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TRANSCRIPT

SPEAKERS:

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HEATHER HEGEDUS: Hello, everybody. Thank you so much for taking the time to join us today for another episode of *Market Sense*. I'm Heather Hegedus with Fidelity. Hope you're staying safe with winter storms across most of the country. 2026 is kicking off with no shortage of both financial and political headlines to talk about these days. It has been a choppy two-week stretch for the S&P 500—giving up ground, then taking it back and then some—as investors continue to try to digest this fast-moving news environment.

We did see a jump in 10-year Treasury yields as bond watchers keep an eye on geopolitics and also Japan. And this as the Fed is meeting right now as we speak. This is their first meeting of 2026. And they're meeting against a backdrop of heightened political tensions as investors await an announcement of who might succeed Chair Jerome Powell as the next Fed chair.

So to talk about that and all of the latest developments, we're grateful today to be joined, as we often are, by Jurrien Timmer, of course, Fidelity's director of global macro. We are also thrilled today to welcome back another fan favorite of the show, Julian Potenza. He is a CFA charterholder and portfolio manager here at Fidelity. And since he was last on our show, Julian's role has shifted from short-duration bonds to all kinds of bonds. So we're excited because today, Julian, you're going to be able to give us your perspective on the full yield curve. So thanks for making the time, Julian, and congratulations on your new role.

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

JURRIEN TIMMER: Yeah. Congrats, Julian. Nice to see you both.

HEATHER: Today's Tuesday, January 27. Before we get into the Fed, Jurrien, I did want to ask you about some of the other headlines that came out of the World Economic Forum in Davos last week. At one point, increased tariffs were on the table for some European allies. That created some initial market volatility. 24 hours later, though, a possible compromise was reached, and the markets rallied. We're still waiting to see how this all plays out, Jurrien. But does this set the tone for tariffs being a market factor once again in 2026 now? And is the so-called sell America trade possibly coming back? And should investors be thinking about those kinds of things?

JURRIEN: Well, it is interesting that last week we had what I would call a little bit of a deja vu moment to back in April after the so-called liberation day. And the markets, of course, went into a tailspin back then. The S&P ended up falling 21% because investors were wondering whether this was a new world order, and where we might have trade wars and maybe even capital wars, and where international investors might move their money out of the US. And back then—this is already 10 months ago—there was an odd juxtaposition of markets because the stock market went down, but the dollar went down and bond yields went up. And usually at a time of stress, the dollar does well, and treasuries are a safe haven. And that did not happen back then.

Now, since then, both the dollar and the bond market have been quiet. And of course, as we know, the S&P, the stock market, has rebounded quite significantly because the tariff threat ended up being a lot less bad than expected, basically. I mean, the effective tariff rate is about 12%, which is a level that is higher than what it used to be, but it's a level that the market at least is comfortable with that it's not too disruptive.

So last week, bond yields did briefly rise, although they're back to a better-behaved level now at about 4.2%. But the dollar is back to testing the lows from last year. So there is a little bit of an echo. But I think the market at this point thinks of what it did before April 2 last year, which is that tariffs are a negotiating tactic. And that's what happened last week. And some deal was struck on the various issues at play. And the market has moved on, as it generally does. So I think we're kind of back to the status quo in that sense.

HEATHER: Terrific insights there. And, Julian, you're a bond portfolio manager, so I'd love to bring you into the discussion here now, too. What do you think diversifying away from US assets could mean for the fixed-income markets?

JULIAN: Yeah, foreign investors are very important participants in the US dollar bond market, so it's certainly a relevant question. Jurrien talked about April. We were thinking about this a lot when we saw the tariff rollout. US policymaking was moving in a less traditional direction. Correlations were changing. Was this going to result in a sort of ongoing, lasting change in the role that foreign investors played in our bond markets, which could be a big deal? As it turns out, in general, as the data's coming in, foreign investors remain very active participants in the US dollar fixed-income markets throughout 2025. I think the reality is the US dollar capital markets are so large and so integrated into the global system that it can be difficult to really disengage.

Now, we don't want to be complacent and overstate the point. Foreign investors may demand higher-risk premia on US assets. It could result in ongoing trends like a weaker dollar or steeper yield curve. But the idea of some kind of a wholesale liquidation or widespread permanent loss of participation resulting in lasting changes is just not something that I see as very likely.

