Fidelity Compass

Fidelity CIO Perspectives: Navigating Volatility in Canadian Equities

Andrew Marchese, Fidelity CIO and Portfolio Manager

Pamela Ritchie, Host

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Pamela Ritchie: Hello and welcome to Fidelity Compass. I'm Pamela Ritchie. All eyes are on the Bank of Canada this week. This is as Governor Tiff Macklem announces what the next rate hike might be. Economists, of course, are expecting another 75-basis point hike to help cool rising inflation, which jumped 7.7% annually in the month of May. That's the largest yearly increase that we've seen since back in 1983. In today's volatile and highly inflationary environment, it's crucial for institutional investors to proactively mitigate risk to protect their investments. How should investors prepare for the weeks ahead and what should they prepare for? More importantly, perhaps, what's the next avenue for growth in society broadly? Joining me today to unpack many of these themes is Fidelity's Chief Investment Officer and portfolio manager Andrew Marchese. Andrew, great to see you.

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Andrew Marchese: Hi, Pamela. A pleasure to be here.

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Pamela Ritchie: Very glad you could be here. I'll invite everyone else who's here with us in this conversation, feel free to send questions in for Andrew. Use the Q&A function there, we have the next 30 minutes or so to put those questions to him throughout our conversation. Andrew, set us up for where we are right now. We've seen tons of action. We know that at this point. You warned us about that some months ago and it's all come to pass. Where do we go from here?

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Andrew Marchese: Building on that, coming into the year I thought in select equities, certainly in long-duration assets, there was the potential for evaluation derating as inflation kind of moved up and interest rates would have to follow in kind. I think inflationary expectations have built throughout the course of the year. As a result, expectations for interest rates and the terminal rate have gone up and as a result we've seen the most expensive equities get devalued the most, other asset classes that were obviously priced for some degree of speculation have also been derated. I think the lion's share of that has actually now occurred ... but now, the narrative kind of moves to, well, we've had a certain amount of interest rate hikes depending on the nation or the region you're speaking of and here, in North America, the market implied policy rate is forecasting another 200-basis points over the course of the next 12 months.

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Now we're fast forwarding to what is going to be the net effect of these interest rate hikes on growth within the economy. What does that mean for corporate profit outlook in the back half of this year into 2023? I think right now, it started about the start of June where you can kind of see even that some of those securities in the late cycle that were doing well to start the year, i.e. energy, oil and gas stocks, now kind of come off forecasting to a degree maybe there's a chance that there will be demand destruction as interest rates rise throughout the back half of the year. That's kind of where we are today and so the market has turned from a valuation story to now, a business cycle and earnings forecast story.

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Pamela Ritchie: Interesting. Earnings are key, we'll be finding out various stories from multiple corporations, obviously, over the course of this earnings season itself, do you feel like there's not a whole lot of risk that's going to be taken until we see some of that and maybe even get further along into the season?

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Andrew Marchese: The fascinating thing is if you stop your watch at the end of April or even at the end of May, and we just take the S&P 500 as kind of a barometer, a good example of a broad view of the world and sectors and securities, earnings estimates were actually going up. Not appreciably so, but they actually moved up relative to January 1st. I think the forecast for 2022 for the S&P 500 was about 7.9%. These are Bloomberg consensus numbers; 2023 was about another 7.9% and 2024, it was actually 9%. We haven't gotten to the stage yet where consensus is actually thinking about dramatically cutting earnings if indeed we need to cut them at all in the future. I think the earnings expectations story isn't yet fully digested by Wall Street and Bay Street amongst the buy side institutions. We're thinking more and more about it every day, not only from an inflationary aspect of input costs, whether it be raw materials or labour, but also, as I said earlier, what's the net effect of interest rate hikes on demand destruction going forward, if any, depending on the good or service you're speaking of?

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Pamela Ritchie: Considering what we did see in certain areas as earnings of relatively healthy companies that delivered in many cases but saw that massive sell-off. We all know the various areas of the market we're talking about. If you see revenue growth, if you know the margin story, much of that has been priced in. Has it? But you see the revenues, the growth, can that sustain it?

