Fidelity Viewpoints®: Market Sense

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TRANSCRIPT

SPEAKERS:

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Jim Armstrong: Hello. And thank you for joining us for Market Sense. Since I'm Jim Armstrong with Fidelity. The Federal Reserve has once again, raised interest rates in an ongoing effort to fight inflation. However, it's really done nothing, at all, to calm concerns about ongoing market volatility or a possible recession. So today we're want to talk about what the Fed is doing, as well as think about some investing ideas that you might want to consider in this market environment. It's also, by the way, election day. So, there's quite a lot to talk about there as well. To help guide this conversation, Jurrien Timmer is here with us. He's director of Global Macro here at Fidelity. So, he's going to be sharing some of his insights into the Fed's latest rate hikes, and what they could mean for markets and customers. And as always, Leanna Devinney has her eye on clients' top questions. So, she'll be sharing how she and her team really can help you figure out some of the ways to make the best of this, admittedly turbulent environment. And maybe even possibly, find a way to benefit from higher rates. So, hello to both of you, and thanks for being here.

Leanna Devinney: Hello, it's great to be here, as always.

Jurrien Timmer: Nice to see you both.

JIM: Hey, Jurrien we'll start with you, please. It's Tuesday, November the 8th. And, you know, as I say, we just saw the Fed fourth consecutive rate hike, another big rate hike this year. Inflation however, still running near four-decade highs. I would love to start with your sense of what you think the Fed is hoping to achieve with this series of increases.

JURRIEN: Yes, no, it's a great question, and obviously it is been the question of the day or of the year. Actually, if I can summarize the narrative for the markets in 16 words or less, it's that the Fed is solving for 2% inflation, and the market is solving for the Fed. Like, and end of story. That's basically what's going on. So the Fed, you know, inflation likely has peaked on a rate of change basis. The numbers are starting to come down, and I think expectations are even at the Fed, that that will continue to happen. It's just the math of rates of change. But that's not enough, right? It's not enough for inflation to peak at 9%, and start coming down. From the Fed's perspective, it has to come down all the way to its target of 2%, or let's say 2% to 2.5%, because the Fed targets what's called Core PCE. And the CPI tends to run about half a point above that.

And 2.5% is a long way from eight plus percent where we are now, and what the Fed did last week at the latest FOMC when is raised rates again by 3/4 of a percent. We're now a 3 and 7/8% likely on the way to 5%. But what the Fed said was, you know, not only are we going to go a little bit further, you know, to five or maybe a little bit higher than five, but we're going to stay there as long as we need until inflation actually goes all the way back to 2 to 2.5%. And I think that's kind of the big takeaway. And so, it's not enough just to get inflation down, it needs to go all the way down to the Feds target. And so that, that increases the likelihood that the Fed—even if it stops raising rates at some point in the next few months, which is likely to happen. You know, the Fed is not going to keep going to 10% or something. But what the risk is at the Fed will just stay there much longer than the market expects, rather than returning quicker to what's called a neutral policy, which will be probably around 3% to 4%.

So the Fed is trying to tame the inflation beast. And getting it down is not enough, it has to go all the way down to its target. And the Fed realizes, I think correctly, although it's hard to say. You know, the Fed is willing to sacrifice the economy in order to reign in inflation and it believes, you know correctly basically, that a short-term recession is a less bad outcome than long-term structural inflation. Because structural inflation really wreaks havoc on the economic system like it did in the 1970's. So that's I think what's happening in the Fed's mind.

JIM: And the Fed gets to have that stance, in part or entirely due to the fact that they're not an elected body, right? They're independent from the government, whereas to speak of elections, today if you're watching or listening live, it's November the 8th. The country is in the midst of voting in the midterm elections. The House and Senate are up for grabs. Those are people who are intimately concerned with recession and very, very interested in whether or not they, as elected officials, get blamed for a recession. So, Jurrien, add that into your analysis, if you could please. How does today's election and it's result play into what could happen with the Fed or beyond?

