

Fidelity Viewpoints®: Market Sense

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TRANSCRIPT

SPEAKERS:

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HEATHER HEGEDUS: Hi there, everybody. Thank you so much for making the time to join us today for *Market Sense* on this pivotal week. I'm Heather Hegedus with Fidelity. I said pivotal, because the Fed is meeting right now. We'll know by tomorrow whether it's moving ahead with a second rate cut for 2025.

Additionally, it is earnings season. And five of the seven of the Mag 7 are reporting their earnings this week. We're also coming off another week of all-time highs for the S&P 500. It was primarily driven by potential for a China trade truce in regards to tariffs, strong earnings reports, the tech rally, and a long awaited inflation report that did come in cooler than expected, making an additional case for more Fed cuts.

And just big picture here for a moment, just to zoom out and remind everybody where we are right now, the S&P is up over 16% year to date and up over 110% when you look at the past five years. So it's been a banner year for the S&P 500 to say the least. We are fortunate today to be joined, as we often are, by Fidelity's Director of Global Macro, Jurrien Timmer. We're also thrilled to welcome back today one of our most popular guests of this year. And I'm talking about Julian Potenza, who is a fixed income fund manager here at Fidelity with a focus on short-term bonds.

I'm really excited for the pairing of you. We've got Jurrien on equities today and Julian on bonds. And I'm going to try not to conflate your two names, Jurrien and Julian. Julian, good to see you.

JULIAN POTENZA: Thanks very much, Heather—good to see you as always, Jurrien—happy to be back.

JURRIEN TIMMER: Good to see you both—and greetings from Gillette Stadium.



HEATHER: What a backdrop you have, very fall like, Jurrien—football season well underway and earnings season well underway—a lot going on, as I mentioned, of the top. Today is Tuesday, October 28—FOMC meeting also underway right now.

So just to remind investors out there, this year, we have seen a 25 basis point cut back in September. Chair Powell has suggested further rate cuts are still on the table. And the market is betting a high probability of another cut coming tomorrow. So, Jurrien, what do you think is going to happen tomorrow? Do you think a 25 basis point cut is pretty much a done deal at this point?

JURRIEN: Certainly, the market is expecting several more rate cuts this year. Even Chair Powell has hinted at that. And we've already got one cut, of course, this year. We had 100 basis points of cuts last year.

So the Fed, I think, is trying to get back to neutral, a neutral policy. The restrictive policy of a few years ago when inflation was running at 9% clearly isn't warranted. Inflation is now running at 3%. And ironically, the market celebrated a 3% inflation rate last week when the CPI was released, even though that's still well above the Fed's target. But it's very on par for 2025.

But the question for me is, how far is the Fed going to keep going? And also, what is neutral? Neutral is based on neutral policy. So neither restrictive nor accommodative is something that is, like, the steady pace for the Fed if all else is in balance.

And right now, inflation, even though it is above the Fed's target, has come down. It has been pretty steady at that 3% rate now for the last year. And of course, the jobs market—we don't get the jobs reports these days because of the government shutdown. But the labor market has been slowing. It's not contracting, but it's been slowing.

So I think the Fed is saying, a neutral policy makes sense. But the question is, what is neutral? The Fed seems to think—or does think—that the long-term neutral rate is 3%. And indeed, when you look at the markets, they're predicting 3%. But that 3% is based on inflation of 2, which is the Fed's target, plus 1%, which is called the natural rate or r^* . So what is neutral is something that continues to be debated.

But in the meantime, the market, like you said, is up 16%. The equal weighted S&P, when you take out the Mag 7, is up 11%. That is very respectable. It's on par with the historical average.

We're in earnings season. Earnings are very positive. And you've got a very friendly, benign bond backdrop, which I know Julian is going to talk to at length. So the market doesn't see a lot that it doesn't like here right now.

HEATHER: Yeah, 2025, what a year so far, Jurrien. You mentioned the lack of jobs data. Despite the government shutdown, though, the BLS, the Bureau of Labor Statistics, was able to release the CPI inflation report on Friday. It showed inflation rose lower than expected.

Can you talk about the context of that? The Fed has restarted the cutting cycle. Given that lack of government data, though, we don't really know how long it might last. Where does the market think this cutting cycle is going, considering, as you mentioned, inflation is still at 3%? What could this also mean for stocks?

