Market Volatility: Your Questions Answered

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Fidelity pros answer questions about recession risks, the market sell-off, and risk.

Key Takeaways

- The US business cycle continues to mature, but a recession does not appear imminent.
- It is common to experience higher levels of market volatility and more muted investment returns as the cycle matures.
- The recent selloff in stocks was unsettling, but having a plan in place can help investors weather different market conditions and stay on track to reach their goals.
- Retirees need to remember that they still may be investing for the long-term, and should seek to maintain investment portfolios that can help stay invested through periods of volatility.

Stocks suffered sharp declines in the fourth quarter of 2018, with the S&P 500® Index delivering its worst calendar year return since 2008.

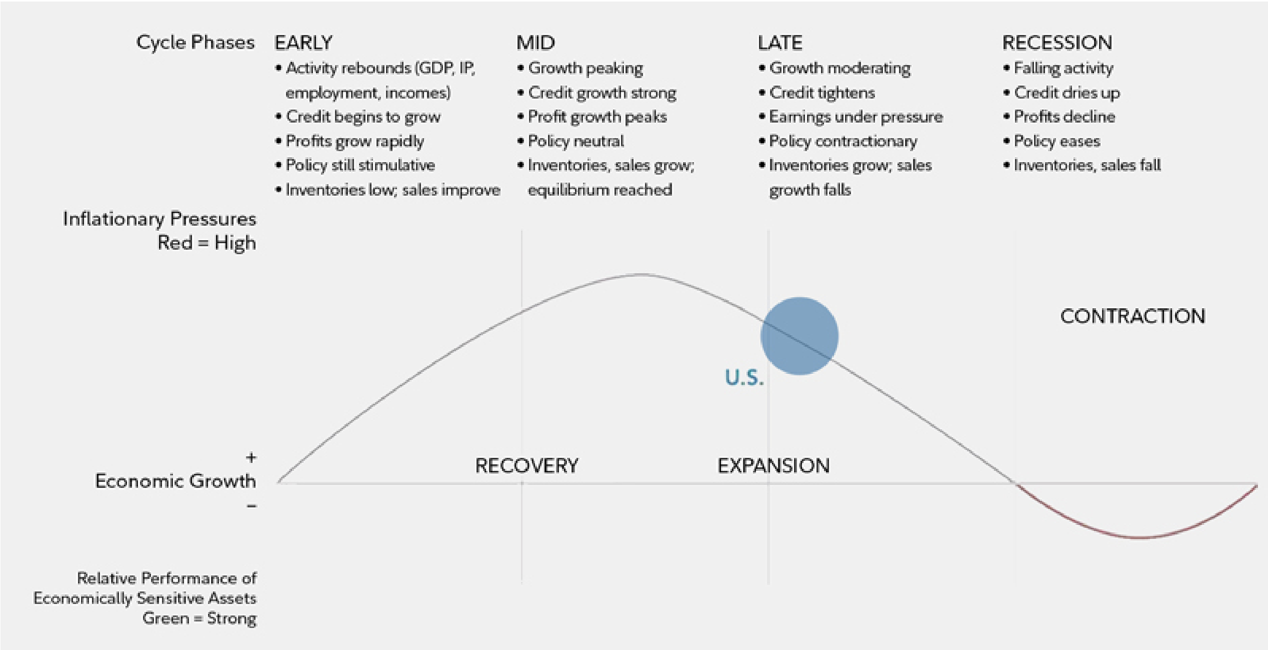
Fidelity has heard from concerned clients, and hosted a webcast with Chief Investment Officer Chris Sheldon and Institutional Portfolio Manager Lars Schuster to understand what caused the market volatility, the current state of the US business cycle, and how to think about investing in this environment. More than 1,500 questions came in during the event: Here are answers to some of the most common questions.

Are we headed for a recession?

Sheldon: If you just looked at stock movement during the fourth quarter, you could be forgiven for thinking there might be a recession around the corner. The price drop and types of stocks that moved had a footprint similar to recessionary markets in the past. But based on the economic data, I think it would be a step too far to say that we are about to go into a recession.

