Fidelity Viewpoints®: Market Sense

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TRANSCRIPT

SPEAKERS:

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Jim Armstrong: Hello, and welcome to Market Sense. Thanks for joining us today. I'm Jim Armstrong with Fidelity. So inflation is officially here from cars to computers, from groceries to gas, prices are on the rise. And though we don't know for sure whether or for how long this surge in prices might continue, we do know they can take a toll on your investments, especially for those of us with fixed income investments like bonds.

So today's conversation will address the concerns that we're hearing from customer across the board about rising rates. And we'll also discuss ways that you might be able to reduce the risk that inflation poses to your portfolio. So to have that conversation, we are very happy to welcome Jurrien Timmer to the discussion. He'll be talking about his ongoing work studying the markets and the economy at large.

And we're also really excited to welcome Ashley Tran to the team today. She'll be with us this week and hopefully, for the next few weeks talking about how she and her team of Fidelity representatives help their customers navigate complicated topics like inflation. Ashley, Jurrien, thanks for being here today.

Ashley Tran: Thanks for having us.

Jurrien Timmer: Great to see you guys.

JIM: Yeah. For sure. Let's start with you, Jurrien. Today's Tuesday, July 27th. You know, I always say, there's been so much that happened in the past week. And again, that's true from Tuesday to Tuesday. There's a lot to catch us up on. I thought maybe we could kick off today's conversation looking at it through the lens of earning season, right, when companies report how well they did in the last three months. I'll leave it for you to tell us, Jurrien. But it sounds like a pretty good story, overall.

JURRIEN: Yes. So we are well into earnings season now—about two weeks in. 151 out of the 500 S&P companies have reported. And so far, 87% of them are beating estimates by an average of about 18 percentage points, so a very, very impressive result. Actually, I'm actually a little bit surprised how good the numbers are, not that I wasn't expecting good numbers. But you know, the first quarter earning's season was completely a blowout season. And I figured analysts would be incorporating those positive surprises into their estimates for the second quarter. And I'm sure they have. But the second quarter is an equally blowout quarter. The earnings estimate—the growth estimate for the second quarter versus a year ago is now at plus 73%. And a lot of this is what we call the base effect. The numbers a year ago were imploding because of the lock downs. And we see that kind of with the inflation numbers as well. The base effect is a very important mathematical thing.

But nevertheless, the earnings numbers are really strong. This chart here shows the year-over-year change in the estimate for the calendar year 2021. And that's already at 40.5% as compared to a year ago where it was minus 22%. So it just shows the reopening, the recovery of the economy after the lock down and hopefully we are done for good with those. But we do have the delta variant right now so unknown how much that will play a role in the coming months. But so far, you know, earnings growth has been very, very strong and that provides obviously a very good underpinning for the stock market, which is a little bit wobbly right now. Today the market is down. Last week we had kind of a scare where the market was down a couple of percent. It came right back.

But the markets are kind of trying to navigate what the delta variant means and also how eager the fed's going to be to start normalizing policy. So we're in that typical period in between early and midcycle where the fed tries to normalize policy and there's a lot of back and forth in terms of what the markets can handle. And so that's kind of what's going on right now. But the fundamental underpinning in terms of earnings is rock solid right now.

JIM: Comforting, I think, to hear you refer to it as typical because on a day to day basis, if we look at the markets, it can feel a little bit hair raising at the least. So let's talk more about inflation in specific now, Jurrien—the topic of the day—maybe through the lens of all the money in the current economy that's, as we say, uninvested, just kind of sitting out there perhaps in savings accounts or checking accounts. Again, it's quite a big number.

JURRIEN: Yeah, and it's really interesting to see, actually. In this chart you see assets in money market mutual funds right now. That's the top line there. And you see it's still four and a half trillion dollars. That's a lot of money. And it's almost as much as was sitting on the sidelines 16-months ago. At the lows in March of 2020, the market is up 101% from that point. And there's still almost the same amount sitting on the sidelines. Even though money has been going into the markets, as we would expect, you see in the bottom panel there's 757 billion flowing into stock, funds and ETFs, 621 billion into bond funds and ETFs, but still a local of money on the sideline.

And I think what we'll see from this conversation today is the need to have our money work for us, to be productive and not sit there. And sitting in cash can be a very productive thing when you're getting paid to do so, right? But right now, interest rates are zero so you're not getting paid to do that. And inflation is running, right now at least, at over 5%. So people sitting in cash are literally losing purchasing power.

So, you know, it's important to keep our money working. One little caveat that I should mention on this chart is that four-and-a-half trillion today has a lot less purchasing power in terms of buying stocks with that cash than it did 16 months ago. 16 months ago, the market value of the S&P 500 was $19 trillion, which means that that four-and-a-half trillion was a quarter of the market's value, and therefore, you could do a lot with that money. Today the market value is almost $40 trillion and so that four and a half trillion is barely 10, 11% of the market's value. So that four-and-a-half trillion goes a lot less than it did a year ago, but still, it's still a big pile of cash doing basically nothing.

JIM: Four-and-a-half trillion doesn't buy what it used to, I guess.

JURRIEN: Exactly.