JURRIEN: Yeah. And just to give a little backdrop—so obviously, we are in a shutdown. It's the second longest now I think in history. And we don't get the jobs data. We don't really get any other data.

But the reason we did get the CPI report is because the government has to set the cost of living adjustments for various benefits. And so that's why the CPI was an exception to that rule.

HEATHER: Isn't it also true that they already had some of that CPI data? So they were able to, this time, release it. But it might be a problem going forward.

JURRIEN: Well, they had to call back some people to do it. But this is a whole other can of worms. Because even from six months ago, the CPI data has not been as robust in terms of the number of data points that government workers are getting. But that's a whole other topic for another show.

But in the meantime, again, it's the juxtaposition or the interplay between the Fed's two mandates. You got inflation, 2%. OK. It's at 3%. The market was happy with that 3%.

So maybe 3% is the new 2%. The Fed would never say that, of course. But maybe that's where the market is at.

And then the jobs data, which is the other mandate—and the two are relatively in balance. And that's why the Fed is getting further away from what it considers a restrictive policy. They were at 5 3/8 just a little over a year ago. They're now at 4 1/8.

And then the question is, how close to the Fed's sense of neutral, which is 3%, can the Fed get? And that will be entirely based on, does the jobs data get weaker? Does inflation go back below 3% towards 2%?

Does it go up? Who knows. We still have a whole tariff question to answer.

And so my sense is that—and this is just my own sense—is that the Fed right now says, OK. We got some more wood to chop. We can cut a few more times. And then we'll wait and see.

And of course, at that point, we get towards the end of Chair Powell's term. This is next year in May. So there'll be all kinds of other dynamics in play.

But again, as I said earlier, right now for the stock market, you get benign interest rates, falling-short rates, a well-behaved 10-year yield. And you get rising earnings. And you have this whole AI narrative. And it's a backdrop where momentum is really dominating. And we see that in the numbers.

HEATHER: Right. Thank you so much, Jurrien. And let's bring Julian in now and talk about the impact on the bond market. So catch us up a little. It's been a while since we've talked to you, Julian. Catch us up on what this rate-cutting cycle has meant for the bond market so far.

JULIAN: Sure. Thanks, Heather, great starting question. So big picture rate cuts, generally a supportive environment for the bond market. When the Fed cuts rates, interest rates tends to fall. That's good for bond prices. That supports bond returns.

We've seen pretty decent returns in the bond market this year. I'm seeing a little over 6% for the overall taxable bond market. So that's handily ahead of inflation running around 3%—as Jurrien suggested, positive on a real basis. And we've seen pretty good returns across the yield curve.

Now that's mostly about Treasury yields so far. That's risk-free rates. That's what the Fed impacts most directly. But I think this is an important point.

When you invest in the bond market, you tend to own securities beyond just Treasuries. You own corporate bonds, securitized products, maybe Muni bonds. These other forms of bonds are usually a little bit riskier than treasury securities.

So you get some extra yield when you buy them. That extra yield, we call it the credit spread. It's the spread or difference between the yield you get on, say, a corporate bond versus similar US Treasury securities. And credit spreads are really the other key driver of bond market returns, along with Treasury yields.

So, how does that work? Obviously, you get some extra yield. But importantly, when credit spreads move, they tend to impact bond prices. And when credit spreads tighten, that's good for bond prices. You see bond prices going up, supportive for returned, all else equal.

It's not a perfect analogy. There's some other factors in the mix for bonds. But you can think of a credit spread as similar to a PE ratio on a stock. When credit spreads are tight, that's like a high PE ratio. So when spreads are tightening, that's good for the performance of bond markets. But the flip side is, at the end of that, they're expensive, which can have an implication for future returns.

Tying that all back to your question, to Jurrien's point, this cycle is a little bit unique. Oftentimes, we see the Fed cutting in response to a deteriorating economy or recession. So Treasury yields are falling, but credit spreads are widening. It's kind of a mixed picture for bonds.

In this case, the Fed is acting proactively to get policy rates back to neutral to prevent the economy from weakening. We've seen growth, pretty healthy, corporate earnings, pretty healthy. Credit spreads have been tightening this year, as well.

So you've kind of had two tailwinds for bond market returns, falling Treasury yields, and tighter credit spreads. That's the equation that gets you the strong returns we've seen in the bond market so far this year.

