

Fidelity Viewpoints®: Market Sense

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TRANSCRIPT

SPEAKERS:

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HEATHER HEGEDUS: Hey there, everybody. It's so good to see you. Thanks so much for making the time today to join us for *Market Sense*. I'm Heather Hegedus with Fidelity.

It is going to be a pivotal week for the markets and for economic forecasts, with of course, the Fed meeting right now as we speak, and the market's pricing in a rate cut tomorrow, which would be the first rate cut of the entire year. We're also going to be listening to what Fed Chair, Jerome Powell, says tomorrow in the news conference after the FOMC meeting, of course, about how the Fed is feeling about the state of the economy. So to talk about what this could all mean for the markets, we are delighted to be joined today, as we often are, by Jurrien Timmer. Of course, he's Fidelity's Director of Global Macro.

We're also pleased today to be joined by Fidelity's Director of Quantitative Market Strategy, Denise Chisholm. Denise is here today to talk about potential investing opportunities with monetary policy possibly easing. So great to see you both, as always, a very timely conversation.

DENISE CHISHOLM: Hey, it's great to be back.

JURRIEN TIMMER: Good to see you both.

HEATHER: All right, well, let's get started. And I just wanted to give a quick note to our audience before we do and say, if you're listening to us as a podcast and you enjoy our weekly discussion, first of all, thank you. And we would love it if you left a review or shared our show with a friend. We do read all of your comments, and they help us shape future episodes. So please, submit those reviews and we really appreciate that.

So it is today, today is Tuesday, September 16. And let's talk about the likelihood of the Fed cutting tomorrow, and perhaps, the bigger question, not if the Fed's going to cut, but by how much? So as I mentioned off the top, the last time the Fed cut was back in December of 2024. Jurrien, what are you expecting to hear tomorrow from the Fed? And I would really just love your thoughts on what you're going to be listening for tomorrow.

JURRIEN: Yeah, so the market overwhelmingly expects a 25 basis point, or a quarter point rate cut tomorrow. Some people are talking about a half point, but that's not really the expectation. And it would be, frankly, a little surprising after so many months of the Fed saying, we're not quite ready yet, because inflation is too sticky, and the economy is still good.

So for them to go from nothing to 50 basis points certainly would be a surprise to me. They did do that last year, but last year, the Fed had gone well into the restrictive zone, right, at 5 and 3/8. So they had some catching up to do as inflation came closer to the Fed's target.

But the inflation rate has been very, very stubborn in the high twos for about a year now, and has not really fallen from that level. And while the jobs market has been softish lately, the labor market seems to be in balance. So I don't think there's a clear and present danger for the Fed to say, OK, we have to catch up and do more.

Having said that, at 4 and 3/8, which is where the Fed is right now, the Fed is pretty close to neutral, if neutral is inflation, plus 1%. So that would bring you to 3 and 3/4 or so. But the Fed does have a couple of rate cuts that it can execute on in the coming months.

So it could do that all tomorrow. But my guess is, it'll stagger it over a few months to get really closer to neutral now that the economy—now that inflation, even though it's sticky, the jobs market is a little bit softer. And then beyond what the Fed actually cuts, or not cuts tomorrow, I think the more interesting parts of tomorrow will be not only the press conference, of course, as you mentioned, but the so-called dot plot.

So as Chair Powell's term gradually comes to an end next year, it'd be interesting to see how the different Fed officials are posturing themselves in terms of what they think is going to happen. So the dot plot will be interesting. And of course, looking for any dissents, if the Fed goes a quarter, which is what the dissenters wanted last time, will they still dissent saying they want more?

And so this is kind of where the political argument comes in. And we saw, of course, Stephen Moran just being appointed to the Fed. And so you can't avoid the political element of this as we get to next year when the next generation of Fed leadership takes hold.

HEATHER: The future of the Fed. You know, we are coming up on the three year anniversary of the bull market, Jurrien, so I'd like to ask you about that as well. We keep seeing this market surprise us again and again with more gains. We are coming up on the third straight year now of double digit returns for investors, even when it might seem like the economic news might be turning negative.

I think to the average person, though, it might seem like this bull market maybe has run more than it was expected to, and might feel overextended to some investors now. So I'm curious if you think it is? What do you think?

