Fidelity Viewpoints®: Market Sense

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TRANSCRIPT

SPEAKERS:

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HEATHER HEGEDUS: Hello there and thank you so much for joining us today for *Market Sense*. I'm Heather Hegedus with Fidelity.

Following a post Election Day rally, markets pulled back last week and it came after Fed Chair Jerome Powell signaled the Fed's not in any rush at this point to cut interest rates further, along with some recent data showing some still elevated inflation pressures.

Also, another big headline last week, Republicans also won control of the House, of course, completing their sweep, which could have big implications for President-elect Donald Trump's ability to execute on some of his more ambitious policy goals. And a slew of cabinet members have been nominated, giving us a bit of a clearer picture now of what this administration could look like, of course, if those picks are confirmed by the Senate. And the markets are still unpacking the potential implications of all of this.

So to talk about how investors should potentially be considering processing some of these latest data points, we are always thrilled to be joined by Jurrien Timmer, of course, Fidelity's Director of Global Macro. Plus, we're also equally as thrilled to be welcoming Dirk Hofschire to the show today. He's the Managing Director of Fidelity's Asset Allocation Research Team. And he'll be sharing with us his insights on fiscal policy, debt, and geopolitics, among other topics.

Thank you both of you, for joining us today.

DIRK HOFSCHIRE: Hi, Heather. Great to be here.

JURRIEN TIMMER: A pleasure to be on the stage with the great Dirk. He's the master.

HEATHER: This is a great team. Really excited to hear from both of you today. You're both masters. And you're very humble.

Today is Tuesday, November 19. And Jurrien, let's start with you and let you catch us up on things, because a lot has happened since we last spoke.

So we had our first show after the election last week. If you missed it, you can always watch that replay. Now, it's been two weeks since the election and that big market reaction that happened the day after the election.

So, Jurrien, you always say that markets are bigger than elections. What do we need to know right now?

JURRIEN: Well, so it's two weeks post election now. It was obviously a very decisive outcome. It was known relatively quickly. And it's a good reminder that markets are brutally efficient in discounting all available information.

And the big reaction on November 6, I think, shows that people have been sort of sitting on their hands because it was supposed to be too close to call. And so there wasn't a lot that the market could really discount. And then, of course, you had a decisive outcome. And on November 6, that outcome was then priced in. And so that's how price discovery works, whether it's a very new asset or a very old asset, like the S&P 500.

And what we know, for now, is that the Trump trade, for the lack of a better term, has clear sort of winners and losers. The market has broadened out. So the leadership has sort of been added to other sectors that are considered more friendly or beneficiary to a red wave, so financials, because of less regulation, energy, more drilling, maybe industrials, if industrial policy returns, and I'm sure Dirk will talk about that as well, and a stronger dollar and potentially rising yields, and potentially fewer rate cuts from the Fed.

So that, I think, is the package. And I think we've been seeing that on our screens for the last two weeks.

HEATHER: Jurrien, investors had been expressing some worries, though, that I'd like to unpack a little bit here about those rising bond yields, although Treasury yields are showing signs of settling down. If we had to keep an eye out for any kind of warning signs, what would be the potential risk to watch out for?

JURRIEN: So the thing that I'm really focused on is, what might 2025 look like relative to Trump 45 back in 2017? How are the markets similar? How are they different? And in many ways, actually, 2024, the last 12 months, looks kind of similar to 2017.

So in 2017, from the day of the election to the end of 2017, so slightly more than a year, you had a very robust market rally of 30% plus. A good chunk of that came from earnings because of the TCJA tax cuts. But a good chunk came from rising PE multiples. And this is how I tend to deconstruct returns. There's a valuation component and an earnings component, and then, of course, the dividends, but they don't change very much. And so 2017 had kind of that double impact, and 2024 has been the same thing. We're up 30%, 40% over the last 12 months. And again, big participation from rising multiples.

Now, how does 2017 look different than 2024 or '25? Rates were much lower. The Fed was barely lifting rates off of the zero bound. Inflation was still very well behaved. And so it was a different economic environment. This time around, inflation, of course, is higher. The latest core CPI was at 3.3. Core PCE is at 2.7. Certainly improving on a rate of change basis, but still elevated. And of course, bond yields are higher, what we call the term premium, which is the risk premium for long term bonds, has been coming up and that's why yields are higher.

And so my sense is that it doesn't preclude 2025 from being a good year for the stock market. But I think that those pressures could hold back a repeat of '24, where it was this double barreled impact from rising earnings and rising PEs. It's hard for me to see that continue, because the PE is already at 25, 26, and to go up another 20%, 30% from that would get us into very high valuation territory.

