Financial Alternatives
integrated wealth management

Investing Newsletter — **July 2023**

Overview

In the first six months of the year, stock and bond markets around the world earned positive returns after last year's declines. See our Quarterly Market Review Newsletter which contains both long and short-term investment return data from markets around the world.

The Federal Reserve's continued interest rate increases to bring down inflation have not seemed to curtail short term market returns. Many investors are now asking themselves how long interest rates will go up and how high they will go? They are also asking themselves if we are headed toward a recession and what they should do about it?

We will briefly discuss both of these questions in the following pages of this newsletter.

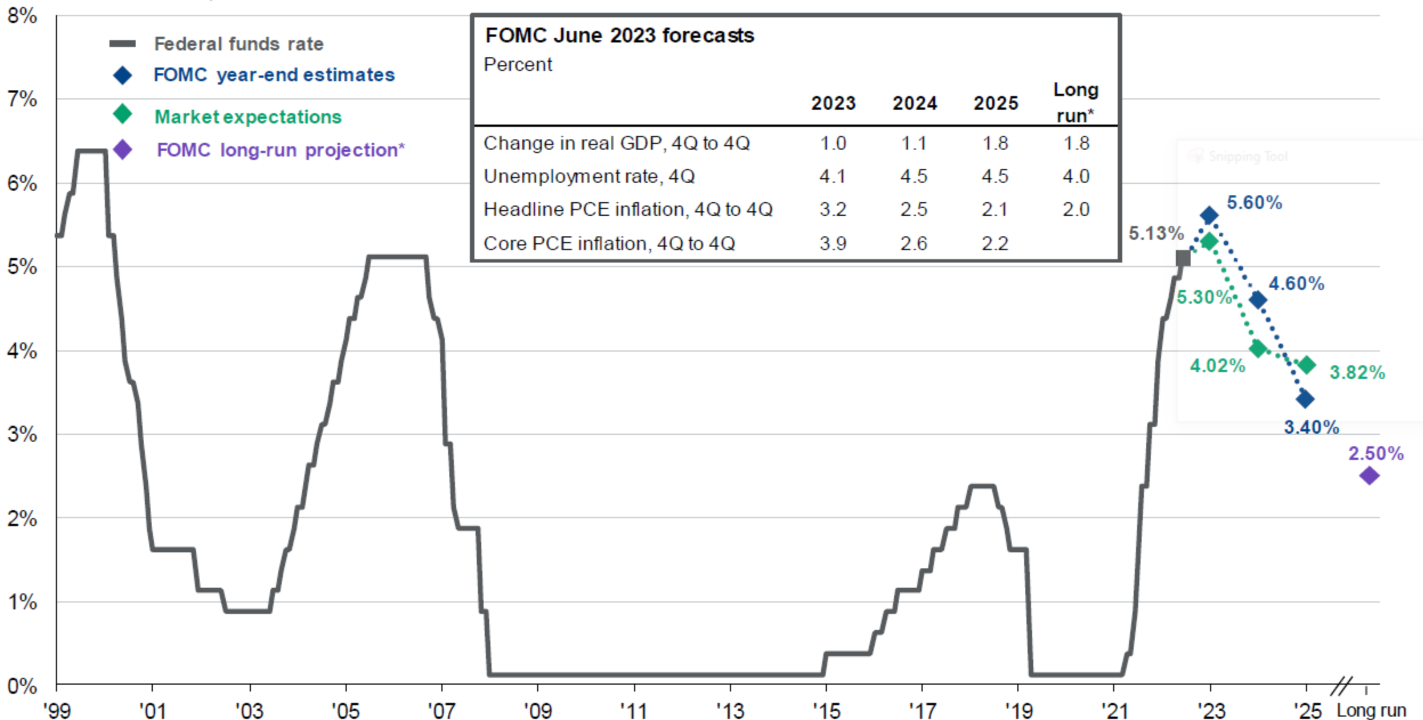
Executive Summary

- Stock and bond returns have been broadly positive for the year to date after last year's declines.
- Interest rates appear to be nearing their short-term peak but will likely go slightly higher before beginning a downward trend.
- In the past century, there have been 15 recessions in the US. In 11 of those instances, stock returns were positive two years after the recession began.
- Stock markets typically drop well before a recession is officially announced and then rebound before the recession is officially over.
- Commit to holding onto your portfolio's stock allocation for the long term and rebalancing it if markets drop due to a recession or any other event that may trigger a bear market.

