Fidelity Viewpoints®: Market Sense

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TRANSCRIPT

SPEAKERS:

Jim Armstrong Jurrien Timmer Leanna Devinney

Jim Armstrong: As this year wraps up, there is talk as there often is around this time of the year about whether or not we are going to see a so-called Santa Claus rally, positive market news that does tend to happen towards the end of December, sometimes even going into the first trading week of the new year. The question is, will we see one in 2022?

Hey, thanks for joining us for Market Sense. I'm Jim Armstrong with Fidelity. A lot to discuss this week. We have a surprisingly strong jobs report as well as a key inflation figure starting to cool. What those factors might mean to the markets in terms of any holiday season gifts, however, remains to be seen. To have that conversation we are joined today by Jurrien Timmer, also going to share with us the market's big picture with us as well. Jurrien is Fidelity's Director of Global Macros. So he's going to be talking about insights into the latest world and national news. He'll talk about market conditions and of course what they mean to all of us.

Also, to dig into some ideas about how we can consider making the most of our cash these days as interest rates continue to climb, we are going to talk to Leanna Devinney. She is a Massachusetts based Branch Leader and she is going to be talking about CD ladders and bond ladders, as well as the potential fixed annuity options as well. Thank you both for taking time to be with us today.

Leanna Devinney: Thank you. Great to be here. Happy December.

Jurrien Timmer: Yes, nice to see you both.

JIM: Jurrien, it is December the 6th and we will start with you, as we often do. Look, any chance that we are going to see a Santa Claus rally this year, if any year felt like it deserved it, it is this one.

JURRIEN: It looks like Santa Claus came early this year because we have had a rally from the October low, which at that point the S&P was down 28% from its high back in January 4th. So obviously 28% is a very significant decline. And we've had a very robust rally since the middle of October. So the S&P which went down to about 3,500 recently just a few days ago went as high as 4,100, so that is an almost 20% rally. But, you know, that rally is based on a number of expectations that things are going to go just the right way, right? And so, the market I think is trying to thread a needle here where either the US economy does not go into a recession. The Fed can back off from raising interest rates just at the right time now that inflation appears to be kind of on a better trajectory. And that will happen, you know, in just the right way so that earnings don't start to fall. And we get the so-called soft landing, which of course is the best-case scenario for the markets.

So I think part of the rally is based on that assumption and whether that assumption is correct or not, we don't really know, that's a story for 2023. And the other part of this rally, I think you know part of it is just the relief rally, the very correct realization that the worst of the inflation story is hopefully behind us, and that will allow the Fed to kind of taper off the number of rate hikes until it reaches some sort of plateau around 4¾ or 5% early next year. And then we will be able to moderate rates. But the other thing that is sort of baked in the cake with this rally, is that the market expects the Fed to bring rates way back down in 2023 and 2024 from close to 5% all the way to 3%. So I think that might be a little bit of an ambitious expectation. So yes, we have had an early Santa Claus rally, whether it continues or not is anyone's guess. But we have had a good run over the last month and a half to two months. But it is built on expectations that may or may not come to fruition in 2023. And that will be really the main story for next year. You know, will we be able to avert a recession and what will that do to earnings?

JIM: Absolutely. I want to ask you a follow-up question about recession in just a couple of questions. But before then, Leanna, I would love to switch to you for a moment. Because we know, obviously, interest rates and high rates are on the mind of our customers. So they are coming into branches like yours or picking up the phone or going online and trying to investigate options for themselves to try to make the most of this environment, which we can't control, we can only react to. What do you say to people who come in and want a solution for what is happening right now?

LEANNA: Yeah, we are seeing a major uptick in a lot of the conservative options just due to the rate hikes. First and foremost, we are talking to clients about where are you holding your cash? Where is your emergency fund? What does your safe money look like? Because there are far more competitive options now than the low interest savings accounts that there used to be.

