

## **Fresh Invest S4E1 Transcript**

**Episode Title:** An investor's briefing

**Episode Description:** Volatile markets and inflation are top of mind for investors. We kick off season 4 by exploring the current economic and financial landscape and the tools investors can use to navigate it.

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### **Transcript:**

Alex Lieberman:

Welcome to season four of Fresh Invest, your favorite investing podcast, sponsored by Fidelity Investments and powered by Morning Brew. I'm Alex Lieberman, co-founder and executive chairman of Morning Brew. If you're new to the podcast, welcome. If you've been tuning in over the last three seasons, it's great to have you back. We're so glad you're here. In season three, we focused on helping you find financial confidence during economic uncertainty. This time around, we're exploring strategies and tips to help you invest wisely wherever you are in life. With help from our friends at Fidelity, we'll dive into the investing life cycle in the context of today's market landscape, emerging trends, and long-term wealth building strategies. Let's get into it.

Now, last time I was behind the Fresh Invest mic, it was November of 2022 and things looked a little different. Silicon Valley Bank was still intact, federal student loan payments were paused, and the phrase generative AI would get you more confused looks than nods. Obviously, a lot has happened since then. So to kick things off, we'll explore how the economic and financial landscape has changed since we left off last season. And today we're joined by Fidelity's own Jurrien Timmer, who will review the current market trends, including market volatility and inflation. And of course, we'll talk through some tangible strategies that you can use to grow your investments in these conditions. Jurrien, it's good to have you back.

Jurrien Timmer:

Great to see you, nice to be back.

Alex Lieberman:

You are becoming a Fresh Invest regular or you're already a Fresh Invest regular, but for those who are new to the show, do you mind just quickly introducing yourself?

Jurrien Timmer:

Yeah, so I've been at Fidelity 28 years, but who's counting? My title is the director of global macro, and that's just a fancy way of saying that I look at the world from a top-down perspective, try to put sort of the pieces of the puzzle together in terms of all the noise and all the data that we get every day from the markets and what are the things that we actually should be focused on and how do we build a solid, sustainable portfolio out of that.

Alex Lieberman:

I love it, and you look at the macro picture and you create macro reports as part of your job. And so if we rewind, we last spoke in November of 2022, so just give the audience a sense of how the macro landscape has changed since our last conversation.

Jurrien Timmer:

Well, it has changed a lot. So last November, the markets of course were just starting to recover from a 28% decline, that was for the S&P 500. Of course, we didn't know in November in real time that the bottom was in. You never know these things in real time, but last year of course was the year of the valuation reset. So, bond yields went way up as the Fed had to really slam on the brakes in order to tame inflation, which so far seems to be happening, but equities reset, the PE went way down, bond yields went way up. And so at that point, we were all licking our wounds, if you will, wondering what the next chapter would be. And the consensus in the market was very much that, okay, this was the first shoe, valuations coming down as the Fed raises the cost of capital.

And if you think about it this way, all investments are really valued as the present value of future cash flows, and that's true for bonds, it's true for stocks. And what the Fed was doing last year was raising the cost of capital and that requires a reset for all assets, and that's exactly what happened. So last November the thinking was, okay, fine, maybe this phase is over, but what's the next phase? Are earnings going to be the next shoe to drop, and will 2023 be the year that we get that recession that the yield curve has been sort of screaming at us about?

And of course here we are, it's August of 2023, there is no recession, there is not even a soft landing barely, and the markets were caught off guard, the consensus was wrong, so far at least, that doesn't mean a recession isn't coming down the road, but the market started to kind of declare victory a little bit that the Fed at least is getting closer to being done. The Fed is still raising rates, so the Fed isn't done yet, but for the stock market, I think there has been a pivot away from the interest rate narrative towards the soft landing earnings recovery narrative, and that's what the market is betting on, and 2024 will tell us whether that was the correct bet or not.

Alex Lieberman:

Totally, and so given the context of, let's call it a softer landing or a no landing at all that we're sitting in right now, how would you describe what the key factors are that are driving the investing landscape at this very moment?

Jurrien Timmer:

So, ultimately the markets come down to earnings, interest rates, that sets valuation. It comes down to sentiment, and clearly going into the year since our last episode, the market was sort of on the wrong foot. I think generally people were positioned defensively, expecting that earnings shoe to drop and the earnings shoe has not dropped. First quarter earnings season actually came in pretty good, and the second quarter has come in pretty good as well. 80% of companies and second quarter earnings season just wrapped up, 80% beating estimates by an average of seven percentage points is pretty good. Now overall, earnings are declining very, very modestly. They're estimated to be down 3% this year, which isn't very much. So, when I say that 80% are beating by a certain percent, it just means that earnings growth ended up being less bad than was expected.

