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TRANSCRIPT

SPEAKERS:

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Heather Hegedus: Hello and thank you so much for joining us for Market Sense. I'm Heather Hegedus with Fidelity. Since we last met rising oil prices have been in the headlines, and investors' concerns have resurfaced over the Fed's interest rate policy path, and whether policymakers may enact another rate hike this year. Joining me today, once again, as he often does is Jurrien Timmer, Fidelity's Director of Global Macro, as well as Ran Randelle Lenoir, vice president and a branch leader who works out of a Fidelity branch, right outside of Chicago to break those headlines down for us today. So they're going to be talking about what's happening with the economy and the markets right now. But also, this is pretty exciting, every year Fidelity takes a really long view to help frame the outlook for investors. And Jurrien and Randelle are going to be talking about global trends that Fidelity has pinpointed that may give us a sense of potential stock market returns over the next—not one but two decades. So good afternoon to both of you, thanks for making the time. I'm looking forward to this discussion today.

Randelle Lenoir: Hey Jurrien, hey Heather. It's always such a pleasure to be here with the two of you.

Jurrien Timmer: Nice to see you in and greetings from Austin, Texas, where I'm spending about five hours before I move on to Boston.

HEATHER: I can almost feel the heat through your through your computer, Jurrien. Thanks to both of you, you're always so generous with your time. And today is Tuesday, September 12th. Just a quick housekeeping note before we get started, I often like to remind you watching this webcast, that if you're watching us live, you can submit your questions for Randelle and Jurrien below the video. That's regardless of whether you're watching us on LinkedIn, or on our website. And we might use your question for a few future Market Sense episode. So we love to hear from you. I hope you keep those questions coming. We want this to be a conversation. Jurrien, let's start with you.

First of all, I'm so glad that you're okay. If people haven't been reading the headlines about Burning Man, you were there. You just got back from that and I'm glad that you made it out because some heavy rains really threw a wrench in your plans there at Burning Man in the desert. You have a lot of energy because now you are at a conference in Austin, as you mentioned a crypto conference, and the big news since we last spoke is oil and gas prices are now at their highest seasonal level in more than a decade. Even though it's after Labor Day, and traditionally this is the end of the US summer travel season.[1] We don't typically talk about oil and gas prices at this point. We're also anticipating a strike from three major US automakers. We've also got some jobless claims data so we've got a lot to talk about here and I was wondering what all of these data points in your mind mean for inflation and the Feds plan?

JURRIEN: Yeah, no it's a great question and you know, inflation certainly has come down, right? The peak in the CPI, the consumer price index was last year, June had a 9% increase. We're down to about 3% so that certainly a great improvement, but a lot of that was energy prices for instance. And as you just mentioned oil prices are firming again, mostly because the supply isn't there, inventories are low, Saudi Arabia is curtailing its production again. And so you know, we've probably seen most of the improvement in inflation and the core levels, right? So we call the core PCE, which is the Fed's favorite gauge, which strips out food and energy remains pretty stubborn at north of 4%. So this is why we continue to hear somewhat hawkish comments from the Fed and that's why the Fed is not ready to kind of declare victory over inflation even though it has improved. So, you know, going forward, we're going to continue to watch the same things that we have been watching, which is how quickly does inflation continue to improve, if at all. And how does that juxtapose against, you know, the economic cycle, and will the economy continue to be able to avoid an overall recession?

HEATHER: Yeah, okay, you know, it's been a while since we've spoken with you, Jurrien, so let's check in with you now also about the macro picture on all of this and how this relates to where we are in the market's cycle. You know, quarter two earning season is over. I can't believe I'm saying this, but we only have three months left in the year. So where does what you're seeing right now suggest where we are in the markets cycle?

