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TRANSCRIPT

SPEAKERS:

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Jim Armstrong: Hello and welcome to Market Sense. Thanks for making time to be with us today. I'm Jim Armstrong from Fidelity. You know, along the many recurring questions I think a lot of us have been asking ourselves recently, maybe one of the top ones is this: How long is the post COVID economic boom going to last? And of course, that answer could play out in any number of ways, but to say nothing of the fact there are some folks who are asking, when can we even start to define post COVID? So that's what we're talking about today, some of the different scenarios for that post COVID boom economy, as well as, of course, some considerations that you might make in your own investment portfolio. So to have that conversation, we are happy, as always, to have Jurrien Timmer join us live. He's been studying, of course, where our economy is, where it has been, and where it might be headed next. Jurrien, thanks, as always, for making time for us today

Jurrien Timmer: Great to be here, Jim, thanks for having me

JIM: Yeah, for sure. So let's start off, again, with sort of a high level look at where we are right now. It's Tuesday, August 24th. And, you know, as I say pretty much every week, there's so much that's happened over the past week or two, so many potential market movers in particular. Off the top of my head, the delta variant comes to mind, the situation in Afghanistan as well, so maybe just sort of set the table for us with what you're seeing the market's doing as we speak?

JURRIEN: Yeah. I mean, it's been a wild ride, right, as we know. I mean, we started this series, what, 80 weeks ago in late March of last year. And it's, you know—I mean, it is one—it is going to be one for the record books. You know, 17 months ago we were really in a global depression—self induced, perhaps—because of the lockdowns but it was like a global natural disaster, right, like an earthquake on a global scale. Everything shuts down and then, you know, it comes back reasonably quickly, but still, it took a while and we're still working from home to this day.

But from 17 months ago to now, it's like an entire cycle compressed into a much smaller time frame, right? So we went from a complete lack of economic activity, a depression, to now, we have inflation pressures, the labor market is super tight. Yes there are still 8 million people unemployed. But there's ten and a half million job openings, so there is still a very big mismatch.

And, of course, the Fed is now, what I like to call, doing the taper dance, right? So the Jackson Hole Symposium is happening this week. It's going to be virtual. But the market is expecting Chairman Powell to, kind of, start dropping some trial balloons about when the Fed starts tapering. So to go from depression to the Fed tightening cycle in 17 months is very, very rare. After the financial crisis, it took a number of years. And so there's a lot of balls in the air. We have the Delta variant. Of course, that's very concerning. And the way I like to think about this is, I always ask the question, is this systemic? And by that, I mean, do I—should I worry about this from the point of view of the market?

So obviously, as people, we worry about these things. We worry about human rights and things happening in Afghanistan and elsewhere. But from a market's perspective, the question is, does this affect the US economy or the global economy and therefore the stock market? And as investors, we kind of have to kind of selfishly look at the world in that way. And obviously, the Delta variant has the potential of being systemic, although so far, there really haven't been much in the place of lockdowns, although travel has come down a little bit. But for Afghanistan, I don't really see that connection. And so it's always a good, kind of, way to separate what's important and what's not, again, from the point of view of what it means to the stock market.

JIM: Right. And that makes perfect sense. And so through that lens, particularly domestically, looking at the domestic economy in our markets here, we've, again, talked a lot about what things are going to continue to look like post COVID. And, again, one of the things we're talking about today is the relative economic boom since the lows we experienced at the worst of the lockdown. And I know you make that point before and I think you'll make it again later today. What we're seeing now, in terms of the boom, is really relative related to the lows from, you know, a year and a half or so ago. But bigger picture, the COVID threat itself really isn't going anywhere in the long term, and I think that's one of the contexts to keep in mind as we have today's discussion. So what can you say about that?

JURRIEN: Yes. I think that's absolutely true. And it was just a few months ago that, you know, on this very show I think we were all kind of breathing a sigh of relief that, wow, maybe we are finally past this.

JIM: Right.

