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.

Just before the webcast gets started, we were just talking about what a fantastic pre fall day it is here in the northeast today. Seasons are about to change and that really gets us in the mind maybe to talk about another sort of four phase cycle in addition to the seasons that really affects our lives, the business cycle. I know it sounds a little abstract, but knowing how the business cycle works can really help you evaluate sort of your situation, perhaps identify some opportunities, and maybe even make some necessary adjustments to your investment strategy. So, that is what we are here to discuss today, hoping also, by the way, to get a little bit of context for days in the market like yesterday.

Monday, the market spooked quite a lot of people, so we are going to help put that in context by using the business cycle. Now, to have that conversation, we are excited to welcome Denise Chisholm back to the show. Denise, as you may remember, is a sector strategist here at Fidelity. She studies what our market—how our markets and our economy work and why. And her analysis, by the way, informs a lot of what we do here at Fidelity, including the conversations that people like our other guest, Leanna Devinney, have with customers every day.

Now, Leanna leads a team of folks who spend their time working one-on-one with people, helping create and maintain financial plans.

So, Denise, Leanna, thank you again for making time to be with us today.

Leanna Devinney: Thank you, Jim. Great to be back.

Denise Chisholm: Great to be back. Thanks, Jim.

JIM: Yeah. We've got a meaty topic today for sure, so let's get right into it.

It is Tuesday, the 21st of September. Leanna, I want to start with you because I know as I mentioned, the business cycle itself can feel really abstract to people, but you and your team help explain it in a way that reinforces its relevancy to every investor, no matter sort of their sophistication level. You can explain how and why the business cycle matters. And again, I think it's just particularly important this week because of what happened yesterday in the markets. You can help situate that in context and maybe help people be calmer about things.

LEANNA: Great. I will and I'll touch on yesterday's volatility in a moment. But I think first, this slide helps show really what the business cycle is—or economic cycle, that we call it—and why we feel it's so important in the conversations we have with our clients.

So first, what it is. It's a measure of GDP, gross domestic product, and that's really the health of our economy. This trend line that you see here on the slide, many clients will at first think, is this the stock market? But it's not. It's the GDP.

So, on the left you can see the plus or minus on economic growth. So, everything above the line is a positive GDP and everything below the line is when GDP is negative.

So, our economy has times where we are expanding, contracting, or in recovery, and there are four phases to our economy, to the economic cycle, early, mid, late, and recession, which you can see left to right.

Just some background. Historically, we have gone through all phases in as short as seven years. And then sometimes it takes historically as long as twelve years.

So, as of this summer, Fidelity believes that the US economy has entered the mid-phase, the mid-cycle. Typically, this is the longest phase. And so, looking at history on average, we see the mid-phase can last three to four years. And in the mid-phase, we see moderate growth, we see economic activity gather momentum, credit growth is strong, profitability is healthy. Since it's the longest phase on average, that is where we also can see the most volatility.

So, days like yesterday is very normal. And in fact, we see the mid-phase that we can see a correction of 5% to 10% really at any given time. I know Denise is going to talk about that further, but also just thinking back to yesterday, Jurrien had said this last week on the webcast.

JIM: Yeah.

LEANNA: September and October is also historically a time where we see volatility have some scary declines. So, again, it's normal.

Just to hit on some of the other phases we have, I just talked on mid, but we have early, late, and recession. So, generally, early is we see that sharp recovery from recession. Late is when the economic activity has often reached its peak and that's where we can see inflation sometimes and higher interest rates. And then the final phase, which I'll talk about later on, is recession. This is where the economic activity can contract, rates and business inventories can fall. There is a lot there. But mid-phase is where we are right now.

JIM: I wanted to—thank you for that, by the way. That was concise and super helpful. And I want to ask Denise a couple of questions but before I do, Leanna, I know that you had a couple of really specific examples from real people who you and your team are working with who are able to sort of incorporate the business cycle into their plans. So, I was just hoping you could share a couple of those stories.