I'll give you a very small anecdote from last week. In the news, there was a small European pension fund that sort of publicly announced it was exiting its US Treasury positions, about $100 million, really a tiny amount relative to the massive US Treasury market. Interestingly, there was another large European sovereign wealth fund, multi-trillion dollars in size. They were asked a similar question. Their answer was, we're more likely to stick to a traditional allocation to the dollar in proportion to its size in the global capital markets. Translation—for someone that big, it's not really realistic to wholesale exit the US dollar. So again, not something we're ignoring, but not likely to precipitate any type of liquidity crisis in the US dollar fixed-income markets, in my opinion.

HEATHER: OK, super reassuring and helpful anecdote there, Julian. Jurrien, today is the first Fed meeting of 2026, so I want to shift gears and talk about that. First of all, how likely do you think it is that Chair Powell implements another cut before his term ends in May? It doesn't sound like many are expecting a cut today, but we don't have much more time with Chair Powell at the head of the Fed.

Also, maybe more importantly in terms of this Fed meeting, Jurrien, what are you expecting to hear tomorrow when Powell speaks during his news conference given the renewed tension that we have seen recently between the Fed and the administration and the Justice Department's investigation into Chair Powell? What are you going to be listening for?

JURRIEN: Yeah, so first of all, I don't expect the Fed to cut rates again. The market doesn't either. The market really isn't pricing in another rate cut until the summer, when, of course, the new Fed leadership would be in place. The Fed did cut several times in a row last year, as we know. And at 3 and 5/8% on the overnight rate, Fed is pretty squarely kind of into the neutral zone. If you think of neutral as inflation plus, let's say, 1% real policy rate, inflation is running at about 2.6%, 2.7%. And so plus 1% gets you to exactly where the Fed is right now.

And inflation has been improving, but it's still above the Fed's target. And the labor market has been soft, but the economy as a whole is pretty robust. The estimates for economic growth are actually going up, not down. So in my view at least, I don't think the Fed really warrants another several rate cuts. And so at 3 and 5/8%, I think the Fed is kind of in a good place to wait and see and wait for the next series of data points to arrive.

And in terms of Chair Powell, I can't imagine he's going to stick his neck out too much in terms of the press conference and say things other than basically what I just summarized. And then we'll see what happens after that as we get to figuring out who the replacement is going to be and how easily that person will be confirmed by the Senate, et cetera, et cetera.

HEATHER: Julian, you were our Fed researcher here at Fidelity for many years as well, so I would like to get your perspective on this as well and the headlines about potential erosion of Fed independence. How do you think about the issue of Fed independence and monetary policy?

JULIAN: I'm a big believer in the importance of Fed independence. I think policy rates should be set based on economic fundamentals, not politics. And I think that's important for the long-term health of both the bond markets and the economy. So it's something that I follow really closely. My base case is that there's enough institutional strength at the Fed that we will retain our tradition of an independent central bank. I think that tradition will hold.

So far, we've seen the Supreme Court appear to treat the Fed a little bit differently than some of the other government agencies, respecting its tradition of independence, and the markets have been encouraged by that sign. And then in the structure of the Fed itself, the way they go about their decision-making. Policy decisions are made by a voting group of governors and regional bank presidents that rotate and have staggered terms. So it's really designed to prevent any one administration from having too much influence on the outcome.

Now, that being said, we have to acknowledge that some of the things we've seen lately have been unprecedented. The bond markets are basically accepting that the next Fed chair will likely be more dovish, so more inclined to lower policy rates, because those are the preferences of the administration. And that is a bit of a change of how we've thought about Fed's in the recent years.

So I don't want to say that nothing is at risk in terms of Fed independence. Base case, in the near term, I agree with Jurrien's take. Economic conditions suggest that the Fed is going to be on pause for a period here. So this subject of Fed independence is not likely to be a major driver of the yield curve in the near term. Over the longer term, if I'm wrong and we do see more erosions of Fed independence, you could see some of those trends Jurrien has talked about like a weaker dollar and a steeper yield curve get a little bit more pernicious.

JURRIEN: And I would just add to that that I think a lot of people are inclined to think about this question of Fed independence as to there's going to be a person in there who's going to cut rates to 1%. And there's going to be all this dissension and conflict and fragmentation at the Fed. And will there be a lot of dissents and this and that? I think it's unlikely to be that dramatic. I think it's more likely a lot of the things that we think about of independence might play out behind the surface.

So think of the Fed being more integrated with the Treasury in terms of coordinating debt management. What is the Treasury going to sell to finance the deficit? What is the Fed buying or not buying? What will happen to bank regulations? Will the Fed and the Treasury try to incentivize the banks to buy more Treasury? So I think it could be very subtle that way. And maybe some coordination, not unlike what we saw all the way back in the 1940s, when a large debt burden had to be financed back then. So there might not be a lot of fireworks around this. But under the surface, it might be happening.