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Andrew Marchese: It's a really good question. My experience over the course of my career has been despite the fact that we've had a meaningful correction in multiple asset classes in select equities across the board, you've basically gotten the market down now to a level on a forward-looking earnings basis that is in line with historical valuations based on where the terminal rate is forecasted to go. You're kind of more or less there from a valuation derating perspective. Now, the question is, is the E, 2022, 2023, 2024, correct? My experience has been if the E doesn't follow, it's hard for any stock to go up until you've reached the point where you're actually well past the late cycle in the economy and now the central bank in question, Bank of Canada, Federal Reserve, is starting to cut rates. Then you can go back out and forecast years in advance. We're not yet at that stage in the business cycle where we can just say, well, whatever earnings may be will be and stocks have sufficiently discounted that based on valuation. I don't think we can make that conclusion.

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Pamela Ritchie: Thoughts on the effects, or whether we have clarity anyway, on the removal of liquidity through the quantitative tightening method. That is another piece of it. I don't know. Do we just let it roll along or is it something that you watch quite carefully?

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Andrew Marchese: It's something we've been watching quite carefully since the global financial crisis. If you think back to 2008, there was an exogenous amount of liquidity put in to keep the system afloat and we never really worked that off. We got to about 2018 and then the Federal Reserve tried to withdraw some of that liquidity. If you may recall, Q4 of 2018, specifically December, the equity markets were not dealing well with that, and then the Federal Reserve kind of backed off from that liquidity stance and things kind of evened out. Fast forward to March of 2020, we got into COVID and the pandemic, and then all of a sudden, we're having to inject a ton more liquidity into the system, actually a lot more than we injected during the global financial crisis. What it does is it spawns risk-taking, right? If money is not worth anything then you speculate, right?

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Part of my concern coming into the year is you've got to drain the liquidity, which has potentially an adverse effect on the pricing of certain securities and asset classes. The second step is along with that, so that's quantitative tightening. The second in concert with that, you're raising interest rates, which also drains liquidity, but also talks about slowing nominal growth. We have to be very clear here, inflation is high because from a nominal basis, the economy is humming. It's really humming. We're overconsuming, largely speaking for the last two years, on goods and now, it's transitioning to services. The economy is really humming. The Federal Reserve and other central banks have to stomp out a little bit of that excess demand for things to bring down inflation. The balancing point is going to be the trick. Ideally, if you're a central banker, you're aiming for 4% nominal and 2% inflation rate to niche out at 2% real. We'll see if we get there.

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Pamela Ritchie: The discussion of what's been brought forward and how that's played into valuations coming down, the rerating in a lot of cases, we know that story from COVID and certainly from various tech names. That said, I'm curious your thoughts more broadly, and this doesn't fit directly with numbers and themes, but I'm just curious how you think that economy ... what we got from all of that being brought forward, essentially. We saw growth, we saw so-called growth as a style and it was a style and it worked very, very well and did very, very well for many, many people. At the end, what are we left with with all our innovations for which valuations were brought forward?

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Andrew Marchese: It's a great question. I don't know if we're left with anything other than it's another instance in time looking at equity markets over decades, 100s+ years, to say that you could ... and a lot of it's hindsight, so you can look back on the cause and effect of things ... growth in the decade between 2010 and the end of 2019, start of 2020, was actually, in North America, fairly anemic but liquidity was quite high. If you compare that decade to previous decades in the post-World War II era, it was actually the slowest period of growth. That being said, we had a transition towards software industry-based growth companies and so you had high liquidity, which fostered a lot of raising of valuation multiples and in some cases pure-on speculation, also, a lot of those companies were capital-light, they generated a lot of cash flow, they bought back their own stock so they could actually grow earnings faster than what could naturally organically be done through the economy.

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Those growth, particularly tech stocks in general, grew faster than the broader market and they were aided and abetted, in part, by liquidity, which further expanded their multiple. So, it's was a two-pronged approach. Earnings went up, valuation multiples went up, so they exponentially outperformed the value peer. Also, the value peer of which resource stocks, particularly energy stocks, is a big component of that, was working off a previous high decade, where at the end of it, you had a lot of investment into it and then more supply and we know that's how the cycle works. You had growth going this way, value going that way and the factors that I talked about, the inputs actually, really made that spread in valuation between those two styles of stocks get amplified.