So, this has been the year of resilience really in the economy. And if you think about it, 70% of the American economy is consumer spending. People are spending money because they have jobs.

Unemployment is very low and wages, now that inflation has come down, it's still elevated, but it's a lot less elevated than it was, and now wages are starting to keep up with inflation better. So people have money in their pockets, they have jobs. We are not seeing wide widespread layoffs or anything like that, and so the economy just kind of continues to churn along.

Alex Lieberman:

Let's talk a little bit more about market volatility and specifically inflation. Obviously, you alluded to it before sharing how some of the intervention from the Fed appears to be having an impact on inflation, but from the retail investor's perspective, what are the asset classes or investment vehicles that are best suited for an inflationary environment or an environment where there is more market volatility?

Jurrien Timmer:

Yes, and it's interesting that last year, obviously stocks were down, bonds were down in price, but usually when you have volatility episodes, let's call it that, the bond market is the port in the storm, and that's the side of the market that acts very calm while the equity side, the more volatile side, is acting up. And last year, the bond market was really the center of the storm, that was the eye of the storm because yields had been so low during the 2020, '21 sort of COVID lockdown days, and so that's where the reset came from. So when we think about the markets now, the good news is that valuations have reset quite nicely, especially on the bond side. You can buy a 10-year treasury now for about 4.1, 4.2% inflation expectations per what we call the TIPS market, the Treasury Inflation-Protected bond market where you can buy treasuries, but priced in real yield terms.

If you subtract the real yield of TIPS from the nominal yield of regular treasuries, you get an implied inflation rate, and that inflation rate is around two and a quarter, two and a half percent, which is the market's way of saying that the Fed will be successful in taming inflation. And remember, the CPI has already gone from 9% last year June to now 3%. So, we have seen significant improvements even though the core measures that the Fed is most interested in is still at 4%. So, that's still well north of the Fed's target, but the good news is that bonds are much better values today. So, you take the 4.2% on nominals, minus two and a quarter on TIPS, you get about a plus 2% real yield, and that's ultimately what's most important because when you're buying bonds and you locked them up for a long time, what you're getting after inflation determines what your real return is.

And two years ago that real yield was minus two, today it's plus two, and that's assuming that the TIPS market of course is correct. And so, bonds are a much better value. If what the yield curve is saying about the economy is true, and we don't know if it is, but if we do get a recession down the road sometime in 2024, then you would think that bonds will do what they normally do, which is to protect investors from volatility. And again, last year bonds were in the eye of the volatility storm, but now that yields are much higher and the Fed is much, much further along the path of interest rate hikes, my guess is that bonds will be a better hedge than they were last year and as they generally are over time.

Alex Lieberman:

Totally, I want to talk in a moment about a recessionary environment if it were to happen and how investors should be thinking about and positioning themselves for it, but I want to talk about the other side of the inflation coin first, which is rates. Rates haven't been this high since I was eight years old. I don't know what grade I was in, but it was 22 years ago. How do you see this impacting current and future investments with where rates currently stand?

Jurrien Timmer:

So, rates are the highest in 22 years, that's correct. So the Fed is now at four and a quarter to four... Sorry, five and a quarter to five and a half, so the Fed thinks of it as a range of a quarter point and a year and a half ago the Fed was at zero to a quarter. So it is one of the fastest, most aggressive rate hiking cycles that we've ever seen. And it was for good reason, of course, and that was the inflation that came out of the reopening following the pandemic, and there were other reasons for it as well.

And the way we think about it is, again, in real terms, so if the Fed is at five and a quarter to five and a half and the expectations are that the Fed is either done raising rates or getting very close to being done, and you take that TIPS break even, and again, the TIPS market doesn't have to be correct necessarily, but that's the collective wisdom, if you will, of the financial markets, and that wisdom or that collective opinion is saying that inflation will be around two and a half percent for the coming five years or so.

So, you subtract two and a half from five and a quarter to five and a half, you get real rates of plus three. That is about where the Fed generally goes in terms of a hiking cycle. So the full cycle tends to be five, six percentage points from two to three below what we would consider a neutral rate, which is generally thought of as about three and a half percent or so, to about two to three percentage points above. So, we've had what appears to be the full pendulum swing from way below to way above, and that I think is how the markets are concluding that we're getting closer to the end.

