

# *Fidelity Viewpoints®: Market Sense*

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## TRANSCRIPT

### SPEAKERS:

Jim Armstrong   Leanna Devinney   Jurrien Timmer

**Jim Armstrong:** Hello, and thank you for joining us for this episode of Market Sense. I'm Jim Armstrong with Fidelity. As has become the custom for anyone following the headlines—this will come as no surprise—there's a lot to cover for investors today: top of mind, of course, inflation. Alongside that, the Federal Reserve's expected interest rate hike this week, and that brings to mind a lot of questions in some people's minds about what the Fed's strategy could mean for the outlook of recession. Of course, there's the ongoing war in Ukraine and renewed supply chain concerns as well. So today we will take our usual shot at trying to break down what that all means for the markets, for you and your money, and maybe talk about possibly some ways to help you weather the storm and protect what you've worked hard and are working hard to build.

To help guide that conversation, we are happy, as always, to have Jurrien Timmer join us. Here's here with a big-picture view of the latest global news and market conditions here at home and as well as a discussion, of course, of what they mean to us as investors. Leanna Devinney will share how she and her team of people help everyone update and create their financial plans in an effort to stay on track with their long-term goals. So, Leanna, Jurrien, thank you, as always, for making time to be with us today.

**Leanna Devinney:** Great to be here. Thank you.

**Jurrien Timmer:** Yeah, nice to see you.

**JIM:** You can't tell—of course, the viewer or listen can't tell, Jurrien, once again is joining us not from his home location today. He's playing "Where in the World is Jurrien Timmer?" How about Dublin is the correct answer. So, Jurrien, thanks for making time to be with us, even from your overseas adventures.



**JURRIEN:** Of course. I just flew in this morning, but I clean up well, I think. And I'm visiting my son who studies here, and then this weekend I'm going off to—onto Holland to visit my parents. So next week, I'll be—well, we'll deal with that next week.

**JIM:** Excellent, excellent. Well, thank you, again, Jurrien. Let's get right into it, though. It is Tuesday, May the 3rd and, as I mentioned, we're on the eve of the Federal Reserve meeting where our central bank is expected to raise rates, once again, by about half-a-percentage points. And what the Fed chair, Jurrien, has signaled could be a series of continued hikes. We are hearing more and more of a focus on, what you've also called, a soft landing. So I would just love you to start us off today with what you think that means to us as investors and to the markets.

**JURRIEN:** Yes. So tomorrow is the FOMC meeting, which is the Fed's meeting, the Federal Open Market Committee meeting. And in March was the—not the last time they met, but that was the first time for this cycle that the Fed raised rates from one-eighths to three-eighths and the expectations are that tomorrow they will raise rates by half a point, which mathematically, they need to do because when you look at what the market is pricing in in terms of the forward curve of where the Fed's going to end up—and you can see that in this chart here—the market's expecting 10 more quarter-point rate hikes between now and just the end of this year, which is only seven months away.

So by definition, that means the Fed's going to have to go big several times in a row, half point increases. And a lot of people are making a very big deal about that, whether—because it deviates from the normal path where the Fed goes a quarter point at a time. But what I'd like to kind of focus on is not how quickly the Fed gets from here to, what we call, the terminal point where it ends that tightening cycle. What really matters is what that terminal point is. How quickly we get there, to me, is not important because the bond market Treasury yields have already done all the work for the Fed.

The Fed is just catching up by raising, what we call, the overnight Fed funds rate. The Fed funds rate is an—not an obscure rate, but it's a rate that is not really even used very much. It's how banks borrow and lend to each other on an overnight basis. So it's not where you and I would borrow or lend money. It's more of a symbolic thing. What matters is where the Fed's going to end up.

And if you look at this chart, this is all in real terms, so inflation adjusted. You can see kind of the pendulum swing of Fed cycles, right? When it's easing policy, it will go below what is considered a neutral rate, which is that smooth blue line in the chart. And when it's tightening, it will tend to go two to three percentage points above. The only time that it went into a tightening mode and stopped at that smooth line and not go over it was actually the last cycle in 2018. What's interesting is that: Based on current inflation expectations, the Fed is expected to raise rates very rapidly—like I said, 10 hikes just this year—but then stop pretty much at that neutral line. And I think that's going to be the next big thing that we're all going to be talking about.

