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. Over the past recent weeks, we've talked about inflation a handful of times, kind of focusing more on how we might feel it day to day. But of course, inflation also matters a lot, potentially, to those of us who have long term financial goals. So if you're saving for a house or for college, certainly, for retirement, and those are just three examples there. So that's what we'll talk about today: our latest expectations when it comes to inflation and what you might want to do about it.

So to have that conversation, our own Jurrien Timmer joins us again this week. His ongoing work focuses on analyzing our economy's big picture, and he uses history to think about what's to come. And Ashley Tran is also back this week. She and her team here at Fidelity help people make decisions to achieve their financial goals, and these days that includes talking about inflation for sure. So Ashley and Jurrien, thanks again for making time to be with us.

Ashley Tran: Thanks, Jim. Nice to see everyone.

Jurrien Timmer: Yeah, great to see you guys.

JIM: So Jurrien, let's start off with you if we could. Today is Tuesday, August 31st. And we're getting ready for a time of the year that you have called seasonally vulnerable for stocks. So just explain what you mean by that if you could.

JURRIEN: Yeah. It's interesting. There is a distinct seasonal pattern in the markets during the calendar year with the caveat that the seasonal pattern exists all else being equal, and of course, all else is never equal. There's always another thing going on. So by no means think of this as this is always happening at this time of year. But there is a pattern. And you can kind of see this if you look down the chart from the top to the bottom, you can see that most of the bars are on the right hand side. And those are positive, weekly returns. And there's a few bars on the left hand side, not too many but a few, and those are negative returns.

And there's one in May. And that kind of, I think, is where the Sell in May Go Away kind of theory comes from. But then you see a couple of them in sort of- late August into September and then a couple more in October. And that often is the retest of whatever seasonally the weaker period of the year is in September. Nobody really knows why this is. Maybe it's Wall Street people being on the beach over the summer and coming back to their desks in September after Labor Day and saying, "Oh, the market's not where I thought it was back in July." I think that's kind of an oversimplification. But so we don't really know why this happens, but we do know that some of the turmoil that has happened in the markets kind of happens during this time frame—by no means, not all of them. Obviously, the lockdowns last year were in March, not in September.

But this is kind of the period of the year where people start wringing their hands a little bit as everyone comes back after Labor Day. You know, there's obviously a few things going on that people might worry about. There's the resurgence of COVID, the fourth wave. That certainly has been disconcerting, to say the least. Although, it has not led to renewed lockdowns, as we know, in the US. And there's the Fed. We'll talk about the Fed in a moment. So there's always things going on. But this is kind of that period where you're going to see more talk about, you know, are we going to have a correction? And again, I tend to focus on the long term. So I don't get particularly worried about this because these are very, very short term patterns. And over the course of a year, the market generally has been up more than it has been down.

JIM: Yeah. For sure. But listen, thanks for that explanation. In case anybody wonders over the next couple of weeks what might be happening behind the scenes, that's a good—you know, something to have in the back of our minds. But to today's topic now, Jurrien, specifically talking about—excuse me—inflation more. You know, I know that there's no exact analog. There's no exact precedent you can look at and say this happened before, so I know this is going to happen now. But that being said, you do often look to history to get a sense of what's to come with inflation. So what's your think thinking there?

JURRIEN: Yeah. So you know, the way I think about inflation—and first of all, it's a question that I don't think anyone really has an answer to. Like, we know that inflation is running hot, right? The CPI is at more than 5% year-over-year. Part of that was the bottlenecks of reopening an economy that was in lockdown. Part of it was what we call the base effect. So it's just a mathematical thing where a year and a half ago, everything was locked down so inflation was very low. Then you have an increase, which is to be expected, but it comes off of that low base. And that's why it's called a base effect.

But now we're at that point where the CPI is running at 5%. The market, as well as the Federal Reserve, assumes that it's transitory. And my guess is that it probably will largely be transitory.

