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TRANSCRIPT

SPEAKERS:

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HEATHER HEGEDUS: Hello there, everybody. Thank you so much for making the time today to join us for *Market Sense*. I'm Heather Hegedus with Fidelity. So the S&P dipped into correction territory last week, but it subsequently actually had the best day since the election as investors seemingly continue to process the impact of changing trade policy. And there were also some negative readings on consumer and business sentiment and other economic indicators that investors may have been digesting as well.

So it's not just investors, though, who felt the impact of all of this, of course. The Fed is meeting right now as we speak. Chair Powell pretty likely to face questions tomorrow as to whether the Fed should be doing more to support the economy during this time. So while the economy this year really did start off on pretty strong footing, uncertainty seems to be the main theme right now that reigns supreme.

So to talk about this and all of the big financial headlines of the past week, we are so fortunate to be joined, as we often are, by my friend and colleague Jurrien Timmer. Of course, he's Fidelity's Director of Global Macro here. We're also excited today to be joined by Julian Potenza, who is a Portfolio Manager here at fidelity in the fixed income division. He's here to talk about the bond outlook today.

And this is especially topical, of course, as investors may be looking for some less risky avenues during times of market volatility. Of course, traditionally bonds have that role of being the port in the storm, and they've been holding up overall so far this year against that market volatility. So Julian is going to help us understand bonds themselves and some of the strategies for using these investment products. Thank you both of you for joining us today. Jurrien and Julian is going to confuse me, but Julian, we're delighted to have you here today.

JULIAN POTENZA: Thanks, Heather. I'm very happy to be here.

JURRIEN TIMMER: Nice to see both of you. Julian, welcome to the show.

JULIAN: Thank you.

HEATHER: And with that, today is Tuesday, March 18th. So we continue to watch the S&P closely right now Jurrien. It officially closed in correction territory, as I mentioned, on Thursday. Then we saw the market buying the dip after that. I haven't talked to you since the initial sell off two weeks ago. That was the last time I was on the show. I wasn't on last week.

And things have been changing so quickly anyway, so I thought this would be a good time to check in with you on where things stand right now, and whether your views have changed at all since I last talked to you. How do we know if that was just a temporary correction? Or could we be entering a full blown bear market now?

JURRIEN: Well, that is the question. And of course, it's a question that we don't have an answer to in real time. But just to unpack the last few weeks, so the S&P as of last Thursday was down 10% from its high. The magnificent seven, those big mega-cap tech stocks, were actually down 22% from their high. And the Russell 2000, which is an index of small stocks, was down 20% from its high. So a little bit of an unusual juxtaposition where the S&P was down 10 and the bookends, small stocks and really big stocks, were down 20.

But again, we have to look at this sort of from a detached level as market historians. And this is the third 10% drawdown that we've had since the current bull market began in 2022. The first one was in October of 2023, when bond yields, Julian's forte, briefly rose to 5%. That put a wobble in the stock market.

And then we had another one last summer when the so-called yen carry trade, where investors borrow in very low yielding currencies like the Japanese yen, and then invest in other markets. So that trade was unwound, and it was clear that a lot of that unwinding took place in those magnificent seven stocks. So the market was down briefly for 10%. Most people have probably already forgotten that.

But so corrections do happen. They happen relatively often. Historically, the odds of a 10% correction are about 40%. And remember, the market goes up over the long term 60%, 70% of the time. But that means it goes down 30% to 40% of the time. And therefore, doing the right thing when the markets are not sort of giving us what we want or need is a very important part of the investment process. And so we need to just kind of keep our emotions at bay.

And so the way I think of it is that investing in the stock market gives you really good returns over the long term, 10, 11%, about 7% after inflation. But the price of admission for those returns is that you need to weather the occasional drawdowns. And those who can do that and are in a diversified, well-balanced portfolio will reap the benefits of that. And those who get emotional and sell do not, because then they have to time the market in both directions, and that usually does not work.

So here we are down 10%, at least as of last Thursday. A repricing, if you will, of the market following the election. Of course, the thought was, OK, animal spirits are going to return to the economy. We're going to have deregulation. Tax cuts will be extended. All good stuff for the markets. And yeah, there's the tariff thing, but let's keep our fingers crossed that that's a negotiating ploy and nothing more. And the market really positioned itself for that outcome.

And whenever positioning is at one extreme or another, you run the risk that if the narrative changes, which of course it has because of the tariffs, also because of the cuts in government spending, that all of a sudden everyone goes from one side of the ship to the other. And that's kind of what we're doing. So the market is now pricing in not the certainty of a recession. We don't know if a recession is going to happen. But it's less confident than it was before that it won't happen. And so that just means that markets need to reprice, and that's what they're doing. And it's just part of the sausage making in the markets. And we just have to accept that that goes on.