Schuster: At this point, I don't think a recession appears imminent. In the US, corporate earnings remain positive, employment is healthy, consumer confidence is at high levels, and inflation is benign. Furthermore, banks are still willing to lend and inventories are largely in check. To me, all of that suggests that no recession is imminent.

Rather, today the US economy appears to have shifted into the late-cycle phase of the business cycle. This isn't recession. Rather, it's a period that is consistent with moderating growth. Historically, corporate earnings are growing, but at a slower pace. Interest rates also tend to rise during this period. The low volatility, high return environment for stocks that we saw over the last several years may be behind us for the time, but the late-cycle phase can still be a positive environment for investments, particularly stocks. However, I think it makes sense to expect more volatility as uncertainty about the future grows.



Note: The diagram above is a hypothetical illustration of the business cycle. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one. We use the classic definition of recession, involving an outright contraction in economic activity, for developed economies. Source: Fidelity Investments (AART), as of 12/31/2018.

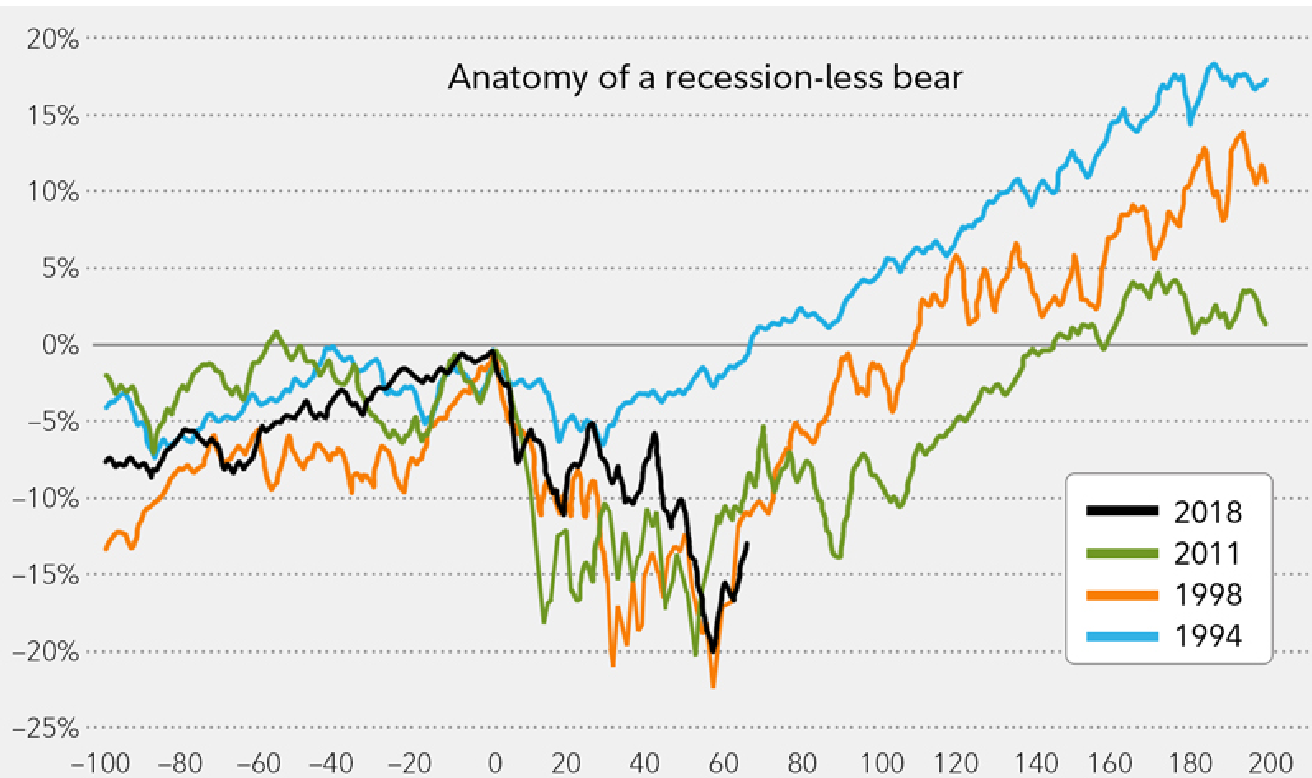
Is this the beginning of a deep bear market, like we saw in 2008?