But you look at home prices, what we're paying for rent, we're looking at wages, and the number of job openings there are, and how tight the labor market is. And so you can definitely see that maybe some of this inflation will be more than transitory as opposed to just kind of these bottleneck that will be resolved. And that puts the Fed kind of on the hot seat, right, because we know the Fed just had its Jackson Hole annual conference. And Fed Chairman, Jay Powell, is teeing up what we call the taper, so the reduction—the future reduction in asset purchases. So right now, the Fed is buying $120 billion a month in bonds. And we know that the Fed probably at some point, maybe in 2023, needs to start raising rates because a lot of the economic crisis related to the pandemic is kind of being resolved.

And the Fed has this dual mandate, right? It has full employment as one goal and price stability or 2% inflation as another goal. And it needs to always weigh those two. And I think right now, the Fed is looking at full employment as the primary goal and is assuming that inflation will be transitory, so it doesn't have to worry too much in terms of having to remove this policy accommodation too quickly. So in this chart here, you see that very smooth line is what we call the natural rate of interest. So that's—it's not a real interest rate. It's not like an observed rate, but it's a theoretical rate where the economy would be in balance. And then the squiggly lines is where the Fed actually has been. And you can see, it's been like a pendulum from below the line to above the line.

And the last time it was below the line to the same degree as it is now was, of course, during the financial crisis. So the Fed is kind of in that same place, 12, 13 years later, and it now is looking to get back towards that smooth line. And the road from here to there could take several years. And there's always the risk that the Fed goes too fast and the market doesn't like it or it goes too slow and the market starts worrying about inflationary pressures, which is our topic today. So the Fed has a delicate balance here to get this just right. And that whole process is now kind of getting started.

JIM: Ashley, I'd love to bring you into the conversation now to talk a little bit about how an individual investor might sort of make sense, operationalize, to use a fancy word—what Jurrien was describing. Let's assume, you know, inflation runs 2 to 3%. So as an investor, obviously, the very least you want to do is earn 2 to 3%. Ideally, you want to earn more than that. What sort of strategies do you suggest, you and your team, when you're sitting across from people who have that goal?

ASHLEY: Yeah. That's a great question. And my team and I are talking about inflation just about every day. And like Jurrien said, we may not have a firm answer for what's going to happen, but we do have some suggestions, or let's call it considerations, if you are concerned with the environment. So for our customers who do have their accounts managed by professionals here at Fidelity, portfolio management with inflationary impact in mind is taken care of for you. But today, I'll talk a little bit about what options individual investors can consider as they manage accounts on their own.

So first, I would consider taking some time in evaluating the stock market. Inflation can be confusing for investors since it appears to create volatility and impact the economy and stock prices. But not at the same rate. However, stocks, both domestic and international, historically have done a really nice job in beating inflation. So in times of inflation, when we see growth stocks start to suffer, we may need a reminder about value stocks. Value stocks have historically been overshadowed by growth stocks, but they can provide potentially better than expected performance in an inflationary environment.

And as we see inflation increasing and purchase power declining, people can view income generating stocks as less attractive because their dividends tend to not keep up with inflation levels. But as they become less attractive, their price points decline, which can provide investors with a really attractive entry point if they're looking up to take up a long-term position in one of those.

So next, I would also think about investing in stocks related to real estate, or Real Estate Investment Trust, REITs, as they're commonly known. Those may do well if higher inflation causes the price of the real assets to increase. And you can also consider investments tied to commodity prices. They've also historically benefited from inflation when there's more demand for things like aluminum, copper, or gas, or even corn. And finally, if you're thinking more about bond investments, there are TIPS that stands for Treasury Inflation Protected Securities. And those investments are intended specifically to adjust and perform well as inflation rises.

JURRIEN: Got it. Okay, you covered a whole heck of a lot there. So for anybody watching who needs a bit of a breather, we just suggest heading to Fidelity's website to learn more about any or all of the options that Ashley just ran through. You can search by key word or topic. And there's other videos and articles you can read of course to learn more about any of the strategies she just listed.

