Fidelity Viewpoints®: Market Sense

Week 114, September 20, 2022

TRANSCRIPT

SPEAKERS:

Jim Armstrong Naveen Malwal Randelle Lenoir

Jim Armstrong: Hello, and thank you for joining us for Market Sense. I'm Jim Armstrong with Fidelity. Yeah, so the headlines kind of staying the same week-to-week. More volatility, after last week's higher than expected inflation data, the markets fell to their lowest point in about two years. And then of course, this week we are anticipating the Federal Reserve meeting where the Central Bank is expected to raise rates by three quarters of a percentage point, maybe more. So that's got us thinking about not the best topic, debt.

We have inflation soaring. It's getting more expensive, I should say, to borrow and hold debt and investors are simultaneously watching their savings shrink. So, today we are going to talk about how you might think about plans to pay down your debt, even as markets continue on their, unfortunately, uncertain paths. We've got a couple of fantastic guests here today, lending their terrific expertise for the conversation. We have Naveen Malwal, he's an Institutional Portfolio Manager with Fidelity Strategic Advisors. So, he's going to be sharing his insights into the latest national and world news, market conditions. And he will, of course, be talking about what rising interest rates mean for each of us as investors.

And as a leader of a Fidelity Branch outside of Chicago, Randelle Lenoir is here to talk about top questions she and her team are hearing, day-in-and-day-out from our customers. Guys, thank you both for making time with us today.

Randelle Lenoir: It's great to be back.

Naveen Malwal: Same, good to be here.

JIM: Alright, let's dive right in and Naveen, we will start with you if that's okay. It is Tuesday the 20th of September. And as I mentioned at the top of the show, we had the Dow falling some 1300 points last week, we don't want to make anybody relive that necessarily, but as a result of the inflation report that cam in that's how the Dow responded. And again, inflation is just still proving to be persistent and stubborn, and as we look ahead to the Fed meeting this week, I'm curious for your take, Naveen on how aggressively you think the Central Bank will move interest rates, and in general help us understand what you are seeing here?

NAVEEN: Yeah so, Jim, you can see on the screen right now the CPI reading, it is ticking down from its peak but it's happening really slowly. And judging by the market reaction we saw last week; it seems like most stock and bond investors were hoping for better results. The hope was inflation could show better signs of slowing, maybe the Federal Reserve doesn't have to raise rates as aggressively, but with inflation number coming in as hot as it did, the feeling is that the Fed will have to keep raising interest rates. And if you think about inflation, it's a mix of things, right? On the one hand, you saw things like gas prices come down, that was good. But on the other side of it, things like rent, food; those are persisting and that's leading to this slower decline in inflation than most of us are hoping for.

JIM: You know I'm curious too, with that as the backdrop, I'm curious, it feels like the Fed almost has to play the hand it's dealt, it simply must keep raising interest rates? How fair is that to say? And what do you see coming down the road?

NAVEEN: That's how most investors think about this, right? The Federal Reserve, it has two mandates. One is to maintain reasonable price increases, or reasonable levels of inflation, nothing too hot like 8% like we are seeing. And the best tool they have to combat that is to raise interest rates. So, we have a research team here at Fidelity, the Asset Allocation Research Team who we partner with really closely. And when they analyze inflation, their view is inflation is likely heading lower. So, they were expecting this decline to take place that we have seen. They also believe though it will take several quarters for this to play out so it could be a story for the rest of the year, into next year, unfortunately. And along with that, maybe some more market volatility. Doesn't mean stocks and bonds will just continue to sell off but we might see the ups and downs that we've seen in the last few weeks as investors go back and forth from optimism to maybe something less optimistic over time.

JIM: You didn't use the word pessimism, you used optimism and less optimism. I would like, I like that very much Naveen. I have a couple of follow up questions for you actually. But before we move there, Randelle I'd love to bring you into the conversation just to get your sense—the types of questions you and your team are hearing from investors who are coming in to talk to you or having Zoom calls or phone calls or whatever the case may be. I'm just curious what they are making of what the markets are doing, what inflation is doing and how they are making plan based on that?