HEATHER: OK, so we got to leave the emotions out of it. A little bit of repricing happening here. And as I mentioned, some investors have been buying the dip? What have you seen has been working during this volatile period, Jurrien? Is there any bright spot here, any parts of the stock market that have actually been holding up fairly well, or is basically everything going down right now?

JURRIEN: No, so it's been a much more balanced period now. And that's a welcome change from what we had in 2022. And of course, Julian and I are going to talk about that as well. But in 2022, bonds were the center of the storm, if you will, the reset in interest rates. And basically, there was no place to hide other than in cash, basically, which went from 0% to 5%.

This time around, foreign stocks have actually done well. So European stocks are up 8% year to date. Emerging market stocks are up 3%, while the S&P is down 4% year to date. Gold is at a new high. Bonds, as Julian will unpack, have done pretty well here. And so this actually has been an OK period if you really are in a diversified portfolio. And that's the way it should be. It wasn't that way in 2022, but that was somewhat of an outlier. So it's good to see that some things are working.

HEATHER: OK, so let's talk about bonds right now. Thanks for that segue, Jurrien. Because US bonds, like treasuries, are one part of the market that's actually up right now so far this year. Julian, I wanted you to be here for this discussion today because so many of our *Market Sense* audience members may be reevaluating their investments right now. And bonds are getting more attention as investors look to potentially add some more stability to their portfolios.

I think it's important to understand the context. Jurrien kind of touched on this, but bonds have had a few challenging years up until now. So I'd love for you to, first of all, set the stage for us right now. What is the situation with the bond market right now, Julian? Would you say that bonds are finally back right now?

JULIAN: Thanks, Heather. You're right. Bonds have had a pretty decent year. The broad bond market benchmarks that I looked at have returned a little bit over 2% through the first half of March while stocks are down and cash has returned a little bit under 1% over the same period.

Now, if you think about what drives bond returns for diversified bond funds for the broader bond market, it's really duration. So that's changes in interest rates like treasury yields and then credit spreads. That's that extra compensation that you receive in yield on top of treasuries when you own riskier bonds. When rates fall, that's good for bond returns. And similarly, when credit spreads tighten, when they fall, that's also good.

So just starting with this year so far, we've seen treasury rates fall 10 year yield down about 30 basis points on the year. Jurrien covered it. The market is sort of reacting to the more uncertain economic policymaking environment and also to what's been going on in the stock market. So that fall in treasury yield has been good for bond returns.

Now, on the other hand, we have seen credit spreads widen modestly. Call it 10 to 15 basis points wider for investment grade corporate bonds. That's not so great for bonds directionally, but thus far it's been pretty modest. What we're seeing here is credit markets in general appear to be outperforming what's going on in the equity market.

So you kind of put those two together, the fallen treasury yields has been dominating what's going on in credit spreads. Bonds have put in pretty decent returns relative to what's going on in other markets. Kind of feels like they're back.

JURRIEN: I just wanted to follow up what Julian said, because I started my career as a bond person, and many people watching may not appreciate how closely intertwined the bond market and the stock market are. But Julian mentioned credit spreads, which speaks to the balance sheet of corporate America, whereas the S&P 500 might speak more about the income statement of corporate America.

And oftentimes, if there really is distress happening in the economy that the stock market would react to, it starts with credit spreads. Because the bond people always get it first. And so the fact that credit spreads are only up very modestly here is one possible signal that the correction in the stock market, it really is just a repricing and not a preparation for a recession.

HEATHER: OK. Great to have that perspective here, since that's where you started your career, and that's reassuring to hear. So as I mentioned before, traditionally bonds are seen as this port in the storm during times of market volatility. Although for the past few years, bonds did not provide as much protection as they traditionally do. A lot has changed, though, since the beginning of the year already. Do you think, Julian, that bonds are back to their traditional portfolio role now? Can we say that? Can they offer that protection from market volatility that investors may be seeking right now?

JULIAN: Right. Another great question. And I know you've discussed on the show this idea of the positive correlation that we've sometimes experienced between stocks and bonds in some recent periods. So that's when stock prices and bond prices are either going up or going down together. Bonds not providing a ton of diversification benefits in those scenarios.

As a general principle, I would say my opinion is that while there's no guarantee that bonds will protect your portfolio in every instance of market volatility that you can envision, I am a big believer that when you really need it, so when those really steep, ugly equity corrections and those periods of truly lasting economic volatility, like a recession, bonds have a very good chance of providing some very welcome ballast to a portfolio.

And fundamentally, the core driver of that relationship is this connective tissue that sort of exists between the economy, the Fed, and the bond market. When the economy turns down the Fed, if they have room, they tend to cut policy interest rates, and that tends to be a really good thing for the bond market.

