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TRANSCRIPT

SPEAKERS:

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HEATHER HEGEDUS: Hello there, and thank you so much for joining us today for *Market Sense*. I'm Heather Hegedus with Fidelity. So the past week has been jam-packed with financial news and headlines, and that's sort of an understatement. And some of that has triggered a bit of market volatility. I'm talking about everything from that surprise AI development out of China, to, you know, news of tariffs on imports continuing to make headlines.

And we have been watching this all closely for you in the past week. It's worth saying that these are fast-moving stories. They continue to evolve.

So we are watching these developments. We're going to do our best today to unpack it all for you. But these are stories that continue, like I said, to change.

But I'm so fortunate today to be joined by two of Fidelity's brightest minds to help walk us through, you know, what the investor impact might be on all of this. So we're delighted to be joined today by Naveen Malwal. Of course, he's an Institutional Portfolio Manager here at Fidelity, and his team manages millions of client accounts day-to-day here at Fidelity.

We're also excited that we've got Denise Chisholm here today. And she's Fidelity's Director of Quantitative Market Strategy. And her research focuses on analyzing market history to try to uncover patterns and probabilities that might be able to help inform the current outlook on the market. So I really appreciate both of you watching these stories so closely for us, and for making the time to talk to us today about them. Denise, so great to have to have you on.

DENISE CHISHOLM: Absolutely. It's great to be back, Heather.

NAVEEN MALWAL: Yes, it's nice to see you both.

HEATHER: And today is Tuesday, February 4. So, boy, January flew by with all of those headlines. I don't know about for you, but for me it did. And we got a lot to unpack, as I said, today.

And I'd like to start with tariffs, the most current news. Naveen, can you first of all walk us through what has happened so far? Because there's been a lot going on in the past even 24 hours.

NAVEEN: Yeah, a lot of developments coming out on tariffs. But I'll just remind folks to take a deep breath and just kind of pause a bit. The market is still doing relatively OK year-to-date, despite the volatility last week. We're continuing to see strong earnings growth last year and so far this year, and the economy is still growing.

So with that as a backdrop, stocks may still have a good runway ahead of them. Now having said that, what's going on with tariffs has caught the attention of the markets. And on Monday there was volatility. And by Tuesday, things had calmed down quite a bit.

So what we've seen is tariffs being announced and then delayed on Canada and Mexico, and tariffs getting announced on China. China already had some tariffs in place. These are going to be additional tariffs on goods coming out of China.

But as you said, Heather this is a really fast-developing story. There's already been conversations around other products or other regions being affected in the coming weeks. So this is something we'll be following very closely as it evolves.

HEATHER: Right. And viewers, as you mentioned, might not know that, you know, some tariffs have been in place in China dating back to 2018. But can you talk about these new potential tariffs and, you know, the potential impact for investors as we know of right now?

NAVEEN: Yeah, so to define it simply, a tariff winds up being a tax on things that are imported into the US from other countries. So what that leads to is higher costs on things coming from overseas. And in this case, the countries that are being potentially targeted—and again, there's been a delay—but if the tariffs do come into place on countries like Canada and Mexico, there the focus might be on areas like auto manufacturing. So a lot of domestic US brands, the manufacturing for cars actually takes place across borders in US, Canada and Mexico to build vehicles. It could also impact food products and household goods from those countries.

And for China—a lot of stuff is made in China, whether it's finished products or it's things that go into other products. So that might have some impact as well. Now, having said all that, there's still a lot of just fluidity around this situation.

One, we don't know how long these tariffs might last. Sometimes they seem to last us for a few hours before they're delayed or canceled. In other cases, they might last longer, perhaps for months or even years after that. We don't know what exceptions may get carved out, what negotiations might take place.

And then finally, how does the rest of the market react to foreign currencies maybe move around to offset some of the tariff impacts? So a lot to kind of figure out. And for me, the bottom line is not to try to speculate or guess what might happen because it changes so quickly.