RANDELLE: Yeah, we are seeing a couple things now. First, it's back-to-school time, so going back to colleges and universities. People are taking their kids back-to-school and refiguring their family routines, maybe even going back to work. So, with that along with this conversation about loan forgiveness and student loans and financial aid, a lot of people are asking about future financial expenses and how to plan for that. I mean that's one place we see a lot of inflation over time, right? The cost of education. And a lot of people that are on the other end of that who maybe already funded their education with loans are making game time decisions around paying off debt or investing in the market, right? So, a lot of conversations there. Also, with things rising as they have for a while, as far as costs, you have a lot of pre-retirees and current retirees coming in to talk about income or future income. I think a lot of them are surprised by when they approach what tools they have available to combat some of this what we are seeing in the market, I think a lot of clients are surprised to learn that just as quickly as the market is changing, just as quickly as costs are expanding, our industry, you know, financial services and wealth management are coming up with tools to fill those gaps for people, as they have new needs.

JIM: I'm curious too, Randelle, how optimistic would you say people are generally speaking, what are you and folks on your team hearing from people?

RANDELLE: Well, I would say cautiously optimistic. We are seeing a mix, there's still people who continue to want to, you know engage with debt like there are still people who want to purchase houses and expand their families and send kids to school and still pursuing those really great goals that we like to see. But just some people are a little curious about what that looks like now, versus 5–10 years ago.

JIM: Yeah, right. That planning in the backwards looking as well, super important. Hey, Naveen, I want to return to the topic of inflation really quickly with you. Just because when you see it covered in the news, you read an article about it or see it on TV. It's obviously, if you are watching here in the US, it's very much focused on what's happening here and a little bit less often times abroad. Giving people maybe the wrong impression that inflation is a domestic-only problem, when in fact it's a global problem right now. So, talk a little about that and how what's happening in the world is impacting us here directly?

NAVEEN: It has been a global phenomenon. Basically, starting from the second half of 2020. And where it started back then were these shut downs related to the pandemic. Where many people were unwilling or unable to work, because of illness or government limitations and that led to shortages in supplies. That's the original supply chain disruption but it just seems it's been a comedy of errors ever since then. It's been one thing after the other. There has been global trade disputes, there's been bad weather events, particularly in 2021. There was a boat that got stranded in a major canal around the world, right? Like one thing after the other kept going wrong. And then finally investors are looking forward to less of that this year. But we've got now the situation in Russia and Ukraine, and China struggling with COVID shut downs so it's still not resolved. However, the good news is that you can see on the screen right now, a measure of the pressures on supply chains, it has come down considerably from its worse scene we saw a few months or even quarters ago, but it's still elevated. So, here is something else that is pointing me in the direction of feeling, "Hey, you know what this inflation thing is probably get better but it might still take time to get there." This is a longer-term chart, so if we can picture that line falling for several more quarters still from here on out.

JIM: That's the example of a chart we want to see the line dropping perfectly. But I want to also ask you about another element that needs to be considered here and that's labor, the job market. You know certainly last week I think a lot of us were following the narrowly avoided railroad strike that would have had—you know talk about a comedy of errors would have had more terrible implications potentially on the supply chain. In general, though, I think the connection between that and just the labor market in general is pretty obvious. So, can you talk about what's going on with jobs and part of that dual mandate you mentioned that the Fed has which is connected to employment.

NAVEEN: It is, so one of the measures or one of the mandates of the Fed we talked about is managing inflation. The other goal of theirs is to maintain full employment. Now, full employment doesn't mean 100% employment. It means enough jobs where most people feel comfortable about their situation and a bit of unemployment that always accounts for people moving jobs and changing things around. What we have right now is an unusually tight job market. Unemployment is still below 4%, which is near its all-time low. The long-term average in the U.S. is closer to 5-6% during an expansion. And closer to 7-8% when there's a recession here. So, with these very low levels, the Fed believes it's part of the challenge of inflation. We have an overly hot job market. It could be something that puts pressure on wages and causes prices to rise.

