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TRANSCRIPT

SPEAKERS:

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Jim Armstrong: Hello, and thanks for joining us for Market Sense. I'm Jim Armstrong with Fidelity. As we inch ever closer to late November, talk turns to turkey, among other things. You probably are starting to see those stories on the news about how the cost of your Thanksgiving dinner is up so much versus last year or the year before that, never more so maybe than these days with all the talk of inflation. And that inflation talk also leads us to a discussion about a different word, stagflation.

Now, sort of a strange word if you haven't heard it in a while—you maybe remember it if you lived through stagflation in the 1970s, or you might remember it, perhaps, from a college or high school economics class, or you've never heard it before. You've completely forgotten it. In any event, we've got you covered today because that's what we're going to be talking about: this intersection of inflation and the potential for stagflation, and of course, what it might mean to us as investors as well as to the markets and the economy as a whole.

So let's get right to it. To have that conversation with us today, we are joined by Fidelity's Jurrien Timmer who will be talking about inflation/stagflation. We're also joined by Leanna Devinney who's going to help translate what that means, again, to our wallets, our pocketbooks, our bottom lines, and how we might go about planning for it. So Jurrien and Leanna, thank you for making time to be with us again.

Leanna Devinney: Thank you for having me, as always, excited.

Jurrien Timmer: Yeah. Happy Tuesday. Great to see you.

JIM: So Jurrien, it is Tuesday, November the 9th. And before we dive into that inflation/stagflation discussion, I wanted to—wanted you to sort of walk us through a wide-angle look at the economy. As expected and as we talked about on the show last week, the Federal Reserve made its announcement just a few days ago that it is beginning to pull back some of those pandemic-induced stimulus plans. The market seemed to take that pretty well.

JURRIEN: Yes, so the Fed has learned that it is better not to surprise the markets, and that as long as the markets are prepared for, you know, a—what we call a policy normalization, that things will likely be okay. And that's exactly what has happened, of course, right? So the Fed, for months, has been signaling that economic conditions no longer justify the kind of extremely accommodative policy that the Fed has been maintaining since the lockdown days of about a year and a half ago. And the Fed's exactly correct on that. And we'll show, in a moment, in the next slide why that is. But the economy has, by and large, returned to full capacity. And that means that 0% interest rates and $120 billion per month of asset purchases are really not justified anymore. And the Fed knows it, and the market knows it.

And so after a lot of signaling and floating of trial balloons about when and how much and how fast the Fed should be tapering its asset purchases, the day is finally here where, this month, it will start at $15 billion per month. And that should mean that by the middle of next year, the Fed will no longer be in the markets buying assets at all other than to reinvest coupons and bonds that are maturing. But that's a different part of the program than these new asset purchases. And so—and at that point, the Fed will, in all likelihood, begin raising rates. And to me, that's really where the big story is.

We have this chart here in front of us that shows the 10-year treasury yield. Those are the black lines there on the left. The Fed funds policy rate. The Fed funds target rate, which is the official policy rate for the US, which is the yellow-gold line. And then we see all these purple dots, and that is the dot plot from the Fed that every quarter it publishes. And that's what the Fed, the FOMC members—there are 16 of them—where they think policy rates are going to be at the end of this year, the end of next year, the end of the year after that, and where they will be over the long term. Those are the dots that are over to the right.

Now, look at that dark blue line. That is what the market actually is pricing in in terms of what it expects the Fed to do. So that's the Fed funds forward curve. So that's the market saying, this is what we think the Fed will do. And what I find really interesting is that—so the taper side—like, nobody's arguing about when and how much to taper and the market seems to be totally fine with that. But what I find interesting is that you look at that dark blue line and those purple dots, for the next two years, they roughly agree, right? That line is kind of where the dots are. But after 2023, which is still a long ways off, of course, the dots are a lot higher than the line. And that means that the market does not think the Fed is going to raise rates as much as the Fed says it's going to do, which is an interesting disconnect.

