Fidelity Viewpoints®: Market Sense

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TRANSCRIPT

SPEAKERS:

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Jim Armstrong: Hello and thank you for joining us for Market Sense. I'm Jim Armstrong with Fidelity. Today we are going to bring you a special edition of Market Sense, it's our outlook for 2023. We are going to be discussing a lot of your top questions for the year ahead, including among others, whether the U.S. could be heading into recession and what that could mean for the markets and for us as investors. We will also talk about how you might consider positions your portfolio through uncertainty like we are living through now. We're also going to look at some of the big issues that dominated headlines last year because they are certainly not going anywhere this year, those will include the bear market, inflation, and of course the Federal Reserve.

To help make sense of all those topics, we are joined today by four absolutely exceptional panelists. Jurrien Timmer will be our guide to stock market dynamics. He's Fidelity's Director of Global Macro. Denise Chisholm is also with us today, she is a historian of market cycles, as well as Fidelity's Director of Quantitative Market Strategy. Ford O'Neil joins us as well. He's a veteran bond fund portfolio manager here at Fidelity. And last but absolutely not least, Dirk Hofschire joins us, he's a Senior Vice-president here of Asset Allocation Research. Thank you all for making time out of what I know are your very busy schedules to be with us today.

Jurrien Timmer: Great to be see you and thrilled to be part of such legendary line-up today.

Denise Chisholm: I agree, great to be here, Jim.

Ford O'Neil: Yep, great to be here. Thank you, Jim.

Dirk Hofschire: Wonderful, thanks.

JIM: Absolutely, thank you again. Before we get started with today's discussion, just quick note for our viewers. If any questions come to mind during this discussion and you happen to be watching on Fidelity's website, you'll see survey underneath the video player where you can submit your questions.

Now, next week on Thursday the 19th of January, I will be hosting a separate Q&A session with Jurrien and Leanna Divinney, she leads one of our Fidelity branch locations. They will actually answer some of the questions we take in today as well as some questions we get live on that day. So again, make sure to submit those questions and we look forward to be able talk with you all then. All right, that is more than enough from me, let's get into today's discussion. Dirk, we'll start with you. It is Tuesday the 10th of January. You know, Market Sense is a weekly show and I want to say every week for probably the last six months, maybe more, we have in one way or another talked about recession; the possibility of, the probability of, the imminence of. We haven't yet had the chance to ask you that question, though. So, how do you see 2023 shaping up through the lens of a possibly recession.

DIRK: Yeah, you're right, the R word has gotten thrown around a lot over the past year really almost now, and you know in some ways you kind of think about this, it may not actually be that shocking if we have a recession. So, that could be part of the silver lining. Let's start with your question from a macro standpoint, you know where are we with the economy? Our contention has always been we are still in a late cycle expansion and we're going to start that here in 2023. But it is clearly an economy that's decelerated a lot over the past year and is probably going to keep decelerating as we go forward. When we look at things that sort of give us really end of cycle type of signals, things like falling profit margins, tightening credit conditions, rising inventories; we are seeing some of those things right now.

So I think a reasonable base case this year is actually that the U.S. economy does probably enter at least a mild recession at some point. Now that doesn't really tell us much about, you know when will it happen, how big will the recession be, and how long will it last. And for this I think we want to think about the other big economic news over the past year and that has been inflation. So we had the highest inflation in four decades in 2022. The good news is it hit over 9%, the Consumer Price Index last year. It has come down to around 7%. We think it is going to keep falling markedly over the next several months, so that's good news and that's relief. And the real question going forward now is going to be sort of how quickly does that happen.

The market is kind of pricing in, and today it is going to fall all the way back down to 2% where the Federal Reserve sort of wants it and then Federal Reserve can start actually easing policy this year. I don't know if that is going to happen, I'm a little concerned that may be a little too quick and too painless but we'll have to see. So I think as base case for the U.S. economy again this year: mild recession at some point and then we will have to see to what extent inflation and monetary policy really affect the outlook after that.

JIM: How about your global perspective? That's a great answer about the U.S. but of course we talk a lot about the business cycle in different countries, different economies entering into the business cycle at different times. What is your outlook globally?

DIRK: Yeah, so this is the part gets I think even a little bit more confusing, and part of it is it becoming a little less synchronized maybe than just thinking that everyone moves up and down at the same time. We are going to start the year in a kind of weak place with the global economy, no question about it. A lot of recessionary type head winds around the world. But when you look at some places, there is some hope that things actually may not get worse and may get better as we progress over the next 12 months. So, you think about Europe, for example, people have been very negative on Europe. They may have tipped into recession, some of these economies, even in the last quarter of last year. But now you are seeing natural gas prices, for instance, come down dramatically in part because of the warm weather. So, some of the challenges from the Russian/Ukraine conflict and the high energy prices and other things are not having quite a biting an impact so far as many people had thought. You look at China, that might be the biggest surprise in the new year is how quickly China moved from a zero COVID policy to really removing almost all these restrictions overnight. It is going to be really, really messy in the near term and there's a lot of reports of, you know huge healthcare problems and other things.