Now this is a tough conversation, because most of us think of a strong job market as being nothing but good, right? I feel thankful for a strong job market, for example. However, I think most of us have also experienced what it's like to deal with a shortage of workers. If you have tried traveling or dining out or shopping. Or maybe other experiences, going to the mechanic, for instance, there's a shortage of workers out there. And that's the market that is considered perhaps too tight, putting a lot of pressure on company's wages and their cost structures. What's happening with higher interest rates though is many companies are now starting to feel, hey if business might slow down a bit from these really hot levels because of higher interest rates, let's ease off on our hiring plans. And a couple of firms talked about laying off, which are always a struggle. I know I have been through one many years ago in my career. But for now, folks getting laid off are still finding jobs. But overall, the hope is if we can get from an overheated job market, something closer to more of the long-term average of say 5% unemployment that might help ease some inflation pressures on the U.S. economy.

JIM: All right, while we have all that going on here at the 30,000-foot macro level, Randelle just old investors, just going to work every day or living through retirement trying to make good financial decisions for themselves. One thing that we have talked about a little bit that we should dive into more is this idea of debt, right? You mentioned student loan debt for some folks, mortgage debt for others. Revenge spending the term I love to think about, people have pent up demand to go out and buy things and take vacations, incurring perhaps some debt if they have over spent their means. What advice or what thoughts do you have for how people might want to think about their debt in exactly the type of high inflation environment that Naveen was just laying out for us?

RANDELLE: Yeah, debt, never a fun topic, but definitely a critical topic to be discussed in your financial plan. So, whether it's credit cards, student loans, paying for your car, home renovation, whatever it might be, all of us will encounter debt at some point in our lives. And getting a handle of your debt is part of not only a strong financial plan, but the ability to navigate the conditions that we are in that Naveen mentioned before. So, particularly when the economy gets tighter, you want to make sure that you have the right steps in place to navigate any type of weather. So, the volatility as we said, has caused people to be concerned about losing their jobs. Some people are getting laid off, right? You see interest rates rising, which means it's more expensive to get a loan, or a mortgage. It's growing more expensive to hold debt in many instances so you have to set yourself up for success.

JIM: And I know that the answer to the question I'm about to give you is really specific to each person, right? There's no magic bullet, there is no one size fits all but generally speaking, what are some steps that people might consider taking to get themselves, you know on the right path at least, when it comes to debt management?

RANDELLE: Yeah, so first and foremost, we believe you should be trying to do both at the same time, if you can. Paying down debt and saving for the future. And I'll break that down. So, whatever your financial priorities are, you want to make sure you are at least making minimum payments on your debt and on time, right? Because if you miss it, or you are not paying at least the minimum, this leads to, you know late fees, late fees lead to low credit scores, higher interest rates and you just find yourself with a growing amount of debt that prevents you from building wealth. Or for saving for retirement, for instance. So now that we have that settled let's get into this plan about how to do both at the same time. So first, you want to build up a little bit of a cash buffer to prevent you from getting into debt unnecessarily. The first thing we recommend is you build an emergency fund of money you set aside in cash, or cash equivalent. Good rule of thumb is six months of expenses so if you lose your job or something unexpected happens, you are covered at least in some way with some cushion. You may expand that a little bit depending on what your comfort level is, but six months is a good rule of thumb. Next, you want to make sure if you are working you are contributing to your 401(k). If you are lucky enough to have a company that matches, a good rule of thumb is to aim to contribute up to the match. So, for example if a company matches at 5%, aim for 5%. But even if you can't do that, everyone is in a different place, at least start contributing to your retirement. Because as we know with investments about time in the market, overtiming, the sooner you start the better. Even if it's just 1% and you increase it as your financial situation gets better, as you get raises or promotions and things like that.

Number two, make sure you are contributing to your 401(k). Then you want to look at your debt. We recommend that you start looking at your high-interest debt. Typically, that's credit cards for most people. You want to tackle paying those down with any extra money you have outside of this plan first. And that will help get you into a better spot. Then you want to look at paying off your private student loans. Those tend to have higher interest rates than your federal student loans so that's why we recommend those first. And then contributing, or then paying off your federal student loans after that. And no matter what side of the conversation you are with Biden's loan forgiveness program, you want to make sure you know how much you owe and that you have a plan to pay it and automate it as well.

