Market update: What's behind the volatility

January 2019 Webcast

RAM SUBRAMANIAM: Good morning, everyone. Thank you for joining us today. My name is Ram Subramaniam. I'm head of wealth management in Fidelity's personal investing business. I want to welcome you all to this event. As you all know, markets have been volatile for the past few weeks, driven by several factors. At Fidelity, our relationship with you is important for us, and we wanted to share our perspectives on what's going on in the markets and the economy. This is part of our commitment to you and your families, so you can remain confident, well-informed, and stay on-course to achieve your long-term financial goals.

Today, you'll be hearing from two Fidelity experts, Chief Investment Officer Chris Sheldon, and Institutional Portfolio Manager, Lars Schuster. They will walk through what's been going on in the markets and the overall economy, and what it means for you, as our clients. Now, many of you have already submitted questions, so thank you so much for that. We've used those questions to inform this event. We will also dedicate time during this call to address as many of your questions as we can. Thank you.

Now, I’m going to turn it over to Chris Sheldon, Chief Investment Officer. Chris?

CHRIS SHELDON: Thank you, Ram. And let me also echo Ram’s welcome to all of you for being on our webcast today. It’s very tempting for me to just turn the page and focus only on 2019. We’re clearly off to a better start than where we ended the year. But, it turns out that a lot of the factors that created this volatility may be with us somewhat in 2019 still as well. So, before we turn the page, I think it is important to focus on, as Ram mentioned, what happened in the market, what’s been going on, because if we were to look and stop the year, which we can never do at any point in time, at the end of September, we probably all would have said, “gee, that was a pretty good market, a pretty good year.” Obviously, some areas not as good as others, but that fourth quarter in particular, many of these things came together to negatively impact the market. Some of what we’re seeing today is maybe the market realizing they’ve pushed a few of these things too far. But, before I go too much further, maybe, Lars, if you could just mention a few of these things that hit the market later in 2018, and then we can talk about how they might manifest in 2019.

LARS SCHUSTER: Yeah, sure thing, Chris. Thanks very much for having me, and thank you everyone for being here, and happy new year. Certainly, the stock market is off to a better start this year than how it ended last year. But, as you can see here on the slide, what we're looking at is just a traditional view of US Stocks over the last year, and certainly a lot more volatile than what our experiences had been over the previous few years. Early in the year, we had a correction of about 10%, and certainly, as Chris just noted, over the final few months here, we had a more significant correction where stocks declined about 19%, culminating on a drop there, just the day before Christmas.

Now, really, I think there's lots of reasons why stocks go up and down every day, but most recently, the market is probably just having a difficult time digesting a few key issues, including the pace of interest rate hikes, slowing Chinese growths, and I think global trade negotiations is still there at the forefront.

Now, all of this kind of happened despite the fact that we had strong corporate earnings last year. Our earnings grew by more than 20%. We had some of the highest levels of consumer confidence in 20 years here in the US. We had significant job growth. And it might be a little counterintuitive, but this has happened before, where here

in US, we've seen double digit earnings growth, and stocks actually either be flat or negative. We saw it in the early 70's, we saw it in 1994, 2002. And so, this isn't uncommon, but it doesn't happen all the time. But I think what it highlights is what the market is really trying to do, and this is the crux of it, which is the market is really just trying to anticipate future events and put a value on the future earnings of those events. And so, maybe what we can do is walk through a little bit about what's happening in that space.

CHRIS SHELDON: Before we turn on, one of the things you mentioned is the volatility in 2018 compared to previous, and I was looking back, and 2017 now seems like distant past, but if we remember, there was not a single month during 2017 where the market was down for the full month, and that, actually, is very typical, where as 2018, it was certainly volatile in the latter part of the year. We saw several moves of down three and four percent, and I would say that is somewhat atypical, but the idea that the market volatility of up or down one percent, up or down two percent, that's actually somewhat normal. Part of the message here is that volatility is probably with us also in 2019, more typically, than what we've seen. It was really

the years building up to 2018 that were probably less difficult than maybe what we've seen last year.

LARS SCHUSTER: Yeah, I think you're right about that, Chris, for sure. We can throw all sorts of stats around what is typical for volatility, but if we just look at a long-term chart, and this is looking at US stocks going back about 50+ years, you can see it's going up and down over time, and volatility is normal, but the general trend over time is that stocks have growth that propels higher. It's not always up in a straight line, but over time, it does rise. And also, the stock market's not always right. You kind of highlighted that, Chris, when you said that maybe the stock market moved a little further in December than many folks would think that it should have, and tried to digest these issues. Because, when you look over this full time period that you see on your screen here, going back to the late 1950s, stocks have had to deal with many different things over time - wars, conflicts, all sorts of news events.

So, what had happened more recently isn't all that unusual or atypical, but we know that very often, we see these declines, and we think that it's signaling something more, like a recession. And, we are not in recession right now. In fact, we are still in a very long expansion here in the US. And this has happened before, where we had seen

stocks decline about 15, 20%, while the US is in expansion. It happened very recently, in fact. It happened in 2015. We had a period where stocks declined pretty significantly, 2011, 1998, 1987, 1988, that little period. So, it's not uncommon for when the market is challenged by a few things, but still in expansion economically. And we still believe we are in expansion today. And I think what's most important, when I look at this chart like this, is what and why do you own stocks? And stocks are there for portfolio for their long-term growth potential, to help you reach long-term financial goals, and what really drives stocks over time is earnings.

So, I'd love to delve into earnings here a little bit, and how recent events may be shaping earnings looking forward.