JURRIEN: And here we are. You look at this chart. You know, the gray bar shows the percentage of US hospital beds occupied by COVID patients. And it's gone from 2.2% in June to now, it's actually even higher than this. It's now at 13.3%. That actually took me back. I was a little surprised at how rapid that increase was because my sense, maybe naively so, was that the US was going to follow the UK, right? The UK had this wave mostly of Delta variant cases, but hospitalizations didn't really pick up very much. And certainly, fatalities did not. And I think the reason was that the UK has more   the vaccination rate's higher in the UK than in the US, but not that much higher. But I think the vaccinations are more uniform.

And in the US, it's much more of a disparate situation. It depends on where you go in terms of different states, different communities. And so even though you can see in this blue line that the total immune kind of rate, if you add both the fully vaccinated people and the people who got COVID, we are already at 63%, so we're getting there. And so far, the fatality rate is well below the hospitalization rate, so that's good news as well. But frankly, I was a little taken aback by the rapid increase in that rate and it is concerning. The question, of course, again, from the perspective of the markets is, will this lead to another wave of lockdowns? And so far, the answer has been no. I mean, more indoor mask mandates, more vaccination requirements, but not a wholesale lockdown in the economy. And so for the market, of course, that is a very important thing.

So my sense is—and, again, I'm not a medical expert, but these waves in the UK and even in India were about 45 days and we're kind of getting to that point. So my sense is that maybe this wave will start to moderate in the coming weeks. And if we can survive it in terms of the economy, then maybe we won't need any lockdowns, and that ultimately is kind of what the stock market is focused on because lockdowns drive earnings which then drive stock prices

JIM: What do you make then—so maybe no lockdowns or sort of government mandated lockdowns, but what about people's perception and lifestyle choices that they start to make as a result of hearing about the Delta variant or, you know, in the northeast, in other part of the country, it's about to turn to fall, which turns to winter, people stay in more. Maybe you're less likely to go to a restaurant. You can eat on a patio right now if you can eat outdoors, but will you be less likely to do those, potentially, what you would perceive as high risk activities—go to the movies, go to the theater, go to restaurants? So it's not a lockdown, but it's kind of a slowdown driven by consumers. What does the market make of that?

JURRIEN: Yeah. I think that is correct. And you can see that in the markets, right? I mean, you can create sort of baskets of stocks, like sectors but even smaller. So the stocks that—the companies that would benefit if people go out versus the companies that would benefit if people stay in and order stuff online. And just, you know, being in Boston and being out and about in recent weeks, you can see there's still a lot of people out. But a lot of people are wearing masks, much more than they were a few months ago, even just outside. So I do think it's changing people's behavior, which I guess is a good thing. I mean I'm not pro or against—I'm not trying to say something pro or against masks, but it shows that people don't necessarily need to be told what to do. They're going to take care of their own health. And so whether it impacts, like you said, indoor dining, it probably has some impact.

And when we look at, for instance, the number of cruise ships out in the water and the number of TSA checkpoints, those numbers are starting to come down. A part of that may just be back to school, people are done with their summer vacations. But part of it certainly may be people saying, okay, you know what, maybe this is not the best time to go on a trip. Maybe I'll wait until this Delta variant wave has crested

JIM: A couple scenarios I want to ask you about now, we'll start with the more optimistic of the two, the camp of people saying, things are going really well right now. Economy's humming along, jobs to be filled, people still yet to get to work. This is a boom that will continue into a multi year period of growth. Is that too optimistic? What do you make of that assessment?

JURRIEN: No, I think there's some real validity to that. And if you think about it, the Fed has kind of declared—not declared, but it seems to be going in the direction of favoring one of the mandates over the other. So the Fed has two mandates, right, full employment and price stability, i.e. 2% inflation. Now, inflation is a lot higher than that right now, but the Fed and the markets kind of are looking through that and assuming that to some degree it's going to be transitory. And the inflation rate will kind of settle down closer to 2 or 2.5%. And I think the Fed will be fine with that. But right now, the Fed seems to be focused on bringing all those unemployed people back to work, which, of course, is a very noble goal. But in the process, it might make the Fed more accommodative than it may have been in the past.

