Fidelity Viewpoints®: Market Sense

Week 103, June 21, 2022

TRANSCRIPT

SPEAKERS:

Jim Armstrong   Leanna Devinney   Lars Schuster

Jim Armstrong: Hello and thank you for joining us for Market Sense. I'm Jim Armstrong with Fidelity.

This week, markets are still coming to terms with what was the biggest interest rate hike seen in nearly thirty years. I'm talking of course of last week's announcement by the Fed of a 3/4 of a percentage point hike that initially triggered a market selloff and continues to trigger some questions about what the Fed could or might do next.

So, that's exactly what we'll be talking about today. We're going to dig into what last week's hike and those that are still to come mean to the markets, to the economy as a whole, and of course, to our personal financial plans.

Leanna Devinney and Lars Schuster are here to help guide today's conversation. Lars joins us from Fidelity's Strategic Advisors. He is the portfolio manager across many of our managed accounts. He's going to walk us through today, some of his team's thoughts on what's going on right now as they manage and make investment decisions on our clients' behalf in the midst of market volatility like this.

Leanna will as always give us an up close look at what she and her team are hearing from Fidelity customers, what their top concerns are related to inflation and interest rates hikes, on track with our financial goals.

Lars, Leanna, thanks for being here.

Leanna Devinney: Thank you. Glad to—glad to be here.

Lars Schuster: Yeah, absolutely glad to be here, thank you.

JIM: Lars, yeah, absolutely. Thank you for joining, Lars. It's been a couple months since you've been with us, but we're always really thrilled to have you with us. And you've got a full plate today, so let's get started.

It's Tuesday, June 21st. As I mentioned, the Federal Reserve has made it pretty clear; skyrocketing inflation needs to be tamped out and they'll only, in the Chairman's words, declare victory when they see really convincing evidence that that's happening.

So, if you could, Lars, just sort of catch us up on what a ¾ of a percentage point hike means for the market and for each of us.

LARS: I think, Jim, in short, it just highlights that the Federal Reserve just wants and is trying to slow down an overheated economy. That's it in a nutshell. Now, was that a surprise to the market I think is a different question. Largely it is what the bond market in particular expected last week with that 0.75% interest rate hike, but that wasn't really the case up until a couple weeks back.

If we all just go back to around that June 10th timeframe, we had the CPI inflation print as you noted about 8.5%, 8.6%. In the two days that followed that higher inflation print, we saw bond yields jump dramatically. So, in other words, the bond market, very, very quickly priced in the expectation that the Fed was going to raise rates to tamp down that overheated growth or that high inflation.

Now, the two-year Treasury really can be a lens of what the market expects the Fed to do over the next eighteen to twenty-four months, so the visual you see on your screen here, you'll see that black line. That's the two-year Treasury. And it has really moved quite significantly just over the last six months, a little bit more stable over the last few days, but you'll see the blue line, that's what the Federal Reserve has done so far. It's well behind it. So again, the bond market simply has priced in a lot more of what the Fed likely needs to do over the coming weeks or so.

Now, in the last week, though, stocks have probably been much more volatile than bonds as the stock market just continues to adjust valuations to this world of higher interest rates, and so why is that? Why is it going through this readjustment process?

Well, higher rates, which again, are designed to slow an overheated economy, just may mean less spending from consumers, maybe less business activity over time, which could lead to slowing corporate profits.

So, a slowing of the overheated economy is one of the key roles of the Fed. That's what they are intending to do. They want to foster an environment of stable prices, something we're not seeing right now. So, inflation really is the key thing that we're really, really watching, and in particular, what's pushed it higher more recently has been fuel, housing, and even things like air fares.

And so, I get this. This is a common refrain we hear which is rising rates really aren't going to impact the fuel or energy side. I think that's true. But it certainly does help impact the housing side and some other areas around how individuals may spend and going out or traveling. And we're already seeing that in the housing side, particularly with higher mortgage rates.

But overall, this is going to take some time. The Fed policy just takes several quarters to really show impact and so we may continue to see inflation toward the 7's by yearend and it's just going to take a little time for the Fed policy to really make a difference.

JIM: And as, Lars, we digest the Fed policy change from last week, really, we need to look ahead to next month. The Fed meets again in July. Expectations for that meeting? And of course, sort of the subtext for all of this is the question I think on a lot of people's minds watching or listening right now, does this mean/are we headed for a recession?