Tomorrow, right—so the 50 basis points that's baked in the cake and probably several more after that—but what Chairman Powell will say in the press conference, or not say, about whether the markets have this right, right, because maybe the markets are further along than the Fed wants to go or maybe they're not far enough along. And so that's what we are all going to be looking at tomorrow as we kind of try to read between the lines and read the tea leaves of what the Fed is going to signal in terms of whether it will stop at neutral, which would be around 3%, or whether it will keep going or fall short. So that's the big thing for tomorrow.

**JIM:** Leanna, I'd love to get a sense from you of what you and your team are hearing from Fidelity customers and clients, right? You're sitting across from them or on the phone or on Zoom calls with them day in and day out. The situation Jurrien's describing, of course, looked at it through the lens of a saver with maybe sitting in cash, might be advantageous, right? They might be able to earn a little more interest on that money that they have in cash. Alternatively, right, if you're looking to finance something—a mortgage or refinance a house, a boat, a car—you've got to pay more for that, so it's an interesting place for all of us to be waiting to see what comes next.

**LEANNA:** It is. And we're hearing a lot from our clients. A lot of the questions I get is: When will inflation end? Wanting to see the end of it. Also getting questions on just the overall health of our economy and questions along: Are we heading in to a recession? So we cover that every week in Market Sense. But, really, I lead a team of financial planners and I get the opportunity to sit in on client meetings throughout the week and hear what's on our client's mind. And April was a tough month volatility-wise and seeing and feeling the impact inflation's having on our spending.

So I'd say clients that we've met with—for the most part, those that have gone through an analysis and have a diversified plan that are aligned to their goals, they were feeling okay, although, still unnerving. And, again, April felt like a tough month. But for those that have that investment plan, we do talk about staying the course and the ability to stay invested, and we do look at history to help support that. So we know, even just looking back to the financial crisis 2008, 2009, stocks dropped nearly 50%.

And now looking back, Fidelity did a study and one-and-a-half million workplace savers found that if they stayed invested in the stock market instead of turning to cash, they were far better off. We know that now. Sometimes these times still feel different, but even going back further in history, five years during the Great Depression, we saw incredible returns after that—367% in great recession, again. Five years starting in 2009, 178% is showing a chart that can help visualize this.

So the point being that there's a lot of concerns and some challenging times and times that feel different based on what's going on in our economic environment. But for those that have built a plan that have some healthy components—I know we'll talk through—have felt okay. For those listening that haven't spent time and gone through an analysis or revisited that plan, it's definitely an opportunity to build an all-weather plan that you're comfortable and confident in.

**JIM:** Yeah. Can you talk a little bit more about that? As you mentioned, we've certainly brought it up several times on Market Sense, but I'd love to revisit the topic as well for just a refresher about this idea of rebalancing or diversification, I suppose, writ large. What should we—what's the picture we should have in our minds?

**LEANNA:** First, I'd say our most successful clients really have three components to their financial plans—so definitely, we'll get into diversification and rebalancing—but first, even taking a step back and making sure you have an emergency fund so you have that liquidity and flexibility in your plan. Second piece is having protection. It could be market protection. It could be making sure that you have a dedicated income stream for those that are in retirement, but first emergency fund, second, protection. Third is growth and having a diversified portfolio—that's a key critical component to every plan—having that growth piece. And, really, the reason why we have that is to keep pace with inflation over the longer term. So focusing on that last component, that's where we talk about asset allocation and having that diversified mix of stocks, bonds, and short term investments. And that's customized to the goals that you have, if it's retirement, if it's a shorter-term time horizon—again, an appropriate mix aligned to you.

