Fidelity Viewpoints®: Market Sense

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TRANSCRIPT

SPEAKERS:

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HEATHER HEGEDUS: Hi there, everybody. Thanks for joining us for another episode of *Market Sense*. I'm Heather Hegedus with Fidelity.

So stocks are down slightly this week. Long-term Treasury yields are rising due to inflation concerns. However, the market is still near its most recent all-time highs that it struck just last week incredibly, and that's coming off of this very strong earnings season. And also some inflation and jobs data from July also help to fuel the market with those all-time highs last week.

So joining us today, as he often does to talk about these market developments and also how he's thinking about them in terms of the bigger picture, we are delighted to be joined today, as we often are, by Jurrien Timmer, who is Fidelity's Director of Global Macro.

We're also excited to welcome to the show once again today Bradford Pineault. He's a CFA and the head of Fidelity's Capital Markets Strategy Group here at Fidelity. And in his role, he travels around the country and he talks to financial advisors about market conditions all the time.

So with quarter 2 earnings season nearly in the books, we asked Bradford to come on the show today and share with us some of the conversations he's having with some of those financial advisors across the country. So great to have you both on the show today. And, Bradford, welcome back.

BRADFORD PINEAULT: Thank you, Heather. Great to be here.

JURRIEN TIMMER: Good to see you both. Welcome back, Bradford.

BRADFORD: Thank you.

HEATHER: So I'm excited about this panel today. Today is Tuesday, August 18. And both the second quarter earnings season and summer unfortunately are beginning to wind down. Jurrien, it's been such a strong month for the markets. I'd love to get your take on this, many companies delivering really impressive profit gains. I'd love to take a step back from you and just get a sense from you on your overall assessment of this earnings season.

JURRIEN: Yeah, it's been spectacular, and I don't use that word lightly. So really, the last four or five quarters have been very, very strong. Typically earnings estimates kind of dwindle down as we go into the quarter, and then they perk back up as companies inevitably beat the estimates.

But the last, I would say, four quarters the numbers have been drifting higher into earnings season and then bouncing even more. And of course, this has something to do with AI. It has to do with just a very strong economy, the One Big, Beautiful Bill from 2025 obviously incentivized companies that do a lot of capital spending, and that results in higher margins.

And so margins have been new all-time highs almost consistently this year. So the momentum is very strong. But even then, the expectations coming into this quarter were very lofty at a 24% growth rate, and my sense was, OK, these are going to be harder numbers to beat just because the expectations are so high.

But lo and behold, the actual result was about 10 percentage points higher at 34%. And even going into the far into the coming quarters and even the coming few years, the expectations are very, very strong. So when you have rising earnings and a rising rate of change of those earnings, so the momentum of those earnings, you've got something really good going on. And that's what the market has right now.

So we really have an earnings bonanza on our hands. At some point, that growth rate is going to start decelerating, as it always does. Doesn't mean the end of the cycle. But at some point, you're going to get rising earnings and a falling rate of change, but we're not there yet. And for now, that creates a lot of momentum.

HEATHER: It has been remarkable to watch, Jurrien. I know something that both you and Bradford have also been watching has been this market rotation story, as investors move some money out of dominant mega-cap tech stocks and AI stocks. But they're not taking the money out of the market, as you just talked about, well, with these earnings. In fact, far from it.

So can you talk about—Bradford, I'll bring you in here. What have been some of the new winners in this market? And as you look ahead, what you're making of this broadening and if you see it continuing?

BRADFORD: Yeah, by all means. So we, from a capital market strategy perspective, have been talking about this idea about the broadening market for some time. And investors probably took note of this last summer into the fall, even earlier this year before the Iranian conflict. And now we're seeing it once again.

From a technical perspective, 75% of the S&P 500 constituents, so 500 companies in the index, are actually outperforming or trading above their respective 200-day moving average. And that sounds pretty technical, but what it really tells us is that there's momentum in basically 75% of those names, so nearly 400 of these names doing quite well. That tells us that technically the market is broadening.

