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TRANSCRIPT

SPEAKERS:

Heather Hegedus   Jurrien Timmer   Denise Chisholm

HEATHER HEGEDUS: Hello there, everybody. Thank you so much for joining us for market sense today. I'm Heather Hegedus with Fidelity, and this is our last show before the holidays. We are so excited that we have brought you roughly 45 episodes this year, quite a feat, in 2024.

And we know that it is a busy time of year for a lot of people. It's also busy for people watching what's going on with the markets and the economy. We are awaiting word from the Fed on whether there will be one last rate cut in 2024. The markets are pricing in a cut, but some are wondering if the Fed, maybe getting a little bit closer now to perhaps pausing or even ending the rate cuts for now because of sticky inflation and the relatively strong economy. So to talk about what that might look like and mean for investors is Jurrien Timmer. He's Fidelity's Director of Global Macro, who has been with us for many of the very large chunk of those almost 45 episodes, or roughly 45 episodes that we have done this year.

We're also joined today by Denise Chisholm. She is Fidelity's Director of Quantitative Market Strategy, and her research focuses on analyzing market history to uncover patterns and probabilities that can help to inform the current market outlook. And she's going to be talking today about potential opportunities and risks in the coming year in 2025. Of course, with the backdrop of a new presidential administration and questions about how much longer this bull market may have to run. Thank you, both of you, for making time around the busy holidays to talk with us.

JURRIEN TIMMER: Good to see you.

DENISE CHISHOLM: Yeah, great to be back, Heather.

HEATHER: So wonderful to have the two of you together. The last time we had the two of you together, we got a lot of comments saying they love the dynamic of both of you. So let's jump right in, because today is Tuesday, December 17. So the Fed is meeting right now for the final time this year. So Jurrien, let's talk about what might happen here. Do all signs point to one more rate cut and that's it? And if the Fed does stop cutting, is that actually one of those scenarios that we talk about sometimes that's disappointing for borrowers, but actually a relatively good sign for the economy? And what clues are you going to be watching from Fed Chair Powell out of this?

JURRIEN: Yeah, so the Fed is meeting today and tomorrow. And the consensus in the market is that they will cut another 25 basis points or 1/4%. But just to backtrack how we started the year since we're ending the year, a year ago, the Fed had what's called pivoted, changing its tone from, we don't know how much further we're going to raise rates, to saying, you know what, we think we're pretty much done here. And in its own summary of economic projections, how it's called, it was indicating that it might cut rates three times in 2024.

And lo and behold, it looks like the Fed will be cutting three times in 2024. So kudos to the Fed for actually saying what they were going to do because nobody really knows ever, even the Fed, like when they're going to cut or raise by how much. But the markets being what the markets are at the beginning of last of this year, the markets were discounting seven rate cuts this year, which was kind of a ridiculous number. And the markets have walked back that expectation quite a bit. And now the markets expectation, if you look at the futures curve, suggests that the Fed will stop at around 3.8% or so.

It's currently at 4 and 5/8, about to presumably go to 4 and 3/8. So that suggests two more rate cuts perhaps in 2025. And the market is now actually above where the Fed said it might be in the coming year. So what I'm looking for from the Fed meeting is not so much whether they will cut 25 or not, but what they say, what the dot plot is going to say and what they expect to happen next year.

And to your other question, an end to Fed rate cuts could be a good thing or a bad thing. I mean, obviously a depends on whether you're a borrower, but it also depends on why they're stopping. If they're stopping because the economy is super strong. And certainly it has been quite resilient. And I'm sure Denise will agree that the animal spirits are returning in a little bit. So that wouldn't necessarily be a bad thing because it would suggest that corporate earnings will go up and that will offset rising rates. But if it's because inflation is getting out of control again, that's a different story.

So we'll see what the Fed says. But for now, I think that's where we're going. And how much further they go is a story for 2025.

HEATHER: All right. Well, let's talk about 2025 and your outlook for it a little bit, Jurrien, and without giving too much away from the entire show that we have planned to for about the 2025 outlook, which will be coming in January. But let's talk a little bit about where we are right now. So the year is ending with a bang. Major stock market averages are at or near all time highs. You have referred to 2024 as a Goldilocks year for stock returns. Can you talk about why that happened? And do you think that could happen again in 2025?

JURRIEN: Yeah, so I would say the distinguishing feature of this year's market, and there are many, is that we had the earnings growth story that Denise and I were expecting a year ago. Earnings are on track to grow 10% this year. And so you would think that, OK, if nothing else changes, that means that stock prices go up 10% from earnings plus whatever the dividends are, which is about 1% these days. But what instead happened was PE ratio. The PE ratio continued to climb.

