Fidelity Viewpoints®: Market Sense

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TRANSCRIPT

SPEAKERS:

Heather Hegedus Jurrien Timmer Julian Potenza

HEATHER HEGEDUS: All right. Hey there everybody. Happy Tuesday. Thank you so much for making the time to join us for another episode of *Market Sense*. I'm Heather Hegedus with Fidelity.

So here we are. It's the last week of July already, but the pace with the markets is anything but slow. Markets are still navigating more tensions in the Middle East right now, another busy week of economic data and major earnings reports. And right now, as we speak, of course, investors are keeping a close eye on this month's Federal Reserve meeting. So joining us, as he often does, is Jurrien Timmer, Fidelity's Director of Global Macro, to help unpack some of these headlines for us today.

We're also, from Jurrien to Julian—We are pleased to welcome back Julian Potenza. Don't confuse the two. Julian Potenza is a portfolio manager here at Fidelity. And he's here to talk about the outlook for interest rates and bonds today. So Julian co-manages the Fidelity Total Bond Fund and the Fidelity Investment Grade Bond Fund. He's also another *Market Sense* fan favorite besides Jurrien, of course.

And we love having Julian on during Fed meetings because Julian is a former Fed analyst here at Fidelity. So we love to get your take when you're available. Thanks for making the time, Julian. And good to see you.

JULIAN POTENZA: Thanks, Heather. Always happy to be here.

JURRIEN TIMMER: Great to see you both. Welcome back to the show, Julian.

HEATHER: With that, as I mentioned, today is Tuesday, July 28. Jurrien, I want to talk about what's been driving the markets this summer now that we are deep into the summer. So we've seen bouts of volatility and chip stocks amid concerns that hyperscalers may be overspending now on this AI build-out. At the same time, uncertainty in the Middle East has continued to contribute to swings in oil prices.

But, on the positive side of things, second quarter earnings season is off to a very strong start. So investors are weighing all of these developments alongside ongoing questions about the economy and about interest rates, which Julian's going to be getting into in a moment. How has the stock market, though, been digesting some of these moving parts?

JURRIEN: Yeah. There are so many crosscurrents, I don't even know where to begin.

HEATHER: Right. I had a long leadup there, right?

JURRIEN: So there, of course, is the inflation, interest rate side, what the Fed's going to do about that. And Julian and I and you will unpack that in a moment. But just within the stock market, there are a lot of crosscurrents as well, because the Mag Seven, of course, those seven very big, powerful trillion dollar stocks that have been propelling the market higher, really for the last, 10, 12 years, are not looking so magnificent these days because many of these companies are spending a lot of money on the AI infrastructure buildout. And investors are starting to push back a little bit about, OK, what is the return on investment going to be for all these trillions that are being spent?

And so the market or investors are taking a more critical look at all of the capex plans. And, of course, we're going to hear more about that in earnings season. And some of the companies have already reported. And it seems like the more money they say they're going to spend, the more their stock goes down these days. And so there's a little bit of a, I don't want to say "backlash," but there's a little bit of a moment of truth for these companies in terms of this race to the finish for AI dominance.

Fortunately, the broader market, the rest of the market, is actually doing quite well. So the S&P equal weighted index, or if you strip out the AI names, market's doing quite well. About 70% of stocks are in uptrends. But the issue that we're having, and we've talked about this many times in the past, is that the market is somewhat concentrated, right?

A handful of stocks make up a large part of the market capitalization. So the top 10 stocks is 40% of the market. The top 50 are 60% of the market. And so what we're seeing right now is a little bit of a churn at the index level, even though beneath the surface, the market is actually doing quite well.

So I'll give you one quick example. The S&P 500 has been sort of locked in a range now since June 2. It has not made a new high since then. So that's almost two months ago. Within that time frame, the Mag Seven is down 9%. The AI names, if we put them all in one bucket, are down about 15%. But the S&P equal weighted index is up about 2%. And the non-AI names, if we put those in a bucket, are up about 5%.