JURRIEN: Well, I hate to give a two-sided answer, but on the surface, the S&P, since it bottomed in October of 2022, so the bull market is 35-months-old, the S&P has gained 88%. The median bull market going back 100 years is 90% over 30 months. So 88% over 35 months is pretty darn average.

So by that measure, this is kind of like a garden variety bull market. But of course, we all know that it hasn't been, because the first year in 2023, if you were not in the Magnificent Seven type stocks, you really were not feeling the bull market very much, because very few stocks participated, and it was really all valuation driven, even though earnings in 2023 actually shrank slightly.

Then '24 was what you would expect to see. So earnings were up 11%, valuations also grew. But generally speaking, by the second or third year, the PE ratios are coming down, and earnings are doing all the heavy lifting.

And earnings are doing the heavy-lifting. They're up again. They're growing at about a 10% growth rate, but there's still that boost from valuation. And again, that comes from the mega cap growth stocks, the Mag Seven.

So in many ways, this has been an unusual, under-the-hood type of scenario. But a bull market is a bull market. And right now, it's a global bull market.

Even non-US stocks, which languished for so long, are participating. If you look at the global stock index, it's making new highs. And about 3/4 of the stocks in the global stock market are rising, are above their 200 day moving average.

So it's actually a very good thing to see. And again, it's driven right now by higher margins and upward revisions in earnings estimates. And that's something that usually is a pretty good situation.

HEATHER: No, an unusual scenario, though, where you do have to look under the hood a little bit to really get the full picture. All right, Denise, let's bring you in here now. And to remind our audience, Denise's research focuses on analyzing market history and data to try to uncover patterns and probabilities, and help inform investors about the future.

So let's talk about how a Fed cutting cycle might factor into the state of things, Denise. How have the markets been impacted in the past when the Fed started cutting?

DENISE: In some ways, there's no playbook. They're all different, and they're all different based on why the Fed is cutting interest rates, to the extent the Fed is cutting because growth is contracting, not just slowing, that we've seen, but actually contracting the onset of a recession, then that hasn't been a good situation for stocks, historically speaking. But the Fed doesn't only cut in recessions. The Fed has cut many times when the economy is just slowing.

And in those circumstances, stocks have over the next six and 12 months, delivered double the average returns that you usually say historically. So that's been a bullish precondition. But even more so than that, I think starting points matter.

With the Fed, this cutting cycle versus the last we saw a year ago, the difference versus history is that you only see 1/3 of the time, earnings growth being this strong. That has also been a positive setup for stocks. So you can say from a historical lens, it's a little different this time. It's very rare that the Fed is cutting interest rates when earnings growth is above 10%. And that's also been a bullish precondition for stocks.

HEATHER: So we're not in a recession right now. But what about the softening that we have been seeing recently in the job market? Do you think that's a sign a recession could be looming, Denise? And would that change your answer too about how the market might be impacted by the Fed getting ready to cut?

DENISE: Well, that's sort of like a dual crossroad, so recession or no recession, and if recession, have stocks actually discounted already. And as it relates to payrolls, this is the interesting part, because there is a statistical reason why we say all the time that payrolls are a lagging indicator. If you look at those revisions, and even when you rebase it relative to actual payrolls, all jobs, what you'll see is, it's the bottom decile of the historical data going back to the '70s that we had. And the worst payroll revisions have been, the better stocks usually are over the next 12 months.

And if that doesn't seem to make sense, the whole reason is because usually by the time payrolls have slowed, stocks have already discounted it and delivered below average returns. And that's essentially what we saw in April when we saw an almost bear market. I think that you could almost interpret history by saying, well, that's exactly what stocks were saying in April, that the data is going to slow.

And in some ways, stocks are the ultimate leading indicator. And the more stocks go up, interestingly enough, the more earnings and growth tends to follow in the future, meaning, as maddening as it sounds, stocks actually usually predict the future better than the data does. But that's not the only leading indicator that we're seeing that has a bounce.

So CEO confidence, or confidence specifically in CEOs' own businesses six months out, has bounced from recessionary levels, even though we're not in a recession. That's also been a good sign for stocks going forward and the labor markets going forward. So it may very well be that while payrolls have been revised down heavily, and while there is very little growth, this might be a situation of a pause that refreshes for later in the year.

HEATHER: So stocks more accurately predict the future than the data, sometimes, you're saying? And that's the case right now. Wow. All right, let's talk about—

DENISE: data is, yep.