JIM: Ashley, eager to bring you into the conversation now because it just strikes me. Until very recently, inflation has almost kind of been a non-issue for a lot of investors, or at least, that's sort of the mindset they've had. Inflation was so low I would imagine that folks on your team must have had maybe a little bit of trouble reminding people that inflation is even something that they should be sort of keeping in mind as they make their investment plans.

ASHLEY: Yeah, absolutely. And thank you again, Jim for having me here, very happy to be here. And you're right. We see a pretty broad spectrum across our customers. Some are concerned or even fearful about this period of inflation and how it will impact their investments as they near milestones like retirement or big life events. And some customers are just so anxious to get out and about again, their only concern is how many more cruises can I book out in the next year. But either way, the topic has been coming up with customers everyday for me and my team.

And as you mentioned earlier, especially with those—that hold bonds or fixed income in their portfolios. So when we talk to our customers about inflation, it is really important to have them understand how rising prices can make the bonds with fixed income payments less valuable. And I would second what Jurrien mentioned earlier, that lies in what we call purchasing power. And for those of you who are not familiar with purchasing power, let's say you buy a bond that's paying you 3%. If inflation is at 5%, the value of your growth will keep that value of your dollar less. So if your dollar is decreasing at a faster rate than your interest, you're losing. And I keep in mind it might be wise to keep enough cash on hand for an emergency fund, let's call it, 3 to 6 months of expenses. But keeping too much in cash means inflation is just eating away at that money.

JIM: And so let's get down to some of the strategies that investors, folks watching right now, can think about using if they are concerned about inflation. One of the things you were going to talk about is something called TIPS, treasury inflation protected securities. So at super high level, what can you tell us about why TIPS, T-I-P-S, might be a good option for somebody who, again, is worried about inflation?

ASHLEY: Yeah. Absolutely. And this is the time period where investors try to get a little bit creative with, you know, what can buy that can benefit us during this time. So high level, TIPS are intended to help reduce the risk that inflation poses to a bond holder. TIPS are simply bonds with interest payments that are designed to rise when inflation does.

So similar to many bonds, they're available in five year, 10 year, 30 year maturities. They have very little default risk as they're backed by the federal government. You can buy them right from the US Government at auction. You can buy them from the Fidelity website or even in the secondary market from someone who already owns one and is looking to sell. So this all probably seems very good and you may be thinking what's the catch here? It's going to help rise with inflation. Well that possible inflation protection does come with a price. And they do tend to be a little more expensive than conventional treasury bonds.

JIM: And I do want—that's a great explanation, and I'd love to ask you how TIPS work. I know that's a question that can get really wonky and really weedy in a hurry. So at a high level, how would you explain how this security works?

ASHLEY: Of course. So to keep it as simple as I can, like I mentioned, TIPS are meant to keep pace with inflation thanks to an adjustment in the principal amount. So let's say, for example, you invest $10,000 in TIPS, paying 1% interest. Every six months, that principal is adjusted based on inflation. If inflation goes up, your principal amount goes up to match that. You'll get semi-interest payments based on the higher principal. And when the TIPS mature, you'll get either your original $10,000 back or the adjusted principal, whichever is higher.

Once again, all seems very good. So a few things to know. The adjustments to your principal amount can also trigger federal taxes even though you don't actually get that money as income. So if TIPS are something that you are considering or you feel like may benefit your portfolio, always wise to check with the tax professional. And they do have interest rate risk just like Treasuries. When interest rates rise, the price of bonds themselves are likely to fall. So keep those things in mind as well.

JIM: Got it. Thank you for that. And I know you have a couple of other—several other investment ideas for folks who might be worried about inflation. And we'll get to those in a moment. But first, I wanted to back to you, Jurrien, just for a little bit more context about this. I think it's probably one of the biggest questions of the day that people have. How long will today's inflation last? Is it likely to be more transitory, kind of short lived? Or is it more structural, longer term? How would you answer that question?

JURRIEN: I mean, that is the big existential question right now. I think the market and again, actually, as Ashley mentioned, the TIPS market actually has become a very important barometer of what people, the collective consciousness of the market believes is going to happen to inflation. So when you dissect the TIPS market, you can derive the expected inflation rate from the pricing, right, when you subtract the yield on TIPS versus the yield on nominal treasuries. And what's interesting is that the market and the fed seem to agree that inflation's going to be transitory, right? So one—the big narrative from the federal reserve is that, you know, we're not worried. We're not going to slam on the brakes and start raising rates because even though the CPI is rising at 5.4% year-over-year right now, we think that is just the result of supply chain bottle necks. Again, the same base effect that I mentioned earlier, right? So a year ago, the CPI was very depressed because of the lock downs and then any increase really kind of it almost overstates the amount of inflation.

And so when you look at what's priced in the TIPS market right now, the TIPS market expects inflation to be around 2.2%. So that's less than half of what the actual CPI is. And I think, you know, that's another way of saying that the market expects that inflation number to come down. So inflation in a way, it's always transitory on a rate of change basis because that is moving up and down. But what's really the big question is structurally underneath that are we building—you know, are we sowing the seeds for a more structural inflation? And that's a really hard question to answer, right, because if look at this chart, you look at policy decisions, right?