And at the intersection of all of that, the S&P index itself, the one that we know and think about, is down about 2%. So down 2% is not really a big deal. It's been going up, of course, like a train in recent months. But it gives you a sense of the churn that happens when the big leaders, who are so big and who drive the index higher or lower, when they're not leading, it's good for an active investor because there's a lot of fish in the sea these days.

But at the same time, it's hard for the index to make a lot of progress. So we're in that churn right now as investors are weighing all the pros and cons of the AI boom. But for me, the glass half full, if you will, is that, to me, this proves that this is not a bubble, because if it was a bubble, nobody would be asking any critical questions because bubbles, that's what they do.

So to me, this is a good sign that the market is taking a very rational and somewhat critical look at this whole space and where it's going to go.

HEATHER: Bubbles are euphoric. Investors are asking critical questions. We're not in a bubble. It's a great time for active investors to seek out some opportunities. Fair to say?

JURRIEN: Correct.

HEATHER: OK. All right. Let's switch gears and talk the Fed meeting that's underway right now, because this is Kevin Walsh's second meeting as Fed Chair. This is being closely watched, of course, not just by Fed watchers, but by the majority of investors right now. In June, the central bank did vote to hold rates steady for Warsh's first Fed meeting as Fed Chair, citing a strict focus on fighting inflation.

However, Julian, Warsh's comments suggested to investors at that time that there is strong potential for hikes ahead. And that created quite a market reaction last month. Since that time, the market's expectations about what the Fed might do at this July meeting have fluctuated. So I'm curious what your thoughts are on all of this as we go into this two-day meeting. What are you expecting to hear from Warsh tomorrow?

JULIAN: Yeah. It's shaping up to be an interesting meeting, isn't it? Right now, the market is putting roughly 30%, 35% odds on the Fed hiking this week, which suggests that there is a real chance it could happen. And, to your point, those odds have really bounced around over the last couple of weeks, much more so than would have been the case under a Powell Fed, in my opinion. So that's already an interesting contrast right there.

As far as what I'm thinking heading into this meeting, obviously, we've seen renewed hostilities in the Middle East recently, which has sent oil prices back up. They're going down this week, but it's volatile. And tariffs are back in the news. So both of those point to ongoing inflation risks, maybe arguing towards hikes.

On the other hand, the Fed decided not to hike at the meeting in June. And since then, the traditional what we call tier one data that really tends to be important to the Fed—so nonfarm payrolls and core CPI—have actually come in a little soft relative to expectations—so a little less job growth, a little less core inflation, which would normally suggest that the Fed can afford to be patient. And, of course, we have a new Fed Chair who, so far, has not been providing much detail in terms of his approach to conducting monetary policy, meeting to meeting, which is adding to the uncertainty factor.

Personally, for me, I think they'll hold off this week. I think it makes sense for Warsh to play for time a bit, especially given how fast things are moving in the Middle East. But, I'll be honest, I don't have a ton of conviction. I think, zooming out a bit, there definitely is a sense building on the FOMC that policy rates may need to rise this year.

If you don't hike this week, I do think Warsh may get a couple of dissents from some of the regional bank presidents. We'll see how the inflation data come in. In my opinion, if it continues to come in hot, which is not guaranteed but definitely possible, then by September, Warsh may need to deliver on a hike, or he could risk starting to lose credibility with the rest of the committee. One way or another, I think this is going to be a really interesting chance for the markets to start to learn a little bit more about how the Warsh Fed is planning to operate.

HEATHER: Yeah. Staying on that point for a moment, on that topic of, what do we think Warsh is going to do here, basically, Julian—after the inaugural news conference that he had last month, I think a lot of investors might have come away with the impression that he's pretty hawkish. He's taking a fairly hawkish stance on rate hikes as a option to tame inflation, which probably surprised a lot of investors given this widespread perception that he was brought in here with a job—that this administration brought him in with an expectation that he was more inclined to cut rates. Is the market reading him wrong? Or what's going on here?

