

Fidelity Viewpoints®: Market Sense

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TRANSCRIPT

SPEAKERS:

Heather Hegedus Jurrien Timmer Eirene Kontopoulos

HEATHER HEGEDUS: Hi there, everybody. Thank you so much for making the time to join us for another episode of *Market Sense*. I'm Heather Hegedus with Fidelity.

We have been watching just a truly exceptional quarter two earnings season unfold, with the market's gains broadening well beyond the big tech names now and extending across many sectors. In fact, this has been one of the strongest profit booms the S&P has seen outside of a post-recession recovery—so really remarkable, indeed.

But this as, of course, many investors are still grappling with signs of a slowing labor market and continued uncertainty in the Middle East. So joining us to talk about the headlines today and the possible takeaways for investors, of course, we are joined today, as we often are, by Jurrien Timmer, who is our Director of Global Macro here at Fidelity.

We are also pleased to welcome to the table Eirene Kontopoulos. And she's a Research Analyst who is focused here at Fidelity on biotech investments. She's a portfolio manager of the stock selector small cap and the Fidelity Advisor Biotech fund. And, impressively, she has a PhD in neuroscience from Harvard Medical School. So some pretty impressive credentials there, really.

We wanted to talk with her about biotech today because a couple of months ago, you might remember, if you're a *Market Sense* fan, we had her colleague, Eddie Yun, on the show, who she works closely with. And he was talking about the health care industry as a sector. But within that sector, biotech has been one of the biggest winners this year when it comes to the S&P and the markets.

So you can still check out that episode with Eddie, by the way, on our YouTube channel. But we want to talk with Eirene today about what's been fueling this biotech rally, and what's on her radar right now, and why she thinks AI may be poised to unlock an entirely new phase of growth for this industry that hasn't even started yet. So, so great to have you on the show, Eirene. Welcome.

EIRENE KONTOPOULOS: Great to be here. And I wore my brightest dress to out-dazzle Jurrien today. I hope I was successful.

JURRIEN TIMMER: It's great to have you on the show.

HEATHER: Well, you were successful, Eirene, in matching with Jurrien without planning that. So I just want everybody at home who is watching us, as opposed to listening to us as a podcast, know that this was just your great minds think alike, because you're both geniuses, I guess.

All right, let's get to it because we have a lot to pack in today's show. Today is Tuesday, August 11. Before we get into the biotech discussion, Jurrien, we do have some new jobs data that I wanted to talk to you about for July. This was big news last week. It shows the labor market is weaker than analysts thought.

And investors might think, at first glance, weaker job market equals stocks going down, right? In fact, though, stocks rallied on that news, betting that with a weaker job market, the Fed might be less likely to raise rates anytime soon. I'd love to get your take on this data, Jurrien, and what this might mean for a Fed that has so far, seemingly, been much more focused on inflation than the job market.

JURRIEN: Yeah. So we did have a soft jobs report last Friday. But it's worth remembering two things. There's always a bunch of cross currents going on. And, of course, we have this whole AI boom. We have an incredible boom in earnings. Earnings are growing at 35% year-over-year.

And that growth rate is still accelerating. So that is the dominant driver for the markets. And remember, the price of a stock or of the S&P 500 is really just the intersection of earnings and valuation. And so rate pressures could knock down valuations, but earnings are going to outweigh that if they're growing as fast as they are today. And that's why the market is still going up.

And in terms of the jobs data, and I don't mean to nerd you out too much, but there are some nuances here. And so, remember, the payroll number, which is what we're all hanging on to the first Friday of every month, it might go up 100,000, or it might go down 20,000. But the labor force in the US, so all the available people who can work, is 170 million people. And so the payroll data, there's a lot of algorithms and models that say, OK, this is how many jobs were gained.

But remember, if it's like 10,000 people as a percentage of 170 million, the tracking error is tiny. And what's happening right now is that what we call the break-even rate for the payroll number is very low, because the labor force is not really growing because there's a lot of baby boomers dropping out of the labor force because they're retiring. Immigration, of course, is much less than it used to be. So there's not a lot of people coming in to the labor force for that reason.

So it takes very little in terms of movement to all of a sudden produce a negative payroll number. But it doesn't quite mean what it might have meant when that break-even rate is higher. So I apologize for being so technical, but it's easy to read too much into this data. And I think that's especially true these days when the labor force really isn't growing very much.

