

Fidelity Viewpoints®: Market Sense

Week 147, June 13, 2023

TRANSCRIPT

SPEAKERS:

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Heather Hegedus: Hello, and thanks for joining us for a special live edition of *Market Sense*. I'm Heather Hegedus with Fidelity. For the first time we're so pleased to all be together to bring you an in-person show. We are bringing you something that our team here has been working on here for weeks, our mid year outlook. Our panelists roundtable are going to be discussing all of your burning questions for the next six months and some of the big issues that dominated the headlines the first half of the year. Including the new inflation report that just came out this morning. The Fed's continued effort to tamp down inflation. When and if the US may go into a inflation, whether we're in a new bull market, the end of the bear market, or somewhere in between and how to consider positioning your portfolio through all of this uncertainty.

So to make sense of all of it, we're joined by three exceptional panelists. Dirk Hofschire, Director of Asset Allocation Research at Fidelity who is going to be unpacking the US and international economic outlook for us. Jurrien Timmer, of course, Fidelity's Director of Global Macro will be explaining where US stocks may be headed next. And Denise Chisholm, Fidelity's Director of Quantitative Market Strategy, who is going to be giving us her insights on what sectors and segments of the market to watch for. Thanks to all of you for making the time out of I know, your very busy schedules to be here today.

And I'm so excited to have—to all be here in person together.

Denise Chisholm: Yeah, it's great to be here.

Jurrien Timmer: Nice to see you all. We got the A team assembled here.

Dirk Hofschire: Yeah, wonderful to be here.

HEATHER: A team indeed. I'm just so humbled to be in your presence. Before we do get started with today's discussion, I do want to share a quick note with our viewers. If any questions come to mind during the discussion and you're watching today on Fidelity's website, you will see a survey underneath the video player. And you can submit questions there, and we're going to do our best to take those questions and then answer them on future episodes of Market Sense. Let's make this interactive. All right, let's kick things off everybody, we want to start pretty high level. Let's start off with you, Dirk, first, you know for roughly the past year it feels like we've been waiting and watching for this recession that hasn't come at this point yet anyway. Where do you see the us being right now? What is your base case scenario for what we might expect from the US economy for the second half of year?

DIRK: Yeah, you know, you are absolutely right. Seems like we've been talking it or it's been in the press quite a while the recession wording. You know, the US economy has actually been holding up pretty well, especially this year. So we did see a pretty big slow down over the course of last year. And the way we would characterize it when we sort of put our lens on, is thinking about this is "where are we in the business cycle?" Because when you look back in history, there is patterns of how the economy tend to move out of recession and then back into it. So it's kind of a late cycle expansion, is what we would characterize it as.

And what that means is, yes there are some things kind of leading indicators that tell us where we're going that have kind of deteriorated. And so if one example would be Federal Reserve is raised rates dramatically 0 to 5%. We know that credit has slowed down. We had some problems in the banking system. So that kind of credit contraction or seeing tighter monetary and credit conditions can overtime lead to some slowing of the economy. So when you kind of think about late cycle, you would think eventually the normal path is going to be recession. What it doesn't tell you is how long it is going to take us to get there. And the good news is consumers have been holding up well. The labor market has been strong. And so it would be unusual if we didn't see slowing in the next 6–12 months, but, you know, at this point we've seen quite a few strengths in the US economy holding us in there.

HEATHER: That's right, we've hung in there for now, but rising risk of recession it sounds like as we continue through the year. Most likely we're not in a recession, as Dirk just said just yet. Jurrien, I'm curious to find out, you know, to find out the expectations for the market out of all of this. You know, it seems to be slowing, like Dirk indicated, but major market indexes are actually up for the year. What is your outlook on where the market might go the next six months?

JURRIEN: So the markets always look ahead and they always discount the future. Not always correctly, right, the market is still a subset of human behavior. So markets are not infallible by any means. And I think, you know, when we look back over the last couple of years, you know, if valuations in the market, whether it's bonds or stocks or anything else, represents the present value of future cash flows, right? How much are you paying in a bond for coupons. How much are you paying for the S&P 500 for earnings? Last year was the reset in interest rates, right? The

Fed raised the cost of capital very aggressively, that lowered present values for cash flows for both bonds and stocks alike. And I think generally there's been a sense of the market waiting for the other shoe to drop this year, that recession, right? Because the valuation gets affected by interest rates, but also by earnings, whether they hold up.

And earnings have been declining somewhat but they've, I think done pretty well considering all the headwinds. And so the market has been sort of waiting for this. And now it's starting to move up. And I think it's leaving maybe a few people wondering if they've missed out.