CHRIS SHELDON: It's interesting, when you load that slide, one of the things that I noticed is that if you looked at just the fourth quarter and the stock movement, you can be forgiven for thinking maybe if you were divorced from any of the economic news that there might be a recession around the corner, because the way the stocks move, and the type of stocks that move, almost look like a recessionary footprint, from markets in the past, and it's important to look at the past, but to say that we are about to go into

recession, I think, would be a step too far, to your point, but many of the stocks in the fourth quarter moved as if that was the market's eminent expectation, and I think part of my comment about repricing that in early 2019 is maybe the market is now realizing that some of that was overdone. So, we'll see, and we can touch on that, but I think that's an important point you have.

LARS SCHUSTER: I would like to touch upon that, for sure, and maybe we just stay on this idea that the earnings of corporations, and what we believe here at Fidelity, particularly in Strategic Advisors, is stocks generally follow earnings. They don't always move in tandem, and this shows that a little bit on your screen. It's showing the relationship, on the blue line, of the US stock market, and the green line is the operating earnings of the market. I think the general takeaway here is they kind of move together over time, but they aren't exact. But the first thing is, is what we saw recently signaling something more?

Well, if you look at it from a corporate earnings perspective, likely not. We don't believe we're imminently facing any sort of recession. Usually, when we've seen these very significant, consistent declines in stocks, and you can see that in the blue line, around that 2000 period, and certainly the 2007-2008 period, it was consistent with

a decline in corporate earnings. Now, let's juxtapose that to today. You see that green line has actually been rising. And over the last year, we've seen that earnings here in the US, for corporations, grew [north?] of 20%. Some of that was boosted by tax reform, but some of it is just good economic growth, and it's supported by jobs and all the other things that we can reference about the strength of the US economy.

The key here is what's happening looking out, and today, estimates have forward-looking earnings, or what earnings would be at the end of 2019, at somewhere in the mid to high single digits. That's actually right within kind of historical norms. That's still just fine, thank you very much. I think what the stock market is trying to figure out is, will that [guide?] slightly lower? Will it stay there? And that's really been driven by key concerns, and there's three, and I want to spend some time going through those. The first is the pace of interest rate hikes. The second is slowing growth in China and globally. And the third is trade and tariffs, and where we are there. So, maybe we just knock those out, Chris, real quick, and talk through it, and let's start with the pace of interest rate hikes.

What we're showing on your screen here, the blue line,

that's a common view of what people think about as interest rates. It's actually the 10-year US Treasury yield. But what's really important here is that our Federal Reserve, our central bank here in the US that has the lever for pulling short-term interest rates, doesn't dictate where the 10-year US Treasury goes. And that's those orange circles that you see. Those are the nine or so interest rate hikes that the Federal Reserve has done since late 2015, and you can see that when the fed raises interest rates, it isn't always consistent with a rising yield for bonds. And in fact, you see it kind of go in different directions. But, over time, what we've seen is modestly higher rates. And that's because the Federal Reserve is typically raising rates when the US economy no longer needs the lifeline of having very low rates. And it's usually a signal of positive economic growth.

And so, last year, you'll see there's four circles. We had four interest rate hikes, and I think what the market is really trying to digest is the pace of ones coming next year, and is that going to stifle growth. Because, when you have too many interest rate hikes, what it can do is slow corporate borrowing. It can slow consumers from buying big-ticket items like houses and cars. And that does have an impact of [earns?]. So, we

don’t have a crystal ball. We don’t know how many interest rates there’ll be next year, in terms of pace of hikes, but that is a key thing that we’re watching, and a typical signal of a maturing, but still good economy in expansion.

CHRIS SHELDON: I think you just put your finger on one of the key uncertainties, even from last year. Broadly, around policy, fear of policy mistakes. So, at the end of last year, the fed was still talking pretty hot and heavy about the increases they’d gone through, and at the same time, forward-looking economic stuff in the global economy was showing some relatively clear signs of softening. I think that concern, specifically, may have [evaded?] here in 2019. The fed has been fairly vocal, just even in the last couple of weeks, about being more tuned-in to that message. And so, I think that will be a key uncertainty for 2019. But at least from my perspective, I think the fed is sending a signal, “Look, we’re not tone-deaf to the global economy, and we will slow down.” Right now, the market, I looked, has basically now - this isn’t the fed’s forecast, but the market is saying, basically, we expect no increases out of the fed, and if we don’t - and we’ll talk about the other policy area of uncertainty, which is around the administration and tariffs and trade - but if those don’t be remedied, and the global economy continues to be weak, I

don’t think that forecast is out of line. So, I think a lot of that will be how this unfolds in the next, you know, six months.

LARS SCHUSTER: Yeah, we’ve seen this throughout history. Over the last 20, 30 years, the Federal Reserve is not always on some preset course just to raise rates, because the economy is fine, thank you very much. They do, and will, take insights from looking at a whole host of factors, and that is actually looking outside of the US, too. So, they’re very cognizant of the fact that there is slowing growth outside of the US. Not negative, just slowing, and I think that this could be taken into account. But, we’ll continue to watch very closely to strategic advisors and make adjustments as necessary for our client accounts.

And I think one thing, maybe keep in mind, it’s always been top of mind when I’m out meeting with clients over the last decade, is “Boy, Lars, we’ve been in this very low interest rate environment, and bonds prices move inversely to bond rates. So, if rates are rising, that’s bad for bonds, and my portfolio.” Here we are, at very, very low interest rate, and that’s only got one way to go up but up. And I think one thing we should all just kind of keep in mind is one, as you can see from this very long-term chart, we are near historical lows, in terms of yield. So, you

know, that's still somewhat of a positive thing for markets, because corporate borrowing can still exist in this environment, and it's not so high that it's creating a challenging environment for debt issues or anything to that effect. But the other thing is, remember what the 10-year yield is really trying to understand, which is the pace of long-term growth and inflation. And if that is just kind of bumping along at a very modest pace, and inflation right now is very benign, there's no reason you should be concerned that rates, i.e. 10-year yield is rising at a very high pace, and bonds still make a lot of sense in the portfolio, given other reasons, which I know we'll talk about.