HEATHER: Let's talk about how this potential rate cut could affect the housing market for one. A lot of people are feeling optimistic that falling rates could help thaw this frozen market, Denise. But when we had the last Fed rate cutting cycle back in 2024, remember, long-term rates, including mortgage rates, not only stayed high, but they actually went higher, which was sort of counterintuitive to see that happen as the Fed was cutting. I'm wondering if you think this time around, though, things might be different. Is there anything different right now?

DENISE: Yeah, the transmission mechanism didn't work last time. And you can see from a historical perspective, we know why housing market is interest rate sensitive. And right now, we've been in as much as the economy isn't in a recession, certainly, housing has been in a rolling recession. Residential investment and home sales contracted in 2022, they bounced, and they're in contraction territory again.

So everybody is wondering, is this rate sensitive actually going to have the transmission mechanism that it usually has? So you do see when the Fed's cutting, versus when they're on hold, or increasing interest rates, that home sales do bounce. But that usually happens when long yields come down and when mortgage rates come down.

And the irony of last year versus this year, when the Fed is cutting, is inflation, despite tariffs, is actually in a better situation from a core CPI perspective than we were a year ago. The lower inflation has been, the more likely it is to have that transmission mechanism of Fed cuts to translate into lower, long yields. So if that is the case, and we are in a better condition this year, we might finally see that rate sensitive be statistically rate sensitive as it has been in history.

HEATHER: All right. So if that is the case, then that's good news for home buyers, for sellers, for small business owners. But let's also talk about what this all might mean for investors, Denise. What do you think this might mean for what you want to own? And we love to hear your opportunities, Denise. So can you talk about which sectors historically are more sensitive to interest rates, which could potentially benefit in the event of a rate cutting cycle?

DENISE: Sure, the classically sector level beneficiary has been consumer discretionary. But within consumer discretionary, the part that looks really interesting to me statistically is the home builders, so the public builders that from a national average build homes. And it's that segment of the market that not only does it look interesting because the odds are higher where there's a real link to home sales, but it's really valuation driven.

Jurrien highlighted that a lot of the multiple expansion has been in technology, stocks, and growth stocks, and that's what's been leadership of the market. And what you'll find is, interest rate sensitive, and small cap stocks, and other areas have essentially been left for dead. And by left for dead, I mean, statistically, in the bottom quartile of their valuation ranges from a historical perspective. So they're cheap.

And when you have a situation where home builder stocks are cheap and interest rates actually fall, so we get that transmission mechanism again, that boosts your odds from in the 60s to now in the high 70s. And if you just say, well, the great financial crisis wasn't a great paradigm to compare it to, well, then now all of a sudden, you're in the 90s in terms of a risk reward. So I think that the setup is not just there in terms of, yes, this is an interest rate sensitive, but now, you're in a situation where this interest rate sensitive has that viable transmission mechanism, and a whole lot has already been priced in. So I think the risk reward for homebuilder stocks looks pretty interesting.

HEATHER: OK, so Denise likes homebuilder stocks. Again, we're talking about publicly-traded, national homebuilders. They're actively traded on major stock exchanges. They're part of the consumer discretionary sector.

So one potential opportunity from Denise, when I was talking to people about this show, and I was explaining to them that you like homebuilder stocks, I think people tend to think of homebuilders as your local guy in town. So people tend to forget that there are national home builders that are publicly traded. OK, so that's one potential opportunity.

Any others that you can mention for us? What are you still liking tech? I know you're really bullish on tech. How are you feeling about tech these days?

DENISE: Yes, I still do like tech. I think that is still market leadership. When I look at it from as much as you've bounced back from a valuation perspective, you're not as expensive as you were going into that almost bear market in April. And the reason is, because fundamentals have been so strong.

And the legislation that's just been recently passed is going to keep fundamentals that strong. That effective corporate tax rate that approximates about 7% is a real big boon for technology stocks as a sector. So I think it's going to be hard for a lot of other sectors to keep up.

And if you go back to that paradigm, well, if the Fed is cutting and we're not in a recession, and if we just say, OK, the level of profits actually reduces your recession risk when you look going forward, and that's one of the reasons why that's been such a bullish precondition for stocks, you usually see a rotation into very economically sensitive sectors, like technology, like financials, like consumer discretionary, and away from those classically defensive sectors, like utilities, consumer staples, health, and I'll add in energy. So I think that pro-cyclical push, or that economically sensitive leverage is still a positive risk reward in the market. So I think the top three sectors that I've been talking about are bin technology, consumer discretionary, and financials.

