Fidelity Viewpoints®: Market Sense

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TRANSCRIPT

SPEAKERS:

Jim Armstrong Jurrien Timmer Leanna Devinney

Jim Armstrong: Hello and thanks for joining us for Market Sense. I'm Jim Armstrong with Fidelity. The pace of price increases seems to be slowing just a little bit if we can say that. Late last week we saw that softer than expected inflation reading. So natural to ask now what that might mean for future interest rate hikes and maybe, can we start to expect inflation to fall a little bit overall? Kind of a spoiler alert. Our pros say not so much. So, today we'll talk about some survival strategies. Four things you can do right now to potentially help you ride out higher prices. To help guide that conversation, Jurrien Timmer is here to share his insights into the latest national and global economic news, market conditions, and what they all mean to us as investors. Leanna Devinney is here as well this week again, to talk about how she and her team are really helping people continue to build and update their plans in the phase of all factors, right Leanna? Including rising prices. Thanks for being here guys.

Leanna Devinney: Great to be here. Thank you.

Jurrien Timmer: Yeah, nice to see you all after last week.

JIM: Yeah, we missed you last week, great to have you back, Jurrien. It is Tuesday the 16th of August and I'd love to start, Jurrien, with you, again with that latest news I referenced just a moment ago about the CPI, the Consumer Price Index showing—thankfully showing an easing in the pace of inflation in part because energy costs have dropped, right? We can all drive past the local gas station and see that the prices there are falling happily. Love to get your sense of how we should be taking in these factors as consumers and investors and what you think it might mean going forward.

JURRIEN: Yeah, so it was certainly a welcome reprieve from the relentless inflation that we've seen so far this year. Remember the CPI got to around 9% and fortunately the latest number was a welcome relief. And that's important for a number of reasons, of course. First of all, as you mentioned, you know, if we're filling our cars with gas and buying stuff at the grocery store. Obviously less robust price increases are very much welcome news after the last six months or so. But it also is useful, in terms of getting some sense of how much further the Fed needs to push interest rates up, right? And in this chart, I show the ten-year treasury yield, that's the black line there. The Fed funds rate which is the policy rate that the Feds sets, that's the gold colored line. And then, what we call the forward curve, so what the market expects the Fed to do in the coming months and even years in the orange line.

And with the inflation news starting to get a little bit better or less worse, let's put it that way, it is giving the market some sense of relief that maybe we are getting towards the end of this rate hiking cycle. And you can see that we are at 2⅜ now, so that's a far cry from zero which is where we were only six months ago, right? So, the Fed has gone very fast to kind of catch up from the very accommodative stance that they were in and many people think they were too accommodative for too long given that things were getting better well before they started to, kind of signal to the market that rates were going to come back up. But that's neither here or there right now. So, the Fed quickly moved back to what it considers to be a neutral policy, which the market generally believes is around 2½% and you can see that if you look at those purple dots, that's the so-called do plot from the Fed which shows what the FOMC members expect rates to be and the ones on the right of the chart, the LT or long-term dots is what the Fed kind of considers to be a neutral policy.

So, the Fed is going to overshoot neutral because inflation is still, you know a problem. I mean, even if the CPI number was flat month on month, year-to-date the CPI is up 6.8%. You know and even if inflation really starts to improve from here, we are probably still going to have 7, maybe 8% inflation for this year. So, the Fed can't really declare victory yet so it is going to go probably to 3½, which is what that orange curve suggests. And then the market thinks actually the Fed will start to ease rates either because it will declare mission accomplished and it will kind of give back some of those rate hikes, because again 3½ would be about a percent above neutral. And neutral, by definition means that's your long-term default rate. So, you would expect the Fed to eventually go back down towards neutral. So, that's kind of the glass half full interpretation. The glass half empty interpretation is that the Fed is going to essentially cause a recession—maybe not cause it but that we'll be in the midst of a recession six months from now or so. That's not my prediction at all, but that's certainly a worry in the markets and that the Fed would then cut rates, not because it can but because it has to.

