

Fidelity Viewpoints®: Market Sense

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TRANSCRIPT

SPEAKERS:

Jim Armstrong Jurrien Timmer Ashley Tran

Jim Armstrong: Might there be a light at the end of the tunnel that was 2022? We're starting to see some signs that inflation may, in fact, be easing, and in terms of housing costs, at least, especially for renters, we're starting to approach pre-pandemic levels. At the same time, however, we've got the Fed meeting again this week. Though we are expecting another rate hike, it likely won't be as big as the ones we've seen recently. Hello there, welcome to Market Sense, thanks for joining us. I'm Jim Armstrong with Fidelity. To help us get a handle on what's happening in our economy big picture, we've got Jurrien Timmer with us today, he's Fidelity's Director of Global Macro and he's got insights as always into what's making financial headlines and what's behind those headlines.

And to get some insight into some of the top reasons why your portfolio might be underperforming these days, we are excited to have Ashley Tran with us again today. She's a Florida based branch leader; she's going to offer some insight on some important things you might be overlooking when it comes to your portfolio's performance. Thank you both for being here and Ashley, welcome back to the show.

Ashley Tran: Thanks, Jim, happy to be here.

Jurrien Timmer: Yeah, nice to see you. Welcome back, Ashley.

JIM: Jurrien, let's get started with you if we can. It is Tuesday the 13th of December. You know, I guess we'll just start with what's making news this week. It's the Federal Reserve's meeting again. How significant do you think what's happening right now could be to the markets?



JURRIEN: Well, it's a—not to overstate it but it's very, very significant. And this week, we're getting the one two punch of the inflation report which we've got this morning and that turned out to be a pretty good report. And then, of course, today, and tomorrow, the Fed is meeting and this is, you know, the Fed meets almost every month but, every quarter including December, is the big two-day meeting where the Fed updates its so-called summary of economic projections. It puts out a new, what we call dot plot which is a chart that shows dots representing each FOMC member's expectation of where rates will be at the end of this year, next year, the year after, and over the long-term. And so, obviously the Fed has been the big story this year because it is trying to tame inflation which, of course, has been a massive problem for everyone and which has caused, you know a very big downturn in the markets both on the bond side and the stocks side. And assuming that the numbers right now hold through the end of the year, 2022 will have the dubious distinction of being a year where both bonds and stocks have declined double digits at the same time and that almost never happens.

So, the Fed is at the center of the storm, well inflation is, but the Fed is trying to, you know slay that inflation dragon. And so the question is, how far will the Fed take rates? That's one question. And then the second question, which I think will become the more important one going forward, is how long will the Fed stay up there, right? So, it's not so much a question anymore of will the Fed go to four or five or six. I think we have a sense that the Fed will go to five or maybe just below it because inflation, at least on a rate of change basis, has peaked. In June, the CPI was at nine. Today, if I'm looking at it, it's around seven. So, still very bad, but, at least not quite as bad as it was six months ago.

So, I think from here on, the question is really if a neutral policy, right, if a neutral Fed was let's say a 3% rate and the Fed is going to be at five in the first or second quarter of 2023, the real question for the market is how long will it stay there and at what point will it go back to neutral and what would cause it to go back to neutral? Will it be just inflation going away or will it be a recession that will force the Fed's hand and cut rates again? So, those are the things that are in play, not just for this meeting coming up, you know today and tomorrow but for future meetings, really, all throughout 2023. So, we're not done talking about the Fed after today, I can promise you that.

JIM: I had a sense for that being the case Jurrien. Thank you for that. Great segue though to Ashley's first question here, before we get to a follow up for you as well, Jurrien. I know that, Ashley, folks are coming in talking to you and members of your team through the lens of everything Jurrien just set up, right? This almost unprecedented volatility, people are watching their own portfolios underperform. What are some things that cause that to happen other than the fact that we're all generally sailing into really rough waters together?

