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TRANSCRIPT

SPEAKERS:

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HEATHER HEGEDUS: Hey there, everybody. Thank you so much for making the time to join us for another episode of *Market Sense*. I'm Heather Hegedus with Fidelity. So the Fed's kicking off its September meeting right now as we speak, and investors are betting right now around a 90% chance that the Fed will hike rates tomorrow. And of course, the Board of Governors is going to be grappling with the reality that inflation is not cooling as quickly as the Fed had hoped. And that is keeping markets on edge and reigniting some questions about where interest rates ought to be and where they ultimately may settle.

So investors are going to be listening closely to this FOMC meeting for clues. And to talk about that, joining us this week, as he often does, we're thrilled to welcome back to the show after a little bit of a break, Jurrien Timmer. Of course, he's Fidelity's Director of Global Macro.

We are also super excited to have on the show today Julian Potenza, who's a portfolio manager here at Fidelity and a co-manager of the Fidelity Total Bond Fund and the Fidelity Investment-Grade Bond Fund. Very timely appearance for you, Julian, today. We asked you to come on to talk, yes, about the Fed, but also the recent global bond market selloff and repricing and what that means for borrowing costs for consumers and businesses, as well as the potential implications for investors, of course.

So great to have you both here today. Really excited. The timing on this show couldn't be more perfect, given what was in the headlines right now in the FOMC meeting. Jurrien, good to see you.

JURRIEN TIMMER: This show and the yield is at 5.01%. So, perfect timing.

JULIAN POTENZA: Happy to be here. Thank you, Heather.

HEATHER: All right. Like I said, a lot to talk about today. So let's get right to it. Today is Tuesday, September 15. Julian, let's kick off things with you, because you are a bond market pro here. And we've got this Fed meeting underway. Expectations, as I said, are building that policymakers are going to be delivering a rate hike. And I'm going to get to that in a minute with you.

But I wanted to talk to you first about the bond market, because investors have been really focused on it lately, with rates rising across the yield curve, both the long end of the yield curve, the intermediate part of the yield curve, in some cases, to levels not seen in decades. And just a reminder for our audience out there, just to level set, of course, the Fed controls short-term rates. The bond market controls long-term rates. So first of all, Julian, as we dive into this discussion, just talk about why yields are rising right now and what this might be saying about the global economy.

JULIAN: Yeah, thanks, Heather. It does seem likely that the Fed is going to hike tomorrow. But I think you're right that the story in the bond market is actually a lot broader than that. As you point out, rates have been rising across the curve. We've passed some important milestones. That's going to generate headlines.

I will tell you that a lot of the headlines that I'm reading in the market, the tone of the coverage, like big, bold, front-page story stuff, has the hint of maybe almost something like a crisis-type dynamic observing in the bond market. I do want to tell you that that is just not what we're experiencing day to day. Bond market conditions are orderly. There's liquidity in the market. Auctions are getting done just fine in the Treasury market. The corporate market has digested a lot of supply. In a way, it just feels like things are a little bit out of touch.

I even got a call with my mom with all the headlines. She was like, are you staying hydrated? What's going on in the bond market? What we are experiencing feels a little bit more like a relatively orderly—though some of the moves have been big—pricing in of the evolving fundamentals. And so what are those fundamentals that I think the bond market is reacting to? There's three core things. One is just growth. The economy, even with rates higher this year, even with oil higher this year on the Iran conflict, the economy has actually accelerated.

Now, some of that is the AI story. CapEx is supporting growth. And plus the big hyperscalers are issuing a lot of debt, which is a factor in the bond market. It's also not just the US. It's a global thing. We're actually seeing some of the most positive revisions to global GDP that we've seen since the financial crisis. That's all information the bond market has taken on board. At the beginning of the year, markets were expecting the Fed to actually ease a little bit. It's now seeming, based on what we're seeing, that that really is not necessary. And in fact, things are leaning the other way.

Now, that's all good news. It's not all good. There is the bad side. Inflation—of course, oil is part of that story, above $100—again, problematic for the economy and for the bond market. But core inflation is also stubbornly above the Fed's 2% target. And I think that is something that is likely factoring heavily into the Fed's decision-making this week.