JURRIEN: So ultimately the market comes down to a couple of things, right? So there's earnings, there's interest rates because if you think about it how we value the stock market is by calculating the present value of future earnings. So you do that by making a prediction over earnings growth and then discounting that with the current interest rate to get to a present value. And that's what the p/e ratio for the market should be. So the good news is that earnings do appear to have bottomed. So the second quarter looks like a list of bottom, second quarter earnings season which of course is now in the rear view mirror, came in, you know, a lot better than expected. And so, that continues a trend that we saw in the first quarter. Third quarter is still expected to be slightly negative, but less so than the second quarter. And after that the expectations are that earnings will continue to recover. So, you know that is the good news. The challenges or the question mark is whether interest rates, you know, will start to come down again. You know the 10-year treasury yield is that 4.2–4.3, so that's certainly along the highest levels we've seen for this cycle. And the Fed is at 5.25–5.5.

Probably my guess is that the Fed has done raising rates, but that doesn't mean it's going to cut rates anytime soon and I don't think that would happen until inflation is much, more closer to the Fed's target. So the interest rates side of the equation, I think is where the pressure remains. And as a result, when you add all of those things together, the market kind of remains in a state of limbo. And if you think about it, you know, the market has gone up this year based on a handful of very large-Cap stocks. But when you look at the equal weighted S&P 500 index for instance, it really hasn't gone anywhere in over a year. So we are in the state of limbo for the lack of a better word where the market is just kind of waiting and hanging out until it has—until it has more clarity. And, you know, it's not necessarily a bad thing, the market can't always go up. It doesn't always go down of course. And so we're in this holding pattern until we get a bit more clarity.

HEATHER: Okay, well, despite this holding pattern, despite this state of limbo and uncertainty. Overall, big picture, the stock market has had a better-than-expected year. And what we do look at the big picture, markets probably conditions have helped the stock and bond markets deliver overall historic gains for decades for investors. However, I wanted to talk long range today and Fidelity's Asset Allocation Research Team, or AART as we call them here at Fidelity. They look for patterns and trends, and right now they are seeing some signs that over the very long term—I'm talking about two decades, economic growth may look a little bit different from what we are seeing right now. So Randelle, I'd love to bring you in right now and first of all, could you explain for everybody out there watching why economic growth matters for investors?

RANDELLE: Yeah, so right Heather, it's been decades of mainly market friendly long-term trends, especially when you consider since 2009.[2] After the last decade, we've been experiencing growth so the graphic on your screen illustrates the key drivers of economic growth. You'll see two components, the first one is population, which population means more workers. Then productivity, which basically means that each of those workers are able to get more output. All of this cumulates into GDP or Gross Domestic Product. And that's what we use to measure economic output. That's what we look at for economic growth. And I like to think about this economic growth concept as a tide that rises all the ships in the harbor. So, economic growth essentially has benefits that extend to a lot of different areas of our economic lives and you want to think about these areas, like the ships in the harbors. So some of these ships are employment opportunities, income, quality of life, consumer and business sentiment interest rates, foreign exchange rates, stock market performance, and that's just to name a few. So you can be clear about why investors look so closely at this. But we've experienced a long period of economic growth overall for much of the past few decades and not just the US, but many other places in the world. And that's been good for stocks. And that's been good for profits.

HEATHER: Wow, you see there's a huge ripple effect there. And what is Fidelity's Asset Allocation Team latest thinking, latest outlook on the next 20 years of stock market returns, Randle?

RANDELLE: Yeah, their research and analysis on the factors that I just mentioned indicate that the favorable trends that we've been benefiting and experiencing over these past few decades maybe giving way to this new environment, this new environment of slower growth, the new environment of increasing Geo-political risk in a new environment of the declining globalization. And what that means is that investors may want to reconsider where they're seeking these opportunities. So they're saying over the very long term, like 20 years, that economic growth may slow in the US and other developing countries. And they still expect growth to happen just slower growth and that will have impact on the financial markets if that's the case.

