Fidelity Viewpoints®: Market Sense

Week 217 October 27, 2026

TRANSCRIPT

SPEAKERS:

Heather Hegedus Matt Reed Jake Weinstein

HEATHER HEGEDUS: Hi there, everybody. Thank you so much for making the time to join us for another episode of *Market Sense*. I'm Heather Hegedus with Fidelity. So, the Fed's meeting, as we speak again, and markets are hanging on every word as investors look for clues about the path ahead for rates, growth, and inflation. At the same time, Wall Street is also grappling now with some pretty big questions around the next phase of the AI buildout, rising energy prices, and continued geopolitical uncertainty.

So to talk about what these crosscurrents might mean for the economy, for the markets, and maybe, most importantly, for your portfolio, we are thrilled to be joined today by Jake Weinstein. He's in for Jurrien today. He's a Senior Vice President on Fidelity's Asset Allocation Research Team. And Jake and his team's economic research helped to inform Fidelity's portfolio managers and investment teams.

And speaking of our portfolio managers and sector leaders, we are thrilled to welcome Matt Reed to the show today. He is a Fidelity Portfolio Manager here and research analyst who's a sector leader here at Fidelity for financials. And we know financial stocks can be particularly sensitive to changes in interest rates. So that's why we're so excited to talk to Matt today about this latest Fed meeting and all of the other trends that he is keeping tabs on right now in the financials sector.

So, thrilled to have you both here. I know this is a particularly nice pairing because the two of you know one another and have worked alongside one another for, what, decades. And Matt, welcome to *Market Sense*.

MATT REED: Yeah, thanks, Heather. It's great to be here. I appreciate you having me. And great to be here with Jake, who I've known for a long time and worked with for a long time here.

JAKE WEINSTEIN: Yeah, happy to be here. Matt, welcome, and hope this is one of many to come in the future for *Market Sense*.

HEATHER: All right. Let's get started. With that, today is Tuesday, October 27. Wow, October is almost behind us. We've got midterm elections in a week. But let's start with the Fed. Jake, the central bank's meeting right now, as we speak, to decide the Fed's next move. The market's not pricing in a hike for now. Markets are expecting, however, a rate hike to happen probably in December and more hikes in 2027. So, Jake, first of all, I was hoping you could talk about what rate hikes mean for the economy. I know your team says, in the current economic backdrop, where we are right now, you don't see rate hikes as something investors should think of as a bad thing. Why is that?

JAKE: Yeah, I mean, if you think about why the Federal Reserve is raising rates, they're raising rates to try to cool the economy. And why are they trying to cool the economy? It's because growth is a little bit even better than maybe trend or better than they expect. So if a central bank is going in and basically saying we need to raise rates to cool things off, that means things are going overall pretty well.

So it would be a concern, I'd say, if there was a lot of inflation, like it was just getting super, super high. Inflation is elevated above their target, but it's not super elevated above their target. So if the Fed can just start raising rates a little bit, it shows credibility. It shows independence, something that maybe last time I was on *Market Sense* maybe hadn't been as evident. So that's good news as well. So overall, it's not a bad sign because they don't have to go too far, too fast at the present time.

HEATHER: So they have room to hike because the economy is strong. However, I know, Jake—and we've talked about this before. We talked about this when you were last on our show, which was, I think, six months ago. It's been a while. Some consumers may not feel like the economy is very strong right now, depending on where they fall in this K-shaped economy, with inflation and gas shocks hitting some Americans much harder than others. I know your team performs the research that informs portfolio managers and sector leaders, just like Matt, about how the economy is doing. So can you remind our audience where we are in the business cycle right now?

JAKE: Yeah, absolutely. And again, part of our process at the Asset Allocation Research Team is the business cycle approach and framework. We look at large economies around the world and assess whether they're in the early stage, mid-cycle phase, late-cycle expansion, or if we think recession risks are elevated. And if you look right now for the US and for large economies across the world, for the most part, most economies are in expansion, and the US is in that mid-cycle phase.

