hey, we can't do these liar loans anymore. We can't do these easy deals anymore. Everyone's going to have to work a little harder to get the same stuff done." And I think that's actually a very good indicator.

Casey Mullooly: What does late in the cycle mean?

Tom: Well, late in the cycle means that we're still seeing the economy expand, but there's some real risk out there. It's not a risk free environment and so, the banks are to say, "Hey, if we're going to lend money to you, we need to get paid for taking that risk. So we're going to raise our interest rates as well." Even in things like, in the commodity markets, we're starting to see these markets now raise their margin requirements because they're trying to stem some of the speculation because it's getting out of hand.

Casey Mullooly: Yeah.

Brendan: Well, it's interesting because I think the whole idea behind the yield curve inverting is just that interest rates on the long end aren't going up [inaudible 00:21:04] with the short end and people take that as a message that the economic outlook for the intermediate to longer term is not so great. And obviously, that is a recession is what we're talking about there, but you got to remember too that the environment we're in is really weird. And so the fed is going to have the hike short term rates based on what's happening with inflation and not to return to their transitory word because it's obviously gone on for longer than most people took that phrase to mean, when they were it out a year plus ago, but just the idea that there's definitely some component of the current inflation that is related to supply chains, and I don't know when they'll be fixed, but that may not be something that is baked in with the usual yield curve inversion, meaning what if the long term rates don't need to rise because the short term rates are also going to drop again back to the levels we saw pre COVID, which was, 1%, 2%, and then 10, 15, 20 years commensurately higher, but not several percentage points.

Brendan: So the idea that's not being baked in at this point while it might invert the yield curve. I think it's also just saying that the current levels of economic activity we're seeing are maybe a little out of whack, still from all the weird economic data points. You look at so many charts because of what happened during the pandemic and they're just broken, there's a spike up and then spike down because we literally shut down the economy.

Casey Mullooly: Yeah. Even just today, we had jobless claims hit a 50 year low today, which speaks to, I think, when we're talking about the fed, we have to talk about both things that they're trying to do, which is price stability and curb inflation, but also have the conditions for a healthy job market. This is potentially the strong

Brendan: ends of the spectrum there in terms of, so they don't want to kill one of those things...
to address the other.

Casey Mullooly: Everyone's worried about inflation, but I feel like no one's really paying attention to how strong the job market is, which is, like we said, they're trying to do both of those things.

Tim: I think the thing about the yield curve and having it invert, and it can predict a recession and there's no timeline to it, but like I was reading this article and even if it can predict the recession, I feel like a large majority of people, what does that mean for them? What do you do with that information? For most people, nothing. It's not like you're going to take your money all out of the market. Most people need to invest their way through a recession anyway.

Casey Mullooly: Right.

Tim: So even if this information is correct, I'm not even sure that there's much to do about it. I think I liked the points that the article made, but at the end, the author said that investors, because he was making the point about its correlation not causation, but he was saying that investors should be closely watching the causation. Which investors? I think it's not for the everyday person.

Brendan: The idea that we're going to invest, even for somebody on the cusp of retirement, 20-30 years let's say, we're creating financial plans for the idea that we're going to invest over that period of time and somehow sidestep every market down or recession along the way, we're going to deal with those over a 20 or 30 year time horizon, we're probably going to have three or four recessions and they may or may not correspond with bear markets or we might not have cyclical bear markets absent or recession throughout that where we're going to have to deal with those sort of things. So the idea that if your plan is contingent upon sidestepping all of those, best of luck to you, but we don't build plans that way because it's just not realistic. I wish it were.

Tim: Yeah. At first, I was like, "All right, well, who is this information valuable for?" And at first, well, I guess if you're getting ready to retire, but then like you just said for most people, even if they're getting ready to retire, the retirement's going to be multiple decades. So even retired people need to work through it I think. Yeah.

Tom: I think the fear for a lot of folks that aren't watching the monitors like we are on a daily basis is, we have inflation that we haven't had in a long time. And the last time that inflation was 5% before last year was 1990. And that was a one year thing, it was a fluke. And prior to that, we're talking about the early eighties. So we're seeing numbers that people haven't seen before and the last time that we had inflation numbers like this, we had inflation numbers like this that went up every year for five or six years, that worries people. And so back to what Brendan was saying about, is this going to be transitory? I think so because of things like the supply chain, because of different things that are going on. COVID was a man-made shutdown of the economy, so it's not a permanent thing.

Tom: The inflation that we had in the seventies and it even, tripped over into the eighties, I mean that all started with things that happened in the sixties. It just took that long to burp its way through the system. So I think the concern for a lot of people is, "Hey, are we going to have to deal with this inflation on a long term basis?"

Tim: Yeah, I think it's coinciding with the fact that stocks have been going down, at the same time that we have inflation, so I think people are confusing their fear with inflation, with what inflation is doing to the stock market. And those are two different things because we've fielded some calls about people worried about inflation and they want to move their money to safer investments, so they don't lose money, but that is literally feeding into the power of inflation. So if you're truly worried about inflation, not the market effects of inflation, you need to invest your way through it.

Casey Mullooly: You need to, yeah, you need to have...

Tim: That's the only way you combat inflation is by having money in the market, working for you.

Brendan: At 2% or 3% inflation after 20 years, you're purchasing power is half.

Casey Mullooly: Right.

Brendan: And so if you're worried about that, that's a pretty normal level of inflation in terms of projections, assumptions over multi decade period, that's the reason we invest or at least have some exposure to the market based upon what you're going to need from the investment. So yeah, the idea that you can stick it safe stuff because of inflation. I mean, inflation's going to destroy you if you want to [crosstalk 00:27:49].

Tim: That's doubling down on the effects of inflation.

Brendan: Absolutely.

Casey Mullooly: I think that's going to wrap it up for episode 389, a lot to talk about here. We had to bring out the big guns and bring Tim back, so thanks for joining us. I know we're getting to the end of March year and we're all big Met fans, so quickly before the regular season, I know we've done this the last couple of years too, before the regular season gets going, let's get some win totals, win total predictions for our beloved Mets.

Brendan: You should take my prediction as seriously as you take people's S&P 500 price targets. I was going to say

Casey: Tim's going over a hundred easy, I see it in his eyes.

Tim: It's a good thing that we're not in the predicting business when it comes to managing investments, because my last couple of predictions for the Mets have been comp completely wrong.

Casey Mullooly: Yeah.

Tim: I could see that, I think they're going to win 90 games, I think they'll probably come in second place in the NL East. I think bare minimum, especially with the expanded playoff format, if this team can't make the playoffs in some capacity, that would be a huge failure.

Casey Mullooly: Sell the team.

Tim: No.

Tom: Well, last year I said they were going to win a hundred games and I couldn't more wrong.

Casey Mullooly: What'd they win 79?

Tom: Close. So I'm going to go with 92 wins and I don't know if they're going to make the playoffs because the Braves are retooling and we can't rule out the and...

Brendan: Yeah. I think they're of like a high eighties win total. Let's say 88.

Casey Mullooly: Wow. I'm the high guy.

Brendan: I think that's good enough for a playoff spot.

Casey Mullooly: I'm going 97 wins.

Brendan: Wow.

Tim: Wow.

Casey Mullooly: Give us the National League East and we'll see you in November.

Tom: Casey Showalter 00:29:44.

Casey Mullooly: All right. Thanks as always for tuning in, we'll be back with you for episode 390.

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