HEATHER: Right, right, right? So in a sense it's been holding up better than one might expect, right? And could possibly continue to do so. Denise, let's turn to you. You have a pretty unique perspective because I know you spend your time looking at historical data. And you really dig into how market history can help us understand where we are right now. What does market history tell us about what we might expect from the stock market the rest of the year?

DENISE: Yeah, a lot of the data that I'm looking at actually does paint a pretty constructive picture for the market. And let's talk about two. One is inflation and the other is sentiment. Or sort of the overall pessimism in the market. First on inflation, I have to say, it's funny that you would think that high inflation can't possibly be a good time for the market. But when you look through history when inflation is high and decelerating, that actually tends to be the sweet spot in the market returns. So from a historical perspective this is not totally surprising. The other thing that's unique this cycle, other than inflation, is the—how rapidly inflation has decelerated.

So the shelter component has in fact been sticky. But when you look at everything in the CPIX, that shelter component, we've seen the fastest deceleration since 1975 and the fastest deceleration without people losing their job. And the reason why that is important is because that's a real critical factor for headwinds that we saw over the last 12 months turning to tailwinds, specifically for the US consumer in real income and specifically for corporate profits and profit margins.

The second part of the cycle that's been unique is the persistence and then dominance of negative sentiment or pessimism. Now there are a bunch of different ways you can calculate it mathematically in terms of the percentage of bulls versus bears. The percentage of days we've spent above 30 on the VIX, which is top decile. Valuation spreads in the equity market but all of those signals do say that we've been a little bit off cycle this cycle. And that is the math behind how the wall of worry can actually be climbed.

HEATHER: Okay, okay, but you are saying a sense of pessimism in there could actually make it easier to see a surprise to the upside when/if that happens. So coming back to you, Jurrien, you've been cautiously optimistic too, like Denise on this. You know, the jury is still out whether we're in a new bull market right now or not. If it does turn out to be a new bull market, and we end up getting that surprise to the upside, what do you think might happen next?

JURRIEN: By the way I just wanted to echo what Denise just said. You know, when we think of the “R” word, recession. We’ve only had one recession in two decades and that happened to be the financial crisis. So I think a lot of people—I don’t want to say they get triggered by the R word but it’s like they hear recession, and like, oh my god the market is going to lose half value. And they are many recessions—they are never fun, obviously, it is a contraction in the economy.

But actually timing the market on the base of that, right? You would need to know four things. You need to know when it starts, how long it is going to last, how bad it is going to be, and how much of it is priced into the market. And you know, like I can’t do that. I don’t think anyone here can. So for the typical investor, that is a pretty high hurdle to overcome. And some recessions can be milder, others can be more severe. But in terms of, you know, the bull market, what lies ahead. To get from bad to good, you need to get to less bad first.

HEATHER: Yeah.

JURRIEN: Right? And so markets tend to turn on what we call the second derivative, which is the rate of change. And one thing that we’re seeing on the earnings front. So earnings are declining, modestly, down maybe 5% this year. But when you look under the hood you can start seeing the number of revisions actually starting to improve and the expected earnings number for 2023 at least, getting less bad. And so that doesn’t mean it can’t get more bad later but it’s that first hurdle where maybe you start to see some stability. And at the same time, the Fed, of course we know the CPI number today was pretty much as expected, but confirms, as Denise said, that inflation is decelerating. We’re mat about 4% for the headline, 5% for the core CPI. And Fed has gone from 0 to 5.5 and a quarter. I’m expecting them to take—to skip this week. Maybe they go one more time or more than one more time in July. But 0 to 5 is a big move. And I think it is safe to say we’re probably closer to the end of the rate cycle than certainly the beginning.

So when you start looking at, again, earnings and interest rates as the two drivers for the market. If earnings are getting less bad and the interest rate cycle is getting closer to an end, then maybe the market starts to find itself on better footing.

HEATHER: Fantastic point you made, by the way, about the fact that, you know, recession is—or contraction you could say is an inevitable part of any market cycle, right? So potentially not something to completely fear. But let’s look at the glass half empty or worst case scenario for a moment.

Jurrien, I’ll turn to you on this question too. What could cause the second half of the year to be worse than expected or worse than the base case?

JURRIEN: I think the main culprit, if it happens, would be that other shoe dropping. That it turns out that just as we start concluding that the recession is never going to come, then all of a sudden, you know, it’s at our doorsteps and earnings estimates end up being much too high. And then

you get kind of that flush, that clearing event of earnings estimates just getting downgraded. And the market can look past that if it's a valley, an earnings valley. But it is harder to look past if it is an abyss. And again, I'm not calling for that, but you are asking, you know, kind of what could go wrong.

And so if we do end up getting a bad recession that just hasn't arrived yet for a variety of reasons. And it's coming and all earnings estimates are 10, or 15, or 20% too high, it's going to be very hard to kind of ignore that.

