

Fidelity Viewpoints®: Market Sense

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TRANSCRIPT

SPEAKERS:

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HEATHER HEGEDUS: Hey there, everybody. Good to have you with us for another episode of *Market Sense*. I'm Heather Hegedus with Fidelity. Fed Chair Kevin Warsh is doubling down on his commitment to bring inflation back to the Fed's 2% target. And his hawkish tone, as well as some recent economic data, is now reinforcing expectations that at least one rate hike could be on the table before the end of this year.

However, the bond market is making a statement of its own right now on the long end of the curve. So this morning, the 10-year Treasury jumped to its highest level since the beginning of 2025 amid renewed tension in the Middle East and higher oil prices. So joining us today to talk about what this all might mean for investors and what the main takeaways may be is Scott McAdam. He's an institutional portfolio manager here at Fidelity, whose team at Strategic Advisors manages millions of Fidelity client accounts here.

And we're also pleased to welcome to the show for the first time today, Zach Turner. He manages Fidelity's Dividend Growth Fund and the Fidelity Capital Appreciation Fund. And in that role, Zach is always on the lookout for companies with an attractive growth rate, as well as reasonable valuations.

And in light of recent tech sell-offs, we asked him to come on the show because there have been a lot of questions recently about whether the AI build-out may now be shifting to a massive new phase. So we wanted to hear from Zach about how the AI trade may be evolving and what he sees as being the next bottleneck or supply chain constraint in the process. So welcome to the show, Scott. Thank you for making the time. And welcome for the first time, Zach.

ZACH TURNER: Hey, Heather. Thanks for having me.

SCOTT MCADAM: Happy to be here, too.

HEATHER: Let's jump right in. So today is Tuesday, September 1. We're ushering in a new month. And some of the world's top economists gathered in Jackson Hole last week. Fed Chair Kevin Warsh used that keynote speech, Scott, to make one thing pretty clear here. It was crystal clear from that speech that he is committed to bringing inflation back to the Fed's long-term 2% target.

And just to give our audience a little bit of context, which I think could be helpful here, Scott, economists have questioned in the past how feasible 2% really is. And there was some talk maybe, Scott, if you agree with this, that maybe 3% is the new 2% when it comes to inflation. I don't know if you'd agree with the way that I put that.

But Warsh is doubling down, nonetheless, on bringing inflation down to the 2% original Fed target. I'm wondering from you, Scott, what are the implications here for interest rates and what we might see at these upcoming FOMC meetings. And for investors, could this mean some headwinds or challenges for investors going forward?

SCOTT: Yeah, there's a lot to unpack there. Anyone hoping for Chairman Warsh, that he would grade inflation on a curve and accept 3% as the new 2%, they were basically told to go take a hike in the Tetons. With the Personal Consumption Expenditure Index growth hovering in the mid to high 3% range, he made it clear that 2% is the target. It's fixed. Progress so far has been modest. And there is, quote unquote, "work to do," which means that the next rate move is probably up, not down.

Now, Fidelity's Asset Allocation Research team is projecting inflation above 3% into early 2027 amid a mid-cycle expansion. So based on that, the Fed funds rate now is likely to stay firmly restricted to try to grind out that last stubborn final mile to 2%. The market is pricing in at least one 1/4% hike by year end, and another one by the end of March 2027. That's likely to pinch longer duration bonds as real yields push higher. Elevated discount rates also bring speculative stock valuations back to earth. So going forward, I expect elevated volatility on every monthly inflation print.

For our managed account clients, real yield can actually be their friend. High-quality investment grade bonds, short to intermediate tips, cash equivalents—they can all provide durable real income ballast. We don't bet the ranch on one speech, however. Diversification beats Fed speak, or, in this case, the lack thereof.

The bottom line is that one or even a few quarter-point Fed moves isn't going to derail a well-thought-out retirement plan. Getting to that 2% may leave some bruises here and there, but letting 3% inflation erode purchasing power in retirement is far more painful. Our approach is to stay disciplined, well-diversified, and positioned for a wide range of outcomes.

HEATHER: OK, so like you said, could be some volatility, as this all gets worked out or during these next FOMC meetings, when there is some Fed speak. And near term, that's what we need to think about. This 2% target is the takeaway from Warsh's comments. But longer term, he talked about the bigger theme that we've been talking about all year here, which is just how big this AI theme is and how that could potentially drive our economy going forward as well.