Sheldon: Late in 2018 the S&P 500 approached, and briefly entered, bear market territory. In some ways, it appeared the market was pricing in a recession. Does that mean stock prices will fall significantly more in the short-term, as they did in 2008 and 2009? It is important to remember how unusual that credit-driven financial

crisis was—even a recession today would probably not be of the same magnitude and duration as the financial crisis, because consumers and businesses have less debt, and the economic fundamentals are better.
There have been a number of bear markets that occurred without a recession, and were followed by strong stock markets. So is a bear market possible? It's possible. But it's also possible the market overreacted late in 2018, and stocks could recover and move higher. Given the range of possible outcomes, we think it makes sense to stick close to your long-term asset allocation mix.

Schuster: Market pullbacks are tough to live through, but they don't necessarily mean a crash like 2008 is around the corner. Very deep market declines are usually associated with negative corporate earnings, which isn't what we see today. The most recent pullback likely highlights the market's difficulty in digesting a few key issues and how they may impact future earnings. These include the pace of interest rate hikes, slowing Chinese and global growth, and ongoing trade negotiations.
It's important to remember that 10% and even 20% drops are not uncommon for stocks, but despite pullbacks, over long time periods stock returns have been positive.

Anatomy of a brief bear



Daily data. Source: Bloomberg; Data source: FMRCo., Bloomberg, Haver Analytics, FactSet. Data as of 1/8/2019.

Should investors move to cash to avoid more losses?

Sheldon: First of all, we think the best approach to investing starts by making an investment mix based on your personal financial situation, goals, and risk tolerance.

Should you move to cash? If you knew a recession was about to start, you might want to consider moving to cash to limit your losses in a down market, and then presumably you would buy back in before stocks came back. But there are a few issues with this. First, I don't see the signs of a recession around the corner and history has shown it is very difficult to predict recessions or short-term market moves. Second, the market has already moved. Finally, the market often rebounds sharply and if you miss those days while you are still in cash it can have a serious impact on your long-term performance.

