Fidelity Viewpoints®: Market Sense

Week 98, May 10, 2022

TRANSCRIPT

SPEAKERS:

Jim Armstrong Leanna Devinney Jurrien Timmer

Jim Armstrong: Hello, and thank you for joining us for Market Sense. I'm Jim Armstrong with Fidelity. As we speak today, markets are reacting to a range of factors: chief among them, the Federal Reserve's recent interest rate hikes. There's also concern over, what some fear could be, our economy's potential dip into recession—to say nothing of the ongoing war in Ukraine and COVID 19 lockdowns in China, both of which are, of course, disrupting supply chains.

So today, we'll do our very best to try to break down what it all means to the markets, to you and your money, and we'll talk about things you might try to do to protect yourself and your investments as well. To help guide that conversation, Jurrien Timmer is here, as always, with his 30,000 foot view of the latest world news and market conditions and, of course, what they mean to us. Leanna Devinney is also here to share how she and her team help people create and update their specific financial plans to help them stay on track with their goals.

I wanted to thank you both for being here. A quick callout: Today marks our 100th episode of Market Sense. At the moment, you could be watching us on Fidelity's website or on any number of social media channels. You could be listening to us on our Market Sense podcast. It's quite an evolution, Jurrien and Leanna, from the emails I sent to you both in March of 2020 when I said, "Could you please join me for a few weeks for a webcast?"

Leanna Devinney: It really is. I can't believe it's been 100 episodes. It's been amazing and I'm glad we've been able to be here through many different market events and client events, so thank you.

Jurrien Timmer: We still haven't actually met each other in person, but we're going to have to change—fix that very soon.

JIM: That does remain true. That's right. Let's get right to it, Jurrien. It's May the 10th. As I mentioned, the Federal Reserve was true its word. They raised interest rates by half a percentage point last week—more rates almost certainly coming very soon. Now, the Fed, of course, is trying to tame inflation, but, Jurrien, I'd love to hear your thoughts right now on that strategy and what you think it'll mean to the markets and investors as we go forward because we also have to mention how the markets have generally been responding over the past few days—and in a word, badly.

JURRIEN: Yeah, so if you just take a look at this chart, right, that yellow line is called the Fed funds rate. That is a short term interest rate that the Fed has direct control over that it sets at its FOMC meetings, as it did last week, and it went up 50 basis points or a half percent. Then that orange line is what we call the forward curve, which is what the market is pricing in in its expectation of what the Fed is going to do going forward which, of course, is in part driven by what the Fed is saying it's going to do, right?

It's kind of a circular loop of the Fed saying -conditioning the markets and the markets executing on that. As you can see, that orange line is going up very, very sharply until about a year from now, and then it starts to level off. And so even though the Fed has only raised rates twice at this point, it has signaled that it's going to go a lot more, including several more half point hikes in the coming months. And if you look at that black line, that's the 10 year Treasury yield. Of course, the bond market is reacting to this, as one would expect, but it's been a pretty violent reaction. You look at how sharply that yield has gone up.

And one way to think about how all of these pieces kind of fit together—and we'll cover this a little bit later as well in our conversation – but the Fed realizes it can't do anything about supply chain disruptions. It can't do anything about the bottlenecks for natural resources because there's a war in Europe or there's a lockdown in Shanghai. It's powerless over that, but what the Fed can do is try to curtail demand and allow inflation to start to moderate that way.

And the US economy is pretty strong still, even though there's been some signs of a slowdown. And as you mentioned, there are fears of a recession, and we can talk about that later as well. But what the Fed's trying to do, it's trying to, what we call, tightening it's trying to tighten financial conditions. Financial conditions is just the access to liquidity. And that could be through interest rates. It can be through the stock market, through credit spreads, through mortgage rates. And as the Fed tries to raise the cost of capital for everyone, whether you're a homebuyer or a company or someone in the stock market, the repercussions of that are felt everywhere, including in the stock market.

And someone might wonder: What do interest rates have to do with the stock market? Well, they're directly related because the way we value stocks or the market in general is: We calculate the present value of future earnings. And the present value uses an interest rate. And if that interest rate goes up, the present value goes down, even though the earnings might still be fine, which they are. So if the present value goes down, the P/E ratio, the price to earnings ratio,

goes down. This process of the markets rerating themselves or derating themselves or repricing themselves in the last so many weeks has been entirely that process of finding out what the right valuation is, given that the cost of capital is going up.