LEANNA: Absolutely. It comes up so often in our meetings so I do think first, we start with education on what the business cycle is, and because of its trends, we do feel and believe it's a key indicator of how stocks and bonds, returns, it impacts the returns over time.

So, first, how we help clients with the business cycle. I think it's first to understand everything we do is around planning for the goals that you have and making sure that you are building that well-diversified plan that you are comfortable in, but so that you can stay invested no matter what phase we are in the economic cycle. So, we like to have the lens of where we are to help clients be proactive and have an understanding of times we see volatility.

So, a gentleman last week, he was in his late 50's and he had a lot on his plate. He has his family and he is also being a caretaker for his mom as a primary caretaker.

100% of his retirement was in one fund and specifically that fund was all growth stocks, all large cap growth stocks. So, we used this chart. We brought this to attention to just share that at different times in the economic cycle, stocks perform differently, bonds perform differently. So, we went over his risk tolerance and time horizon and instead we started building a strategy that's a little bit more diversified that he is again able to stay invested no matter what phase of the economy we are in.

And then going a little deeper, we see this too, a woman who was working in her late 40's, over half of her portfolio was in one category of the market sectors. It was in technology. And so, during different phases of the economy, this might have performed very well but then it could react very differently in other phases of the economy.

So, in her case, we also talked about the business cycle, what those ups and downs can mean, and again, making sure we are building that plan that you're able to stay invested no matter what phase we are in in the economy.

JIM: Makes a lot of sense. And again, as you said, that is a really important point to make that the business cycle gets situated within sort of an individual investor's, you know, personal goals, their timelines, their horizon, how much risk they want to take on. So, it's interesting to see how it all fits together in that—in that universe of things to be concerned about.

Denise, I would love to sort of broaden the conversation right now a little bit and talk about what you are seeing and what your analysis is showing about sort of the state and health of the economy at large at the moment. And again, in particular, if you could sort of keep in mind, yesterday in the markets which I had I think more than a few of us concerned, let's say that.

DENISE: Yeah, let's talk about corrections first and then we can talk about sort of the state of the economy as I measure it more quantitatively than Leanna was talking about.

But corrections, I mean, I think investors know that they are a normal and a healthy aspect of equity market, but then they happen and they don't feel so normal and healthy. So, some context around those could actually be helpful.

So, in 60% of the years, so most of the time since 1962, you have a correction anywhere between 5% and 15%, but in 75% of those years, you end up "up" in the equity market, right? So, there is a statistic that says that corrections happen in most years. The question is what should you do with it? And this is the math behind why investors, why you hear people say buy the dip.

So, if your average returns going back to 1962 are about 8% in the equity market and you have 75% odds of it being an advancing equity market over the course of those years, what you see is if you added capital after we had a 10% dip, then you would actually boost those average returns from 8% to 10.5%, so 250 basis points just by adding on that dip, increasing your odds to about 85%.

To incorporate Leanna's analysis of the business cycle, to the extent that you have confidence that we are in the mid-cycle and not enter recession over the next twelve months, then those odds shift substantially, and after a 10% correction, you get an increase in average returns not from 8% to 10.5% but from 8% to 24% on average with 100% odds historically.

So, that is the rationale behind why we talk about buying the dip and staying invested.

Now, as it relates to the second topic which is talking about what I would call peak everything. I think that there is a concern that we have seen the strong recovery and now that strong recovery, while still strong from the economic growth perspective, is very clearly decelerating. So, is really the best of equity market returns behind us?

So, there is no doubt that we're seeing deceleration in GDP, even capital goods orders that are surprising to the upside which is sort of a measure of capital expenditures in the overall economy, but what you can see is the part that matters to the markets is not whether it decelerates, it's what it decelerates to.

So, to the extent that we are in the mid part of the economic cycle and we slow, but says something greater than 2.5% GDP growth, you notice on the left-hand chart that that doesn't really change your odds in market advance versus any baseline. 73% odds like we were talking about, 75% odds in that deceleration phase if we end up slowing only to that sort of soft landing.

And if you are sort of wondering whether or not that that is likely, even without knowing where you are in the economic cycle, that goldilocks situation actually does have the highest odds at 75%.