HEATHER: Jurrien nerding out a little bit there, but we always appreciate you nerding out, Jurrien. But bottom line, like you said, easy to read too much into this data. Let's wait and see, going forward, how things progress. All right, I want to bring in Eirene now, because we're just so excited to hear from you today. And I just think, Eirene when we bring new guests on the show, it's always helpful to find out a little bit more about them and what might make them tick or what might have drawn them to this industry or to Fidelity.

So I would love for you to quickly tell about this impressive path with a PhD in neuroscience from Harvard Medical School, and going from being a scientist to being a portfolio manager and investing. I'm wondering, how did that track happen? How did you go from researcher to picking stocks?

EIRENE: Yeah, it's a really unorthodox path, Heather. So I love science. I love biology. I still do. And I always thought I wanted to be a researcher and have my own laboratory. And I worked for five years during my PhD in an Alzheimer's and Parkinson's disease laboratory.

And I don't know, around the fourth or fifth year, I started to get a little bit depressed. I was slicing open mouse brains and fly brains and making a difference—making a difference in finding new things, but I thought, I want to see more people and feel my contributions, I could see them in real time, the way that I see them in the market when we decide to do a stock offering for a company that's developing a new drug. So Fidelity took a chance on me almost 20 years ago, which I'm grateful. I don't know that I would get the job today, but I really, really love nerding out like Jurrien does, but in my case, on biotech and biology.

HEATHER: I think they would take a chance on you any day of the week, Eirene. And so it sounds like you find this profession to be very fulfilling, both on the end of investing in companies, but also investing on behalf of people at home who are watching this and who are using that information to help bolster their retirement accounts and savings.

So, all right, you have got this perfect recipe and background to prepare for where you are today. It sounds like it's been a pretty exciting career for you, going from splicing these animal brains to investing in these startups. And you've had a front row seat recently to what's been a pretty remarkable comeback for biotech stocks.

And for a lot of people in our audience, just to give them a quick recap, who maybe weren't tuned into biotech stocks this year—of course, they were very strong during the pandemic because of the COVID-19 vaccines. Post-pandemic, this industry went through a bit of a downturn. It has since recovered. And, Eirene, would you agree it's been about the past 18 months or so that biotech stocks have rallied pretty sharply?

EIRENE: Yeah, that's right. I was really walking in the desert from 2022 to 2023 when generalists thought that the sector was completely out of favor.

HEATHER: And what has been happening with biotech stocks? What is driving this most recent surge right now?

EIRENE: Well, so, in 2021, biotech was really the savior. It allowed all of us to get our COVID vaccines and rejoin humanity. And so generalists were like, what is this biotech? Everything seems to work. If we can go from nothing to a COVID vaccine in under 12 months, that's amazing. Tell me more about these biotech names.

Everything worked in 2021. The number of biotech names quintupled. I was seeing three IPOs a day. It was absolute insanity. Anytime you see an industry surge that quickly, though, the quality goes down. It's really supply demand. And there weren't even enough highly qualified people to staff these companies, if you can believe it.

And so 2022, 2023, we had a little bit of a bust there. But what's come out of that has been, actually, really wonderful. It's been survival of the fittest. It's been the best companies with the best drugs.

And in 2021, we were looking at companies that were just trading on dreams. They had no data. They only had mouse data. Now, we have the most companies we've ever had that are actually commercial. So if you look at the XBI right now, 40% of it is companies that actually have real drugs that are selling and helping people. And if we look out, Jefferies has projected that that's going to be 75% by 2027.

So that's amazing. We have real companies with positive clinical data that's being rewarded. They're highly innovative. One of the things we like to track is just the clinical trial hit rate, because that gives you a sense of sentiment in the space. So, obviously, if you're hearing a lot of negative news in biotech, you're not going to want to invest.

The clinical trial hit rate has been anywhere from 30% positive clinical trials to anywhere up to 65%. And we've been hovering around that 50% to 65% area for the past 18 months, which tells you that the companies that have survived now have real drugs that are now unveiling clinical cards that are positive. And that really is a boon for the industry.

So all of that, coupled with the fact that pharma is sitting on record piles of cash—there are patent cliffs in 2030 that are insurmountable unless they fill their coffers with some of these biotech companies—and they've got about \$1 trillion in firepower right now to buy some of these advanced, innovative companies.