JIM: I want to—that was fantastic, thank you for that. But I want to pair back a question I have heard a ton and probably you have as well. This question of so I have this debt, how do I navigate paying it down and investing. I hear some people say I'm not even think about investing until 100% of the debt is gone. What is the perspective on that for you?

RANDELLE: So, because time is so important for compound interest and all of the things we need to do to make sure we are in a good place for retirement, you should be trying to do both at the same time. But here is a great rule of thumb when you are looking at the debt that you hold, whether or not it makes sense to rush to pay it off or can it wait, right? For many people it generally makes sense to pay down debt with an interest rate of 6% or greater, 6% or greater. Now this principal rule of thumb has a lot of assumptions that we are making here so I will run down a few of them. It's assuming that you have at least ten years until retirement. It's assuming that you are investing in a well-balanced disciplined portfolio with about a 50% allocation to stocks. And that you are doing a lot of the things that I discussed earlier. Especially that you are saving for retirement in a tax advantaged account like a 401(k), or an IRA.

So, we use the guideline of 6% for this reason. We find that if your debt is less than 6% it may make sense to invest those extra dollars in the market because your potential returns there are greater, right? So that's why 6% is the rule of thumb. And if you think about it, your ability to amass wealth and to build some financial stability by doing both and making these decisions, can help you get into a better financial situation more quickly with this rule of thumb. If you do have student loans or mortgages, another thing to think about here is to make sure you are getting the tax advantages of any of the interest you are paying. So, make sure you are having those discussions. And ultimately when you think about, "Okay, Randelle where should I be aiming to save, right? How much should I be saving, especially for retirement?" A rule of thumb here is 15%, 15%. And again, if you are lucky enough to work for an employer that matches that, that includes the part they would contribute to your 401(k) as a match. So, 15% is a good aim for how much everyone should try to save for their retirement.

But of course, everyone's situation is different. We hope that it's enough to at least get your wheels turning how to approach this. But if you are confused or if you have a special situation, I don't want anyone to hesitate to reach out to a financial professional. I mean that's what we are here for, we are here to help you figure out how to navigate these things.

JIM: Yeah, fantastic reminder there, thank you for that. Naveen, with a couple minutes we have left, I would love to go build on what Randelle was just talking about I term of investing with a particular focus on bonds, right? We know that the interest rate environment and certainly the inflationary environment all plays a role for the average bond investor. What do we need to know right now?

NAVEEN: Yeah, I think some of the numbers Randelle was sharing, that 6% rule, yeah that sounds about right for half stock, half bond allocation and here is part of the reason why. So far this year, bond investors have had an extremely rough experience. Typically, a down draft of bonds is considered minus 2, minus 3%—maybe 5% is considered a bad stretch. We are looking at –10 so far this year. It not unprecedented, but unfortunately it seems to happen around times where inflation is surprisingly high, and interest rates are rising. We had something no different this time around. So, the back drop painful for bond investors. However, I feel much more constructive about where things go from here for bond investors. One example we are looking at now is the yield that we are able to get on bonds is much higher than it was at the start of the year. Over on the left side of the chart, we have investment grade bonds. So, think about a mix of treasuries, high quality corporate bonds. There, the yield is close to 4% these days. So tremendous compared to what we have seen more recently which has been maybe 2% or less.

On the right side of the chart, we have high-yield bonds which typically have more risk, have more volatility but if you are patient with a long-term view you could benefit from a yield closer to 8% in that part of the bond market. So, at this stage a bond investor could find a mix of bonds that get them a yield 4–5–6% if not more, depending on how much risk they want to take and that could be a powerful part of an investor's portfolio to help balance some of the risk that might come from stock portion which can grow overtime but also tends to experience more volatility.