You know, we have an old saying, "Don't find the Fed," but in a way, the market is fighting the Fed here and is expecting the Fed to raise rates fewer times than what the dot plot suggests. And obviously the caveat is that the dot plot is just a current snapshot in time. It's subject to change. It's the FOMC members. And some of those members are going to be changing because we've had a number of resignations. So, again, this is a moving target. But, to me, this is an interesting disconnect because the market doesn't think the Fed is going to raise rates as much as the Fed says or thinks that it does. And that creates an interesting bifurcation in the market that we can discuss in a few minutes.

JIM: And at that, I think is the perfect segue into the next question, diving into the meat of today's topic, and that's stagflation. A lot to cover here, but I think a lot of it has to do with, to your exact point, whether or not you, as an investor, feel like inflation rates, as they are now, are here to stay or are they more transitory? Will they calm down when the global economy evens out post-COVID? So before we start, just a quick—just a quick level set Jurrien, a quick definition. Stagflation is generally characterized by three things all happening at once: so relatively high unemployment, slow economic growth, and rising prices. So, Jurrien, I'll start. Are we there yet with those three criteria?

JURRIEN: I feel pretty strongly that we do not have stagflation. We have inflation, and we have strong growth. So you could call it an inflation boom, certainly in the aftermath of the lockdown. Same, you see this with the supply chain disruptions. I mean, you try to fly somewhere, the planes are still pretty full. It's still hard to get a rental car. It's not as hard as it was three or six months ago. But—so I do not see this as a stagflationary environment. I think the economy is very solid. You look at company earnings, you know, we're just wrapping up earnings seasons—really, really solid numbers. If we had stagflation, and as you said, that would be rising inflation and very slow or slowing economic output, that would be a different story.

Now, the economy is probably going to slow from here, so I do want to make sure people don't mistaken that for stagflation. So the economy cannot grow at an increasing rate of growth all the time because that's just not sustainable. So coming out of the pandemic, we obviously had a very fast recovery. And again, I continue to liken the downturn and the recovery more like a natural disaster than your typical recession where you have imbalances in the economy. So it's been this V-shaped recovery, and obviously, we can't continue to grow at the rates of the last few quarters. That goes for earnings, it goes for unemployment, for everything.

So the growth will slow, and my particular sense is—and I think a number of people agree with that—is that inflation is partly transitory. Those supply chain bottlenecks will get resolved. You have trillion-dollar companies trying their best to make that happen, and you're already starting to see a little bit of that. And now, the Biden Administration is trying to intervene as well to make sure the ports are—ships are being unloaded on time, etcetera. But the economy will slow from here, not go into a recession, but slow. And so people are going to immediately combine that with persistent inflation because we have a very tight labor market.

You see that in this chart here, right? The gray line is the spread between the unemployment rate and what is considered full employment. It has completely round-tripped back to, essentially, zero, which means that there is no longer a gap. So I get a little pushback on this sometimes, but the output gap, which was created during the lockdown, by all accounts, pretty much has been closed. And from here, the rate of growth will slow, still be positive but slow. And so if inflation does remain somewhat sticky because of these labor pressures and because of a booming housing market, for instance, people are going to conclude, oh, we're in stagflation.

But stagflation is a very unique environment. It really only happened once during the '70s. And it was very high unemployment, as you said, and high inflation. It's a pretty rare event. So for the most part, I think, whether we are going to have persistent inflation or not, is the big question. But I would not be quick to label the environment as stagflationary.

JIM: Perfect. Thank you for that. And that actually leads me right into Leanna. I wanted to bring you into the conversation and ask you specifically—you know, Jurrien just sort of set the table for us with a high-level look at the economy, but I feel like it translates specifically into a couple of questions that you and your team have been getting from everyday investors saying, for example, one, how do I deal with, or control for, or adjust to inflation in my portfolio with my investments? And then, two there's, as you've told us, a bit of a sense from folks, you know, the post-pandemic market seems to be doing really well. How sustainable is that and how do I plan for what I don't know is coming?

LEANNA: Yeah, it's two key themes that we're getting a lot of. And inflation has been a common concern in questions that we've gotten more recently. And it is one of the key risks that we plan for financially when we partner with clients. And we have seen a surge. It is more front of mind, as Jurrien said, this inflation boom. But where we help clients is educating them on ways to combat inflation and what we can do.