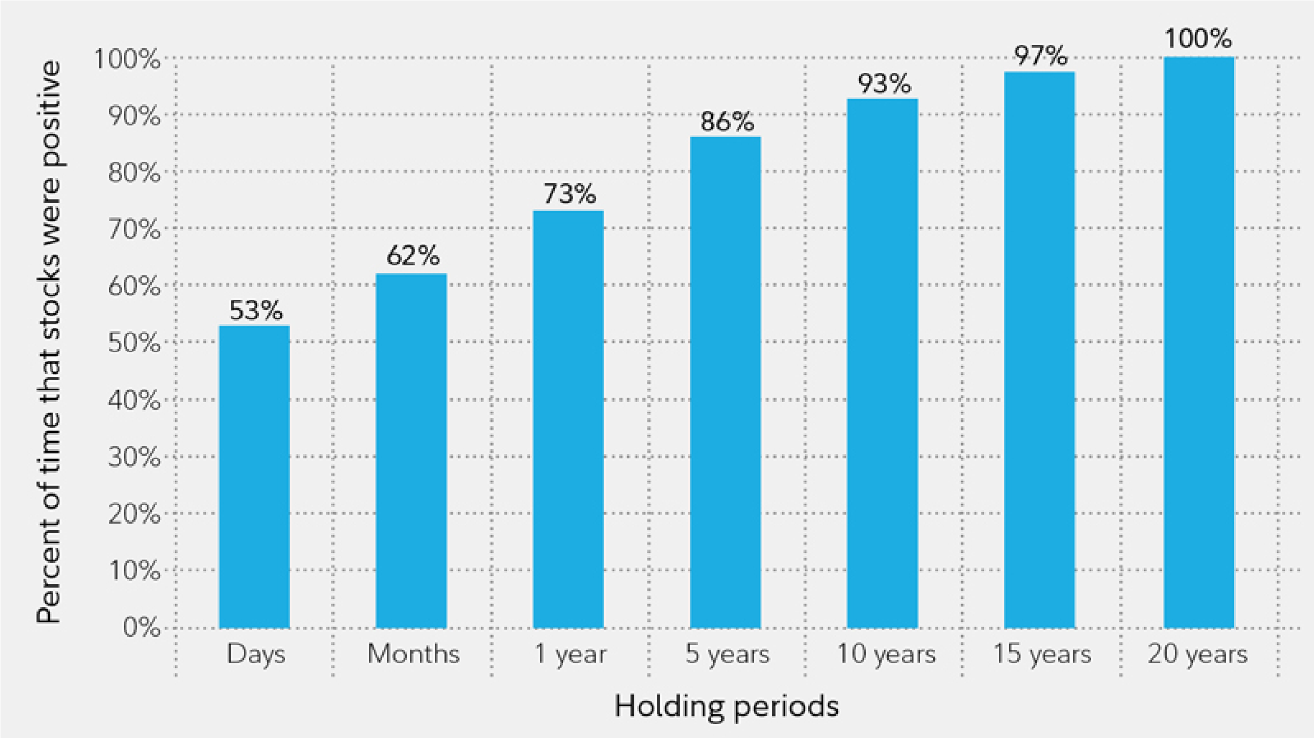
In fact, we looked at what happened during the financial crisis and the following 10 years to see how these 2 approaches played out. A Fidelity study of 3.9 million workplace savers found that those who stayed invested in the stock market during the downturn far outpaced those who went to the sidelines. From the fourth quarter of 2008 through the end of 2015, investors who stayed in the markets saw their account balances—which reflected the impact of their investment choices and contributions—grow 147%. That's twice the average 74% return for those who moved out of stocks and into cash during the fourth quarter of 2008 or first quarter of 2009. More than 25% of the investors who sold out of stocks during that downturn never got back into the market—missing out on all of the recovery and gains of the following years. The vast majority of 401(k) participants did not make any asset allocation changes during the market downturn, but for those who did it was a fateful decision that had a lasting impact.

What should people approaching or in retirement consider?

Schuster: As humans, when we see the value of our investments fall over a short period of time, our instinct may be to hide. This is where having a plan that aligns to your financial goals can be most helpful. If you have plan, when markets go through short-term declines you can ask yourself some simple questions. Has my financial situation changed? Has my tolerance for risk changed? Has my financial goal changed? Has the time horizon for that goal changed? If none of those things have meaningfully changed, then the best decision very well could be doing nothing at all, with the exception of rebalancing.

Sheldon: There are certainly some goals for which you might have no equities whatsoever. For instance, if you have a very short-term goal and you really need the money soon. But even in retirement when you may be spending a small portion of your savings each year, many of us need to plan for 10 years, 20 years, or even longer. And over longer periods of time the probability that stocks outperform cash or even cash and bonds is reasonably high. And we actually have to be careful about the purchasing power of our money against inflation—becoming too cautious can actually be costly.

Of course there is no one-size-fits-all answer, so you may want to discuss this with your advisor.



Source: Bloomberg, S&P 500® Index total annual return for December 30, 1927 to December 31, 2018.
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In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.) Fixed income securities also carry inflation risk, liquidity risk, call risk, and credit and default risks for both issuers and counterparties. Unlike individual bonds, most bond funds do not have a maturity date, so holding them until maturity to avoid losses caused by price volatility is not possible. Any fixed income security sold or redeemed prior to maturity may be subject to loss.