HEATHER: It's really exciting times that we are living in. I heard you say "innovative" several times there. One of the things that's been exciting has been these obesity drugs, or GLP1's, which have been a major area of growth for some of these big pharma companies and a new area of growth for biotech. What in this space has your attention right now? And how is that space continuing to evolve as we see more companies getting into the game now?

EIRENE: Yeah. So the advent of GLP's has really been transformative. You can see it just all around you. Everyone seems thinner.

HEATHER: Totally.

EIRENE: There are people with real metabolic disorders. This is life changing. I have a friend who just lost 100 pounds and has reversed her diabetes. It's absolutely incredible. But one of the drawbacks here is that when you lose that amount of weight, 40% of that weight loss is not fat, 40% of it is lean muscle mass.

And what is muscle? Muscle is our biggest metabolic organ. We need our muscle, especially as we age. So what's going to be really important as we go forward is to create drugs that preserve that muscle mass.

And then my friends that are on this, they're nauseous. They're nauseous a lot. Part of that is they don't want to eat anymore. And so being able to look at oral therapies, not injectable therapies, that curtail that nausea, but also let you keep that lean muscle mass—because if you go off of a GLP1, you need that muscle there, so if you gain weight, you want it to stop you from regaining all that weight. That's your metabolism right there. So those are the things that I'm focused on right now.

HEATHER: Yeah. Real problems. And I can see where your PhD from Harvard is coming in handy here, Eirene. Beyond obesity drugs, what other types of innovations and cutting edge technologies are on your radar right now and are you excited about?

EIRENE: Yeah. I'm really focused on the power of genetics. So if you look at clinical trials, if you understand the genetic basis of a disease, it's anywhere from three to seven times more likely that the clinical trial will be positive and that the drug will eventually get into the hands of patients. And so where genetics is really powerful is oncology.

So we used to think cancer was this nebulous thing and we'd give you chemotherapy—and all chemotherapy is just a poison to kill rapidly dividing cells. Now, we can look at your cancer and say, you have an ALK mutation, you have a ROS1 mutation. I'm going to give you a drug that's specifically shuts off that bad actor. And that is extremely powerful. It's helping people live 20, 30 years with cancer.

And if they fail that, then they can go into an even more efficacious drug and a more efficacious drug after that. So there are some cancers right now that are turning into chronic therapies, where you just live with it for the rest of your life. And you have a great quality of life. And that's something that it's really only been in the last decade that we've seen it.

HEATHER: It's just life changing, as you said. And let's talk a little bit more about the AI impact on what you were just talking about, because AI and uses for AI are certainly infiltrating every sector. But one could argue this is probably one of the most exciting spaces where AI could make the most impact, to your point about how it could reshape modern medicine, and how we look at diseases, and how we eventually cure them.

But I'm wondering from you, are we just in the infancy stages of this? Or have we not even started yet? Where are we in the timeline of AI impacting drug development and cures for all different kinds of diseases?

EIRENE: Yeah. It's a great question. So there have been a lot of luminaries in the AI space that look at biology as this untapped frontier. And I think just at the pace of AI development makes them very hopeful that, hey, maybe we could cure cancer by 2030.

Unfortunately, I think the human body is really, really tricky and smart. You try to outsmart cancer one way, it finds another way around it. And the other thing about AI is that these models are trained on mouse models, cell models. When you put a drug that looks really great in a mouse and you put it into a human, you have literally no idea how it's going to behave.

We have so many millions of proteins running around our body that this drug could be interacting with. So it's just the physiology is so complicated that I don't think AI is going to help us predict a priori which drug is going to work. But I think there are several ways that AI is going to help.

So, for example, once you have a drug target through genetics, because that is really where we find most of our drug targets—and I think that is going to continue to be the case because you're basically using the human body as your test subject—once you have that target and you design a drug, I think AI is going to really help you tweak that drug so that it works as most efficacious as it possibly could be. Because right now, we have humans in the laboratory, chemists in the laboratory tweaking that drug. They're brilliant. But with the tool of AI with them, we could do it a lot faster, is my hope.