So I wanted to get into this discussion with you, Zach, now about how AI has been the market's dominant story for the last few years. And you've been here at Fidelity, Zach, for 15 years. You spent the first half of your career here at Fidelity, in the technology space. So first of all, I'd love for you to just give us a little bit of background on yourself, and tell us how your time researching technology prepared you for the current AI enthusiasm in the markets right now.

ZACH: Yeah, no, thanks for the question, Heather. This is one of the biggest industrialization events of our lifetime. The ChatGPT moment happened about four years ago now. And at the time, it was clear that we had made a major technology breakthrough. But there was a reasonable debate as to how big of an investment cycle it would kick off. The debate was basically, is this going to be a short flash in the pan or something much bigger and more meaningful to the economy?

Today we have a clearer picture. From a capital formation standpoint, the AI buildout is already bigger than the internet and the personal computer. And to find something of similar magnitude, we'd have to go all the way back to the railroad boom in the 19th century. And so, this is a truly rare, historical event. And as you might imagine, it's creating a dynamic investing backdrop.

Investing is a tricky business. A transformational technology does not automatically translate into a great investment. The internet transformed the world, but many internet and telecom investors faced financial ruin before it all played out. The transistor, likewise, created extraordinary economic value. Yet the industry repeatedly suffered brutal inventory cycles and price declines and overcapacity. And something similar happened during the railroad boom, too.

And that is all to say that AI will absolutely change the economy, but that doesn't mean that every AI supplier will be a good investment. And so, to navigate all this, it really helps to map the value chain end-to-end from semi-cap equipment to fabrication facilities, to memory networking, compute, all the way up to the model and application layer.

I've spent a lot of my career studying the various layers of the AI stack. And we have an extraordinary research team here at Fidelity with decades of institutional knowledge. And we work together as a team to make investment decisions that are informed.

HEATHER: So that chart that you just showed, Zach, just mentioned the incredibly complex supply and value chain behind the AI buildout. But today, we really want to focus on the bottlenecks within the AI system as well, the constraints, in other words, that could slow AI deployment and growth down when there's this tremendous demand.

I know data center construction is one choke point or bottleneck. It's faced a lot of scrutiny. We've read so many articles about that. There's been a lot of headlines about that. But I'm wondering, what other choke points beyond the data center construction are you watching right now closely? And why the focus on bottlenecks? What do they tell us about the next phase of what could be ahead here?

ZACH: Yeah, no, good question. The capital that flows into building out AI doesn't evenly spread profits across the entire value chain. In an event like this, the economic value often concentrates around the kink points in the supply chain where supply is least able to expand with the demand. And so, an AI system has thousands of supply chain inputs. And when there's incredible demand like there is right now, the supply chain becomes strained, and there's shortages of various inputs.

The overall output of the AI system is constrained by the scarcest necessary input, or the bottleneck. So for example, if we could wave a magic wand and double the amount of AI chips in existence, the total available AI data center capacity would actually not double quickly, unfortunately. And it's because there's not sufficient amounts of power or packaging or memory, or even the labor to assemble the racks and stand up the data center.

And so, when a few constrained inputs dictate how much of the total AI system can operate, customers will pay unusually high prices to secure that input, understandably. And so, this manifests in pricing power and better contracting terms and higher levels of profitability and, ultimately, strong stock performance. And so, right now, one of the bottlenecks that I'm most focused on is memory.

HEATHER: So you see these potential problems or workarounds as potential opportunities, like memory. Why the focus on memory?

ZACH: Yeah, so like I was saying, memory is a bottleneck. And it's not just the chip. And I'm going to try to use a metaphor to illustrate this. Think of ChatGPT as a very smart student. And think of memory as the books that the student has to work with on their desk. For years, the frontier labs focused on making the student smarter, a better writer, more thoughtful. And they were really successful in doing that.

The desk, in the meantime, didn't improve much. It's too small and cramped. Most of the books sit across the campus in the library, actually. And so every time the student writes a sentence, they have to get up, walk over to the library, grab a new book, and walk back to complete the next sentence. And as you can imagine, this is really a slow process where intelligence is actually not the limiting factor. The walk is.

And so the industry came up with a solution to this problem called HBM, or High-Bandwidth Memory. And you can think of it as a bigger desk. It keeps more of the books right in front of the student, so they can write at the speed that they are actually capable of reading and thinking. And only three companies in the world right now make high-bandwidth memory. They didn't build enough. And a new factory takes years to bring online. And so we have smarter students and not enough large desks.

