Fidelity Viewpoints®: Market Sense

Week 134, March 14, 2023

TRANSCRIPT

SPEAKERS:

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Jim Armstrong: Hello and thank you for joining us for this *Market Sense* special report. I'm Jim Armstrong with Fidelity. We've seen some fast-moving developments in the markets over the past few days with two important failures in the financial sector, Silicon Valley Bank and Signature Bank, marking the second and third largest failures in the US banking system.[1] We recognize that this can be troubling news to hear, so we've shifted the format of our show today to focus solely on those developments and we'll talk about what they might mean to us as individuals.

To guide us through today's conversation we're going to be speaking with Jurrien Timmer, he's Fidelity's Director of Global Macro. Leanna Devinney is with us as well, she is a financial planner and a Massachusetts based branch leader. And we're also joined by Lars Schuster today. He's an Institutional Portfolio Manager here at Fidelity as well. I want to thank the three of you for taking time out of your schedules during a week like this to talk to us and our customers.

Leanna Devinney: Thank you, great to be here.

Jurrien Timmer: Yeah, good to see you all.

Lars Schuster: Looking forward to the conversation. Thanks very much.

JIM: Absolutely, Lars. One quick note for our viewers, you know *Market Sense* episodes typically last around 20 minute or so. But just a heads up that we'll probably go a couple or a few minutes longer for this particular episode just so that we can be deliberate and thoughtful and share everything that we know at the time. So with that out of the way, Jurrien, let's start with you, it is the 14th of March. And looking just for your perspective on what you think what's happened over the last few days. Regulators shut down the two banks that I mentioned. The Federal Government

stepped in, tried to calm the fears of investors and depositors. Really, really strong echoes—it feels like at least, echoes that feel like 2008. So how close are we to a repeat of what happened 15 years ago, if at all?

JURRIEN: Well, in my sense we're not that close at all. So what we, so generally speaking, the banks are in very, very good shape, you know, financially. So what happened, of course, during the financial crisis we had both a liquidity problem as well as a solvency problem. And in a way the liquidity problem is a story as old as the markets itself. Because what happens when the Fed is raising rates, of course, as it has been doing for the last year, is that historically generally short rates end up going higher than long rates. They go above long rates and that inverts the yield curve. And if you're a bank, you start having what's called an asset liability mismatch or an ALM, where your borrowing short. And, you know, you're paying depositors short or you're borrowing short, and you're lending long.

And, you know, so when short rates then go above long rates, it can create a liquidity issue. And in some cases, also a solvency issue, in other words, if banks have made bad loans. Like and we saw that in the financial crisis, of course, as housing prices started to come down. So we don't have anything like that on the second category. Silicon Valley Bank invested basically its deposits, for a large extent, in government bonds and mortgage-backed securities which are among the safest investments you can make. But, of course, as a byproduct of the Fed raising rates, they bought those bonds a few years ago when rates were at generational lows and now those bonds are at a loss. And at the same time, deposits which had been flowing into Silicon Valley Bank, in large part because of the boom in venture capital and things like that, those deposits started to get withdrawn. And that left basically that mismatch.

So Silicon Valley Bank had to sell those assets but had to do so at a loss. And then it needed a capital raise and before you know it there was a bank run on Silicon Valley Bank. And, you know, in the old days you have to stand outside your bank branch to get your money out. These days, it's just a couple clicks away. And so in one day they lost $50 billion or so of deposits. And the next day they were seized by the regulators. And then, of course, two days later as we now saw with the regulators announcing, you know, the backstop programs to make sure that those deposits are kept whole or made whole so that there isn't that need for a bank run. So this was a classic liquidity crunch, but my sense is that it's somewhat of an isolated incident. And again, because we had all this regulation coming, stemming from the financial crisis in '08, most banks especially the really big ones, are in very, very good shape. You know, they've been stress tested; they've been regulated. And so this is not, in my view, a systemic or system wide problem in the banking system.