CHRIS SHELDON: Well, I think to that point, you mentioned earlier, stocks follow earnings, and I think realistically, partly, yes, but they also follow the projection of where they go, and you kind of say that, likewise on yields, that the yield tries to discern [where?] an inflation will be, and if we go back to the beginning of last year, I think many more investors expected - and the fed - expected inflation to pick up last year, expected [final?] rates to go up meaningfully, and inflation really has been somewhat of a dog that didn't bark, and that has been a place where, despite a pretty strong economy, to your point, despite a

good labor picture, inflation hasn't picked up, and that's one of the things that I think gives the fed a little bit more breathing room in 2019, but it also is something to watch for, because if that does begin to transition into that more mature cycle where you'd expect, that may tie the hands with that a little bit more.

LARS SCHUSTER: That is spot-on. Typically, throughout history, the fed is there to tamp down inflation, to slow economic growth. We are by no means an overheated economic growth situation, nor is inflation burning hot. And so, that gives a bit of a slower pace that the fed can, potentially, take. You're absolutely right.

Let's move onto the second issue, very quickly, which is kind of slowing global growth, and particularly the concern of the slowing growth in China, and what that might mean for the balance of the world. A brief explanation of what this chart is. Just stay with me, very long-term chart, goes back about 10 years. The green line, what that's really highlighting is the share of the largest economies, and it's the 30 largest economies around the world, and their business activities. Think manufacturing, industrial activity. And, you know, about 70 to 80% are in expansion. They are actually growing. Now, the counter to this, though, is the blue line, which you see at a very low

level, about 20%. That's the same countries that have had improving manufacturing or business activity over the last six months.

So, in other words, while economies are growing, they have shown a sign of slowing. And, particularly, we see this coming out of China. China has dealt with this a few times before, over the last decade, where they have what we would call a growth recession, where they're growing, but it's below long-term averages. And that has a broad ramification on many outside economies. So, think Germany, think Australia, think all these large economies that are exporters to China and their growth engine over time.

Now, China has a lot of different tools to try to reinvigorate growth. They can cut rates, they have lots of money to spend, and certainly, they have been doing that more recently. We just haven't seen that really kick in and show efficacy for stimulating some growth. But, that is one of those questions and concerns out there, is, will a lot of the interest rate cuts and spending that they've sought to do as a centrally-planned government, come to fruition in 2019? Remains to be seen. It's a key item that we're watching.

CHRIS SHELDON: Yeah, and a really good recent example, in the pre-announcement by Apple, where they explained a lot of

the slow down they saw, in sales at least, on China. Now, they also blamed the rest of the world, so take your pick, but I think clearly what that says to me is you - global financial companies, even those based here, can't completely avoid the slow-down, and when I talk to other investors, including some of the ones here and outside, it's pretty clear that there is a slow-down in many regions, and across many, many industries, and so, I think that's real, but the good news is I think that's more recognized than maybe the tone would have given us, even a month ago, and I think that will help tamp down some of this uncertainly coming into 2019, but the question is, does that exacerbate or do some of these moves that they take and actually help alleviate that.

LAURS SCHUSTER: Right, and certainly one of the wild cards to all this situation is somewhat related to China and the US, of course, is the trade negotiations that we've been going through. And look, we don't have any added edge here, in understating the situation that anybody else does, in fact, it's really being done somewhat unilaterally by our administration. So, we have to kind of just wait and see, and see how it all flows out. But I just want to give everyone some thoughts and how to think about it, and maybe why the markets are trying to keep a lens on it.

So far, you've seen a tariff of, let's call it 10%, on about $250 billion worth of goods. Much of that has actually really just impacted the value chain of how companies put things together. So, the little components. And most companies have been able to actually not have to pass on those higher costs onto consumers. So, it hasn't had a big consumer effect. The bigger concern was the fact that we would be adding another $200 billion worth of goods towards the end of 2018, and raising that tariff to 25%. That would start potentially having an effect on consumers. Now, there is a pause on that, as we would say, a ceasefire between China and the US right now, and there's some negotiation happening. And this matters, because manufacturers are trying to figure out whether, down the road, they are going to have to lift prices, if consumers are going to have to take that on, and that does have a potential impact on consumers.

Now, I don't think, personally, that all of this negotiation is going to go back to what we all had before. It's likely that we do have some of a new world order, in terms of deglobalization, but it's going to take some time to probably play out. So, what I'm showing on here is just one way of kind of thinking about it, is over the last, let's call it 30 years, many of us, consumers here in the

US, and the consumer is a big part of our economic growth situation, right? It's about two-thirds of our economic growth is dictated by the strength of the consumer. And, we've really benefitted consumers from lower prices, or prices really being kept in check.

So, we have two lines on here, against how it splits out for inflation, and the prices of goods. The one line that's going up, that's services, and the other line, the green line, that's goods. So, let's think of goods, he simple one would be something like a computer, or maybe a phone. The fact is, if you bought a computer 30 years ago, it's a heck of a lot cheaper today than it was 30 years ago. And that just shows you the benefits of maybe globalization, and the benefit is consumers paying lower prices.