The final factor I'll mention is fiscal. I see this all over in the coverage. It's definitely a factor, but I think it's a little more nuanced than most realize. Yes, a large deficit means the Treasury Department has a lot of bonds to sell. And that is certainly something that the bond market deals with day to day. But that's not really new information. The deficit has been large for a while. The outlook for fiscal has been relatively unchanged lately.

I think the other way that the fiscal backdrop impacts the bond market is it actually supports the economy. I think one of the reasons the economy has been resilient to a number of shocks that we've seen in recent years is the wide deficit itself. And so, again, the deficit is absolutely playing a role in what's going on in the bond market, but not all through the supply and demand-type channels. So again, that's a mix of good and bad factors, but I would say, all standard fundamental drivers of the bond market.

Now, does it matter what's driving the bond market? Mortgage rates will still go up either way. It's going to create some headwinds for the economy, whether it's good or bad news. I actually think it does matter, because if bond yields are rising in large part due to stronger economic fundamentals, it actually makes it more likely that the economy can shoulder that burden of higher interest rates versus if the yields were spiking because of some type of fiscal crisis dynamic. And as of right now, that's just not what I'm seeing day to day in the bond market.

HEATHER: So it's pricing in the evolving fundamentals, like you said. Glad your mom is doing OK. You're able to reassure her, let her know no crisis mode right now. Jurrien, let's bring you in right now because we're already two weeks into September. And September is historically one of the most challenging months for stocks. But so far, for all the reasons we just talked about with Julian, the bond market has gotten a lot of the focus recently. And we've seen some of this bond market volatility spilling into the stock market. So I was hoping you could connect the dots for us here, Jurrien, and talk about what rising bond yields mean for equities for stocks.

JURRIEN: Yeah, so we are seasonally in the weaker part of the year, let's say, July to middle of October. But the caveat is always that that's all else being equal, and all else is, of course never equal. But we do have a few headwinds. Not only is the AI trade has lost some of its mojo, if you will. That's really since June. The stock market really hasn't gone anywhere since early June, actually. And so that momentum aspect plays a part of that. But the rate side certainly plays a part as well.

And the way I like to describe this, not to sound too nerdy, but when you value a stock or a business or a piece of real estate—it could be anything—you use what we call a discounted cash flow model, where you put in the expected cash flow or earnings in the numerator of the formula, and the cost of capital goes in the denominator. And you combine the two, and you get a present value of future cash flows. And that is the valuation or the PE that you want to pay for an asset, no matter what it is.

And so the numerator—earnings—are, of course, booming. Earnings are growing 30% year over year right now. It's an incredible earnings boom that we're seeing. But the cost of capital is rising, now that the 10-year yield is at 5%. It was at 4% only a few months ago. And the question is, what does that do to price? So what we call the risk-free rate—so Treasury yields—we know that when they are competitive with the stock market, which they are. Like 5% on a risk-free asset is a very competitive yield, especially considering that the real yield is about 2.6%.

So when the yield is generous and competitive, and it goes up, as has been happening, the stock market needs to pay attention. It lowers the PE for the stock market or for a stock, again, all else being equal. And then it's a matter of how much of that is being offset by earnings. So in 2022, for instance—we all remember that year when the stock market and the bond market went down—then earnings were growing only 8%, and they were decelerating. And of course, the cost of capital rose substantially. And that really knocked the stock market down by 28%

This time around, the cost of capital is rising a lot more modestly so far at least. But earnings are booming, and that should allow the stock market to withstand more of this than it would have done if earnings were growing at, say, 5% or something like that. So I think that's why the stock market—even though it's down today, was down yesterday, and it hasn't really gone anywhere in a few months—is taking this with some stride.

HEATHER: OK. All right, stock market taking in some stride Julian, let's talk about the Fed now with the FOMC meeting underway right now and how the Fed might be thinking about all of this. So what are you going to be watching most closely tomorrow at tomorrow's Fed news conference from Chair Warsh?