JIM ARMSTRONG: Fantastic perspective. This was I think the speediest 20-minute episode we have done in a long time. So, thank you both for sharing your insights, we really appreciate it. For the folks in the audience, we know you have a ton of ways to watch Market Sense each week, but if you happen to be watching on Fidelity's website right now, you will find a quick three-question survey just under this video. If you could take literally less than a minute to fill it out and let us know what you think of the show, we would very much appreciate it. Again, that's only available for those of you watching on Fidelity's website.

And as always, I want to leave you with the reminder as Randelle mentioned, if you have questions about making or updating your financial plans, staying on track with your current one, Fidelity can help. Give us a call, go online, visit our website, download our app, and begin to learn more that way. Again, huge, huge thank you to Fidelity's Naveen Malwal and Randelle Lenoir. We hope to see everybody back here next week.

Methodology for **Debt vs Investing** slide:

This guideline is based on estimates of future investment returns3—which, of course, aren't guaranteed. By contrast, the "return" you earn on every dollar of debt you pay down is indeed guaranteed (through the extra interest you avoid).

Most people prefer a sure thing to a risky bet, so we incorporated an additional margin of safety into our methodology. In essence, our guideline assumes that you would only choose investing (the risky bet) if it has at least a 70% chance of beating the guaranteed return you would earn by paying down debt (based on our estimates of what likely future investing returns will look like).

Put another way, if our methodology2 suggests that you should invest, that doesn't mean we're 100% sure that investing will come out ahead. But we believe it should beat the return you'd get from paying down debt about 70% of the time.

[1]The "less aggressive" asset allocation assumes a 20% allocation to stocks, the "balanced" asset allocation assumes a 50% allocation to stocks, and the "more aggressive" asset allocation assumes a 100% allocation to stocks. Critical interest rates are calculated using estimated asset class returns distributions. See footnotes 3 and 4 for further details.

[2]This analysis used a horizon of 10-40 years comparing the rates of return that could be experienced with various levels of interest rates. First the return over the accumulation horizon is determined by running 250 Monte Carlo simulations of the balance growth of a portfolio. Next a 70% confidence level was used to identify the rate of return over which debt would be preferable to pay down. The 70% confidence level is used because it represents a typical level of loss aversion. After determining the effective rate of return over the horizon at the 70% confidence level, this return is used to compare to interest rates on the debt. If the debt interest rate is greater than the return over that horizon then paying down debt would be preferential.

[3]The values in this article are based on a Monte Carlo simulation–based approach to estimate potential growth of account balances. The analysis is based on historical market data to estimate a range of potential outcomes for various hypothetical portfolios under different market conditions. Monte Carlo simulations are mathematical methods used to estimate the likelihood of a particular outcome based on market performance historical analysis. While over very long periods of time, markets have averages, it is often the case that the market performs both above and below these averages. The Monte Carlo simulations are designed to reflect this historical market volatility.

Information presented herein is for discussion and illustrative purposes only and is not a recommendation or an offer or solicitation to buy or sell any securities. Views expressed are as of the date indicated, based on the information available at that time, and may change based on market and other conditions. Unless otherwise noted, the opinions provided are those of the speakers and not necessarily those of Fidelity Investments or its affiliates. Fidelity does not assume any duty to update any of the information.

To the extent any investment information in this material is deemed to be a recommendation, it is not meant to be impartial investment advice or advice in a fiduciary capacity and is not intended to be used as a primary basis for you or your clients' investment decisions. Fidelity and its representatives may have a conflict of interest in the products or services mentioned in this material because they have a financial interest in them and receive compensation, directly or indirectly, in connection with the management, distribution, or servicing of these products or services, including Fidelity funds, certain third-party funds and products, and certain investment services.

Investing involves risk, including risk of loss.

Past performance is no guarantee of future results.

All indexes are unmanaged, and performance of the indexes includes reinvestment of dividends and interest income, unless otherwise noted. Indexes are not illustrative of any particular investment, and it is not possible to invest directly in an index.