As opposed to services, and those prices have been rising. The easiest one I can think of there is college education. Certainly, it has been rising at a very fast pace over the last 30 years. But if we take into account the fact that we may have a little bit less globalization, a bit of a rollover into slow deglobalization, because now we have two large economies that are interconnected in terms of trade, this may have the impact of raising consumer prices over time. It's likely to be born out over

time, and I think what the market is just kind of struggling with right now, is is that going to happen at a faster pace, in the next year, or is this going to be something that will be born out over time? Again, something to keep watching. But that's really what the trade negotiation may be all about right now.

CHRIS SHELDON: I would add - I think that was well said. I actually think that's one of those uncertainties that will continue to be with us through 2019, and probably beyond, but I do think the first order of effects are the uncertainty that has been created just by the talks, and you know, even domestically, some of what's going on today. So, is there enough to cause the folks to come together and get to some type of near-term agreement? Your point, I doubt is the final, ultimate agreement, but I could see that happening. I could see that [lifting?] a little bit of the near-term uncertainty, but I also think this one of those that's going to be with us for some time.

LARS SCHUSTER: So, I think that's kind of a look-back, and maybe what's happening right now, and what does this all mean for my portfolio - not specifically mine, but I think, generally, we can say all of ours. From a Strategic Advisor's, and our management of client portfolios, and many of you may be on the phone today, in terms of owning a

managed account, others, maybe doing it yourself. I think the most important thing that we consider is, one, having a plan, and then two, having a process with that plan. And, for how we think about managing our clients' assets, as Strategic Advisors, we want to ensure our clients have the right mix of stocks and bonds and short-term investments for their very long-term goals. But we do follow a process where we make slight adjustments from that mix, dependent on your particular situation, and our process is following where we are in a business cycle, and this is a very pedantic, a very scholarly view of what you would imagine a business cycle to look like, this boom and bust period, and there are, in our belief, strong connections between where the economy is in the business cycle, and investment markets. And we do believe we're shifting to this phase, which is still expansion. This is not recession. We do not see any sort of imminent recession. But we do see a more mature expansion.

So, to this end, we'll make adjustments as we deem necessary. We can walk through some of those adjustments, but just to give you some things that we would watch. One is where we are in the inventory cycle, where we are in the credit cycle, and where we are in the profit cycle. And that kind of shapes how our view of where we are in the

overall business cycle, and the overall fact is, profits are pretty darn good, but they're just slowing a little bit, but still positive, when we're looking at here, in 2019. The credit cycle is actually still just fine. We're seeing banks willingness to lend. Although, as we just spoke about interest rates, they slowly may be moving higher. And inventories are largely in check. There's not a lot of things sitting on shelves, but there are pockets of challenges. You know, you think about maybe cars. There's probably more automobiles on lots now than there were five years ago.

So, all this signals to us is that we are in a mature expansion that's still a positive environment for investments, particularly stocks, but it is consistent with higher volatility.

CHRIS SHELDON: I would also say one of the challenges about a chart like this, that makes it look clean and nice and you can point to exactly where it is, the reality is that there's many underlying factors that contribute to this, and classifying where we are going is to later in the maturing cycle, I think, is a good way to think about it, because late cycle, to me, connotes that you've got overheating economy, or at least increasing inflation, and things like oil prices and others going up, and that's

certainly not what we experienced in 2018. In fact, obviously, in the later part of the year, energy prices went down considerably, and that's a little bit of the potential silver lining, both for inflation and for the consumers, because while the manufacturing activity is clearly slowed, that hasn't been the case with the service economy, which I think you made the point, is a bigger part of the economy going forward. So, there are some silver linings in there, despite what we see as a clear slow-down.

LARS SCHUSTER: And what's really important, too, Chris, you're highlighting this briefly, is, this isn't a forecasting mechanism. What's really most important is just knowing where you are today. And that really has shown throughout history to be just fine for investing and making adjustments. We call it now-casting. So, where we are now is much more important than thinking about where you could be two years from now, because so many things could really occur.

And, so, when we think about where we are now, and typically, what you see throughout history, we know that when you look back across the 10 previous business cycles we've been in in this country, dating back to 1950, there are some things that we can kind of take from history, and as we see on the right-hand side, that dark blue bar,

that's stocks. Traditionally, they're still positive, just not as great as they were earlier in the cycle, and that makes sense, because we're no longer expanding at a fast pace. It's just kind of a much more mature environment. But one thing we do tend to see is inflation slowly creep up. And that's really driven by the fact that there is more people going to work, they're getting paid more, and they tend to spend more. And inflation slowly rises. And so, you see that darker bar there highlighting commodities, think about it as an inflation-resistant type of investment asset class, owning things like oil and other hard currencies, they tend to actually do pretty well in this late-cycle environment.

So, for our clients, and how we think about adjusting portfolios, it's about maybe going a little closer to home. So, if you have a mix of stocks and bonds and short-term investments, that, let's just say is 60-40 stocks bonds, we would be much closer to that today than we would have two years ago, when we were firmly in a mid-cycle expansion, which was greater environment for stocks. By no means walking away from stocks, it's still a positive environment, just a little bit more volatile type of period.

CHRIS SHELDON: Maybe be a little more careful on the bets that you're taking, and how much you're putting in specific areas.

LARS SCHUSTER: Yeah, just smaller tilts away from that. The other thing that I think we should all just kind of keep in mind too, is just to stay disciplined. This aligns to our process, and how we think about managing our client accounts, is that over any one-year period, anything can happen, and certainly, we saw this past year. But over time, the odds of success keep going up and up and up, and positive outcomes are present.