I'll end the metaphor there, but this dynamic is why companies like Microsoft and Google and Amazon have been forced to increase their memory budgets by many, many billions of dollars this year. And it's also why you might notice that your phone and laptop may cost more, too. Phones and laptops have to compete for the same finite pool of memory in the industry.

HEATHER: Oh, that's interesting. OK, that's important to keep in mind. So you talked about how we need bigger desks. There's only three desk suppliers there, to use that analogy. What are some of the risks, though, of, then, leaning into thinking about opportunities within these desk companies and this memory bottleneck?

ZACH: Yeah, so from an investment standpoint, the central risk with any bottleneck is that the conditions that the bottleneck create actually invite things like creative thinking, new solutions, and ultimately, overbuilding capacity. In the long run, bottlenecks loosen up. And then any supernormal levels of profit that the company was earning mean revert back to a more normal level. And these types of processes usually produce pretty lousy stock performance.

And so, it's really important to differentiate between cyclical and secular changes in a company's earnings trajectory. Cyclical changes are temporary, and secular changes are more structural in nature, and they last longer. And so some of these bottlenecks will prove to be short-term cyclical, and some will be longer-lasting secular changes. And it's on us to be able to spot the difference between the two when we're valuing these companies.

HEATHER: I'm going to bring Scott back in here for a minute. So Scott, you have an SMA, a Separately Managed Account team, Strategic Advisors. And within that team, of course, there are many Fidelity managers in your lineup. But your team also talks with external investment managers from other financial institutions, too.

So I'm just curious for their perspective on this as well. I know you speak with them frequently. Have you heard any other perspectives from them about how they are thinking about these AI bottlenecks as investors, or is it pretty similar to how Zach and his team are thinking about this right now?

SCOTT: Oh, yeah, for sure, it's similar to what Zach's saying here. But what's so powerful about this massive AI expenditure and the bottlenecks that result is the breadth of the opportunity set that's been created. Zach mentioned memory, also mentioned power and labor and packaging as bottlenecks. And so, all the companies that are relieving that supply chain in those areas certainly are opportunities, just like memory is.

And there are also ancillary products and services that are being rewarded. Whether they're cyclical or secular is for, certainly, folks like—for Zach to decide. But there's a remarkable story about a Japanese company that actually manufactures high-end toilets. Yes, toilets, right? And their stock more than doubled this year.

And who would have thought that a toilet company would get swept up in the AI phenomenon? But as it turns out, their ceramic fabrication expertise holds a near-monopoly on a component that's critical in the production of semiconductors. This is just one of many examples of how far AI investments have reached various direct and indirect beneficiaries.

HEATHER: Even toilets are beneficiaries. All right. Well, I want to bring in Zach again, too, not to talk about toilets, Zach, but I did want to ask you about a question that's been out there for a long time. But I'd love to hear your POV on this as well. We keep hearing about this massive spending that it's taking to perform this AI buildout. And now, some of the larger tech companies are issuing debt. And there's a lot of discussion about how much farther can this AI spending really go here.

Just wondering, based on the conversations that you have with companies—because I know that you're on the ground all the time, too, just like Scott—what are you seeing in terms of data center investment and CapEx, capital expenditures, and demand? Are there any indications right now that AI spending has peaked, or are we still in the middle innings of this game here?

ZACH: Yeah, I mean, this is the most important question. And we could restate this question in the form of, is there a sustainable return on investment on the spend? And my view is that there absolutely is. And I compared this technology cycle to the railroad buildout earlier. The railroad buildout was a multi-decade investment that, in part, helped to accelerate the Industrial Revolution, but it was also interrupted by bouts of overbuilding, financial panics, rounds of bankruptcy, industry consolidation.

And my best mental model for the AI cycle is not quite the same as the railroads, but there might be some similarities. I see this as a decade-long journey ahead with lots of volatility and psychodynamics that need to be risk-managed. But my view is that ultimately, AI is going to unleash productivity that will justify all the spending that we're seeing today. And I'm very optimistic that there will be strong investment returns available, but it will require skill and selectivity to generate them.

HEATHER: Well, we just wrapped up a very strong quarter two earnings season, and we learned NVIDIA beat earnings expectations that were already very high. But just as noteworthy, I thought, NVIDIA also expects revenue growth of 70% for fiscal 2028. And it actually said demand for their products is even greater than 70%, but the company is just so constrained right now on the amount of product it can supply, speaking to this conversation that we were just having, Zach.