But if you think about this on a 12-month basis it probably means a much more opened Chinese economy over the course of the next year which should provide a cyclical upturn over the slump that they have been in the past couple of years. So, it is going to be a tough picture, there are a lot of cross winds but I think the good news is some of these regions and countries in part because some of the weaknesses already occurred and has been well recognized up to this point actually have a chance of stabilizing and even getting better in 2023.

JIM: Jurrien, I would like to turn to you now and talk a little but more about stocks. Sort of a similar question that we asked Dirk, but what's your outlook for the market as we head into 2023 right now?

JURRIEN: If we can back up for a second, you and I have been doing this show for almost three years now. And 2020 was the year, of course, of the pandemic and then the start of the recovery. I would define 2021 as almost a year of a little mini asset bubble because the Fed, you know leaned into that lockdown so hard that it created very unusually low interest rates and that elevated valuations in the stock market. Then 2022 was the great reset, right? The Fed took the punch bowl away and then some, and bond yields went up, the stock market went down. And then the question is, 2023, will this be the year of the earnings reset, right? So Dirk just mentioned the likelihood or possibility of a recession. Generally, when you have recessions, earnings go down. Not always because people think of earnings more in nominal terms, so when there's more inflation, earnings might hold up.

And so the question is, will we have a recession? Will there be an earnings contraction? And you know, this is where it gets kind of messy because over the very long-term, we know that stock prices follow earnings. You know, you go back 100 years, the correlation is one. But over the near term, they don't always, you know sink up together and the reason for that is that the market anticipates, you know changes in the fundamentals. So, the big question for 2023 is: how much of a recession, if any, has already been anticipated, discounted by the 28% decline that we saw in 2022? And then, of course, the associated question is, what will that do to fed policy? Will the Fed be able to pivot, you know as Dirk mentioned, to the degree that the bond market is expecting and, you know, when you use the inflation expectations in a TIPS market.

So it is kind of a hard call. Like in a way 2022 was an easier call to make because valuation started at a really high level and then when the Fed raises the cost of capital for everyone, valuations generally come down. 2023 is going to be a harder year and it is a more difficult year just to say up or down and my sense is that maybe it will be a year that frustrates both bulls and bears alike.

JIM: You've called that in the past a sideways market for most of the year. What forces do you think could push or pull it off of that sideways trajectory, for lack of a better word?

JURRIEN: Yes, you have different forces pulling and pushing the whole narrative. So one, of course, as I just said, is the earnings narrative. So earnings expectations—earnings went from growing at a 50% rate in 2021 to now not growing at all basically and in real terms adjusted for inflation, earnings actually fell in 2022. The expectations for 2023 are pretty modest, you know 2% to 4%, which probably won't even keep up with inflation. But for 2023, the consensus estimates are pretty optimistic again that earnings will grow 10% or so. If we do get a recession at some point, maybe in the second half of the year, going into 2024, that kind of complacent outlook gets challenged because in that scenario earnings will likely go down.

And so that would be the bearish case to say we are not going—we don't have the catalyst yet for a new bull market, you know usually that comes at the tail side of a recession or a downturn. And we are just kind of starting one, if we are. And then the other one is on the Fed, you know, the Fed seems to be blue in the face telling us in the markets, you know, we are going to raise rates and then we are not going to drop them for a while. It's like parents lecturing their children, like will you listen to me now? And the market just says, "Yeah, no we think you're going to go to 5% and then you're going to drop rates to 3%." And again, that may very well happen but that is factored into valuations as well. And so a lot of things need to go right for a new bull market to emerge.

But again, I need to offset that by saying, you know, we went down 28% last year. The PE ratio went down 32%. So a lot of this is already priced in or a lot of bad news is priced in, maybe not specifically this news. And so, the juxtaposition of those two things tells me that maybe this is going to be a choppy market where a bullish narrative will win for a few months and then a bearish one will kind of take over and maybe we just kind of use this as a base-building place for eventually the, you know, the next bull market.

JIM: That's great. That's a perfect segue to Denise who I have the next question here for. This—taking a bit of a deeper dive into the markets. In specific, looking at sectors, which I know is very much your area of expertise. Despite everything that we heard to this moment, what are some areas of opportunity, potential opportunity you see in the coming year? Where are you bullish and bearish as well?

DENISE: Yeah, I mean Jurrien highlighted the fact that equities are tricky because they can discount bad news in advance and obviously that peaked and contracted almost 30%, which we typically see in recessions, can discount a lot. I'll throw in another indicator of relative valuation which is one of the better ways to look at what the market has discounted. So, if you sort of look at sectors and divide them into defensive areas and economically sensitive or cyclical areas, you can find that defensive sectors like consumer staples, healthcare, utilities, to a lesser extent real estate, have now been only more expensive about 4% of the time historically. That is another way to say that the market has discounted a significant amount of bad news and it might be that your margin of safety almost regardless of what the action in the overall stock market may be over the next six to 12 months might be higher in economically sensitive sectors that have discounted more of that bad news. Like I'll point out financials and materials here.