So that's a chapter for a later part in the story. But, you know, as you mentioned in terms of what our experts are saying about inflation coming down, I think that will be the big next story that we are all going to be talking about a few months from now. Because right now there seems to be a sense of okay, we have a sense of where the Fed is going to go, they are not done. They will go

another percent or so into yearend but how quickly inflation will come back down towards the Fed's target which is 2% for the PCE and—not to give you too many acronyms but let's say it about 2½% on the CPI is the Fed's long-term target. So, the question from here on is, okay inflation is peaking, what will it come down to? And if it comes down to 2½, then I think that would be great. That means that Goldilocks has returned and we can all sigh some relief there. But if it only goes let's say from 8 to 4 instead of to 2, what is that going to mean for monetary policy going forward? If we do end up in a recession 6 or 12 months from now, will the Fed be able to ease policy as much as it has in the past if that inflation number remains sticky. And, again I don't have the answers to that right now but that's certainly going to be something we'll be talking about down the road.

JIM: Of the three of us Leanna you and your team certainly have the closest connection to customers, right? The investors who are coming in and meeting with you and your team on a daily basis. Really curious to hear what folks are making of Jurrien's half glass full interpretation there. The fact that things are a little bit cheaper at the gas pump, for example, and inflation seem to be ticking down a little bit. Are you seeing that in people's expectations when they come in to talk to you and your team?

LEANNA: Yes, we certainly—my team shared clients that felt a little bit of a breather. So, we felt a reprieve from the markets and the volatility. We have been feeling a lot of investor fatigue. It was daunting the day-to-day volatility and it was a longer stretch of time. We haven't had that in over a decade having month after month of the market turmoil. So, definitely have the breather. High inflation is still front of minds, to Jurrien's point it is still significantly high. Yes, it is nice and assuring to see the dip in gas prices, but we are still hearing of high inflation and concerns around that. So, we'll talk on some of the action items we help our clients with on the investing side and spending side. But the good news is clients are still sharing with us they're traveling, they're getting out, they're spending money. So, although high, still some positive lens there, too.

JIM: I know one question that you have shared you have gotten from investors I wanted to bounce to Jurrien now as well. This idea of where we are, helping people orient themselves in where we are in the market, right? Are we—so we are in a bear market but have we bottomed out in the bear? Are we in sort of a mini bull inside of bear? It is really hard these days to figure out where we are.

JURRIEN: That's the big question right now, right? So just to recap what has happened over the past six months, you know the market peaked on January 4th and it fell 25% and has bottomed so far on June 16th. And that decline, 25%, certainly qualifies as a bear market. But so far it has been a bear market only driven by the rate cycle. So, what the Fed is doing. What's happening to interest rates, the Fed taking the punch bowl away, removing liquidity. Again, as I said earlier maybe a little too late. And so, we've had a significant derating in the valuation of the markets. But in the meantime, earnings are still okay and we'll talk about that a little bit later. And second

quarter earnings season is what we kind of learned is that investors were waiting for that next shoe to drop, right? So, they were bracing for a recession and so far, that recession hasn't happened.

And, you know you mentioned—Leanna mentioned travel. The TSA checkpoints are still running at about 2.4 million a day which is the highest since 2019. And if you think about it, that's the most discretionary form of consumer spending, traveling, going on vacation. And if that's holding up, you know maybe the economy will actually hold up better than we all think and now with inflation potentially peaking, that removes or it reduces the risk that the Fed has to go so far above neutral that it really is going to break the economy.

So, part of the rally that we've seen since June 16th and we've gone up 17% since that number. And if we go up a few more percentage points, everyone in social media or the regular media will proclaim a new bull market because it's up 20%. I don't really think that's really a thing. You know, we know that down 20% is a bear market but up 20% may or may not mean much. So, the technical indicator that I'm watching the most is on this chart here. Because the fact that we're up 17% since mid June really doesn't tell us whether we're in a bull market or not and even up 20% it's not going to tell us.