ASHLEY: Yeah, it has certainly felt a bit of a roller coaster but I think what a lot of investors don't realize is they may be making that roller coaster a little rockier than it needs to be. I think there are three main reasons—or three main things that we do that contribute to our portfolios underperforming. The first one is going to be holding more cash than you need. And don't get me

wrong, holding some cash or short-term investments to account for things like emergencies and short-term needs is often necessary but when you move an excess amount of your portfolio into cash, you're missing out on the potential for long-term growth and missing out on the few best days of the market can be very costly. You can recoup the downward loss but you can't really make up for the missed upside. And you also have to think about inflation, the longer you sit in cash the more the purchasing power of those dollars erodes. So that's one. Two is having too much invested in a single stock. Some investors may have a large portion of their portfolio tied up in a single stock and sometimes that's by design.

For example, maybe they received company stock as compensation from their employer or they just have a sentimental attachment to a certain company and they keep a high concentration there. But keep in mind, if you concentrate in a single stock position, that comes with three times the volatility as a diversified index potentially exposing you to a more significant risk. And then third is not accounting for taxes. Taxes isn't something we often think about when we invest but on average, taxes can reduce portfolio returns by 2% when we don't consider them. There are some techniques that we can take advantage of, like tax smart asset location. For example, making sure you're placing particular investments in a type of account most appropriate for it like placing a dividend or income generating investment in a tax deferred or tax-exempt account. And also, techniques like tax loss harvesting. This is where you realize losses to offset the tax impact of your gains.

JIM: Got it. Thank you for that. You mentioned—oh, sorry go ahead.

JURRIEN: No, I was just going to add to the point Ashley made, mentioned about cash. It's so tempting, right, in a year like this year. You know like last year cash was at zero so it wasn't quite as tempting if the market had gone down in that environment, but this year, with cash being over 4% it's tempting. But it's worth remembering when you go from long-term investments to cash, you're basically market timing and that's a really, really tricky thing to do. And you know, a year from now, cash may be from four back to three, while the stock market goes up. And when you're in it for the long run, you have to compound those returns year after year, not just one year. And so, it's tricky because it's so tempting but it's also wrought with risks.

JIM: Yeah, that perspective is so useful. Thank you for that. I did want to ask you a question, Jurrien, based on something Ashley had just said. She mentioned the performance of, for example, the diversified index. And I think we talk a lot about relative performance, right? How your portfolio, how my portfolio is doing, versus an index. But again, as you mentioned in a year when stocks are down double digits, I think a common question for people is, when are things going to get better? With inflation starting to come down, is it possible the market is turning the corner? I know I embedded about four questions in there for you.

JURRIEN: Well, there's a couple questions. One is, you know has the stock market bottomed? And will a new bull market—has a new bull market begun? And I think the, kind of related

questions is, you know the 60/40, right? The stocks and bonds this year have both posted declines, which is fairly rare. And will 2023 be a year where at least one of them starts to work? So, first answer first, you know the reset in terms of valuation, right, from a high PE to a much more reasonable PE or price to earnings ratio, that has happened. And that same thing has happened to the bond market. If you think about it, when you value an asset, whether it's a piece of real estate or stock portfolio, you're calculating the present value of future earnings and you're doing that by using an interest rate. When the Fed is moving that interest rates way, way up as it has done this year, the present value goes down, which means that the fair value price to earnings ratio goes down.

And that's exactly what happened this year. We were at 23 times earnings at the beginning of the year. We were at 15 times in October. We're at about 17 and a half times now. So, I feel pretty good that at least that part of this reset is behind us. But the question then looms about, will we have a recession next year? When would it start? How long would it last? How deep would it be if there is one? And what does that do to corporate earnings, right, because earnings is also a driver for returns, not just evaluation. So, we may not be out of the woods yet, by which I don't mean that we're going to have a whole other down leg for this bear market but I think we'll need to be patient in waiting for the fundamentals to start improving and part of that will be about, you know how far the Fed pushes it and then how long it will stay up there. But one thing I think is starting to look more promising is that even if that 60 side of that 60/40 requires more patience. Meaning maybe a choppy next year instead of an up year, my sense is that the bond market now that is has a lot more value, will maybe start to perform the way it should be doing by being a port in the storm if there is indeed a storm.

JIM: Got it. Ashley, I wanted to return back to you talking about ports in storms a little bit here. You mentioned the idea of perhaps holding too much of one's portfolio in cash, with interest rates on the rise as Jurrien was just describing there. What are some alternatives that people might want to consider other than pure cash?