HEATHER: Two tailwinds—sounds pretty good, much better than two headwinds. The other big recent news on the Fed front, Julian, is that Chair Powell has indicated it may be finally close to the end of its quantitative tightening program. Of course, just to level set here, make sure everybody knows what we're talking about, this has been the Fed's effort to shrink its balance sheet and let bonds that it bought up during COVID mature.

And I know this might sound a little bit like inside baseball. And people might not think that this matters directly to them. But can you explain why it does matter and whether this could have real, significant impacts on the bond market?

JULIAN: Yeah, sure, very topical question. I'm debating this all the time on my team these days. So big picture, thinking back, the Fed, after the global financial crisis and after COVID when the pandemic hit, they wanted to support the economy, even though rates were already at 0. So they announced these big, quantitative easing programs.

They bought bonds at of the market. They basically created electronic cash to pay for them. That was to help stabilize the markets.

Fast forward to now, over the last two years, they've been putting that process in reverse. So the Fed's balance sheet has been in the slow process of shrinking. We refer to that as Quantitative Tightening, the opposite of quantitative easing.

And when QT is underway, it does create some modest headwinds for the bond markets. This is what we've been living through. As bonds mature off the Fed's balance sheet, they have to be reissued back into the private markets. So this is Treasury securities, agency mortgage-backed securities. That extra supply can put upward pressure on bond yields.

In addition, that process destroys some of the liquidity that the Fed created when they expanded the balance sheet. So we've seen this kind of modest headwind in terms of tightening liquidity conditions. Now obviously, as we started, we've still seen pretty decent returns in the bond market despite the QT program being underway.

So you don't want to overstate its importance. The big kind of macro calls, what's going on with the economy, inflation, Fed policy rates tend to be more important, I would argue. But we are now starting to see some emerging signs of that liquidity drain process tightening up the money markets.

Short-term rates that we look at, repurchase rates, interbank rates, they're starting to drift up above the range that the Fed is trying to keep them—nothing concerning yet but signs that we're getting back to a more normal liquidity environment, as opposed to this excess liquidity environment that we've been operating under for the past couple of years. The Fed is paying very, very close attention to those signals, sending the message that it's about time to stop the QT process. That could happen this week. We'll find out tomorrow.

If not, it's almost definitely going to happen by the end of the year. Basically, the end of that QT process will mark the end of this minor headwind that the bond market has been living with—so less supply to be absorbed by the private markets and no more of this liquidity drain dynamic. So that's a good thing. That's a tailwind.

I would say, it's pretty well-expected and pretty well-priced in at this point. So I wouldn't expect any big surprises. You never know. But that's the base case.

HEATHER: OK, so probably baked in—but certainly, worth keeping an eye on—

JULIAN: Something we'll be watching closely.

HEATHER: —not tuning out. Yeah. OK, and right now, we're talking about rate cuts, Julian. But back in April, tariffs were dominating the headlines. It seems so long ago.

But we did see long-term Treasury yields rise as global investors worried about the future of US trade policy back then. And that was kind of a surprising reaction to many investors. Because typically, Treasury yields fall in times of market volatility as investors are seeking safe haven investments. But that's not what happened. Does it seem like the bond market now has shaken off tariff concerns for now?

JULIAN: Yeah, another great question—definitely an interesting month. We saw two things going on in the bond market. One, to our earlier discussion, credit spreads widened pretty sharply. That reflected the risk of economic disruption from tariffs.

And then, two, to your point, treasuries, they behaved a little differently, a lot of volatility. Treasury yields didn't just fall as we're used to seeing. I think there was two things going on.

One, the impact of tariffs on the economy—it's kind of a tricky thing for the bond markets to discount. It's got offsetting implications. It's bad for growth, which usually makes risk-free rates fall. But it also is potentially inflationary, which can make them rise. And so it's a tricky thing to discount.

The other important thing, the whole concept of a trade war, speaks to rising tensions with our major trading partners. And they also tend to be major investors in the Treasury market. So in April, investors were worried about global investors views of US dollar assets, like treasuries. Are they going to effectively abandon this market in the face of the trade war? If so, how's the Treasury Department going to be able to sell all the debt that it needs to fund the government?

Since then, we've seen two developments. One, the economic impact, generally speaking, of tariffs has been less bad than feared at the time. You can see impacts on CEO business confidence. We've seen the softening in the labor market that Jurrien mentioned. We've seen a little bit of tariff inflation coming into to goods prices.