The Fed and interest rates

Federal funds rate expectations

FOMC and market expectations for the federal funds rate



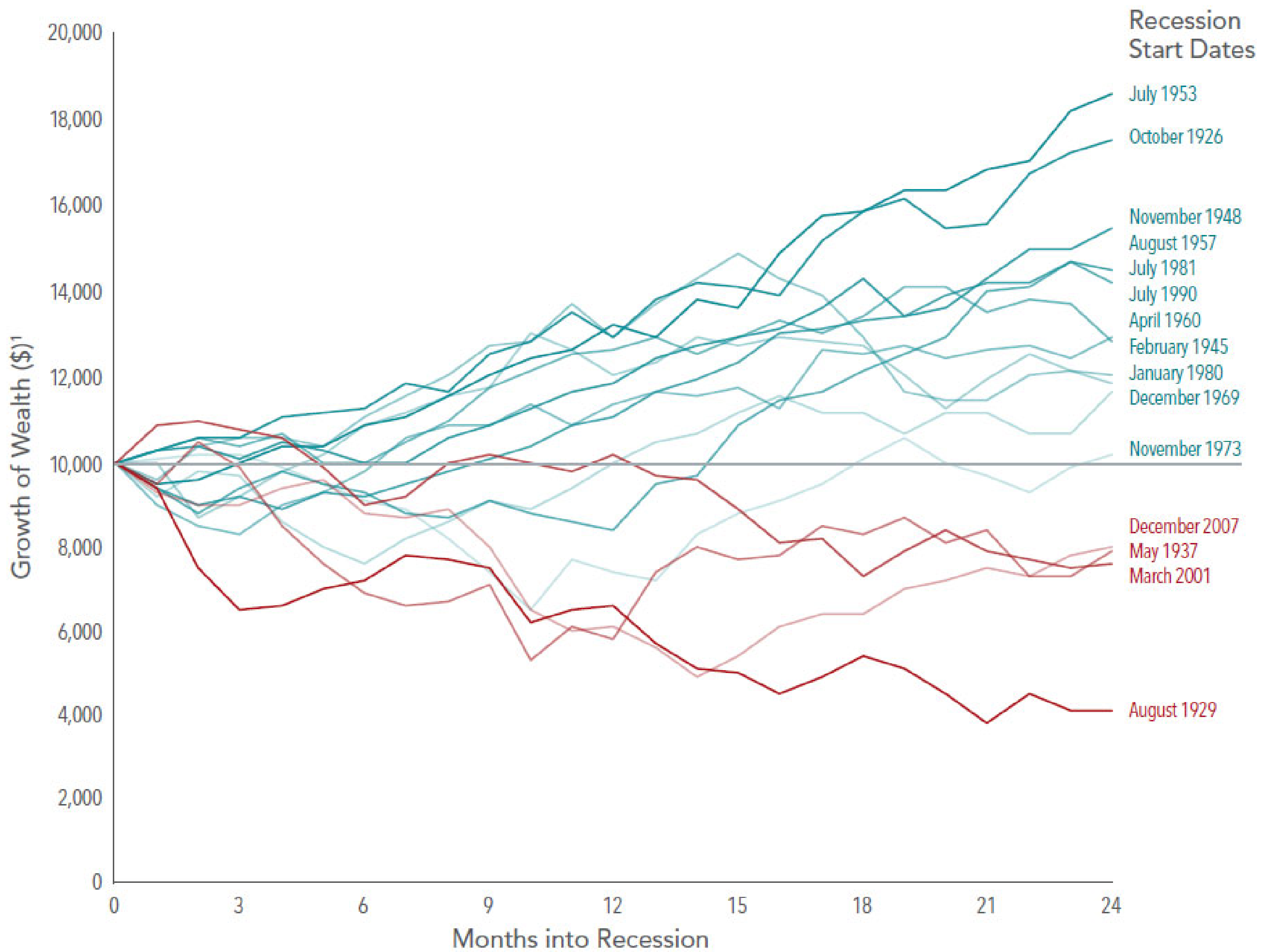
FOMC June 2023 forecasts

Percent

	2023	2024	2025	Long run*
Change in real GDP, 4Q to 4Q	1.0	1.1	1.8	1.8
Unemployment rate, 4Q	4.1	4.5	4.5	4.0
Headline PCE inflation, 4Q to 4Q	3.2	2.5	2.1	2.0
Core PCE inflation, 4Q to 4Q	3.9	2.6	2.2	

Source: J.P. Morgan Asset Management (Guide to the Markets dated June 28, 2023), Bloomberg, FactSet, Federal Reserve. Please refer to original source document for full disclosures which is available upon request.