So Scott, I'll bring you back in and ask you about this, too, because I asked you earlier about Warsh's comments at Jackson Hole. And as I mentioned, he also spoke a lot at Jackson Hole about AI. Wondering what your takeaways were from what Warsh had to say about it. And how are you and your team thinking about all of this aggressive AI spending as well and how it can impact a multi-asset class portfolio?

SCOTT: Sure. To Zach's point about being revolutionary, Chairman Walsh highlighted AI's long-term potential as a massive productivity booster, and that would, ultimately, be disinflationary. But in the short run, all this aggressive spending on data centers and chips and power sources, that all acts as a huge stimulus to overall demand. That is expected by many to continue for the next couple of years, at least.

That CapEx sustainability is really less of a question than what Zach had mentioned, too, is, hey, which companies are capable of turning this compute power into bottom-line profits, right? Many investment managers in our lineup are looking for downstream beneficiaries like, say, industrial automation, health care, financials. These are some of the companies that have adopted and implemented AI capabilities.

The AI investment also extends into other areas besides stocks. So you mentioned debt. Corporate debt issuance has seen a significant rise as companies race to invest in this technology. So there are opportunities to get 5-plus percent yields on high-quality investment-grade bonds without taking equity risk.

So this is all why, despite this expected volatility—which I'm sure will come—it's why we strive to be well-diversified into all kinds of stocks, bonds, commodities. As strategic advisors, our job is to help ensure that our client portfolios are participating in this incredible value created by the likes of NVIDIA, but not depend on one company beating whisper numbers by double digits every quarter.

HEATHER: Makes total sense. We're almost at time. We're at 2:20. We try to aim for a 20-minute show here, but I would love to end this discussion with a final question for you, Zach, and just to be able to pick your brain for a moment on when we look back at this pivotal moment that we're in that you're likening to the advent of the railroad, say, five years from now, what do you think investors are going to say was the biggest surprise of this AI buildout?

Just thinking like when I think back to 2023 and we were on the cusp of LLMs, Large-Language Models, coming out, it felt like one of the things that society was most worried about was simply whether it would do kids' homework for them. And we've certainly moved beyond that. I mean, Scott was talking about how even toilets are benefiting from AI.

So, we've moved past that initial understanding of the capabilities here, where this is a trillion dollar infrastructure investment. We're talking about potentially curing diseases, knowledge work. So what do you think? Could be something that we're underestimating here that in five years from now, we're going to be like, wow, we didn't even realize that was just the tip of the iceberg. What do you think?

ZACH: Yeah, so, I think people generally understand that AI will transform knowledge work. Today, we have near-PhD-level expertise in many fields on the phones in our pockets today, which is just an amazing thing. I think the degree to which these same technologies will transform the physical world is potentially still a bit underappreciated. These models are really good at generating text and language and video because these are digital domains where we have lots of training data, thanks to the internet.

They're still pretty weak at modeling the physical world. This is sometimes referred to as physical AI. The challenge with physical AI is that the training data for teaching these models how the physical world works is not readily available, and it's also pretty difficult to generate. And so, one of the earlier examples of physical AI that you might be familiar with is autonomous driving. This is one of the few physical domains where we do have some decent training data. And it's why we've seen some good progress so far in that area. But autonomous driving is still not a solved problem.

Physical AI and its data problem is an area where the frontier labs are starting to put a lot of resources into it. And, I'm expecting to see progress in the years ahead. Think robotics, biology, autonomous factories, things like that. And so, this is an area that I think could be a big surprise for its impact. And it's also an area that I'm on the lookout for new investment ideas.

HEATHER: Right, physical AI, robotics, biology, autonomous factories. It's sometimes hard to wrap your head around the potential, I think. But you did a good job there trying to keep this discussion grounded in real takeaways. So thank you so much, Zach. Thank you, Scott. We got to leave it at that. But thank you so much for taking the time to share your insights and your research today.

And to our audience, if you would like to continue your research here, and read more about the latest market trends and AI bottlenecks, we have a resource for you. You might want to bookmark [Fidelity.com/PMInsights](https://www.fidelity.com/PMInsights), PM being for Portfolio Manager. There we've got a library of articles and videos from many of our other talented and brilliant portfolio managers, just like Zach. So, definitely something that you might want to keep coming back to because it's constantly being updated with new thought leadership on that website.

On behalf of Scott and Zach, I'm Heather Hegedus. We are off next week for the Labor Day holiday, but we'll be back at it right after that. Remember, we're on Tuesdays at 2:00 Eastern. And we'll be back Tuesday, September 15. See you then. Take care.

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