Fidelity Viewpoints®: Market Sense

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TRANSCRIPT

SPEAKERS:

Jim Armstrong   Leanna Devinney   Jurrien Timmer

Colleen Rolph: Hello, and thanks for joining us for Market Sense. I'm Colleen Rolph with Fidelity. There's a lot on investors' plates these days. The brutal war in Ukraine continues, unfortunately, and it's affecting the economy and markets. The Fed is raising interest rates—far and fast enough—in hopes of taming inflation without tipping the US into recession. And that inflation is the highest it's been in 40 years, pushing up prices for the goods and services we all buy.

So today, we're talking about protecting your money from inflation. We're going to look at investment strategies you may want to consider—you may want to consider to weather soaring inflation and what we can learn from past high inflation periods to better protect our portfolios. To help guide our conversations, we're back with Jurrien Timmer. He's here with a big-picture view of the latest world news, market conditions, and what they mean to us. And Leanna Devinney: She's going to cover how she and her team help build and update financial plans for people like yourselves to weather potential storms like we're having and to stay on track with your goals. Thank you both for being here.

Leanna Devinney: Thank you. It's great to be here.

Jurrien Timmer: Nice to see you both.

COLLEEN: Yeah, great to see you both. It's been a while. So, Jurrien, I'm going to turn to you first, so let's start off. It's Tuesday, April 19th, and there's been a lot of talk about whether we're headed for a recession, either in the near or the long term. And it feels like the news is evolving rapidly on this front. So can you bring us up to speed on your latest thinking on: Are we going into a recession? And what factors are driving your perspective?

JURRIEN: Yeah. No, it's obviously an important question, and for a long time   so the Fed has these two mandates, right: full employment, stable inflation. And the full employment stuff is certainly working. As we all know, the job market is very strong. And the economy, generally speaking, is still very strong. So we don't really see a recession on the horizon anytime soon, but the market has flashed a few warning signals. One is the yield curve, right, the difference between short term rates and long term rates—very briefly inverted, meaning long rates fell below short rates. And that historically has been an indicator of recession, although certainly not—one with various lead and lag times.

But then the other part is the inflation part. And in this chart, I show the 10 year Treasury yield. That's the black line. You can see how much that has gone up in recent months. And then the yellow line is what the market expected the Fed, the Federal Reserve, to do for monetary policy four months ago before this inflation story became so urgent. And the blue line is what the Fed is expected to do now, in the coming years, but as a current snapshot. And you can see that the yellow line and the blue line are totally different shapes, right? So what was the thought a few months ago was that the Fed would gradually bring policy back to normal, right? So during the pandemic, the Fed brought rates down to zero. It started doing asset purchases, $120 billion a month.

And the idea was: Okay, the Fed can take its time to kind of bring policy back to neutral. And neutral is considered about 2.5% on the Fed funds rate. With inflation becoming a much more urgent problem—we're at 8.5% year-over-year inflation—and even though the bottle—the supply chain bottlenecks seem to be getting better, but now we have the war between Russia and the Ukraine. That obviously is bringing the price of natural resources up. Now Shanghai is in a complete lockdown because of COVID. So there are no ships going from Shanghai to anywhere else at this point. And so this inflation problem is becoming a lot more persistent.

And what the Fed has to do: It has to kind of shock the system into, what I like to call, slaying the inflation dragon. And in order to shock the system, the Fed needs to raise rates pretty dramatically. And you can see that right now the Fed is expected to bring rates up to over 3%. That is a far cry from where we were, you know, three, four, five, six months ago. So that's what's—the state of play right now. And the Fed is trying to slow the economy. The Fed can't do anything about oil not leaving Russia or containers not leaving Shanghai, but it can try to do something about the strong demand in the economy in order to bring inflation down. And that's basically what it's doing, and it's doing it by raising interest rates, right? You see it in mortgage rates. You see it in Treasury yields. And through that means, they're trying to cool the economy down enough so that the inflation problem hopefully will dissipate. But it's a story without a known ending at this point.

COLLEEN: Yeah, and as you said, I mean, got to look at what's in their control. And slaying that inflation dragon, I like that saying. So, Leanna, speaking of that, right, we've already mentioned highest inflation in 40 years. We've already felt the pain at the gas pump with rising oil prices—ugh. And the USDA says groceries, eating out, will get more expensive. And the price that we're all paying for everyday items, as Jurrien mentioned, it rose 8.5% in March. It's no small amount. We all want to be protecting the money we have. So it's understandable if investors are nervous, given all of this. So why does inflation matter to our financial plan?

LEANNA: Yes, thank you. And 8.5% end of March—historically high—and we're feeling and seeing this everywhere. So it's one of the key risks that we help our clients plan for, and it's a critical component to our analysis that we do. And the reason why is: Inflation impacts our purchasing power, and it impacts the future value of our money.

