Fidelity Viewpoints®: Market Sense

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TRANSCRIPT

SPEAKERS:

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Jim Armstrong: Hello, and thank you for joining us for Market Sense. I'm Jim Armstrong with Fidelity. There is a lot of news to cover for investors today. The tragic war in the Ukraine does continue, unfortunately. Here at home, sky-high inflation is making a lot of headlines, the head of the Federal Reserve Bank signaling a half-percentage point interest rate increase coming soon, maybe with more hikes on the way as well. Mortgage rates have jumped again also. All of that comes as the spring home-buying market, of course, kicks into full swing.

So today, we're going to take a look at the markets and the economy as a whole, like we always do, but we'll dig a little bit deeper into real estate. We'll look at mortgage rates and their impact on the housing market and the overall economy, especially for someone who might be planning to buy or refinance. We'll also talk about how real estate as an investment might fit into your financial plan. So to help guide that conversation, Jurrien Timmer is here with his big picture view of the latest world news and market conditions and, crucially, what they mean to us as investors. And Randelle Lenoir is back to share how she and her team help people build and update their financial plans to stay on track with their personal goals, even during times like these. Jurrien, great to see you, as always. Thanks for being here, but Randelle, welcome back. It's been a few months since you've been on Market Sense, so it's great to see you again.

Randelle Lenoir: Yes, great to be back.

Jurrien Timmer: Great to see you guys.

JIM: Jurrien, let's start with you if we could. It is Tuesday, April the 26th, and as I mentioned, I really want to dig into the headlines, this news that's coming, the Federal Reserve set to increase interest rates, as you say, going big maybe with more to come. Just sort of help us wrap our heads around what we should be thinking about this.

JURRIEN: Yeah, so it's been obviously an unusual cycle, to say the least. The Fed six months ago was, I think, expecting or the market was expecting the Fed to just gradually return to a—what's considered a neutral policy. Remember, during COVID, the Fed lowered rates to zero. It did $120 billion per month of asset purchases. And then when the crisis passed, at least economically speaking, that was no longer justified. So the Fed then—what it normally does, it tries to bring policy from highly accommodative back to what is considered neutral, which the market views and the Fed views as at around 2.5% in terms of short term interest rates. But that was six months ago when the inflation story was considered to be transitory. Of course, we all know that it's being a lot more persistent.

Not only have the supply chain bottlenecks persisted, but then we had the Russia/Ukraine conflict on top of that, which created, through sanctions, a whole new set of supply chain bottlenecks, but more in terms of natural resources: natural gas, oil, diesel, corn, wheat, fertilizers, you name it. Now we have, of course, lockdowns in Shanghai and now Beijing where—which obviously, China is a major producer of a lot of stuff that we Americans buy. So the inflation story has become more persistent. And as we all know, the CPI is up 8.5% from a year ago. So that has caused or forced the Fed to kind of use more of a shock therapy, if you will, more of a shock-and-awe type of approach.

And if you look at this chart, right, that yellow line was, what we call, the forward curve, the expected path of the Fed six months ago. And you could see a gradual return to something around 2%. Now we have the blue curve, which is a much, much steeper curve to a higher ending point, which we call the terminal rate. Instead of going to 1.2% or 2%, now the market expects the Fed to go above 3%, which would be considered a tight policy, right, if the neutral policy is 2.5%.

So given that the Fed has actually barely even moved its interest rate, right—it's only tightened once by a quarter point back a month ago—just mathematically, if the Fed's going to go from here to over 3% in the next year, it better get on it. And that's why the expectations are that the Fed will go half a point next week when it meets at its next FOMC meeting and possibly, or probably, half point increases from there until it gets to that terminal point. There's a lot of people thinking about: What does that mean? For me, the more important part is where the Fed ends up, not how quickly it gets there because remember, the rate that the Fed actually sets is called the overnight Fed funds rate, which is a rate that banks use to borrow money from against each other from. Not many banks even use that rate anymore.

So what happens these days is that what the Fed signals that it's going to do something and then the bond market does the actual move, which it already has done. You see the black line there. That's the 10 year yield. It went to 3% last week. And it was 1% a year ago. So a lot of movement has already taken place. And that's why next week when the Fed does its big move, it's really just catching up to what's already happening.