So now, when we see clients that have heavy cash at the banks or low-rate CDs, we know that over the long term, it's not necessarily prudent to stay in those for that long period of time, just quite simply, because it doesn't keep pace with inflation. What we do know keeps pace with inflation is investing in a diversified portfolio that is aligned to your goals and is a way to hedge inflation over the long run.

So a client, actually, last week, my team and I partnered with, had just recently retired. And he came in wanting to know if this strategy was okay where he allocated the next five years' worth of his expenses that he needed in retirement. And he put it in cash and just kind for that cash-under-the-mattress approach of: I don't want to worry about the market, and if I just take from this the next five years, I know I'll be able to cover my expenses. But we talked through that because, again, in this rate environment, it may feel safe but it's not keeping pace with inflation. So we talked about how to diversify and the ways that we can draw down from that portfolio while staying invested and having that healthy mix of stocks, bonds, and cash.

So questions that we get with that, though, is, well, what about the pace of the economy? If I invest, am I going to lose? How can I help manage that risk? That's where cash feels safe, but we want to be smart around inflation. So we talk a lot about rebalancing. And so rebalancing really is a mechanism that helps us manage risk and ensures that we maintain the appropriate investment mix over time with our investments. So when the market grows, if the market is really going up and up, we see that our allocation can shift.

So there's a chart right here that shows this, and it's showing actually over ten years, a portfolio that has about 60% in stocks, 40% in more fixed. If we don't touch it and we just let it go, the stocks, over the past ten years, have gone up over time. So we see that our allocation has grown. In this hypothetical example, we're seeing that the US stocks go from 42% to 59%. Rebalancing, it does not mean that we miss out on growth, but it makes sure that we are taking those gains, rebalancing them, and maintaining that example of the 60/40 portfolio that we know is most prudent because it really aligns with your goals, your timeframe, your whole financial picture.

JIM: That's so great. I know it's just a hypothetical. It's just, you know, looking at it at one snapshot in time, but I think it really helps illustrate your larger point there. When talking about inflation, though, any other things you typically discuss with people? I know, for example, reallocation is another topic that I sort of kind of understand myself, so the clearer you can make it for me, the better. It would be great.

LEANNA: Yes, and so they can go hand-in-hand how we talk about rebalancing and reallocation. But they aren't the same. So again, when we talk about rebalancing, that's a way to keep your portfolio in line with your goals and your risk level. So hypothetical, that 60/40 mix, how do we maintain that as the market continues to shift, grow, and move? Reallocation is a way that, within that 60/40, what can we do to have a lens of what's going on in our economy or things like inflation, how we can help combat that.

So in that 60/40 example, let's say we were able to reallocate our fixed investment to more inflation-protected securities, such as TIPS. So this slide is showing an example of that. So it's important to reallocate because, again, it keeps a lens of where we are in the economy and it allows us to have some subtle tweaks and changes that we can make. This slide is showing a scale, and I like that because it's showing, in times of recession or outside of recession, what can we overweight or underweight, essentially, reallocate to keep pace with those changes?

JIM: Makes sense. Thank you for that. Hey, Jurrien, I wanted to ask you a follow-up question as well to something you said earlier, before I forget. Sort of all the elements for classic stagflation might not be there right now, but again, as you said, inflation still remains a concern for people. What else do you see coming down the road in terms of inflation?

JURRIEN: So inflation is the big question. I mean, it really has its implications for everything we just talked about with Leanna. You know, the 60/40 paradigm really hinges on bonds being negatively correlated to stocks because that is that diversifying effect. You know, in the old days, bond adjusters would get paid to diversify because we would earn a nice coupon. That coupon has gotten a lot smaller over time. The 10-year treasury is yielding about 1.5%, and the CPI is running at about 5.4%. And that, to some degree, is expected to be transitory because of the supply chain bottlenecks that I mentioned earlier.