And so, if you look at the return, 10% has come from earnings but another 20% has come from a rising valuation, a rising PE ratio. And that's why we have such an outsized return in 2024. Now, it usually doesn't happen that way. Usually valuations come down or they at least don't go up as earnings go up. And that's just because price anticipates earnings. So they don't always move in the same direction at the same time. And so from my perspective, if I look at interest rates, and inflation, and the Fed, and just the level of valuation, and the degree by which they have gone up this year, I find it hard to see the markets repeating that next year. Which is not to say the markets won't go up. The earnings prognosis is still very good, another 10% to 12% next year. But to get that amplified effect, I think it's going to be hard to do that twice, I think.

HEATHER: OK. All right. Well, while we're talking about the new year, one of the other big question marks in the new year is, how much can the new presidential administration's policies have on the economy and the markets? We're just about a month, a little bit over a month from inauguration day. President-elect Trump has been sharing details of his economic plan, which includes leveraging tariffs. He's also said he's going to potentially cut corporate taxes even further, and potentially make some big changes to immigration policy. So, Denise, I was hoping I could ask you, should investors be trying to trade on those potential policy changes.

And, as a historian, what does history tell us about making investing bets on political policies that may or may not be coming?

DENISE: Yeah, it's pretty risky, actually, to make investment decisions on political policies for a bunch of different reasons. In part because you don't really know what the direct impact of those is going to be. And then almost more importantly, you don't know if that's already somehow discounted in the stock market. I'll give you two anecdotes of how it didn't work the way you might think, as an investor, that it did, that it would work. One is the green energy push that we saw with the Biden administration, which was one of the biggest industrial pushes we've ever seen in the United States.

And in fact, green energy stocks were underperformers over the course of that administration by a large amount. And in fact, you saw the opposite side happen in the mid 90s with health care reform, when health care reform was widely believed to damage the health care sector on a go forward basis. And health care was actually leadership for the next five years in the stock market. So look, starting points on valuation matter a lot to what performance might be in the future. So always remember that there are other core drivers, other than politics, that actually might be more important to determining the returns in the overall market.

HEATHER: Well, along those lines, I know that you are always looking for opportunities, Denise. So let's talk about where you are seeing opportunities right now for 2025. What do you think?

DENISE: Yeah, let's talk about two areas. First, small caps, which I've talked about before. And then financials. And they're somewhat related, but they're two really interesting areas to me. I think most investors know or at least have heard by now that when the Federal Reserve is cutting interest rates, small caps 70% of the time tend to beat their large cap peers. I think what's really interesting about the math behind that is it's specifically good when small cap stocks are cheap, because interest rate cuts work on the relative multiple.

So again, back to those starting points matter on valuation. Small cap stocks are in the bottom quartile of their valuation range back to the 90s relative to their large cap peers on both price to book and price to earnings. That, in and of itself, usually increases your risk reward to higher outperformance. And that's even higher when the Federal Reserve is cutting interest rates. So I think 2025 is a good setup for small cap stocks that have been laggards over the last couple of years, although have caught up over the last couple of months.

Financials are as interesting as small caps in a lot of ways, because they've also started to work over the last couple of months and have actually outperformed the S&P 500 year to date. And I get a lot of diversified portfolio managers asking me, well, we've seen this movie before. Isn't this Groundhog Day? Every time financial stocks work, don't we really want to sell them, Denise? And I think look, two things that have been true over the last decade are still true, which is to say that the stocks are cheap. And historically, that has been a good risk reward. And relative earnings growth has turned this year, which also tends to be beneficial.

That said, we did see this movie before in 2016. The two very different situations that I think are even more predictive, why the stocks have more upside in 2025 are, one, valuation spreads are still very wide. So this is my mathematical expression of fear. When investors sell anything they think is risky, they buy anything they think is safe, right? Think commercial real estate selling, the big banks buying. In terms of that, like a safety trade. And that you usually see only in recessions.

And although we're not in recession, we are seeing that in the financial sector. So whatever it is that you're worried about, whether or not it's regulation, whether or not it's banks are going to need more capital, whether or not it's the 2 and a half year long inversion of the yield curve, all of that could potentially be priced into the financial sector. So that's data point number one that I think gives upside. And data point number two is we're in a very unique situation on rates coming down and credit spreads coming down.

With the credit market saying maybe there's not as many solvency issues as maybe the market is going to worry about. So when that is the case, which we haven't really seen for the better part of 15 years, that's also been a positive risk reward.