JIM: Randelle, I would love to bring you into the conversation. You and your team are literally on the front lines talking to investors and clients every day. They're coming to you and your team with the subtext of everything Jurrien's just described, right: the highest inflation we've seen in 40 years. Mortgage rates, in specific, they're above 5%, which is almost out of recent memory for most of us, 5% for a 30 year fixed rate. I'm curious what you and your team are hearing from folks who want to buy or sell, or maybe invest in real estate in this kind of environment, in particular.

RANDELLE: Yeah, you're right. Inflation, mortgage rates—there's a lot to consider here, but the bottom-line question is: Can you afford it, right? Can you afford it? So there are a lot of different things that you should be considering here—your income, your amount of a down payment that you can afford, your credit and your credit score, right, and your other debt that you're dealing with at the time—to determine whether or not you can afford it. So a good rule of thumb here is that your total home value that you're looking for should be a maximum of three to five times your annual household income. And your placement on that range from three to five depends on debt, okay? So this is a consideration to make. I'll walk you through all three of them, right?

So let's say you're debt free. First of all, good job. Good job. You're debt free. You should probably consider a house that is no more than five times your annual income, right? But let's say you're like many Americans out here; you're furnishing debt with your income. And let's say the amount of debt that you're furnishing is less than 20% of your income, then maybe you should aim for no more than four times your annual income for the amount of house that you're trying to buy. And let's say you're spending more money to pay down that debt, like more than 20% of your income. You should aim to spend no more than three times your annual income on a home. And that's a good rule of thumb for people to consider, as far as what they can afford.

JIM: Before the webcast got started, we were just talking off camera. You were mentioning that, as I call them, real people really are coming in to Fidelity branches and saying, "Hey, I'm curious about buying a house." That blew my mind. I hadn't thought about it because, again, as Jurrien was laying out, mortgage rates are high, home prices themselves are high. What's really driving people's interest in real estate right now do you think?

RANDELLE: Yeah. I think one thing to consider here is that we always think that different changes in the market will drive people away from buying homes, but people still want homes. People are still having families. People still want more space. People still want to move from the city out to the suburbs. They want a backyard. All of these things are still happening. And like you mentioned before, springtime is just the time that it tends to be on people's minds. So, yeah, people are coming in quite often to talk about whether or not they can afford to buy a home right now.

JIM: When they do come in with those questions, Randelle, what do you sort of suggest? Any rules of thumb for folks who might want to be better prepared as they get ready for a move?

RANDELLE: Yeah. So lenders are often looking at your debt to income ratio, which is your monthly amount that you're paying, you know, to pay down your debt and your income -divided by your income, sorry. So that's your debt to income ratio. Now, lenders—it depends on the lender—but lenders usually want to see this no more than anywhere from 36% to 42%, right?

You're considering, again, affordability. Especially in this environment with inflation, it's really important to make sure that you're considering how much you can afford with your home and other things that are going on right now, like the amount that it takes to fill up your car, the gas tank, right now, the amount it takes for you to buy groceries, even your favorite streaming service, right? All of these costs need to be taken into account when you're considering your budget and how much that you can afford. And, again, don't forget about the long term important things as well when you're considering your budget: saving for retirement, saving for those long term healthcare costs, and for college. So all of this goes into how you approach a lender.

JIM: Love it—thanks for that. Jurrien, I'd love to get your historical perspective, if I could, here. I know you've done some thinking about inflation and home prices going back in time. And going back in time to 2007, 2008, 2009, not the most awesome time to be in the housing market. Lots of people remember some hard days back then.

JURRIEN: Yes. Back then, of course, people were—how do we call it—they were monetizing the equity in their homes, right? Remember in '06, '07, '08, we had pretty shady underwriting standards, or underwriting practices, happening in the mortgage market—mortgage underwriters originating mortgages to people who maybe couldn't afford as much. And what Randelle said about, kind of, these guidelines is very important. But people had equity. They had extra equity that they hadn't borrowed against in their home and then they got equity lines of credit on top of their first mortgages. They got second mortgages, HELOCs.

