Fidelity Viewpoints®: Market Sense

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TRANSCRIPT

SPEAKERS:

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Jim Armstrong: Hello and thank you for joining us for Market Sense. I'm Jim Armstrong with Fidelity.

Checking our investment account balances has become a harrowing kind of experience once again these days. Inflation concerns, supply chain woes, the war in Ukraine, more concerns about COVID, all of those are potential market movers.

So today, we'll work on maintaining our focus on how we can plan for the worst but still stay invested. We're going to dig into the three main categories that you might want to consider in your financial plan and we'll talk about potential opportunities in the market right now.

Jurrien Timmer and Leanna Devinney are back with us this week as always to guide our discussion. Jurrien has got his fresh take on the markets and our economy as a whole, and Leanna is going to be talking about the steps we might want to take to build and update plans to help us see past volatility of the sort that we're living through right now.

Before we get too far into that discussion, we did want to share a little something with the audience. After more than two years and more than one hundred episodes of Market Sense, Jurrien, Leanna, and I were finally able to meet in person last Friday.

So, I am not standing on a step, for those of you looking at the picture. That's what we look like in person. We're all actually 3D people. It's amazing.

Leanna Devinney: It was great and we were really surprised. Two years and we had no idea that Jim was 6'5".

Jurrien Timmer: Yeah. No, I opened the door and I'm like—you know, because in Zoom—Zoom is the great equalizer. We look all exactly the same height. So, anyway, it was great to see you both in person finally after two years.

JIM: Yeah. Thank you for hosting us, Jurrien. We had a wonderful time. And yeah, it was just great to—to have that time not talking about the markets necessarily, although we did a little bit, trying to have some good time with each other as friends.

With that said, however, we do have to talk about the markets. This is a nice way to maybe set the table for what could be a bit of a rocky discussion or at least the topic will be rocky.

It's Tuesday, May the 24th, and markets are hovering near lows again and lots of discussion that started late last week about whether or not we've entered bear market territory. So, Jurrien, maybe start us off this week with—with sort of that baseline definition of what a bear market is and your assessment of whether or not we're actually there right now.

JURRIEN: Yeah. So, in this table which I know is going to be maybe hard for some of you to read if you're watching this on a smaller device, but here I have shown all the declines of 20% which generally are considered bear markets, although there is a little bit of a nuance which I'll get to in just a moment, since 1870. So, just to show that we take our market history seriously. And by my count, there have been twenty-seven of them, so that's about one every five years which makes sense because typically the economic cycle is about four to five years long, or at least it used to be. It's gotten a little bit more stretched out in recent decades. And it shows just, you know, that the typical bear market decline of more than 20%. And there's a few in there that are not 20% but that have felt like bear markets and that's why they're in there.

But the typical decline is 30% and lasts nineteen months. And it produces a valuation decline, a decline in the P/E ratio, which is ultimately the most important thing, of about 32%. But as is always the case in life, there are lots of nuances here. And in the same way that people like to call a recession a recession based on two consecutive quarters of declines in GDP—which is not the formal definition of a recession, it's much more nuanced than that—by the same token, I wouldn't be so quick to call a 20% decline a bear market.

And that may seem like a minor detail but we've had 20% declines, for instance, in late 2018, in the summer of 2011, and those were not recessions and I don't think anyone—most people wouldn't even really think of them as bear markets. They were just deep—deep corrections, scary ones, but that reversed relatively quickly. And I'm not predicting that this one is going to reverse quickly or even that it has ended at down 20%, but it's just a little bit of a—of a caveat that, you know, just because something is down 20% doesn't mean we should immediately conclude that a recession is next, for instance.

And actually, the table shows that there is a big distinction between what I would call a recession bear market and a non-recession bear market. And so, you do get 20%, possibly more than that declines even if there's not a recession, and the ones I mentioned, 2018, 2011 were two, 1998, 1994. So, there are a number of them. And if you look at the bottom row there, you can see that the typical non-recession bear market lasts only four months and produces a decline of 22% and a valuation decline of 28%.

And guess what? Again, I'm not predicting that this is over, but guess what? This current decline, the peak was January 4th, so it is now four and a half months old. And as of Friday morning on an intraday basis, the market was down 21%. So, and the valuation was down 25% to 30% depending on what kind of P/E ratio you're using.

So, so far, assuming that this ends, which nobody knows if it will, this has been actually fairly typical of a non-recession bear market. And just to kind of drive that point home a little bit further, if we can skip to the next slide, what I've shown in this chart is not the—the percentage decline or recovery but the amount of time that it takes to go down, which is on the left-hand side, and then the amount of time that it takes to recover back to the previous highs.