JULIAN: Yeah, great question. We live in cynical times, I guess. So there was this concern in the market that maybe Warsh was coming in with a little bit of a preset agenda to cut rates, even if it were not appropriate for the economy. Bond market, obviously, would be concerned about that.

I will say, in his first couple of public appearances as chair, he has certainly said all the right things in terms of the importance of an independent Fed, of following the data, and of bringing inflation back down to the Fed's 2% target, which, of course, it's been above for quite some time. I think that's been reassuring to the bond market. And Warsh is a good communicator. It's actually pretty common for new Fed chairs to stumble a bit as they find their voice. And, I have to say, Warsh has been pretty smooth so far.

But I will say this—one thing that I've noticed, Warsh is very firmly hawkish in the abstract, general sense, talking in broad strokes, strokes about unsticking sticky prices, inflation is a choice, the Warsh Fed will hit the inflation target. When it gets down to something more concrete, maybe about the near-term inflation outlook, things that may impact policy in the very near future, he suddenly gets a lot more nuanced and vague. And I think he's been really careful not to say anything that could really pin him down in terms of near-term policy action.

And so, in a way, I think we have yet to learn what this kind of general hawkishness is going to mean in terms of the here and now, where the rubber meets the road. To a certain degree, that's very consistent. Warsh has been clear that he is not a fan of forward guidance, which is central bankers aggressively trying to manage the market's expectations. But to me, there is a distinction between telling the market what you're going to do, that's traditional forward guidance, and helping the market understand what economists call your reaction function, or how you might react to various outcomes in the economy.

Warsh has really not been willing to provide much of either. One result of that is more potential for volatility around Fed decisions. We saw that in June. There's certainly a chance that we see that again tomorrow.

JURRIEN: I would just add to that, one clever way I've heard, potentially, the new Fed being described is that it is less of this super polished thing where one person clearly is in charge and everything is of a unanimous decision based on that very tight sort of level of groupthink, for the lack of a better word, and that the new Fed under Warsh might be more how we think about the Supreme Court, where it can be any division of votes, and it's not necessarily unanimous. You could have more dissension, and there's going to be different wings. And so I think that that's one way we can think about how this Fed might evolve over time.

HEATHER: So a more vague Fed Chair who is not keen on forward guidance. We've maybe heard the term—there might be more in-family fighting, used by Warsh himself, making it sound like a healthy family debate, but debate nonetheless. So we're still all trying to look for clues on where Warsh stands with things. And I know that we've gotten some information, Julian, about where he might stand based on the five new task forces that he created. What have those tasks forces told us about what we can glean to be his priorities?

JULIAN: Yeah. So that's definitely something we've been focused on. Warsh previewed these task forces at his first press conference, and they cover some of the key areas he's identified as maybe due for an update—communications, the balance sheet, the inflation framework were some of the important ones. Since then, we have seen the Fed announce the members of the task forces, the leaders. And so we've gotten our first clues as to what they might start to say when they release their findings later this year.

I think, as opposed to going through them one by one, the main takeaway is that these task forces are staffed with credible, impressive people. These are not people from the fringes of economic sort of policy debates. These are respected economists, former policymakers, and high level business leaders. You see a pretty wide range of views represented, and the members are generally prominent enough that I would think the task force findings are going to have some credibility, both inside the Fed and with the markets more generally.

To me, this doesn't really look like a list that was put together to serve a particular agenda or with the answers predetermined—maybe an exception on the AI and productivity task force. That does seem set up to be pretty bullish on AI. But I think, big picture, it's a really good group. I do think that many of the task force members have been somewhat critical of some of the standard views of contemporary central bankers, so maybe another good family fight coming. And it's going to be interesting, but all within the bounds of mainstream sort of debate around central banking.

To me, it's not looking like we're going to hear anything too shocking or disruptive to the markets, which is a good thing. But we'll definitely be paying attention as the task forces start to release their findings.