And then there are other sectors like consumer discretionary, where we have seen a significant number of, I want to call them recessionary contrarian indicators even though without the recession of the payroll decline, where we are seeing very high valuation spreads which are an expression of fear, bottom quartile consumer sentiment, bottom quartile corporate sentiment, two negative sequential quarters of GDP growth. Usually that's positive for customer discretionary and what you're seeing is down the cap spectrum, so the further down you go in terms of size, equal weighted of customer discretionary stocks have clear valuation support. So, there are areas in the market where you can say it is more likely that they've discounted the coming bad news.

JIM: I want to ask you in specific about a couple of sectors, energy and tech energy had a pretty strong 2022. Tech, not so much? Where do you see both headed in the new year?

DENISE: Yeah, tech in some ways was, you know down side leadership. So technology, I think investors need to know it is massively different, what I see in the data is massively different than anything we saw during the last, let's call it decade of technology dominance. And that's the relative valuation starting level. So if you roll back to 7/8 years ago, technology—sure inflation was low and that's a driver for multiples but it started out from a relatively low valuation starting point and obviously margins were actually increasing. Now fast forward to today, we are bumping up against that top quartile. Technology has not been this expensive, on a relative valuation basis, since about 2005. So there is certainly, you know a bunch of investors who think, well if inflation is in fact coming down, that has to be bullish for technology stocks but if you look through history and say which matters more statistically, is it that the relative valuation starting point or the underlying level of valuation—underlying level of inflation? You actually find out that except for extremes with inflation being over 7% or under 2%, really your starting point for relative valuation is more important.

So unless you think that inflation is really going to bail you out and be in the under 2% or one and change, then technology might still have that relative valuation headwind to work off. It doesn't necessarily have to be as bad as it was last year or down side leadership, but it creates a negative risk/reward framework. Energy is the exact opposite, energy is still cheap, has been cheap the entire time partly because investors underestimated earnings to the tune of like 30% a month in the beginning part of the pandemic. But now cheap is the only thing you have going for energy stocks. Where I see this as a clear shift from last year, where we are now bumping up against top quartile fundamentals so you have to be open-minded as an investor that earnings might decline next year. And that you can see usually leading indicators that are negative, both the U.S. LEI and the OECD LEI are now declining. I think your base case has to be that that is certainly a risk. Energy does not historically have an ability, or at least high probability, of looking through those earnings declines.

I will say that's the opposite of materials which has a really strong history of looking through poor fundamentals if you have valuation support. So I think for those investors that are interested in the commodity space, to me materials actually screens a little bit better than energy here.

JIM: Interesting perspective. Thank you for that. Thank you for that. Hey Ford, thanks for your patience as we get through the horn here and head over to you here. Let's move from equities to bonds and at the risk of a massive understatement, bonds had a rough year, right? It took a lot analysts, experts, and just casual investors by surprise. Where do you see bonds headed in the new year?

FORD: Yep, so Jim you're right. It was a major disappointment for the fixed income markets in 2022. And just to put that in perspective, the Bloomberg AGG is the Aggregate Index, that's the one that we all use. And over the past 50 years, it had only experienced four losses over that time period. And an old joke that I used to use was that the worst loss in those 50 years was 2.9%. I used to joke that a bad year on the AGG was a bad day on the NASDAQ. Well, that joke doesn't work anymore because last year the Index was down more than 10%. The only question was how is that possible relative to history? And Jurrien pointed out that, you know Fed was aggressively hiking rates last year, inflation hit 40-year highs, and that combination led to much higher Treasury yields across the curve.

In addition to that credit spread sectors like corporate bonds and agency mortgages, those tend not to be correlated with Treasuries—less correlation, but they also performed very, very poorly as well. So it was sort of the perfect storm across the entire market. So why am I optimistic this year? Well, the bad news is that the yield on that index bottomed at 1%, about two years ago. Today it is almost 5%, so your yield is up almost five-fold over that time period, and you know if Jurrien is right and we're right that we believe inflation will be heading below 5% and hopefully closer to

3% or maybe 2% longer term. All of a sudden, you know the yield on the index is generating real returns, meaning returns over and above that inflation. And you may just think back to the last decade during QE when often times yields on Treasuries was less than that of inflation. So I think the good news for bond investors is we have yield back in the market and why do you want to own bond? It is because you want income. Great news, we have income back in the market. But we also got to remember, you know, preservation of capital is very important. We have volatility levels that are usually one-third that of stocks and also diversification.

You know, we are hoping that comes back this year and bonds than aren't moving in the same direction as stocks but hopefully helping cushion some of that roller coaster in the stock market in 2023.

JIM: Can't let your appearance on Market Sense go without asking you for your thoughts on where you think you see the most compelling potential opportunities coming forward in the bond market in the year ahead?