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It's happened before in history. I don't know if you learn anything other than during the COVID period. I think what was unique over the COVID period relative to every other kind of ... that was a very brief recession, if you want to call it that, but we pulled a lot of consumption of goods forward, right? We were all in our homes and we couldn't spend on services and whatnot, so your discretionary dollar went disproportionately to goods consumption and we saw that manifest itself in a ton of numbers. Think of e-commerce companies or anything retail related, anything really consumer related, so you pulled that forward. The question is, I guess, maybe for that collection of stocks globally is, how long does that take to unwind itself? If we can kind of get society going back to a pre-COVID behavioural basis, do we just consume services for a longer stretch of time? We do know that ... if you've been out to a restaurant or stayed at a hotel or traveled a little bit, prices are going up through the roof and people seem to be all too willing to pay for them. So that's a big...

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Pamela Ritchie: Regardless of the service.

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Andrew Marchese: Right. That is a big component of inflation as well. If the Fed and other central banks go too far in stomping out inflation that will all retract itself, but when it comes out again as we start a new business cycle at, say, some point in the future, do the services just kind of take over and the goods kind of lay at a level where they don't look like previous cycles because you've kind of overconsumed in a very big way?

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Pamela Ritchie: Do we take years to work that off on some level?

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Andrew Marchese: I think for certain groups of stocks, yes. I think for certain sub-industries that are, let's call it, very, very discretionary and built around discretionary, around the home type of stuff, I think potentially it could take years, a couple of years, three years, four years to work off. A lot of this stuff was purchased ... in some ways, debt allows you to borrow from the future, as does speculation. If you're feeling wealthier in other asset classes, then you're more apt to kind of spend today. It's all a circular reference, it all impacts each other in the spending thereof. It's one of the things we're kind of thinking about when forecasting revenue for goods versus services companies.

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Pamela Ritchie: In the last couple of weeks, we've seen some real risk-on moments, trying to test, perhaps, where things might end and so-called, find the bottom and what that looks like. What do you think is happening in those moments of rallying? What's being accomplished?

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Andrew Marchese: I think what's being accomplished is some people who are looking at their portfolio like, oh, I'll take the energy stocks that have been kind of ... had a great start to the year and then in kind of June, we saw some of the peak, particularly in the higher beta [indecipherable] companies in Canada and across the globe, and people take profits as noise around a potential recession, who knows, kind of comes to fruition and the natural rotation isn't to some of those growth stocks that have gotten beaten up that may be down 50, 60, 75% year to date. I think that's all that occurs. There's a little bit of churn underneath the surface and these are very short amount of times. You see this all the time when you get into in the late stages of the economic cycle, or we're seeing kind of more of you're seeing less stocks maintain their highs. There's a higher degree of correlation between securities on days when the market's down now relative to where we were in January and February. That's just symptomatic of people just moving to the sideline. Historically, it's a sign of people moving to the sideline and moving to cash, albeit for a very short amount of time. Here in Canada we're getting into the summer months, all this stuff kind of lines up on a very short-term basis.

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Pamela Ritchie: On a very short-term basis. How does Canada look on a medium-term basis? Maybe long-term basis, but at least medium.

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Andrew Marchese: Part of it is your take on secular inflation. We have had a lack of investment in natural resource companies, whether you're talking about oil and gas or mining in particular, for a variety of reasons. Cost of capital, historically, has risen for those companies. There is a lack of supply in a lot of these commodity-based businesses, that's certainly true. To the extent that you have something that resembles more of a mid-cycle slowdown here and, eventually, central banks are able to navigate a soft landing, and then you're kind off to the races again and commodity prices, as a result, because of the lack of investment and the lack of supply, any incremental increase in demand has an underlying bid to prices.