HEATHER: One more question for you—and I appreciate Dirk and Denise sitting tight here for a moment but we've been talking about the Fed's interest rate hikes on Market Sense all year long. Of course, it's been a key factor in market performance all year long. We've seen the market do a lot of calibrating and recalibrating as it tried to anticipate the Fed's next move, the Fed's endgame, and this morning we just got the CPI report out that I wanted to ask you about.

We learned inflation rose at a 4% annual rate in May, which is the lowest in two years. Still above the Fed's target rate of 2%. But before we get too excited my understanding is core inflation is really the Fed's main concern here, and that's still pretty high, it's at 5.3%. So the Fed's meeting right now, they are going to be wrapping up their June meeting tomorrow.

What do you think they will do?

JURRIEN: I think that—if I was at the Fed, which I'm not, I would take a pause here. Because the Fed has had to move very, very quickly in a very big way. I think the Fed normally in a more normal cycle where inflation isn't this existential threat. The Fed would move in smaller increments, more gradually so that it has time to kind of take a pause and say, okay, what we've just done, like what are the impacts of that, right? But the Fed did not raise rates, in my view, quickly enough when inflation proved to be more than transitory. And the economy came roaring back to life after the pandemic lockdowns.

And so because it did too little too late it is now doing kind of maybe too much, too fast. And so, I think it would be wise to take a pause here because they have moved in a big way. And in such a big way that actually we saw some tremors in the banking system, which is already now three months ago. It's amazing how time flies but that was early March.

HEATHER: Right.

JURRIEN: So clearly there is an impact on the economy. And so I think taking a pause. And also recognizing that if a neutral policy rate, let's say, so where the Fed were neither restrictive or accommodate. If that's around 3½ or so, that is my guess at least. The Fed went from 0 to presumably 5½ by July, if they go again, which we won't know. Then that is a pretty big round trip in terms of pendulum of the Fed, right? The Fed rarely sits around and does nothing, it's either

tightening or easing. And so that takes you a couple of percentage points above what I would think is the neutral rate, which is, you know, pretty significantly restrictive. And I would want to just take a pause here and say okay, maybe what we've done is enough. Even though the inflation rate remains about twice as high as the Fed's target.

HEATHER: All right, take a pause at least for June you're saying, we're not talking about what might happen after that, right? So of course the Fed is going to continually to be driven by the data. And I'd like to turn to you now, Dirk, thanks for your patience. With so much hanging on inflation right now, what are you expecting for the rest of the year? And when do you think we might finally get a break as consumers from these rising prices that we're all still experiencing when we fill up our gas tanks and when we go to the grocery store?

DIRK: Well, you know the good news as both you and Denise articulated is its come down. So we're were up at 9%, you know, several months ago. Four decade high and now somewhere between 4 and 5%, depending on how you measure it. But the big disinflation that we've seen is actually what you mentioned, gasoline prices,—excuse me—commodity prices. A lot of the supply chain issues that we had coming out of the pandemic, those largely have been fixed. And so on the good side, like stuff that we buy, we've seen disinflation. It is still the core component that's built around services that is more tied to the labor market that has decelerated. But lot of categories have been a lot more persistent and are still running pretty hot. And that is a harder nut to crack.

Because that's tied then to the labor markets. So you think about why is services prices staying high? Well, what is the biggest cost for a business in the service industry? It's your workers. So record low unemployment, wages still going up, that's pressure then on that type of inflation. And this is where then you bring it back to the Fed, and this is the tradeoff. We can hope that wages kind of come down without much pain in the labor market and we get this sort of benign disinflation where stocks and bonds do well and everything is fine. But more likely what usually happens is you get a labor market that then tends to weaken. And how much it'll weaken and will it be enough to go into recession? You know, we'll see. But the likelihood is that we'll have to have some tradeoff here at some point in the second half of the year where if we keep bringing core inflation down then it is going to get a little rough on the economy. And it is not rougher on the economy and good news for the labor markets, then that might mean inflation might surprise on the upside and we push the Fed either further or higher from where it is today, or at least make it really difficult for them to ease back to that more neutral rate that Jurrien referred to.

HEATHER: Okay, so sounds like the challenge for consumers is still, you know, not going away immediately, Dirk. Let's talk about what this means for investors though. You know given the outlook for inflation and what we were just discussing. How might investors consider positioning their portfolios right now?