JIM: I want to push back a little bit there and ask a follow up question, this idea that this could be fairly limited. I want you to sort of explain what happened really diving deeper into, if you could, the role that interest rates spurred by the Federal Reserve played because that is system wide, right? How would some banks be less or more subject to having negative consequences because of those global changes?

JURRIEN: Yes, and this speaks to what we call the moral hazard aspect of this whole situation. And that is that interest rates were so low for so long, and of course in the aftermath of the pandemic three years ago, the Fed pushed rates all the way to zero and they did all of this QE as we call it, quantitative easing which means it was buying $120 billion of bonds every month. And added that to its balance sheet and when you do that, you're pushing down yields, right, it's supply and demand. So if you're all of a sudden a huge marginal buyer in the market, rates will come down. And, you know we can Monday morning quarterback about whether the Fed made policy errors or whether they did too much or held on to that for too long. But I think it's fairly evident at this point that the potency of the stimulus from the pandemic era was very strong, created the inflation and that maybe the Fed should have kind of taken the punch bowl away sooner.

And so the moral hazard, and again this is a discussion for another day perhaps. But people will be talking about that, is that rates were so low for so long that it affected people's behavior. So it led to a venture capital boom, which then caused all this money to flow into Silicon Valley Bank, and all of a sudden they were sitting on hundreds of billions of deposits, which they had to do something with. And what they did was they invested a good chunk of that in the bond market, again, at these generational lows in interest rates. Now, those bonds are sitting at a loss.

So if there's a systemic problem, it's that banks in general, including the Central Bank, the Fed, have portfolios, bond portfolios that have lost money because rates have gone up a lot. So this is the byproduct of the Fed typing policy which it had to do because inflation is a very big problem. The CPI was released this morning and it's still at 5.5%, that's still well, well north of the Fed's target. And so the Fed had to do this and in the process the yield curve inverted. And that is another way for the market to say, hey, everyone, you know we're going to have this mismatch. And so, if there's a systemic issue, it's that mismatch is probably being felt by other institutions. But those institutions are more liquid and are more able to meet redemptions of deposits should that happen. And now with the Fed's backstop, of course, those deposits beyond the $250,000 FDIC guarantee limit, are basically protected as well.

So this—so in a way the Fed removed what we call the tail risk, which it did in '08 but did it much later. It did it during 2020 during COVID. And so, it quickly removed that tail risk and that's how, in my view, is how this will not likely become a systemic issue.

JIM: So against that backdrop, Leanna, I would love to turn to you of the four of us, you as always remain the most closely connected to our customers, you and your team at the branch. You know, take calls and emails and visits all the time; what are you telling folks who are concerned about the safety of their money today?

LEANNA: Yeah, so I lead a team of financial planners. We're here in Hingham, Massachusetts and we've certainly gotten a lot of calls from our clients who bank outside of Fidelity. And they've shared just hearing about a bank closure causes alarm. And, you know, there were feelings around 2008, I know Jurrien just shared this, but it's very different. And it's not a matter of a safety issue

but more on the accessibility. And I think there was an initial lack of clarity over what might happen to the SVB depositors holding more than the insured amount. But the Fed came in and shared that folks would start having access to their money beginning yesterday.

So on our end, I think it's an important reminder to take a look at the cash that you hold and have an understanding of the insurance policies when you're speaking with your firm or who you bank with and start to ask questions around their safety and protection. So Fidelity, we're a brokerage firm; we're not a bank. And so as a brokerage firm, our accounts are covered by SIPC, that's Securities Investment Protection Corporation. So we offer that for, you know, things like stocks, bonds, mutual funds. We also have FDIC coverage for products, FDIC insurance. And that's familiar at banks but that's going to be things like checking accounts, savings accounts, CDs. And as a brokerage firm, Fidelity will allow customers who have FDIC coverage, originally up to $250,000; we actually sweep those balances and give coverage for up to $5 million of FDIC insurance coverage.[3]

So I think at the core of this, again, it's an opportunity to make sure the critical assets that you hold, your cash, your savings, that it's safe, accessible, and aligned to the preferences that you're looking for. And these are the questions that we help answer for our clients and investors and those to ask your firm as well.