JULIAN: Yeah, and as I said earlier, it does seem likely that we'll get a 25 basis point hike tomorrow from the Fed. Not assured, of course, but seems likely. We had seen a couple of months of softer core inflation prints over the summer. It raised some hopes that maybe core was finally moving back down towards 2%, and the Fed could wiggle out of this. But the last couple CPI and PPI prints that we saw last week showed things firming back up again. Oil's back up above $100.

Also had a strong jobs report this last month after a string of slightly weaker ones. It really is feeling like a hike is appropriate. Now, you mentioned this before. We're talking about the policy rate here. That's the overnight rate. That's what the Fed directly controls. It heavily influences short-term Treasury yields like the two-year. It's a factor in longer term yields like the 10-year and 30-year, but only a relatively modest one.

You mentioned this, but I think it's worth covering. Traders are currently pricing in almost 90% chance that the Fed hikes a quarter point in its meeting tomorrow. Just to give you some context, the Fed had hiked aggressively back in 2022. Jurrien was talking about that period, which was challenging for all markets. In 2024, they had cut rates by 100 basis points. Last year in 2025, they had cut rates by 75 basis points.

One way to look at the evolving Fed outlook here is the Fed is maybe rethinking those three cuts. Last year, they were referred to as insurance cuts at the time. I've heard some people think about maybe three insurance hikes in the opposite direction is a reasonable outlook. The market is currently priced for about three to four total hikes through the end of next year. So a lot of what we're talking about is already reflected in the bond market. We may not actually see all that much volatility upon the actual hikes, should it happen tomorrow, depending upon the details of the meeting, of course.

The other things that I'm going to be paying attention to, I think this is a little bit of put up or shut up time for Chair Warsh. He's gone back and forth. My observation has been he talks a really good game about focusing on price stability in the abstract. But when it comes to decision times on rates, it gets a little bit more vague. I think this is a final test and a good opportunity for him to cement his inflation-fighting credibility.

Obviously, we'll all be watching for any signs of what this means from here. As I said before, it's not usually just one hike. Famously, Chair Warsh is not a huge fan of forward guidance or really, sometimes, even current guidance. So I'm not sure how much we'll get. But any signs and some of the related materials the Fed releases, like the dot plot about what the Fed is expecting to do from here, will certainly be of interest and could impact the market's reaction.

JURRIEN: And I would just add—I think you laid it out really well, Julian—the Fed eased preemptively last year when we all thought AI was taking all the jobs away, and turns out that it doesn't appear to have done that. And so I think the market probably looks at this as you have to undo those last few rate cuts. And so that's different from saying we're in a prolonged, new tightening cycle. And I think that's why the market is generally fairly calm about this.

But one other observation I would make is, Kevin Warsh, I think, is trying to be the next Alan Greenspan, who famously was very opaque about saying anything about the markets. And since then, we got Bernanke, Yellen, Powell, who were extremely transparent. And if you take away transparency, you're creating uncertainty.

And when you have more uncertainty, investors want to be compensated for that, both in the stock market or the bond market. And that suggests a higher risk premium for long dated bonds. And that's exactly what we're getting. So you could argue that part of this is by design, although I'm not so sure that it was. But I think that's another explanation for why yields have rallied here.

HEATHER: Certainly a different approach than Marsh's predecessor. Important point there, Jurrien. Julian, so I wanted to ask you, we're used to the Fed being a big influence in the bond market, but since we talked to you last, the Treasury Department has also been looking to play a bigger role by trying to bring down interest rates on longer term government debt—in other words, trying to keep long-term borrowing costs from rising too much. So I did want to ask you about this, too. I was thinking a lot about you as this was happening.

And for viewers who may not be following the bond market closely, I thought it might be helpful if you could walk us through how this Treasury buyback strategy works, and more importantly, maybe, what the act of the Treasury Department feeling that they needed to do this might be telling us.

JULIAN: Yeah, definitely been in the news. I mean, I will say I think the subject is probably getting a little bit more attention than it deserves in general, but it's been such a point of focus that I think it is worth spending a little time here. So a Treasury buyback is a technical operation where the Treasury Department issues new debt, often very short-term debt, and then it uses the proceeds of that issuance to buy back existing, often longer term and less liquid Treasury bonds out of the market.