DIRK: Yeah, so, you know, everything we've talked about so far has been really short term. We've been talking about, you know, inflation now, recession now. I mean, the first thing probably as a reminder is, you want to think long term. And financial planning and getting your risk/return objectives, getting your financial plan in place and sticking to it. Long term diversified portfolio, all of that, that's like 95% of everything. So what we're talking about is, you know, making little tilts along the way in the allocation if you feel better or worse about the near term. That is sort of the philosophy that we take on it. So long term, we've been in a tremendous run for asset prices over the past 10, 20, 30, 40 years. Inflation's come down, interest rate come down, stocks and bonds have done great; very little volatility.

Going forward that might be tougher. Especially, you know, some of the stock valuations are pretty high. So anticipating that we're going to need more diversification that, might include things like non US equities that are now much less expensive, haven't done very well. You know keeping that diversification in the portfolio is probably the biggest thing. Although if we bring it back to the short term, late cycle actually tells you are not ready to get really worried because you don't know when recession is coming. But you are also not ready to just jump on and add a lot of extra risks in the portfolio than you normally would. So it's kind of stay tight to the that long term strategy and actually don't deviate from it very much.

HEATHER: Okay, all right, Dirk, thank you. And Denise, thanks for your patience. I'm going to dig a little bit more deeply into stock and into the different segments of the stock market. So I know the conventional wisdom might suggest the possibility—with the possibility of a recession looming that it would be time to get defensive with your portfolio, right? And among stocks that would mean looking at the defensive sectors, things like health care, utilities, consumer staples, the kinds of things people spend money on when times are tight that they are still spending money on, right? Do you think that is the right approach.

DENISE: I think it is tricky. In the sense obviously that Dirk highlighted that, you know, recessions can happen just because we're late cycle. You know, you can sort of see that it will happen at some point. But Jurrien highlighted the fact that stocks are a discounting mechanism. So I like to think about the fact that this cycle we're a little off cycle. And it's partly that the starting point on relative valuation's really mattered. So in a typical recession, and there is no real true average. But what you see is those defensive sectors outperforming the market by about a thousand basis points going into the recession. And then by about another thousand points during the recession. What we had into that year, into that June low in the market, the original June low was an outperformance in defensive sectors, consumer staples, healthcare, utilities. The old telecommunications services, by 3,000 basis points. So in some ways this was a very, very different pattern that we saw historically and it left them not only outperforming more but relatively more expensive than that historical pattern by about 20–25%.

So the question becomes mathematically, because there are no 100% odds, what you see if you are right and recession ensues, that increases possibility of those defensive sectors outperforming.

But you will find the valuation, starting point actually detracts more than that. So it doesn't tell you what will happen but it tells you the risk/reward if you don't get that base case correct, what's your upside risk in the market and your underperformance risk for the overall defensive sectors. So to me that starting point on valuation is sometimes more important than macro.

HEATHER: Okay.

JURRIEN: Just want to add that you mentioned off cycle. It's interesting how defensive sectors last year, like utilities, they did extremely well and they did so in a rising interest rate environment which is pretty rare. So it was a weird year in many respects.

HEATHER: Yes, yes, a lot—

DENISE: That's a good way to put it.

HEATHER: A lot of things we would not expect.

Let's talk about cyclical sectors. What are some cyclical sectors that might be well positioned.

DENISE: Yeah, because defensive sectors have started out so expensive, what you are seeing the opposite in terms of cyclical sectors. They have potentially a higher margin of safety than defense even if the underlying conditions get worse. And I'll highlight too, technology and consumer discretionary. And they are both similar but, in some ways, the bi-case is on different rationale. I mean, technology, what's interesting is that that is the sector, and consumer discretionary, where you've seen a decline in earnings already. So we've seen a broad based decline in earnings for the overall market, but as Jurrien highlighted is already getting better on the margin and when revisions are turning up. And interestingly enough, the top two sectors for revisions are technology and consumer discretionary, which was the opposite of what we saw last year.

So in some ways this is an off cycle from last year, finally, we're seeing the improvement. Now technology valuations are still pretty pricey but that doesn't hinder your outperformance, usually when earnings are negative because earnings can rebound. And you essentially grow into that normalized valuation. So what you are seeing in technology, is I know it is in some ways run a lot over the last, let's call it month two or three. But what you are seeing historically is that you have a positive macro backdrop in terms of lower interest rates potentially and lower inflation. And now you have a turn in earnings where valuation is in a particularly head wind.

Now consumer discretionary looks similar in terms of earnings but actually has valuation support on price to book as well, especially on an equal weighted basis. So where a lot of people see sort of valuation disconnects, I actually see support that you saw during the pandemic, which increases your odds of outperformance and increases that margin of safety. So even to the extent that news

gets worse, valuation actually provides a positive risk/reward for cyclical technology and consumer discretionary.

HEATHER: Very interesting, all right any thoughts there too that you guys want to say something Jurrien?