But big picture, all those things have been less than feared. And so that process has helped credit spreads, particularly, come back down. That's been a big part of the strong bond market performance this year.

On the global investor side, we have seen the administration sign trade deals with many of our major trading partners. Now could argue about the process and if it's fully over. But I think some of that fear of a disruptive rupture that would see foreign investors permanently abandon the market has calmed back down.

So I think that's all pointing to the fact that, while we're not completely through the tariff story, thus far, I think the bond market has weathered it pretty well, gotten its arms kind of around how to think about these risks. And it should see it more likely that we see some of the more traditional bond market relationships with other markets going forward.

HEATHER: Hey, Julian, you mentioned government debt. We know that is something the bond market is really watching, rising government debt levels. How might bond investors consider approaching additional uncertainties like fiscal dynamics?

JULIAN: Yeah, yeah, another great question. There's been a ton of focus on that this year around the passage of the fiscal tax bill earlier this year. Look, debt levels are high. Deficits are high.

That's concerning. It's something that we think about a lot. The bond market—as an investor, you need some compensation for that.

I think the flip side of that is, as a bond investor, I'm always trying to think about, what's already in the price in the market, and what is the new information? And to me, as soon as the election happened last November, bond markets largely expected the tax cuts from the first Trump administration to be extended. So when the bill was passed earlier this year, there was a little bit of nuance differences from that expectation.

But big picture, there wasn't a ton of new information. What's really been new on the fiscal side is the tariffs. And so we talked about tariffs being disruptive to inflation, all that. They also do raise a lot of revenue. And the government is collecting a lot of tariff revenue.

It's effectively a form of a tax hike. There's a question about, who's ultimately going to pay for this tax? Is it US importers, consumers, foreign exporters? So far, it seems kind of a mix of all. We're not fully through that story.

But it is improving deficit forecasts. And so we could debate if tariffs are the most efficient way to raise revenues. But that has actually helped stabilize the fiscal picture somewhat. And that really has been some of the new information on the fiscal side that is part of that kind of calming bond market dynamic that we discussed earlier.

HEATHER: Yeah, an interesting perspective. Because we kept hearing about tariffs, inflation. But also, tariffs are a revenue generator, you're saying, when it comes down to it. What about growing political pressure on the Fed? Is that something that we should be watching and that could impact the bond market?

JULIAN: Yep. Yeah, no, another great question, something we think about a lot. Look, as a bond investor, I think that Fed independence is crucially important for the long-term stability of the bond market. Too much influence on the monetary policy process has a long history of leading to bad outcomes. We spend a lot of time thinking about it.

We do think that the Fed is a strong institution. The Trump administration will have the ability, obviously, to impact personnel. But there is a process, and procedures of votes, and distribution of power that we think is going to hold up and prevent some of those worst-case outcomes.

Now, both of these topics are areas that can have different impacts across the yield curve. And I would argue, short-term bonds are a lot less at risk to either Fed independence or long-term deficit concerns. Those tend to show up more in the long end of the curve. So if you are

very worried about those factors, short-duration bonds or bond funds could be a good option to consider.

JURRIEN: Yeah, Julian makes some really good points. One of them is that the market is brutally efficient in discounting information. And like he said, the one Big, Beautiful Bill with the extensions of the tax cuts wasn't new information. I mean, that was already sort of thrown up in the air back in November. So it wasn't really game changing from that perspective.

But in terms of the Fed's independence, obviously, we've talked about this a lot. And the difference between short and long rates—the difference between those is—there's a thing called the term premium, which is like a risk premium for bonds. Julian mentioned credit spreads being like a PE.

Well, there's even—it's not a credit spread. But the sum of the difference between long and short rates can be explained by investors' willingness or unwillingness to take the risk of lending to a company or a government for a long period of time. And that definitely is one of the risks that, if there's too much fiscal shenanigans, or if the Fed does get flipped by the administration, or skewed in a more dovish direction, that would be the transition mechanism for that to play out in the market. And the term premium was negative for a while, which doesn't make a lot of sense. But that was during the QE days, the Quantitative Easing days.

Those days are now over. And the term premium has become positive. But it's fairly stable. And that's why the 10-year yield is at 4%. It was close to 5% just six months ago. So things are very, very quiet despite all of these headlines and risks.

