Fidelity Compass

CIO Perspectives - 2023 Outlook

Andrew Marchese, Fidelity CIO and Portfolio Manager

Bryan Borzykowski, Host

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Bryan Borzykowski: Hi and welcome to Fidelity Compass. I'm Bryan Borzykowski. Both the Bank of Canada and the U.S. Federal Reserve raised interest rates seven times in 2022 to 4.25% and 4.5% respectively. Many people now want to know where do we go from here?

Today's U.S. CPI data marks the sixth straight monthly deceleration since the mid-2022 peak, perhaps foreshadowing the Fed's rate hike pace this year. How much higher do rates need to go? How will institutional investors know when to start taking on more risk?

Joining me today to unpack all of this and more is Fidelity Chief Investment Officer and Portfolio Manager, Andrew Marchese. Andrew, thanks for being here.

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Andrew Marchese: Pleasure to be here, Bryan.

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Bryan Borzykowski: Let's start off with a bit of an outlook for 2023. Not a lot to look at here but the last couple of weeks have been okay for equity markets. What are you looking at and where do you think things might go?

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Andrew Marchese: If we recap – to know where we're going we've got to a little bit understand where we came from. Last year was very much about valuation resetting in pretty much all risk assets due to one, higher-than-expected inflation, stickier-than-expected inflation, and the commensurate rise in interest rates in North America to the tune of about 400 basis points. That obviously compressed valuation multiples for equities, real estate, other speculative risk asset classes, obviously, fixed income as well. Now I think 2023 is the manifestation of those interest rate hikes into the mainstream general economy.

What we'll be seeing going forward is probably a slowing of the global economy, and we've already seen global PMI, manufacturing PMIs are now dipped below 50 and now we have to kind of assess what are, if any, profit revisions going forward for publicly traded companies in North America and Europe and Asia. I think that's the next chapter in the book. The interest rate hikes that occurred last year devalued risk assets, and appropriately so. There was many risk assets that were overvalued. Now those interest rate hikes are going to seep into the general economy and we have to measure their effects on corporate profits and cash flow going forward. I think that's the challenge for equity investors in 2023.

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Bryan Borzykowski: Tell me more about that. We've seen these big rate hikes; everyone's talking about these big rate hikes. Are you saying they have not made their way through the economy yet? What would that look like, I guess, when they do?

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Andrew Marchese: Yes. If you think the rate hikes have really started kind of at the start of last year, historically, if you look at history as precedent and as a guide, it takes anywhere from 6 to 18 months for interest rate hikes to kind of make their way through manufacturing, service, the general economy. You look for signs of that actually starts taking place. One of the first signs to look at is housing. We know that housing, new starts, etc., other measures of housing health in both the United States and Canada have come off. Secondarily, you look at things like new orders, leading economic indicators that show a slowdown or a peaking. We kind of saw that dating back to 2021, that actually started happening before the interest rate hikes started getting into the system.

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The next step then is profits. It looks like, based on Bloomberg consensus estimates, profit growth kind of peaked mid of last year. What we have seen, if you look at Wall Street and Bay Street estimates, is basically a few months back, outlook for Q4 2022 profit growth would have been 10%. It actually, getting into the end of December, came down to about 0% growth year-over-year. Those negative earnings revisions have started taking place.

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Now, if you look forward to Wall Street estimates for Q1 and Q2 of 2023, they've already been revised down to about call it -1.5% growth for each of those two quarters relative to about six to nine months ago there were forecasts for anywhere between 5 and 10% growth in the market in general.

Obviously, there's a danger in speaking to averages, so this is where we come into play as active equity managers is to look where we think that are the greatest risk to profits and cash flow going forward and, similarly, where the most opportunities may exist. In other words, where people are either a) not bullish enough or b) too bearish.

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Bryan Borzykowski: I've got to ask, you're saying there are some indications that the economy is slowing and interest rates could work their way through but last week there were 104,000 jobs added to the Canadian economy. That, to me, seems like things maybe aren't slowing down. What did you make of that number and why are we seeing some of these indicators maybe going in different directions?