I don't see any evidence of the system being stretched like that this time, but COVID has changed the economy, right? People have much more flexibility of how they work. You know, many—most people are back to work. Actually, there's a lot more job openings than job seekers. So it's a very tight labor market. And that also feeds into what Randelle is saying that even if your mortgage costs should be seen as a percentage of your income, if the income is going up, then you can afford more, right? So when we think about mortgage rates—and you see that in the purple line here—they've gone from about 3% a year ago to 5% or higher now, but we need to see that in context of what people are earning, right? So if your earnings are going up, you can afford a higher rate.

But we do have kind of a perfect storm here because if you look at the top panel, that's the actually change in home prices, and they're up about 20%, 30%, since the lockdowns began. And for a while, until a few months ago, you had a surge in home prices, but you still had very, very low mortgage rates. So that still kind of worked. Now you have higher mortgage rates on top of higher home prices, and that's a different dynamic. And now in parts of the country, homes are being built very quickly.

So there will be an increased supply, which hopefully will kind of correct that market dynamic, but that doesn't happen in all parts of the country. Certainly, the parts that we're coming from, there's only so much space to build new houses. So I think it depends on where you live. But as Randelle said, demographically, things are changing because of COVID and people have more freedom to live where they want. And I think the areas that are more interesting or more affordable in terms of homes will get played out that way.

JIM: Randelle, maybe you can build on that idea just a little bit, what Jurrien just described: the situation of, perhaps, potential homebuyers or movers having a little bit less buying power, potentially, certainly dealing with higher prices and higher mortgage rates. What might you suggest for buyers to just sort of put themselves in the best possible position given those maybe unfavorable circumstances?

RANDELLE: Yeah, absolutely. Well, first thing, you want to make sure you have a good handle on your credit before you approach any lender for a pre approval. Mistakes happen. So make sure you check your credit report. Make sure everything's up to date and as accurate as possible before you have that conversation. The second thing is: You want to make sure that your credit score is as high as possible. The difference in a good credit score could really mean thousands or more money over time that you're spending above what you might otherwise if you had a less favorable credit score. So get your credit score as high as possible. That helps make sure that you get a good rate.

Another way to consider getting a good rate is how much of a down payment that you can afford. So if you can afford a larger down payment, that is a good way to approach the lender in the pre approval process and get an optimal rate for this home that you're looking for. And a lot of what's going on right now, what Jurrien mentioned, the housing market's hot in a lot of places. People are buying homes. They're paying way above the asking price. There are all cash offers going on. I mean, it's a lot going on out there. So you have to consider whether or not you can compete in that market. And if you can't, maybe you should consider a lower price range home when you're approaching this conversation.

JIM: I want—yeah, that's really good advice, exactly. This might not be the time, ultimately, so you have to make a really strategic decision. I want to ask you to pivot a little bit, Randelle. We've talked up to this point for folks largely maybe thinking about buying their first home or relocating, moving to a bigger or downsizing to a smaller home. How about folks who want to look at real estate as a pure investment, maybe folks who think it could be potentially a hedge during inflationary times like these? So what advice would you have for someone who's maybe not necessarily looking to move in but looking for real estate as an investment?

RANDELLE: Yeah, absolutely. So this option's available for many investors in their investment accounts: real estate stocks or Real Estate Investment Trust. We also call those REITs. These may do well when there's higher inflation that's pushing up the price of real estate assets. So what a REIT is: It's the company that owns, operates, or finances income producing properties, properties like apartment buildings, hotels, real estate centers—those types of properties that produce that steady income potential. So that's what a REIT is. Now, this sounds attractive in certain markets, but the market's always subject to change. Storms come. None of us have a crystal ball about what's coming up, so we still truly believe that diversifying is the key to success.

And I can talk a little bit about actual real estate here. I would love for people to consider that the house that you buy to live in may not traditionally be something that we consider an asset or an investment, right? You should buy a home because you want to enjoy it. Now, if you buy a home, of course, the price can go up and you can sell it for more than you spent, like if you made some money on paper, but sometimes the real cost—you consider the maintenance and the taxes that you pay to purchase that home—it ends up being a wash sometimes. So, again, if you're approaching this as a purchase for something for you to live in, I wouldn't necessarily consider that an investment, right? The home that you're living in, you should buy it for enjoyment.

