

Fidelity Viewpoints[®]: Market Sense

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TRANSCRIPT

SPEAKERS:

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HEATHER HEGEDUS: Hi there, everybody. Thank you so much for making the time today to watch or listen to *Market Sense*. I'm Heather Hegedus with Fidelity. So let's talk about the headlines. And stocks are coming off their best week since June, with a rally in big tech driving the NASDAQ to all-time highs, with the S&P approaching 6,400, which is close to another record.

And then this morning, we got another inflation report that shows consumer prices rose in July but less than expected. So the big question still remains at this point, what this might mean for the Fed cutting rates in September. And to talk about what this all could mean for investors, as well, we are joined by Fidelity's Director of Global Macro, Jurrien Timmer.

And we're also joined today by Fidelity's Director of Quantitative Market Strategy, Denise Chisholm. She's going to be sharing with us today some pretty interesting historical data about what typically happens in the markets after a long pause in monetary policy like the one that we've just experienced this entire year. And it should be a fascinating discussion with both of you, Jurrien, Denise. This is certainly a very timely topic, and it's so great to see you both. Hey there, Denise.

DENISE CHISHOLM: Yeah, it's great to be here, Heather. Thanks for having me back.

JURRIEN TIMMER: Nice to see you both.

HEATHER: And before we get started, just a quick note—if you're listening to us as a podcast and you enjoy our weekly discussions, we would really appreciate it—we would love it if you would review our podcast or share our show with a friend. We do read all of your comments, and they do help us shape future *Market Sense* episodes.

But let's get right into it, because today is Tuesday, August 12, and seasonally, we have now hit that stretch where we are now in the weakest part of the year you're in. It's from now until mid-October. At this point, though, I mean, that would be something that most people would not guess given the way the markets have been performing.

As I mentioned, off the top, the S&P 500 is coming off its best week since June, thanks to another strong corporate earnings season. And I think, Jurrien, I think a lot of investors are really feeling confident right now and wondering if we are really going to see any kind of real impact from tariffs. So first of all, are there other economic indicators that are maybe helping to offset the pressure right now from those tariffs? What are you seeing?

JURRIEN: Yes, so there are definitely a lot of crosscurrents. And with regard to the seasonal pattern, of course, the caveat when you do studies like that is always that, is this true, all else being equal. And of course, this is very 2025. So nothing else is equal. So you have to take these indicators like seasonality with a grain of salt. They don't always work, because there could be other more important forces at work that are driving the markets.

And of course, there are a lot of forces at work right now. We have the tariff. We have the tariff tantrum in April. That kind of went away, and some of it has come back. But it's still—like, for instance, China was just announced another 90-day holding period. So we don't really know how the cookie is going to crumble on the tariff side.

A lot of companies, of course, frontloaded their orderings. And so we have only seen a fraction of the tariff story play out, maybe 1/3 of it, and 2/3 is still out there. And we don't know how much of the cost of these import taxes are going to be borne on consumers or the companies importing the goods, or even the companies exporting the goods. And so there's a lot still that we don't know.

And at the same time, of course, we have this very large fiscal bill, the Big Beautiful Bill, that is certainly driving some more confidence on the corporate side. And as you mentioned, earnings season was really very, very strong, with about an 800—an 8-percentage-point bounce in the growth estimate for second-quarter earnings. And so the fundamentals are very strong.

Earnings growth, which was expected to be high for 2025 and then took, essentially, a markdown in April as analysts started to price in the effect from tariffs, is now reaccelerating. And so we're kind of making up for some of those markdowns. But at the same time, we have inflation. CPI was just reported this morning, as you mentioned.

And inflation remains pretty sticky, at around 2.8% if you use the core PCE, which is jargon for one of the measures of inflation that the Fed is particularly attuned to. And the CPI showed that core CPI, so ex food and energy, is rising at about 3%, 3.1%, so not quite victory declared, but

certainly has been moving in the right direction. But that's sort of where we are. It always comes down to growth and inflation in terms of what it means for the markets. And there have been a lot of crosscurrents, but generally speaking, they've been more positive than negative.