FORD: Sure, Jim I probably haven't said Treasuries in the past 14 years. But two- and three-year Treasuries at 4–4¼%, I think aren't a bad place to hide if you really want to add very little volatility in your overall portfolio. I think short-term, investment grade corporate bonds at 5–6% offer a lot of value. I think there's some value in the structured area as well. So I think there's a lot of great opportunities. I would still avoid agency mortgage-backed securities, I think there's potential for widenings there so that's an area that I'm underweight. But I'm also still cautious on emerging market debt securities as well.

JIM: Okay, thank you all for that. That was an excellent start to the conversation. I want to ask a question now about recession and I'll open it up to the four of you, answer as you see fit. You know there's obviously, how should I say it? We often talk about—we hear in the news, for example, the potential for recession, how long would it be, how deep with it be, through the lens of in the media, how can it be avoided? Why can't the President stop this recession? Why isn't the Congress acting to prevent this recession? When if fact I think you all would agree, recessions are a necessary part of business cycle. You don't have growth without that contraction. That said however, we still need to position our portfolios in such a way to make that transition from the late cycle of the phase to recession. So, how might we go about thinking about how to get that done?

DIRK: I'll start off since I'm the macro guy throwing the recession word around for this year. I think the first thing I would have to say is remember even the way we this about in from an asset allocation standpoint is, thinking about positioning for a recession and then thinking about business cycle investing and changes in your portfolio, that's a really, really small piece of the puzzle. That is one tool in a really large toolkit. Much more important is sort of your long-term diversification. You are not going to get all the short-term timing things right. And as Jurrien and Denise pointed out by the time everyone hears about recession, the market already traded off of it anyway. So with all of that being said, the typical playbook then when you go back over decades and decades of history is if you do have a recession, especially one that's worse than expected let's say, more defensive assets tend to hold up better than more cyclically sensitive ones. So things like bonds hold up better than things like equities.

So I agree with Ford, I think this year is a much, much better place for bonds to be good diversifiers in a portfolio. They can benefit, if inflation falls like everyone thinks and equities do fine, bonds could still do well. If there's a much worse economic environment than expected that's probably where bonds get the upper hand. I'd also mention too going back to my initial comments at the beginning that if you think about the rest of the world and the fact that some of these recessions in Europe and China were kind of priced in, and these are in markets that came in to this decade, you know, being ten years under performers relative to U.S. markets and being inexpensive relative to U.S. stocks, that's another way to diversify the portfolio in the event of a U.S. downturn.

JIM: Denise, Ford, Jurrien, any other thoughts about that?

DENISE: Yeah, I mean like Dirk's thoughts on diversification, and I think that's true from a sector perspective as well. What I find intriguing is as much as it is true across asset classes it is not necessarily true within equities. So, I mean I'll take technology during the pandemic. It is not really—you shouldn't take it for granted what sectors work and what sectors don't in an economic downturn. Technology was leadership throughout the recession. So I would say that when you think of sectors within your portfolio, don't forget that the relative valuation starting point is an important driver of that margin of safety. So when you think of diversification, it doesn't all just have to be defensive within your stock portfolio. There is actually room for relative valuation support for economically sensitive sectors. And again, I would highlight financials, consumer discretionary, and materials here.

JURRIEN: Yeah, and just to follow up on what Denise said, you know starting valuation, I don't think all investors appreciate how important that is, right? And one of the reasons we had this perfect storm last year of both bonds and stocks doing poorly is because they both had very high starting valuations, right? If you flip the yield on the ten-year Treasury upside down and you express it as a PE, back in 2021, the PE on bonds was 180 times the cash flow you would get. And so then when the Fed, you know resets the cost of capital, you know that basically lowers the present value of all asset classes because the valuation is really just a present value of future cash flows.

So that is the reason why 2022 was a year where basically nothing worked. 2023 I think will be different because now valuations have reset. Right, the S&P is at 17 times expected earnings. The bond market is at around 25 times. Again, if you again flip that yield upside down. And so the starting valuation problem has largely been addressed. And to me that means that, or that suggests that the 40 of the 60/40, the bond side can do its job again. You know, we will have to rely on Ford to make sure that that happens, but the bond portfolio can be that port in the storm again because now we are at attractive valuations again.

And just, you know it is tempting to say, "Oh my God, we are going to have a recession. Why don't I sell everything and going into cash?" And you know as Ford said you can buy a two-year Treasury at 4½%. But just bear in mind that that involves market timing, right? If you take all your money and put it in T-Bills you getting a really nice return for the next year or six months. But you are market timing at that point and that is a really, really tough thing to do. And so strategic allocation, I think, is a much better way to focus than tactical. And, you know as Dirk mentioned, around the world there are opportunities again. We are in kind of this more fragmented global cycle where, you know the U.S. is kind of slowing, possibly going into recession. China has been basically locked down for two and a half years and now is reopening. It won't be a linear thing, but it will probably happen.

And so again maybe less thinking about first order effects of how much should I have in stocks versus bonds versus cash. And more second order effects as Denise said in sectors but also in regions, maybe that's where we can add some value in 2023 rather than just say the market is going up or down.