Ashley, I want to ask you specifically about folks who have a lot of cash right now. This is a phenomenon that we've been talking about for the better part of a year now: sitting on a lot of cash—raw money in the bank, for example. Without any activity behind that money, it just becomes less and less valuable because of inflation, especially in the long term.

ASHLEY: Yeah. Right. Well we typically suggest keeping enough cash on hand to pay three to six months of your essential expenses. If you prefer to keep more, that's fine if that's most comfortable for you. But just know that in a world of 2 to 3% inflation, that cash is going to be worth less and less each year. So a good way to illustrate this and how inflation can impact your expenses is to look at some scenarios in retirement. So let's say you retire and decide that you need $100,000 a year to pay all of your expenses, your medical bills, travelling to see all the grandkids, et cetera. Because of inflation, you'll always need to take out more and more each year.

So even in a relatively low inflation environment, let's call it 2%, in a decade or two, you could need 140, 150, $160,000 every year just to meet those same bills, to cover medical expenses and go see the grandkids. So the numbers grow as inflation does. If inflation's closer to 4%, your initial withdrawal of $100,000 per year could be twice that or more the longer you live into retirement. So if you're worried about inflation, an appropriate course of action rather than moving more to cash, may actually be moving less to cash and investing more.

We have a lot of long term clients who are now in retirement and moving from the accumulation and savings phase to the distribution phase of their life. And inflation can feel very scary when you transition during that time. And when people feel scared, their gut extinct goes into protection mode. And a lot of people think cash when they think protection. But unless the assets are growing at the same rate or inflation or greater, you're going to feel like you can't afford as much a few years from now. And moving more money to cash can leave you exposed if the cash can't keep up. So we have some clients that have moved a large portion of their holdings in cash since retiring, but the inflationary environment is causing them to rethink that conservative strategy. Because even if the cash isn't intended to cover essential living expenses, we still need needs for our money, for example, preserving it or leaving it for a legacy. So we always encourage investors, aim to invest for growth. Make sure that you're taking on the right level of risk for your age and your comfort level.

JIM: I like—thank you for sharing the fact that if your gut says go to cash as a way to preserve your assets, it's maybe not advised, but you're not alone if that's your suggestion, right? That's pretty natural to feel like that's the direction you should go in intuitively, even if the math doesn't quite work out that way, which leads me actually to Jurrien for your next question. I know that you've been doing some thinking recently about interest rates through the lens of inflation—two topics that are intimately connected, of course. But especially for folks who are currently relying or think they might soon rely on income, for example, from long term US Treasury bonds.

JURRIEN: Yeah. And you know, you look at this chart. This goes back to 1978. And it's a chart of the yield of the long term Treasury bond. And you can see that is a very distinct trend, right? Lower lows, lower highs is how I would define this downtrend. And so we're at this point now where short term yields are at zero. The Fed does want to move them higher, but it would be probably very gradual over a number of years. And inflation is already running well ahead of that.

And so, you know, to Ashley's point, even though our loss aversion tendencies might want—might lead us to put our money in cash, it's not working for us when it's in cash, at least not right now when it's earning zero and inflation is running at five. Now, that five probably will come down. But even the bond market, if you look at what the TIPS market is signaling, the market's expecting about 2.25% inflation over the next five years, which is well north of not only where short term rates are, which is what your cash would be earning, but it's even well above where the ten year Treasury Yield is, which is 1.3%.

So the entire what we call the term structure of the bond market is below the inflation rate. And so if you're an investor and you don't want have to have a lot of risk in the market and you want to rely just on income, it's a challenge because just having it sitting in the Treasury bond market is not going to be enough. So there are other assets—asset classes that will get us that yield. There's obviously corporate bonds. Ashley mentioned REITs, which I think is a very good one because it's considered a hard asset that also has a yield. But I think the whole point is you want your assets to be productive, right? And so if you go back way into history, we can see that inflation generally over, let's say 100 years, has averaged at about 3%. The S&P has run at about 10, 11%. The bond market has performed by about 6% or so. And cash generally has been at or above the inflation rate.