JURRIEN: Denise highlights a great point, which is that market timing is difficult anyway. But market timing during the cyclical inflection points, if that is where we are.

HEATHER: Yeah.

JURRIEN: Is like next to impossible. Because as we talked about earlier, the market always discounts, not always correctly. But if we are in at the end of a bear market—if—and at the beginning of a new cyclical bull market. The price action almost never makes sense to the untrained eye because price usually bottoms before earnings. It did so in 2020 after the pandemic lockdowns and did so in 2009 after the financial crisis. And it makes no sense. And that's—this is why it is such a confusing time for, you know, for the typical investor who just gets his or her news from, you know, whatever, the media channels or the newspapers.

It is a very difficult time to understand what is going on, which is why just having a broadly diversified portfolio, as Dirk mentioned. Is, you know, for most of us, myself included, the best way to invest.

HEATHER: Yes, exactly; it is a confusing time and that is why I appreciate your insight and this program, Market Sense, where we've been able to kind of help people make sense of these confusing times on a weekly basis. Denise, let me stick with you for one more question if you would please. We talked earlier in the show about how the market's gains this year have been largely driven by a handful of mega cap stocks.

Many of those in the tech sector or adjacent sectors like the communications services. Do you think there could be upside potential still for the tech sector this year, even after that strong rebound year to year? And if so, are there any segments in particular where you see some potential value there.

DENISE: So I do still think that there is still potential upside. And I know Jurrien can come and we'll add on market breadth. But in some ways the way you measure market breadth kind of matters because as much as that sounds like all the gains are driven by a handful of stocks which the math is correct. 50% of the stocks in the S&P 500 are up year to date. So that doesn't sound quite so bad but only 38% are actually outperforming that benchmark. When you look at that level historically, that is in the bottom quartile of all the data going back to 1928. But what you'll find is it says something. But it is not very predictive meaning if I look on a forward basis what actually happens to the market. Of those quartiles, wherever that trailing measure could be, you actually

have the best quartile. Which tells you that 80% of the time the market actually broadens out to match what you have seen in terms of price. Just because it is a narrow market doesn't mean it is a bad market.

Narrow markets more often than not tend to broaden into good markets over time. But with specifically, technology and with that as leadership, it does seem a little odd that technology has been one of the best sectors with one of the worst earnings but that happens 15% of the time historically. And what Jurrien pointed out is exactly how the math plays out. More often than not the stocks react first and then earnings actually comes through over the course of the next year. Which means stocks more often than not actually get the turn right.

So it could very well be the technology sector is leading and outperforming so much are a forward predictor that we may be emerging from that earnings recession. So that is the upside in terms of technology over all. But within technology, I would say I see the most valuation support, which again skews my risk/reward, in semiconductors.

HEATHER: Okay.

DENISE: So when I look historically, again, relative price to book is a great, consistent leading indicator of where the opportunities are and it's price to book relative to the overall market. And that's still for semiconductors in the bottom quartile of history. And you will see a nice clear monotonic relationship, the cheaper they are relative to the rest of the market, the higher the odds of outperformance. And the higher the odds of outperformance despite the fact that margins might still come down more or earnings have not bottomed and might still be quite poor. So that risk/reward again shows you that maybe there is opportunity on the upside as much as there is worry about the downwards risk. There is also upside risk when you're at valuation support. So I do see that an attractive area within technology.

HEATHER: Semiconductors. And I love it how Denise is just a walking encyclopedia of, you know back in 1928. You have all this data. It is amazing your data, it's just impressive. So we've talked a lot about the US here. So let's pivot unless there was anything else that you guys wanted to pinpoint on the US before we move a little bit and talk about the outlook elsewhere in the globe too. You know, because sometimes we can learn from what's happening. And Dirk, I wanted to turn to you, let's start with the developed markets in Europe. What's happening there right now?

DIRK: So Europe, if you remember was really facing dire straits kind of the end of last year. You had the Ukrainian war, commodity prices, especially natural gas were kind of flying through the roof. And what happened over the past several months is actually things kind of got better. So Europe was kind of recessionary several months ago, it's probably moved back to kind of a late cycle expansion. But we'd still call it late cycle because they have lot of same issues we have in the US. So they got a lot of monetary tightening in the pipeline.

They also have big inflation problem that they are still dealing with. So kind of an okay type of situation in Europe. And what that—what's been good in the equity markets for Europe this year is it is coming off really a lot of depressed sentiment with Europe thinking—a lot of people thinking Europe was going to sort of fall off the edge of the earth and it hasn't. So that's at least been positive.

HEATHER: You just came back from Europe, right, Jurrien? Anything from having your ear to the ground there that you picked up on?