So we talk a lot to our clients about protecting the lifestyle they want—and lifestyle in retirement or the lifestyle that you want for your future retirement, so protecting your ability to spend and spend on what you want, if it's ability to travel, dine out, spend at the grocery store, college for children or grandchildren. Sitting in a client meeting a couple weeks ago, a client shared one of their longer-term goals is to help their grandchildren for college. And when they went to college—they went to a private university—it was $15,000. Now we know college is upsides of 40, $50,000. So although we're in a historically high inflationary period today, inflation is always a risk that we help our clients navigate.

So there are different ways that we can combat inflation, and I know we'll get into that later on. But I'd just say, we may not be able to avoid inflation completely, but there are steps that we can take to add that protection to your portfolio and start protecting your lifestyle for that future purchasing power, and it's just things that we can do to help mitigate some of the impact that can have on inflation on your goals.

COLLEEN: Yeah. No, and before we get to the how to protect those plans and the steps that you mentioned, Leanna, Jurrien, I want to turn back to you. Can you give us some historical perspective on how these different periods of inflation have affected the markets of investors in the long run?

JURRIEN: Yes, absolutely. So in this chart, I show kind of like the menu of basically most investable asset classes. And I show what we think about as risk on the horizontal access, which is actually the annualized volatility—maybe slightly different way to think about risk than what most people would think about, which is a loss of capital, but volatility is one way to think about this. And on the vertical axis is the annualized return. And this chart goes back 70 years, so it gives a good representation of what the risk/return characteristics have been of various asset classes.

And the average inflation rate, historically, is around 3, 3.5%. That is the horizontal line. And, of course, as investors, we want to be above that line, right? We want the return on our portfolios to be positive not only in nominal terms, obviously, but also in real terms so that we are maintaining our purchasing power. And generally speaking, the stock market is well above that line so—the stock—equities is a good [Indiscernible 0:13:15] of inflation protection because you have growth and you have the compounding of that growth. Bonds, historically, have been good as well, but of course in the last few years, they have not been. The real yield has been negative. It's getting a lot less negative now. And actually, the 10-year yield is now at about a zero real yield. So they tend to be above that line, but in recent history, they have not been.

And then you get into other asset classes like commodities, which are very, very volatile. You can see them kind of at the bottom right there. So commodities tend to not be an all-weather asset, but they certainly are good assets during inflationary periods like we see today. So certainly in the last, you know, couple of years, commodities have done extremely well. So the reason I'm showing this chart is because a lot of us think in terms of a 60/40 index or model, right? You've got 60% stocks, 40% bonds. And during periods of low inflation, like the last 20 years, the 40 of that 60/40 tends to have a negative correlation to the 60.

So even if bonds don't give you a lot of yield, which they certainly don't—although they're becoming more competitive almost by the day—at least they give you that insurance that if the 60 goes down, the 40 goes up. But that only tends to work during periods of low inflation. During periods of above average inflation—and of course, the '70s comes to mind. I think we're not in the '70s, but periods of higher inflation tend to produce a positive correlation between the 60 and the 40.

And so what I've done here is I've highlighted the 60/40, which you can see is right on that curve, which is kind of like an efficient frontier, right? So in other words, you're getting a good amount of return for an appropriate amount of risk or volatility. But then I just kind of did a back-of-the-envelope exercise. And in that 60/40, I added more value stocks, which tend to be good inflation hedges, historically. And on the 40 side, I took out some of the bonds and put in TIPS, for instance, a little cash, some high yield bonds, which tend to have a higher yield than treasuries and a lower maturity, a lower duration, so that makes them a little bit more, kind of, interest rate proof, if you will.

And I added some commodities and some gold, and you can see that that kind of inflation, 60/40—which is not portfolio, it's just a back-of-the-envelope-index that I created—tends to produce a little bit more volatility, but also more return. So I think when we think about inflation-proofing our portfolio, I think part of the task is to just think more creatively about what goes into 60 and what goes into 40. And obviously, folks like Leanna are very well equipped to do exactly that.

COLLEEN: Yeah, and on that note, Jurrien, that diversification between the 60/40, Leanna, let's turn to you now because we wanted to talk about some of those things that investors should be thinking about with the higher levels of inflation. And speaking to what Jurrien just said, can you add to that?

LEANNA: Yeah, thank you. So it comes down to really looking at that investment mix as a whole and evaluate where you stand. We put this chart up a lot, but left to right it shows the different types of asset allocation we have. And this is the foundation of the plans and how we work with our clients. First, before inflation—that's a big part of this—but it comes down to building that portfolio that's aligned with you, so your risk tolerance, your time horizon, the goals that you have, your financial picture. And you can see left to right here it goes from a conservative allocation to aggressive growth.

So we speak to the power of a diversified portfolio, and we speak often of how having that diversification broken down between the different asset classes—you can see the colors here: stocks, bonds, and cash. Stocks—I'll use as an example in a moment—are the blue. But having the diversification really helps manage and spread out the risk that we can feel, especially in times of market volatility and the ups and downs that we can feel and see. But also the power of a diversified portfolios does help with inflation, as Jurrien was just mentioning, combatting that over time. So the equity component of a diversified portfolio—Jurrien just pointed out—equities will keep pace with inflation more so than some of the other vehicles.