HEATHER: Fascinating how history might be a little bit repeating itself from 2017 there, Jurrien. Thank you for that. And of course, the economy is the foundation for corporate earnings. It's the foundation for the stock market. Dirk, this is a good time to bring you in here. Your team, the Asset Allocation Research Team, focuses on studying the US economy and the US business cycle.

So from your team's standpoint, first of all, how is the economy doing right now? And how much fuel do you think the US economy still has in the tank for further growth during this business cycle?

DIRK: Yeah. Well, the economy is actually doing pretty well. It's been pretty resilient over the past couple of years. Seems to have survived the Federal Reserve taking interest rates up quite a bit. Consumer remains strong. Labor markets are still tight. They've softened some but wages are still rising. We're at near full employment. And you still have really good turnaround in corporate earnings that Jurrien mentioned. So kind of stabilized profit margins and a pretty good outlook going forward.

So it's a pretty decent backdrop. The expansion has been very persistent. It probably does have a little bit of mix of some late cycle flavor, along with some mid, as you see depicted in this chart here. So maybe not completely off to the races but doing all right.

One of the things that we are watching still is the inflation that Jurrien just mentioned. So, yes, inflation has come down a lot. And that disinflation story over the past year in the markets has really been a terrific narrative and a terrific tailwind for markets themselves. But we've seen kind of a stalling out. And that stalling out in some of these metrics is closer to a 3% ish sort of inflation rate, compared to where the Fed wants to get at 2%.

So it's not a go-go early cycle type of feel to it. It's maybe a more mature cycle overall, but still doing pretty well.

HEATHER: More mature. OK. So I want to, in a moment, dig into some of the specific policies and potential impacts of the new Trump administration.

But just a baseline question here at a high level, are presidential administrations able to change where we are in the business cycle? And are there any potential policies from this incoming administration that are on your radar that you see potentially have the potential to change the overall trajectory that the US economy is on right now, Dirk?

DIRK: I think in general, we probably overexaggerate how important the presidency is to the economic cycle and to the markets and everything. We get so inundated with all the news and the elections and everything. But if you look at it historically, probably a lot of times, presidents are either unlucky or lucky, because the business cycle has a life of its own. The whole idea is there's this pattern of behavior between the free market economy, the markets themselves, consumers, businesses, as well as other policymakers that aren't in the government, like the Federal Reserve.

So I do think that presidents can have, and new administrations and Congress, can have some impact, but they have to make really significant changes in policy. And then it's probably less about reversing the business cycle and more about, as an overlay, how did they change it.

And I think there are some big areas traditionally that governments and new administrations can do this, especially with fiscal policy. So changing spending and tax policy overnight can have a difference. But there's other areas, such as regulation. And certainly with this incoming administration, we've heard a lot about potential changes in trade or tariff policies and immigration as well.

HEATHER: So it could be an overlay, but not going to reverse things. Let's dig into some of the potential policies now. So the two potential policy areas that President-elect Trump may be able to tackle quickly and without congressional approval are deregulation and increasing tariffs. So he has proposed tariffs against China and much of the world, 10% on foreign goods imported to the US, 60% on Chinese goods. On deregulation, he's expected to potentially roll back some of the Biden era policies and regulations via government agencies.

How do you think deregulation and tariffs affect markets and economies? And in turn, how might they affect individual investors and consumers?

DIRK: Yeah, so deregulation is generally positive for business. It's positive for profits. It gets animal spirits going. You hope to see more investments as a result of that. So we'll see. It's always hard to measure deregulation. When big regulatory changes are made, you can tell. But sometimes there's just a feeling that you're enforcing things less or you're encouraging things more. And so a lot of times you have to see it show up in optimism surveys and actually in investment. So we'll see over time. But certainly a more positive business tone that people are anticipating. Tariffs, it's a little bit different. The proponents of raising tariffs actually have a long-term objective that they think is kind of similar in that they allege that there's a lot of unfair trading practices by China and others around the world, and they're essentially want to raise the cost of those foreign imports so that US companies will have incentive to build here in the United States. But that takes time.

So the first thing that happens with tariffs is you have the uncertainty of, well, which products are going to get tariffs and where am I going to source or am I going to pay the tariff. Is there an alternative? So there's a lot that goes on there that actually kind of contradicts, at least at the beginning, those animal spirits because of the uncertainty.