JIM: Excellent, thank you for that. Lars, I would love to bring you into the conversation now to ask specifically, you know, it's impossible I suppose, to insulate ourselves entirely from shocks like this. But at the same time, we can take steps as investors to prepare for and then react to them. And that, I feel like that's with what I would love to hear from you about.

LARS: Yeah, absolutely Jim. It's very hard to know exactly what's going to happen from one day to the next. But it is moments like this that really highlight to me the benefits of just having a plan. That can be a lot of hard work, though, in initiating that plan. You know, just this alignment of your short-term, your medium-term, your long-term goals with just what might be the most appropriate mix of stocks, bonds, short term investments. And it can be really, really helpful in these moments, because it instills just this boost of confidence that you made, you know not—you just might not need to do anything drastic in terms of changes to investment positioning when moments like this arise.

Jim, to me, what it really, really highlights is the benefit of diversification and how it can be your friend. And maybe if I think about it a little differently, this diversification across stocks, bonds, short term investments can really just help manage your risk exposure so you don't have any one sector, industry, company, just area of the market, really have an undo impact on your overall risk and return, something that I would call concentration risk. So at Fidelity Strategic Advisors, we actually seek to minimize the impact of concentration risk across our clients' well diversified portfolios.

Now I will say that broad diversification doesn't always feel great. And as we all know, there are no promises when it comes to investments and just because you diversify doesn't mean that you necessarily profit or protects against risk. But there are short periods of time where diversification doesn't feel like it's helping you and I think about last year come to—really does come to mind. It was a year when stocks and bonds both fell. But over time, I just have this really, really strong belief that the benefits of diversification become more clear. And it really just helps you stay invested and stay on track to a future financial goal.

LEANNA: And I would just say too on our end again partnering with clients, we spent a lot of time last year talking about why diversification. And 2022 was a hard year on both the stock side and the bond side. And many investors were seeking and feeling a lot of instant gratification, if you will, with investing in cash or CDs or money markets. So when we partner with our client again, we want to take that longer term view with you and we're going to educate our investors around the roles and responsibilities of your wealth as part of that full plan. So to Lars' point, you have your short term goals, your intermediate, your long term goals; those may have different risk profiles, they may have different preferences to that. But we want to make sure that we have that investment strategy aligned to the goals that you have.

JIM: Lars, I want to follow up on a theme that I've heard from a couple of folks just so far today. This idea that money markets could benefit because of the rates moving, but what about bonds? What's your perspective on those going forward?

LARS: Yeah, and you know last year, Jim, of course, this is one of the sore spots for investors. And Jurrien was just talking about that, you had this dramatic rise of interest rates and bond prices and bond rates move inversely to each other. So as rates rose, bond prices fell. And it was all done for the Fed to try to quell inflation, like Jurrien said. But rates moving up really did weigh on bond prices yet but, in that environment, and in particular last year, the investment team at Strategic Advisors, we actually sought to raise the profile of high quality bonds across our clients' well diversified accounts. And really kind of buy into some of that what, I guess could be perceived as weakness.

And one of the reasons for that was our view that the higher rates would really help provide more cushion, or shock absorbers if you will, for diversified portfolios should stock volatility become more elevated at periods. And we're just seeing that play out over the last several days. There was this broad rally in high quality bond rates like US Treasuries, meaning bond prices have moved up. Now, I would caution that we saw some very, very big moves just in the last three or four days or so in the markets. And you just need to be careful as an investor not to extrapolate these very, very short term moves into something more broader, something more significant. I think you're even seeing a rates back up to a degree today.

But to me what it just generally means is that this—it's a reminder that the journey to a financial goal is a marathon and not a sprint. And that means that during that journey, there are various components of a portfolio, whether stocks, bonds, or something else; there are moments that you will have growth provided by those instruments, but then other moments where you will have some support. And again, aligning your investment plan and financial plan together can really just help you provide a little sense of confidence in that journey.