FORD: Jim, just to finish up from a bond lens perspective, you know I'm surprised it seems that all the pundits are arguing not if we're going to have a recession but when is it coming? And as I think from a macro perspective, our economy is driven primarily, let's say two-thirds or so by the consumer. You know, they have—unemployment is 3½%, 10 million jobs are available. It is not going to be consumer-led. We just passed a $1.7 trillion Omnibus Bill which Dirk knows in great detail. The government is going to be spending money hand over fist throughout the year. So it really it all boils down to corporations and are they going to start laying off people at a fast and rapid pace. And so focus on continuing claims every Thursday at 8:30. I think that's one of the best coincident indicators of how the economy is going to be doing. And of course, average hourly earnings and the monthly payroll numbers. Those are the keys. But we have had great economic growth with unemployment at 4½–5%. So I'm struggling how you see how you get to at least a hard landing. I'm arguing for a soft landing or shallow recession at worse.

JIM: I think that's why in each of your separate answers, you used the word tricky or messy or murky. These are difficult things to figure out for sure. One thing that we sort of attempt to do on Market Sense is to help casual investors and folks watching and listening, figure out some of what they are hearing in the headlines and how to make sense of it. And so we've all used the term, myself included, the business cycle. How would you—how would you help that sort of academic abstract concepts of the business cycle make sense to an everyday investor? How would you ever been called to do that or how would you do that? Open question to any of you.

DIRK: No, I mean the business cycle is just a pattern, a historical pattern. The way that economies tend to move in and out of recessions. And you know, we have it as a four-phase cycle where you emerge from recession, you go into an early cycle where things are getting better, and everyone is being surprised. Mid cycle is usually a long expansion where things sort of moderate. Late cycle, where we have been over the past year or more, is then sort of that transition where things are still pretty good, you are still expanding but you are slowing. And then recession is the contraction that we have been talking about.

And the reason we think about this is you can go back decades, especially in a big economy like the U.S. that tends to be relatively stable from its own domestic activity. You can see that there have been patterns in and out. And every cycle is different so that's the tricky thing, and that's one of the things we all have to keep in mind as we are thinking about all the different indicators and the different sectors and sub calls. But a good starting point is just thinking about where you are and where you may be headed, and again, it is one small tool though. You don't want to bet wholesale on these changes and then be changing 90% of your portfolio based on a six-month call on the economy. But it is a way over the course of 10, 15, 20 years to think about things on a one-to-two to three-year basis, maybe make some rebalancing and some changes in the portfolio now and again to smooth out the ride.

JURRIEN: I would add to that, that it's almost like the seasons of the year, right? You have winter, spring, summer, and fall, but in this case as Dirk very aptly pointed out, one of the pitfalls of doing kind of macro analysis like we are doing, is that there is no such thing as an average business cycle or an average bear market. When we look at the overall big picture and, you know go back 100 plus years, every cycle is different. And so for 2022 ironically, the decline from best to worse was 28%, the average decline going back 150 years is 31%. So, it was kind of like an average bear market, but there is no such thing as an average bear market and the timing is very tricky as well.

Like we know being here in the northeast that the winter is going to be about three months but the winter in the market cycle could be two years or it could be three weeks, you know like it can be anything. And, you know how the different dynamics have stacked up will make a big impact. So it is tricky to look at averages and better to look at each individual cycle. We can always learn from past cycles, of course, and we've highlighted those in this show many times. But every cycle is different and that's what makes it both tricky and interesting at the same time.

DENISE: Yeah, I mean recessions are not on/off switches or if/then statements. There is massive variability as obviously Dirk and Jurrien pointed out. But I think to Dirk's point that doesn't mean you shouldn't recognize the pattern nor the probabilities associated with that pattern and then possibly alter your bet size based on that shift in probabilities.

JIM: We love to ask for, as we continue to look forward, ask the four of you to take a bit of a look back potentially, a look back at 2022. Key learnings, I think that's sort of, the easy question relatively, but I would love to get your sense of what the last year taught you, what you will bring forward in '23? The tougher question that maybe I'll give you a couple more seconds to think about here is what did you get wrong in 2022? What did you think was going to happen that didn't? Or what did you sort of what was a near miss that you, again, learned from and said, "Aha, I see what happened that didn't fall—the cards didn't fall the way I thought they would last year?"

DIRK: I guess I'll go first. You know, I think actually, you know we are reasonably cautious going into last year and one of the things I think we did a good job with on our team, on the asset allocation research side, was the inflation research. And really recognizing that inflation wasn't going to be as transitory as everyone thought. So we sort of had the direction of it right, and were cautious in thinking that we were entering a higher inflation regime and that we should think about asset allocation a little bit differently than a normal cycle. But what we got wrong is just the magnitude of everything. I think I never thought we would get to 9% inflation probably in my lifetime. You think about even a few years ago when we started talking a lot about how the long-term inflation back drop could eventually drift higher than what we experienced in the last couple decades. I always thought it will never be the 1970's, and I think they said that out loud. We got dangerously close to double digit inflation and that obviously not only just sort of upset the apple cart as we talked about with diversification with both stocks and bonds doing poorly, but they did really, really poorly to a magnitude that we have actually never seen in modern history so I think that was surprising.