HEATHER: Well, and Fed policy is obviously a huge driver for the bond market, Julian, because the Fed sets the baseline interest rate for the economy, which affects bond payouts. So let's switch gears and talk to you now about how the bond market is doing right now and put your bond PM hat on as opposed to your Fed analyst hat. So with this current uncertainty surrounding interest rates and the energy market shocks that we have seen this year, it's been a bumpy first half of the year for the bond market. Prices are down, yields are up—at the long end of the curve I'm talking about.

10 or 30-year treasuries, they seem to be treading water, if that's the right way to put it, but around 4.5% to over 5% right now. And that's the highest that they've been since the global financial crisis. So I was wondering from you, do you actually see these yields as an opportunity, though? Perhaps an actually more attractive entry point for investors who might be sitting on the sidelines on cash to get into bonds?

JULIAN: Yeah, it's a great question. So just maybe to set the context—talking about returns this year. Credit spreads are roughly flat. So there was some volatility around Iran, a little bit of widening. But that's mostly come back. So that's been pretty neutral for returns. The 10-year Treasury yield is up 45 basis points, roughly, on the year, which is a negative.

So, overall, the bond market is posting modestly negative returns for the year—call it down about 60 basis points at the broad index level. And then, just for context, cash has returned about 2% this year. And stocks are up about 9% in general terms. Jurrien is the expert on the details there. So, to your question, not really a great start in terms of performance, obviously, down modestly.

But if you think about it, we've had a war break out causing oil prices to spike. We've had Fed expectations switching from cuts to hikes. We have a new Fed Chair who, so far, is sounding pretty hawkish. And we've had hundreds of billions of dollars of supply related to AI data center buildout, on top of the deficit and all the rest of the corporate bond issuance.

So that's a pretty rough setup in terms of macro conditions for the bond market. And I would say modestly negative total returns is actually a decent outcome in the context, which does get to one point that I think could be important for our viewers. When thinking about investing in bonds, your starting yield really matters. When yields are at decent levels, you at least are starting with an income cushion that can protect you from things like wider spreads or, this year, higher Treasury yields, which is exactly what has happened this year. That starting yield has helped offset the rise in the 10-year Treasury.

Now, of course, there's no guarantees, but in the past several years, many times when bond yields reach these general levels, it did prove to be an attractive entry point. And, again, that entry point really matters. I know when I interact with retail investors, I often hear people saying, hey, the five-year return on my bond funds are, like, 0. Why would I be interested in adding to that?

Well, look where yields were five years ago. In 2021, the 10 year was under 1.5%, historically a very low level, very little income cushion. That starting point was a big part of the horrible year bonds had in 2022. 500 bips of Fed hikes didn't help either. Actually, if you zoom out, and this is the exhibit we're showing, it's pretty rare for the bond market to post a negative return in a given year in nominal terms. 2022 was definitely one of those years. And it continues to really impact the five-year returns of bond funds to this day.

But if yields are starting kind of somewhere in the ballpark of their long term averages, like they are today, then your odds of earning a decent return are generally much better. Now, again, there's no guarantees in terms of the next move in interest rates, but I do think, with the rise we've seen recently in yields, the bond market does look more attractive as far as an entry point.

HEATHER: Just press you on this a little bit, Julian—and I know you're always a good sport about this kind of stuff—so you just said that both stocks and cash have outperformed bonds this year. What is the downside to just sitting in cash if cash is outperforming bonds?

JULIAN: Yeah. Look, cash has been a great performer in recent years. Risk adjusted returns at these higher policy rate levels have been really high. That's worked well for a lot of people. You have a high certainty of earning your income in the near term.

But what you don't get in cash is the potential for price appreciation in a true stock market correction or economic downturn, like a recession. In those type of scenarios, you typically see the Fed cutting rates. And so the return on your cash melts away just as your stocks are under pressure. This is where bonds can really help out in a total portfolio context, because those changing Fed expectations are typically a positive tailwind for strong total returns from the bond market.