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Andrew Marchese: Areas of service inflation of which wages are part of that are a lagging indicator. So is generally employment as a whole. Wages coming off and then possibly unemployment rising are going to be the most lagging of lagging indicators based on a business cycle. It just tells you that the economy continues to be strong. If you look at nominal GDP, it continues to be quite strong. So, despite the fact that we've had 400+ basis points of rate hikes in North America, consumers are still consuming at a pretty high level. As you said, wage gains are still pretty strong. Employment's still very strong.

We would look for those things, once those interest rate hikes that occurred, let's say, in the middle to three-quarters of the way through last year start making their way to the economy, the sign for central banks will be, are they having a material effect or if not, do we have to keep along the path of tightening? That's kind of where we sit right now. I think both the Bank of Canada and the Federal Reserve have been quite transparent on what they plan to do. This has been the most vocalized and communicated path to rate hikes that I can remember throughout the course of my 24+ year career but we need to see that manifesting, or how it's going to manifest, in some company-specific data and consumer-specific data.

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Bryan Borzykowski: I know no one can predict whether a recession is going to happen. Even within Fidelity, the what kind of recession may or may not come, different people have different ideas. But as you're planning as a Portfolio Manager, as a CIO, what are you looking at or thinking in terms of the potential for recession? Could we have a big one, a small one, none at all? What's your views in the way you're planning?

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Andrew Marchese: I think it's a little bit of a fool's errand to call kind of recessions and then the magnitude and the duration of them. I think if you look at historical precedents and you look at any measure of the yield curve, which I still think is very much a useful and very strong measure, there's a cottage industry out there that kind of tries to devalue the importance of the risk curve, I'm not one of those people. I think it's still very telling.

If you look at history, the 10-minus-1-year yield has had a perfect batting average, if you will, accuracy record of calling recessions. It's very much inverted right now. We'll see if the past is prologue kind of going forward. But rather than dwelling on that, what I'm trying to measure is where equities in particular have adequately discounted the worst-case outcome for a fall in profits for companies that tend to be more cyclical and for those that tend to be a little bit more stable, to the other side, how much are we really paying for defense at this point in the cycle?

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Last year leading sectors were kind of staples, energy and utilities. Well, when you kind of go through on a case by case, security by security basis, really, how much are we really paying for that defense going forward on a risk-adjusted basis or a risk-reward basis? Is it better to cycle some of that capital to the more cyclical ends of the economy if they are indeed discounted sufficiently, and wait for things to turn and then eventually rise?

That's a lot of the exercise we're going through right now. I tend to think this year, I've called it the homework year where I think we know what to look out for but we're not all the way there yet. For all the parents out there who've taken a car ride with their children, you always get asked, are we there yet, are we there yet, meaning, are we there yet to start a new investment cycle? No, we're not there yet.

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The best we can do right now is look for the guideposts along the way to indicate if we're getting closer and the homework being done should be really at a security valuation perspective to say risk-reward, upside, downside, am I better off kind of cycling to what are typically more riskier areas of the market because they've been adequately discounted and I'm getting paid to wait. I think that's the exercise that I've been counselling our staff to really kind of look at and examine because I think, generally speaking, last year we were kind of more defensively positioned in higher quality positions, in general, along of a myriad of metrics. So, just kind of continuing to kind of do our homework in that vein and trying to determine when is going to be the opportunity that we need to capitalize on to kind of change that mix of the portfolio, if you will.

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Bryan Borzykowski: I just want to clarify, right now, still the sort of risk-off kind of play but looking at the opportunities at sort of when to go risk-on, that's what you're looking at. I guess, that's what a lot of people are wondering now too.

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Andrew Marchese: I think the market's going to be kind of an ebb and flow type of market this year. I think there's some people pointing to optimism about China reopening, kind of getting rid of the zero-COVID policy and that will generally get China out of their growth recession, so there's that speculation there. You've seen some risk assets even in Q4 since about mid-October kind of rise. Then you're going to see possibly some more negative earnings revisions by Wall Street kind of going forward in some select industries.

If, again, past is prologue, those interest rate hikes that occurred six months ago should start showing up in the second half of the year and what does that do for aggregate demand for various services and goods. That's the stuff that is still to come and I think it's being offset with some optimism about maybe possibly some reopening in China, maybe some valuation spread gap closing between North America, chiefly the U.S. and Europe. You have some forces kind of trading off against one another and I think that's going to make for somewhat of a ... it may appear from afar like a lack of leadership in the market or direction in the market – you kind of ebb and flow from month to month – but I think what we're trying to determine really is when will be the opportunity over the next 12 to 18 months, call it, to add more risk in kind of a material or statistically significant way.