What's that mid-cycle phase? As you look at this diagram, what does that mean? It means that labor markets are holding up. Policies are generally accommodative, both on the fiscal front and the monetary side. You've got manufacturing improving, profit margins strong, and, as Matt will probably talk about in a bit, credit is still flowing through the system.

So if there's any issues that consumers or corporations have, if banks are there or the capital markets are there and open, the access and availability of credit is a super important factor, which we're still seeing. So mid-cycle is good. Historically, it takes quite some time before you get to recession when you're in mid-cycle. So we're at a pretty good phase of the economy right now.

HEATHER: All right, Matt, I want to bring you into the conversation. Nice way to tee Matt up there, Jake. Because the financial sector sits right at the intersection of so many of the economic forces that Jake was just discussing. We're in quarter three earnings season right now. Many of the big banks that make up your sector were the first to report. I was hoping we might want to start off with you talking about what some of the takeaways were from those bank earnings reports. And how could a period of higher for longer rates impact the financial sector?

MATT: Yeah, sure, Heather. Thanks. Look, yeah, we're right in the heart of earnings season here. The big banks are some of the first to go, as you said. And so I've spent the last few weeks digging through reports, listening to management. And I think it's not inconsistent with what you heard from Jake. Loan growth has been good. Activity stayed strong. Credit continues to perform well so far. And broadly, the group in this higher rate environment has been earning good returns on capital. So that's what we're seeing from the bottom up in the earnings reports.

HEATHER: We always get the question, Matt, are high rates or low rates better for financials? What's the answer to that?

MATT: Yeah, that's a great question. It's one I get a lot, actually, as you might imagine. Are high rates better? I'd even expand it to, are rising or falling. Is it level? Is it moving faster, higher, or lower? So the unfortunate answer is, outside of extremes, the level and pace are a little bit less relevant than what it tells us. So the answer is almost always it depends.

So the most important question isn't the right level or the rate, again, outside of extreme levels of rates, but why are the rates doing what they're doing, and what is it telling us about the economy? And that's really the most important question. Yes, bottoms up, there are certain companies that do a little bit better or a little bit worse if certain things happen with the interest rates, but that kind of misses the forest through the trees, because the most important question for financials, they're levered to the economy. And so the question is, what's happening in rates? What is that telling us about future expectations for the economy? Because that's going to be the most important thing for the sector.

HEATHER: So what rates are telling us about the economy is what investors really should be paying attention to if they're interested in financials, especially. Jake, when investors see 10 and 30-year bond yields surpassing 5% now, the highest we've seen in more than two decades, what do you think the bond market is telling us about the economy?

JAKE: Yeah, no, so it's super interesting and important, the fact that yields have been rising. In fact, why have they been rising? And it's three factors. One point I mentioned before, growth is good. That basically suggests rates go higher. Fed's raising rates. There's more competition for capital, so you should expect rates to rise in a good growth environment.

But rates are also rising because inflation has been elevated, and it's been above the Fed's target for five years. And so if the Fed is serious about fighting inflation, as it says it has, then you have to have higher rates to get to a point where inflation could fall back down to its target. So you've got growth going higher, inflation remaining above the Fed's target, and then finally, something that just is not going to go away—it's going to be with us for quite some time—is there's a significant amount, if not an unsustainable amount, of debt issued from the public sector, the US, the global bond markets as well.

And so you've got the trifecta of all those things that basically has pushed interest rates higher. So that's really what the bond market is basically saying. But we've gotten to this point now where interest rates are above 5% for the 10-year and 30-year. Equity markets are still around their all-time highs. The economy is still doing well. And so the way I interpret this is that the market and the economy, I should say right now, both on the corporate sector and the consumer sector, can handle higher rates at these levels.