So this has not been an earnings story at all, but it's been an interest rate story. Of course, the bond market is directly impacted because that's a direct reflection of interest rates. But the stock market is also impacted. And at first, the market was kind of ignoring all of this, but then in the last few weeks, the market is recognizing that, okay, yeah, this affects us, too.

JIM: A couple of follow ups for you on that, particularly on bonds, in just a moment, Jurrien. But first, Leanna, I'd love to bring you into the conversation for your sense of how folks are reacting to this when they're talking to you and your teams about decisions they should be making themselves. I know in past weeks, you've said a big concern people have brought to you is: When will inflation calm down? When will I have to stop worrying about inflation? So that's what—the Federal Reserve is trying to answer that question indirectly, right? But it comes at the expense of other experiences in our lives. So maybe just walk us through that a little bit.

LEANNA: Yeah, you're exactly right. I think what we're hearing often is that they're feeling the volatility. So it's volatility and concerns about the market, inflation, when will it go down, questions on what they're seeing in the headlines such as: Is a recession on the horizon? And so, overall, people don't like to see their investment accounts drop, of course. And April was a hard month in the market. In the past week since the rate hike, we are seeing the markets respond poorly, but we see, and history shows us, that rate increases are followed and accompanied by stock market volatility. And sometimes we can see a sizable pullback, which we have seen.

With the increased rate hikes and the impact, we're seeing everything from: That's going to impact credit cards to car loans and savings rates. So I think it's helpful to just understand when rates go up, it's first going to immediately impact what we're borrowing, so that's rates on credit cards. We're seeing that in mortgages. The perspective is: For credit cards or personal loan interest, as an example, the interest may rise, but it's small enough where that's not going to make a huge impact on your monthly payment as much.

When we see rates go up on—for our earnings, such as savings, fixed income – what we'll talk on—we see that come a little bit slower. So I'd say we'll spend time on the fixed income and bonds in a moment because we're definitely seeing clients ask more about the rates that they can get on their cash savings and CDs, but certainly, getting a mixture of concerns with the stock market volatility and just understanding the why behind it.

JIM: Thank you for that. That's a perfect segue to one of the follow ups I had for you, Jurrien. I wanted to talk more about bonds. Certainly, higher interest rates could be good for those who feel comfortable or want to lean into fixed income investments, and that hasn't been the case for the past few years. Is that too simplistic a way to look at it?

JURRIEN: No, it's not. And if we look at this chart here, in the top in the black you see the nominal yield. So when we think about Treasury yields, we think mostly about nominal yields. We've had a pretty epic run up, right? I mean, two years ago, very briefly during—in March of 2020, the 10 year yield dropped to 0.3%—an unheard of number. And even a year ago, it was at around 1%. As of yesterday, it was over 3%. We're still there, but it's coming down a little bit. That brings us back to the level that we saw back in 2018. So we've had quite a reversal.

But what's interesting is that if you look at the orange line, that is the real rate. It's not the way we tend to think about real yields is to subtract not what's currently the inflation rate from the CPI because that tends to be backward looking, but we tend to subtract the inflation expectation implied by the TIPS market, which are Treasury Inflation Protected Securities. So that's a pretty big part of the Treasury market, and investors are weighing every day what they think inflation is going to be. That is reflected in real yields from the TIPS market, and that's what the orange line shows.

What you can see is that until very recently, the rise in nominal yields was not accompanied by a rise in real yields. And that's because the rise in nominals was kind of, you know, reflected by inflation, but not so much by rising real yields. But now that the Fed is really serious—it's entered warp speed in terms of bringing financial conditions back to kind of where they used to be—the real yields have reset very, very rapidly. And that's an important thing for bond investors because, as we all know, the last few months have not been friendly for kind of a traditional 60/40 type of portfolio where you have some stocks and you have some bonds and you kind of had to hold your nose a little bit to own the bonds because you weren't getting much yield, but you were supposedly getting the diversification benefits.

In the last few months, that has not worked out, right? Bond yields have gone up while stock prices have gone down. But now with yields above 3% and real yields, more importantly, back to positive levels after several years of deeply negative levels, I think that kind of creates a more interesting value proposition for investors because now you may still think 3% is not enough if inflation is 8.5%, but it's better than 1%. And guess what? Inflation expectations are starting to come down.