Now, historically, this has really been a liquidity management tool, really managing the liquidity profile of outstanding treasuries, so taking older, less liquid, often off-the-run securities—so that's what we call not-recently-issued treasuries—and replacing them with new, fresh on-the-runs, which is supposed to maintain a liquid yield curve. It does serve, when you are issuing short debt to retire long-term debt, to reduce the supply of longer term debt and shorten the average maturity, so it can have an impact on the level of rates and the shape of the yield curve.

Now, it's important to understand that the Treasury Department also has the broader responsibility for deciding where on the curve it wants to issue all of its debt in general. That is usually conducted in what's historically been a regular and predictable manner via the slow-moving process called the quarterly refunding announcements. I think part of what's causing all the focus here is that these buyback changes were rolled out without really any signs of liquidity issues in the market.

Actually, one of the portfolio managers on my team was out of the office when that announcement was made. And he actually called in to our rates trading desk to check in, what's going on with liquidity? I saw these buyback announcements. And they reported back, we don't see any liquidity issues at all. So it does seem like the buyback tool is being deployed in a way that's a little new and different for the bond market. It's being used a little more for traditional debt management, like where on the curve do you want your outstanding supply to be, potentially motivated by the rise in yields and some of these notable yield levels that we've reached.

Now, I do want to make two points. I mean, one, these supply details, even the broader where does Treasury treasuries issue on the curve, it's important for bond market professionals like me. It can influence the shape of the yield curve. I have generally found, over time, in my career, it tends to be a second-order driver of the things that really matter. What really matters is some of those economic fundamentals like growth, inflation, what that means for the Fed. That is ultimately more important than these supply questions for the bond market. And I think that's what investors should be focused on.

I will also say that one thing we're learning is this administration has a little bit of a different approach to economic policymaking. And the way I would describe it is their intervention threshold, the threshold to make announcements and to intervene in markets—something like these buyback announcements—is just lower than we're used to in the past. Historically, in many cases, a surprise government announcement like this is a sign of some type of problem or crisis, like the liquidity points that I made before. I think it's just a different approach. And we've actually seen that across a number of interventions in various markets.

The takeaway for the bond market—and I think this is a little bit of that media tone that we were discussing—is just because the Treasury Department is maybe operating in the bond market in a way that's a little different, doesn't necessarily mean that they're responding to a crisis. It does mean that they're sensitive to the level of long-term interest rates. Most administrations are. And that's something that, as a bond investor, I take seriously. But I think the important point is, I don't take it as a sign that there's some type of brewing crisis, liquidity, or funding issue in the Treasury market.

HEATHER: OK, again, different approach. Their intervention threshold may be maybe a little bit lower than the previous administration. Jurrien, it was about, what, 24 hours after the Treasury Department implemented that buyback strategy that yields went down, but then they went back up again. I'm wondering what you also make of it all and what you think the takeaway is for investors as well. I know Julian talked a little bit about the takeaway maybe is that those aren't the fundamentals that investors should be paying attention to. This might be secondary. But what's your takeaway on the way that the Treasury market reacted to all of this?

JURRIEN: Yeah, so I will echo what Julian said. There are forces pushing yields higher. And it's not just the US. So it's not like what we call the bond vigilantes are picking on Scott Bessent at Treasury and saying, we're going to challenge you. Yields are rising all over the world with the exception of China, which has a massive savings glut, and Switzerland, which has its own very peculiar circumstances. But in Canada, the UK, Germany, Japan, yields are rising everywhere, and they're making new highs since the highs made back in 2022, '23.

So yields are now in an uptrend, really, since 2021 around most of the world. So these are big forces. And I think the market generally looks at what the Treasury Secretary did with those buybacks and saying that's like a grain of sand on a beach. It's a drop in the bucket. And if you're going to try to change the course of rates—and of course, it's a big priority in the White House or in the administration to keep yields low because there's a lot of debt to finance. And right now, that debt is competing with a lot of corporate debt. The AI buildout is costing trillions of dollars. And a lot of that is finding its way into the bond market.