So just as one example, the tariffs on Canada and Mexico for were set, in part, according to the administration because they didn't feel those countries were doing enough to help on illegal immigration. So if these countries were to step up and start to make more of an effort that the US government felt was more agreeable, then maybe the tariffs go away. So that's how much this can change sort of day-to-day or even week-to-week. And which is why it's not something I'm looking to make predictions off of, but rather react to as it evolves.

HEATHER: Yeah, we certainly seen how much can change just in the past 24 hours. As I said, a lot of moving parts here still. And we certainly, like you said, Naveen, are not going to try to make predictions today. But we do have Denise with us today, who looks at, like I said, market history to uncover patterns and probabilities. So, Denise, can you talk just from a historical standpoint what history tells us about the potential impact that tariffs can have on the market?

DENISE: Yeah, sure. I think what Naveen said was exactly right in terms of "take a deep breath." I mean, we've seen, you know, very aggressive headlines before.

Back in 2023, we saw Silicon Valley Bank go bankrupt in 2023. And that was, you know, the fifth largest bank bankruptcy that we hadn't seen in over 25 years—and yet, the market was up over 20%. So you do always have to be mindful as an equity market investor not to necessarily trade on the headlines.

And I think one of the reasons why it's such a cautionary note, when you look back in the historical data, is the market is a discounting mechanism. So some headlines may or may not durably impact earnings growth or GDP growth. But more importantly, the starting point of how fearful the market already is over what headline is hitting is actually quite compelling and interesting to look at from a data perspective.

So what has been unique to me this cycle is that I think fear is still very persistent, and that's been true over the last couple of years. And this is very rare to see in a non-recessionary period, and I measure it quantitatively. I'm going to get really quanty for a second by looking at something called valuation spreads.

And it's just the difference between really cheap stocks and really expensive stocks. And that gap usually widens when you're in a recession. And it happens when investors sell anything they think is risky, right, then get cheaper, and buy anything they think is safe, tho—those names get more expensive. And that valuation gap usually is an opportunity for equity market investors to look through any volatility and actually make money to the upside.

Another way to think about this is the more visible the whatever it is that you're worried about, or the headline is—tariffs, monetary policy uncertainty—some of that may be priced in, which creates an upside skew. That's exactly what we saw happen in 2023 with that bankruptcy.

So sometimes you can think of it as like the mathematical expression of the market climbing the wall of worry. Things do go wrong, and yet the market climbs them anyway. The market goes up anyway.

HEATHER: So you're not willing to bet against this market? You're still pretty bullish on this market right now, because some of it has been priced in?

DENISE: Yes.

HEATHER: So let's talk about, you know, what kind of impact tariffs could have, potentially. Again, we're not going to completely speculate here. But we've heard examples of avocados, of cars. Historically speaking, Naveen, what kind of impact do tariffs have on businesses and on consumers?

NAVEEN: Specifics matter quite a bit on the potential impact of tariffs. So it depends a lot on the countries being targeted. And then even more narrowly than that, what are the actual goods and services that we're importing from those countries?

I mentioned auto manufacturing as an example. So there, it can be car parts or even some of the work that's done before those eventual components make it back into the US for assembly. That is something that could have an effect.

You mentioned avocados. That's an example of a food that just isn't as easy to grow in the US. Yet US consumers love it, so we wound up importing those from Mexico.

Same thing for maple syrup from Canada. A unique product they make that we want more of, so we manage to import it. So those are examples.

HEATHER: I knew you had to throw the Canadian maple syrup in, by the way, because you're Canadian.

NAVEEN: I do.

HEATHER: Right.

NAVEEN: So the Dutch tulips, the Canadian maple syrup.

HEATHER: Yes.

NAVEEN: So those are examples of the kinds of things that can happen. Now, what's interesting about this, it's a relatively narrow list. So I want to distinguish this from the broad based inflation that many of us felt was coming the last few years.