LARS: Right, well here I think the market expects and is leaning towards another 75 basis points, or again, 0.75% hike. That would be in late July. There's a lot of data points here for the market to digest between now and late July, and in particular, another inflation print mid-July. So, I think we should prepare ourselves that the inflation print is probably going to stay high for some time, so maybe that won't be as directionally as important maybe as the last couple. But the fact is, is we still have some time to play out before we see another 3/4 of a basis point hike.

So, what in the interim does this concern of higher rates mean to the economy? And this gets to your, Jim, your question around recession.

I think some are suggesting now that we're in recession. I think that's probably a bit premature, and I think that's largely attributable to stocks being down, you know, 20%, 22%, 23%, but recessions are inevitable. They're a normal part of the cycle. They do happen. The question is, just when? And they very well could be a twelve months out, could be twenty-four months out, but as we see the world right now, we still see some positives that are happening. Consumers are still spending. We see that in credit card and debit card analysis. But it is showing signs of slowing.

Corporate profits are still positive and they're projected to grow by year-end, but again, that bears watching. And banks are still willing to lend but it's getting a little tougher because rates are going up, individuals may not want to borrow as much, as I noted about housing before.

So, I would anticipate slowing growth, with bouts of volatility over this next several months or so, and likely the higher inflation that we see is going to hamper spending, so we're going to be watching earnings as we manage our clients' well diversified accounts here at Strategic Advisers. We're going to be watching for deterioration of employment. These things don't happen overnight, and they're not necessarily immediately recessionary, but it does kind of rhyme with the slowing growth scenario.

JIM: And as those bouts of volatility, as you called them, Lars, end up catching our attention, we see them on the news, we hear about them, people are talking about them at cookouts over the summer, Leanna, I've got to imagine a lot of those questions and concerns are finding their way to you and your team. Maybe after the relative calm of 2021, people are anxious for a lot of reasons.

LEANNA: They are, and market volatility like this brings stress, and typically why we invest is tied to the goals that we have and that can be emotional. So, it's certainly natural to feel uneasy. So, in times like this, my team, really, we start and we educate our clients on what we're seeing in the market. We take a look at where we are in the economy, and again, why we're seeing volatility, as Lars just described.

But we also make sure that every client plan that we look at has three core areas, and we talk about this a lot on the show, but really making sure that we have that all-weather plan.

So, first, it's making sure that every financial plan has liquidity for those unexpected expenses that come up, so really making sure you have that emergency fund.

Second, you know, critical component to every plan is making sure that there's protection, and that can mean different things to different investors. It could be having a conservative income plan if you're taking income to pay for your expenses. It could be adding in a fixed rate investment that may provide a hedge against the stock market, but all things, that's the down weather for your plan, the protection piece.

The last component though, is having that diversified portfolio over the long-term. Even if you're in retirement, we want a long and healthy retirement, so we are planning for the long-term and that gives us the most potential to keep pace with inflation, having that growth piece to your plan.

So, clients who have those three components, they are feeling okay. I think others that this could be an opportunity to further diversify, it's an opportunity to rebalance and we'll talk about that in a bit, or it could be an opportunity to build in some of that protection if your appetite for risk has changed.

But I'd say again, overall, if you have that plan, specific to the goals that you have, I think it's important during times like this to know, while unsettling, volatility is very normal, bear markets are normal. We're seeing recessions, that's a normal course of investing over the long-term.

JIM: Thanks for that. I happen to have my annual checkup scheduled for every June. Mine is coming up later this week. It couldn't be a better time because I have a lot of questions, but yeah, very much can speak to the value of having that plan and taking that breather. So, thank you.

And I have a couple of follow-ups for you, Leanna, but first I want to get back to Lars just to catch up on something you mentioned earlier, talk a little bit more about the bonds. In particular, we know that the Fed is selling off Treasury bonds, mortgage backed securities as well. I know we run the risk of getting a little bit in the weeds there but could you just talk about the strategy a little bit? What does that mean to us?

LARS: Okay, so, yeah. Following the pandemic in 2020, the Fed did a couple of things. They lowered interest rates and they initiated this thing called quantitative easing where they bought U.S. treasuries, mortgage backed securities. It was all in the goal of keeping interest rates low to really stimulate demand.

Now they're on the opposite side of this. They're raising rates and they're embarking on what's called quantitative tightening. That's what you're referring to.

It's the goal of just removing liquidity from the system to again slow down overheated growth. Technically, Jim, it's not selling. Rather what they're doing is just letting Treasury and mortgage bonds on their balance sheet mature, and just expire if you will, and not replace them.