JIM: Yeah, great—

JURRIEN: And if I could add to what Lars said, you made a great point, Lars. And that is that at times like this one, when the news is moving so fast it's obviously very tempting to be glued to our screen as we all are. But the moves are just, you know historical. I mean just the moves in short rates like are rates that we haven't seen in many, many years. So it's important to kind of take a moving average view of what's happening and not extrapolate very short term movements. Because the markets are always repricing and pricing in what is known. And that's always just a snapshot in time and it's a moving target. And so everything can look totally different tomorrow than it did today, and today does look different from what it did last week. So taking the long view and not making those impulsive decisions based on what's happening on the tape right now, I think, is very important.

JIM: So let's actually do a bit of that, Jurrien. Let's look ahead towards tomorrow just a little bit. You're our go to person when we want to talk about the Federal Reserve's actions, or in this case reactions. I think, I mean as recently as a week ago, as recently probably as Wednesday or Thursday of last week, you know, we would have all been predicting that when the Fed meets again later this month, we would see another significant to moderate interest rate hike. How much, if at all, has that changed, do you think based on what happened over the past few days? Is the Fed going to start to pull back?

JURRIEN: Well, so that is the big question, right? So there are really three big questions right now. One has been, I think has been answered so question one was, is this becoming—is this going to become a systemic crisis? Like is this going to be a run on the banks like we saw in the early 1930s? And I think with the Fed's backstop, I think we can safely say—maybe not safely—but I think we can say that's unlikely to happen. The Fed have removed that left tail risk.

So that leaves two other questions. And one is that, you know that issue that I mentioned before where you have that asset liability mismatch because rates are rising and short rates have risen more than long rates. That banks, the financial industry as a whole, does have an issue with, you know, how much it costs for them to borrow and how much they make on their investments, either loans or bond portfolios. And one thing that's happened with the banks, and I don't mean to pick on the banks, and this always happens during rate cycles is that the rate that you earn on a bank deposit rises much slowers—more slowly than it does—than the Fed is actually raising rates.

But the bank rates have only been half a percent, right? So part of the reason that the banks are kind of in a bit of a bind here is, of course, the fact that their portfolio has lost money as rates rise, right, as Lars said, bond prices move inversely from bond yields. And the other is that depositors are like, well, you know I can get 5% on a T-bill, why am I paying you half a percent on the deposit? Why am I only getting a half percent on the deposit. And so I think the banks may have to start competing for deposits a little harder. And if that's the case, then what we call the NIM, or the net interest margin, might come down, which may mean that banks will become less profitable. Which if you extrapolate that into the economy might lead to banks' lending less money into the economy.

And when you see historically, when you've had recessions, they generally happen when there's what we call a credit crunch. Banks don't want to lend money anymore because they're more cautious. And so if we get kind of a small credit crunch in the economy, then that's a consequence of what we're seeing today that could affect sort of the macro, the actual economy. So maybe if we end up in a recession next year and we've talked about the recession risk over time here on the show, maybe that kind of credit crunch scenario starts to play a role.

So that would, of course, presumably weigh on the Fed's actions as to how much more it will raise rates, if at all. Right now, the markets are saying the Fed isn't going to raise rates anymore at all. And just a week ago, I mean just one week ago, Chair Powell was in front of Congress saying, "Hey, guys, you know we may raise rates more than you think." And we were starting to talk about 6% as the Fed's, you know, new target. And we've gone from that conversation to now saying the Fed is done and is going to be cutting rates before the end of year. But again, that's a snapshot in time, that what the markets are saying they will likely say something different tomorrow. So my sense is that the Fed is not done but what this whole episode describes is that the Fed may be done sooner than we all thought just a week ago. And that really comes down to the inflation story.

And if there's a real dilemma that comes out of this for policy, for monetary policy is that the Fed has this dual mandate, right, full employment/price stability. And the economy is at full employment, the economy is pretty strong but of course inflation, as we all know has been very stubborn. The CPI report today, again, still at 5.5% year over year change. But there's this third kind of unspoken mandate of financial conditions. And sometimes the Fed will pivot just to make sure that the financial markets are okay. And so what this episode suggests could happen is that the battle in the coming months will being less about employment versus inflation, the two mandates, and more about financial stability versus inflation. And if inflation stays stubborn but the financial system is getting a little shaky, then the Fed has a really difficult dilemma.