HEATHER: I like the way you put it, that it's so 2025, basically, that all things are not necessarily equal right now. So let's set the scene for folks for our rate cuts discussion. So the Fed hasn't cut rates at all this year, in 2025. At the beginning of the year, the FOMC did pencil in two rate cuts for 2025, of course, depending on the economic conditions. Here we are, almost into the fall now.

There were two dissents at the July FOMC meeting. We had that stunning jobs report that we talked a lot about back on August 1 that was surprising to many. So is the consensus now that a September rate cut is looking pretty likely? Is that fair to say, Jurrien? And how much of a cut do you think is in the cards? Could we even perhaps be in for a catch-up cut, like we saw in September of 2024, to make sure—to make up for holding rates in 2025 for so long?

JURRIEN: I think the latter is very unlikely, but the former is very likely. So the market, basically, is concluding that the Fed will cut in September. There's been enough movement, if you will, on the gross side. So clearly, the economy is growing somewhat—not a lot, but somewhat.

And the jobs report kind of indicates that companies aren't really hiring. They're not really firing. But there's sort of a status quo going on the jobs front. And inflation, again, above the Fed's target of 2%, but not accelerating higher. And so I do think that the Fed is going to conclude in September that, OK, they can cut because if you think about what a neutral policy is, it's inflation plus 1%, right?

So if inflation is 2.83%, and the natural rate of growth, if you will, is 1%, you're getting to about 3 and 3/4 or so, and the Fed is at 4 and 3/8. So the Fed is just above both neutral. And it can certainly go down to neutral. I don't think it's really justified to go below neutral. Then you would need a really weak economy for that to happen.

But the Fed can cut a couple of times. It's waited a while because it wasn't sure how the tariff story was going to play out in terms of who was going to pay for the tariffs. But I think, at this point, enough time has gone by that the Fed has the green light to cut. But I think it will cut very incrementally and certainly not in a double rate cut like it did in 2024.

HEATHER: All right, let's get into this discussion a little bit further. And Denise, You've been studying the data, and you have some pretty interesting findings about how markets tend to react when the Fed cuts rates. So historically speaking, you say the outcome from a rate cut or cuts really depends on the economic background that we're in. Can you talk about that a little bit further? What did your research find?

DENISE: Yeah, a lot of people ask, what happens next? So we've had a long pause in terms of the Fed being on hold. Well, what happens next? What's the playbook?

And the playbook is really it just depends on the overall economy. More importantly, it depends on why the Federal Reserve is cutting interest rates. To the extent that the Federal Reserve is cutting interest rates because they have to—unemployment is rising rapidly, job growth is contracting—that's a recessionary environment. That hasn't been good historically for stocks.

But if they are cutting because they can, maybe we don't have quite enough of a hit to the US consumer in terms of tipping consumption growth negative and starting that vicious spiral into recession. If tariffs are a big enough shock to do that, then we may be in the situation that we are avoiding recession once again. And the market just potentially priced in a recession in April without having it happen. That's a much better setup for stocks.

The irony is, either way, going into this rate cut, you have usually seen below-average returns in and stocks. And up until recently, that's really been the case given the almost bear market in April. So in some ways, there's no real playbook. The answer behind what stocks do is really a function of why the Federal Reserve is cutting interest rates.

HEATHER: So to follow up on that, so we don't seem to be in a recession right now by any means. Although, the tricky thing with recessions, that I know you've pointed out many times, is you don't immediately know that you're in them. But if the Fed does cut rates in September, Denise, and we're still not in recession, what could that mean for stock returns? This could be a pretty good thing for investors.