And I've been through a lot of different cycles. And I remember back in the 90's—long time ago—the Greenspan Fed came out of nowhere, raised rates from 3% to 6%. And it was really about the price stability mandate much more so than the unemployment—the full employment mandate. This stead seems to be a little bit more socially conscious, I guess, is one way of thinking about it. But that's a long answer to your question in saying that if the policy response is more asymmetric, the Fed is more quick to ease policy when something goes wrong and more slow to tighten policy when everything is going in the other direction, then that could prolong the lifespan of the cycle, maybe at the expense of inflation, right? Because then you're letting things run a little hot.

But just to give you an illustration of this, so the Fed kind of has this dual mandate, right? So unemployment—or full employment, price stability—the problem with that, with those mandates is that when you wait for the economic data to come to you, it's kind of old news, right? By the time the CPI gets released, what do you do with that? The Fed sets policy that has a lot of repercussions well into the future, right? So it sets forward looking policy. And if you do that based on backward looking information, you run the risk of policy errors.

And so the Fed, in addition to looking at the real economy—employment, inflation—it also looks at the financial economy. And this chart here shows what we call the Financial Conditions Index, which is a measure of stock prices, credit spreads, short-term interest rates, long term interest rates, and the dollar. And when the line goes up, it's bad. That means financial conditions are tightening. When it goes down, it's good. It means that there's more liquidity in the market and that's kind of the grease that makes the stock market go, right? It greases the wheels of the stock market.

And so what you see here is I have the last four cycles here. And you can see how slowly financial conditions were tightening. And then you get the policy response like the financial crisis or the Dot Com bubble. Then the Fed comes in, eases policy, and you've got a gradual improvement. And then look at the black line, that's the COVID cycle, an immediate spike in the index. But then as immediate as that spike went, the policy response came in so big, both the fiscal and the monetary—so the CARES Act, stimulus checks, as well as the Fed lower rates to zero and increasing its balance sheet, which is now $8.4 trillion. And that response, because it was double barreled, fiscal and monetary, made it much more powerful than just a monetary response.

So back after the financial crisis in '09 and 2010, there was some deficit spending at the time. But it was mostly the Fed and the assets that the Fed bought—so it was buying bonds, putting it on this balance sheet, otherwise known as QE—that money was just sitting there in the banks as excess reserves and the banks didn't really do anything with it. So that stimulus was kind of lost in a way. It was sitting idle.

This time around, the stimulus that the Fed is doing is there to absorb the increase in the debt that the Treasury is doing as part of its fiscal stimulus, and so it has much higher multiplier effect, which is how we think about it. So you see this cycle has been truncated and how that black line has gone below the zero line, which is the start of that cycle, you know, years before in the past cycles that happened. So if you have that asymmetric response and you have this kind of natural disaster type of cycle, so not a balance sheet recession where you had a lot of leverage or the banks were making bad loans, none of those things really happened in this during COVID

So if the Fed response to this rapid improvement and by not over responding with tightening, you could make the argument that the cycle can last a long, long time. And a lot of it will depend on whether the Fed is following, again, that employment mandate or that inflation mandate. And it looks like it's following the employment mandate. And if that's the case, then the Fed will remain fairly accommodative for a while to come. And in the mean time you have a lot of demand. You know, consumers are flush with cash. We had, of course, the stimulus checks, but on top of that, we also have a housing boom as we all know, right? We look at the headlines. Home prices are up 20% just since COVID. And the average mortgage rate for a 30-year fixed rate mortgage is down to under 3%.

So if you're worried about inflation, get yourself a 30 year fixed rate mortgage at 3%, and that's probably one of the best investments you can make. And so that's causing homeowners to refinance, and not only just refinance, but to do cash out refinancing where they actually take some money out of their home equity. So maybe that's another after burner of the fiscal stimulus and another reason why this cycle actually may stay in good shape for a while.