So, what we're showing here is just a mix of stocks and bonds. The bonds are in green, the blue is highlighting stocks, and then the bars, you'll see on the one year timeframe on the left, that's highlighting the percentage of holding period that actually had negative returns over the last 90 years of history. And the fact is, is, the odds of success are pretty good. So, about 75% of the time, an optimist, I kind of look in reverse here, about 75% of the time, over any one-year period, stocks were positive. And about 90% of the time, bonds were positive. There are occasions, of course, when stocks and bonds are negative. But, if you keep driving your eyes across the right-hand side of the chart here, you'll see

that over a five-year period, stocks are positive almost 90% of the time, and bonds, actually, throughout history, have never had a negative return period over any five-year period.

So, for many clients, and maybe many of you on the phone today, you likely have financial goals that are five, seven, ten, fifteen, twenty years in the distance. Just kind of keep your eye on what your goal is, and try not to get too wrapped up in the one-year timeframe, because those volatility and those negative periods occur, but the outcome of positive success continues to rise as time passes. So, being very, very cognizant of your time horizon is very important.

CHRIS SHELDON: Yeah, and that was definitely a theme I saw in some of the advance questions, so we can spend some more time on that in the Q&A. One of the things that also, we have to think about, is coming into 2018, so, last year, US stocks, domestic stocks like the SMP 500, the valuation was not (inaudible) cheap. Something in the are of 19 times earnings, in other words, that's not historically a cheap market. Because of what happened, and when we talk about here today, today, that's closer to 15 times forward-looking earnings for 2019. Again, I don't know that that makes it a giveaway cheap market, but it's certainly after

what was almost a 20% decline in some of these markets, you look at the opportunity and say that's something you should take into consideration as you're factoring in what your portfolio should look like, not before those things have moved, but after the fact.

LARS SCHUSTER: Absolutely, and you just knocked on a key element here, is of diversified portfolios. We've talked a lot about the US today, but we also believe very strongly that international stocks need to be a part of that, and certainly, over the last several years, it hasn't felt so great for investing in international stocks, and you talked about valuation as well. Overseas, international stocks are significantly much cheaper than US stocks, and sometimes, you don't need a lot of great news to have stock growth, and right now, there's a lot of pricing in for international stocks as something that doesn't feel great.

But, when we think long-term, I think we all should just be very cognizant that international stocks, in our belief, still play a very important role in those up-and-down environments, and what we're looking at here is just looking in - orange is international stocks, US stocks is in blue - is that they don't always go together with one another over time, but they kind of end up in the same spot over a longer period of time, and when you combine them

together, they can actually have similar returns as just investing in US stocks alone, but with less risk. And that's what you see underneath that chart, is just a little bit of that data. And so, we continue to own international stocks for our clients. We have adjusted them down slightly over the last few months, given some of the slowing growth we've seen overseas, but they're still a very important part of the portfolio, and given the fact that they had very compelling valuation, they could actually provide some positive outcomes for clients in the near term.

CHRIS SHELDON: Yeah, I think you just gave a very good definition of diversification. Last year, one of the unique things is almost everything was a challenge for diversification, and most things went down together, and there wasn't a lot of difference in asset classes, other than on the down side, and international stocks actually got off to a worse start in 2018, but there were little glimpses, towards the end of the year, where at least the developed international in some of the more emerging countries actually held up better in that fourth quarter, and particularly in December. I don't want to take one month and do anything special with it, but the hope would be you'd get some of those things performing differently,

because, to your point, that's certainly been the case over time.

Now, I know we want to get to the questions and answers. I don't know if you have another last chart you want to highlight here, or?

LARS SCHUSTER: No, I think maybe we just focus on one last thing, and then we'll get right to questions. And this is something I think that - look, it's very emotionally unsettling to deal with stock declines. I think we all feel really great when stocks move up, and we've seen a lot of it over the last few years. However, most recently, it's been a bit jarring. And I'm just here to tell you that that's normal. That happens. So, this slide that I have up here, just the last one that I really want to highlight, it's just to show you how normal it is for us to experience market corrections, and the fact that a 19% decline, which we felt in the last 3 months of the year, isn't totally abnormal. What we're showing here is US stocks and their calendar year returns in green and red there, going back to 1980. First observation: there's a lot more green on that slide than red. However, we all have this emotional feeling, it's called risk-loss aversion, that we feel twice as much pain from loss than the pleasure of the equivalent gain. So, what we really

feel and what we remember are those red bars.

So, you will likely remember what happened last year moreso than you do those previous seven or eight years where we saw stocks go up. But, the fact of the matter is it's very normal to see stocks correct in any given year, and that's what those blue bubbles are showing. It's the largest inter-year decline in any given of these calendar year periods that we're showing. Last year, we had an inter-year decline of about 19%. You'll see lots of other blue bubbles up on that screen that actually go a lot deeper than that. When I average up all those inter-year declines, going back to 1980, it's about 13 or 14%. So, in other words, it's not uncommon to see stocks have declines of more than 10% in any given year. What's really important in my mind, though, is that when you look at this entire period, which is a very long-term period, it's 39 years, stocks were up about 80% of the time, and they grew at about an average annual pace of about 13%. So, in other words, if you can look beyond the short-term market declines, really be cognizant of your financial goals, and own the right amount of stocks that really provide, one, the growth to your financial plan, but two, that you're able to stomach, because stocks are volatile, that is

really what's going to help you stay invested and meet that future financial goal down the line.

CHRIS SHELDON: Great, thanks Lars. A good reminder and probably time to turn to the questions and answers, and maybe we'll go back and forth, and I can take the first one and go from there.

LARS SCHUSTER: Sure. Go right ahead.