However, when you think about buying something as an investment property, a physical investment property, there are three things that you should really consider. It takes a little expertise to know how to approach the market, right? There are a lot of different components that go into that, like housing costs in the trend of those costs, like Jurrien was talking about, the rates. Are people moving into that area? Are people moving out? What types of real estate are they looking for? These are all things that take a little expertise—probably a lot of expertise, right—for you to do successfully.

Effort—to be a landlord takes a little effort, right? You're going to be making those plumbing calls late at night and then dealing with tenants, right, or you can hire it out, right? You can pay a little extra money, but it takes effort. Lastly, it takes time. It takes time. Do you have the time to invest in something long term to see it through? So those are the considerations that I would invite people to consider when they're thinking about getting into an investment property. Of course, it's a great way to get some passive income, but if you don't have the expertise or you lack the effort or you lack the time, maybe it's a good time to talk to your financial consultant or financial planner and really approach how this looks for your situation. There's options for everybody, right?

JIM: Yeah, I know, I think that's the bottom line, right, is that no one investment fits everybody. Whatever fits you is pretty much unique to you and your circumstances, your risk tolerance, your timeline. So all of that is really well said. Thank you for that, Randelle. Hey, Jurrien, with a couple minutes left, one final question for you about, sort of, inflation writ large. Maybe get a little bit into the headspace of us as a collective here. Inflation's hot right now, right? That can get people fearing or anticipating ever increasing inflation. That worry about the future has the potential to affect what's happening right now. I mean, is that a real fear?

JURRIEN: Yes. So inflation usually starts as a tangible something, a shock, right? Think about the oil embargo of the '70s, the supply chain bottlenecks, this time, Russia/Ukraine. But the risk is that the longer it persists, the more it becomes a feedback loop on itself, right? So remember—well, not all of us were around in the '70s, but what happened in the '70s was people started to change their behavior because they expected inflation to persist. Then, you know—and back then, about a quarter of the workforce was unionized.

So through cost-of-living adjustments, there was a lot of collective bargaining going on. And people got those expected inflation changes built into their wages, which, of course, is a good thing. But for the Fed, I think this is kind of the main risk right now. We know that part of the inflation story is transitory because the base effects start to wane. So I don't think anyone expects inflation to be 8% at the end of this year the way it is right now. Maybe it's at 5% or even 4% a year from now, so you will get some improvement there.

But I think what the Fed is concerned about and what we all should be concerned about is that if the psychological impact starts to feed on itself and people start to change their behavior because they expect this to continue, then I think for the Fed, it will be more difficult to put the genie back in the bottle in terms of inflation. And one way that I follow this is in this chart. This is a very esoteric inflation indicator, but it's the five-year/five-year forward TIPS breakeven, which is what the market expects inflation to be five years from now for the next five years. I mean, who makes this stuff up, right? But anyway—

JIM: That's why we look to you. We look to you for this.

JURRIEN: It's a very long term expectation for inflation—

JIM: Okay.

JURRIEN:—that accommodates for all the bottlenecks and all the base effects that we're seeing now. You can see that that's starting to move up a little bit, and I think that's going to be an important factor to consider when we wonder when is all the red on our screens going to end, which is when the Fed is going to kind of declare victory over inflation.

JIM: Got it, okay. So plenty to follow up with you on over the coming weeks and months, as always, so thanks for that. And, Randelle, thanks for joining us again this week. For those faithful viewers in the audience, Leanna Devinney will be back next week. Also, for folks in the audience, if you've got questions about making a financial plan or staying on track, just remember that Fidelity can certainly help you with that. You can always call us, go online, download our app, take us with you on a mobile device, and begin to learn more that way by asking questions digitally. Again, huge thanks to Fidelity's Jurrien Timmer and Randelle Lenoir. Next week, we'll take another fresh look at the news, the markets, and how it's all affecting your money. We hope to see you then.

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