DENISE: Yeah, historically speaking, it has been. So the interesting part you pointed out about recessions is, you're right, I mean, by the time you're in a recession, which the NBER, or the National Bureau of Economic Research, the entity that declares recessions, doesn't declare them until after you've been in them for quite some time, usually around six months. By the time you have found out you're in a recession, historically speaking, on average, stocks have already bottomed.

So in some ways, the recession math behind it is quite tricky. And you see this play out even with that payroll report that just came out. If you said, well, what I really want to focus on to know whether I'm in a recession is jobs, you have to understand as an equity market investor, jobs are a lagging indicator. And the interesting part is you see a really consistent pattern in history. The bigger the negative revisions to payrolls, the more likely the market is to be higher over the next 12 months, not lower.

And the why behind that is because usually, by that point, you have already seen some below-average returns in the market. Or said differently, the market prices it in ahead of time. The market reacts early. Payrolls react late. So one way to interpret what happened over the last

three to four months is that was the tantrum that we saw in April, predicting the payroll report that we just witnessed. So it is a bit of a cautionary flag for investors not to overreact to negative headlines, because a lot of the time, the market might have already priced in the bad news.

HEATHER: Got it. Jobs are a lagging indicator. Weaker jobs number's probably already priced in. But you say it's not, technically, the Fed cutting rates that is driving those strong returns, but rather the market's pricing in future growth. Is that right?

DENISE: Well, that's the complicated part. So I think that the understanding or the guess around how Fed rate cuts impact the economy is that they stimulate growth. And they do, but more in the out years. So over the next 12 months, half the time they do. You see a growth acceleration. Half the time, you don't. But 80% of the time, multiples expand, or stocks get more expensive.

Why would stocks get more expensive for the same exact earnings power and companies? Well, it's because the stock market reacts ahead of time. So if the stock market thinks that growth is likely very visible in the future, whether it's a function of Fed rate cuts bolstering the economy or, Jurrien talked about, the recent legislation and the Big Beautiful Bill that passed, to the extent that earnings growth becomes visible over the next couple of years, the stock market isn't going to wait for it.

It's going to price it in before it happens, which in some ways, makes it look slightly irrational, meaning we could be sitting here six months, nine months from now, saying, we're looking at the same fundamentals. There are some laggard areas of the market, like smaller caps, that aren't earning what you would think they earn. But everything got more expensive because stocks are pricing in the earnings recovery that might not come for a year or two ahead of time.

The more interesting part, I think, in the math, when you look at history, is, yes, stocks are expensive, but if you just quartile out and say, OK, the valuation, meaning how much you're paying for stock earnings growth, that valuation, that top quartile valuation from a starting point, you still get 80% odds that you have valuation expansion on top of it. So in some ways, valuation isn't always the headwind that you would think to the extent that earnings growth becomes visible to the market.

HEATHER: OK. Jurrien, I wanted to bring you back in to talk about bonds and what this might mean for bonds, because we know, when interest rates fall, bond prices tend to rise. They have that inverse relationship. So what could a rate cut mean for the bond market and the bond market's correlation to stocks? And what could it mean for traditional 60/40 portfolio?

JURRIEN: Yeah, it's a great question because the Fed controls short rates. And then, from those short rates, the rest of what we call the yield curve is formed, so two-year yields, five-year yields, 10-year yields, 30-year yields. And those longer yields tend to be driven more by inflation expectations. the term premium, which is like a risk premium for bonds.

So the Fed only really controls so much of this unless it's also using its balance sheet, which it isn't right now. And I think one of the reasons why the Fed has waited is because it wanted to see—to make sure that inflation was indeed stable enough to warrant rate cuts, or growth was slowing enough. And if the Fed had made, let's say, a political decision or, otherwise, a decision to cut rates when the economy really wasn't justifying it, then the risk would have been that long yields would have actually gone up even as short yields went down. And that would have been a problem.

And the fact that the long end of the yield curve, the 10-year Treasury yield, is so stable, at around 4.3%, is, in part, a reflection that growth is slowing. And generally, yields come down when growth is slowing. And as Denise said, generally, the Fed is cutting when growth is slowing. And so that's why short rates will impact long rates in the same direction, generally speaking, when the Fed is cutting rates.