People ask me, oh, is this the return of inflation like it was two or three years ago? This feels quite different. Yes, the prices of certain things may go up, but it's not the same as a broad based economic inflationary cycle. So this is something that I think is more narrow in scope.

But the other thing I'll harp on again is just how quickly things can change, potentially. So these are relatively short-lived. They may not be that much of an impact on businesses. A business is not going to suddenly open up a new factory if tariffs are only in place for a few hours or days or weeks.

However, if the tariffs are more long-lasting, if they're put into place—for example, Heather, you mentioned some tariffs have been on place in China for years now. You know, once that starts to kind of become more concrete, businesses may adjust. They may adjust where they get certain supplies from. They might develop new ways of manufacturing that in a different country or even domestically.

But again, those are slow-moving developments. I wouldn't just presume, because we've had tariff headlines, that we're going to see a sudden surge in US manufacturing overnight. That will take time to develop as a potential outcome.

HEATHER: All right, you mentioned Dutch tulips, too, of course, in reference to Jurrien Timmer, another one of our frequent guests here. Right now, I don't know of any tariffs on those Dutch tulip—tulips though, do you, Naveen?

NAVEEN: Not yet.

HEATHER: We're not trying to say that that is one of the categories here. But so I think your point is that, you know, we're not talking about across the board price increases. And I think that's a really important point, because I think that consumers might still have some PTSD from when inflation was at its peak a few years ago. And you're talking about a little bit more selective price increases on certain products, so an important point.

NAVEEN: Mm-hmm.

HEATHER: You know, Denise, let's get your take here. You know, what's your take on people's concerns that tariffs could lead to higher prices?

DENISE: Yeah, I think it's interesting when you look at the data. Obviously, we just lived through tariffs in 2018, and the 2018 episode not to the same degree that we're talking about right now. Although to Naveen's point, we'll see how it all plays out. But we have a handful of episodes going back to the 1970s of when tariffs were placed on imported goods. And what you can find is that most of the time—in fact, all of those five or six instances—inflation actually decelerated, so slowed.

So back to Naveen's point where it wasn't a broad level of price increases—in fact, there were offsets. And maybe one of the ways that we can think about tariffs is not necessarily a broad level of inflation, or an increase in the broad level of inflation, but as more attacks to the US consumer. But not all of the price increase lands on the US consumer—there are actually offsets.

So maybe the foreign producer decides to not make as much money, right, and become less profitable because they don't want to give up that US consumer. Or maybe what we saw in 2018 was that the exchange rate somewhat offset it, where the US consumer can actually buy more of the foreign goods, given the fact that the US dollar appreciated, or could buy more.

And then there's also the fact that the consumer themselves can substitute. So if all of a sudden Mexican avocados become as expensive as California avocados that were more expensive at the time, you as a consumer could consume less avocados. Or you could consume no avocados. So there's really—I don't want to say no impact—but there's no economic impact to that person, other than being grumpy because they gave up, you know, avocados, right? And everybody likes more avocados.

HEATHER: No more avocado toast for a while.

DENISE: Right.

HEATHER: But there are other things you can put on your toast.

DENISE: Exactly. So there are offsets that not the entirety of the tariff increase falls on the US consumer. So that makes it such that it might not be the big headwind that you expect for either corporate profits or on US consumption. Which might mean that there's something more critical that we should watch always for the stock market in 2025, which is earnings growth matters. So the fact that earnings growth has been, and I think is likely to stay quite durable in 2025, is the critical factor.

HEATHER: Durable meaning long-lasting? Pretty strong right now?

DENISE: Durable, meaning long-lasting. In fact, I mean, you know, we're off-cycle this cycle. And 2022 was actually a double-digit contraction in earnings growth. So we didn't turn positive in terms of earnings growth, or profitability of US companies, until just last year, at the end of last year.

So we're in year one of an earnings cycle recovery, let's call it. And earnings cycle recoveries typically last over three years. So once corporate America becomes profitable, it usually has some staying power.