HEATHER: All right, so we've enjoyed a relatively healthy global economy for decades but 20 years into the future there are some global factors that I understand AART says could have potential consequences for the stock market and Jurrien, I know this is right in your wheelhouse as Fidelity's Director of Global Macro. So can you talk about some of those factors that I'm sure you are watching every day?

JURRIEN: Yes, and, you know, I sit actually right next to the AART team in Boston. So S know them very well and they produce really outstanding research. But, you know, the long-term stuff is important because as we create a portfolio, it's good to have a sense of, you know, the 10, even 20-year outlook at how do you want to strategically allocate among, you know, those building blocks. And so, in terms of the very long-term, you know, obviously productivity, labor growth, those are factors that that drive, you know, overall the overall economy. I have a very simple model—or I didn't create it but it's, you know there is this fairly well known model where when we look at the prevailing valuation, right? So the price to earnings ratio, the price that investors are today paying for future earnings. Valuations are on the high side, right? On a one-year trailing basis, they're higher than normal but not super high. But when you look at a 10-year P/E, so using the 10-year average earnings, that's what we call the Shiller CAPE, the cyclically typically adjusted P/E model. When we look at the 10-year P/E, we found—we find that it has very high predictive power for the return in the market over the next 10 years.

Now, the next 10 years is not super helpful because it doesn't tell us anything about what happens three months from now or two years from now. But a 10-year, annualized return for the next 10 years, as you can see, that's the pink and the and the yellow line in the bottom panel there. Has a very high inverse correlation with the prevailing 10-year P/E ratio. And what we can see is that the returns have likely peaked to at around, you know, high double-digit returns, about 17%. And are likely to come down to 3–9% over the next 10 years. And, again, 10 years is a long time. This is an annualized return so it doesn't tell us, you know, we could have 20 or 30% returns next year and -10% returns of the year after that. And we could still average out to this 10-year average return. But it's suggests that the days of double digit returns that we've seen over the past decade plus, that those have likely come to an end for the reasons that Randelle mentioned. So, you know, deglobalization, increased geopolitical tensions, an aging labor force, and you know indicators like that. So doesn't mean that equities won't do well at all, 3–9% is still better than better than zero and it's still higher than the prevailing inflation rate. But it's not likely going to be quite as generous as what we've—what we're used to seeing over the past decade.

HEATHER: For sure, yeah, that 3–9% is half of the market's return over the past decade. But having said that Jurrien, you said 10 years is a long time from now and artists looking 20 years into the future with their forecast so you know, I don't—there are a number of things that could change in the next 20 years. One thing that comes to my mind is AI, we talk so much about AI these days. So I'm wondering, you know, could advances and developments in that space, or others as well, boost future growth for the US and other countries beyond what we're currently expecting and change this forecast at all?

JURRIEN: Absolutely, there's always a lot of different variables and again when we think about the potential growth rate in the economy, and as Randelle mentioned as economy goes, generally corporate profits go as well. So the two factors, you know, that drive potential GDP growth are changes in the labor force and changes your productivity. So if we have, for instance, higher immigration for instance, then may be our labor force grows more than it might in some other countries. Because we do know that we have an aging population so labor force growths has been declining and as that happens, potential economic growth declines as well. So immigration is a variable but as you mentioned, AI, if that becomes a game changer for productivity. Changes in productivity are the other factors. And so these are all variables that are kind of hard to predict. But that but they are potential game changers, maybe not in the absolute sense, although maybe there as well. But relative to maybe other parts of the world and that, you know, will help us in our global asset allocation as well.

HEATHER: Okay, you mentioned global productivity and population growth, say they are slowing down Randel, what can investors do to help protect their investments? What do you say to your customers about that?

RANDELLE: So, this is something that we talk about on Market Sense all the time, it's one of those evergreen foundational things that you should be thinking about in it's asset allocation and diversification so investors who's portfolios are well diversified across a broad global set of opportunities may be best positioned to take advantage of some of the future growth that Jurrien was talking about. Even if the growth is slower, right? So, think about it this way, diversification is to investing like a well-balanced diet is to wellness, right? So you probably couldn't expect longevity and wellness by eating only food group. You know, I wish that I could survive on doughnuts, sorry it's not the case.