And we're seeing this outside of the technology sector or, more broadly, the growth style. So areas like financials, so banking, industrials, small caps, even parts of the international ecosystem, they're outperforming, and they're doing relatively well. And to us, real simply, this tells us that cyclicality is working.

I love that word. It sounds fancy. But what it tells us is that companies that have their revenues tied to the vitality of economic activity, so if the economy is doing well, these companies fundamentals are emblematic of that. Those are doing well.

And that's exactly what we're seeing. As Jurrien talks about, not only earnings doing well, but the broadening in earnings is doing well. And that's something that is very indicative of a healthier, not weaker, market.

The other thing I would just say, Heather, is the artificial intelligence story, which I know we're going to talk a little bit about here today in a lot of different ways, we are seeing some of these sectors outside of tech benefiting from that. Financials are seeing loan growth go up as a result. Industrials are seeing their activity go up as they're building out these data centers as a simple example.

And then what we don't yet but the market is asking lots of questions is, to what extent does artificial intelligence actually benefit the fundamentals of the non-tech space? It remains to be seen, but so far, this broadening market to us has potential for more legs, meaning this could be a protracted rotation. And it's certainly welcome for investors.

HEATHER: So banking, industrials, small caps, a little bit of internationals, some of these sectors that didn't work for a decade are working now. But even as leadership is broadening, AI is certainly remaining the bull markets biggest theme, as you said, Bradford, and, Jurrien, just to drive home that point, I'd love to bring you in here because I wanted to get your thoughts on a stat that I saw that I thought was particularly telling here.

It was some recent research that I heard on Bloomberg, and then I saw it repeated a lot this week that found AI-related stocks are now responsible for about half of the S&P's index by weight. So more than half of the index is either AI or AI related, which Bradford was just talking about with financials. I'm wondering, Jurrien, from your perspective, how are you thinking about AI and concentration risk in the tech sector these days?

JURRIEN: Yeah, so I'll take both of those a little separately. The market is now passing a test that it has repeatedly failed over the last 10, 12 years in terms of concentration. So we know the Mag 7 or at least let's say the top 10 stocks are about 40% of the market. And from 2014, when they started to really dominate, until about a year or two ago, whenever the Mag 7 were sold off, if investors lost interest, it would take the market down because the stocks were just too big for the market not to be able to withstand a sell off.

And that happened repeatedly over a number of years. More recently that's changed. So earlier this year, we had what I call a bullish broadening. And even over the summer, just over the last few months, the Mag 7 fell about 10%. The AI stocks fell about 15% to 20%.

And the S&P index as a whole actually did OK. It didn't go up a lot, but it only went down a few percent as the market rotated. And as Bradford says, 75% of the stocks in the S&P are in uptrends. They're above their 200-day moving average.

And if you look at the S&P equal weighted index, so if you measure every stock as having the same weight as opposed to being driven by its capitalization, the S&P equal weighted index has now outperformed the Mag 7 by 13 percentage points over the last three months. And it's done that in a rising market, and that's a real change in what we've seen for a long time.

So it's a very good story. It's good for active investors. It's good for if you're a broad investor and you don't want to be completely dominated by what only a handful of stocks do.

And the AI versus non-AI question, there's good news there as well. Again, from June until just a week or so ago, there was a significant correction in the AI stocks, including the semiconductors, the Mag 7, and the market did OK. And whenever the AI stocks go down, the non-AI stocks go up.

So it creates a nice level of diversification. And actually the correlation of AI stocks to non-AI stocks is negative. So non-AI stocks, even though they're still stocks and they're still in the S&P 500, are acting like a real good diversifier. And that's a good thing to have because, with AI, there's, of course, a lot of promise.

But there are risks as well as there always are because there's a lot we just don't yet, including how much money it's going to take to actually bring this thing to the broader economy. But that's a whole different question.