And you also look at some surveys—whether it's the Philadelphia Fed Survey of Business Expectations, or the Small Business Survey of how do you expect earnings to be every quarter. We're seeing inflections, which is to say that earnings growth, that's correlated with the durability or the level of earnings growth. And now we're actually seeing it finally confirmed in revisions.

So each analyst has revisions—has earnings forecasts on every individual stock, and they can take it up or down every quarter that goes by to say, is this company going to be more or less profitable over the next 12 months? And what you're seeing is, if you look at all of the number of up revisions—hey, the companies are becoming more profitable—and you subtract out all the down revisions—companies are becoming less profitable—you'll start to see an inflection. And that inflection is now at top decile levels. And that top decile level is correlated to durable earnings growth and strong earnings growth, usually an average of 18%.

So if you go back to the, well, be cautious with trading headlines and the impacts might not be as systemic as you think, what is the core driver? If earnings growth is a core driver in 2025, we've got a lot of mathematical indicators contributing to a pretty positive risk reward.

HEATHER: I like what I'm hearing. So this market has a lot more room to run—at least a couple of years. Let's talk a little bit of that—about that AI shake-up, too, because that obviously had some impact last week on the market.

You know, this concern from China that—that led to a little bit of volatility last week. The NASBAC—the NASDAQ rebounded, you know, after those initial losses. First of all, Naveen, can you kind of walk us through what happened for those of us who weren't paying attention? Because that was a pretty short cycle news story, as well. And how did the market respond to that, and how does it continue to respond?

NAVEEN: Yeah, in the first half of the week, we thought we'd be talking just about this topic until basically Friday afternoon. So early in the week—

HEATHER: Then the tariffs over, right.

NAVEEN: —you might have forgotten, but early in the week, there was an announcement from a startup that they had potentially cracked some impressive AI innovations at a much lower cost than competitors. And that led to a lot of volatility in global stocks related to artificial intelligence. Now, to your point, Heather, since that time, the market did seem to recover much of its footing. Some stocks are still down, depending on exactly how you analyze the situation.

And there's a lot of questions around the claims the company made around what exactly it pulled off, how it did it, what kind of technology did it use or not use. A lot of debate. And what exactly was the cost at the end of the day? It's a lot of debate around this.

However, it did underline how innovation can be bumpy. You may get companies that are doing really well and seem to be clear winners. Then suddenly you have a breakthrough from a competitor that can kind of change the order of how things are shaking out.

So for me, there's two takeaways. One, this is not unprecedented. If you go back and look at developments in other nascent technologies, or even drug discovery, this is part of the cycle. You do get volatility.

And two, maybe one of the ways to get around this is to diversify. So in other words, don't just hang your hat on one or two really big names, assuming that they will always keep winning. But instead invest in a basket of stocks that may be playing a particular theme. And on this theme of AI investing, while last week's news was something to—to behold and digest, I still believe there's a long-term runway here for investors if they're still interested in pursuing this theme across many companies around the world and those ways of investing in this.

HEATHER: So it became a little bit of a blip on the radar, even though in the moment it seemed like a really big story.

NAVEEN: Yes.

HEATHER: How about you, Denise? You know, what do you think about whether competition from China, AI competition, has the potential to be a game-changer for our stock market here in the US?

DENISE: Yeah. If you back up—I mean, Naveen described it completely accurately. It's a technological advance, right? So companies can now do more, potentially for less.

Historically speaking, that's been a good thing for the overall market and a good thing for the overall economy. That doesn't mean there's not going to be winners and losers, right? So there's always idiosyncratic risk to individual players.

But even for the broader technology sector, to the extent that what you find is that technology companies can use AI for less money, that means that because they need to spend less, they might generate more profits. And that's what actually drives the broader market, when you look at technology stocks or the overall market. Said differently, when you look at the bear markets that we're worried about, right, that's a peak to trough contraction of 20%, right—so a more permanent loss of capital, when you look at it historically. Most of them are correlated with recessions, not technological advancements.