JURRIEN: Well, I was in Budapest, Vienna, Frankfurt, London, and the Hague where my parents live in Holland. What is remarkable, at least, you know, we're always talking about inflation here. And we're down to 5%, which is still very, very problematic. But in Hungary the inflation rate is 20% and in Austria 10% or 12%.

HEATHER: Wow, I mean, that really puts things in perspective.

JURRIEN: Yes.

HEATHER: 20% inflation.

JURRIEN: Yep, so anyway, but the economy, you know, the cities are busy. But cities generally are. But, you know, on the fundamental side you know, I look at global earnings and emerging markets, Europe, US, or non-US developed. And it is interesting because this has been a unique cycle in some ways, where, earnings in emerging markets fell off a cliff a couple years ago. And China is only now reopening, right, several years after the US and maybe a year after Europe. And so its caused a bit of a desynchronized earnings cycle, which I think creates some opportunities.

HEATHER: Yeah, some desynchronized, they are not in lock step with one another, these economies. Let's talk a little bit more about China because at the onset of this year we were anticipating that that might really affect the market here, because it was, as you said, locked down for so long and just reopening. Did we see that impact from China that we were anticipating?

DIRK: So, you know, China's economy bounced back some at the beginning of the year and it still has some forward momentum. And, you know, when you think about how draconian their lockdowns were, they went from one of sort of the tightest pandemic era regimes to almost opening up overnight. So you almost have to have some economic impetus, you know, coming out of that. And we've seen that the first few months of year. And it has put it on a somewhat different trajectory because there you've got inflation coming down and monetary policy makers actually easing interest rates and completely different dynamic.

The issue now is China is kind of running into a place where you are getting that initial, sort of, sugar high already working through the system. And the structural issues, the more long term

picture that's kind of been holding China's growth back, is it still very much in force. And that has to do with a lot of debt out of economy over the past decade, especially in the property markets. Lot of overbuilding. So kind of a bubble type of environment. And that's been kind of sapping the energy and momentum, and it is probably not going to go away any time soon. So it's still on a different trajectory so, you know, China will probably be fine this year. And the real question is sort of what happens maybe in 2024. But I think when you think about this globally and for everything else then. This is actually a little more disinflationary force for the rest of global economy. It probably takes a little bit of demand off the table for commodities, helps us again keep commodity prices down. So that is probably a good thing on the inflation side. A less good thing on the growth side. But definitely a less synchronized global environment as Jurrien pointed out that we've had in some part time.

HEATHER: Okay.

JURRIEN: Well, and, you know, you add to the earnings divergence. Because China emerging markets are now bouncing off very, very low levels. Whereas the US is still decelerating from a very high level. Because we had that post COVID earnings boom of about 50% growth. So you get this convergence now of non-US earnings growth really outpacing US earnings growth. And on top of that a really large valuation differential, right? I mean, emerging markets, Europe are trading around 13 times forward earnings. The US is at 19 times and valuation on its own, I wouldn't say that's reason enough for another region in the world to outperform. But when you add this earnings differential, amplified by a valuation discount, you know, that's a different story.

HEATHER: Okay, finally coming back to the US. It's probably worth talking about the issue that dominated the headlines for the past few weeks. I know it is sort of in the rear-view mirror for a lot of us already, we've already forgotten about it but of course I'm talking about the debt ceiling debate. It was resolved but there is a big question here still about what that means for investors, the impact of it. And also, you know, whether the US should be getting into so much debt and whether that is long term problem that investors should be concerned about. Dirk, do you want to take a stab at that?

JURRIEN: He wrote the book on this.

DIRK: Well it is always nice that we got past, again, not shooting ourselves in the foot and defaulting on our debt, that would have actually be a really big problem for financial markets. I think the debt is a long-term problem. We have higher public debt to GDP ratio than we've ever had.

Roughly around the same, you know, amount that we had sort of post-World War II when we financed the entire war. And even worse, going forward we've got a lot more people retiring, a lot more Medicare and other entitlement benefits that are going to be paid out. Unfunded liabilities that we're going to have to figure how to pay for.

So the long-term/medium-term fiscal trajectory of the US is not good. We're not the only ones, Japan and many other advanced economies in Europe are in a similar boat. But I think where it comes back to the financial markets, it's less about that we're going to wake up to tomorrow and all of sudden everything collapses because there is so much debt. Because we can see we can sort of live with this over time. But as interest rates go up it becomes more problematic. And this is where it starts to come back to the fiscal policy, the more you have to pay out in interest rates it's going to make it even harder to close deficits, even if you can cut some spending.