The sheer size of the deficits and the amount of debt that's being created, all the fiscal programs, the fed is essentially monetizing those programs by doing all of this quantitative easing, $120 billion per month including TIPS by the way. And actually, a little trivia, the fed owns about 28% of the TIPS market. So that's kind of how big the central bank is looming here. So as inflationary as that is, and you look at rent, we know what's happened to real estate prices. We see what's happening in the labor market, right? Over 9 million job openings, but they're not being filled even though there are 8 million people unemployed. And so does that create wage inflation?

So there are a number of reasons to expect maybe some structural inflation to come out of this period. But on the other hand, you know, you look at that yellow line running through that panel of the bond yield in the chart, that's the five year growth in the labor force. In other words, that's the demographics of an aging population. And that, in my view, is pretty profoundly deflationary. And on top of that, you have technological innovation, globalization. So to me, it is not a foregone conclusion that we're going to have structural inflation. I think there are always pros and cons to it.

And you look at Japan, which in many ways, is many years ahead of us on the demographic, you know, trend. They have no inflation there, even though the bank of Japan, its balance sheet is 130% of GDP, whereas in the US, the fed is only at 36%. So the Japanese have printed far more money than the US has and they still have no inflation. So it's a tough question but from my perspective, and I think Ashley's as well, considering TIPS as one of the building blocks in a portfolio is perhaps a very good way to have some insurance, just in case inflation does become structural.

JIM: So Ashley, let's talk about then maybe some other building blocks or strategies, thoughts investors might want to have in their minds if in fact, they are, again, concerned about inflation and how to build a portfolio that accounts for it. What would you say?

ASHLEY: Yeah. Absolutely. It's interesting you say building blocks. And I mentioned earlier, investors are getting creative. Many people who are feeling very uncomfortable during this time of inflation are people that have a very high cash concentration. So before we get into any specifics, I would say, underneath everything, diversification will be key in times like these and really at any time. We do believe that having an efficient diversification plan across the three primary asset classes: stocks, bonds, cash. That is the best way to lower a portfolio's risk while maintaining its expected return potential. So as investors get creative here, I would encourage those to consider the opportunity that stocks could provide to you at times like these. They can serve as an effective hedge against inflation, including international stocks.

International stocks could be an option because they offer opportunities to diversify at reasonable prices. Typically, their stock prices are lower relative to those of US stocks. And here's a fun fact for you. Over the past 16 years, stock markets from 12 different countries have taken turns claiming the title of best performing market. That divergence of performance really demonstrates why exposure to international stocks may nearly always provide diversification to your portfolio. And more recently, as many countries have recovered strongly from the unprecedented global recession, many companies and industries present great opportunities for growth and value investors.

I would also encourage others to think of value stocks. Historically, value stocks have been overshadowed by growth stocks. And sometimes, just like the concept of inflation, we need a reminder that they can provide potentially better than expected performance, particularly in an inflationary environment.

So we think about the past year. And while government stimulus and welfare spending is helping drive consumer demand for goods and services, capital spending is rising to meet that increased demand. So to meet demand and comply with new regulations, companies are spending money to reconfigure their existing plans, their equipment, their processes. And stocks of these types of companies are usually classified in that value category. And history shows they've tended to do well when inflation ticks higher. So value stocks may offer more opportunity for stronger returns than many investors realize and can help you diversify the portfolio. So overall, I would encourage everyone to, you know, revisit your asset allocation. Make sure your investments are in line with your life and your goals right now.

Ask yourself: do I need to rebalance, especially now that our dollars have less spending power? And that's something that you can take time. You can do that alone. You can do that with someone here at Fidelity. We have certified financial planners that are happy to help. The big idea is just to make sure your investments are working to help you meet your goals, they're appropriate for your age, and sensitive to how much risk you want to take on. And I'll leave you with one quick story that I heard. We have a couple that's been working with one of our certified financial planners for many years now—great couple. They have a son and they love to travel and leave their son Joey at home. He's 26. So Joey's fine by himself.

JIM: [Laughter]

ASHLEY: But towards the beginning of the pandemic, they realized, hey, maybe we need to sit down and reevaluate what our portfolio looks like. So we took a look at the current economic environment, their asset allocation. And over the year, their portfolio has had a higher expected return than they had estimated by about 3%. So they took that 3%. They threw that cash on their personal balance sheet. And now, they're taking Joey to Spain when they go on their next trip. So all in all, always a good time to revisit the asset allocation and make sure you have a good plan in place.

JIM: I think I wouldn't move out either, Joey. Good for you. If there were free trips to Europe on the offhand, I'd say, yes, please. Oh, that's great. Thank you for that story. Thank you both for making time for being with us here today. And again, for our viewers thank you for watching. Just a reminder that if you need help with your financial planning or if you have questions on how Fidelity can help you, you can visit our website, download our app, and continue to learn more about the topics we covered today. And about a lot more, whatever questions you may have, you can also explore our planning solutions via those opportunities as well. Again, huge thanks to Fidelity's Jurrien Timmer and Ashley Tran. And hope to see you next week.

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