So again, backing up and saying is this—you know, are there winners and losers? Absolutely. Is there idiosyncratic risk to have all of your money in one or two people that are winning right now? Absolutely. But when you sort of back up and look at broader technology stocks, or the broader market overall, these are usually positive productivity shocks.

HEATHER: OK. And Naveen, when this was all happening, we got a lot of viewer questions from people who remember what happened in the early 2000s—the dot com bubble that burst, that significant sell-off in technology that affected the whole market. I know that you've been looking at that. How does—does this time around feel different to you? And how is it different than the early 2000s?

NAVEEN: It does feel different. My career started around then. And back then, things were—were drastically different for technology.

And two things that really stand out to me, one is a topic Denise has already touched on—valuations. So measuring companies on how much do you pay for the company, versus their profitability. And normally, a lower number is considered a more attractive valuation.

So back in the late '90s and early 2000s, some of those companies had hardly any profit growth, or hardly any even sales growth, and yet people are very excited to invest in them. Today, we have something very different where companies are actually seeing tremendous sales growth and actual profits coming through, and they've been doing that for years. So these are not fly-by-night startups that just appeared. These are some of the biggest businesses on the planet we're talking about.

Now, tying that back to valuations back in the late '90s early 2000s. If you look at something like the forward price to earnings ratio on the S&P 500 Index, it started getting into the 40s or even the 50s at some point during that market rally and eventual sell-off. Today, that same ratio is sitting in the 20s. And yes, that's above its long-term average, but that's nowhere near the valuation stretch we saw back then nearly 25 years ago. So this feels very different for me on those two fronts.

HEATHER: All right. And Denise, out of what happened last week, where are you seeing potential opportunities out of AI right now, out of this shakeup?

DENISE: Yeah, it's interesting. I mean, in some ways, because I think it's a positive technology shock, as opposed to a potential headwind. I'd say that the opportunities are where I saw them anyway.

But specifically, within technology, I think that software companies are really interesting here. We remember software companies going back five to seven years ago as very expensive stocks—what Naveen was just talking about. Expensive stocks on an absolute multiple perspective, price to earnings ratios, how much you're paying for what profits they generate, or especially relative to the market. They were some of the most expensive stocks in the market.

Fast forward to today, because they've been such good businesses that Naveen was just talking about, these are not fly-by-night companies anymore. This isn't the dot com bubble where they were actually, you know, contracting in terms of earnings growth. This is sustained generated earnings growth year after year. The stocks are no longer expensive.

And cheap valuation—and by cheap, I mean I'm going to give you a quanty term in the bottom half of the distribution when I look at the data going back to the 1960s—what you find is that's fairly protective, historically. So when the stocks are cheap and earnings growth is positive, you tend to outperform. And when the stocks are cheap, even if earnings growth isn't positive and is negative, you tend to outperform. And that's the positive risk reward that I'm looking for.

So I think that software is an interesting space. I think you might remember it as an expensive area of the stock market. But really when you look at the data, there's actually a fair amount of valuation support that I think makes it a positive risk reward.

And I'm also seeing opportunities outside technology, as well. Specifically in economic sensitive sectors like consumer discretionary and like financials—both of which I think have idiosyncratic drivers for positive fundamentals, or positive profitability, over the course of the next year. And also have strong valuation support where you see that same math, when all of a sudden you're in the bottom half of the distribution, relatively cheap versus history, it tends to be a protective area.

HEATHER: And how about on the flip side of this—risks that could come out of this potential—or out of this AI shakeup. It's not a potential shakeup, but what happened last week.

DENISE: Yeah, it wouldn't necessarily be just on that news flow. I think that this sector was in the penalty box coming into this year, which would be utilities.

HEATHER: OK.

DENISE: So utilities tends to be a more classically defensive sector. If you ask me, like, how often going back to the '60s does utilities outperform the market or beat the S&P 500, it's only 35% of the time. And you usually don't want to own utility stocks when earnings growth is durable or increasing, which is exactly the situation that we're seeing right now.