HEATHER: Sort of behind the scenes and maybe not right in front of investors' eyes. But that's where you come in, Jurrien, to let us know what might be going on behind the scenes there. Let's stick with the headlines for a moment. And, Julian, there have been a lot of announcements from the Trump administration this month that could influence interest rates, so I wanted to hit on that with you. We're talking about mortgage-backed securities purchases, that possible cap on credit card rates that was announced, even a proposal to try to keep institutional investors from owning single-family rental homes. So given all of those potential policies now that have been announced that are in play, what could it ultimately mean for your space for the bond market?

JULIAN: Yeah, it's definitely been a busy start to the year. Our analysts certainly have their hands full keeping tabs of all the news impacting all the different sectors. I think one of the ongoing challenges of this policy environment is really distilling what is likely to have a lasting impact on either a sector, the economy, or the markets more generally, and what's just noise. And I think, generally speaking, what we found—not every time—is once our analysts have really dug into the details of some of these announcements, the impacts, they end up being a little bit less dramatic than initially felt.

And so I'll give you one example of the things you mentioned, mortgage-backed securities purchases. This is an interesting one. In the last couple of weeks, the administration announced that the government-sponsored enterprises Fannie Mae, Freddie Mac—the mortgage housing authorities—were going to be purchasing $200 billion of mortgage-backed securities in an effort to help lower mortgage rates and support affordability in the housing market. Sounds like a big deal. $200 billion is a big number. Now, the agency MBS market is a multi-trillion dollar market, so it's a big market.

The other nuance, the markets—I talked to our mortgage traders—were actually already expecting the GSEs to purchase $100 to $150 billion of mortgage-backed securities. So the incremental sort of news content to the market was a lot less dramatic than the initial $200 billion number sounded. And that is a little bit of a theme with these policy announcements.

Now, it did have an impact on the market. Mortgage-backed securities tightened. That will flow through into lower mortgage rates. The order of magnitude is call it an 1/8 of a point so far. So say 12 basis points, something like 6 and 1/4% down to 6 and 1/8% or 6 and an 1/8% down to 6% That's meaningful. That could pick up refinance activity a little bit. That could help housing on the margin, but it's not the same as mortgage rates from, say, 6 and 1/2% down to 3%. And that is a little bit of a theme that we've seen along these announcements.

Sometimes it's interesting. If you zoom out, valuations, pretty healthy; measures of market volatility, pretty low. Yet we have this kind of policy environment that at times can feel a little bit chaotic, all types of announcements. It can feel like the markets are being a little bit complacent. But actually, the other perspective is maybe the markets are actually exhibiting a little bit of wisdom, looking through some of the noise, trying to focus more on the signal.

One of the lessons, again, from the last year is that there's often more sound and fury with these announcements than there is ultimately substances. Again, theme here—not being complacent. We're paying attention to all of it, but often it's best to focus on the big picture. Is the consumer still spending? How's the labor market? What's going on with inflation? How is that likely to impact the Fed? There the picture is largely pretty good, and I think that's what you're seeing reflected in markets more broadly.

HEATHER: Yeah, let's stay on that topic of the big-picture zooming out like you said, if you will, for a little bit here, Julian, and talk about the environment for the fixed-income space this year. Just to set the table so that people know what we're coming into in 2026, 2025 saw the bond market's best performance in five years. That was in part due to Fed easing and a supportive economy. In 2026, investors may be weighing some of the things that we just talked about, whether a slowdown or end to Fed rate cuts, some of the new fiscal policies you just hit on there, Julian, could halt that momentum. So what do you think that might mean for bonds in 2026? Do you think bond investors are clipping coupons, or are they able to still find some total return?

JULIAN: Yeah, well, it's very nice to have a strong year under our belt after a couple tough years there, particularly in 2022, when the Fed was hiking aggressively. One way to think about bonds, they spit off a coupon. They pay you some interest. And that's your starting point for your expectation of the yield, the return that you're going to earn. And then when interest rates move, you can get some price movements relative to that starting interest income. So when interest rates fall, bond prices go up, and you get extra return on top of your coupon. When interest rates go up, the opposite happens. Bond prices fall. You get some of your coupon taken back, or you even post an overall loss.

With the Fed probably on hold, at least for the first half of the year, this could be a little bit more of a coupon-clipping type year as opposed to the big positive total return year that we saw last year. However, if you zoom out, it's important to remember that at these current yield levels, that coupon is still relatively attractive, something above 4% in many parts of the bond market.