So economically, we're used to thinking about what's called the crowding out effect of governments borrowing too much and then strangling the corporate sector. You wonder if it's not a little bit the other way around right now. And so my point is, the forces are big. You can't turn those forces around by doing a $6 billion buyback. And inevitably, that gets you into the question of, well, if it keeps going, what else can they do? And do we get another period like we saw during COVID or even World War II a long time ago, where there is financial repression, where the Fed and the Treasury try to keep the cost of borrowing down?

Because again, the simple math is that for debt to be sustainable, the cost of borrowing needs to be below the growth in the economy. And of course, the AI boom holds a lot of promise that we'll get that growth. But until we get that productivity miracle—which, hopefully, we will get—it's costing a lot of money to build the infrastructure. And I think that adds to the inflation story as well.

HEATHER: Perfect segue there, Jurrien. Julian, I was just going to ask you about debt because the national debt just reached $40 trillion. Jurrien was just talking about AI debt. We've got the midterm elections around the corner. I'm wondering if you think that might foster more of a national conversation around debt. Or just, how are you thinking about all this debt being issued in the economy right now, as a bond portfolio manager?

JULIAN: Yeah. Yeah, it's a great question. I think the consensus outlook for post-midterm election is some form of divided government. And historically, that's not been the best environment for big action, legislatively. So I don't know if I'm so optimistic in the near term. I think that when you think about the fiscal situation more generally, it is fair to say that the bond market is starting to show some warning signs in terms of fiscal concerns.

Jurrien mentioned something that I think is really important, like the relationship between bond yields and the growth rate. It's important to have a framework for thinking about the fiscal issues, as opposed to just saying they're bad. So I do that. I look at longer term real rates relative to the potential growth rate of the US economy. Long-term real rates are now a little bit above potential growth. And I would say that's a yellow warning sign in terms of the need for fiscal consolidation.

But it's important to remember that we spent many, many years with the opposite paradigm, with rates well below the level of growth, which was, in a way, the bond market asking policymakers to borrow and spend more. They've definitely done that, particularly since the pandemic. And maybe we're seeing signs that we moved a little bit too far in that direction.

I think if you zoom out a little bit, right now—Jurrien talks about this a lot—part of what we're experiencing in the bond market is just a renormalization of that relationship between bond yields and economic growth. Part of the reason rates were so low in the years after the financial crisis, there was this big excess savings in the economy after everyone hunkered down after the housing bust.

And now, between the government deficit and the AI CapEx boom, it's the opposite dynamic, and it's pushing interest rates up. So I do think there are fiscal concerns that are showing up in the bond market, but I think they're at a fairly early stage. And I think a lot of the fiscal situation is relatively widely known and priced in at this point.

HEATHER: And Julian, just hold there for a minute, because I do want to ask you, too, about opportunities here. Of course, higher bond yields mean higher borrowing costs, which isn't great for current bond holders. But for bond investors, this could present opportunities. Do you subscribe by the phrase "the income is back in fixed income"? Or how are you thinking about this right now?

JULIAN: I do. I mean, you raised a point we should acknowledge. If you are a bondholder, then higher yields are not great. There's no doubt about it. But put it in context. The Bloomberg Aggregate Index—we call it the Agg—you can see why—easier to pronounce—it's the broadest bond market benchmark—it's down about a percent and a half year to date. It's down about half a percent over the last year. So not great returns, but nothing like what we experienced in 2022—really pretty modest.

To your point, if you're buying bonds, higher yields can provide a more attractive entry point. When there's more yield in the market, you just have more income cushion in your bond allocation to protect you from things going wrong. Very different from 2022, where we started with very, very low yields. We talked about that in the past.

Just to put some very rough numbers on it, that index I mentioned, the Agg, it currently yields around 5.3%. It has a duration of around six years. I won't get too crazy with the math. If yields rise 100 basis points from here, that means you would lose about 6% in price terms, but you would have that 5% yield to offset it. So call it a 1% net loss if rates rise by 100 basis points. On the other hand, if they fall by 100 basis points, you'd actually earn 6% in price appreciation, plus the 5% coupon. So that's almost 12%

The point is, is that as yields rise, that income cushion helps push the distribution of your returns in your favor and increases your odds of earning a decent return. Obviously, hard to predict the next move in rates. We just talked about a lot of secular factors pulling rates higher.