And the good news about that is if real rates have been stretched as far as possible to the upside, then any future surprises may be more likely to come from real rates falling and real rates going from positive to less positive or from positive to negative generally is considered a favorable development for the stock market, for the bond market, for crypto, you name it. Generally, the markets will feed on that in a positive way. So, the glass half full here is that yes, the Fed is very restrictive, that's very painful for a lot of asset classes as we've seen in the bond and the stock markets and other markets as well, but if we're getting toward that sort of that eighth or ninth inning, then maybe the next game will be more favorable.

Alex Lieberman:

Now, I want you to put yourself in the shoes of a retail investor right now who is worried about what the impact is of inflation on their portfolio. I think a lot of people will watch the news, they'll see at least where inflation was, and they'll hear that... What this does is it takes away purchasing power from the money that they have in the bank, and they get concerned of, are they going to be able to live in the same way? What are strategies that they should be employing given where inflation is? How would you be thinking about this if you were a retail investor that you were providing guidance to?

Jurrien Timmer:

So, one thing to remember is that stocks or equities historically have been a good hedge against inflation. Stock prices follow earnings. Earnings are measured in nominal terms because if a company sells more stuff, it's measured in price and volume. And so the stock market, generally speaking, not always, but generally speaking has been a good inflation hedge. So, you're compounding returns over time and those returns in nominal terms generally, historically speaking, have been above the inflation rate. So, if you go way back in time and you look at the average compound annual growth rate for the S&P 500, it's about 10, 11% in nominal terms. That doesn't mean that that's what you get every year,

but that's over the long term like a 50-year, 20-year period. And in real terms, it's about six and a half percent. So, that's over and above the inflation rate.

And again, a lot of it comes down to whether the market is correct in expecting inflation to be under control going forward at about two and a half percent. And remember, as I mentioned before, the CPI has already gone from nine back down to three. So, three is pretty close to what the TIPS market has been saying. I think that the lifting will be a little heavier going forward because what we call the base effects, that rate of change calculation where you add in the current month and you drop out the data from 12 months ago, the base effects are basically behind us because the inflation peaked about 13 months ago.

So, getting from three to two will be harder than getting from nine to three, if you will, but still, the way a retail investor, I think, might look at this is you look at real rates, you look at historical probabilities, you look at the reset that has already taken place in the bond market from minus two real to plus two, you look at the valuation reset that happened, and of course, valuations have expanded over the past nine months or so since we last talked because last November the PE was at 15, today it's at 20, so it is a lot higher as the market anticipates this recovery.

Remember, the market always anticipates, not always correctly, but it does always anticipate, but over the long term, if inflation is a big concern, then you want to look at those assets that hold their value the best, and that may be stocks over bonds, but even in the bond market you have different sectors. You have nominal treasuries, you have TIPS, the inflation protected bonds, you have corporate bonds, you have floating rate bonds. So, there's a pretty broad menu of items that you can choose from even within an otherwise fairly narrow asset class.

Alex Lieberman:

Absolutely, so we've spoken about inflation and how inflation has changed over the last nine months. We've talked about the Fed's policies around rates and how rates have moved over this period of time. We've talked about earnings and the modest change in earnings we've seen from companies relative to what the market anticipated. What are other current market trends that investors should be paying attention to right now?

Jurrien Timmer:

Well, as I mentioned, earnings, interest rates, valuation sentiment for the stock market, I think, are the four sort of pillars, if you will. And I would say the most noteworthy thing to mention that's happened between when we last talked in November to now is that the market has priced in a very specific scenario, it has priced in a soft landing, and we don't know if that soft landing is going to materialize. It has so far. I think this year certainly the economy has been firmer than most people expected, and you see this, if you look at economist growth projections for GDP at the beginning of the year. The economists were expecting basically no growth for the year. Now they're expecting close to 2% real growth. So, clearly those expectations have been reset and the market has probably correctly basically pivoted to that scenario, but the market has priced it in.

So, the market always discounts the future, and so the PE ratio for the S&P has gone from 15 to 20. That's a pretty big move. That's an almost 30% move in the market. And so, now this soft landing has to continue to materialize or the markets might be sort of on the wrong foot. So, I think that really becomes the main issue I think for the next six to 12 months is, will the scenario that the market has already priced in now come to fruition? And if it does, the market can continue to rally because what we

see typically in a market cycle is you have a cyclical bottom, and it looks like last October may have been exactly that, and then you have an early cycle recovery based on eventually an earnings recovery, but the market discounts that.