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We're not there yet, I don't believe, from doing our valuation analysis and also our forecasting on fundamental. As always, when the price becomes reasonable, for whatever reason, you act and before you know it ... If you do that in a serially correct fashion, before you know it, you've actually, in a very stealth-wise fashion, kind of gotten there as opposed to picking a point in time to say, okay, we're going from this stance in our portfolio to that. That's not how it should work. If you're doing it right it should actually happen stealthily and before you know it, you're kind of moving with better risk-adjusted investment opportunities in the context of an equity or multi-asset portfolio.

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Bryan Borzykowski: Let's talk about the homework a bit. What do you and your team look for? Are there indicators saying, hey, things are changing now, now let's get more risk-on? What are the indicators you're looking at? What kind of homework are you really doing?

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Andrew Marchese: Really for us on the research side, it really starts at a bottom-up fundamental standpoint. We've been talking a lot about macro, and macro, obviously, influences the aggregate demand for all goods and services, but then you examine these investment opportunities at a bottom-up fundamental standpoint, you kind of see if the micro is dovetailing with the macro, so to speak. What we're looking for is we're examining the companies that we're investing in, looking at their costs, expenses, aggregate demand or sales, forecasting that, health of the balance sheet kind of going forward and also kind of dovetailing that with both what their customers are saying and their supply chain might be saying. Where there's a mismatch, it might pose some concern for us that we can further go back to that company and kind of ask more questions about the state of their business and then, more importantly, what we're forecasting over the next 1 to 3 years and even beyond that, in terms of what we think the profit and cash-flow profile is going to look like for the company in question. A lot of our work's really being done at a micro level. All the while, we're kind of, as I said, kind of bouncing that off or dovetailing that with what we're seeing from a macroeconomic standpoint.

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Bryan Borzykowski: Just on the leadership guiding the market, when we do sees things start to shift what will be the areas of the markets that could lead the way when things kind of change?

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Andrew Marchese: Historically, when you go into a slowdown, if you look at 100 years of history – we'll use the S&P 500 because it's a nice diversified benchmark – you go into a slowdown in the general economy, you're going to see groups like staples, utilities, health care. Generally speaking, industries don't require a huge economic tailwind to continue to grow revenue and profits and distribute capital back to shareholders. That's the general theme. Things that are more cyclical need an economic tailwind at their back to really kind of get into their stronger earnings profile, peak earnings strength, so to speak, generally don't trade as well. The big rotation in the market comes, historically, at some time, if you indeed go into a recession, generally speaking, what you find is that the front end of the economy actually starts working relative to the market, from an active return standpoint, about halfway through the recession. That's been categorically true pretty much in every recession.

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Now, there's two caveats in there. One, you've got to ask yourself, are we going into a recession or a mid-cycle slowdown? The profile of outperformance in terms of magnitude looks a little bit different in those two scenarios, but generally the leadership is the same as I described it. But it also affects your timing about when you want to rotate into more cyclical areas of the economy, if indeed that's what you want to do.

The other thing you have to note is kind of, generally speaking, the yield curve, which is inverted today, starts actually turning positively sloping when the recession starts. Even economic news is going to look and sound really bad. If, indeed, that's what transpires over the next 12 months that may be another cue, combined with the fact that maybe global PMIs continue to fall, maybe housing gets worse, profits continue to get negatively revised, investors should actually start leaning into risk as opposed to away from risk.

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We should be ahead of that, maybe lower beta stances in our portfolios, sectors that, again, as I say, don't require an economic tailwind. But then when you get the manifestation of that data both on a micro and macro basis, you want to start leaning into risk. I think that's the hardest thing for a lot of investors to do is embrace risk when it sounds really bad. If you give yourself a multi-year horizon, three to five years, as I always say to our staff, listen, if you can buy a security with really high upside to peak earnings potential and really low downside, you just use the rule of doubling. If you think the security has more than 100% upside in it from kind of trough to peak, you're paid to wait five years at least because that's 15.6% compounded return a year. That generally beats the market.