And then the other place I think AI is going to help us is in clinical trials—speeding up clinical trials, stratifying patients, enrolling the right patients into clinical trials to get the right answer. AI is going to help there. And one way I'm seeing it help right now already is once you have a drug and a company is commercializing it, you have to go find patients that have this disease so you can give them the drug. Well, wouldn't it be great to use AI to look at medical records, EKGs, echocardiograms, and say, wow, this is a patient that has this rare heart disease.

The doctor hasn't diagnosed it yet, but I know that five patients like this are in this medical network. They should be on this drug. So all of that's going to be really explosive to biotech. Because once you get to the point of these commercial biotechs that we're seeing more and more of, AI is going to help them become even more profitable as they sell their drugs.

HEATHER: Yeah. Interesting—organizing ideas, looking for trends, the way that even people like you—well, maybe not you, but me—and then others at home use LLMs right now, to go through lots of paperwork and to try to synthesize things and look for the key points. Just so exciting.

But when we talk about biotech, I want to talk about another trend, too, while we have you here, Eirene, that we are seeing right now in this space. And that's a surge of mergers and acquisitions, M&A—namely, pharma companies buying biotechs. And wondering how that might impact the field, and what's been behind this, and do you think that we're going to be seeing more of this?

EIRENE: Yeah. So, as we mentioned earlier, like, I've always sat here and thought, why isn't pharma buying more biotech? Because we've had this patent cliff in 2030 looming. And I thought back in 2022 and 2023, when the valuations were depressed, that we were going to see a lot more of it.

But what I think happened was these board discussions in the biotech company, they were thinking, look, we were three times the valuation in 2021. Why would I settle for a smaller premium just because the market's out of favor? I think now there's been a lot of rationalization in the biotech boardrooms that they're willing to come to the table with pharma and talk about being acquired. That's one.

Two is that pharma is getting closer to that 2030 timeline. And they're saying we need to do something. And they're sitting on record cash levels of \$1 trillion—they have all this firepower to do these deals. So we've seen over 20 large deals already. And that's at a much higher pace than we've seen over the past couple of years.

So I always say that M&A is not the reason to own biotech. You never know what's going to get acquired in your portfolio. It's always a fun day when it happens, but it's not the main reason. But one of the nice things about M&A in the space is that when there is M&A, biotech fund managers like me now have a lot of money to redeploy.

And so I'm redeploying it right back into biotech. I'm buying more biotech stocks, and I'm further supporting the industry. I'm not putting it into AI. So it is just another tailwind for biotech if there's more money to redeploy.

HEATHER: Speaking of buying, let's talk about valuations. Can you give us a snapshot of where biotech valuations are right now?

EIRENE: Yeah. They've obviously recovered from the lows. But when I look at my portfolio, and I won't go into specific stocks, but I look at a lot of these names and think, wow, half of the pipeline is not being factored accordingly in the valuation. And this really is a stock picker's group.

These companies have money. They've raised money and there's more money coming into the sector. So they've been able to deploy that into their R&D pipelines. And there's a lot of innovation coming from those pipelines. And I think investors are going to start to value that more and more. So, yeah, I don't think people have missed the space at all. I think there are a lot of opportunities, a lot of really, really interesting companies out there with pipelines.

HEATHER: Yes. And sometimes some of the most exciting opportunities are the ones that almost everybody else has overlooked. Jurrien, I'd love to bring it back into this discussion here for a moment with a global macro take on some of this. So the biotech resurgence has been one of the key drivers behind what you've been talking about here on *Market Sense* recently, which is small cap stocks gaining strength, the market expanding and broadening, as we call it.

And you've said that kind of broadening is healthy for the market. Why do you feel like that?

JURRIEN: Yeah. So the market has been broadening quite nicely. 74% of all the stocks in the S&P 500 are now above their 200-day moving average, which is another way of saying that they're in uptrends. And that's a very healthy number. So even though the big mega cap tech stocks are still driving the market, and they had really good earnings just over the last few weeks, the AI space is underperforming a little bit here. And the rest of the market, the non-AI space, is doing very well.

And this is a great time to be diversified because the AI story has a lot of promise, but it also has risks. We're seeing that in terms of are people starting to use more of the cheaper Chinese open weight models as opposed to the frontier models in the US. And if that's the case, will these frontier models that we all know and use, will they be able to launch an IPO or fund their capital spending?