JIM: Absolutely. And of course, inflation is not only an economic problem, but it's a political problem as well. And the Fed, fortunately has stayed out of the fray, or I would say the government that stay out of the fray and, you know, getting the Fed overly, you know involved in the conversation. So, Feds doing what it needs to do and, you know, it's being left alone to do that. But we do have a midterm election happening today, as you mentioned. And you know, that's it's—I'm no political expert of course. But you know, what's the likely outcome appears to be that the Democrats will lose the House, which is a fairly common occurrence in a midterm, that whoever party is in power, will lose the House in the following midterm. That happens with some good regularity and there's even a chance that the Senate might flip over to the Republicans. Although that's a pretty close battle, and we actually may not know the outcome tomorrow, of the Senate because they may be run-offs in the state of Georgia for instance. There might be contested elections, I mean, you know, I hate to go back two years ago when we had to deal with all of that. But, you know, that could happen in the coming days.

But I think from purely a policy point of view, you know, I think when we look back as to where did this inflation come from? Obviously, part of it was supply chain bottlenecks, part of it was Russia invading the Ukraine, but part of it, I think was also this very unique and powerful combination of fiscal and monetary policy response to Covid. You know, we've talked about this in the past. We don't tend to see that kind of one-two punch very often. We have to go all the way back to the 1940's to get that, kind of combined response. And I think in retrospect maybe there was too much stimulation for too long. Obviously, the stimulus was needed at the time, but maybe it kind of stayed there for too long and contributed to the inflation story.

And so if we do get a switch in Congress from one party to the other, that will likely create some grid lock. You know, it will create obviously a divided government. It will reduce the chances that much of any fiscal policy changes will happen in the next two years. And you know without—and I'm not making a political statement here that that's good or bad. But I think from the market's point of view, and even the Fed's point of view, that might be welcome because the Fed has to deal with this other variable of fiscal policy, when generally it's just dealing with policy and economic policy, and monetary policy in isolation. So having fiscal, kind of be taken off the shelf for awhile, I think might be seen in a favorable light by the bond market but also by the Fed. Because it won't muddy the water in terms of what the Fed is trying to accomplish, which is to bring inflation down to 2%.

JIM: Thank you for that. Leanna, let's bring in the customer point of view. That's one point of view that Jurrien didn't touch on in that answer. You know, you and your team are meeting with Fidelity's customers day in and day out. Let's start off first and foremost with how our customers are feeling right now, given rates and the current state of inflation? How are they responding to what's going on?

LEANNA: I would actually say that the past few weeks, client sentiment has been a bit calmer overall. And my teams have shared that lately that they've been getting more comfortable getting invested and actually some less questions along like, "Is this ever going to end? Stop the bleeding." You know, maybe because we're 11 months into this kind of painful volatility. But also, headlines were sharing October was a really strong month for stocks. The DOW had a record stock month. So, headlines naturally can bring some investor reprieve and kind of exhale a bit. So, I would say still nervous but a little more calm than usual.

JIM: That's great.

LEANNA: Further—

JIM: I was going to say are there other ways they can sort of respond to what's happening?

LEANNA: Yeah, so for raising rates and inflation, like this year has presented a big challenge for stocks and bonds. But we've actually been having a lot of conversations on how rates can affect in a positive way. So, this slide is showing all of the ways rates will impact you as an investor, credit cards, loans, mortgages, you know it's the non-fun stuff. But savings rates are the positive impact. So cash, money markets, we'll talk later on about CDs, T-bills, individual bonds. But right now, they're very appealing for clients. And so, we're talking with investors and just simply asking what rate are you getting on our savings account in cash. It's a huge opportunity to get the competitive rates that are out there.

JIM: Jurrien, I'd love it if you can you build on that too? I guess, we sort of generally tend to default to talking about the equity markets, talking about stocks. But what about the bond market? What can you tell us about how that's been responding to everything going on?

JURRIEN: Well, the bond market—I mean, you know, what has made this year such a difficult year for basically all investors, is that the bond market has not been a port in the storm when the stock market has declined, right? The S&P 500 at its worst point in October was down 28%, it's up from there now as Leanna mentioned. But you know the bond market, the investment grade bond index, I think was down like 16% year to date. Usually, when there's a shock to the stock market, the bond yields go down, which means bond prices go up, which the bond portfolio does well. That has not happened this year, because the Fed has you know—well, there's kind of two sides to it.