HEATHER: OK. Speaking of the consumer, I think that's a great segue into you, Matt, again, because I know the consumer plays a huge role in the health of the financial sector. They're interacting with the financial sector for everything from credit cards to bank loans, to bank accounts. And we often, as I mentioned, discuss the K-shaped economy here on *Market Sense,* meaning some households are basically able to spend without much limitations these days, and others are really feeling a lot of pressure these days from inflation. How does consumer spending and consumer credit, how much does that matter to the banks that you are interacting with, Matt?

MATT: Yeah, thanks. I would actually expand it beyond banks, just broad financials, because I think, as you touched on, they lend money to people and businesses. They process transactions. They enable payments. They help people invest. They help people manage their wealth. So there's a lot that the consumer touches. And the consumer is so important to financials because they're so important to the economy.

And so what we see right now is interesting, which is that consumer spending and consumer credit continues to hold up well from the data that we've got. And that might feel like a contradiction against a backdrop of pretty weak consumer sentiment. So it makes for an interesting time. But the data is good. And I think part of the reason is consumers tend to be pretty resilient, and they tend to be pretty financially savvy and responsible. And one thing that's anchored all this has been employment that's stayed pretty strong.

So Jake referenced a little bit earlier we've had some wage growth. So we continue to have wage growth. And the employment market has stayed pretty strong. And so it's shocks that tend to be the biggest impact to the consumer when we think about what happens for credit shocks. And the biggest shock to most consumers' income statements tends to be around employment. And with employment holding up well and some wage growth, so far, the data we've seen has pointed to a pretty resilient consumer.

HEATHER: You know what? I just realized, probably a good place right now to remind people, too, that Fidelity is not a bank, and we're not part of the financial sector. You probably get that question sometimes, too—but not publicly traded, so not a part of the financial sector that you're representing.

All right, Jake, from a macro perspective, thinking about the pressures on consumers these days, does the labor market and wage growth data still support a resilient consumer, one that can still pay off debt to the financial firms that Matt is researching and investing in? Or are you seeing signs that there could be some stress ahead?

JAKE: No, absolutely. And you asked Matt about the K-shaped economy. So, I mean, I'd be remiss to basically suggest, when I talk about this in aggregate terms, there aren't people out there that are, indeed, struggling. It is difficult. In some sectors, some different occupations, that's always the case. But again, when there's things like higher interest rates or higher gas prices, that really could hurt a lot of people, even if in aggregate, the entire US consumer, as we talk about, is still growing and is still spending money and still has positive wage growth relative to inflation.

And so there are a lot of things that we have to look through and that matter. But in the aggregate, what matters to the earnings of, say, the firms that Matt's looking at or other people are looking at in terms of profit margins and earnings expectations, it's the aggregate consumption basket.

So as far as the consumer right now, one thing that's been huge has been the fact that they've been super resilient in the face that market's going higher, home prices not going up by that much, but still not going down and staying elevated. So people with assets feel like they're wealthier if they're looking at their statements, especially those on the higher end of the consumption bucket, in terms of the income bucket. And they are continuing to consume.

And so labor market being strong as a component, as Matt alluded to it, that actually has helped some people out and caused some consumption growth to go up. And so but one point that Matt mentioned was, indeed, sentiment going down, which is sort of odd. But if you actually look at it and compare consumer sentiment relative to gas prices, a lot of that reason for that decline in sentiment, as of the last several quarters, really, since March, has been because gas prices go higher.

And so you look at that. You're like, oh, sentiment is bad. Does that mean bad spending? Well, yeah, I mean, it's tough for a lot of people because they don't like higher gas prices. But if you look at an aggregate and you look at the consumption numbers beyond that and beyond sentiment, consumers are actually looking like they're in a pretty good place.

And again, that's supported by wealth effect, and it's also supported by a job market that's bounced back significantly since last year. We've seen over half a million jobs created across a large, much more broader set of the economy, from professional services to construction type of jobs, compared to last year, where there was just a smattering of job growth across some health care and other government sectors.