HEATHER: Well, I want to talk a little bit more about short-duration bonds. Thanks for that setup there, Jurrien. Just to make sure to level set here, we're talking about bonds with maturities of less than five years issued by either the government or corporations.

In recent years, a lot of investors have been parking their cash in cash-like accounts, like money markets, Julian. But now with those rates coming down, investors may be starting to take advantage of short-duration bonds, which are typically less impacted by changes in interest rates. Given the market pricing and more rate cuts, like we talked about at the beginning of the show, is the short end of the curve the place to be right now?

JULIAN: Yeah, another great question, Heather. Definitely seen flows into the short-duration space, Short-duration bond space pick up since the Fed started cutting late last year. I think those cuts remind people that the attractive money market yields, which have been fantastic risk adjusted return, they can melt away pretty quickly when the Fed is in motion. And moving out the curve into the short duration of space, you can attempt to lock in some of that yield.

As a general statement, I like the short part of the curve. In this environment, it's the most levered to what the Fed does. So it should be supported by further Fed cuts.

And while the yield curve has steepened this year, it's roughly in the middle of its long-term range in terms of steepness. And the implication of that is you don't sacrifice all that much yield relative to longer-term bonds by staying in the short end, while you also avoid taking on too much interest rate risk. Some of the other big-picture risks we've been talking about, the deficit, Fed independence, et cetera, as Jurrien covered, those show up in the term premium—bigger issue for the long end of the curve.

To your direct question, I do think there's an opportunity here. I think it is important to note that the market is already expecting a series of Fed cuts. So if the Fed just cuts another couple times in line what the market is already pricing in, the returns between short duration and cash will be relatively similar.

However, it's the scenario where the Fed ends up cutting more than expected that the short duration space could really pay off. We got a little reminder of that in this past quarter. In early August, we got the jobs report for July—pretty weak, negative revisions.

We saw pretty big rally in the bond market and pretty strong performance. I think that's a good example of where the short duration space could provide some welcome duration to your portfolio. At the meantime, yields are kind of between 4% and 5% nominally, all in pretty attractive on the historical basis. Of course, past performance is no guarantee of future results. But to me, the short duration space is a pretty nice, sweet spot in between money markets and longer-duration bond funds.

HEATHER: And when we talk about short-term bonds, what parts of the market look promising to you right now and beyond as we get ready for 2026?

JULIAN: Yeah, I like short-duration investment grade. So that's high-quality bonds with low default risk, nice diversification yield, and relatively low risk. We talked about how credit spreads are tight.

The implication is you don't just get that much extra compensation for taking on more credit risk. So I don't think you abandon credit completely. But it's a good time to think about upgrading the credit quality in your portfolio, maybe moving some of your high yield to investment grade.

That's certainly how I'm approaching this landscape on the portfolios I manage on my team. When you aren't getting paid to move out the risk spectrum, sometimes the prudent approach, hunker down, be patient, wait for a better environment. I think the short-duration investment grade space is a really good spot to do that at this point in the cycle.

HEATHER: Wow, fantastic perspective there, Julian. You covered a lot of ground. Before we go, I always like to give Jurrien a chance to give his take—we call this Timmer's Take—to hear what investors might want to be watching this week. It's a big week for earnings besides it being a Fed week, Jurrien.

JURRIEN: Yeah, so I think the Fed is not controversial at this point. Neither are earnings. But it is earnings season.

150 companies have reported. 85% have beaten estimates by about 8 percentage points, on average—so very, very solid. And as you mentioned, five out of the Mag 7 are reporting. And obviously, those are the big bellwether. So we'll see what they do.

HEATHER: They're the big ones. All right, Julian and Jurrien, we've got to leave it at that. Thank you to you both. And thanks to everybody out there watching and for sending us your questions.

Today, we always like to leave you with a resource. And today, we are leaving you with a link to our fixed income bonds and CDs page, which is a great place where you can look up the current yields on everything that Julian talked about today. That website is [fidelity.com/bondsearch](https://www.fidelity.com/bondsearch).

So on behalf of Jurrien Timmer and Julian Potenza, I'm Heather Hegedus. Thanks for the pleasure of your time today. And remember, we'll be back next Tuesday at 2:00 o'clock Eastern live. Take care.

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