So we're in a unique period in time. And I think the big picture of what's driving these trends is demographics, aging baby boomers reaching for yield, an era of very low interest rates because of the debt dynamics, the demographic dynamics. And it's a real challenge because investors want to have income. And during this kind of the period since the financial crisis, investors have had to get more and more creative to get that income, including by going to stocks that generate a lot of cash flow, whether it's very conservative like utilities or more kind of the big tech companies that don't have paid dividends, but they generate cash flow and they kind of return that indirectly via buybacks, which is maybe a topic for another day.

JIM: In that, with the two or three minutes we have left, I'm wondering if I could sort of pick both of your brains a little bit. Ashley, we were talking as we were preparing for this week's webcast. You were mentioning how you and your team were working with investors all the time who, as we said, are really concerned about long term goals and how to protect what they've saved, which I think everyone can identify with or empathize with certainly. So we'll start with you and then off to Jurrien too about sort of how you're hearing those concerns and more suggestions that you might have for folks.

ASHLEY: Sure. And it's obviously a big concern. You've worked hard for decades to save and invest, and at the very least, you want your money to be there for as long as you live. But the one thing we see is common is that no one wants to see their hard-earned money chipped away due to loss. You know, we've had clients who don't have kids and they don't need to leave a legacy to the next generation, but they feel really strongly about using not losing the money that they've made. They, like all of us, still have that fear of loss and really want to protect their principal.

So that's what teams like mine can help with at Fidelity. For example, we can help come up with strategies to try and preserve or use, not lose. For example, one thing that we discussed is what's called an Anchor Strategy. And that's where you invest some fixed assets to protect your principal, and then add a sleeve of investments, maybe stocks for potential growth. It has everything to do with your unique needs and just being aware of what's happening in the world around you. And just know that you have a team here at Fidelity that can learn more about what you need and help you get a really good plan in place.

JURRIEN: And I would just add, you know, the older and hopefully wiser that I get, having been through many, many market cycles now in my career, is that the long road, keeping an eye on the big picture is so much more rewarding as an investor and a much better strategy than worrying about every little wrinkle in the market cycle. And so back to kind of the earlier chart of the seasonals, you know, just being on the right side of the long term trends, having your money be productive, having it work for you. Don't hide it under a mattress.

And being in the right asset classes over the long term and rebalancing from time to time, and even using corrections when they happen to your advantage by rebalancing into those corrections. But not panicking or selling every single time you worry that the markets are working against you because remember, the S&P over the long term goes up 11% a year, or it has gone up 11% a year, but the market only goes up 60% of the time. That means 40% of the time, the market's going against us. And there's always reasons or excuses to want to just get out and wait for it to be over. But then you break that compounding math, that magic, right? The compounding magic of being in the right asset classes over the long term and having them grow over time is to actually be in there. And if you get out because you think things are going to get shaky and you don't get back in on time, you've broken that chain. And it's going to be very hard to recover. So the big picture to me is always the place to think about.

JIM: Absolutely. Thank you, both. And again, to do that, to make that happen, guys, you've got to sort of fight your intuition, fight your gut. And that's much, much easier said than done, especially when it comes to what you've spent decades, perhaps, saving for and investing for. So great to keep in mind, even if it is hard to accomplish in real life. But thank you for taking the time, both of you, to be with us here today.

For our viewers, of course, thank you again for watching. And just another reminder that if you need help with your financial planning or you've got questions about how Fidelity can help, again, you can visit our website or download our app and do topic searches and look for more information there talking about what we discussed today and a whole lot more as well. And you can also use those resources to explore our planning solutions. So again, huge thanks today to Fidelity's Jurrien Timmer and Ashley Tran. A quick programming note, we will be taking Labor Day week off, so our next live webcast will be September 14th. Hope to see you then, and have a great holiday week.

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