So we are talking with investors on options like CDs, individual bonds and we mentioned fixed annuities. But starting with CDs first, that is pretty much a step up from high yield savings accounts or cash, kind of first on the spectrum. So CDs are offering a yield, they come with a term. So you can have a three-month, six-month, nine-month, year—many years CDs and they come with that fixed rate. So a CD is a savings product, and it's issued by the bank and then you get guaranteed that interest promised by the bank and it is FDIC insured up to a certain amount.

Where we are talking with investors these days for CDs, especially looking at your emergency fund or savings accounts, are CD ladders. So this is an opportunity to get those fixed rates, but ladder it out. Meaning you may have a 6-month, 12-month, 18-month, 2-year, and you then get flexibility and liquidity when a CD comes due. So, you get the diversification of having short-term CDs and long-term CDs, getting a competitive rate, you know again yielding far more than you are seeing in high yield savings accounts or, you know money market bank accounts. But it is a great opportunity for your emergency fund, your safer money, to get those competitive rates.

JIM: Potentially a way to maybe to capitalize on rates that you think are going to go up in the future? Is that fair to say?

LEANNA: It is fair to say and I think something you want to be cautious of as we kind of wait and say I am going to hold off until the Fed raises rates, but we don't want to stay in a low interest-bearing account to keep waiting. It is an opportunity to capture that now and plan for the goals that you have. CDs are just one option; we'll get into more of the conservative fixed options.

JIM: Sounds good. Hey Jurrien, I would love to get your perspective on fixed income right now. To say the least, bonds have not had the most impressive year ever. What is your sense of where they are and where they are headed?

JURRIEN: You know, if we think back not just for this year, which of course is one that we probably would all like to forget, but just the last couple of years, right? So, we had the markets kind of in some form of equilibrium. Then COVID happened, and we had that kind of crash in the market, 35% in five weeks. Then we had this enormous policy response both from the fiscal side and the monetary side. And that one-two punch was so powerful that it, you know made the markets go way, way up really beyond what was justified because there was so much stimulus in the system.

And that drove bond yields way, way down and it drove real yields, so the yield you would get on the bond minus the inflation rate, to really unsustainably negative levels, right? The real yield on the ten-year Treasury yield was about –2% a year ago and then just a month or so ago after this enormous reset they were +2%. So it is a very large valuation reset both on the stock market side and on the bond market side. And you know, the good news, if there is any this year, is that after this very tumultuous several year, pendulum swinging from one extreme to the other, the markets are a lot better value today. And you know again, as I mentioned earlier, whether the earnings—whether earnings will be a shoe that is still going to drop next year is a question we don't have an answer to right now. But when you look at the bond market and I show the bond yield here in the upper panel and that band that you see there is just a simple model based on what the market expects the Fed to do and what the trend in GDP are, and economic growth are. It does suggest that bonds have some value here, now that real rates have completely gone full circle from negative to positive.

And so, when we think about the 60/40 paradigm, you know the basis for many of our portfolios is diversified equity and bond portfolio. Neither of those sides have worked this year which has, you know been obviously a very problematic story. But what I'm seeing is that for next year, even if the stock market still needs time to find itself in terms of where the earnings picture ends up, the bond market at least has a competitive value proposition now that real yields are positive. And I think that hopefully will at least provide some port in the storm, some shelter if there does end up being a recession next year.

JIM: That's a great segue. Thank you for that, a great segue to head back over to Leanna. So, you talked about CD ladders. Now let's talk, if we can, about bond ladders which are similar and not in some key ways. So let's dive into those.

LEANNA: Yeah, great way to say it. So, bonds are that step up on the spectrum when we go through the conservative options because there are a few more risks associated with them. I would say first and foremost there are many types of bonds. So, we hear of municipal bonds, there's government bonds; Treasuries are very big these days, corporate bonds. Why we own bonds? They are there for income and stability. So bonds are really a glorified IOU. They are a debt obligation so you are getting promised back your principal with time, and you can get interest along the way.