So the risk reward for utilities is fairly negative. If you look at what drove some outperformance during the past year, I've heard the term that utilities are in AI play through power. To the extent that one of this AI advancements was that you can actually do the same amount or more using less power, using less of that what you needed before, then that might be a slight negative in terms of at least the vernacular around utilities and AI. So I think that that's where of all the, you know, sectors in the market that I look at, all 11 sectors, I think that that's the riskiest area to think about keeping up with the broader S&P 500.

HEATHER: And it tied back to what happened last week, though. I know you said that it was sort of at risk for a while. But this Chinese startup said they produced better results with 5% of the cost. And that cost was the utilities, the power, right?

DENISE: Correct.

HEATHER: So that's—that's part of it. All right, this has been a fantastic conversation. We had so much ground to cover today. And I—and I hate to wrap it. But Naveen, maybe a good way to sort of tie this conversation up with a bow, so to speak, would be to talk about some of the investor takeaways that you'd like people watching and listening today to think about after this webcast.

NAVEEN: Yeah. So I'll leave you with three things. One, Denise and I both touched on this, but market volatility happens for all kinds of reasons, even when the economy and earnings are positive. And the market tends to rise when earnings growth and earnings growth—and, excuse me, economic growth are both tailwinds, which is the case right now.

So yes, last week was bumpy. But let's look forward to the longer-term. We may see positive market developments inspired these headlines.

A second thing, diversification may be helpful, right? So for folks who are narrowly invested in just a handful of stocks or a couple of ETFs, maybe think about investing more broadly so they're not exposed as much to these headlines that are affecting particular markets, particular sectors, particular countries. And the rest of the portfolio, be it stocks, commodities, inflation-protected securities, can help alleviate some of the stress in your portfolio.

And then three, just try not to overreact to every headline. Try to stay disciplined. Try to stay focused.

If it's hard for you to do this on your own, we have help available at Fidelity. So working with a financial professional may be a productive way of getting that. Because these headlines are probably not going to go away or get any easier over the coming years.

HEATHER HEGEDUS: Well, I would say that both of you probably helped a lot of investors out there today regain a lot of confidence after hearing what you had to say in your insights today. So thank you so much to both of you.

And along those lines, we always love to leave you with resources that might be helpful in continuing your education on the stock market and things to watch. And we're going to be sharing a resource right on your screen right now that you can refer to whenever there are noteworthy market developments. It's the Fidelity Viewpoints Market Insights page.

So you can scan the QR code on your screen right now, or you can simply go to fidelity.com/marketvolatility. And there you'll find articles that continue our conversation about what's next for big tech. You'll also find an article about the fed's rate cut pause, which we haven't even talked much about because we've had so many other things to talk about in the past couple of weeks.

You can also sign up for Fidelity Viewpoints Newsletter there, where you can get other investing articles delivered straight to your inbox, as well. Terrific conversation, guys. Grateful to have you on today.

On behalf of Denise Chisholm and Naveen Malwal, I'm Heather Hegedus. We hope to see you back here next week. Remember, we're on Tuesdays at 2:00 Eastern.

[1]Fidelity Viewpoints, January 29, 2025: https://www.fidelity.com/learning-center/trading-investing/mag-7-AI

[2]Fidelity Viewpoints, February 3, 2025: https://wwwxq1.fidelity.com/learning-center/trading-investing/what-is-a-tariff

[3]Fidelity Wealth Management. January 29, 2025: https://www.fidelity.com/learning-center/wealth-management-insights/ai-investing-outlook

[4]The Economist: January 23, 2025: https://www.economist.com/finance-and-economics/2025/01/23/do-tariffs-raise-inflation

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The technology industries can be significantly affected by obsolescence of existing technology, short product cycles, falling prices and profits, competition from new market entrants, and general economic condition.

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