HEATHER: And let's talk about consumer discretionary. That's another category I hear you talking about and read in your papers that you hit on a lot of the time. Consumer discretionary, of course, are businesses that sell non-essential goods and services. And we are very well into the holiday season right now, but also inflation is very high right now, and we keep hearing that many customers are still feeling pinched right now because of inflation. So you would expect the sector to perhaps be underperforming this year, given inflation. What have you been seeing with consumer discretionary?

DENISE: Well, up until three months ago it was actually outperforming, which just shows you how it was—

HEATHER: It was outperforming?

DENISE: It was underperforming, up until, yes, up until three months ago, I'm sorry, it was underperforming. And it just shows you just how quickly that sector landscape can shift. But I think consumer discretionary is another interesting area of the market based on that valuation trend. So earnings growth has been really strong, especially in the cap weighted sector over the last year. And free cash flow growth has been strong. So the fundamentals of the businesses have been quite good. The reason behind the underperformance up until recently was all relative multiple degradation.

So the stocks just got bid cheaper and cheaper relative to the rest of the market. So now as we enter 2025, we're in the bottom quartile of price to free cash flow valuation. And in some ways to the bottom decile of data back to the 80s that we have. So that has historically also shifted your risk reward. So it skews your upside. So you're in the unique situation where fundamentals are still strong, earnings are growing, and you have this valuation support. So as we go into 2025, consumer discretionary could have multiple tailwinds. One from earnings growth, and two from multiple expansion versus the rest of the market.

HEATHER: So it had been underperforming going into the new year. Several potential tailwinds that could also keep it underperforming. Got it.

DENISE: Yeah.

HEATHER: So as we also close out the new year, sometimes it's fun to talk about the winners and the losers of the year. So far, and I know that the year is not over quite yet, but it looks like the award for best performing sector of 2024 is going to go to, and I think everybody at home knows the answer, technology, right? And the worst performing sector seems to be either health care or materials. With a couple of weeks left in the year, of course. I'm wondering what your thoughts are on those categories, the best and the worst. And if you think tech will continue to lead in 2025, despite this market broadening that we've been seeing, and would you consider tech to be another opportunity on your list for 2025?

DENISE: I do think tech is still an outperformer and a likely opportunity into 2025. The interesting part is, over the last six months, it's underperformed by a smidge. And during that underperformance, because earnings growth has been so strong, valuations came in out of that top quartile range, which you usually see as a negative risk reward. So that valuation range has been really important over the course of the last three years to understanding when technology is a little bit too full and when technology is an opportunity. And right now it's screening is an opportunity. And I do think that the stocks are still expensive, although not as expensive as they were six months ago, but expensive for a reason because fundamentals have been so strong.

And on the opposite side of the ledger are sectors like health, where, yes, it's true, the stocks are cheap. And by cheap I mean, bottom quartile on a lot of the valuation ranges that I look at versus the overall market. But they are also cheap for a reason. Operating margins and profitability peaked in the 90s, in the late 90s, and have been actually one of the worst 18 months on record for the health care sector overall, or for any sector overall has been the last 18 months in their operating margins. So I think that some areas of the market that have underperformed and are valuation sensitive in terms of they're still cheap, do still offer a negative risk reward because of that fundamental offset.

HEATHER: OK.

JURRIEN: Are you still—

HEATHER: Oh, go ahead.

JURRIEN: I would just add just quickly on the technology. As Denise says, their relative performance and absolute performance continues to be justified by sharply rising earnings estimates. And if there's one thing we've learned is that earnings revisions are a good leading indicator for performance. So the fundamentals are still good. But along with the inflation question that we talked about earlier, this concentration in the market. Magnificent Seven are 30% of the market. And when, and how, and if that ever changes, and what that does to the overall market landscape.

That's one of the big existential questions that I think about a lot. And I'm sure we'll be discussing next year.

HEATHER: And then back to the question of the negative risk reward here. Should we be buying the worst performing 2024 sector in 2025 as a potential bounceback opportunity, Denise?

DENISE: Yeah, I mean, reversion trades. Statistically speaking, they don't really work from a sector perspective. Like, when you look back to the data since 1962, you have 43% odds, which is not zero. But it's not great either. You don't even break even. So if you bought the worst performing sector, you have 43% odds of outperformance over the next year. If you bought the best performing sector, it's 53%. So it shows you that there is a little truth behind the momentum skew.

Sometimes things that work, work for a reason because they have strong fundamentals. And sometimes, and by the date it means more often than not, which is not to say all the time, they continue to work because fundamentals continue to be strong.