JURRIEN: Sorry, go ahead, Ford.

FORD: Jim, I would argue about the challenges of forecasting. Not just last year but the last three years. When you think about, you know, in 2020 we knew about COVID. But no one in their wildest dreams imagined it could shut the whole world down. And obviously, you had to completely change your investment outlook due to that. To Dirk's point in '21, who could have imagined inflation which was transitory at the time according to the Fed, was going to 9%? People knew inflation was going to be rising but never that dramatic amount.

And then this past year we knew there were troops on the border, but who could have imagined the largest European war since 1945? And so, what I would argue is, those are all very challenging and you need to pivot the portfolio based on events that, you know you might have said it is possible, but in no way probable. And the last thing in terms of what I got wrong, I went to college and I went to business school and was trained to make economic decisions whenever possible. And I think one of the challenges was that you had a country that shut itself down, making what I would argue a truly noneconomic decision. And then you had a President going to war, again with sanctions and all sorts of other challenges to their country that was clearly noneconomic. And those dominated 2022 and it was just hard for me to get my head around the fact that those two made sense, not only for short-term but obviously for a long time period.

DENISE: Yeah, I would say that the thing I got wrong and interesting was to not observably be concerned about the rise in crude oil prices. So I mean, what were we like up around 70 and we spiked into 120. And as much as when I went back and measured through history, you say we are only at levels that are still less than 5% of income, this is not as significant—as much as it has been a significant rise, it is not a significant shock to the U.S. consumer or corporations. But I think that that filtered through to the overall economy to inflation and the Fed. And I think that that is an interesting dynamic that took what something was maybe a base case of inflation, maybe stopping at around 4 or 5, and potentially spiking it into almost the double digits that Dirk really highlighted.

But I think that on the flip side, I'll give sort of a bright side to that. We are now seeing peak contractions in the commodity world of 25 to 30%. And to the extent that I missed that last year, the significance of that, that could be the silver lining for 2023. Let's not underestimate the drag that crude created and the stimulus that it might create going into next year. And this is not something we saw in the '70s, and I think that that's what makes it unique. This isn't a map of the '70s, what we saw from inflation perspective. We've been seeing, I mean Dirk and Jurrien correct me if I'm wrong, I don't think we saw crude actually contract on a yearly basis until mid '80s. I want to say sometime between '83 and '85. So this is significantly different than what we have seen back then. That might be a significant stimulus for the U.S. consumer that really Ford highlighted being typically strong right now because of the job market. And we'll see from a real income perspective.

JURRIEN: I would just echo what Dirk said that I think, you know we got the direction mostly right, but the magnitude was a series of goal posts that kept moving, right? So we would think, okay, the Fed is going to 3% and, you know we are waiting for the market to catch up to that. And then we say okay, we are finally getting in balance and all of a sudden there is another horrific CPI print and the then Fed is basically signaling we are going to go to 4%, and then 4½%. And so that moving of the goal posts was, you know in terms of the magnitude of the cycle, was something that I don't think anyone really saw coming. And you know, to Ford's point every year there is stuff that happens that nobody could possibly even think of. And we have to be humble to know that that's likely going to happen. And that when we are having this show a year from now, we are going to talk about something that none of us had on the radar screen. And it's yet another reason to have a broadly diversified portfolio that meets your objectives for returns and income, but also lets you sleep at night.

And even if you have that perfectly diversified portfolio as we learned the hard way last year it may still not protect you because it didn't in 2022. But in most years, it will or at least over the long-term, it likely will. And so, it is a good reminder that even though it didn't work last year that doesn't mean you should throw it out the window.

JIM: Jurrien, I want to ask you specifically about the impact and influence that you see of the Federal Reserve just in the next couple of quarters in particular, moving in the markets?

JURRIEN: So the Fed is—so it's interesting because every time the market gets a sense that the Fed is getting closer to the finish line, the market has a relief rally. But when the markets rally, right, yields come down, stocks go up. There is this thing called financial conditions, which is a look into the financial side of the economy through the stock market, through the bond market, through the dollar, that ultimately has some bearing on the real economy. So whenever the markets rally, financial conditions loosen, but if they loosen, the Fed is then worried that animal spirits are going to not be contained and therefore, inflation is not going to be contained. So every time the markets rally the Fed has to kind of say, "No, no, not yet, we have to wait for 2% inflation not 5%, not 4%, but 2%." And so the Fed is going out of its way, and you know we had the December FOMC meeting. The Fed goes out of its way saying we are going to probably 5% and then we're going to stay there for a while, until, not until inflation comes down, which it already is. But until it comes down a lot more closer to the Fed's target.