And on the monetary side there is going to be a halt that monetary policy makers will be able to keep those interest rates low enough so that debt service costs don't go up and if there is some inflation, it is going to make that even harder. So long story short, I think what that does is it's a bit of a growth head wind for the economy. But it also puts policy making both fiscal and monetary right in the center of what markets are thinking about continuously. And that makes for a more volatile mix, which eventually will probably overtime just mean sort of more continuous volatility in the markets related to policy.

JURRIEN: So maybe back to the old days of the boom/bust cycle, as opposed to this great moderation that we've had over the past three decades?

DIRK: Yeah, really hard, I think to get back to where we were for the, you know, especially the past 15 years or so when you had, again, inflation really low. The Federal Reserves and many other monetary policy makers able to take rates down to 0. Pump a lot of extra liquidity into the markets that help. If you don't get that underlying stability and you've got these concerns about debt and servicing it and all that, it is hard to get back to that. But, you know, volatility in and of itself doesn't mean bad returns or disastrous results. It just mean we should probably be prepared for things to bounce around a lot more and realize we're going to have to be more patient and think about this less as a, I'm going to coast for 10 years and never face a bad move.

JURRIEN: And that's a good reminder that, you know, the market over a very long term tends to go up 10% per year. I mean, not every year, and about 6.5% after inflation. But it only goes up about 60% of the time, so that means 40% of the time it goes down. And that is when, you know, things get a little nervous. And so even if it stays on that 10% track but if it becomes a more volatile path, I think, you know, it makes it important for investors to kind of keep an eye on the long view and not get whip sawed by these moves because, you know, chances are we're going to do the wrong thing if we react emotionally.

HEATHER: Go ahead.

DENISE: There is some positive news on I want to call it the debt front. Not in government land but certainly for US consumers where we see even debt to income is now back at levels that we saw maybe 20 years ago. And debt service as a percentage of disposable income is still at all time lows even after the interest rate increases. So there are pockets of the economy, I would say the

US consumer being one, that does actually look better on leverage ratios. Now we've traded that for government debt in a way but when you look at what has been more important to markets over time, it's actually been consumer debt, financial debt, corporate debt; things like that. Where we're seeing less onerous measures overall.

JURRIEN: And a great point because, you know, we're waiting for the recession as Dirk was talking about earlier. And you always have to ask—you never want to say it is different this time because those are very famous last words to utter.

HEATHER: Don't want to eat those words.

JURRIEN: But we should talk about, you know, what are mitigating circumstances? What can explain why the recession isn't here yet? And, you know, Dirk mentioned labor and people have jobs. They are getting, you know, wages are kind of keeping up with inflation, right? But if you think about the stock of mortgages in the US, most of it was replaced or refinanced in 2020 and 2021 during COVID when rates were—really went down a lot. And the consumer has already sort of delevered from the financial crisis and on, right?

So you can think about the consumer's balance sheet is probably in pretty good shape because they are sitting maybe on a 3% mortgage and as long as you don't move you are not affected that much by what the Fed's doing. So these are things to think about, you know, as why is the economy as resilient as it is.

HEATHER: All right, and we're lucky enough to get in during a recession in a house and you are not waiting to move. Well, certainly this conversation that we've had about, you know, credit and debt, something that we've be talking about beyond the next six months. But to wrap up our conversation, I kind of want to have a little fun with you guys and do a lightning round. So we're going try to keep the questions moving. I am going to pose some questions, we're going to line, we're going to start with you, Dirk. And I am going to, you know, if you can keep to it one to two sentences. We have time to about one to two sentences on each, okay? So first question, biggest surprise that we have seen so far in 2023, Dirk?

DIRK: So to me it is not that US stocks have done reasonably well. But it's that they have far outperformed everything. So bonds, outperformed non-US stocks, commodities, anything else you can buy. And part of it is maybe those really narrow markets that we were talking about. But that was surprising definitely.

HEATHER: All right, Jurrien?

JURRIEN: Earnings resilience, I would have expected earnings to be on their way to be down 10-15%. And they are down 5% and starting to recover it seems.

HEATHER: All right, Denise?

DENISE: I think the fact that we had a banking crisis in March, and from a sector perspective, energy is the worst sector, not financials. Which I think shows you valuation support, perhaps.

HEATHER: Okay, what issue are you all most focused on for the rest of 2023? Dirk?

DIRK: So probably labor markets and labor market inflation, so wages and other indicators of the that. Because that is the crux of the decision for the Fed. Again, can we get this perfectly landed plane where these wages come off and unemployment doesn't go up. If we can get that, that'll be amazing. If not, we'll have to figure out what the tradeoffs are between growth and inflation.

HEATHER: We're all hoping for that soft landing, right? Jurrien, how about you?

JURRIEN: Yeah, along those lines. It's, you know, what could happen that is different from what is priced in?