But in this case, there's also an element of, OK, the Fed waited a little longer. And that actually is having a positive impact on the back end of the curve, because otherwise, the curve would have what we call bear steepened. And that would have been an issue for other parts of the economy, like people with mortgages, et cetera.

So I think, at this point, bonds are actually doing what they're supposed to do, which is to reflect economic conditions and go down when growth gets softer, or inflation gets softer, or the Fed is cutting rates. So at this point, the 60/40, as we think of it, is actually behaving the way we would expect it to.

HEATHER: All right. And Denise, let's talk about the flip side of the coin for a minute, as well. Let's talk about the risks of cutting rates. So critics will say earnings are strong, consumer spending is strong, so why would the Fed vote for a rate cut if we have these positive economic indicators? And inflation is still just above the Fed's 2% target. It's not very much higher than 2%. Jurrien was saying about 3%, I think. So isn't there a fear a rate cut will just accelerate inflation even further?

DENISE: Yeah, could this be a replay of 2022? That is certainly a concern of a lot of investors that I talk to. When I look through history, inflation is just harder to achieve in that historical data than you would think. Just, really, ask Japan.

2022, or post-COVID, was a very unique time where we literally dumped cash on the consumer to the tune of 12% of GDP. So that's a very significant monetary phenomenon, which then generated that inflation. That is not the situation that we're seeing currently. And even in the tariffs, yes, you're seeing some prices go up, goods prices go up.

But you're also seeing an offset in service prices. Let's take airlines' airfares. And what you see is, to the extent that the consumer isn't growing rapidly in terms of that real income growth in excess of inflation, whatever you pay more in one item might be something that you have to pay less in another item. So you're not seeing that broad-based inflation, which is not to say that you aren't seeing some prices rise. It's just being offset in other areas.

Now, look, we are seeing a modest acceleration to maybe 3. Maybe it even accelerates further from here. The interesting part in my research is as much as, again, we live through an inflationary impulse, the amount and magnitude is really important to the equity market. The sweet spot for equity returns is actually between 3% and 4% inflation.

So if you tell me, as sort of a statistician or somebody who studies markets, that inflation is likely to accelerate, and it might even accelerate to 3.5%, for the most part, when I look at the historical data, I don't really think that that's a particular problem for equities. So as much as inflation might be lurking in the background and being sticky, I don't think that necessarily, especially given the broad-based stability relative to the inflation impulse we've seen in the past, is a problem for equity markets going forward.

HEATHER: Jurrien—

JURRIEN: I'd—

HEATHER: Yeah, go ahead.

JURRIEN: Sorry, I would just add to that. Denise makes a very good point. The other factor there is sort of the second derivative of inflation, which is the volatility of inflation. So if inflation were to be at 3%, let's say, for the next five years, that's above the Fed's target. But if it's not moving a lot away from 3% in either direction. That shows stability on that side. And as Denise pointed out, that is not necessarily a negative for equities.

HEATHER: Terrific point, Jurrien. I did want to ask you another question, too, about Denise saying this would be a positive development for US stocks because we know global stocks are having their own rally. We've been talking about this a lot. Specifically, European stocks are still offering some pretty stiff competition. So how do you look at that?

JURRIEN: Well, so the rest of the world has been in a more accommodative mode already. So the Bank of Canada has been cutting, the European Central Bank. And so, again, what the Fed is presumably about to do in September has long been expected by the markets already. If you look at what we call the forward curve, which is the futures market pricing in what it thinks the Fed is going to do, it thinks the Fed is going to cut, eventually, to about 3 and 1/4 over the next year or so.

And so if the Fed just follows along that path, it really doesn't make news, because the Fed's just doing what the markets have already priced in. So I don't think it upends the game at all in terms of US versus non-US equities. There are much more powerful drivers happening there in terms of fiscal policy, earnings growth, the shareholder engineering of buybacks and things like that.