But we work with clients to first break down: What is most prudent for you to be in based on the goals that you have in your financial picture? But how could we also potentially reallocate some of the investments? We'll say that 60/40, again, as an example. How can we break down the different types of stocks, the different types of bonds or certain investments that we know may stand up better than others when it comes to inflation?

Just the last thing I'd say before we break down the how: I think for those that are longer to retirement or longer to the need to start using their money—so let's say those are 20, 30-plus years away from retirement—typically your growth, if it's 70/30, 60/40, but your diversified growth portfolio is going to keep up with inflation over time. For retirees or those in more of a conservative investment mix, they may be exposed today to that higher inflationary risk. So adding different types of inflationary resistant vehicles to your portfolio can help mitigate that. And then also those in retire—who are retired today, they also benefit from things like inflationary adjusted income, such as Social Security or defined benefit pension in addition to what your portfolio has. But adding inflation resistant investments and diversifying across may help reduce the risk.

COLLEEN: Yeah, so I want to dig into that a little bit, Leanna, in terms of: What kinds of investments are you actually talking about? And Jurrien had mentioned TIPS, for instance. So let me ask you to define some of the financial terms we're hearing—because in the headlines, there's a ton of things going on, and it's a lot to take in—and then would love to hear the impact on those closer to or in retirement, as you just said.

LEANNA: Yes. So here we bolded out the different types of inflation resistant investments. And I know Jurrien had just listed them out on his back-of-the-envelope example, and we put these here just to help define them. So first, there are equity investments to consider, so that could be commodities, commodity producing equities like energy or material. There are value stocks. So those can be our growth stocks that often can pay a dividend. They're the value companies we speak on.

There's US and international stock as well as real estate investment trusts, REITS. Those have typically fared well in inflationary periods. A REIT—a little bit of a financial term there—but it's a company that owns—operates financial income producing properties, so think like apartment buildings or hotels or retail centers that have an income stream kicking off of it. So there are six investments. We just mentioned TIPS. TIPS stands for—and that's a lot in the headlines—Treasury Inflation Protected Securities. They are bonds whose principal and interest rate payments are designed to ride along with what inflation is doing. TIPS also is a great way to help protect the value of other fixed income portions that you may have in your portfolio.

Lastly—we talked about this—gold. So commodity historically has been an effective hedge against extreme inflation, but we have seen that it doesn't have the compounding returns and through different times has been relatively flat. So that's why I think it's important to keep in mind, for those in retirement or close to retirement: The fundamentals of investing go back to that diversified portfolio and making sure that you have that healthy mix of stocks, bonds, and short term investments. And then we can make these subtle tweaks to help reallocate the underlying investments to be more of those inflationary resistant type of investments.

COLLEEN: Yeah, the healthy mix is really important. So, Jurrien, Leanna talked a lot about those types of investments and a good start on equities. But let's get to your perspective as well here. What are you seeing? And what should investors be thinking about, given the latest market moves?

JURRIEN: Yeah, so the market—the stock market, I think, requires a little bit of patience at this point. There are times when there are a lot of tailwinds—it's like being out on a boat—and there are times when those tailwinds are not as strong or even turn into headwinds. So for instance, last year, we had 50% earnings growth in the stock market, in part because of the rebound from the pandemic lockdowns. On top of that, the liquidity environment was very, very ample, right? The Fed was buying bonds. Interest rates were super low. The 10 year Treasury was at 1%. It's now at almost 3%. There were lots of tailwinds and the market went up a lot, right? In the last two years until this year, the S&P was up about 116% from the lows in March of 2020.

At this point, though, earnings growth is still positive. It's expected—we're in earning season actually right now and so far, so good. Earnings are expected to grow at about 10% this year. So that's still good. It's not 50%, but it's better than nothing. But the liquidity environment is—you know, that tide is going back out. So as the cost of capital rises for everyone, it does for the stock market or for the companies in the stock market as well. That doesn't mean the market goes down, but it does mean that you have less of a tailwind from earnings and you no longer have that tailwind of valuations benefiting from an increase in liquidity. So, to me, it suggests that the markets are going to be in a holding pattern for a while, which is actually fairly typical during periods when the Fed is tightening policy. So I think for investors, some patience is called for here in the stock market.

COLLEEN: For sure. Patience is key. Well, it looks like 20 minutes has flown by pretty fast with both of you, so thank you both, as always. And to those in the audience, if you have questions about making a financial plan or staying on track, Fidelity can help. And you can always call us, go online, or go to our website, download Fidelity's app to learn more.

And again, thanks—huge thanks—to both Fidelity's Jurrien Timmer and Leanna Devinney. Great to see you both again. And next week, we will take a fresh look at the news, the markets, and what's affecting your money. Hope to see you then. And last, speaking of investments, remember Earth Day is this Friday and the theme is Invest in Our Planet. So have a great rest of your week.

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