But one of the big differences is, bonds are sensitive to the interest rate environment so we see that more. Just before getting to the bond ladders, you know many income seeking investors will look to get exposure from bonds. It could be mutual funds, exchange rate of funds. They provide great diversification, but you do see that interest rate sensitivity. When rates go up, the bond prices go down, and sometimes bond investors can panic. So where individual bonds, you know, may feel appropriate, or bond ladders, it gives investors that predictable stream of income where you are owning the individual bond out right. It can reduce exposure to volatile stocks. 2022 aside, it has been a tough year for bonds overall. But when we think of the long-term view of why we own bonds, again they are there for income and stability.

So, the ladder, similar to CDs, it can be very useful when interest rates are increasing because it is going to free up part of your portfolio regularly. So, you might have again a one-year, an 18-month, a two-year, and it can go on and on. But when you have that time where it matures and then you can reinvest or do other things, it provides flexibility.

JIM: Are bond—I know you mentioned interest rate change really being the crux so that's what everybody is paying attention to. Are bond ladders more sensitive to interest rate changes than CDs are?

LEANNA: Overall they are, because again they are a different animal than CDs. You can buy a bond at a premium or a discount. There is a coupon, different maturities. Some bonds are callable, meaning they can get pulled back. So, all of those factors can impact rates. Ladders, again overall, can just help provide some of that protection with the possibility of rising interest rates. So when bond prices fall, bond holders, you still get that full principal and interest back when it matures.

JIM: Can you talk a little bit more maybe about the temperament of someone who has—how do you know whether you are better suited for a CD ladder or bond ladder?

LEANNA: Yeah, I'd say it all goes back to the goals. We always say like we want our investors to know what you own and why you own it. So, you should have the temperament when it comes to any investment, but bonds in specific allow you—you want to ride out what is happening in the interest rate environment. So, you are buying a bond to hold it to maturity so that you can get that interest along the way. What I have seen over time is many bond investors can panic. So, when interest rates rise, they say why are my bonds going down? They are not supposed to. They are supposed to be here for income and stability. So it's just that education around what you own, why you own it, and the purpose of why we own bonds.

JIM: Perfect.

JURRIEN: I would just add to that, you know that when you buy like a bond fund you always, the fund or the index will always have the same maturity or duration, right? So, you take interest rate risk, of course, as you always do when you buy bonds. But with a ladder, you lock in these different maturities, and so you kind of know that you have this exit at a certain point that you wouldn't have in a fund because the fund would always have the same duration.

And I would just—not to get too technical here, but in the last month or two the yield curve has inverted quite a bit, which is another way of saying that short rates are now significantly above long rates. And that creates more relative value in what we call the belly of the curve, kind of the two to seven-year sector of the maturity range. And that's another reason why a ladder, actually, gives you exposure to the part of the curve that actually has the highest yields now.

JIM: Yeah. You can't get too technical for us, Jurrien, and that is your value add, that's what you do here, and thank you for that. Leanna, one quick follow-up for you. You mentioned earlier fixed annuities, I know that that is also a question that we get a lot from customers.

LEANNA: It is. So, fixed annuities are just another alternative. You know they compare or are more similar to CDs. So you are getting that fixed guaranteed rate of return over a period of time. And getting your principal back. So a CD is backed by a bank, a fixed annuity is backed by the insurance company that is giving you that fixed contract. A couple key differences is fixed annuities offer compounding interest over time. CDs provide simple interest, and fixed annuities are tax deferred. So, you put a sum of money in, again it is growing tax deferred, you get back that fixed rate compounded over time and your principal.