Now, you may say—I can almost hear Jurrien about to say it—all right, what about this year? Bonds have not been that great of a diversifier. And I would say, fair point. But stocks are up, like, 9% this year. So it's off the recent highs, but, in general, that's a reasonable outcome. So there hasn't really been the type of big negative market correction that we would hope for bonds to hedge. And I think that's an important thing to keep in mind in the big picture.

HEATHER: Hey, Jurrien, yeah, let's get you back in here for your take on this too. I want to get your views from an asset allocation perspective. So stocks and bonds are positively correlated right now. They're moving in the same direction, which means instead of providing balance during volatility, they're traveling up and down together. What does that mean for how investors might want to think about bond allocation in a portfolio at this moment?

JURRIEN: So the way I would describe it is there are times when, in the markets or in the economy, that we have growth shocks. So think of COVID as a growth shock. The financial crisis back in '08 was a growth shock. When you have growth shocks to the economy, typically, they're deflationary. And bonds behave like bond like we tend to think of how bonds should behave, which is as a shock absorber in a portfolio that if the 60 of the 60/40, the equity side, goes down, the bonds are going to zig while the equities are zagging. And that, of course, has been the case from, let's say, the late 1990s until COVID. And that was a period of negative correlations between bond returns—so not bond yields, but bond returns—and stock returns.

But since 2022, we've been in a period where rate shocks, instead of growth shocks, have been more prevalent. So, of course, we've had all the fiscal spending—$5 trillion during COVID, another $5 trillion just last year with the Big Beautiful Bill. The debt is running up against $40 trillion now, deficits as far as the eye can see.

Inflation has been sticky. It's been above the Fed's target for the last five years in a row. And in that scenario, it's been the rate shocks that have been the thing that has moved the bond market. And in that scenario, stocks and bonds become positively correlated. And the higher the yield goes on treasuries, which is considered the risk free asset, the more competitive it is against risky assets like equities.

And so if the 10-year Treasury goes from 4% to 4.5%, maybe to 5%, who knows—that's not a prediction—the stock market starts to get a little wobbly because it needs to compete against that very attractive yield. And so that's the dynamic we've been in for the last four years or so. And that's why the correlation has been positive.

But, to Julian's point, that could flip literally at any time. We could have a growth shock tomorrow where, all of a sudden, the Fed might have to ease again. It's certainly not in the cards right now, because the Fed is thinking of hiking. But that's why I don't want to say you should not own any bonds, because you never know where the next shock is going to come from, whether it's an interest rate shock or a growth shock.

And that's why some bonds are always a good thing to have as a diversifier. But, in all likelihood, there's other assets we should consider as well, including real assets like tips, which are bonds, or even some cash, or other assets like commodities or what have you. And that's maybe a broader way of constructing a broad portfolio. But bonds are always going to play a role in that.

HEATHER: OK. Akk right. Hey, Julian, Jurrien just talked about some other asset classes that might help construct a broad portfolio. But where do you see the most compelling value right now, Julian? I know you and your team are constantly evaluating opportunities across the entire yield curve. So I'd love to hear from you what parts of the market are kind of standing out for you right now as the best balance of potential return and risk as well.

JULIAN: Yeah. I generally like high quality bonds in the belly of the yield curve—so call at the 5 to 10-year maturity spectrum. They provide a nice mix of yield and the potential diversification benefits we've talked about without being exposed to the high interest rate risk, say, the 30-year part of the curve, where deficit and inflation worries could really hurt you a little more.

We think there's a lot of value in treasuries right now. Yields are high relative to their history. It's not the most exciting part of the bond market, but it is a reliable provider of income, and, again, those diversification benefits. Credit spreads—so that's the extra compensation that you earn for riskier bonds like corporate bonds, whether investment grade or high yield—they're just really tight right now. And high yield has had a good year, but I think, given where valuations are, I think it makes sense to be a little bit more cautious in terms of the amount of credit risk in your portfolio. I would never suggest owning no credit, but maybe short duration a little bit up in quality credit paired with 5 to 10-year treasuries sounds like a pretty good combination for this environment to me.