ASHLEY: Yeah, certificates of deposit or CDs as we commonly know them, can play an important part—or an important role in the portfolio. With the interest environment that we've been experiencing, we're actually seeing that CDs may offer higher yields than many higher risk investments. We'll do a quick overview on CDs if you're not familiar with them. CDs pay a fixed rate of interest over a predefined term, and can be a way to lock in a certain rate of return. CDs are a savings products issued by banks and the interest rates the banks pay on those CDs are influenced by the interest rates that we're seeing being set by the Federal Reserve among a few other factors. And with the Fed raising rates as it has been doing to help fight inflation, newly issued CDs may actually be paying more now than similar old ones issued by the same bank.

And you may have heard of the term a brokered CD, and thought what is a brokered CD? How is it different? All that means is that the bank has issued out CDs to brokerage firms in large denominations and then the brokerage firms divides them up into smaller denominations and

offers the market to sell them to customers. Since these CDs are still obligations of the bank, not the brokerage firm, we still have FDIC insurance that still applies. And since brokerage CDs have a secondary market to trade on, they're generally a little more liquid than bank CDs. So with the CD you experience little tradeoff between risk and reward, as long as you're okay with the fact that you're giving up easy access to the cash in return for the some income.

JIM: Right, absolutely. I wanted to also ask you a little bit of a follow up on that idea about being overconcentrated in a single stock. A few years ago, I was talking to a Fidelity customer who proudly was telling me in the group that we're in that he was in—his retirement fund 100% is company stock. But it was to your exact point, he felt such a sense of pride in that company. He said this company has supported me for my working life. I'm repaying that. My gratitude is holding 100% of my retirement in their stock. But the numbers you shared a moment ago make that feel a little bit more harrowing.

ASHLEY: Yeah, absolutely. Like I said, there can be a sentimental value tied to it. We have to find a balance between emotional and intellectual decisions when it comes to investing. So if we're thinking about what we can do to not be overly concentrated in a single stock, it makes me think about index funds. So, in contrast to a single stock, an index fund is going to be like a basket of funds and there are two basic types of indexes. Indexes that track the overall market, such as the S&P 500 and indexes which will track a more targeted subset of the overall market such as small cap growth stocks or large cap value stocks. There are also indexes on things like bonds, commodities, and currencies. The objectives of an index-based ETF are to earn the return of the market, or the subset of the market that it aims to replicate, less the fees. They are stable baskets of stocks, bonds, commodities, or other assets whose overall price level, risk, and return are used in standard measurements worldwide.

Indexes represent the universe of opportunities that investors have to choose from in the weightings that are actually available in the marketplace. In an equity index, the securities are generally passively selective and capitalization is weighted. So for the individual investor, they may do best by investing in low cost market indices and adjusting their allocation between stocks, bonds, and other assets in accordance with their age and changing risk/reward profiles.

JIM: Got it and the final, potential underperformance factor you noted off the top of the show was really maybe not paying enough attention to taxes. I think you said it can cost up to 2% ultimately if you're not really accounting for taxes. So maybe talk a minute or two if you could about tax loss harvesting, what it is, and how people might consider using it if they're not familiar?

ASHLEY: Yeah, definitely, taxes are a big deal when it comes to investing. And when I think of tax considerations, I think of, what can I do to keep more of what I've earned? We see our performance but we forget what comes off the top of them. So with tax loss harvesting, that can provide a lot of value to a portfolio, especially through times of market volatility like we're experiencing by generating capital losses that can offset future taxes on potential gains and

income. So, typically when we think loss, it has a negative connotation, we think bad. But investment losses can be used in two helpful ways. The first, the losses can be used to offset investment gain. And then the second, if you have more capital losses than gains, you may be able to use up to \$3,000 of that a year to offset ordinary income on federal income taxes and you can carry over the rest to future years indefinitely, which is a great benefit.

Now, there are two types of gains and losses, and that's short-term, and long-term. Short-term capital gains and losses are those realized from the sales of investments that you have owned a year or less. The gain or loss from anything held longer than that would be classified as long-term. And the key difference besides one year plus, between those two is going to be the rate at which those are taxed, which is very important. The short-term capital gains are taxed at your marginal tax rate as ordinary income and the top marginal federal tax rate on ordinary income is 37%. And for those who are subject to net investment income tax, the effective rate can be as high as 40.8%. And then, of course, add your state and local income taxes, those rates can be even higher.