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That's why it's very important to kind of lean into risk if data gets worse. That's why I'm saying we've got to do our homework now because if and when the time comes, you've got to be prepared and act in a very kind of dispassionate fashion. The homework's been done, trust your analysis, go, and you'll feel great after the fact for it and you'll do best for your clients when you look at your returns on a multi-year basis.

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Bryan Borzykowski: What is the buying strategy here? You don't want to time the markets because you can't do that. You don't want to miss out on sort of the initial upswing. You're worried about maybe getting in too early. What's your recommendation on how to actually act?

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Andrew Marchese: This is where I think we're really benefited at Fidelity from having the number of research resources that we do have. We're kicking the tires on all these investments and we're doing it across the globe, whether it's in Canada, the U.S., Europe, Asia. When you're pulling all this research into our databases and portfolio managers are looking at all this, you can spot the trends. You're sitting down with companies, you spot the trends, you see what's happening, and then you're doing your valuation analysis. All the while, that's what's going to allow you to maybe make changes in your portfolio where something you've been successful with for the past, whatever, three to five years or maybe even longer, you start to marginally sell that security down because you don't see the amount of upside left in it and at the same time you cycle to something else where you do see that preferable upside-downside trade off. That's the homework.

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People always say, you can't time the market, and you cannot, but if you do it at a single security level and you're very smart about it and you're very on top of it, you will catch a lot of these things. As I said, stealthily, your portfolio over time will take on a different profile that's probably more levered at some point for a new economic cycle.

If you look at the globe right now, China has been in a growth recession, we are slowing, North America is slowing, Europe is slowing, Australia is slowing. We're not going to sit here and predict whether it's going to be a hard landing or a soft landing – time will tell – but we're doing our work at the profit level to kind of be prepared for either of those two scenarios. If we do it well at a micro basis, on a bottom-up basis, then our portfolio is naturally going to be geared to a better upside-downside scenario for a new economic cycle whenever that comes to pass.

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Bryan Borzykowski: We have been focusing on equities but there is another side to this that not a lot of people really wanted to talk about over the last, maybe, little while. Fixed income. Do you find that institutions, your clients, are rethinking their fixed-income strategy? How do you approach fixed income today after last year's bad year but things have changed?

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Andrew Marchese: As you said, last year was a bond-bear market and rightly so for all the reasons I mentioned earlier. From the small sample size of our clients that I talk to, the answer to your question is yes, those clients have been kind of reassessing the portion of their overall portfolio in fixed income. If we continue to slow, certainly historically, Treasuries look appealing if we continue to slow at some point.

If you look at the market implied policy rates going forward for 2023, 2024 and 2025, you see a falling interest rate cycle at some point to kind of restimulate the economy. There are many people out there that say that the Federal Reserve, the Bank of Canada and other central banks have tightened beyond the natural rate of interest. That implies that we're in this kind of restrictive monetary backdrop now as opposed to the one that we've experienced prior to the start of 2022. That was very accommodative.

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Based on, again, if past is prologue, Treasuries should look good over that scenario. Then, by definition, certain investment grade bonds should also probably look okay but that requires investors to do their diligence on a bottom-up basis again to kind of discern what are risky and what aren't. Again, we're slowing, all the macroeconomic data would suggest we're slowing, we don't know to the extent by how much, the magnitude, and the duration but under a slowing environment with maybe, on a two-to-three year basis, a bias towards more accommodative central bank policy then those instruments I mentioned should look better.

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Bryan Borzykowski: There is the appreciation that you're talking about but just the yields now are higher, so that's got to help returns too.

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Andrew Marchese: Exactly. You get it from yield and you get it from, obviously, return as well. Again, from the small sample size of people I spoke to, that's kind of what they're kind of reconsidering.

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Bryan Borzykowski: Have they acted? Do you find there's more talk now or are you actually seeing people make those adjustments yet? Or is maybe now the time to actually stop talking about it and maybe make some of those changes?