What we can learn from history is that when a bear market—when the market stops going down and it starts going up, it basically never retraces more than half of the preceding decline, unless it's a new bull market. So, in other words, if it's a bear market rally, if it's just a bounce inside a bear market, it really doesn't go much more than a 50% retracement. And you can see it in the chart. So, by definition based on history, what we can conclude potentially is that if the market keeps going here, then it must be a new bull market, right? And I think the Fed maybe being able to step off the brakes sooner rather than later, certainly is part of that narrative as that starts to create. And the earnings part may be another one. But again, it remains to be seen.

But, so right now what we've seen so far in the markets really doesn't tell us whether it's a bear market rally or a bull market. But if the retracement keeps going up above 50%, then historically there really to me is no other conclusion that a new bull market is born. A little baby bull.

JIM: Baby bull. Nice. You know, Leanna I want to bounce back to something you mentioned earlier, you know this idea of bulls and bears side for just a second. I think of more practical importance to a lot of investors is inflation as you mentioned is what they're seeing, what they are having to spend their money on these days day-to-day. What if any practical terms might you offer in terms of investing through the lens of higher inflation?

LEANNA: Yeah, so similar to investing, I think it's important to remember when we plan for inflation, we're looking at a longer-term view. So, there has been some good news but we know inflation is still very elevated. We don't want to focus on one to two years or a period of short-term high inflation and have that impact our decisions on the investing side. Just like we don't want to focus on a poor month or one bear market over the long-term and many bear markets we'll have

in the stock market. So, inflation is one of the key risks that we plan for when it comes to building the investment portfolios. In periods of high and low inflation we focus on it. And the slide shows the reason why. Inflation impacts our purchasing power. You can see here this is just showing the impact of inflation over a long period of time. Just at the grocery store looking at bread, eggs, milk and we're hearing these stories day after day from our clients going to the store and buying these goods, I'm really feeling it at the grocery store.

So, where we help is outside of an emergency fund where we want to make sure we have liquidity and flexibility and have that in cash or short-term type of vehicles, we want to invest our wealth and money aligned to the goals that we have. But in order to help keep pace with inflation. So how we do that and what we believe in at Fidelity, our core philosophy and our foundation is having a diversified portfolio and having that asset allocation, that's that mix of stocks, bonds, and short-term investments, again in line to the goals you have. And diversification and asset allocation, that's not going to ensure profit or guarantee against loss, but we've seen that it can help lessen the impact of inflation when we have that diversified mix. And when you do have that diversified portfolio, there are subtle tweaks we can make to help protect furthermore from inflation.

JIM: And I know, I could guess there are a dozen or more answers to this question but how do you add that inflation protection when you are thinking about diversifying?

LEANNA: So, the first step is having that appropriate mix aligned to your goals and looking at your core allocation. So, if you haven't reviewed in a while, you just want to make sure you have that mix of stocks, bonds, and cash. So, the second is looking what is within that, that's where we talk about diversification. So, inside each asset class is where you can reallocate and have certain investments that have been known to potentially, kind of keep pace with inflation.

So, example, this could be real estate, commodities, something we hear often TIPS—those are Treasury Inflation Protected Securities. And then on the equity side we see stocks that are able to keep pace with inflation over the long run. So, these investments that potentially keep pace with inflation, they do come with some risks and so that's why we talk about having small exposures, depending on what your goals are or making sure you are focused on the long term. Because historically stocks and equities, they have offered the highest average return, but we also, like we see this year, can come with bouts of volatility. So, we want to make sure it is aligned to our risk tolerance, our time frame, our whole financial picture. But having a diversified portfolio, that's going to give us a best chance of helping reach our goals like retirement, like that your child's education. And on the flip side there are risks in being too conservative. Inflation is one of those risks and having that cash.

JIM: Yeah, we're living through that right now in real-time. What else can investors do, would you say, to stay on track?

LEANNA: So, outside of investing we're talking to our clients about their cash flow and their spending and really the impact of spending, and your budget. So, for example, we'll review an analysis with our clients and we show the impact of spending. So as an example, what if we spent a little less on a monthly basis in certain areas month over month, that will have a drastic improvement on your investment plan. So, if you are concerned about the impact of inflation and the ability on you to save, it could be an opportunity to reduce some of your discretionary costs.