Now, that point I just made, if they have room, that's pretty key. Another way to say that is that the starting point in terms of where you are is yields really matters. Jurrien covered 2022 very well. I like the way he put it. Awful year for the bond market. But you got to remember that in 2021, yields were incredibly low after the Fed had cut rates to 0 in response to COVID. The Fed really was the cause of the volatility in 2022. And so in those circumstances, of course, bonds are not going to be a great hedge for the portfolio.

The main point I want to make here is that's very different from the current situation. It is true that the Fed did cut rates by 100 basis points last year. But if you look across the yield curve, rates are still fairly high by the standards of recent history, between 4% and 5% in nominal terms. They've fallen a bit recently. But if you zoom out, that's in the highest range that we've been in since prior to the global financial crisis in 2008.

And I think obviously that's good for the incoming generation potential of bonds. Higher yields means more income. But it also means that they have much better odds of providing welcome diversification to a portfolio, because they have room to fall if things get ugly.

HEATHER: So helpful to hear your perspective. I know you're a bond person, but that you feel that when you really, really need that protection, bonds are there for you. And you just mentioned the Fed. And the Fed's meeting as we speak. So although they're broadly expected to hold rates steady right now, Julian, with all the uncertainty lately, it does seem it's getting harder and harder to predict what the Fed might do. And it seems like it may be a moving target a little bit too. How are fixed income fund managers navigating policy now under this economic landscape that we find ourselves in?

JULIAN: Yeah, a topic that's near and dear to my heart. I was our Fed analyst for many years before becoming a portfolio manager, so I'm always up for a good Fed discussion. Seems quite unlikely that the Fed is going to announce any major policy changes this week. They will be releasing some updated economic projections, so the markets will be looking closely at those for any clues to how the Fed is thinking about the economy.

But big picture, it seems like the fed is on hold here for the near term, and that's actually a pretty big change. The fed has been so dominant in the markets over the past couple of years, the hiking cycle, then the transition into easing last year. I think we've kind of entered a different part of the cycle. The Fed's always going to be important, but maybe a little bit less dominant in the near term. I mean, one reason rates have come down 100 BPs from their peak, inflation closer to target. Not all the way back there, but closer.

The economy pretty stable for now, but the outlook is a little more uncertain. I think the Fed really feels like they can kind of pause here and wait and see how the economic data come in. And then, of course, there's the new administration, obviously a wide range of policy options that have been discussed, some of them fairly aggressive. That creates a lot of uncertainty for the Fed as they think about the economic outlook. And so I think they just as soon kind of sit here, hold rates where we are, and wait and see what we actually get in terms of policy.

Now, as far as what I'm thinking about the Fed outlook, I tend to think in terms of broad distributions of outcomes. I think most likely the Fed's hold rates here in the near term. But the one thing that jumps out at me is that the hurdle for them to go back to hiking seems to be very, very high. Anything can happen, of course. Lots of policy uncertainty.

But even if you think about tariffs, they have some potential to raise inflation in the near term. They also seem to be bad for growth. So those forces kind of offsets. Bottom line, I think the base case is the Fed is on hold. But the odds of them cutting look a lot higher to me than the odds of them going back to hiking.

HEATHER: OK. Yeah. And the storyline, like you said, has changed a little bit for investors. And on our show, you'll notice we're talking for months and months about the Fed only. And there's a lot of other things to watch now for sure. And we'll see what happens tomorrow when the Fed does speak tomorrow after their two day meeting. But are there any other factors independent of the Fed, Julian, that you're watching right now that could impact the bond market directly that we might want to be aware of or bond investors might want to be aware of?

JULIAN: Yeah, some of the other policy changes being discussed with the administration are of interest to the bond market. There's a question of the deficit. If we get tax cuts, what does that mean for treasury supply, which is already elevated? The treasury secretary has talked about a desire to term out our debt, to issue more long term debt. That can have implications for the yield curve. And then, of course, there's trade policy, which has been kind of the core focus of the markets lately.

It's interesting. Jurrien touched on this. Right after the election, it seemed like the markets were mostly focused on some of the policies that could be good for growth, raise inflation, raise bond yields. I always thought that the distribution of what we might get was maybe a little bit more balanced than that. And I think the market has been coming around to that view. I think that's part of why we've seen interest rates come down this year.

But again, zooming out, rates above 4% across the curve. The Fed is on hold with the policy rate a little bit above four. More likely to cut than they are to hike. I come back to thinking the level of yields overall looks pretty attractive here.

HEATHER: Another question for you because we read our customers and our viewer, audience, and listener emails every single week, and we know that a lot of our customers right now are sort of feeling better keeping some money in cash right now. Can you talk a little bit to those people, speak directly to them? How can bonds help when there's stock market volatility? Are there other avenues than cash? And where do bonds come in?

JULIAN: Yeah, absolutely. Great question. Money market funds have been very popular in recent years with the yield curve inverted. That's made all the sense in the world. They still probably make sense for many investors. I'll just make a few quick points.