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Andrew Marchese: Well, I'll say this. I haven't seen it in data, industry wide data. There's several things to kind of consider. I don't know if this will actually occur or not but you have to remember in 2020, if you look at the United States, obviously, a very large market to examine in terms of investment in equities, it was off the charts. Flows into equities in the back half of 2020 and even into 2021 were very, very high. Now, if you imagine at some point, if you think that retail and possibly institutional clients are disproportionately exposed to equities for those reasons, that's an assumption on my part, but if you take that data as a whole that I've seen from various third party vendors and whatnot, you would think that some of that, even a fraction of that big kind of inflow into equities in that period of time that I mentioned, has to flow back somewhere. So maybe it goes to fixed income, maybe it's term deposits. Time will tell it where it is but certainly, I guess, maybe the ingredients are ripe for some kind of asset allocation redistribution to change the look of whether it's individuals' or institutionals' multi-asset portfolios.

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Bryan Borzykowski: Just shifting gears quickly, we only have a couple of minutes left, but you mentioned China before. That's reopening and I think some people are excited about that, how that could impact the economy but what's your take on China's reopening? Does it give the global economy a boost or where do you think that can play out?

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Andrew Marchese: From simply a mathematical standpoint, it should give a little boost to the global economy. The question, I think, when asking, you can't look at China in a vacuum though. So, you've got China which may kind of increase its economic activity and that has a natural kind of demand function for various basic materials, goods, services, etc. The question then becomes is some of the other stuff that's kind of continuing to contract, does that completely offset it and more? So, while it helps, we live in a global marketplace that is more intertwined than, if you compare these last 20 years to the previous 100, we're more intertwined than we have been. I'm always a little bit cautious around knee-jerk reactions as it pertains to one large economy kind of saying, oh, it's getting better while all these other ones are, at least from what the data we see, slowing.

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The natural reaction in China, well, that means good things for copper, that means good things for oil, that means good things for certain services because travel can be done and that has knock-on effects for various service industries. It's a natural knee-jerk reaction. I'm always very trepidatious at making grand conclusions for that. I understand why the knee-jerk reaction leads to maybe short-term movements in stock prices or certain security prices but we're not investing for a quarter here, so we're trying to paint a picture that we think is reasonable on a multi-year basis from a risk-reward standpoint. We've got to kind of ferret out what all that means on a multi-year basis as opposed to what it might mean over the next three to six months.

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Bryan Borzykowski: Just on the risk-on topic here, you talked about some sectors and the leadership changing but are there any parts maybe outside of Canada or globally or types of investments that people may want to look at as we move into that risk-on space?

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Andrew Marchese: Certainly, there's a disparity right now in valuation between the U.S. and, I'll just say the non-U.S., particularly the European areas of the market and you're kind of seeing that at the start of the year. The European markets have been behaving better. Ex-U.S. is looking, from strictly a valuation spread perspective, maybe a little bit better. We've even seen within the U.S., if you take out the big mega-caps, the rest of the market's actually been looking good. In Q4, it's the biggest ones, the Facebooks and the Microsofts of the world, that have not been behaving as well. I think there's a valuation spread that might be closing in the short term. You have to remember, though, and this is not a prediction, it's kind of a what if scenario basis, if the global economy continues to slow and if that slowdown in that profit contraction is worse than Wall Street estimates right now, you always have to remember the U.S. dollar is a low-beta currency. It's the reserve currency of the world and generally tends to do well. That further tightens the economy.

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When the U.S. dollar is strong, which it was last year, pretty much relative to any currency out there, that's a tough thing for the globe to overcome. You have to kind of trade those things off. Obviously, once central bank policy changes, and you look at the way it's relatively changing amongst the big central banks, that will dictate the fate of currencies. If the U.S. dollar should get weaker, as it should during a new economic cycle when things look better and the market prepares for a new cycle, then you would expect things in rest of the world, emerging markets start to look better as well.

All this stuff is kind of tied together and you've got to kind of follow it around where the economic cycle is kind of going. These are, again, they're not predictions, they're kind of like what-if scenarios and you've got to determine how you're going to invest accordingly as these scenarios possibly play out or you have more data to say, this is much more likely or probable to occur, and you invest accordingly.

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Bryan Borzykowski: It should be an exciting year nonetheless, and we'll leave it there. Thank you so much for being here today.

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Andrew Marchese: Thank you, Bryan. It's a pleasure.

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Bryan Borzykowski: Thanks to everybody else for tuning in. As always, if you have suggestions on future topics or guests you'd like to see on the show, please share your ideas with us.

In the meantime, stay tuned for more Fidelity Compass webcasts in the weeks and months ahead. I'm Bryan Borzykowski. Thanks again for being here.