And what you can see is that there is very wide dispersion, right? So, the recession—the really bad recession bear market, so think of 2008, 2000 to 2001, that was the dot com bubble, it would take many, many, many months to get back to the old high. But then you look at some of the non-recession bear markets, or sharp corrections, including actually 2020, which was a bear market. That was down 35%. It took only six months to recover. 2018, it took only seven months to recover. 2011, it took ten months to recover.

And so, it's just a way to make us remember that just because you see on your CNBC screen, "Down 20%; bear market has started," the reality is often more nuanced and we have to think about the context and not just make a blanket assumption that oh, down 20%? A recession is next. Because sometimes it does but oftentimes it does not either.

JIM: Nuance and context, particularly hard to come by generally speaking on cable news. So, that's why this is a great program to do exactly that, to spend a long time with these—these detailed explanations.

So, to which, I would love to draw your attention next, Jurrien, to inflation, where again, a nuanced answer of where we are and where we could be coming, I think would serve people pretty well.

JURRIEN: Yeah. So, we obviously, we all know inflation is a massive issue. It is front and center for most—on most peoples' minds in this country and around the world. The most recent CPI report still shows an 8.2% year over year gain in inflation. Now, that's down from the peak which was 8.5%, but still, it's a small enough difference. And we've seen, for instance, some earnings reports from big retailers last week that shows that that inflation is impacting the way people consume and behave.

So, I don't want to understate in any way that inflation is the biggest issue right now in the markets. But there is, I think, maybe some silver lining around this cloud. And one of them is that, as I just said, the rate of change looks like it has peaked, and I think there is a consensus building in the Wallstreet community around—among economists that at least on a rate of change basis, maybe we've seen the worst.

And that's important because for the Federal Reserve, you know, one of the issues with this market not only on the stock market side but on the bond market side is that, you know, about six months ago, the Fed started moving the goal post, saying, you know, it had been saying, maybe we're going to raise rates to here and then stop. And then they would say, no, we're going to raise them much higher and then we're going to also shrink the balance sheet and do this and we're going to do it much faster.

And so, that is—kind of has unnerved the market really during the duration of this decline which started in January. And if the inflation rate of change peaks here and maybe starts to come down, that doesn't mean the Fed is not going to raise rates further. I mean, that's almost a certainty that it will. But maybe that will help see the market—help the market see the end game more clearly and help the Fed see the end game more clearly.

So, right now the consensus is that the Fed will go up to 3% and just stop there at least for a while. And if the inflation numbers start to behave a little bit better, then maybe the market can get some solace that okay, we kind of see where this is going to go and it's not going to get worse from that. And for the markets, which are always discounting the future, that is a hugely important thing, right?

So, the Fed, a lot of people are saying, well, the Fed needs to start cutting rates before the market can rally, and I don't agree with that. I think the market just has to get a sense of, okay, that's the end game and it's not going to change anymore.

And on that note, in this chart, I show a long-term view of what the market expects inflation to be. So, this is the TIPS, the Treasury Inflation-Protected Securities, implied inflation rate over the next five to ten years. And you can see that in recent weeks, that number actually has been coming down. And I think again, this will be an important part of the conversation that if the market starts to feel a little bit more comfortable, that the Fed is not going to yet again, you know, move the goal post to a higher end game, then the market can start to kind of heal and recover and maybe we start getting closer to the end of this correction.

JIM: Leanna, I'd love to get your perspective here as well. You know, I mentioned at the top of the show, we're back to those days when opening that envelope or looking online and seeing your investment account balance is—I think I used the word harrowing. For me at least it is.

You've said many times, and Jurrien has echoed it as well, if you've got a good plan that matches your goals and your risk and your time horizon, stick with it and you should be fine, all else being equal. But we also know it's hard to do that when the market is doing what it's doing right now.

So, there's a, sort of an all-weather plan that I think you can walk us through a little bit. That would be great.

LEANNA: It is. And times like this, it's really hard, and I would say times like this is when our true risk tolerance comes out and learning really what we can stomach. So, we've had clients like you, Jim, that simply just say, I'm not looking.

JIM: Yeah.

LEANNA: I'm not turning on the TV. I don't want to see it.

And then we're having other clients call in really proactive to make sure that they're still on track for whatever their goals are, or those that are in retirement, making sure that they still have that sustainable income plan to pay their expenses.

So, really, what we talk about is this all-weather plan. And our clients who often feel the most comfortable and confident during these times, although still very hard, they have three critical components to their plan. They have emergency in their plan. They have protection in their plan. They have growth in their plan. And we'll dive through each of those but we go through an exercise and we start talking about really assigning different roles and responsibilities for the wealth that you have and it allows you to again, stay more comfortable and confident through times like this.