Another just big key difference is there is a flexibility feature to fixed annuities. The majority give you a 10% a year withdrawal feature. So, if you ever need to access money—that's what we talk about with CDs or individual bonds you may be locking out for a period of time. Fixed annuities provide that 10% flex. We help clients understand options, understand what you are looking for, what's going to be most appropriate, and go through the conservative options for you. And then I just have to show this slide. I think this year is a unique year, both stocks and bonds are down. Fixed rates are far more appealing, that is the conversation we are having with our investors. You know, many people are saying, "Why wouldn't I just go to the fixed rate options, right? I can lock in 4 to 5%." You know, this chart does help give the long-term perspective. Just left to right it is showing our last recession, the market downturn in 2008/2009. And you saw okay, cash was positive.

And then to the middle, you are seeing the five-year run up. Where seeing stocks in a diversified portfolio really made a comeback. And then it is showing over time a long period perspective, that diversified portfolio typically does outperform. That is showing a lower interest rate environment. But again, I think it is important that everything comes back to your specific goals, your time frame. And we can lose perspective and have some of that short-term view when we are saying okay, I can get 4 to 5% this year.

JURRIEN: Yeah again, I would just add to that that as tempting as it is just to park everything in cash, you know, there is an old kind of rule of thumb that the power of building a nest egg and achieving financial wealth is to compound returns, right? And so, cash may be kind of the cleanest dirty shirt right now but we don't know that short-term interest rates are going to stay at these levels. They could be down again a year from now or two years from now. And the stock market and the bond market could be up. And so, compounding those returns year after year after year, you have to kind of be in it to win it. And so, cash is very alluring and there is obviously a place for it somewhere in the portfolio.

But when you go from long-term investments like bonds and stocks into cash, you are basically doing market timing. And market timing, I can tell you being in the business 37 years, is an extremely difficult if not impossible task to undertake. And even if you get the top right, you are probably going to miss the bottom. And so, just be mindful that when you just take everything out and put it in cash, as attractive as those yields are, you are basically market timing and that involves at some point getting back in, and that's a very difficult game to play.

JIM: Absolutely. Hey, Jurrien, with the couple minute we have left I would like to return back to part of your answer the first part of the question where we raised the specter again of potential recession. And it has been a question that we have been talking about probably for at least six months on this show actively, almost every episode. What are you looking at to gauge recession risk these days? Because if you are reading some article these days, it sounds like people—some folks are saying at least well, we were crying wolf the whole time and the recession risk really wasn't there. Where do you land?

JURRIEN: Yeah, so you know recessions aren't as common as they used to be, right? In the old days, maybe 50 years ago, the economy was much more cyclical. So, the manufacturing sector was a much bigger part of it. And the manufacturing sector is in and out of a recession every four years or so, that's called the four-year cycle. And in fact, the manufacturing sector right now seems to be dipping into a recession as we speak, basically. But manufacturing is only maybe a tenth of the economy these days. And so, the services sector is much more stable and we see the jobs report, we had one last Friday, still pretty robust. So people are employed; they have money to spend, even though disposable incomes have been eroded by inflation. And so, it is hard to kind of say that that's a recessionary environment.

But we do know that looking at forward-looking indicators, that the Fed is raising rates and even though there is a sense that the Fed is going to be wrapping this up maybe in the next three to six months, the yield curve, which I mentioned earlier that difference between short and long rates is now inverted, meaning long rates are below short rates. And when you go back, you know 50 plus years, that has actually been a pretty accurate indicator or predictor for recessions. You know, the problem is that there is varying lead and lag times. So, sometimes the recession comes six months after an inversion, sometimes it comes two years after. We don't know how long it will be or how severe it will be, if it happens. And then, from an investment point of view, even if you knew all of the answers to that question, you still have to compare that to what is actually already priced in.

And so, often times recessions are already priced in before they even start. And remember, the market already fell 28% this year to its lowest point in October. So it is entirely possible that most of the bad news, even if it is still coming next year, that it has already been priced into the market. So that is why we always go back to kind of have a diversified portfolio; don't try to market time. Because it is never that simple and it certainly isn't this time around.

JIM: Bad news behind us, bad news priced in sounds just fine to me as we wrap up this year. So, thank you for that. Jurrien and Leanna, thank you for your time as well.

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