And it's starting slow. It just started over the last week or so and it will ramp up over time. They did do this back in 2008, and what we saw in the markets as investors is less liquidity, tighter financial conditions, i.e., volatility, and the potential for higher rates.

So, some of this is really, really unknown of how this is going to shake out over the next year or more. We just don't have a lot of history to deal with quantitative tightening, but it may not have a material impact to banks and rates for some time.

But nevertheless, I think bond investors, if you look at it from this lens, have faced one of the most challenging environments in decades, and the question that we commonly hear is why continue to hold bonds? We have this visual here and maybe just to help provide a little of the upside to down markets in these types of occasions with where we have seen over the last thirty, forty years or so when bond interest rates spike over a short period of time, what you can see in the blue columns there, high quality bonds have had negative performance over periods.

Now, the kicker here is that once higher interest rates or yields are in bonds, that can help provide higher levels of income and boost return over time.

So, what we're showing there in the green is the following two or three years' returns, and you can see that some of these are pretty strong returns because the higher yields help boost those future returns.

Now, the upside also of having higher yields is that they can provide more stability or a cushion, if you will. Should stocks remain elevated in their terms of volatility, that extra yield can just help offset some of that volatility in a well-diversified portfolio.

JIM: That's excellent. Thank you for that because that's a great segue into what I wanted to ask you about, Leanna, bonds in particular. Fixed income can be pretty important to people as they head into and through retirement. You mentioned retirees specifically in your last answer.

So, I'm curious, sort of for folks nearing or in retirement or those of us maybe decades away still planning for it, it's—I think it's easy to feel like we're a bit of helpless bystanders watching things happen. What can we do to feel a little bit less so?

LEANNA: So, we do get a question a lot on like, what can I be doing? How often should I be looking? How often should I monitor?

So, I'd say, if you do have that investment plan aligned to your specific goals, generally speaking, staying the course is going to be the best course of action. And if you do have members of like Lars' team, Strategic Advisers, or you can have a portfolio set up where it's things like rebalancing are happening, those that are checking daily or even weekly, we find we see there's a greater chance as an investor if you're checking daily or weekly that you end up making a change due to emotions versus being able to stay invested for your long-term goals.

So, I'd say if all this volatility is again provoking a time where you feel like your appetite for risk has changed and you're not able to stay invested to meet those goals, I think this is a time where you can meet with a financial planner and reset your priorities. But the number one goal for us is to build that plan, that you're able to stay invested through short-term market changes and these changing economic conditions.

JIM: Yeah, no, I get that. It is more than an act of faith, right? I go out of my way not to look sometimes because again, I say okay, I have this. The plan is built. I've checked up on it. But the temptation to look and then get discouraged when you do look is just, I'm taking you down a rabbit hole of fights I have in my own head about investing so I'll stop.

But I would like it if you could talk a little bit more about rebalancing and protection. I think a lot of people have questions about what exactly that means or what it could mean.

LEANNA: Yeah. So, this goes back to that sentiment again of, what can I be doing? Or what should others be doing for me and for my portfolio?

So, we talk about rebalancing, and rebalancing is a way to really manage risk in your portfolio and keep your allocation aligned to what your specific goals are.

So, if we go to this next slide, many people will setup an appropriate allocation, and this happens a lot, let's say, you know, first 401(k) plans that you have or retirement plans and you're at somewhere in your life, maybe you don't have children or you're farther from your goals, let's say, and naturally we see you're more aggressive. What happens when you don't rebalance is that your portfolio can shift.

So, again, the goal of rebalancing is so that you're staying in line with what your allocation should be based on your risk tolerance, your timeframe, your whole financial picture aligned to you.

So, what this visual is showing, this is a chart from our Fidelity Wealth Services of showing how often rebalancing can take place, because it's a question I get often of, well, how often should I rebalance? The answer really is that it depends.

So, you can see on this visual up front, we have this gold line, that's the stock market. Blue line is the bond market. There's little diamonds or squares. And you can see when the diamonds are not shaded in, that's when, on the gold line, we've had to sell stocks. So, the portfolio—the market has gone up, your portfolio has shifted, you're taking those gains and buying bonds. That's something we call a happy rebalancing.

On the flip side though, let's say the stock market goes down and then we want to be buying low, selling high really. That's the mechanism. So, we're buying stocks when the portfolio—the stock market has drifted, all in line to keep you rebalanced, again, based on your risk tolerance, your timeframe, your financial picture. That creates the allocation.

So, in just how can I be proactive? It's making sure that—these are times in rebalancing as an opportunity during market volatility to make sure you're staying in line to the goals that you have.