HEATHER: It'll be interesting to see what the consumer sentiment studies show, if the conflict in Iran is over and when the gas prices come back down again.

JAKE: Yeah, and that's a great point because if they do come down, sentiment might go up, and there might even be a bigger boost to consumption. I mean, obviously, things work in isolation, but that's just another thing. We're not trying to predict that, but it's just another factor that may be unanticipated that could provide some green shoots ahead.

HEATHER: Yeah, that was a helpful chart that you showed that shows the relationship so far. Matt, we talked a little bit about the K-shaped economy just now, but I wanted to talk about another dominant theme right now for the economy, perhaps even more dominant. And of course, that's AI, which is transforming just about every sector of the economy. And we've talked about it with all of the various kinds of portfolio managers that we've had on *Market Sense*.

So many of the portfolio managers sectors that we've talked to over the past year, their sectors are being impacted by AI in different ways, and the financial industry is no exception. So I'd really love to hear from you about what has been the AI impact on your sector. And where are you seeing the biggest potential, but also, potential for disruption?

MATT: Yeah, no, it's interesting because AI has been a topic we've talked about for a while, but it moves so fast and changes so rapidly. It's something we're constantly looking at. And I'd say there's two areas that we see it most directly, probably. Some firms are finding ways to leverage AI to help their customers consume or utilize their data or information more efficiently, more effectively, more frequently, and improve the utilization of the product.

Other areas, probably the biggest area that we hear talked about is the efficiency opportunity. I would say, in both of those cases, it's pretty early days still. Despite how long it feels like we've been talking about this, it's really still early in terms of the implementation of getting this done. And some of this efficiency opportunity will really just mean that businesses can do more to add value to the products and services they're bringing to their customers at a faster pace.

So the question that I spend my time on is, strategically, which firms can actually improve the value proposition of their product to their customers in a way that's unique, relative to their peers? And that we spend a lot of time on. And it's still evolving. Again, it's moving quickly. But from a direct AI use case, I would say, those are the areas that we see the firms talking about it.

But I think there's another AI topic here, which is simply that the financial firms provide financing to the economy. And the AI data center expansion, obviously, requires a lot of capital. And it's been a long time since we've had a meaningful CapEx cycle, in my opinion. And so now we've got the financial industry, broadly, at the heart of helping to provide financing, also, for the broader AI opportunity.

And some people will do that well, and some people might do it less well. And we spend a lot of time figuring out who do we think is doing a good job, where is there an opportunity to improve and grow the business. And this is just one more chance for financials to be additive to the ecosystem.

HEATHER: Well, you were talking about CapEx and funding the AI buildout. But also, we know that banks are facing greater regulation these days since the Great Financial Crisis, or global financial crisis, and capital requirements. And so we've seen private credit step in to fill part of the lending gap. I'm curious to hear from you how—whether you think, really, I should say, whether you think that's reshaping the financial ecosystem. And do you see private credit as a complement or competition to traditional banks?

MATT: Yeah, I would say, the regulatory changes that happened, there were some of those. And I think that story has largely played itself out. And there will be on-the-edges things. But I think the bigger picture—I view this as an evolution of the financial system. For decades, we've had evolutions of finding ways to provide capital to the economy, whether it's leveraged loans, corporate bonds, high-yield bonds, securitized debt. So all these things, effectively, all they are, are ways to find the most efficient means of getting capital into the economy to fuel the growth. And I view private credit as a part of that ecosystem.

And so at this point, I view it as a complement, and they're part of the ecosystem. And the ecosystem always has some competition or coopetition. But at the end of the day, what we're trying to do is, the financial system needs to find the most efficient capital for the use case that is being demanded to fund the economy and fund the growth in the economy. And I see this all as part of that equation. And so I view it much more as an evolution of the financial system.