And then over time, it just sort of depends on how it plays out. Some industries and some products have substitutes that you can readily turn to as a business, but sometimes you'll have to just pay the tariff and accept the import, and then the company either has a lower profit margin or it has to pass the higher cost to consumers, and that's more inflationary.

So not as positive of a tone on tariffs. And we'll just have to see how these two things are implemented and staggered in and how quickly, as well, they are. Because you could see maybe deregulation fueling better spirits up front, whereas tariffs, over time, if it takes a while, might be a little bit of a headwind for that.

HEATHER: Yeah, the implications could be pretty complicated. It's not cut and dry there.

So as I mentioned earlier, we now know the GOP will have full control of Congress, which, of course, means a lot less gridlock when the president is trying to get some of his key legislative goals through. One key piece of business, of course, that will be taken up right away, we think, is the Tax Cuts and Jobs Act of 2017 because parts are set to expire at the end of 2025.

So extending tax cuts can have some complex impacts as well. It gives people more money to spend, but it can also add to government deficits. So pay me now or pay me later. Can you walk us through a little bit how you think extending these tax cuts, and even possibly expanding on them, as has been proposed, could impact the economy and the markets over both the short and long term?

DIRK: Sure. Let me just clarify for a minute. So I think what we're talking about with the tax cut extensions is mostly on the consumer side. The president throughout the campaign actually said many things on the fiscal side, a lot of taxes he wanted to lower or get rid of.

And I think if you think about this from an investment perspective first, the thing that the stock market would love to see the most is a decline in corporate tax cuts. And the president did actually say that he'd like to take them down from a 21% tax rate to 15%. They were previously taken down during his first administration from 35% to 21%. So we already saw a big tax cut there.

But that would have to be new tax cuts on the table. What you're talking about is the $4.5 trillion of tax cuts that's going to expire at the end of next year. And that's mostly on the personal income tax side. So there, if you extend the tax cuts, it's not actually giving people more money. It's just not raising their taxes in 2026. So you actually don't have a significant impact on the economy or on spending or anything like that. It would just be that you'd have $4.5 trillion of extra spending that you'd have to somehow either finance or put on the credit card.

So when you put it together, I think what we're looking at from this fiscal standpoint is a tremendous desire, stated desire to keep taxes the same or even lower them from here. The challenging part is, are you going to pay for any of that? Because as I mentioned, you're already talking about $4.5 trillion without even actually lowering taxes. If you want to go further, you're going to have to either increase the debt by a significantly more amount or find some other offsets or ways to pay for it.

HEATHER: Yeah, let's dig a little deeper on the topic of the debt here, Dirk, because it seems like so far government deficits have not impacted the market significantly or the economy. But it sounds like you think there is potential that this time could be different. Do I have that right? And what do you think that will look like for investors and consumers, if we do start to see deficits impacting the economy and the markets in a more tangible way?

DIRK: Well, it's pretty simple, really. The past couple of decades, when interest rates have been so low, I mean, think about the long period of zero interest rates we had with the Federal Reserve and even the 10-year Treasury yield was trading 2% or 3%, that means the debt service costs for the government was sort of negligible. So it wasn't just the markets that were ignoring this, but politicians were ignoring it. And we just kept increasing deficits and debt.

But when you think back to earlier history, let's go back to the '80s or '90s, you can actually remember a time when markets did care about debates around fiscal policy because they cared about the size of the deficit. They cared about how much new Treasury issuance they might be, and actually pushed interest rates up, at times, where those policies looked like they were going to be a little more fiscally expansionary or potentially irresponsible.

So I think we're more in that type of an environment now, where we have a near record amount of debt. We have a very high deficit, as high as it's ever been in peacetime, non-pandemic era. So tremendous fiscal pressures with interest rates at a much higher level. And so it really makes this debate in Congress and the White House that we'll see next year around, how do you think about fiscal policy and tax extensions and everything else, it makes it much more pertinent to bond yields.

And to the extent that it puts upward pressure on bond yields, potentially, if it looks kind of fiscally irresponsible or not paid for, I think markets will care. Because as we know, when those bond yields have gone up over the past two, three years, we've also seen volatility in stock markets and it's had sort of an impact across the entire financial market system.

JURRIEN: Yeah. And I would just add to that, stocks have to supposedly compete with bonds, which are considered the risk-free asset, to earn a superior return. And so historically, stocks outperform government bonds by 5% per year. And so if there were pressure on rates again through the term premium that I mentioned earlier, it would, the stock market in theory would have to reevaluate what PE it's trading at in order to remain competitive.