So, usually the price will start to rally two to three quarters before earnings, and so far we're on that timeline. The consensus expectations are for earnings to bottom basically in the third quarter. And what you see is that during those two to three quarters where the price is going up, but earnings haven't recovered, to the casual observer in the market, the price action doesn't make any sense because the price is divorced from what you see around you.

And so, what needs to happen now is for those earnings to come in, and it looks like they are. Like I said, Q1 and Q2 earnings season were better than was expected, and if that earnings pivot comes and that earnings recovery happens, then the market can continue to advance on the basis of rising earnings, but the phase where it rises purely on the PE going up, that I think is now ending, and I think in the last few weeks we've seen some indigestion in the markets, and I think that's kind of a typical place where that happens because we've had that PE rally and now we need to transition to the earnings rally and those earnings need to come through.

Alex Lieberman:

Yep, makes total sense. You've alluded a number of times to a soft landing, but you did mention just the notion a recession earlier, and while anything can happen, it seems like the odds of a recession are lower or a full-blown recession and something closer to a soft landing is much more likely, but I told you I wanted to revisit the concept of a recession for investors. So the million-dollar question is, as a retail investor, how should I be thinking about investing into a recession should one happen?

Jurrien Timmer:

That's a great question, and it's one that I've fielded many, many times in recent months, and people ask, "Give me a recession portfolio. How do we invest recession proof?" And the problem is that recessions are... We know the yield curve is very inverted, and it has been inverted for a long time. So short-term rates are well above long-term rates, and they've been that way for almost a year. And we know historically that that yield curve signal has been very accurate in terms of forecasting a recession. So by that measure, we should get a recession maybe in 2024. The problem is that the lead times between the inversion of the curve and the eventual recession is all over the place. It can be as little as six months, it can be as long as two years. It doesn't really tell you how severe the recession will be, how long it lasts.

And so my answer is always, in order to trade the recession playbook, you have to market time. And I can tell you, I've been in the business almost four decades and I can't do it, and I have all the resources at my disposal to try to do it. And it's just a really tough game because you need to know four things in order to trade around a recession. You need to know when it starts, you need to know how long it lasts, how bad it's going to be. And even if you know all of those things, you need to know what's already priced in because the market always discounts. And so, right now the market is not pricing in a recession, it's pricing in a soft landing. So at least you can have that as an angle, but it's a really tough game. And so, my advice always is have a well-balanced portfolio.

It sounds kind of lame and boring, but have a portfolio that lets you sleep at night, but still trying to produce the returns that you need for retirement or whatever your goals are. And finding that intersection, which we call the efficient frontier between return and risk and having enough different

assets in that portfolio, so that the drawdown of the entire portfolio does not get to a point where you really can't sleep at night. And even worse, where it might trigger you to sell when you actually should be buying or at least holding. And so for me, it's finding that balance, I think is the best we can do in order to recession-proof our portfolio with the caveat that there is no such thing as recession proofing.

I think that's a better strategy, in my personal view, than trying to trade around this playbook of, okay, when does the recession start, when does it end? And usually the NBER, the National Bureau of Economic Research is the official arbiter of recessions, and sometimes we don't even hear from them in terms of when a recession starts sometimes until after it's already over. And so, in real time it's really hard to play this game of timing around a recession. So, just having a portfolio that gets you what you need while being able to live with the volatility that occasionally happens, to me, that's still the best approach.

Alex Lieberman:

It sounds like unless you have a genie in a bottle or a friend who's a psychic, trading the recession probably isn't the best idea. As always, Jurrien, it's so incredibly valuable, all of the insights from your 40 years of work that you share with the podcast, you've done for the last four years. So, we're super grateful for the time and can't wait to talk with you next year.

Jurrien Timmer:

Great, thank you very much.

Alex Lieberman:

Thanks for joining me today to kick off season four. I hope this conversation helped you understand a little bit more about today's economic conditions and how to navigate them as an investor. I said it last season and I'll say it again, it is an interesting time to be an investor. And like any challenge that pushes us outside of our comfort zone, I think we can use these market conditions to become better, wiser investors. Throughout the season, we'll continue to explore strategies that can help you diversify your portfolio, cushion stock market volatility, and offset the effects of inflation. Thanks again for listening, and make sure to join us next week when we'll be joined by a very special guest, the rich girl herself, Money with Katie. Katie will join us to talk about a very important topic, women's financial wellness. We'll discuss why men and women have such different lived experiences when it comes to money, and how women can overcome the unique financial challenges that they face. Thank you so much for listening, and we'll catch you next episode.

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