CHRIS SHELDON: Good. So, the first question is, do we see potential for a 2008-type global crash in the economy, resulting in a 50 or 60% drop of the stock market? You never want to discount those far-outlying events, because those are typically the things that surprise the market, almost by definition. If it's in expectation, it doesn't move the market very much. That said, it's interesting, on this very first question, to your point, that we have that, because the likelihood of that, in my opinion, is quite low, if we don't have something outside of what we talked about here. Even a normal recession would likely trigger a fair market, we almost had that for a brief moment, but to go beyond that, it would take something far outside of what we're seeing, at least what I'm seeing so far. But it's kind of good, in my mind, that investors still, after ten years, have that thought in their minds that it could happen. I think it maybe takes it in check a little bit of

that excess of adding to greed, and adding the things when things are really good. And that's something where I think, to your point, I think we do better when we're balanced when things are down and challenged. So, my own view is that it's less likely. Never impossible, but not certainly in my year-term forecast.

LARS SCHUSTER: So, you know, Chris, I just talked about risk-loss aversion as a behavioral bias. There's another one called recency bias, that, what has happened most recent we think will happen again. Typically, it doesn't. So, the last recession that we went through, or the last significant market decline was that 2008 period. I think it's really important to remember that that was a very atypical type of environment where we had a credit crisis. The overall financial system today is much healthier than it was in 2007 and 2008. Corporate balance sheets are much healthier. There's a lot more cash in the books. And then consumers are not as levered as they were before. In fact, they spent a lot of the last ten years paying down household debts, and really, consumer lending has been much more in check.

So, it's not to say a recession couldn't happen sometime in the future. It probably will. Who knows when? We don't see it imminently on the horizon. But, a 2008-

type of period where we had a credit crisis doesn't seem in the cards at this point.

CHRIS SHELDON: Even if we were to have a recession, I think, what you just mentioned, the excesses are not there in the economy, and we've got, in my mind, it'd be more likely to be a normal recession, and a recession is not always caused only by stock market decline. Typically, there's some other factors in there that we have to watch for. But right now, probably not there. We could answer one question all day probably, but I'll let you go to the next one.

LARS SCHUSTER: So, what we have here, the next one is, are bond funds riskier now than they were before the volatility? I don't think that, in my mind, that the volatility of stock markets necessarily changes the path of whether bond funds are more risky or not. It depends on what kind of bond fund we're probably talking about. For the sake of the question right now, let's just talk about kind of higher-quality investment-grade bond funds. The fact is that what they are really trying to do is own a wide variety of different underlying bonds, including US Treasuries, corporate bonds, as well as potentially some other areas of the market, like mortgages, and maybe even high-yield bonds. The fact is, the managers that we talk to, and the

bond funds that we utilize in our client portfolios as Strategic Advisors, we've seen many of them continue to increase the quality, or the backdrop of the types of things they're investing in. So, five, six years ago, you would have seen more bond funds probably have a higher amount of high-yield bonds, non-US bonds, mortgages, other things that would provide some kind of yield and return as well. We've seen more bond fund managers go into higher-quality type instruments.

I think overall, what you can say right now is that bond funds really are probably playing their traditional role as being that stabilization for portfolios. So, we saw stock market volatility, what happened in the final months of 2018, is bond funds actually - broadly speaking, again - largely rose in value, at least investment-grade bond funds, and provided that stabilization offset to some degree for stocks and stock funds in client portfolios. And I think that just highlights that regardless of the direction of interest rates, bonds continue to play their diversification roles, and I think that's what we should really be most focused on.

CHRIS SHELDON: Does the oversold market we're in today justify rebalancing to a heavier equity position? Well, interestingly on that question, I think a lot of times, the

inclination in volatility is, should I go the other way and become more conservative in order to cash? But, this one at least implies an idea of rebalancing towards the asset class that hasn’t done as well, which would be equities recently. So, I would tend to agree with that. The key point there being, you have to have the property at long-term timeframe in your positioning. So, I can see a situation where despite the [open?] equities, if somebody hadn’t looked at that mix for a very long period of time, and this volatility was a reminder to do that, it’s not always an automatic set-it-and-forget-it, where you just add to the thing that went down, but for long-term investors, that’s actually a strategy that I know that you employ as Strategic Advisors, is oftentimes, it’s that ongoing rebalancing towards the things that haven’t done as well, and that’s one of those things that helps to give discipline. So, for the long-term investor, I think that that’s generally good advice, but it does depend on perspective and timeframe.

LAURS SCHUSTER: So, as a retiree, depending on these funds - and I don’t know what we’re - what “these funds” is referring to - but, would it be advisable to put a large percentage into cash, or interest-bearing instruments, in order to preserve and not lose more? I think, again, this

all comes back to the fact that whenever we all, as humans, experience any sort of jarring experience, and we see the value of our investments fall over a short period of time, our instinct is to go to a flight to safety and to hide. And what we really want to remind our clients that we manage long-term assets for, and their critical assets for reaching future financial goals, is just to go actually back to, why am I investing this money, and what is it for? It's part of having a financial plan, and then making sure that the investment plan aligns to that. So, has your financial situation changed? Has your tolerance for risk changed? Has your financial goal changed? Has the time horizon for that goal changed? If none of those things have really changed meaningfully from where they were six, twelve, twenty-four months ago, then the answer very simply could be, the best decision is doing nothing at all, and just being patient and continuing to be invested against your financial plan.

So, it's very difficult to really give you any advice here, because it really depends on understanding those factors, and this isn't about market timing. This isn't about trying to move to cash, and then figuring out when's the best time to come back into stocks, when they're really cheap and they're ready to move up 25, 30%. You know,

typically, what we have seen throughout history is that the best days for stock returns happen after some of the worst days. And that is just the market going up and down over short periods of time, and it's dealing with uncertainty, so it's likely best, in our view, just to stay invested to your goal, and doing it in a manner that is most comfortable and gives you the best chance of a positive outcome.