So it doesn't have to necessarily end a bull market for stocks, but it could slow it down and it could interrupt it and it could create little tantrums, the volatility that Dirk mentioned.

HEATHER: Something that Art and Dirk's team are closely watching.

Let's talk also, we have time for probably one more question about President-elect Trump's administration and new policies. And his immigration policies are also vastly different from those of the outgoing administration.

Just to remind folks, the president, as the head of the executive branch, is ultimately in charge of enforcing immigration laws of the US. So he's promised to deport undocumented immigrants.

Dirk, how do you and your team think that could affect the labor markets and inflation? Because I know, you mentioned how you study inflation closely, and I know the labor markets are also something that your team studies very closely.

DIRK: So the whole debate around what to do with undocumented immigrants, it's difficult to measure, because, by nature, we don't, at any moment in time, know necessarily how many people are here, how many people are working. But let's assume that the official estimates are somewhat right. You've got at least several million undocumented workers in the US economy employed right now.

So no matter how you feel about it from of a judgment value standpoint, those are people that are working for businesses. So the extent that this deportation does become sort of a mass deportation and you start grabbing workers out of businesses and deporting them, that's disruptive to businesses. It's also a problem for the labor markets that are already really, really tight, as we discussed.

So that immigrant labor over time has helped the supply of labor in the United States and demographics are working against us now. So it does have the potential to tighten things up, maybe provide not just some disruption but some extra inflation into the business calculation. So not overly positive from a macroeconomic standpoint, but a lot will depend on exactly what the magnitude is of the plan that's carried out.

HEATHER: And there's also no question this new administration is going to take a different approach on certain aspects of geopolitical relations, too, Dirk. It's also coming at a point in time when you have described the world as potentially more dangerous than it has ever been in past decades.

Do you see this approach impacting the global economy at all? Are there any takeaways or risks that investors maybe want to keep in the back of their minds?

DIRK: You know, I think, sort of like the business cycle, the president inherits the global landscape. And as you mentioned, we really believe the global landscape is more unstable than it's been in decades. We have rivals, like China and Russia, that define themselves antithetically to US leadership in the world. And that's creating instability throughout the world. I don't think it changes things overnight. I think we have two wars in the Middle East and Ukraine now that are likely to be difficult conflicts to resolve. I think we're going to have a lot of tension with China and we'll see it in the trade aspect of the relationship as well.

So I think President-elect Trump will hold a very different view of the world than President Biden. But I think the challenges and risks will be the same. And we'll have to be concerned about them. But even though there's a lot of things always going wrong around the world, it won't necessarily have a material impact on our economy or on the markets on a day-to-day basis.

HEATHER: All right, Dirk, thank you. And just to wrap it all up and bring it home for us, Jurrien, what are some of your thoughts on lessons learned about what we've talked about today and two weeks since the election, lessons learned for investors.

JURRIEN: I think the ultimate lesson learned, and we saw this on November 6, is that the market will discount new information faster than you're able to adjust your portfolio. And that is as good a reminder as any to not try to market time these things. Just have a portfolio that makes sense, that can withstand some bumps, but that also grows over time. And the market's always going to be ahead of you so don't try to outsmart it.

HEATHER: I think that's a fantastic place to leave the discussion.

Thank you, Dirk and Jurrien, for the thoughtful insights, unbiased, nonpartisan facts and ideas that you've supplied us with today. So I appreciate that.

And a quick programming note, too. We're off next week for Thanksgiving, so we will see you back here the first Tuesday in December at our regular time. We're always on Tuesdays at 2:00 Eastern.

On behalf of Jurrien Timmer and Dirk Hofschire, I'm Heather Hegedus. Take care, everybody.

[1] Bloomberg, November 14, 2024: https://www.bloomberg.com/news/articles/2024-11-14/stock-market-today-dow-s-p-live-updates

[2] Reuters, November 12, 2024: https://www.yahoo.com/news/trump-day-one-plans-immigration-212626257.html

[3] ABC News, November 12, 2024: https://abcnews.go.com/US/trumps-deportation-plan-private-prison-industry-sees-lucrative/story?id=115775702

[4] Washington Post, November 6, 2024: https://www.washingtonpost.com/world/2024/11/06/trump-presidency-global-impact-us-election-winner/

[5] Fidelity Quarterly Market Update, October 6, 2024: https://www.fidelity.com/viewpoints/market-and-economic-insights/quarterly-market-update

[6] Fidelity Viewpoints, November 6, 2024: https://www.fidelity.com/learning-center/trading-investing/trump-election-2024

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