HEATHER: All right. So government bonds, short duration treasuries looking attractive to you right now with credit spreads being tight. What about corporate bonds, Julian? How are you thinking about them right now and the huge amount of debt that we are seeing now being issued by big tech?

Jurrien talked about this a little bit, about the questions about the funding here. Is there a time when it overwhelms the credit markets' capacity and that funding does come into question? And how is your team, your fixed income team, thinking about or approaching this new AI play?

JULIAN: Yeah, great question. Huge theme in our markets right now. I mean, just, first, for the corporate market generally, as I just said, spreads are tight limiting the opportunity set. And so our credit risk is dialed to the more conservative edge of our historical range. To some degree, that reflects strong fundamentals, strong corporate earnings, strong bank balance sheets. But I just think a lot of it is already reflected in price.

The hyperscaler theme is fascinating, and it's actually a great example. The numbers are really, really big. A lot of these issuers are starting with very strong balance sheets and pretty tight credit spreads. But, man, $200 billion plus of issuance so far this year, and expected to just continue.

All that debt issuance is starting to show a little bit of pressure. This is one of those places where equity investors and bond investors have different perspectives. As a lender to these businesses, I just don't have the same upside. And with the AI story moving so fast, it's been really hard for us to build the confidence that we need to lend to these rapidly changing issuers for a long period of time.

Now, to your question, so far, the market has been able to absorb all the supply in what I would say is a pretty impressive fashion overall. But we are starting to see some signs of pressure. And this could be related a little bit to the Jurrien talked about in the stock market at the start of the show.

The sheer amount of supply is just pushing spreads wider for the hyperscalers and other related issuers. When they bring deals to the market, there's this concept of the book that they build, that the dealers build ahead of the deal. How much interest is there in the deals relative to how much they're looking to issue? At the start of the year, these books were many times covered, tons of interest. Lately, they're still being covered. They're still getting done. But we're definitely seeing some signs that demand is waning a bit. And that's pressuring spreads wider.

So, again, nothing alarming yet, not at the exhaustion point, but some signs that, yeah, the pressure is starting to build. And, boy, just as they're working in one deal, you hear whispers that the next kind of multi-billion dollar deal is coming. So we think that we're going to have plenty of opportunities, and we're being pretty cautious in our approach to the space.

HEATHER: OK. Cautious approach. You're watching it closely—obviously, also watching the Fed. And we'd love to have you back on in September, Julian, during the Fed's September meeting. But before we go, Jurrien, I know you're watching the Fed meeting, what else are you watching this week? What's on your mind?

JURRIEN: So, certainly, the Fed and, of course, earnings season is in full swing. And just tomorrow, we get a couple of reports of big AI names. And, again, it's what are they saying about their capex budgets? And how does the market either reward that or punish it? And so that's the dance that is happening right now. And so I'll be watching those earnings reports.

HEATHER: All right. We'll be watching alongside both of you, Jurrien and Julian. Thank you so much for the timely discussion today. And if you at home would like to hear more from Fidelity's top portfolio managers just like Julian, we've got a great free resource for you that you might want to check out and bookmark. It's our Portfolio Managers Insights Page.

It's simply Fidelity.com/PM—PM for "portfolio manager." On that page, you'll find some of our portfolio managers' highest conviction ideas right now grouped by sector, themes, and investing strategies. It's a terrific resource.

On behalf of Jurrien and Julian, I'm Heather Hegedus. We hope to see you back here next Tuesday right here at 2 o'clock Eastern live, with the replay always available shortly thereafter. And if you're on the go during these dog days of summer, might I suggest trying to listen to us as well wherever you get your podcasts. Take care.

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