And it is kind of this, you know, back and forth between the markets and the Fed, and every time the markets rally too much for the Fed's liking the Fed will lean into that. But that is kind of the dance, if you will. And so, the Fed funds rate at 4⅜'s I think it is, going to around five supposedly, that is what the Fed has been hinting through its dot plot. And then I think the Fed is going to wait to see until it is comfortable that inflation really has been defeated. And then it will start returning rates not to kind of levels we saw during the pandemic but to levels that are more consistent with what we call a neutral policy. A neutral policy being neither restrictive nor accommodative. And neutral, you know the market and the Fed seem to think neutral is around 3%, so the question for the markets is, how long will it take for the Fed to get back to the neutral after it gets into the restrictive zone. And I think that going to be the battle if you will, for lack of a better word, that's going to be playing out in 2023.

JIM: Ford, I would like to take that ball and pass it to you and talk a little bit about optimism for the future, right? I actually would love everyone to weigh in after Ford starts. What do you think investors should be looking for, what should they be watching for to signal perhaps the beginning of another bull market?

FORD: A bull market in bonds would be challenging. And the reason I say that is, remember in the 1980s we went from mid or double digit yields down to 1%. Now that is what I would call a true bull market. I'm not expecting a huge rally in rates in 2023. Maybe a modest rally once as Jurrien said, you know, the pivotal question, pun intended is when does the Fed pivot? And when they do you may get a little bit of rally in rates, but my view is that as long as you are generating yields and returns over and above inflation, I think that is really attractive for bond investors going forward.

JIM: Denise, anything you are looking out for?

DENISE: I don't know about the start of a new bull market, but what I always watch is the market that typically leads equities and that is the credit markets. So what I find intriguing this time is that credit spreads really, as much as they are certainly widened and Ford would know this better than me, they are just below median historic levels when you measure it. Meaning, they are not signaling anything kind of severe or a very severe recession. And what is interesting over the last three months you've actually seen credit spreads on the high yield basis at least, come in substantially. When you see that, especially when equity valuations spreads are wide, which they are. There's a lot more fear in the equity markets than there is right now in the bond market. Bond market is usually more often than not right. So that's usually what I watch and right now indicators are looking fairly positive.

JIM: Excellent, great. Thank you again for your time and for your candor so far. As we start to wrap up, I would like to do sort of a lightning round at the very least. One question to each of you: What is the one single question that you think is facing the markets this year that you personally are looking to get an answer on? Something that doesn't necessarily keep you up at night per se, but it is something that you would love to see answered in the coming 12 months. And Dirk, we can start with you.

DIRK: Sure. I'm actually going to pick up on one that Ford hinted at before. And I want to know how much labor markets are going to weaken this year. So remember, we've talked about these patterns, if every cycle is the same we could look at the average and know exactly what is going to happen. What is different this time? One of the things on a long-term basis is the labor markets are tighter. For structural reasons there's less supply of workers, demographics, and other things that aren't going to change any time soon. So I want to know how quickly we are going to see unemployment go up some and see loosening in the wage growth come down. This is the double edge sword pivot for the whole market, I think. Because on one hand if that wage growth and the labor markets hold up better, to Ford's point, we are much less likely to have much of a recession at all, maybe even avoid one. The problem is then maybe it's harder for that core inflation to come down and harder for the Federal Reserve to get to the end of the tightening cycle and so there some other things that could be troublesome for the market. So I think that's a big issue.

DENISE: Yeah, when I look at the one macro some valuable, I would focus again on crude. And I think that's the intriguing one to me. How much upside is there in crude oil specifically as China recovers. Because I think if that's what got us into part of the mess that was 2022, and it was only just one driver of the mess that was 2022, I think that if there is not as much upside as investors expect or if there is not as much bottleneck because of excess capacity or declining demand, then there may not be as much of a stock. So that is the one macro indicator that I'm looking at.

JURRIEN: I would just say it is always easier to see the downside risks than the upside. I think it speaks to the behavioral economic, you know concept of loss aversion. So worrying about the earnings shoe being the next to drop or the Fed not returning rates to neutral as quickly as the market would like to see. Those are the two very palpable risks. But at the other side, I always want to be cognizant of like what can go right, right? And both Ford and Dirk mentioned a few factors in terms of the resiliency of the labor market and Denise mentioned credit spreads. You know, we have to remember that we had a very long period of very, very low interest rates that allowed most homeowners to refinance probably at 3% or less from an adjustable mortgage to a fixed rate mortgage.

Corporates did the same thing. They did what we call termed out their debt capturing those lower yields. So maybe the economy is a lot more resilient to what normally would be a Fed going enough into the restrictive zone to cause a recession, but you know as Dirk mentioned there is another side to that which mean that maybe then inflation doesn't fall as quickly either. But the coveted soft landing, which is something that the Fed does not have a great track record at achieving, but if that were to happen then maybe the earnings estimates are correct. And if inflation comes down, even if it is not all the way to 2% but to three or four, that is certainly better than nine. And if that happens without actually there being a recession, yeah, maybe the Fed stays above neutral longer but not as far above neutral as it is now about to get. So I'm always want to make sure we recognize the glass half full side of the debate as well.