Performance of a Hypothetical $10,000 Invested When a US Recession Began



Source: Dimensional (Fama/French Total US Market Research index)

How Long Will Interest Rates Keep Going Up and How High Will They Go?

To address that question, we refer to both estimates from the Fed and market expectations of interest rates. J.P. Morgan produces a very good graph to illustrate this information titled "The Fed and interest rates" that we show on page 1. The black line shows where the Fed funds rate has been from 1999 to date. Right now, it's listed at 5.13% on the graph since the target rate is currently 5.00% to 5.25%, and 5.13% (rounded) is the midpoint.

The blue diamonds to the right of the graph represent the FOMC's (Federal Open Market Committee's) year-end estimates – this committee sets the rate. They are estimating the Federal funds rate will be 5.60% at the end of 2023, 4.6% at the end of 2024 and 3.4% at the end of 2025.

The green diamonds are the market expectations for the Federal funds rate. As you can see, the market expects rates to be 5.30% at the end of 2023, 4.02% at the end of 2024 and 3.82% at the end of 2025. To illustrate market expectations, they use the respective Federal fund futures contracts for December expiry.

And finally, the purple diamond represents the FOMC's long-run target Fed funds rate. This 2.5% rate is where they would like to see it settle in the long term.

Jerome Powell, the head of the FOMC has said he believes a few more rate hikes may be needed in 2023 before the economy has slowed enough to bring inflation under control and they can then begin reducing interest rates to the lower numbers as forecasted on the page 1 graph.

So, the response to the question on interest rates is good news. Rates appear to be nearing their short-term peak but will likely go slightly higher before beginning a downward trend.

Are We Heading Toward a Recession and What Should I Do About It?

Many economic and finance experts look to the yield curve to attempt to predict whether a recession is imminent or not – the yield curve can be upward sloping, flat, or downward sloping (or "inverted"). It is the last circumstance, an inverted yield curve, that we have found ourselves in for many months now. The inverted curve shows that investors expect lower interest rates (and growth) further down the road rather than the present, and there is a tendency for the yield curve to invert ahead of a recession.

As we have shown in this newsletter in the past, recessions can occur anytime and can vary considerably in their depth and duration. Based on the frequency of recessions we've experienced in the US, we should expect to experience a recession about once every six years

So, we could very well be heading toward a recession, but that does not mean you should alter your portfolio's allocation.

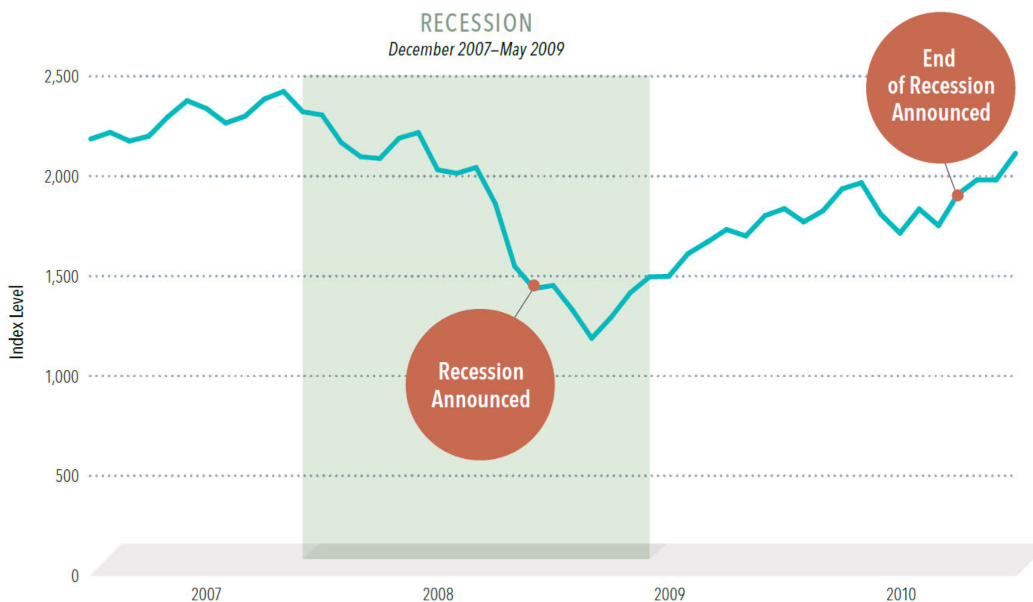
As you can see from the chart on page 2 entitled, "Performance of a Hypothetical $10,000 Invested When a US Recession Began", there have been 15 recessions in the past century. In 11 of those 15 instances, stock returns were positive two years after the recession began. The average annualized return after the onset of the 15 recessions was 7.8%.