HEATHER: Well, let's stick with the AI question for a minute. And, Bradford, over the course of earnings season, we did see some investors really scrutinize the enormous capital spending required to build the AI infrastructure. And companies designing and manufacturing this critical technology have been amongst the market's biggest beneficiaries, as Jurrien was just talking about. But we've also seen some volatility here too now. So I was wondering if you could talk about what the latest is with semis, with semiconductors, and where you see the potentially biggest opportunities going forward when it comes to AI.

BRADFORD: Yeah, by all means, and I'll just maybe anchor off of what Jurrien just said. This question, this inquiry, this topic is a pretty large one, and it seems to be at the nucleus of what's happening, not just from a market perspective but from an economic perspective.

But to your question, Heather, the semiconductor space has been seeing a significant amount of earnings growth. And the demand for compute and intelligence is really at the center of it all. And this graphic summarizes it pretty well, just at a very high level.

But the market is wrestling with, from a bull versus bear perspective, is, will AI demand, will the demand for compute, will it grow fast enough to absorb, to your point, this build out that seems to be quite historic? And there's been comparisons of this build out to the cloud computing that we've seen, to energy, to even electricity into railroads, way back when, 200 years ago.

But that's really the wrestling here. And if you look at some of these bull statements, these "four bullet points, we really at Fidelity believe that the demand for AI is still supply constrained. So if you just get back to the law of economics, if the demand for anything is greater than supply, there could be a potential for more earnings growth or at least a favorable setup from a bull perspective.

The hyperscalers, as we just saw, the four big ones, all confirm that they're going to continue to spend to accelerate CapEx, Capital Expenditures, into 2027 and perhaps beyond that. Remains to be seen, but at least that's what they're telling us. So it doesn't seem as if they're decelerating their expensing.

And then the inference demand, well, what is inference? It sounds fancy again. But think of it this way.

The early days of AI, the last decade or so, was all around the training of models, so any of these models that we might all use on our smart devices. The training of models obviously led to the demand for semiconductors like GPUs, so microchips. memory storage.

The inference stage is where now those models can be utilized. The way I think of it is it's like building out a highway. That's the training. And then how many cars will travel over the highway? Or building a factory and then actually using the factory.

The first stage is training. The second stage is inference. And that demand is expected to go up significantly as we see more corporations, the enterprise, as well as consumers utilize this.

And then lastly, new workloads emerge faster. What that basically means is there are industries and use cases for artificial intelligence that we can only dream of. And it's really all speculative. But if all that happens, the pie grows bigger.

The biggest bear case around semiconductors is that the visibility of the return on investment remains opaque. So all this spending could be for not. And maybe the greatest concern is that we're overbuilding for something that just doesn't grow as maybe the bulls think it will.

I have to be very transparent here, Heather. There are more questions than answers around this topic. I, for one, personally remain in the bull camp. But that doesn't mean that this can't be volatile.

We saw significant volatility on the upside in April and May and really into the latter part of June. And then we saw significant downside volatility really in July. And now I believe today, August the 18th, is a pretty significant down day.

But all I would caution investors to think about is the long-term story here, remain diversified, and understand that this is not the end all, be all. There will be some significant down days ahead, but maybe the structural bull case wins out at the end. But it does remain to be seen.

HEATHER: Very balanced answer there, laying out both the bull and the bear perspectives on that, Bradford. Thank you.

So we've talked about where growth is coming from in this economy, and I wanted to zoom out now and talk about the interest rate picture as well, another hot topic as of late. So just in the past two days, the yield on the 30-year Treasury has surged to its highest level since prior to the global financial crisis. And the reason for that is everything from inflation concerns and rising oil prices to growing Treasury issuance.

So I wanted to ask you about this, Jurrien, and ask you, in your mind, is this related to the new Fed leadership here? What are you making of this? And what could it mean for whether the Fed does decide to raise rates in September?

JURRIEN: Yeah, I think that there's a lot of answers to this question, but yes, long bonds, so the 10 year, the 30 year, especially the 30 year, are making new highs not seen since 2007, which is quite some time ago. And it's driven mostly by real rates.