JIM: That's great. Well, let's do what you—what you just laid out there, go through each of those, maybe starting with an emergency plan, right?

LEANNA: Yes. So, emergency fund. So, this is really making sure that we are planning for the unexpected. So, many times we work with clients and they have an understanding of what their spending is so then we can plan out and build portfolios, understanding what just your expenses is and your assets. But we never can plan for what's those unanticipated expenses. So, having an emergency fund saves for those rainy days or those emergencies.

So, we like to say having three to six months' worth of your essential expenses is a great starting point. For many, that six month number can feel really big, so you can certainly aim smaller and just start dedicating one month at a time.

On the other end of the spectrum, a client recently in retirement felt comfortable actually having one years' worth of expenses and also knowing they may need to help family members down the line who didn't have an emergency fund. So, just find that number that's comfortable and it should be customized to you.

The second piece, protection. This is a critical piece of any well-rounded plan and I say it's critical for those that are farther away from retirement, if they're saving and maximizing. It's also critical for those that are in retirement and may need to have more conservative parts of their plan.

So, protection could be things foundational like life insurance or protecting income in case of disability or basic estate planning.

Protection for some is also protecting from the stock market. A portion of your money that cannot go down. It's a fixed rate. So, things like CDs or Treasuries, these are, again, taking a small portion of your wealth and almost making an anchor. And clients know they have peace of mind that that portion of their money can never lose. It's not subject to the stock market.

Another part of protection we see for those taking income, for some in their mid-70's, 80's, and 90's that have retirement accounts, you're mandated to take a required minimum distribution. So, in years like this, if you're taking that distribution from accounts that are volatile and the stock market is going down and you have to take money out for this mandated required distribution, it, again, can feel unnerving. So, you're taking money out as the markets are going down in this case.

When you have protection, it allows you to say, I'm going to take from my safer money for my required minimum distribution and allow my growth piece to grow over the long run, so.

JIM: Interesting different lenses you can look at for protection there. How about the last—the last of the three there, growth?

LEANNA: Yes, the growth one. I almost skipped over it but this is generally the largest piece of your plan. And growth potential, it really allows us to again, accumulate and hopefully stay invested through those ups and downs and it also allows us to keep up with inflation.

I always say, growth doesn't mean put everything in the stock market. This is really where we talk about the power of diversification and having that healthy mix of stocks, bonds, and short-term investments in a diversified portfolio that's aligned with you, your time horizon, your financial situation, your risk tolerance.

So, those three components really allow clients that have emergency for the unanticipated expenses, protection kind of really provides that peace of mind through downturns, and growth to keep up with inflation and keep up with your goals.

JIM: You know what else would be great if you could talk about, Leanna? This idea of the opportunity that might present itself or the opportunities that present themselves during a time like this. Again, it can be harrowing but there's another way to look at what's happening right now.

LEANNA: So, I'd say talking about the normalcy of this, I know Jurrien just spoke to two events, 2018, 2011 where we saw a 20% downturn. And we forget that happened. We can almost have that short-term memory loss when we look back at times. So, just level setting. It's certainly not uncommon for stocks to go through this type of volatility.

This graph here is showing those different times that we've seen. This is looking back from 1980's to now. Pretty much any one of these market events, clients would often share with us or investors, we feel, well, this time feels different because of X, Y, Z. You know, we've heard it a lot. This feels different because inflation is so high. Or this feels different because we're in a global pandemic. This has never happened before.

So, I would just say, the market event or what's going on in the world, world event, is different every time, but typically how the market reacts is not different. And so, we can see through history that really sticking with the fundamentals can pay off. And so, that's why again, we help and make sure that you have that appropriate plan aligned to the goals that you have, that you have things like that asset allocation, diversification, which again, it doesn't ensure gains or guarantee against losses, but it does allow that smoother experience and allows many to stay the course.

JIM: You know, Jurrien, we started this year, 2022, with you reminding us of what you thought would be the importance of corporate earnings this year really being where you were thinking of spending a lot of time focusing your attention. Can you just catch us up on—on why that's the case and if it's still planning out or still working out that way?

JURRIEN: Yeah. So, I—you know, the last three, four months or so of this correction, I think the focus was mostly on inflation and it still is, of course. I mean, that is what's driving the Fed to raise rates. But with Treasury yields having largely reset, right, the ten-year yield which right now is at 275, it was at 320 about a week or two ago. I think the bond market has kind of repriced itself and I think the stock market has repriced itself on the basis of those expectations for a different inflationary backdrop.