One is that during the Covid days and the response to—the policy response to that. The Fed kind of got involved in the bond market with sort of a heavy hand, right? Not only did it lower rates to zero, but it started buying $120 billion dollars per month of bonds, adding that to its balance sheet. And it continued that from, you know April of 2020 all the way until March of this year. And so that's a lot—that's on the order of $4 trillion dollars. When you—when a buyer of $4 trillion dollars of bonds comes into the bond market, guess what happens to rates? They go down, which, of course, was the purpose of it all. But yields went down basically more than they really should have gone.

And so, then when the Fed removes itself from the markets, all of a sudden there are no buyers, and yields have to go up that much more. So, the ten-year treasury yield, which was briefly at 0.23% in March of 2020, but really stayed at around 1% or so for awhile, is now at 4.2%. And short rates which were near zero, and Leanna mentioned, you know short rates, the two-year yields at 4.7% now. And so that kind of move from very, very low rates to much higher rates obviously has an impact on the bond market. And the 60/40, kind of model we all sort of think about as the foundation of a diversified portfolio has been, you know, neither of those two have worked today or this year. And that's why, as I said earlier, you know the Fed is solving for 2% inflation. The markets are solving for the Fed. Like, when does the Fed finish this and we can kind of return to our normal lives in the 60/40 world. But so, it's been a relentless storm. And really the only asset class that has worked this year has been cash, like T-bills, money markets, ex cetera.

JIM: You said return to normal life. I don't know how far back to go to identify what normal is but I'd like to get back there, for sure. Leanna, let me play the role of a customer then coming to you or someone on your team. We know a lot of folks, almost regardless of age, right? I think older folks, people nearing retirement, during retirement think about fixed income a lot. But fixed income can play an important part in a anyone's portfolio, potentially. What do you say to someone who comes to you and says, "What's the opportunity in a fixed income given in this environment no matter where I am in the time frame?"

LEANNA: Yeah, so I'd say for fixed income, a lot of investors these days have been saying, like why would I own bonds? Like, I can earn more in cash this year. So, I think it always goes back to, you know I want all my clients to know what you own, why you own it. You know, what the purpose of the investment? How it's aligned to you? So why we own bonds is really for income instability. And, you know this year aside, we really only saw the latter, the stability, you know the past few years it was very slow and steady. It would be inverse to the stock market. But now fixed income, for the first time in decades, we're seeing it for those income seeking investors. And so, as of the end of October, I know Jurrien just said this but short-term treasuries are yielding more than 4%. Investment grade corporate bonds are more than 6%. Some high yield corporate bonds out there are close to 9%.

So I think overall, fixed income can feel complex to many investors. But at Fidelity, we can help you navigate what type of bonds may be appropriate for you, help you research, we have professional help to construct a portfolio all around your risk tolerance, your time horizon, and the goals that you have. But we can help navigate the fixed income market.

JIM: So, I know it's a much deeper conversation than the question I'm about to ask you but how do people find opportunities like that?

LEANNA: So, I would say if you're interested in adding bonds, you can choose from individual bonds, you can choose from bond mutual funds, there's exchange traded funds; all of these can provide those opportunities in your portfolio. You know, Fidelity offers over 120,000 individual bonds and CDs that you can research right on Fidelity.com. We also have a fixed income desk to help. But I'd say the individual bonds, those I see a lot for retirees or those seeking income and want to hold an individual bond, and you hold that to maturity. It's a great way to generate that reliable flow of income. And you're getting higher income than we've seen in a decade.

Bond funds and ETFs, those are opportunities in a portfolio that provide diversification and they give a little bit more flexibility than individual bonds, because you don't necessarily have to hold them to maturity. But you do want to hold them to the duration of the bond. But I'd say overall, you know we're spending a lot of time on fixed income and bonds, but generally it's one portion of your overall portfolio that that you have. So, this slide shows all the different mixes that you can have from a conservative investment portfolio all the way to aggressive growth. And you can see Fidelity our core philosophy, we very much believe in asset allocation and diversification. So, we believe in having a healthy mix of stocks, bonds, short term investments like cash. Outside of 2022, these three components and that diversified portfolio is really going to help you get to the goals that you have aligned to you, again, risk tolerance, time frame, your whole financial picture.