But, when it comes to long-term capital gains, the capital gains tax rate applies, and that is significantly lower. So, when you're looking for tax loss selling candidates, take a look at your portfolio and consider investments that no longer fit in your strategy, have poor prospects for future growth, or can be easily replaced by other investments that will fill a similar role in the portfolio. And when you're looking for tax losses, focusing on short term losses provides the greatest benefit because those are the first used to offset short-term gains. And remember, those short-term gains are taxed as a higher rate. And as you think about offsetting your taxes, it's important to remember that short-term and long-term losses must be used first to offset gains of the same type, but if your losses of one style exceed your gains of the same type, you can actually apply the excess to the other.

JIM: Super valuable and quite a lot of information, reminding me that it's always good for us to remind the audience that you want to check with your accountant, your CPA, your tax professional to make sure that you're understanding everything and making the best choices for yourself. But, thank you for that recap nevertheless. But, Jurrien, it strikes me that as Ashley was talking there, we're talking about all of the different potential levers that an investor can pull to make sure their portfolios are working hard for them. But at the same time, what you're invested in is also a big driver of returns and I know that you've been writing a bit lately about how we could be at a moment when market leadership is changing. So, maybe just start off by explaining what you mean by that and what it could mean to us as investors?

JURRIEN: Sure, I mean not to throw more acronyms at everyone but there's what we call the Beta which is the market performance, like the index performance, S&P 500, whatever, NSDAQ, DOW Jones. And then there is what we call the Alpha, which is the relative performance which is of course what we're discussing today, relative to that index. And one of the things we've had in the market for the last almost decade is a fairly concentrated leadership of the very large cap growth companies. So, think about the FANG stocks, if you will. And this chart shows the relative

performance of those largest 50 companies against the next 450 in the S&P 500. And you can see that generally speaking over the very long-term, and this chart goes back about 60 years, the market is fairly broad. Meaning that smaller and mid cap companies outperform the really big mega cap companies.

But that there are these periods, like what we've had over the past ten years and what we saw in the 1990s, also, in the early 70s, called the NIFTY 50 era where the leadership in the market is concentrated in just a handful of stocks. And so, for the last ten years, of course, that produced a very big bull market. And of course, that bull market went in reverse this year as those stocks went into reverse as well. And so, it's hard to conclude from this chart what exactly will happen, but my guess is, my sense is, that 2023 may be a choppy year for the overall market. I don't think the S&P will necessarily go very far as we wait for kind of this recession story to unfold. But underneath the surface, there might be quite a bit of Alpha there to be had. And so, if their leadership transitions from the mega caps to everything else, then think about the opportunities for a much broader, more actively managed portfolio that has value stocks and small caps and maybe non-US stocks, emerging markets, internationally developed stocks.

So, my sense is that 2023, even though it might be a frustrating year for the overall market, actually holds some promise that a broadly diversified portfolio, not only of stocks and bonds, but also within the stock market of lots of different sectors and styles, may actually deliver that relative performance that we're talking about today.

JIM: Excellent, really great perspective there. We'll confirm those hypotheses as 2023 progresses but thank you for helping us get a sense of what might be to come right now. For our viewers, maybe a more immediate term concern is Tuesday, January 10th. We'd love if you could mark your calendars for that date, it's a few weeks away. On the 10th of January we're going to be doing a longer Market Sense episode, around 45 minutes compared to our normal 20 minutes or so. And what we'll be doing is presenting a 2023 investing outlook. So we'll have Jurrien on, of course along with three other Fidelity colleagues of ours to discuss the markets and investing, everything coming up through 2023. It will be a great conversation and we're also going to be giving you in a little bit of time here—a while—a chance rather, to submit your own questions for that group to answer. So, stay tuned for more details on that. But, in the immediate term, just get prepped for the 10th of January for an extra special episode of Market Sense I suppose.

As always in the meantime, if you've got questions about making a financial plan or perhaps about staying on track with the plan you've got, Fidelity can help. You can give us a call, go online, visit our website, download our app, lots of ways to continue to learn more. And hopefully get answers to your questions. Again, a huge thanks to Fidelity's Jurrien Timmer and to Ashley Tran. Hope everybody has a great week and we'll see you right back here next week.

ASHLEY: Thanks everyone.

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