CHRIS SHELDON: I think that's well-said. I would say there are certainly some goals in which you maybe should have no equities whatsoever. If it's a very short-term goal, and you really need the money. But you wouldn't be occasioned by this recent volatility. And I would go back to, Lars, what you said earlier on, which is in a longer period of time, 10 and certainly 20 years, the probability that stocks outperform cash or even cash and bonds is reasonably high, two-thirds or more, in some of those longer time periods. So, if we have that time period, we actually have to be careful about the purchasing power of our money against inflation, about the value of a dollar, and becoming too cautious can actually be costly. But, I get it, and the right answer is making sure that it fits all of those parameters that you mentioned.

LAURS SCHUSTER: So, Chris, can I add something, maybe a little statistic behind that, right? The idea of positive outcomes over time, and if we're just talking about stocks right now. Let's just talk about stocks. They're an important growth engine for a future financial goal. Over any one-day period, if you look back to something like the beginning of 1928, up until the end of this year. Over any one-day period, stocks are positive just north of 50% of the time. It's almost half-and-half, that they lose versus when they win. But when I move that out to one month, one year, three years, five years, those odds of success continue to rise. And in fact, over a 10-year period, it's about 95% of the time that they're positive. In fact, we haven't had a 20-year period in this country where stocks have had negative outcomes. So, the fact is, again, aligning to what your time horizon is is one of the most important elements for the level of stock ownership for a future financial goal.

CHRIS SHELDON: I'll take this one. I'm concerned with the market downfall lately. Is waiting for it to come up again the best plan for me? And again, that presumes a lot of information in there, and that's not always the right answer in every single situation, but let me imagine a long-term investor who had appropriate positioning, and

didn't really find that their ability to bear risk changed dramatically, then I think we ought to realize that volatility is a part of long-term investing, and the idea that you have a market correction, in my mind, 10% or more, those happen actually more frequently than we see lately. Even a bare market, a 20% decline or more, those happen, and they're not that uncommon, and so part of that is just you have to build that into your investment thinking, and stay in that course. Even though that can sound trite when things are challenging, you have to build that into the portfolio, because the idea that you knew in advance those things would go down is a tough thing to do, what you'd call market time. After a large market decline, like we saw in that fourth quarter, it's another thing to say, "Now that stocks are down X, will they be down another 10% on top of that?" And those very large market draw-downs, like the question from 2008, fortunately are very infrequent. And so, I don't think we want to have this reflexive, just always assume things are going to come back, but trying to fine-tune it too much is difficult. I'm not saying that, as active investors making strategic allocations, that Lars, I think you gave that example about thinking about the business cycle, thinking about valuations, thinking about the macroenvironments, and yes, trying to do that

without trying to get too focused in the very short-term market changes.

LARS SCHUSTER: You know, it's funny, Chris. We talk about these various timeframes, and we talk about, over the last 30 years, what stocks have done, 50 years, 80 years. And it all sounds like it should be very simple. And it probably is, right? Which is, just stay invested for the long term and you'll be fine. But, in those moments, from day-to-day, it's emotionally jarring. And, all of our impulses, when we turn on the TV, when we read the paper, when we look at whatever, it's our phones and alerts, it's telling us we should be doing something. And very often, doing something can be the wrong decision. And sometimes, the best investment decision, at least for longer-term goals, is knowing when to not do anything at all.

And, so, I think that's why we're all here, is just to provide a guiding hand, some help, and making sure that in these moments, that you have a financial plan that's aligned to an investment plan, and that you're just kind of able to gut it out, because these are emotionally unsettling, but usually, as we've seen, over time, patience has been rewarded.

CHRIS SHELDON: And I think that's another way of saying having that discipline and that judgement to be forward-looking

and not be reflective to what already just happened, that certainly has a bearing, as we talked about today, about being able to separate the noise from true signal into what's going on is a very difficult endeavor, only made more difficult when our behavioral aspects turn on, which is very natural, and you highlighted several of them today.

LARS SCHUSTER: Very natural. Next question we have here is, are managed accounts - and that's, here at Strategic Advisors, what we do for 700,000+ families around the country today - are they being changed because of fluctuations in markets? And the second part of this question is, what is the process for protecting gains?

Let's take the first part first here, are managed accounts being changed because of fluctuations in the market? Yes and no. And, as I noted before, when we think about making adjustments to our clients' accounts versus their long-term asset allocation mix, and everyone has a different one, a different mix of stocks, bonds, and short-term investments, we tend to make modest adjustments over time, based on where we think we are in the business cycle. So, it's not necessarily because stocks or bonds have moved in any certain way over a short period of time that would give us the guidance that we should make adjustments. We would want to make adjustments based on where we believe we

are today in the business cycle, and over the recent couple of months, we've made very modest adjustments, because we just believe that the cycle is maturing. So, what that has meant is just taking down slight tilts towards international stocks and US stocks, as well as making sure that we actually maintain some inflation-type assets, so, things like Treasury inflation, protected securities as well as commodities. These have been very modest adjustments.

Now, when there are fluctuations in the markets, we make adjustments in the near-term, regarding rebalancing. So, where we might sell those things that have done well, or held up more recently, and buying things that have not, to make sure that the overall portfolio is aligned to each client goal, yes. And we've actually been doing quite a lot of rebalancing over this previous year, here in 2018, given the market fluctuations. That isn't necessarily a broad change. We see that as a way of taking advantage of what the market is giving to us. And those little rebalancing-type of opportunities can really add up to some positive outcomes over a longer period of time.