HEATHER: I wanted to touch quickly on another dynamic affecting the market right now that could be top of mind for investors watching and listening. And that is long term interest rates, which are tied to things like 10-year treasuries, 30-year mortgage rates. They're actually going up while the Fed is cutting. This is a concern that this could be a sign from so-called bond vigilantes that deficit spending is going to be causing higher inflation over the long run. So, Jurrien, I know you've written a lot about this. Should investors be worried about this, and how do you think that could impact the outlook for stocks in 2025?

JURRIEN: Yeah, so in our jargon this is called a bear steepener. Meaning that yields are going up and long yields are going up more. And when we look at history, so in the stock market we think about a risk premium because stocks are riskier than safe assets like bonds or cash. In the bond market, there's also a risk premium called the term premium, which means that if you buy really long term bonds like 10 or 30 years, you should get compensated for that because you are lending money to either a company or a government for a very long time. And so fiscal discipline, for instance, comes into mind. Inflation comes into mind.

And we all know the story about deficits and the debt in the US. And so, to what degree the term premium, which is currently close to 0, goes back to some level consistent with history, will tell us a lot about what the bond market will do. Which is not to say that the bond market doesn't have value. As we like to say here, the income is back in fixed income. And the inflation rate is around 2.8. The 10-year Treasury yields are around 4 and a half. So you're getting a positive real yield.

But for the stock market it's only one input right. If you think about valuation in the stock market you are calculating the present value of future cash flows, which you do by looking at earnings growth. So what or the expected earnings growth. And then you discount that by an interest rate. And that interest rate matters. If it goes up, the present value all else being equal of those future earnings goes down. But the earnings side of that equation is far more powerful than the interest rate side. So it really still does come down mostly to earnings as it pertains to stock investors.

HEATHER: Hey, Denise, based on market history, what do you think we should take away from these signals from the bond market?

DENISE: Yeah, I mean, I think it's interesting. It happens 50% of the time that the Fed's cutting interest rates. The long end goes up 30% of the time over the course of the full year. And actually, interestingly enough, you might think that would be a bad signal for the equity market. That actually is a situation where the equity market produces above average returns, right? 11% returns versus the average returns of 8. So I'm not necessarily sure that it's a negative sign for the equity market, meaning that the Fed cut has been potentially taken away.

Usually what you see is interest rates rising as a function of growth. And we are seeing that with positive earnings growth, really the stock market has had no issue with higher rates to the extent that it's joined with higher growth.

HEATHER: And unfortunately we are at time, I hate to say it, our last show of 2024, but let's do one final Timur's take before the end of the year. So Jurrien, what are you going to be watching between now and in 2025 when we hear from you next?

JURRIEN: Hopefully I'm not going to be watching much of anything relating to the markets.

HEATHER: I thought you loved it.

JURRIEN: But because both Christmas and New Year's are in the middle of the week, maybe everyone takes off at the same time and nothing happens, which would be a nice rest. But barring that, one question I have is how much of this momentum of the new administration and the red wave will have been priced in by the time we get to inauguration? But that will be, we'll have more shows before then.

HEATHER: And that's not to say that many of us are not working through the holidays or on call here at Fidelity.

JURRIEN: Of course.

HEATHER: But we do have to leave it at that. Thank you so much, Jurrien and Denise, for great insights today. You both had just some terrific information for us and historical examples. And we get that sometimes it can get confusing. So just a reminder to reach out to us if you do have questions and you need a little bit of help getting 2025 off on the right foot.

Speaking of the new year, we have a fantastic 2025 outlook show that I mentioned earlier, that's planned for January seven. So mark your calendars. That is our regular date and time of Tuesdays at 2:00 o'clock Eastern. Our panel of experts got together in person. Jurrien was one of them, to talk about what we might expect in the coming year. So you can hover over the QR code right now on your screen to be taken to the registration page. Or you can type in Fidelity.com/marketsenseoutlook. And that will take you to the register page as well. So that you can add it to your calendar.

So on behalf of Jurrien Timmer and Denise Chisholm, I'm Heather Hegedus. Happy holidays, everybody. And we will see you in the new year.

[1]Bloomberg: November 26, 2024: www.bloomberg.com/news/articles/2024-11-26/mexico-hints-at-retaliation-after-trump-threatens-steep-tariffs

[2]Haver, FactSet and Fidelity Management and Research Company October 2024

[3]Fidelity Viewpoints, November 13, 2024: www.fidelity.com/learning-center/trading-investing/market-insights

[4]Fidelity Viewpoints, October 25, 2024: www.fidelity.com/viewpoints/investing-ideas/investment-research-update

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