HEATHER: Chocolate, you can't survive on just chocolate and caffeine?

RANDELLE: Sorry to break it to you, sorry to break it to you. So your body needs a well-balanced diet to deal with the different things that you go through in life. And the same thing goes for your portfolio, your portfolio needs a balanced of different economic environments and different economic opportunities to endure what's going to happen in the markets and in the economy as you progress towards your goal. Whether you goal is retirement or something else. So you want to balance across stocks, bonds, and cash. When we draw something like stocks there's even more diversification there. Large companies, small companies, domestic companies, foreign companies, there is, just to name a few to think about here, and let me give you a few things to consider if you were thinking about diversifying.

One of the easiest ways to do that is to use products. You can look at ETFs and mutual funds, we have a fantastic mutual fund screener available on the website. You can use professionally managed portfolios, and if you are out there and you are curious but you are stuck, I want to make sure you know my team and a lot of teams across the country, we are here to help out with that. Just give us a call, it's free to get support, we can help you get started.

HEATHER: All right, Randelle, diversification, thank you. And I'm really bummed about the fact that we can't just have one food group all of the time. You know, we talked about the long term, let's talk about the short term. Jurrien, I talked about this on the last episode of Market Sense with Naveen Malwal, our portfolio manager who was in for that episode but historically September has been a weak month or it has a bad rap for being a weak month for stocks. So I wanted to check in with you two about what you see ahead for stock the remainder of this month and through the end of the year as I said, we are only three months out to the end of 2023, now what do you see?

JURRIEN: yeah, so it is true from around the beginning of August until mid-October is seasonally the weakest period of the year, but the caveat is that study is true all else being equal. And, of course, rarely all else is equal so there are always other things that might overwhelm that seasonal tendency. But the seasonal tendency is certainly there, again for long term investors who I think are generally the folks we are talking to here, that doesn't really matter. If anything, maybe it's an opportunity to rebalance, you know, in September or October if there is any kind of air pocket in the market. But I think at this point the risks and opportunities in the markets are fairly well defined. It's, you know, the question of whether earnings are indeed bottoming and how long— you know how far out in the future is this supposed recession we have been waiting for the last year going to happen? Is the Fed done raising rates? How quickly does inflation come down? And obviously the CPI report is coming out this week which will give us a further clue.

So I think we still come down to these different factors, and, you know, the reality is that the market has rallied quite a bit from its lows almost a year ago now, mid-October of last year. And the market has gained five P/E points, it's given back one of them in recent weeks, but it's gained a fair amount of valuation in the anticipation that a soft landing is going to happen and so the question is, is the soft landing going to happen and so far, the answer seems to be yes. But I think that's ultimately what's going to drive the cycle more than the seasonal tendencies that we are talking about.

HEATHER: All right, Jurrien, you mentioned the CPI report that's coming out tomorrow. I know you're going to be watching that. Terrific and insightful conversation today, thank you so much to both of you. To our audience, Fidelity has a lot of resources for you. Right now, you can scan the QR code or type in the URL that's right on your screen and that's going to take you to Fidelity Viewpoints where we have an article with the headline "Investing in a Slow Growth World," you can see a screen shot of that article right there. And that article goes further in depth into this very conversation we just had and it also includes some mutual fund ideas to consider. And also within the article you can sign up to get our free weekly Viewpoint subscription sent straight to your inbox, which is a terrific and free resource.

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[1]Bloomberg 9/5/2023: www.bloomberg.com/news/articles/2023-09-05/pump-prices-in-us-hit-highest-seasonal-level-in-more-than-decade#xj4y7vzkg

[2]Fidelity, 9/5/2023: www.fidelity.com/viewpoints/market-and-economic-insights/investing-for-the-next-20-years

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