JIM: How do people hear that message, do you think, when you and your team sit down with them? Do they need a little bit of convincing sometimes or how is that message heard?

LEANNA: No, I think it's a great way to see how proactive that we can be, and again, Lars' team and Strategic Advisers are saying, what are you doing during times of volatility to make sure my risk tolerance is staying true, that I'm still allocated well.

Another thing that happens is how we reallocate what's within the portfolio. So, we're in times of inflation right now. So, what is in that allocation that is helping the inflationary fighter?

So, we talk a lot on this show about REITs or Treasury Inflation Protected Securities, all ways that we can be building that portfolio again during times of volatility.

JIM: Thank you for that again.

Hey, Lars, with the few minutes we have left, if you could just look ahead a little bit. We talked a little bit maybe about July and what the next Fed meeting might bring, but how about a little bit beyond that? What do you see going forward?

LARS: Well, you know, as I noted before, I think we're entering a period where it is still expansionary but we would anticipate slowing growth and more balance of volatility. And I think when you put that in combination with the fact that inflation is just remaining stubbornly high and it's likely to just take time for it to ease, it's going to be a challenge. It's very unsettling and some of the market conditions that we've already seen is the market is trying to anticipate some of that.

So, maybe some of the worst could be behind us here but these are difficult times. So, if I think about it as just an investor and a person, you know, I just—I completely appreciate why this can be such a stressful time for investors to want to do something, as Leanna was just kind of noting. But just remember that we've seen difficult markets on several occasions over the last just forty years, right? So, the Black Monday crash in '87, the tech bubble, and 9/11, the global financial crisis, several more episodes. These were all very anxious times. But in my experience, in my career, some of the most patient investors use those moments to buy investments at lower prices.

And that may not feel good in the moment, particularly with things like stocks, which act as the growth engine for a well-diversified portfolio, and they're down 20%, which many would refer to as a bear market. Yeah, but some of the best market returns typically happen at what feels like the worst moments, and that's a little what I wanted to show here.

When you look back to 1980, and you have the fifty best days for U.S. stocks, dating back to 1980, almost half of them occurred during a bear market. That's when stocks are already down 20%.

So, if you have a time horizon that is three, five, ten years or more, I think it may be prudent to just consider that stocks over time typically recover after challenging situations have eased.

Now, the other consideration here is that during down markets, is you can use this as an opportunity to build tax assets to offset future gains in those accounts where taxes matter. It's something we call tax loss harvesting. For many of our clients in taxable portfolios, we have been doing that very significantly this year.

We do have a belief that over time, stocks will rise and we want to help offset some of those future gains with those tax assets that we are banking now.

So, in my experience, maybe to close out, to answer the question, Jim, is actions like these, they often have helped boost long-term returns as each crisis has unfolded over the last whether it's ten, twenty, thirty, or forty years, and eventually markets do recover.

JIM: Though sometimes surprising best days Lars, to your point, I think a lot of us have forgotten—many of us forgot how quickly some of the markets turned around during the pandemic, right. March or April of 2020, things looked dire. Leanna has talked in the past about some of the best days came right, Leanna, that summer.

LEANNA: Yes, or even looking today. I know we're just looking at two days, but looking at Friday versus Monday, sometimes we see these big swings day after day, so it can be really hard if we're getting nervous and saying, I'm just going to step out and be on the sidelines and wait for things to settle, and volatility is a two-way street, so those strong days closely follow some of the worst days we have.

JIM: Thank you again, both, for your time and spending some time with us here this afternoon.

For our audience, if you're not already watching on a mobile device, you might want to grab your phone, because if you're interested in learning more about what's happening today in the markets, or just looking to learn more about any number of financial topics, you can scan the QR Code on your screen right now. That will give you access to free on-demand video education available any time.

Again, just take out your phone. You can use the camera to tap on the QR code once you get it in the camera's sights there. And that will direct you to Fidelity's webcast hub.

If you're already watching us on your phone or listening to us on your phone, you can of course just go manually to Fidelity.com/webcasts.

Our regular reminder as well this week, if you've got questions about making your financial plan or staying on track during times like these, Fidelity can of course help. You can go online or give us a call, visit our website, download Fidelity's app. All of those are fantastic ways to learn more and get yourself feeling more comfortable with your particular plan and where you are.

Again, huge thanks to Fidelity's Leanna Devinney and to Lars Schuster. We hope to see everyone here next week with a fresh look at the markets, what's moving them, and what it means to you. We'll see you then.

923295.152.1