HEATHER: Fascinating. All right. Well, we've talked about a lot of themes today. We talked about rates. We talked about consumer spending. We talked about AI and private credit. Just, Jake, was hoping you could talk about, if you step back and look at the bigger picture, what are you and your team watching for 2027? Because we're already in the fourth quarter here, already looking into a new year. And what do you think investors should be focusing on along those lines in 2027?

JAKE: Yeah, Heather, it's crazy because when I first asked this a couple of weeks ago, I'm like, I have to really think about 2027 so far? But yeah, it's right around the corner. So there's several things when we think about how this is going to take shape.

And we're not trying to predict exactly where the cycle is. We don't have a magical crystal ball that's going to tell us all these things. It's always an evolving thing. But rather, what makes sense is to think forth in terms of the '27 outlook and say, what are the three core themes that are going to matter and drive asset market performance and just really drive economic resiliency, or if there's any type of shock to the system?

And the first one is the AI—Matt mentioned this—its impact on funding markets, the labor markets, its impact on inflation, will it ever be disinflationary, and how that's going to ultimately impact growth, earnings, productivity, and how markets are going to interpret that. So AI is obviously the biggest one.

The second one really is the Fed and the market think inflation is going to be able to get back to its target. We think that restoring inflation back down to the Federal Reserve's 2% target may take a little bit longer than anticipated. So expect that to take a little bit longer.

And then the third thing is, really, there's been a huge shift in terms of global capital flows over the last 20 years. A lot of money has come overseas and been invested in the US. It may not happen next year, but just be prepared that there may be some sort of shift in terms of how global capital flows away from the US, possibly, could impact markets. And that really just warrants focus on a globally diversified portfolio.

HEATHER: Terrific takeaways there, Jake. And what about you, Matt? As you look across the financial sector, either short term into 2027 or even longer term, where are you seeing the most compelling potential future opportunities?

MATT: Yeah, this is an exciting time for me. I tend to take a three to five-year view of where we think businesses are going, how they'll be strategically positioned, whether we think they'll be able to earn more or less or have better returns. And you've mentioned we've touched on a lot of the things that drive a lot of the uncertainty and volatility in the market today. But for a stock picker, that should be a great thing.

I'm looking forward to all the bottoms-up work we're doing on companies to figure out how they're going to be positioned to thrive or be challenged in the future. And I'm anticipating a period of single stock dispersion, which, for a stock picker and somebody who's looking to pick stocks for a living, that should be a good thing, as long as I execute well.

And so I've got a team here focused on all these things, and they do a great job. And so we're really excited about what this means from the bottoms-up stock picking opportunity. Financials are always symbiotic with the economy, but also, underlying under the hood, there's always some firms that are going to do better and some firms that are going to do less well. And so that's what we're trying to tease out.

JAKE: Yeah, and I'd echo on that, Matt, that in a normalized interest rate environment, it tends to be a better and more easier time for stock pickers to find those companies because you just don't have low rates that are just really creating any type of disruption in financial markets.

MATT: That's right.

HEATHER: Well, if you're following financials, you're following the economy. So this was a perfect pairing of the two of you today. Thank you to both of you for making time out of your busy schedules to be with me together. To have a sector leader on financials and Jake, whose team provides those economic backdrop insights to Matt's team, just really a nice way to have a full conversation today. Great discussion.

To our audience, if you are looking for more market insights from our Fidelity leaders like Matt and Jake, you might want to bookmark this page, Fidelity.com/MarketVolatility. And there you'll find articles from our Fidelity Viewpoints partners addressing all the latest market headlines and guidance on navigating potentially volatile markets ahead.

There's also a market outlook article up there right now, too, from our Jurrien Timmer and links to the latest *Market Sense* episodes. So you might want to check that out while you're on that page. On behalf of Jake and Matt, I'm Heather Hegedus. Thanks for the pleasure of your time. And we hope to see you back here next Tuesday at 2:00 Eastern. Take care, everybody.

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