So, I think that the takeaway from this chart is that the second derivative or that rate of change slowing matters less to the market than how durable the economic cycle is going forward.

JIM: Great, great context to help us sort of figure out where we are in time. And again, like I keep saying, to ride through, to live through an event like yesterday and understand sort of how it fits into a larger historical context.

Denise, while I have you here, I sort of want to take particular advantage of your expertise when it comes to the various sectors of our economy, in particular, cyclical sectors. I know you spend a lot of time focusing on those parts of the economy, those industries that really move in tandem with the cycles of the business cycle, right?

DENISE: They do. One of the reasons why I study sectors it because it's nice and neat the way you can divide them into what I would call defensive sectors like consumer staples, utilities, healthcare, the whole telecommunications services sector, things that you do even despite a big stock market correction or an economic recession. You still tend to buy your toothpaste. You still tend to turn the lights on. You still tend to go to the doctor. Versus any other sector that is really economically sensitive that you might pare back on during times of higher unemployment or contraction in GDP, like technology, consumer discretionary, financials, energy, industrials, and materials, and I'd even throw in real estate.

And if I said those all too fast, you can go to Fidelity.com/QSU and look at that sector score card.

But what's interesting is the way you divide them up, you can really start to see a pattern around the economic cycle. That is where it becomes key for cyclical sectors in terms of that second derivative is not necessarily a bad thing. Again, if we sort of focus on the left chart with the odds, the right chart with the average alpha, so cyclicals versus those defensive sectors, you'll see as long as you are decelerating to a rate that is above what I call sort of the soft landing, 2.5%, you still get good odds in those—owning those cyclical sectors that are more economically geared with an advantage in—versus the defensive sectors.

And I think that given what we are seeing in the market, this cycle has been different in the sense that wages are now quite a bit above their prior peaks, which took us three years in the prior recovery to get to, but only eleven months. So, that is not including transfer of payments or any kind of unemployment insurance benefits from the government. This is just the people that are employed times the wages. You'll see actually the baton has now been handed which actually creates a more durable economic cycle going forward which increases the odds of cyclical sectors still outperforming the defensive categories.

JIM: That's interesting. So, if I heard you correctly, then that is stronger wages that folks who are still employed who are earning bolsters the overall health of the economy. Am I hearing that right?

DENISE: That's exactly right. And it's very different from last cycle which we didn't really see.

JIM: Great. Okay. Thank you for that.

Speaking of cycles, Leanna, I wanted to ask you a question too. I know that, you know, probably if you stopped ten people on the street and said, name one of the—name part of the business cycle, you're probably going to hear the same one over and over again and it tends to be that one part of the cycle that—I don't want to say matters the least but can be the most distracting, right? So, can you talk a little about that?

LEANNA: Yes. I love that example because I don't think anyone on the street is going to say mid-phase expansion, early phase.

The one we know and feel the most is recession. So, that is what our clients ask us about the most. That is what we talk about and that's what can be the most unnerving and overwhelming too.

So, recession can feel scary and it also makes people not wanting to be invested. But like I said earlier, historically, it's the shortest of the phases. They happen fast and on average through all of the cycles, they are less than one year.

I think what's important to know though is very often we don't know that we are out of a recession, until it's officially over, until we are far out of that.

So, let's use last year as an example. In 2020, the National Bureau of Economic Research stated that the recession ended in April 2020. Very short. But they didn't say that until the summer, this summer, so almost fourteen months later.

So, why I bring that example up is there were many clients last year in early 2020 who said, I think I'm going to sit this one out. I just want to sit out until the recession is over.

And unfortunately, the getting out can be the easy part but it's when do we get back in? Again, if we are waiting on the announcement fourteen months later, we have now missed the early phase and into the mid-phase of that economic cycle. So, in sum, it's really important to have a lens as to where we are in the economy so we can feel comfortable and confident. Really important to have that plan aligned with our goals.