However, over the medium term, personally, I can see more scenarios where rates fall 100 basis points relative to rising a further 100 basis points from here. I don't necessarily see them imminently. They could take a while to play out. But in those scenarios, the total return potential in the bond market these levels is quite significant.

HEATHER: Well, talking about all these changes in the bond market also has me thinking about other asset classes as well. And we get a lot of questions, Jurrien, about gold and Bitcoin. And the prices have been rising of both of those asset classes after gold had a few rough months. Crypto's winter maybe hasn't totally thawed, but showing some signs of improvement. Just wondering, if you think that trend will continue now.

JURRIEN: Yeah, so both of those assets have been down for some time now, for about a year. And again, as we get into this conversation about how high is too high for yields and what can the government do to reverse that, it inevitably gets you back to the question of what we call financial repression, where the Fed and the Treasury, in coordination, try to push yields down through asset purchases and what we call yield curve control and things like that. And that would, in theory, push down real rates. And that tends to be very positive for hard assets, stores of value—gold, Bitcoin, real estate, commodities.

And so I think part of the perking up a little bit in all of these asset classes in recent weeks is that the market sees what Mr. Bessent is trying to do with his buybacks. And they're saying that's not nearly enough. And in order to do a lot more, that could get us down the slippery slope of financial repression. So I think that's the narrative that's playing out in the natural resource and hard asset space.

HEATHER: All right. We're super tight on time here. I just wanted to tie a bow on our discussion today with you, though, Julian, and ask you, what are the big questions that the bond market is thinking about right now? What are the takeaways here? And potentially, what could that mean for bond yields as we head into quarter four?

JULIAN: Yeah, honestly, for all the focus in the news on some of these bond-specific issues, like the deficit, like the Fed, I actually think the biggest questions driving the bond market from here are some of the same questions that most investors are asking about almost any asset class. What is the outlook for the AI boom? How is all this CapEx going to play out? What is the ultimate return on investment going to be on all this capital investment? And how will AI impact some of the economic fundamentals that are crucial for bonds like growth, inflation, productivity, the labor market? That's my main message today.

What I'm seeing in the bond market appears to be a logical response to evolving economic fundamentals. I'm just not seeing a lot of signs of crisis-type fiscal dynamics. I do see fiscal impacts on the bond market, but it doesn't appear to be a sort of self-reinforcing crisis paradigm. I think that's important because if I'm right about that and the bond market is following fundamentals, then we can be more confident that in the future, if fundamentals evolve in a different direction than we're currently expecting—if growth slows, if stocks correct, a recession, stuff that Jurrien refers to as growth shocks—then bonds can perform well and provide their historical diversification in a portfolio context.

To me, that's what all the day-to-day evidence in the bond market suggests. I don't know how those economic fundamentals are going to evolve, but I do take some comfort in the fact that bond markets appear to be reacting to those fundamentals in a historically logical manner, and in my opinion, are offering a pretty attractive entry point here.

HEATHER: All right. We've got to end things here. But before we go, we always like to end with Timmer's Take and ask Jurrien what's on his mind for the week. And it's been a while since we've talked to you, Jurrien, so I didn't want to shortchange you. And I wanted to make sure we got to this question. What's on your mind right now, other than the FOMC meeting?

JURRIEN: Well, what's on my mind is what Mr. Warsh says and does, and how the long end of the yield curve responds. If he backs his hawkish rhetoric with hawkish action, I would expect the curve to flatten in the backend, meaning yields go back down. And if he doesn't do that, then yields will go back up. So I'm going to look at the bond market's reaction to whatever happens in the coming days.

HEATHER: All right. We will be watching alongside you, Jurrien. And Julian, thank you so much for this especially timely discussion. And to our audience, before you go, we always like to leave you with a resource to further your education on the day's topic. And if this discussion piqued your interest in fixed income, we want to suggest a great page where you can further your research and look up yields on about 100,000 new issuance, secondary market bonds and CDs. It's Fidelity.com/BondSearch. On behalf of Jurrien and Julian, I'm Heather Hegedus. We hope to see you back here next week. Remember, we are on live Tuesdays at 2:00 Eastern. Take care.

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