The graphic below, "US Recession and Stock Performance During the Global Financial Crisis" illustrates how the stock market often behaves during recessions - using the 2008 financial crisis as an example. Research has shown that stock prices incorporate expectations of a recession and generally fall well before a recession is officially announced, and then rebound before the recession is officially over.

Investors may be tempted to abandon stock positions and move to cash when there is a high risk of an economic downturn. However, as we described above, stock market performance does not match the prevailing economic environment but instead tends to precede it. So investors could end up both selling stocks late (when the economy seems to be at its worst), and buying back into stocks late (when the market rebound is well underway). As we have discussed many times before, profitable market timing is extremely hard to execute.

US Recession and Stock Performance During the Global Financial Crisis

S&P 500 Index, January 2007-December 2010



Some investors may worry about the stock market sinking after a recession is officially announced. But history shows that markets incorporate expectations ahead of the news.

- The global financial crisis offers a lesson in the forward-looking nature of the stock market. The US recession spanned from December 2007 to May 2009 (shaded area).
- But the official "in recession" announcement came in December 2008–a year after the recession had started. By then, stock prices had already dropped more than 40%.
- Although the recession ended in May 2009, the announcement came 16 months later, by which time US stocks had rebounded.

Investors who look beyond after-the-fact headlines about markets and the economy and stick to a plan may be better positioned for long-term success.

Source: Dimensional

What to Do Now?

Despite all of the above, there are steps you can take to prepare – here are a few suggestions:

- Commit to holding onto your portfolio's stock allocation for the long term and rebalancing it if markets drop due to a recession or any other event that may trigger a bear market.
- Review your bank balances and ensure all your cash is earning a competitive interest rate. A competitive money market interest rate is currently 4.75% to 5%.
- If you are working, take steps to ensure you are at a competitive advantage and have marketable skills both within and outside your existing organization. This could involve investing in additional training or simply ensuring you have good work-related connections.
- If you are not working but are still worried about how a recession could impact you, revisit your sources and uses of cash. Your portfolio probably generates income through dividends and interest that may not dramatically change in a recession; and this could be in addition to more stable pension or social security payments. Understanding how these sources of income cover some or all of your essential expenses would provide you with a significant sense of security.
- Consider how you might time major purchases or discretionary spending in a downturn. It's more likely that certain costs will come down as the economy cools (e.g. home remodeling).
- Realistically evaluate how much of an "emergency" cash reserve you should maintain and either have it set aside or have a plan to save toward that goal.
- Consider applying now for any debt (such as a Home Equity Line of Credit "HELOC") if you think it may be more expensive or harder for you to obtain during a recession.

Let us know if you'd like to discuss any of these suggestions further.

Summary

Stock and bond returns have been broadly positive year to date after last year's declines. See our Quarterly Market Review Newsletter for more detailed performance information on various market indexes from around the world.

Short-term interest rates appear to be nearing a peak and will likely begin to decline later this year or sometime next year. Check to be sure you are earning a competitive interest rate on all of your cash.

The economy could officially dip into a recession but the market may not necessarily decline because of it. It is not a prudent strategy to try to time moving into and out of the stock market to avoid short-term market declines due to the expectation or official announcement of a recession. Attempting such a strategy is just as likely to cause an investor to miss the next upswing.

Consider the various other ways you can prepare for a recession such as ensuring you have an adequate cash reserve and reviewing your cash income and spending plans.

Let us know if you would like to discuss your investments or any other aspect of your financial life in greater detail. We hope you have a wonderful summer.

Past performance is no guarantee of future results. All content in this newsletter is intended as general information, not specific advice. Performance data listed is for illustrative purposes only. Portfolios are personalized and often consider many variables, including investment objectives, age, time horizon, risk tolerance, and tax variables. Information contained herein has been obtained from sources believed reliable, but not guaranteed.

Any forward-looking statements are hypothetical in nature and may not be interpreted as guarantees of any sort.

FA Financial Alternatives
integrated wealth management

7825 Fay Avenue, Suite 210
La Jolla, CA 92037

858 459 8289
www.financialalternatives.com