HEATHER: Got it. All right. On the flip side, any potential risks that you see moving forward with the current economic backdrop, Denise? You've painted a really compelling picture of what could go right for these sectors, but what could go wrong?

DENISE: Yeah, I think, well, we can talk about homebuilders. And the interesting part is, when you say the Fed's cutting interest rates, what percentage of time does the long end actually follow, meaning, long yields fall? You'd only see historically 70% of the time. If you do have that lower CPI, it's 85% of the time.

That extra 15%, you usually see if growth escalates very rapidly. So you saw a situation where the Fed was cutting, and I think it was '95, '96, certainly, '98, '99, and then '03-'04'ish, where the Fed was cutting that the long end backed up quite substantially. But that was really a reflection of growth. GDP growth on a real basis actually hit around 4.5%.

That's a little bit of a reach relative to what we're seeing now, so that's certainly not my base case. And you would say that might have a situation where that dampens that transmission mechanism we were just talking about as it relates to home builders. But for the overall stock market, that usually isn't a problem. If long rates are higher, and GDP growth is actually that high, that hasn't been a problem for the market historically, meaning, that if rates are a reflection of growth, the risk reward for stocks is usually still positive.

HEATHER: OK, so just final thought from you, Denise, final takeaways from you, what you like and you don't like?

DENISE: Yes, so economically sensitive sectors, like technology, consumer discretionary, specifically home builders, and financials look a whole lot like leadership to me when I look at the data. And I think that that rotation away from those defensive sectors, like we're already seeing happen in utilities, health care, and consumer staples, is likely to continue making the risk reward very negative there.

HEATHER: Thanks for summing it all up for us, Denise. And Jurrien, we would love to give you just a little bit more time to give us your final thoughts too, on what to watch tomorrow, or as we anticipate this big Fed press conference after the FOMC meeting wraps tomorrow. Any final takeaways, or things to watch tomorrow, about the conference and the minutes that follow?

JURRIEN: So I think—and just to give a little context against Denise’s very excellent comments—we have to make the difference between is this a full easing cycle, which typically comes during times of economic distress? Or is it just a tweaking of bringing policy back away from a very restrictive stance, to a more neutral stance? And I think clearly, it’s the latter, at least at this point. That could change, of course.

But the Fed went way restrictive because inflation was at 9% a couple of years ago. And now, that storm seems to have passed, not entirely, but mostly, so the Fed can go back to neutral. And then it’s a question of what the Fed is doing and what the markets are expecting. The markets are expecting the Fed to go below 3% in the coming year or more. I don’t quite see that happening, but that doesn’t mean it won’t.

So beyond reading the tea leaves of what Jerome Powell is saying tomorrow, and whether there are dissensions or not, the market reactions that I ultimately am going to be watching is the 10 year treasury yield and the dollar, because if the market concludes that the Fed is doing something political, which it’s not going to do tomorrow, but the risk is that it might in the future, that it does something political that’s not justified by economic conditions. You would see a reaction in both yields and the dollar like we did back in April and last year. And so I think those will probably be the more interesting things to watch. But beyond that, I think the Fed meeting will be fairly plain, just because we’re still in the old Fed, if you will.

HEATHER: Fairly plain? All right, but we’re going to be watching alongside you, Jurrien and Denise, and of course, we’ll take note on how this impacts, as you said, the 10 year treasury yield and the dollar. And then we’ll be back here next week of course, to break it all down for you. Next week on *Market Sense*, Jurrien will be back on with Jake Weinstein from our Asset Allocation Research team to talk more about what happened.

Also, if you want to stay up to speed on interest rates, inflation, and anything else that affects your investments, be sure to subscribe to the Fidelity Viewpoints newsletter. It’s Fidelity.com/FidelityViewpoints. You can bookmark it. And our partners at Viewpoints are going to be posting an article immediately after the Fed meeting tomorrow with further analysis of the decision and what it might mean for your investments. And while you’re there, can also watch our *Market Sense* replay and get a full library of Viewpoints’ articles there as well.

So on behalf of Jurrien Timmer and Denise Chisholm, thank you to both of you. Terrific conversation today. I’m Heather Hegedus. Thanks for your time. And remember, we’re on live Tuesdays 2:00 Eastern. Thanks, everybody. See you next week.

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