And so, I find that clients that have an understanding of this and know that it's a key influencer of stock and bond returns and the different sectors depending on what phase we are in the market, it does allow us, again, to stay invested and just be more proactive with our goals versus reacting to the short-term news lines or seeing what the market is doing.

JIM: Yeah. I also wanted a quick follow-up, Leanna. I think when Jurrien is on the show too, he often talks about folks who try to time the market, thinking they're getting out and getting in at the exact right moment. But your point is so well taken. It's all but impossible to do that in practice, is that fair to say?

LEANNA: It is impossible and I'd say, you know, the easiest part, again, is getting out. This doesn't feel right, let me get out. I'm going to sit out. But time and time again, it's saying, okay, well, when are we going to get back in?

And very often, last summer as an example, if it was June 2020, many people were not getting back in. They weren't ready, seeing that sharp decline. But we were again, already out of that recession at that point.

JIM: So, thank you for that. Denise, I want to ask you, again, another question about—for folks who are in the market now or maybe contemplating the extent they want to engage or reengage. It's this idea that things are too expensive right now, right? What would you say to somebody who hit you with that question?

DENISE: Yeah, it's interesting. So, when you look at it historically, certainly stocks are still expensive in the sense that on trailing PE—and I have the data going back to 1962—you're still well into the top quartile of history. I think at thirty-five times the Synthetic Russell 3000 Index that I look at.

But what investors should know is two things. One is that we have actually seen a compression of 40% from the peak and at a year-on-year basis, you can see in the left-hand chart, we are down double digits in terms of compression. And that is actually at the bottom quartile of its history.

So, you might be tempted to say, well, if multiples have compressed this much and if they're likely to continue to compress, isn't that likely to be a headwind next year? But the answer is more often that not, no. If you quartile out the data on the left and look at your odds of the markets advance on the right, you will see after that deterioration or multiple compression, you actually have the highest odds of an advancing market.

And the reason is what you wouldn't suspect as an investor. It's because usually when multiples compress that much, it's because you got the earnings growth wrong.

So, during that next year, it's usually the earnings growth is also the highest.

So, I think that the message from this chart is valuation isn't indicative of what the market is discounting, especially so at turning points like you can obviously see on the charts in terms of the recession.

And if history is a guide, what you can look at is as much from an economic standpoint, 2009, 2010, 2011 was the slowest economic recovery on record, it was one of the quickest in terms of profitability because incremental margins—that's your next dollar of sales divided by your next dollar of earnings or vice versa, your next dollar of earnings divided by your next dollar of sales—more fell to the bottom line.

If you compare our margins today relative to 2009 when we were dropped to the bottom line, it's even higher.

So, the bottom line from the multiple compression we have seen to the earnings growth we are likely to see to the higher incremental margins versus prior cycles, the bottom line is really don't underestimate how powerful the earnings recovery may be in 2022.

JIM: Great. Okay. Thank you for that. And I want to thank you both again. I mean, it's so easy, especially after a day like yesterday, to get wrapped up in the headlines and to run to go online to check your balances and to start sort of—the lizard part of your brain starts to think, oh no, what do I do?

But it's amazing how much we forget even though the lesson is learned from a year and a half ago, to say nothing from 2008, 2009, to say nothing of your charts going back to the 60's, Jurrien's that go back to the 1860's. So, thank you again for helping us get a good sense of that history which I hope, for me at least, helps me take a breath on days like yesterday. So, thank you for sharing that with us today.

For our viewers, of course, thank you for watching as well. Just a reminder that if you need help with your own financial planning or want to update or create a financial plan of your own, you can get started by visiting Fidelity's website, maybe downloading our app. Those are a couple of really good ways potentially to help you get a little bit educated about the topics we discussed today and get answers to those questions and a lot of other ones as well.

Again, huge thanks to Fidelity's Denise Chisholm and Leanna Devinney. We'll see you back here next week when we are going to be talking about what's being called "The great resignation." Millions of Americans are in the process of or thinking of switching jobs or leaving work all together. So, we are going to talk about what that could mean for each of us at the individual level and for the economy as a whole. So, we hope to see you then.

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