There is just one last thing that I would probably venture to discuss very quickly. There are taxable accounts, so, if you look outside of your IRA or 401k, you

may have a brokerage account, you may have a trust account, where taxes matter. And when we have fluctuations in the market, we're very proud of the effort we have in that space for taxable accounts of taking advantage of what the market gives us, taking and banking some short-term losses, potentially, to offset what we would see as future financial, or future financial growth. And that's really just using the tax code to our benefit for taxable accounts, but those are some different things we might do on a fluctuating market.

CHRIS SHELDON: Unfortunately, hearing of that, it almost sounds counterintuitive, but when we listen carefully, you're not saying we hope to have losses in the portfolio. As we talked about fluctuations, they're a natural part of investing. What you're saying is, when they happen, then there's something you can do about it by harvesting in a way of thinking that loss to offset future gains, and our experience is that I think that can be a very important source of protecting some of those capital gains, because it offsets against the taxes, which is one of the major costs of investing.

LARS SCHUSTER: Yes. And the second part, Chris, what is the process for protecting gains? Let's cut to the chase: we do not put protection on portfolios, because we're trying

to have some type of stable or long-term growth, depending on a financial goal. Any time you're putting protection on something, there is a cost that comes to the other side of that. There are different investments out there that offer some floor, maybe provide some shirt income over time. For how we manage client assets for future financial goals, it has a lens towards growth over time, it's just how much growth. Is it 20% stocks, is it 85% stocks? And that can provide different experiences over time. But there isn't necessarily a protection that we might put on there.

I will maybe just one kind of commercial here, which is, we do have strategies that are more defensive in nature. It is not a protection, but there are different investments you can use that help actually just smooth out the ride in those rockier moments, where you can invest in more conservative stocks. You can invest in things that are, perhaps, what they refer to as a flight-quality, things like the US Treasury type bonds, where, when there are stressors in the environment, actually, US Treasuries tend to get bit up. So, we do have defensive strategies that may have a more smoother investment experience for those rockier times, that if you're interested, please feel free to talk about with one of our Financial Advisors here at Fidelity.

CHRIS SHELDON: All right. Are we in a recession? I hope we answered that, at least from what we see today. And, do we need to liquidate all positions and move to CDs or other bond instruments? I think, from the tone of the call, my view is that would be no, even if you knew that we were in a recession, the market is already moved considerably, but the idea is it's after the fact. If we knew there were to be a recession in the market, and we knew the market were to go down considerably more, possibly, but those are two things that I think are very difficult to get right. The timing of those, and the magnitude, and reacting to what already happened. My short answer on that one would be, I don't believe so.

LARS SCHUSTER: Maybe, Chris, what would be the things that would look like a recession, right? Typically, what you would see in a recession is unemployment rising. You wouldn't see positive job growth from month-to-month. We've actually had 99 months of positive job growth, which is one of the longest - it actually is the longest in history, here in this country. You would see interest rates probably being cut pretty substantially. We're just not seeing any sort of those signals today. We are not imminently facing - and you would see negative earnings growth. You would see corporations probably having

challenges making any sort of profit. And it’s just not the environment that we see today.

CHRIS SHELDON: Yeah, one thing I think that might be something the market wrestles with is the idea of an earnings recession. I think one of the other fundamental questions for next year - for 2019, this year - is, do stocks earnings go down so much that you have a technical earnings recession? But that’s very different than an economic recession. I think the sensitivity of the market to volatility is more so than the economy. The economy seems to be fairly resilient right now. So, there are different types of recessions, and an earnings recession is very different than the broad recession.

LARS SCHUSTER: So, the last question we have here, Chris, is, based on the state of trade and tariffs contributing to stock market volatility - and we did highlight that is likely one of the things that is effecting volatility - what do you think would happen if trade disputes with China were resolved, but international policies of today were to continue. Look, I - who knows what’s going to happen, because it’s the only - you can’t take it in a microcosm of event in isolation, there’s lots of things that are occurring. Would it be very plausible to say that if we had some resolution about a trade dispute with China, that

that would have some kind of short-term Euphoria? Yeah, probably. That sounds, I think, like conventional wisdom. I would further stress, though, is it likely to look at something where we were five years ago, in terms of trade? Probably not. I think there's going to be some adjustment. I think companies and consumers get used to this adjustment. But in the near-term, we probably have to just kind of live with the fact that we don't know where that's going to be, and it's likely not going to be and look like what it was five, ten, fifteen years ago. But, you know, what we have seen is companies that drive corporate earnings, which drive stocks, are resilient over time. And, they would make adjustments that will try to help grow corporate earnings, and that gives, again, a good basis for owning stocks for the long term and being diversified.

CHRIS SHELDON: Yeah, I would say a full resolution, that would be a clear market positive. I think even a modest loan would take away a little bit of this near-term focus and could give the market a small boost, but I think there will still be other uncertainties.

I think, maybe with that, that's a good place to end it. And first of all, thank you all again for being on the call, to say that we are here to help you, and please remember to reach out to your advisor, your representative,

we are here to help. I would leave us with three points here to think about. Number one is that volatility is a part of that longer-term investing. We need to recognize that it may not be here to stay in the same degree as we saw in the fourth quarter, but it's part of investing, number one. Number two, we don't see - or, I don't see - the conditions that would indicate a recession is imminent, and that's something to think about as you position your portfolio. And finally, moving to the later stages, or more mature stage of the economy, by itself, does not mean a recession is around the corner.

So, I know we gave you a lot to chew on here today. Hopefully, also, some signs that things could get better, and some things that maybe check some of the things that are not as good and not likely to get better. But, again, leave it to say thank you, and we're here to help, and please reach out if you have further questions. Thank you all very much.

END OF AUDIO

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