So if you buy a 10-year TIP, which is the Treasury Inflation-Protected Securities, you can lock in a real return of about 2.5%. And that's the highest we've seen, again, since the financial crisis. So real rates are driving yields higher.

And we can come up with different reasons for this. One, of course, has to do with the energy, supply chain bottlenecks that still exist in the Middle East. We have a strong economy, even though the jobs data few weeks ago were a little bit soft. But I think that's mostly a statistical anomaly. So by most measures, the economy still runs fairly hot.

And of course, all of this, AI build out with trillions of dollars of spending, is going to be inflationary. It might be deflationary down the road when the productivity gains are seen. But this is a lot of buildings to build, and they require labor and resources and everything.

But then, finally, I think one important component of this is Federal Reserve policy, especially now under the new leadership of Kevin Warsh. The way I think of it is that, when the Fed started cutting rates in 2024, it was justified in doing some of that because 5 and 3/8, which is where the Fed ended up in '23, was no longer really justified given that inflation was starting to come down.

But then last year, it cut a few more times because it was concerned about AI destroying jobs, and inflation was making more progress. And it cut rates a few times when really it didn't need to. The AI job thing has not really been a problem yet, and of course, inflation since the Iran conflict has been quite sticky.

And so I think what the market is saying to the Fed that you should not have cut rates, and now you have to undo those rate cuts by raising them again. And that's a tall order. The Fed doesn't really like to admit to mistakes.

And of course, we have the new chair who is talking a good game in terms of hawkish and we will get inflation to 2%. But so far he hasn't done anything about it other than talk. And so I think the market is testing the Fed saying, OK, you need to raise rates, and if you don't do it, we're going to raise rates for you by raising long-term yields.

And then there's one final angle to this, and this is that Kevin Warsh wants to make the Fed less transparent. He wants to be, I think, a little bit more like how Alan Greenspan was back in the '80s and '90s. And if you are going to be less transparent, you're going to create more uncertainty.

When you create more uncertainty, risk premiums, the amount of compensation that investors want to get, is going to go up, whether it's stocks or bonds or real estate or anything else. And so part of this might also just be the bond market saying, if we're going to get less hand-holding, we want to be compensated through a higher term premium. And that drives long yields higher, even if short yields are staying put. So I think there's a number of factors going on here.

HEATHER: Market's saying, if we're going to get less forward guidance from the Fed, we want to be compensated for that. Hey, Bradford, I know you have argued that inflation isn't always a bad thing, which is a tough case to make to consumers at the grocery store, at the gas pump in that moment as they're feeling that sticker shock. But I was wondering if you could walk us through that line of reasoning and why you say that.

BRADFORD: Yeah, no doubt about it. Inflation, we're all consumers here, ladies and gentlemen. So inflation is a real story, and prices are certainly higher.

But what I would say is inflation does seem to be at the center point of, let's just say, not the hatred but the significant dislike of what's happening. So consumer sentiment does seem to be pretty low.

However, to your point, inflation is not always a bad thing. And if you look at this graphic would be to keep it simple, the inflation that's a bad thing is where monetary policy has to tighten as a result of it. So think 2022, where clearly inflation at 9%, which was the high back in June of 2022, had to be dealt with right with the Fed precipitous tightening. And that was a challenge for the market.

We're not there today. And to Jurrien's point, we're not back at the 2% price stability. But at the same time, I would tell you that there's a bear case, there's a bull case, and there's a super bull case.

The bear case is pretty simple. And again, we know we don't know 100%, but if rates remain higher because inflation is sticky or perhaps going higher, that could be a challenge as the Fed has to address it. That could drive up the price we are willing to pay for a share of a company's profits.

In other words, we could see multiples come down as a result of that. It could bring about more bond volatility as rates go higher. And there's a potential for a market correction.

Our base case is more of the middle here, where it is maybe bullish to say that inflation at the end of the day is too much money chasing too few goods. Or if you will, it's emblematic of an economy that's stronger, not weaker, once again.