Estimate based on a hypothetical opposite-sex couple retiring in 2022, 65-years-old, with life expectancies that align with Society of Actuaries' RP-2014 Healthy Annuitant rates projected with Mortality Improvements Scale MP-2020 as of 2022. Actual assets needed may be more or less depending on actual health status, area of residence, and longevity. Estimate is net of taxes. The Fidelity Retiree Health Care Cost Estimate assumes individuals do not have employer-provided retiree health care coverage, but do qualify for the federal government's insurance program, Original Medicare. The calculation takes into account cost-sharing provisions (such as deductibles and coinsurance) associated with Medicare Part A and Part B (inpatient and outpatient medical insurance). It also considers Medicare Part D (prescription drug coverage) premiums and out-of-pocket costs, as well as certain services excluded by Original Medicare. The estimate does not include other health-related expenses, such as over-the-counter medications, most dental services and long-term care.

The commodities industry can be significantly affected by commodity prices, world events, import controls, worldwide competition, government regulations, and economic conditions.

The S&P 500® Index is a market capitalization–weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. S&P and S&P 500 are registered service marks of Standard & Poor's Financial Services LLC. You cannot invest directly in an index.

Diversification and/or asset allocation do not ensure a profit or protect against loss.

Stock markets are volatile and can fluctuate significantly in response to company, industry, political, regulatory, market, or economic developments. Investing in stock involves risks, including the loss of principal.

Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies.

The consumer discretionary industries can be significantly affected by the performance of the overall economy, interest rates, competition, consumer confidence and spending, and changes in demographics and consumer tastes.

The technology industries can be significantly affected by obsolescence of existing technology, short product cycles, falling prices and profits, competition from new market entrants, and general economic condition.

Foreign markets can be more volatile than U.S. markets due to increased risks of adverse issuer, political, market, or economic developments, all of which are magnified in emerging markets. These risks are particularly significant for investments that focus on a single country or region.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities). Fixed-income securities also carry inflation risk, liquidity risk, call risk, and credit and default risks for both issuers and counterparties. Lower-quality fixed-income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

High-yield/non-investment-grade bonds involve greater price volatility and risk of default than investment-grade bonds.

Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies.

Dollar-cost averaging does not assure a profit or protect against loss in declining markets. For the strategy to be effective, you must continue to purchase shares in both market ups and downs.

Fidelity Wealth Services provides non-discretionary financial planning and discretionary investment management through one or more Portfolio Advisory Services accounts for a fee.

Advisory services offered by Fidelity Personal and Workplace Advisors LLC (FPWA), a registered investment adviser. Fidelity managed accounts refer to the discretionary portfolio management services provided by Strategic Advisers LLC (Strategic Advisers), a registered investment adviser. **These services are provided for a fee.** Brokerage services provided by Fidelity Brokerage Services LLC (FBS), and custodial and related services provided by National Financial Services LLC (NFS), each a member NYSE and SIPC. FPWA, FBS, and NFS are Fidelity Investments companies.

The CFP® certification is offered by the Certified Financial Planner Board of Standards Inc. ("CFP Board"). To obtain the CFP® certification, candidates must pass the comprehensive CFP® Certification examination, pass the CFP® Board's fitness standards for candidates and registrants, agree to abide by the CFP Board's Code of Ethics and Professional Responsibility, and have at least three years of qualifying work experience, among other requirements. The CFP Board owns the certification mark CFP® in the United States.

Fidelity does not provide legal or tax advice. The information herein is general and educational in nature and should not be considered legal or tax advice. Tax laws and regulations are complex and subject to change, which can materially impact investment results. Fidelity cannot guarantee that the information herein is accurate, complete, or timely. Fidelity makes no warranties with regard to such information or results obtained by its use and disclaims any liability arising out of your use of, or any tax position taken in reliance on, such information. Consult an attorney or tax professional regarding your specific situation.

Before investing in any mutual fund or exchange-traded fund, you should consider its investment objectives, risks, charges, and expenses. Contact Fidelity for a prospectus, an offering circular, or, if available, a summary prospectus containing this information. Read it carefully.

Personal and workplace investment products are provided by Fidelity Brokerage Services LLC, Member NYSE, SIPC, 900 Salem Street, Smithfield, RI 02917

923295.174.1