Fidelity uses a great, general rule on just budgets and so it's called the 50, 15, 5 rule. So, if you are on your way to retirement this would be 50%—spending no more than 50% on your essential expenses. So, 50% of your take home pay on those essential expenses. And then 15% pre-tax would go to your employer sponsored plans, your retirement savings. And that's including an employer match if you do have one. And then it gives 5% for your short-term goals like that emergency fund and 30% would be more on discretionary spending.

JIM: And I know you have mentioned this before, Leanna but how do you take into account those unexpected expenses? Because I think, especially during times of inflation, those can—they have the potential to be even more painful than normal?

LEANNA: They can and with the costs of those essential expenses rising, like gas or at grocery store, we talk about maybe needing to increase that emergency fund as well. So, Fidelity recommends setting aside enough money to cover 3 to 6 months of essential expenses. Maybe that's looking at adding an additional month, or I've had clients with the dollar amount that they feel really comfortable with. And if it feels hard to get to treat your emergency fund like a bill that you pay monthly. So, these are the ways we can help and we'll also talk about what should be in your emergency fund, if that's money markets, higher interest savings accounts, CDs—these are all ways that we help.

JIM: Got it, thank you for that. Hey Jurrien, as we wrap up, I wanted to ask one last question of you a little bit forward-looking, I guess as we look at the big picture here. You both have brought up the R word, we've talked about the potential for recession and you've talked a little bit about earnings as well. So, if you could, sort of tie those two things together. Tell us how companies are doing and what that puts in your mind in terms of what could be coming down the pike?

JURRIEN: Yeah, so earnings are holding up, I think, better than many people expected. So, when we look at second quarter earnings season which is now in the rear-view mirror, 75% of companies beat estimates, I'll be it that those estimates were lowered, right as companies guide down the estimate. But that basically is what always happens, and so 3/4 of companies beat estimates by 4 percentage points. And so, that's the good news, right? So far, it's the shoe that hasn't dropped. And that's an important distinction to make because as I mentioned earlier, you know the markets went down 25% and that's very much in line historically with bear markets that are not associated with a recession, right? And if you have a recession, you are going to get an earnings contraction

so the two go hand in hand. So, 25% is consistent with just a valuation decline based on interest rates going up and the Fed raising rates, etcetera, but it's less than what we would normally see if we had a full-blown recession because those bear markets tend to be more like 35% instead of 25.

So, if the economy holds up, and so far, it seems to be doing that, even though we technically have those two quarters of negative GDP growth. But certainly, the consumer is holding up and Leanna mentioned that earlier that when she is talking to her clients. And now that the Fed can maybe not overshoot a neutral rate as much as the market feared earlier, maybe we don't get to that point—that breaking point where the Fed is just going to cause a recession and then earnings become the other shoe to fall and then all of a sudden, we're in a 35% bear market instead of a 25. But that all speaks to that second chart we showed with the retracement.

So, we're in the fork in the road right now where if the economy is going to hold up, then I think the bottom is in. But if we do end up in a significant recession, which I don't expect, but if that were to happen, then that would suggest there is not a lot of upside from here or maybe even a little bit of down side.

So, to me that's kind of the thing that we need to be looking at. We don't have the answers right now but if you think about it in a real simplistic way, a 35% bear market would be a traditional recession bear market. We went down 25, which means that 25 divided by 35, we have discounted 70% of a normal kind of recession where people get laid off and things like that. And I would argue that 70%—it's not 100% but it's a long way towards 100%. And so, if we either get a shallow recession or no recession, then you can kind of understand why the market is doing better because it means they've fully discounted something that either will happen that way or won't happen and then the market is on a lot better footing.

JIM: Fascinating. Thank you for that incredibly clear explanation. I get it, I understand and with the potential to talk about baby bulls and some growing bears. There is a lot more to follow up in the coming weeks and months. So, plenty of questions for you both as we meet again through the end of the summer and onto the fall.

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our website, download our app to learn more. Those are three pretty simple ways to continue your learning process. Again, huge thanks to Jurrien and to Leanna, and we'll see you back here next week.