So perhaps this is indicative of better earnings. Jurrien said it pretty well. Earnings are pretty exceptional. Productivity gains, there's a potential for that with artificial intelligence.

And this also is indicative of that cyclicality, where the market is broadening. So it remains to be seen what the Fed does. I just have to say, though, Heather, all the way to the right-hand side of this graphic, hopefully you all appreciate the dark green bull, different ways to connotate the super bull story, and this is where artificial intelligence comes through with more efficient and productivity gains, which really allows for inflation to be less of a concern.

So this is like having your cake and eating it too. In other words, economic growth could grow, but inflation's not such a problem that the Fed has to address it. So you have good strong earnings, a durable bull market. The Fed might be benign in this outcome, and it could be the very best outcome.

So to me, the middle seems quite plausible, but there is a chance for one of these ends to happen, either the bear or the bull, the super bull. But the base case would be right down the middle.

HEATHER: Something on the end of the spectrum, the super bull, not to be confused with Super Bowl. I think your Boston accent was making it sound like Super Bowl, although that would feel like the Super Bowl of stock markets, of bull markets.

BRADFORD: Guilty as charged. Guilty as charged.

HEATHER: Brad, thanks for letting me just give you a little bit of a hard time with your Boston accent. I'm guilty of that too.

So, Bradford, you've been saying that, given everything that we've been talking about today, this strong economy and the strong earnings situation, that you believe that we are in a golden age of stock picking right now. Can you talk about what you mean by that and what the takeaways might be for investors in our audience today?

BRADFORD: Yeah, by all means. So the two simple observations, we've spoken about both of them briefly. One is interest rates, and the other is this innovative technology known as artificial intelligence.

The interest rate story, quite simply, is that interest rates are no longer 0%. And you mentioned we haven't seen 30-year yields like this since pre-GFC. In fact, it was 2007. So it's been a long time, And investor's memories tend not to go back 20 years for sure.

But because it's been a long time, it feels a little bit different. And what I would say is the Fed is either, A, going to stay on hold or, B, hike, to Jurrien's point, to take back those rate cuts that maybe they shouldn't have done in '24 and to '25. We'll see what happens there.

But I can tell that doesn't seem to be a C scenario, meaning it doesn't seem like the Fed's going to continue to cut to make the cost of borrowing, the cost of capital homogeneous and cheaper. So real fundamentals matter here, Heather. Revenue growth, margins, how a company deploys resources and capital matters again, whereas it didn't matter as much when rates were almost free of charge, cost of capital.

The second observation is AI. When you have a technology like this, this is not a rising tide lifting all boats. That not every constituent in the S&P or every sector of every industry is going to utilize artificial intelligence to the same degree. Some might hold off and wait to it to be a bit more real. Others are early adopters.

So because of that, we do believe that you have to employ some discretion as to what companies you want to own, what mutual funds, what ETFs you want to select. This is not going to be an easy investing past 15-plus years. And we know historically active management tends to give you alpha and tends to outperform over time.

And of course, we're always hedging our bets here. But our outlook does tilt into that arena. And we're irrationally optimistic about the prospects of it.

HEATHER: All right. Well, thank you so much to both of you. We got to leave it at that. But, Jurrien and Bradford, just a terrific discussion today.

We've had a lot of great questions that we couldn't get to today in these 20 minutes. In fact, Jurrien, I will write down that goal question for next time that we had to skip over. But I did want to share a new resource for our audience that you might want to head to if you felt like one of your questions was left unanswered today.

It's Fidelity.com/InvestorQuestions, and there, our Fidelity team has compiled some of the other most frequently asked questions that you've brought us, including other in-depth market and economic insights, and put those questions to our thought leaders. And they've got some terrific insights there as well.

So check that page out. But on behalf of Jurrien and Bradford, I'm Heather Hegedus. Hope you have a great rest of your week, and we will see you back here next time. Remember we're on live Tuesdays at 2:00 Eastern. Take care.

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