JIM: Yeah, thanks for pointing out how important it really is to make sure that your investments are aligned to you uniquely. I know you must get this question a lot. How old should I be when I retire? How much money should I have in this account? How much do I need to retire? But it's all so intimately connected to you as a person and where you are in life and what you want to accomplish.

LEANNA: It is completely customed to you and your specific goals. So that's why I say, you always want to build your portfolio rooted into an analysis of what are my goals? You know, if I want to retire early at, you know age 55 maybe and help my children or leave a legacy, all these specific goals we have, we're going to build that portfolio to help you achieve those.

JIM: Excellent, thanks for that. Hey Jurrien, with the couple minute we have left, I would love to just get your perspective on sort of everything Leanna was saying there. And in general, this higher interest rate environment? I mean, I think it's hard for people to wrap their heads around it because it's evolving so quickly. And the paradigms that we maybe relied on for decades are shifting.

JURRIEN: Yes, no, absolutely. And the era that most of us are living in and have lived in as investors over the past, let's say 25 years or so, has been called the great moderation, right? So, if you go back into history, which of course I love to do, you know cycles were more volatile. They were maybe shorter, inflation was, kind of not a recurring problem but it was a feature of every cycle, which is why the Fed would then have to raise rates a lot. And then you would have a bear market, and then a recovery. And that kind of boom, bust cycle was kind of the norm until what's called the great moderation started in the late '90s or so. Which was a period of consistently low inflation and falling interest rates. And that reduced the amount of volatility. It reduced the need for the Fed to raise rates a lot. I mean, it did raise rates, you know during these cyclical moves, but it was kind of a kindler, gentler market environment.

And you know obviously, we're not in that anymore, at least for the time being. Maybe we'll return to that. Obviously, the pandemic was a 100-year storm that came out of nowhere. So, we're still licking our wounds from that. But you know that's kind of what people are used to, and that's why what we saw this year, which is unusual by any standard but certainly unusual by the standard of the last couple of decades. So, I would just add to what Leanna was saying. Interesting to think about bond ladders versus bond funds, I think they both have a place. And especially if maybe you're in retirement and you're solving purely for that cash flow, you know a ladder is—could be an attractive vehicle, because, you know bond funds are always going to have the same maturity, right? It's always going to the same duration, whether it's ten years or five years or what have you. But a ladder, if you do a ladder over the next, let's say five years, a year from now, it's going to be four years and then three years, so it's going to have a very finite term structure.

And then just the only other thing I would mention, you know it's been very tempting this year to just hide in cash whether it's a money market or buying T-bills. And, you know it's totally understandable. It's literally the only asset class that has worked this year. But as tempting as it is to just kind of take all your marbles and put it in T-bills, we do have to be aware that that can be a trap, right? Because if you're taking your money out of long duration assets like stocks and bonds, and putting it in cash whether it's six months, a year, or three months, you're basically market timing, right? You're timing the market, which I can tell you after doing this for 37 years, market timing is next to impossible.

And even if you got the top just right, chances are extremely high that you're going to miss the bottom. Because bottoms are these big V shaped things. And if you're two weeks early, you're off by 20%. If you're two weeks late, you're off by 20%. So just be mindful that as tempting as it might be to just kind of keep your money in T-bills, you are market timing. And you're likely to miss whatever the bottom is whether it already occurred last month, or is going to happen some time next year. And just something to be cognizant of.

JIM: Absolutely. Thank you, both, again for taking time to be with us today. Election day, a reminder if you haven't gotten out and voted yet, you still have many hours to do so. So, please go ahead and do that. But of course, if you've got questions about making a financial plan or staying on track, perhaps with the plan you already have, get in touch with Fidelity. You can give us a call. Go online, download or use our app on your phone or mobile device. Tons of ways to get in touch with us and continue to learn more.

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