So I think this is an ongoing, evolving story. And what we see today may not be the same as what we see tomorrow. But that will be the tension, I think, that will play out. And maybe the Fed slows down the rate hikes and just kind of takes a wait and see attitude. Or maybe the Fed continues it while at the same time creating this backstop. Which is kind of confusing because is it tightening or is it easing? And these are the issues that the markets are grappling with right now.

JIM: I think you can anticipate questions on all of the above when we meet again next Tuesday for that episode of Market Sense. But before we leave this episode, Leanna, one last question for you, as if customers didn't have enough to worry about right now. Events like what happened over the past few days, if you're a cybercriminal, look like an opportunity. People looking to prey on or leverage the fears of investors who maybe they're more willing to pick up a phone number on their cell phone if it looks like it's coming from a bank or something like that. There's lots of potential scams out there. What, at a high level, would suggest people start to think about to protect themselves, especially right now?

LEANNA: There are, so it's called phishing. So a technique used by criminals to really trick victims into providing personal information to then be used for identity theft. So a lot of criminals will play into the current news headlines to then request you to click on a link, download attachment, or provide any personal information. So just be really suspicious of anyone asking for Social Security number, date of birth, obviously financial account numbers, PIN, emails, passwords. I just say word of caution, we're getting, you know, as providers are sending out emails and trying to communicate with their clients, these are the times that criminals will try to prey on that and use links to get you to click.

JIM: All right, so be extra vigilant about that; a great reminder. I want to thank all three of you, Leanna, Lars, and Jurrien, for taking time to be with us today. Really, really appreciate it.

LEANNA: Thank you.

JIM: Absolutely, great time also to remind our audience that Fidelity has a weekly newsletter, it's called Viewpoints. Where you can get access to even more expert insights about markets and money and current events and investing. To sign up to receive that newsletter, you can scan the QR code that you see on your screen right now or you can simply type in the URL that you see there as well just under the QR code. And as always, if you've got questions about updating a financial plan, maybe starting with one fresh right now, keeping an old one on track, whatever the case may be, Fidelity is here to help. You can give us a call, ask your questions that way. You can visit our website at Fidelity.com, download's Fidelity's app on your mobile device, use that as a way to learn more. Lots of ways to continue to get your questions answered as you need them. Thank you again for watching this week. And we hope to see you back here next week.

[1]Staff Reporter. "Two US banks collapse: Biggest bank demises since 2008 financial crisis". MSN.com. March 13, 2023.

[2]"Are my deposit accounts insured by the FDIC". FDIC.com

[3]The Cash Balance in the Fidelity Cash Management Account is swept into an FDIC-Insured interest-bearing account at one or more program banks and, under certain circumstances, a Money Market mutual fund (the "Money Market Overflow"). The deposits swept into the program bank(s) are eligible for FDIC Insurance, subject to FDIC insurance coverage limits. Balances that are swept to the Money Market Overflow are not eligible for FDIC insurance but are eligible for SIPC coverage under SIPC rules. At a minimum, there are five banks available to accept these deposits, providing for up to $1,250,000 of FDIC insurance. If the number of available banks changes, or you elect not to use, and/or have existing assets at, one or more of the available banks, the actual amount could be higher or lower. All assets of the account holder at the depository institution will generally be counted toward the aggregate limit. For more information on FDIC insurance coverage, please visit www.FDIC.gov. Customers are responsible for monitoring their total assets at each of the Program Banks to determine the extent of available FDIC insurance coverage in accordance with FDIC rules. The deposits at [Program Banks](https://accountopening.fidelity.com/ftgw/aong/aongapp/fdicBankList?type=fcma) are not covered by SIPC. For additional information please see the [Fidelity Cash Management Account FDIC Disclosure Document (PDF)](https://www.fidelity.com/bin-public/060_www_fidelity_com/documents/PDF_Fidelity_Cash_Management_Account_FDIC_Disclosure_document_

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