Now, I think it's important to think about how that distribution of those interest rates moves around that starting coupon return looks in any given environment. And here, Jurrien mentioned, OK, inflation, still above target. Maybe that says the Fed is on pause for a while here. They are very, very unlikely to go back to hiking interest rates. Now, you could see the yield curve steepen. You could see other impacts on the yield curve. But big picture, with the Fed on hold, you're unlikely to get hurt too badly relative to your coupon income.

On the other hand, you can picture a number of scenarios where the Fed ends up cutting rates more than is currently expected. Some of these are scenarios where the economy turns down unexpectedly. In those environments, the bond market can still provide above coupon returns, which could provide some really welcome diversification benefits to your portfolio.

HEATHER: Credit spreads were tight last year, Julian, obviously, the extra yield that investors demand for holding traditionally riskier corporate bonds than traditionally safer government bonds. Can you talk to us why that matters? And what are you expecting for credit spreads in 2026?

JULIAN: Yeah, we talked about it in a prior show. Credit spreads are like our version of a P/E ratio, so we care about them a lot. There's no doubt credit spreads are tight, in many cases at or near all-time tights. That's true across most credit instruments—investment-grade corporate bonds, high-yield structured products, pretty much everything.

Now, spreads are tight because corporate fundamentals are healthy—the banking system, capital liquidity, good. Profits are strong. Defaults are low. We also have a very strong technical backdrop in the bond market. Demand for fixed-income product feels very good relative to supply. Every year at the start of the year, the new issue markets reopen. That's happened this January. That supply has been absolutely gobbled up. So the technical conditions are very, very strong.

All that said, based on valuations, we don't see huge potential for credit spreads to move much tighter here. It's kind of like that coupon clipping theme we talked about earlier. It applies to base risk-free rates and to credit spreads as well.

HEATHER: How about bond opportunities, Julian? What's looking attractive to you and your team these days?

JULIAN: Yeah, big picture, I go back to what I said before. Interest rates are still at relatively attractive levels relative to history. All-in yields, even with spreads tight, look pretty good. Interestingly, with credit spreads so tight, we are a little bit cautious on credit. That doesn't mean that you own no credit, but we stay up in quality. We rely on our analysts to try to pick the best securities for our portfolios.

It sounds kind of boring, but I actually like US Treasuries here and other high-quality segments of the bond markets. For the riskier segments, I think it makes sense to wait. Be patient. Wait for spread voli to pick up. Look at a better opportunity to move out the credit risk spectrum.

Final thing I'll mention—we do like a yield curve steepener. We think there's a number of ways you could see the yield curve steepen—aggressive Fed cuts, fiscal worries, some of the global bond market dynamics we talked about earlier. We don't have a strong view that any one of those things is definitely going to be coming. But do think when you think about the combined probabilities, yield curve steepener is a trade that I like in the portfolios.

HEATHER: All right. You've given our audience plenty to think about in research. Thank you so much, Julian. And we covered a lot of ground today. But before we go, we do like to end with Timmer's Take to find out what your Jurrien is watching right now. Jurrien, take it away.

JURRIEN: Well, the dollar index, for one—it's testing the lows from last year—and of course earnings season. Earnings season is well underway for the fourth quarter. We've got about 65 companies already reported, which is not that many. But this week is a big one with some of the Mag Seven reporting. And whether the earnings momentum of the third quarter will continue, obviously it's going to matter for this market.

HEATHER: It's a big week, and we will be watching alongside the both of you. Thank you so much to both of you for the timely discussion today. To our audience, if you liked this episode, we are planning to add more portfolio managers just like Julian to our show lineup in 2026.

Meantime, if something that Julian said today maybe piqued your interest and you'd like to research rates yourself, you can head on over to Fidelity.com/BondSearch. And there you'll find a full list of the current yields on Treasuries, corporate bonds, and munis, municipal bonds. There's also a wide range of information there on things like how to set up bond ladders, as well as the potential benefits of having a managed account.

So on behalf of Jurrien and Julian, I'm Heather Hegedus. Thanks so much for your time, and we hope to see you back here next week. We are live Tuesdays at 2:00 Eastern on Fidelity.com/MarketSense, LinkedIn, YouTube. Replays are also available, and we're also available wherever you get your podcasts.

[1]Reuters, December 30, 2025: https://www.reuters.com/business/us-bonds-shined-2025-returns-could-lose-altitude-next-year-2025-12-30/

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