FORD: And can I would finish with the Fed, you know they have a dual mandate. Full employment, 3½%, check, stable inflation, 2% on PCE. Clearly, they have work to do there. The question now, and Powell has said clearly inflation is a tax on everyone. And so it is very important that we get it back to stability, or 2%. The question I have is, if it is heading in that direction, do they pause? Or do they keep hiking all the way until it gets to 2%? I hope it's the former but I think that will be a key question for the market in 2023.

JIM: Yeah, 100%. Thank you all for this discussion and thank you for seeding the next years' worth, probably of Market Sense episodes with excellent questions or look outs for us to be focused on in the coming weeks and months. For our audience, if you are not already watching on a mobile device, you might want to grab your phone, and scan the QR code that you see on your screen. Doing so will connect you to some more investing insights for the new year and well beyond that as well. You can do that by opening the camera on your phone and hovering over the QR code that you see there and click on the link that appears and it will direct you to additional resources aligned to many, most of the topics that this excellent panel discussed today. Or you can simply just type in the URL listed on the screen as well, and you can also through that link as well sign up for our weekly viewpoints newsletters as well.

Now at the top of the show, I mentioned I will be hosting a Q&A event next week with Jurrien and with Leanna Devinney. That will be on the 19th of January, noon Eastern—12 noon Eastern. It's a LinkedIn audio event, the first time we tried one of those so we're pretty excited about that. You can only watch that particular episode through the LinkedIn platform by going to the Fidelity Investments LinkedIn page. You can submit questions for that Q&A as well if you are viewing today's Market Sense right on Fidelity's website just again below the video player you are looking at right now you will see a survey link to submit questions. But you can also ask questions live during that event next week as well. So save that date and we would love to chat with you then.

I really can't thank the four of you enough. I know that your schedules are absolutely jam packed and what you shared today I always feel personally a bit selfish that I get to have questions with people like the four of you. So thank you for making me incrementally smarter and more confident today, and I'm sure you did the exact same for the thousands of people watching. So thank you for taking the time to be with us today.

Stock markets are volatile and can fluctuate significantly in response to company, industry, political, regulatory, market, or economic developments. Investing in stock involves risks, including the loss of principal.

Foreign markets can be more volatile than U.S. markets due to increased risks of adverse issuer, political, market, or economic developments, all of which are magnified in emerging markets. These risks are particularly significant for investments that focus on a single country or region.

High yield/non-investment grade bonds involve greater price volatility and risk of default than investment grade bonds.

Lower-quality debt securities generally offer higher yields, but they also involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. As well, any fixed income security sold or redeemed prior to maturity may be subject to loss.

Credit and default risk: Structured products are subject to the risk of default by the issuer. Therefore, the financial condition and creditworthiness of the issuer are important considerations when assessing the ability of the issuer to meet its obligations according to the terms of the structured product. In summary, if the issuer defaults or declares bankruptcy, the investor may lose all or some of the investment. In the case of FDIC-insured market-linked CDs, deposit amounts exceeding applicable FDIC coverage limits are subject to the credit risk of the issuing bank. Other limitations on FDIC coverage may apply. Structured products which are senior unsecured notes are not FDIC-insured. In the event of issuer default on a non-FDIC-insured product, repayment of principal would be subject to the issuer's restructuring and liquidation process and is in no way guaranteed. **Limited FDIC protection:** For FDIC-insured market-linked CDs, FDIC coverage generally applies to the amount of invested principal only. Any appreciation relating to the linked index or benchmark is typically not FDIC-insured. If you hold more than the FDIC-insured limitations in deposits with the issuing bank, you will not receive the benefit of FDIC insurance for any balance in excess of FDIC limits. In this instance, amounts in excess of FDIC-insured limits are subject to the credit risk of the issuing bank. **Liquidity risk:** Structured products are intended to be held until maturity. Due to a limited secondary market, it may not be possible to sell a structured product prior to maturity. Additionally, should a secondary market exist, investors who need to sell a structured product prior to maturity may be subject to a significant loss. **Market or opportunity risk:** The potential return on structured products is subject to market volatility and the risks associated with the linked index or basket. The return of a structured product may be zero or less than what could have been earned on a traditional fixed income security. **Derivatives risk:** The issuers of structured products may choose to hedge their obligations by entering into derivatives and/or trading in one or more instruments, such as options, swaps or futures. The costs associated with such hedging activity could affect the market value of a structured product or the price at which the issuer may be willing to purchase a structured product in the secondary market. **Commodity price risk:** If the investment benchmark is linked to one or more commodities, you may be subject to market volatility and risks relating to commodities. Trading in commodity futures contracts associated with an underlying commodity index is speculative and can be extremely volatile. The performance of the commodity index or basket of commodities may deviate significantly from the performance of the referenced commodity or commodities. **Currency and exchange rate risk:** If the investment benchmark is linked to a foreign currency or currency basket, you may be subject to foreign currency risks. The value of foreign currencies can be highly volatile and may change based on various factors, which may include changes in national debt levels and trade deficits, domestic and foreign inflation rates, domestic and foreign interest rates, and global or regional political, regulatory, economic or financial events. Performance may deviate significantly from the performance of the referenced currencies or exchange rates.

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