With concerns of inflation, we talk through ways that we can reallocate in that asset allocation and making sure that you have some investment vehicles in there that tend to fight inflation over the long term. They fight inflationary pressures better. So as an example, we know stocks have tended to keep up with inflation over the long term, having equities. We also know that there's other vehicles, like exposure to real estate, commodities or TIPS, Treasury Inflation Protected Securities. These are the conversations that we're having. Again, first, let's make sure that you have those three components. Second, let's build that portfolio that's really well diversified, aligned to the goals that you have, making sure it's combatting things like inflation and also making sure that it's getting rebalanced over time as well.

**JIM:** Love the first thing you said: clients and customers saying to you, "When's inflation going to end? When do we get to the end of this?" So, Jurrien, I'll bounce that question right over to you because I know you have the—you've got the charts to back up your answers and the historical perspective as well. Impossible to answer the question exactly, but what pieces go into that puzzle as you're starting to assemble it with supply chain concerns and everything happening globally as well as domestically?

**JURRIEN:** Yes. No, that is really the million-dollar question. And just to think about the inflation math, right, there's the level of—the price level that we pay for stuff and then there's the rate of change in terms of the inflation rate. So if we were paying \$1 for something last year and we're paying \$1.10 today, that means 10% inflation. What happens next, though, if it's for a commodity and the price goes down, then maybe that \$1.10 goes back to \$1 or \$1.05, and then the inflation rate completely reverses and goes from positive to negative. If the inflation rate just goes from 10% to 0%, then that \$1.10 will still be \$1.10, right? It won't be \$1.20, but it also won't be \$1.

So it's important to understand, what we call, the second derivative or the rate of change. Of course, we all know the story that what started as something that seemed logically enough to be a transitory inflation from the lockdowns to supply chain bottlenecks, and once the economy reopens, everything goes back to normal—or that was the idea. And this is what the Fed used as its rationale for not raising rates too fast and too high. But then we had the Russia/Ukraine war and what that means for the price of wheat and fertilizer and gas and oil. Now we have the lockdowns, the COVID lockdowns, in Shanghai, and there's hundreds and hundreds of ships that are waiting to load and bring stuff over to the US and elsewhere.

So it's just—the hits keep coming. And the risk is that that \$1 goes to \$1.10, goes to \$1.20, goes to \$1.30, and for the Fed, that's obviously an important challenge because if consumers or workers start to—if this becomes—if this affects the psychology of how people spend and save and the inflation expectations become embedded—that's what happened in the '70s, right—and you add the cost-of-living adjustments. And the reason I'm saying all this is because if that were to happen—and I don't know if it is or not—but if the expectations for ongoing inflation become more engrained rather than everyone just assuming that once this problem goes away, prices will go back to normal, then it's going to be harder for the Fed to put the genie back in the bottle.

So this chart kind of speaks to that. This is what we esoterically call the TIPS five-year/five-year forward breakeven spread, which is a fancy way of saying: This is what investors think the long-run inflation rate is going to be. And you can see that it was in a long downtrend until the pandemic, then it was in a recovery, which, on its own, is understandable because it went down a lot first. Then we've been sitting in this range for a while, and now it's starting to move a little bit out of the range.

And the reason I mention all of this is because if that starts to move maturely higher, it would suggest that maybe the Fed is not going to be done based on what the market expects the Fed to do now and maybe it has to keep pushing rates higher. Of course, that would have implications for both the stock market and the bond market. So the juxtaposition of not only the price levels, which, of course, are going up, but the rate of change at which they are going up, I think, is something that the Fed really has to try to figure out, and unfortunately, nobody has the answers at this point.

**JIM:** Thank you for that. I do want to ask you a follow up question in just a moment, though, about that longer-term outlook. But before I do, Leanna, I wanted to turn back to you for a sense of how rising rates and inflation are really impacting customers: the average investor, everyday people. Last week on this show we talked about the housing market and how two things are happening simultaneously, right: Mortgages are getting more expensive because of higher interest rates, but the housing market, prices are going up as well, thanks in part due to inflation. I'm curious where else you're seeing that sort of dichotomy play out.