If you look at the TIPS breakevens, for instance, for the five year time horizon, in March, those were 3.75%. Today they're about 3.20%. So investors are starting to price in the expectation that inflation is going to start moderating. By the way, tomorrow we have the CPI report, and that'll be an important data point to either validate that or question it. But if inflation pressures are starting to moderate a bit and now real yields are positive and nominal yields are at least above 3%, maybe that starts to become more interesting for not only bond investors but just diversified investors who use bonds as one of the anchors in a portfolio.

JIM: Perfect. Perfect lead in to Leanna to the heavy lifting question that we've saved for you to help put these pieces together now, right? So I've got my portfolio. I meet with someone regularly to go over it and it's aligned to my age and my risk tolerance, how much risk I want, my time

horizon. But I also have to be aware of how the world around me is shifting, exactly as how Jurrien just described. So how do you help people put those pieces together?

LEANNA: Yeah, so we can see here on the screen the different mixes out there. We'll talk in a moment how we build those for the clients and, again, customized to your specific situation. But with this rate increase, we have been getting questions from our fixed income owners and investors as well as those that have that healthy mix of stocks and bonds. So we've been talking a lot about, in general, why we own bonds and, really, it's two reasons. It's income and stability is why you purchase bonds or have them as part of your mix. Stability of what that provides when you're in a diversified portfolio, it can help smooth out your investing experience. So even two years ago, going back to the March to May 2020 time horizon, we had a significant pullback in the stock market. And overall, clients who had a diversified mix felt comfortable and confident.

During that time in this low interest rate environment we were in, we weren't getting the income component of bonds. But now with rates rising, that income piece will be prevalent, and fixed income buyers will now feel the benefit of those higher rates. But what we do see, it's an inverse relationship to the price of bonds. So when interest rates rise, the current market price, we're seeing bonds decline.

So it reminded me back in 2018, I was an advisor at that point in time. A lot of investors who had that diversified portfolio were calling in and questioning why their bonds were losing money. Again, it's that inverse relationship. So I think it's helpful to remember, again: Why do we own bonds? They're there for income and stability. And depending what your specific goals are, bonds and fixed income are a great way to achieve diversification and can play an important role.

Looking at these—there's four allocations here on this chart—it's showing the different mixes of stocks and bonds that you can have. So generally speaking, those who are farther from their goals and are able to weather short term volatility and some of the ups and downs, we typically see they invest   their investment looks more on the right side. We see more stocks than bonds. We know with stocks, when we have time on our hands, we're going to see growth, and over time, that helps keep pace with inflation as well.

Those that are in the middle or more toward the left, they're shorter to their goals or they're using money or in need of it, in need of more income producing, we see less risk, also less returns over time as well. So, again, I think this is generally speaking, but it's helpful as we build plans for clients customized to your situation. It's helpful to understand what and why we own it and the parts that they play.

JIM: Yeah, absolutely—absolutely the case. With the few minutes we have left, let's look forward a little bit. And, Jurrien, we can start with you. I mean, no crystal balls, of course, but I know that as a student of history and someone who appreciates trends and looks for things in the past that could

echo in the future, as you've said, what do you see in the near term based on what's happened recently? In particular, I know you wanted to shed a little more light on recent equity market activity.

JURRIEN: Yeah, so I think one good way to think about the different factors influencing stock prices is that you have earnings, and you have valuation, so the price to earnings ratio. It's kind of like a three dimensional puzzle. So when we think about the market, we look at our screens or we look at the news, and we see the S&P 500, the Dow Jones, the Nasdaq and all we see, really, is price. And so that's how a lot of us tend to gauge performance. And, of course, price is the ultimate scorekeeper of where the markets are.

But the way to think about valuation is that prices at the intersection of the P/E ratio, which is the price to earnings ratio, and earnings. And during some corrective phases—not this one, at least not yet—you have earnings falling, and you have the price to earnings ratio falling at the same time. Think about how much price would have to fall, being in the numerator of the P/E ratio, for both of those things to happen at the same time. That typically happens in a recession, which produces a steep bear market usually. Again, I'm not seeing any signs of a recession out there, but I'm not an economist.

Other cycles, like this one so far, you have earnings rising and you see in this chart, the purple line is the expected earnings over a year from now. The pink line is current earnings. The difference between the two is in the panel below. The expected growth is 10%. And that number has been holding very steady, right? So if we were on the brink of a recession, my guess is that that line would be going down, right? The expectations for future earnings would go down because earnings are a reflection of the economy, and if the economy is going into a recession, earnings would be as well. That's not happening.