With 100 BPs of cuts that we saw last year, we have seen the yield curve re-steepen somewhat. So yield actually increase as you move out the curve. What a concept. Money market funds, they're a great store of value, but they don't have that same potential for capital appreciation like bonds when interest rates fall.

And again, that tends to happen if the economy turns down. Moreover, money market yields will fall pretty quickly if the Fed goes back to cutting. By moving into bonds, investors can lock in some of that yield. I think the bottom line is the evolving yield curve environment makes the diversification benefits of bonds a little bit more interesting relative to cash, because you don't have to sacrifice yield to take on duration risk like you did when the curve was inverted.

HEATHER: Any caution that we should mention to investors today, Julian? Any potential risks that bond investors need to be aware of?

JULIAN: Yeah, yeah. Always important to talk about risk. And I go right back to where I started. Core risk factors in the bond market are always duration and credit risk. So duration I sort of mentioned. I think the Fed's on hold, more likely to cut than to hike. That means short dated treasury yields should stay under control. But some of those fiscal policy dynamics I talked about, the deficit, where they issue along the curve, those do have the potential to impact long term treasury yields. If we were to see the curve steepen aggressively, you could see longer duration products underperform.

I think for investors concerned about interest rate risk, short duration bond funds could make a lot of sense. Yields are comparable to longer products, with the curve still pretty flat, but they have much lower price sensitivity to change in interest rates. And if you look at the historical data, short duration bond funds actually have a pretty good track record in terms of delivering competitive returns versus longer products but with lower return volatility. And then I'll just make a—

HEATHER: Oh, go ahead, go ahead.

JULIAN: I was just going to make a very quick question point on credit risk. I mentioned spreads have widened. They're still pretty tight. That's kind of like the credit market's version of having a high PE ratio. Credit is pretty expensive. There's definitely still quality credits out there in the market. But if you think about the riskier segments of the bond market like high yield, I would say in this point in the cycle, in my opinion, your exposure should maybe be on the lower end through the cycle range.

HEATHER: You're doing a great job packing it all. There's so much to unpack here and we can't squeeze it all in. But just real quick final question for you, because we know that a lot of our audience are DIY investors. So any guidance for DIY investors trying to navigate purchasing individual bonds on their own?

JULIAN: Yeah, another great question. The bond market is a complex place. There's lots of nooks and crannies that can make it a little challenging for an individual. Getting good execution on smaller trades can also be tough. I will say that those complexities, those potential inefficiencies, do also make it very fertile ground for professional investors hunting for alpha.

I will say the ladder. It's kind of a tried and true concept for individual investors. You space out your maturities. You try to have the duration of your ladder roughly the same as your investing time horizon. Beyond a risk free treasury ladder, or maybe a ladder of tax efficient, high quality muni bonds, I would argue that many investors may be better served using an actively managed bond fund.

At a place like Fidelity, we have deeply experienced research and trading teams that really help us hunt through the bond market, looking for attractively priced securities for our shareholders. I'll leave it there.

HEATHER: OK, thank you so much, Julian. You're such a wealth of information. It's where an advisor might be helpful too. Jurrien, just quickly, we have time for Timmer's Take. What are you watching this week besides the Fed?

JURRIEN: Obviously the Fed. I mean, there are so many headlines. And managing the noise to signal ratio is a full time job these days. We're still a month from earnings season. So there is kind of a quiet phase there. But certainly, we would be on the lookout for credit spreads, how they behave, and maybe if companies are guiding earnings estimates lower or higher. We're looking for real time clues about whether the economy is actually slowing the way the market seems to be expecting.

HEATHER: All right. We've got to leave it at that. And thank you so much to both of you for offering great perspective on a topic that, admittedly, can be a little bit harder to wrap your head around than equities. It's just not quite as simple.

And if you would like to further your education on this topic knowing that, we want to leave you with a resource today. You can hover over your QR code on your screen right there, and we'll be taking you to our fixed income page. Or if you're listening to us as a podcast, write this down. Fidelity.com/bondsearch. So you can start your own bond research there and further your education.

Before we go, I just want to say happy belated birthday to my dad. Jurrien, I know you talk about your parents on the show a lot, so thank you for indulging me for a minute to say to my dad how much I love him. He is the reason that I got into financial services and wanted to educate people about this, because he was my educator and the person I look up to and admire. And watching him put his customers first has helped me take that on as my career and my mission too. So love you dad.

Thanks so much, Jurrien and Julian. I made it through without confusing your names or making a Julian Jurrien combination there. Have a great week, everybody. We'll see you back here next week. Remember, we're on every Tuesday at 2:00 Eastern.

[1]Fidelity Viewpoints, March 13, 2025: https://www.fidelity.com/learning- center/trading-investing/volatility-2025

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