And so it's a good time to really not have your eggs all in one basket. And biotech, financials, there are many, many other areas that have a lot of promise in terms of the downstream effects of the AI boom. And, for instance, the non-AI side of the S&P 500 is almost completely uncorrelated to the S&P. So from an active, diversified portfolio allocation point of view, it's a really good time to paint the world with a very broad brush. And that not only creates opportunities, but it also protects you in case something happens to the AI space where it becomes over-believed or overcrowded.

HEATHER: So I heard you say an opportunity from the downstream effects of the AI boom—potential opportunity there. Before we go, Eirene, we talked a lot about the opportunities in the biotech space today and all of the exciting innovations happening. But we should also acknowledge the risks, of course. And we know that this is an industry that is sometimes known for its volatility, to be candid here. So what do you think, in your mind, investors should think about before investing in some of these companies that we talked about or these kinds of companies that we talked about?

EIRENE: Yeah, no, that's a really important point. And, as we talked about, biology is really tricky and full of risk. You can have the perfect drug and the perfect trial, and, for whatever reason, the trial fails. These stocks can go up 300% or they can go to 0.

So that's why we try to own a basket of biotech stocks. So if we have one that goes to 0 and three that are up 200%, we're having a good week. So I always joke with my kids that if you get a 60% on a test, that's not the best grade. But if I get stocks right 60% of the time, I'm doing really well. A 60% hit rate in a diversified basket is really, really good.

So that's why I always say you want to own a basket of stocks, at least over 15 to 20, just because of the volatility, and hope that your hit rate's greater than 60%. And we use all of our science and biology toolkit to try to nudge it up more close to 70% or 80%.

HEATHER: Well, I'm sure your kids think that's pretty unfair, though—that that is the bar.

EIRENE: I know.

HEATHER: Lastly, just looking ahead, I'd love to just find out from you about possible headwinds, because you talked a little bit about possible tailwinds in this space. But what's coming down the pike? And what are the possible headwinds that might be helpful here?

EIRENE: Yeah. So a potential headwind that I'm watching is that, obviously, a lot of these companies are raising money. And so we talked about supply demand. You don't want to see a lot of money flooding the space and destroying the party.

So one thing I watch closely is we talked about M&A proceeds. When that's put back into my hand to redeploy it into the biotech space, that's a good thing. That has to outstrip how much paper is coming into the market, how much supply of these companies raising money. So that's something I track very closely.

Then, in terms of just positive things, data really matters for this space. These companies live and die on good data because good data is what you bring to the FDA and then hopefully try to get these drugs approved and commercialized. And in a typical year, you might see 50 or 60 really impactful data events.

George Anai, who works with me on our biotech fund, we look at all of the binary events out 18 months. And we were just so flabbergasted the next 18 months—there are over 100 high impact events. And we've gone through all of them, and we've placed our positions.

HEATHER: Eirene, really terrific insights there. We're going to wrap for now. But I do want to quickly just give Jurrien in the last word. We usually ask him what he's watching for the rest of the week. And we call this segment, Eirene, Timmer's Take. So, Jurrien, what's your take on the headlines that we're expecting to see starting with tomorrow? We got an important print coming tomorrow.

JURRIEN: Yeah. We got the inflation data tomorrow. Earnings season is wrapping up. It was just an incredibly positive season. The Fed just met recently. Kevin Warsh will give a speech at Jackson Hole.

But, other than that, it's the summer doldrums a little bit. So hopefully we can all have a little time off and go to the beach or whatever.

HEATHER: Yeah. Congress is out of session. We're looking ahead to days after August, right, into everybody returning to the office. All right. We've got to leave it at that. But, Eirene and Jurrien, thank you so much for this timely discussion and really exciting stuff that you brought to our audience today, Irina.

And to those folks at home out there who your interest might have been piqued by what Eirene was talking about and you'd like to read more about the latest happenings with stocks or what our Fidelity portfolio managers are working on and thinking about, you might want to bookmark [Fidelity.com/PMInsights](https://www.fidelity.com/PMInsights). PM, meaning portfolio manager.

On that page, you'll find some more thought leadership from portfolio managers here at Fidelity who are almost as equally as impressive as Eirene, and brilliant, and on the top of their game just like her. On behalf of Eirene and Jurrien, I'm Heather Hegedus. We hope to see you back here next Tuesday. Remember, we're live Tuesdays at 2:00 Eastern. See you then.

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