Because the market is always pricing in the future. And it would have to come down to, again, earnings either not being as strong as the estimates are or maybe stronger than the estimates are.

And the Fed, you know, is the Fed actually getting to the end? Or is it going to keep going? So these are open questions.

HEATHER: Yeah, absolutely. Denise?

DENISE: I'll tell you what I watch, and I watch credit spreads. And because they are the smarter market, meaning they more often get the future right than the equity markets but specifically equity valuation spreads which is kind of the measure of fear relative to the credit spreads, mathematically helps you predict the upside in equities because there is more fear in the equities market than the credit market. So that why I watch.

HEATHER: Credit spreads, okay. All right, how about wild cards? Anything that might pop up that maybe might not even on radar right now? What do you think?

DIRK: So many things on the radar or off the radar. We haven't talked about geopolitics at all. So I'll throw that in, I mean, we haven't mentioned Ukraine war. We have a raging war in Europe. We never know what can happen with war so there's all sorts of things that can go wrong. But more generally, when you think about this sort of medium term, we're in a definitely completely different picture geopolitically than we've been the past few decades. There's much more rivalry with China, where the US and China have really important economic commercial relationships. So just a lot more that can go wrong. Even though you don't want to obsess about geopolitical risk.

Definitely wild cards all over the place.

HH; You know, and that shows that you came from the Georgetown School of Foreign Service, if I can just give a shout out to our alma mater there. Go Hoyas.

DIRK: Hoyas.

HEATHER: Good one, Dirk. All right, Jurrien?

JURRIEN: In addition what Dirk just said on geopolitics. I would say the wild card, that if it would be a wild card because I don't expect to know—I don't think anyone is. But if inflation were to somehow reaccelerate higher and it forces the Fed to go to like 7 or 8%. Which again, not expecting, that would be a pretty tough nut to swallow for the market.

HEATHER: I think for consumers definitely. How about you, Denise?

DENISE: I'll be the optimist. Maybe rumblings that the Fed might change their 2% target. Since that was never set in stone and when you look from an equity market perspective, the sweet spot for equities is actually between 3 and 4.5%.

HEATHER: Okay.

JURRIEN: And the Fed may not have much choice to eventually to that. They would probably have to write a bunch of white papers and have a seminal speech before they change it but yeah. If we end up landing at 3 and not going any further, you know maybe that is the necessity of the situation.

HEATHER: Same, yeah, we did the best that we could. Okay, finally, and I think lot of the people watching would like to hear this one. What is the one suggestion—just one—that you would give investors right now at this moment? Dirk?

DIRK: Wow, so a different flavor maybe than some of the stuff we talked about. Don't use current volatility as your guide of what to do. Lot of times when volatility is pretty low and markets have actually been doing all right, like right now. Feels like that is the best time to invest and so do lot more; invest a lot more. Other times when volatility is high, people think that, oh things must be terrible so I got to pull everything out or do the opposite. Those are really, really near term indicators so try not to focus on volatility as kind of your metric what to do.

HEATHER: Think the far term and not the near term view. Okay, Jurrien?

JURRIEN: Whenever I'm on TV the eyes of the host roll over when they ask me what should investors and I always say the same thing is have a plan and stick with the plan. And they're like, oh God, we're not inviting you back.

HEATHER: All right, so give us another answer, Jurrien. Please don't make me roll my eyes.

JURRIEN: But the third iteration of that is to rebalance when the markets move a lot. And the markets haven't moved that much so it may not be necessary right now. But when you have big moves, make sure you are actually in a portfolio that you think you are because maybe those allocations have moved around.

HEATHER: Okay, Denise?

DENISE: I would say don't ever assume you know the outcome. I mean, crude oil is a great example in 2022 we had a war in Europe and for the year crude oil ended down where we thought we were going to have one of the biggest supply shocks that we've seen in some ways in our lifetime. So the market is a discounting mechanism. Don't ever assume you know the outcome.

HEATHER: Okay, all right, we'll leave it at that. Fantastic job to all of you. It is always so great to get a range of ideas and lots of different things to think about.

And I think you guys all provided unique perspectives and just a tremendous conversation. So great too have you in person as well. Thank you so much.

DENISE: Great to be here in person.

HEATHER: I know.

JURRIEN: And I learned a new word, monotonic. I like it.

DENISE: Great, I'll take it.

HEATHER: Well, thank you so much. And a big thank you too to the team and crew who worked to make this special episode possible. To our audience if you aren't already watching on a mobile device, grab your phone right now. So I'll give you a second to take it out. And then you want to scan the QR code that you see on the screen for more investing insights for the next six months, and beyond.

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today. You can also just type in the URL listed so I'll pause for a moment so you can look at that URL there if you don't have the ability to use the camera on your phone.

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