So the earnings story stays   is staying very strong right now. And all of the price action is a reflection of falling P/E ratios, which, actually, is perfectly rational when you think about what I said earlier. The Fed is trying to slow the economy. It's not trying to break the economy, but it's trying to slow it just enough to tame the inflation beast. And it's doing so by tightening financial conditions, by raising rates, raising the cost of capital. And as I said earlier, the cost of capital isn't input into how we value equities or the stock market.

And so that is a direct reflection of the P/E ratio, which has fallen. It's actually   the P/E ratio based on trailing earnings has fallen nine points already during this correction. And the forward P/E ratio using expected earnings has fallen five points. That is a significant haircut, if you will, in the valuation of equities and something that gives me some comfort that—I'm not predicting that that's all we're going to see, but that's a pretty big derating already. And it's something to keep in mind as we and everyone watching this is pondering what to do with our portfolio next.

JIM: Oh, that's a fantastic perspective. I think that – I hope that comes as a relief, that context, at least, for folks watching and listening. With the couple minutes we have left, I want to ask some

more forward looking questions. Leanna and I were talking last week. The market had a particularly bad day. And we were discussing the fact that—well, hoping that there'd be a quick turnaround the next day because we've almost come to expect that, even, in particular, this calendar year, right?

We've had a really bad Wednesday often followed by a fantastic Thursday or a Friday. You kind of get into that cycle where you expect an immediate turnaround and when you get into a rut or a situation like we're living in right now, and that doesn't happen, people get jittery, right? Anxieties rise up. So, Leanna and Jurrien, I'd love to ask you both. When faced with that question, "What should I do? This feels different than it did even a month or two ago", what do you say?

LEANNA: I'll start. I agree. These are times, as an investor, where your true risk tolerance can come out, your appetite for risk, seeing these swings, and having those expectations. No one likes market downturns. And as investors, we feel the loss two times more than we feel the gain that we have. So I'd say I think it's important to remember that times like these can be really challenging. Those have felt confidence, although still hard, felt confidence when they were building a plan aligned to their specific goals—goals such as their – including their risk tolerance, time horizon, withdrawal need, when they need to use their money. So those that have that plan aligned to specific goals are able to feel less jittery in times like this.

JURRIEN: Yeah. I would just add: Nobody likes this feeling. I don't like it either. You know, corrections that are swift but then reverse quickly, it's almost like a bad dream. It's like, okay, it's over. And this one has some legs to it, and that's not a good feeling at all. But I would just say try to take the other side of it and saying, you know, even though there's red on the screen, maybe there's an opportunity there, and rebalancing, of course, is one of them. So there's nothing we can do about what just happened, but we can think clearly about what the opportunities might be that come from all of this red on the screen.

JIM: Thank you both, again, for sharing your perspective and your time with us today. For those in our audience, another reminder: We know that you can watch or listen to our show in many places, but if you happen to be watching right now on Fidelity's website, you'll find a quick three question survey just underneath this video. If you could fill that out, we'd really, really appreciate your feedback. Again, that's only available, at the moment, if you are watching on Fidelity's website.

And our regular reminder: No matter how you're watching or listening, if you've got questions about making or updating or financial plans or about how to stay on track during conditions like these, Fidelity can always help. You can call us or go online to our website or download Fidelity's app to learn more. Again, tremendous thanks to Fidelity's Jurrien Timmer and Leanna Devinney. Next week, we'll be back to take a fresh look at the markets and how they're continuing to respond to current events and, of course, how you can respond to that. Hope to see you then.

Additional information on Investment Mix:

Data Source: Fidelity Investments and Morningstar Inc. Hypothetical value of assets held in untaxed portfolios invested in US stocks, foreign stocks, bonds, or short-term investments. Historical returns and volatility of the stock, bond, and short-term asset classes are based on the historical performance data of various unmanaged indexes from 1926 through the latest year-end data available from Morningstar. Domestic stocks represented by IA SBBI US Large Stock TR USD Ext Jan 1926-Jan 1987, then by Dow Jones US Total Market data starting Feb 1987 to Present. Foreign stocks represented by IA SBBI US Large Stock TR USD Ext Jan 1926–Dec 1969, MSCI EAFE Jan 1970-Nov 2000, then MSCI ACWI Ex USA GR USD Dec 2000 to Present. Bonds represented by US Intermediate-Term Government Bond Index Jan 1926–Dec 1975, then Barclays Aggregate Bond Jan 1976—Present. Short-term/cash represented by 30-day US Treasury bills beginning in Jan 1926 to Present. Past performance is no guarantee of future results. The purpose of the target asset mixes is to show how target asset mixes may be created with different risk and return characteristics to help meet an investor's goals. You should choose your own investments based on your particular objectives and situation. Be sure to review your decisions periodically to make sure they are still consistent with your goals.