And I think going forward, the focus will be increasingly more on the growth side rather than the inflation side because as I mentioned, the inflation rate of change looks like it has peaked, so that number should be coming down, you know, from 8% to 7% to 6% to 5%, and then it really becomes a question of where it settles down. Does it go all of the way back to 2% or does it stay at 5% or 4%?

But I think at this point, the market is getting more worried about the growth side. And you know, just to revisit that table at the beginning, the difference between a recession bear market and a non-recession bear market—sounds obvious because I am already burying the lead here—is that one produces the recession or one is associated with a recession, and the other one is not.

And when you have an economic recession, you tend to have a decline in earnings. And so, this chart just shows the progression of earnings estimates by sector. And you can see that if you look at the right-hand side, that, you know, energy is in the lead, which is not a surprise given where oil prices are, and that consumer discretionary like the retails are at the bottom, and that's not a surprise given what we just had been hearing about some of these earnings numbers last week from the big retailers.

But by and large, the number for the market as a whole is positive and is holding in pretty well despite the fears of a slowdown or a recession and despite, you know, inflation impacting consumer behavior or maybe profit margins.

And so, to me, the thing that I'm watching more than anything else, and I watch everything, is the earnings trajectory going forward, because if you think about the math, right, price, stock prices are at the intersection of the P/E ratio and the E, the earnings side. And what we've seen so far is a derating or a resetting of the P/E, right?

Last year, the P/E was 23 times expected earnings. Now it's around 16/17 times. And that's an appropriate derating because the more abundant liquidity is, the higher the P/E goes, and the opposite happens as well. And of course, we know that the liquidity environment is becoming a lot more restrictive.

But the E side is important because right now, the P/E has fallen more than price because the earnings side is kind of lifting things up, right? Earnings are not growing at the rate they were last year which was 40%, but they're still expected to grow at 10% this year. And so, that will offset some of the derating that we're seeing in valuation.

If that were to change, and again, that's not a prediction at all, I don't see a lot of evidence that a recession is imminent or that corporate earnings are about to fall off a cliff, but if that were to change and the E side were to fall while the P/E is also falling, then you could—then just mathematically, price would have to fall more just to make those numbers match, right?

And so, going forward, I think this is really the focus in the markets is will we avoid a recession and will the Fed be able to land this plane in a soft landing and not in a hard landing. And that's—I'm sure we will spend many—many Tuesdays, you know, discussing that.

JIM: Let's cheer for a soft landing for sure.

With about a minute or so left, I'd love it if you could each just take about thirty seconds apiece, knowing that many folks watching and listening right now are at least a little bit anxious about what's happening in the markets, what's happening to their personal bottom lines. What—what one or two things would you leave people with as we look ahead to the coming week or two?

And Leanna, we can start with you.

LEANNA: I would just go back to the clients that we hear from that say, you know, I don't like this but I do feel comfortable with the plan I have, have those three components. And so, it's looking at your wealth and making sure that you have that emergency fund, you have protection in whatever that would look like for your situation, and you have growth as well.

So, I'd say working with a financial consultant or professional can be really advantageous and we're here to help.

JURRIEN: I would just say, you know, the market only goes up 60% of the time and it goes down at least 20%, one every four to five years. And obviously, we're in that—in that space right now.

And it's easy to second guess and say oh, I should have gotten out in January. There's nothing we can do about that now. What we can do is take a fresh look. Okay, the market is down 20%. Some stocks have gone down for the right reasons but others have gone down because everything else is falling. And is that an opportunity, right? With a crisis or with a problem often comes an opportunity, and the opportunity to rebalance not only into the stock market but even into bonds, right. At 3%, maybe we've seen the worst. And so, if you do happen to have a lot of cash handy for whatever reason, you know, maybe this is the time to sit down with Leanna or one of her colleagues and say, should I be rebalancing here?

JIM: Yeah. That was some great advice, great counsel as always. Thank you both for your time.

For folks in our audience, thank you for spending time with us as well. We know, by the way, you've got many ways to watch and listen to Market Sense, but if at the moment you happen to be watching on Fidelity's website, you will find a really quick three-question survey underneath this video. If you could take just a moment to fill that out and let us know what you think, we would very much appreciate that feedback. Again, that's only available if you are watching this on Fidelity's website.

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Again, huge thanks to Fidelity's Jurrien Timmer and Leanna Devinney.

We are off next week for the Memorial Day holiday, so we will see you back here live on June 7th with a fresh look at the markets, what they're doing, and what it means potentially to you as an investor. We hope to see you then.

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