**LEANNA:** So we're seeing this in gas. We're seeing this at the grocery store, going out to eat, rent, possibly heating our homes next winter, renovations, home labor. We were just talking. I had shared a couple of clients that were doing project work, had gotten a quote 18 months ago compared to now—significantly more expensive. So outside of investing, we are talking to our clients about the impact of spending and inflationary pressures. And it comes down to reviewing our budget of it and taking a look at our spending and seeing if there's areas that we can cut back.

No one wants to ever cut back on their spending or talk about a budget. But even recently, a client who's in a very successful position, to retire and live the lifestyle they want, it comes down to comfort right now because they're feeling concerned with the high inflation. And so they took a look and revisited their discretionary spending and just said, "For now, I'm going to change my dining out to once a month versus twice a month." So little things like that can help you feel better to help navigate these times, but when we talk about saving and spending, we follow a nice rule at Fidelity and it's 50%. So 50% of your income should go to your expenses, 15%—if you're in your maximizing years and maximizing for retirement—taking 15% to retirement, 5% will go to savings.

So if we can focus on our spending, then we're going to have less impact on credit card concerns. You ask: What else is happening in this interest rate environment? Well, we can see interest rate on credit cards begin to snowball. If we're not taking a look at our spending and we're spending more or we might have to use a credit card, that's where sometimes debt can become a concern, so just an opportunity to make sure: Are we spending the right way in lines with the means that we have? Are we taking a look at our budget and making sure that these interest rates wouldn't impact debt later on?

**JIM:** Great. Good advice, particularly in this climate, so thank you for that. Jurrien, last question to you, again, about inflation, revisiting what you said just a moment ago. I'd like you to talk a little bit about the idea that inflation expectations are actually starting to come down a little bit. Is it too soon to get excited about that or is it? I mean, how should I be reading those?

**JURRIEN:** Well, yes. So in the last chart, I showed the five-year/five-year forward, which is what investors think inflation will be five years from now for the next five years. I know, really esoteric, but it's one of the Fed's favorite indicators actually. This chart shows the five year yield and the expectation for what inflation will be from now over the next five years. And what you can see—that's the bars there—that it is starting to come down a little bit, which is really good news. Now, whether it's coming down for the right reasons or the wrong reasons, meaning investors are getting worried about a recession, is something we can discuss at another time.

But from my perspective, I think the risk of a recession is pretty low, although, very clearly, the economy is starting to soften a little bit as would be expected in a period of tightening financial conditions, which is what is happening. But for the Fed, this matters because the Fed is going to be raising rates. The market has already done it for it, so now the Fed just has to catch up and go through those motions. But if inflation expectations do start to fall here, which would be obviously

great news for all of us as consumers, it would also mean that the Fed would not have to keep pushing as hard as it has been doing.

But the reason I point this out is that: If the inflation fever were to break, you can think about the relief rally that you could see not only on the interest rate side but even on the stock market side. And it's just another reminder that even if we figured out—to get out at the top, that bottom could happen three months from now or it could happen tomorrow. So it's just so hard to time these things. And I think, as Leanna said, a diversified portfolio, even at times when neither the bond nor the equity side seem to be working very well together, is the really best path forward.

**JIM:** Yeah, particularly true for those of us with those long-term goals. Exactly, so worth both of you taking the time to remind us of that again today. Thank you for that. Also to remind folks in the audience, if you've got questions about making financial plans, staying on track with your current one, or looking at it and starting from scratch, Fidelity can help get that done. A weekly reminder, of course, that you can always call us at Fidelity. You can go online to learn more. Download our app. There's tons of tools and articles and videos, webcasts, podcasts, calculators, things that you can use to help get your questions answered in addition to or in place of giving us a phone call—lots of options for you.

Again, huge thanks to Fidelity's Leanna Devinney and Jurrien Timmer doing the long-distance dedication to us here. We appreciate that. Next week, we'll see you from a brand-new country in Europe—love it. Also, next week, we'll take a fresh look at what's happening in the news. Of course, by next week, the Fed rate hike will be on its way to becoming older news, so we'll be able to talk about how the markets and how investors have digested that news and what's coming next, so plenty to talk about when we gather again next week. We hope to see you then.

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