But if you look at this chart, this shows the—what we call the TIPS breakeven spread. And that's a mouthful, but basically, it shows what investors expect inflation to be in terms of how the market is pricing the TIPS market, right? So implied between the nominal yield and the real yield is the expected inflation rate. And for the next ten years, that rate is expected to be only about 2.3%, which is not much higher than what it used to be. It was—it's a little bit higher, but not very much. So implicit in what the market is saying right now is that the current 5.4% reading on the CPI is not going to last, and that number is going to come down.

And I don't doubt that it will because, again, the rate of change, transitory nature of everything—earnings, inflation, you name it—but if the market is wrong, and the market is not often wrong, but it is sometimes wrong. And in this case, the Fed has kind of the heavy hand in the market, right? The Fed, of course, has been buying bonds, not just TIPS, but treasuries, nominals as well. But you see in the bottom panel here, the Fed owns 29% of the TIPS market. So there's a question as to whether the bond market is really still an effective indicator of where things are because it's been kind of repressed by the Fed's heavy hand.

So there's a risk and an opportunity here that if the TIPS market ends up getting repriced and inflation is going to be structurally higher—let's say 3% instead of 2%, which I think is extremely plausible given where the labor market is, where the housing market is—then the TIPS market is mispriced. And then for those of us who are in that 60/40 paradigm, which is most of us, and we're trying to tinker with the toolbox on the 40 side, right? I'm not inclined to mess with the 60 side because equities, except for the 1970s, which is that stagflation regime, in most cases, they are an effective inflation hedge. So I'm not inclined to mess with the 60. But the 40, you know, I can see where we might want to put some new things in the toolkit there. And TIPS, as Leanna mentioned, are one of them, as an inflation hedge. And if the TIPS are underpricing the risk of inflation, then they make even more sense as an alternative or a substitute for traditional bonds.

JIM: And just to keep us all on the same page, I'll fly a little bit without a net here. TIPS are Treasury Inflation-Protected Securities. Am I good so far, right? Okay, and so that's what Leanna was just talking about as something that might work its way, be considered into your portfolio as part of your reallocation. Do I have that right?

JURRIEN: Yes.

JIM: Because of its unique sort of existence in the ecosystem as something you could invest in that is meant to be an inflation hedge—did I say any of that correctly?

JURRIEN: No, that's exactly correct. And we know, for instance, that if you buy bonds and you hold them to maturity, the yield you're getting on the bond—like you're buying the bond, you're getting 1.5%—that, essentially, becomes your return, right? I mean, if you're trading it, if you buy a bond fund that portfolio manager is moving things around, that's not necessarily the case. But if you just buy a 10-year bond and hold it to maturity, whatever the yield is today is the return that you're going to earn.

And the yield is 1.5%. And even just by measuring the TIPS breakeven, inflation is over 2%. So already there, you're going to lock in a negative real return, which is ultimately what we care about. We care about maintaining our purchasing power. And if inflation is understated and is really, let's say 3% or 3.5%, then we get an even bigger negative return. And then you want to start moving things around, and TIPS, of course, is one of those—is one of those areas. There's others as well—floating rate notes, high-yield corporate bonds have a lower maturity and a higher yield, so they are a better buffer as well, although, they're more economically sensitive, which makes them less inversely correlated to stocks. But there's a whole menu of building blocks that we can choose from. And of course, folks like Leanna are the people to talk to if you're wondering which of the building blocks should go in there.

JIMs: You took the words literally right out of my mouth there. I couldn't have said it better, and I won't even attempt to repeat it. So thank you both. That's going to do it for us for time today. So I just wanted to thank you, again, both, for making time to be with us. And again, for folks watching, thanks for taking time out of your day—covered a lot of topics today that, again, if you want some more help with or figuring out how it matters to you and your particular situation, as Jurrien correctly said, reach out to someone here at Fidelity. Certainly, go to our website, download our app, and begin the process that way as well of learning more, and then, ultimately, if you're comfortable making a connection here and then letting us help you with whatever your needs might be. Again, huge thanks to Fidelity's Jurrien Timmer and Leanna Devinney. And we will see you back here again next week.

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