And, of course, currencies—the dollar has been relatively weak. And if the Fed starts to cut again, you could argue that the dollar might actually fall a little bit more. And for US investors in investing overseas, that would provide positive currency translation.

HEATHER: OK, helpful to hear how you think about that. Hey, Denise, let's also talk about sectors, are there any specific sectors that have historically benefited more than others in these types of financial conditions, with the economy slowing, but not in a recession? And in the instance that the Fed were to cut, what do you think sector-wise there, in that scenario?

DENISE: When you look at rate cuts and the economy avoids recession, you do see a tilt towards economically sensitive sectors like technology, industrials, consumer discretionary, financials, and away from those very classically defensive sectors like consumer staples, utilities, and health care. So you do see a tilt towards what we call beta or cyclical or just economically sensitive stocks.

I will say, in my work, it's the same as we talked about in the midyear outlook, which is to say that we saw a very quick, broad-based valuation reset in the technology sector that set up the technology sector for a really positive risk-reward in terms of what it had already priced in. So I do think, of those economically sensitive sectors, the technology actually floats to the top of the list. And then I'd say, closely followed by financials.

Interestingly enough, just going into July, financials, the expectations for earnings was about flat. And in fact, as Jurrien pointed out, this is broad for the market, but financial earnings came in at growing double digits. So I do think that there's opportunities in financials, as well, more on the capital markets and brokers side that are a little bit more levered in terms of the upside that I see in the market.

HEATHER: We're right up against the clock, but Jurrien, I'd love to, lastly, just get your thoughts on the fact that there's been just as much speculation almost about rate cuts as there has been about who might replace Chairman Jay Powell when his term ends next year. And then, just last week, President Trump also announced the nomination to fill the vacancy on the Fed's Board of Governors. Stephen Miran, who chaired the Council of Economic Advisors. How do you think this could all play out? And could a replacement be appointed before Powell's term is up? And how much of an economic impact could that have?

JURRIEN: So this could get very interesting once we get past the summer because the thinking is—and I don't know if it's correct or not, but the thinking is that the replacement would probably get announced before Chair Powell's term ends next year in May. And so you would have the actual chair making decisions, with the committee, of course. The chair doesn't make decisions by him or herself. But then you would have a shadow chair also making proclamations in speeches and stuff.

And so if the general direction of policy is in the same—is going in the same way, so the Fed is predisposed to cut rates, and maybe the shadow chair wants to cut more, and the current chair wants to cut less, then I don't think it matters that much. But if you were in a position where the chair wanted to raise rates, and the next chair wanted to lower rates, that would, obviously, potentially be a confusing signal for the markets. But I'm not expecting anything that dramatic. But it will be possibly interesting theater once we get to the fall.

HEATHER: OK. Well, we'll certainly be watching in the fall, could get very interesting, indeed. We do have to leave it at that. But before we go, we do have some important information for our *Market Sense* community that we want to quickly share.

Incidents of fraud are rising across financial institutions. And we wanted to take this opportunity to remind our audience, you should never trust unexpected calls or texts from individuals claiming to represent financial institutions or the IRS or technical support. And you should never click on a link in a text or email, give out a security code, or type it into your phone unless you have initiated the call to Fidelity or another financial institution.

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Well, terrific conversation today. Thank you so much, Denise and Jurrien. And on behalf of Denise Chisholm and Jurrien Timmer, I'm Heather Hegedus. Hope to see you back here next week. Remember, we are on live. You can catch us live, weekdays, Tuesdays at 2:00 Eastern. Take care.

'Bloomberg: August 8, 2025: https://www.bloomberg.com/news/articles/2025-08-07/stock-market-today-dow-s-p-live-updates?cmpid=eveus&utm_medium=email&utm_source=newsletter&utm_term=250808&utm_campaign=eveus

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