Information presented herein is for discussion and illustrative purposes only and is not a recommendation or an offer or solicitation to buy or sell any securities. Views expressed are as of the date indicated, based on the information available at that time, and may change based on market and other conditions. Unless otherwise noted, the opinions provided are those of the speakers and not necessarily those of Fidelity Investments or its affiliates. Fidelity does not assume any duty to update any of the information.

To the extent any investment information in this material is deemed to be a recommendation, it is not meant to be impartial investment advice or advice in a fiduciary capacity and is not intended to be used as a primary basis for you or your clients' investment decisions. Fidelity and its representatives may have a conflict of interest in the products or services mentioned in this material because they have a financial interest in them and receive compensation, directly or indirectly, in connection with the management, distribution, or servicing of these products or services, including Fidelity funds, certain third-party funds and products, and certain investment services.

Investing involves risk, including risk of loss.

Past performance is no guarantee of future results.

All indexes are unmanaged, and performance of the indexes includes reinvestment of dividends and interest income, unless otherwise noted. Indexes are not illustrative of any particular investment, and it is not possible to invest directly in an index.

The S&P 500® Index is a market capitalization–weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. S&P and S&P 500 are registered service marks of Standard & Poor's Financial Services LLC. You cannot invest directly in an index.

Diversification and/or asset allocation do not ensure a profit or protect against loss.

Stock markets are volatile and can fluctuate significantly in response to company, industry, political, regulatory, market, or economic developments. Investing in stock involves risks, including the loss of principal.

Foreign markets can be more volatile than U.S. markets due to increased risks of adverse issuer, political, market, or economic developments, all of which are magnified in emerging markets. These risks are particularly significant for investments that focus on a single country or region.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities). Fixed-income securities also carry inflation risk, liquidity risk, call risk, and credit and default risks for both issuers and counterparties. Lower-quality fixed-income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

Dollar-cost averaging does not assure a profit or protect against loss in declining markets. For the strategy to be effective, you must continue to purchase shares in both market ups and downs.

Fidelity Wealth Services provides non-discretionary financial planning and discretionary investment management through one or more Portfolio Advisory Services accounts for a fee.

Advisory services offered by Fidelity Personal and Workplace Advisors LLC (FPWA), a registered investment adviser. Discretionary portfolio management services provided by Strategic Advisers LLC (Strategic Advisers), a registered investment adviser. Brokerage services provided by Fidelity Brokerage Services LLC (FBS), and custodial and related services provided by National Financial Services LLC (NFS), each a member NYSE and SIPC. FPWA, FBS, and NFS are Fidelity Investments companies.

The CFP® certification is offered by the Certified Financial Planner Board of Standards Inc. ("CFP Board"). To obtain the CFP® certification, candidates must pass the comprehensive CFP® Certification examination, pass the CFP® Board's fitness standards for candidates and registrants, agree to abide by the CFP Board's Code of Ethics and Professional Responsibility, and have at least three years of qualifying work experience, among other requirements. The CFP Board owns the certification mark CFP® in the United States.

Fidelity does not provide legal or tax advice. The information herein is general and educational in nature and should not be considered legal or tax advice. Tax laws and regulations are complex and subject to change, which can materially impact investment results. Fidelity cannot guarantee that the information herein is accurate, complete, or timely. Fidelity makes no warranties with regard to such information or results obtained by its use and disclaims any liability arising out of your use of, or any tax position taken in reliance on, such information. Consult an attorney or tax professional regarding your specific situation.

Before investing in any mutual fund or exchange-traded fund, you should consider its investment objectives, risks, charges, and expenses. Contact Fidelity for a prospectus, an offering circular, or, if available, a summary prospectus containing this information. Read it carefully.

Personal and workplace investment products are provided by Fidelity Brokerage Services LLC, Member NYSE, SIPC, 900 Salem Street, Smithfield, RI 02917

© 2022 FMR LLC. All rights reserved.

923295.141.1