JIM: I certainly know that people feel wealthier and they act like they're wealthier when their home values are up. Not just cash out, but you feel like, oh, I've got $100,000, $200,000 or more equity in my house. I feel more flushed with cash and then I behave that way. So that's certainly an argument in favor of that first camp. How about the second camp though? Maybe they are a little bit more pessimistic. Some would say realistic. I mean, and your answer to that question, you mentioned the Fed a dozen times. The Fed pulls back a little bit. The stimulus ceases. Will that cause sort of the economy to fizzle long term post COVID?

JURRIEN: Yeah. So it's certainly a good point and a lot of it comes down to the Fed's response function. And a lot of that, I think, comes down to whether inflation will be transitory or structural. And that is the $64,000 question that we're all trying to answer, right? We know inflation has come up. It's over 5%. We kind of saw that coming, supply chain bottlenecks, base effect, all that stuff. The question now is, you know, it will probably come down in the months ahead. You already look at, for instance, lumber prices—complete round trip, right? The semiconductor shortage, that will resolve itself. So these supply chain bottlenecks do get resolved. It might take a little time. So the inflation rate will come will come down, I'm sure, in the coming months. But the question is, how far will it come down before it then maybe starts to rise again? Because this is always a cycle.

And so, to me, that is really the main thing that—the main unknown, right, because inflation surprises to the upside—and that's not a prediction, but if you look at wages which are coming up and rightfully so because employers are trying to bring people back and they're not as interested maybe as they were before because older people are dropping out of the labor force. There's a lot of dynamics going on there. But so that's one kind of piece of inflation that could be structural.

The other one is home prices, like we just said. Rents, that's 40% of core inflation. That's a big, big nugget and that's going to be kind of sticky, too, right? The housing market doesn't go up and down every month. So if inflation becomes a little bit more embedded, and maybe we go from what used to be 2% and we go to 3 or 4%, that kind of puts the Fed in a bind because then maybe it doesn't have the luxury anymore to choose the employment mandate over the inflation mandate. And maybe that forces the Fed to get a little bit more hawkish or aggressive. And that brings the Fed, kind of, really into the crosshairs here because, as I said earlier, the Fed has its Jackson Hole Conference right now.

The Fed—the dot plot, as it's called, is hinting that rates will start to rise in 2023. That's still a-ways off. But the common understanding in the markets is that before the Fed starts raising rates, it needs to taper its asset purchases. And by taper, I mean the Fed is now buying $120 billion per month in bonds, mostly treasuries but also some mortgage backed securities. Generally, it needs to bring that level of purchases down to $0 before it raises rates, otherwise you get—it starts to affect the plumbing of the bond market. You don't want to go there.

But to go from $120 billion to $0, and you're starting to raise rates in, let's say a year and a half, that's a fairly small window because—so they have to key this up, float the balloon, make sure the market's okay with it, then start, and then reduce its purchases maybe by $10 billion a month or so until it gets to $0, and then raise rates. And so the Fed has kind of a delicate operation here that it needs to get underway.

And then it becomes a question of how the markets react. And so, to your question, if the market says fine, the Fed can taper and then raise rates because the system is strong, it can handle it, then the stock market I think will be okay and the cycle can prolong. But if the market says no, no, you're going too fast, and the Fed says, well, we have no choice because inflation's now at 5%, then you can get that indigestion and then you get into the financial conditions part of the cycle, right, so financial conditions, the financial economy—the real economy—and then you get into a more murky territory. So it's a delicate balance and it's one that the Fed really needs to get going on

JIM: Delicate is exactly the word that I was thinking as you said that. So thanks for bringing some context to everything that we're seeing happening in the world around us right now, Jurrien. As always, tremendously helpful to us as we look at our own portfolios and investments and, again, just try to get a handle on what's happening. So thanks again, for being with us today. And for our viewers, of course, thank you for watching, as always.

Just a reminder, if you need help with your financial planning or you've just got questions about how Fidelity can help you, you can visit our website or download our app. Again, those are a couple of really good ways to continue learning more about things that Jurrien and I discussed today or any other topics that you might be interested in related to Fidelity's planning solutions. Again, huge thanks to Fidelity's Jurrien Timmer and we hope to see you right back here next week as well.

JURRIEN: Great. Thanks.

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