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The other side of the coin is, the other big sector in Canada is, obviously, financials, principally the Canadian banks, which people talk about, it usually centres around housing and the price of housing and the amount of indebtedness by the Canadian consumer. Relative to the rest of the globe, the indebtedness by the Canadian consumer is high. Other parts of the globe look better from a consumer debt perspective. The question then becomes, how deleterious is the effect on, let's say, an incremental based on what market-implied policy rates are today, which forecasts another 200-basis points by consensus in interest rate hikes, how deleterious is that to the consumption pattern of Canadians, their ability to service their debt and, more importantly, to the economy? I think the one thing I've learned over the course of my career, I tend to keep it simple with real estate and housing affordability.

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These things only are impacted by two things. One is interest rates, the other is unemployment. If you have a job, you have really every way to extend it, right? But if unemployment, which is a lagging indicator traditionally, starts really ticking up, and in the face of higher interest rates, then you have the potential for a big knock-on effect to a PCL type of cycle, a loan loss provisions cycle to Canadian banks. I don't think we're there yet. I think in a lot of ways that still remains to be seen. We're still talking about interest rates levels that historically are still quite low. But as always, the delta matters. The delta will matter in concert with if the economy does actually ... if growth does get suppressed to the point where businesses have to start to cut heads and whatnot and unemployment ticks up, then I think it becomes a more challenging argument and something you've really got to sharpen your pencil on.

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Pamela Ritchie: I don't know if you'll agree with the premise of this question, but if ESG is not as crushing right now to some of the oil companies, does that help the banks out that lend to them, for instance?

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Andrew Marchese: It can. We have to think about ESG not just from an environmental standpoint. I think obviously decarbonization is one aspect of that. I think the banks and anyone else who lends to an oil and gas company should be concerned about all aspects of the ESG acronym. We have to think about that. I think, obviously, energy diversification is a plus over the course of time. I don't think it's strictly about divestiture, cutting off all sources of funding to certain companies. I don't think that unabashedly is the answer because the transition to a greener, sustainable energy source takes time. You can't just turn off the spigot to one and hope that the others pick up the slack, so to speak. So, I think, it is about energy diversification. I think it's about looking at all aspects of ESG. That's what we're trying to do here at Fidelity and being smart about it and really grilling our companies about it and what they're doing from an emissions standpoint, also from a governance standpoint, which sometimes I think gets lost in the discussion and we're certainly not losing sight of that. On the sustainable investing side, the same things apply. These same things that they may not have the decarbonization issue necessarily, but there's governance and potentially social issues that we do need to consider. We go pretty hard on that as well.

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Pamela Ritchie: For institutional investors, which are joining in this conversation here today, for the long-term thinking, what are some of the concerns about, for instance, asset mix? It's all a rate story when you look at it from that perspective as well. How would you think about that for those [crosstalk]?

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Andrew Marchese: Depending on what your view is of secular inflation, one of the things I think about if I were to think on a 10+ year time horizon, one of the things I think about from an inflation standpoint, I still think there ... and this is just my personal opinion ... I still think there are more disinflationary forces in the world than inflationary forces. I think that generally speaking at the government level is high global, let's just call it globally, that's disinflationary. We have an inverted age pyramid and demographics in most of the developed world, that's disinflationary. Technology is disinflationary. We can increase productivity without any adverse effects on necessarily input costs. I think as a society we have proven over time that we can make advancements to enhance efficiency and productivity. Those are three big aspects.

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I also think people leaving the workforce is disinflationary. If you take those four aspects, those are largely big disinflationary headwinds. You don't see them on the day-to-day, but they slowly kind of appear year after year after year and they keep kind of, as I said, inflationary headwinds at bay to a degree. The question, I think, becomes the cyclical inflation that we have seen over the course of the last 6 to 9 months, do we eventually get it down to a much more manageable level and it's easier to navigate the interest rate toggle, so to speak, for central banks going forward. Then it becomes thinking about your asset mix. Fixed income will obviously look interesting again. There will be other asset classes that may look better from a more steady state or even disinflationary backdrop.

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To me, as we sit here today while the cyclical inflationary forces are real and they're palpable and you can see them clearly in the data, the question is once we get through this with central banks raising rates, are the disinflationary forces just so great that we're always kind of at some kind of level of kind of an interest rate band where we're, I don't know, at some band on the 10-year where it's relatively low relative to the last 50, 70 years? That has implications for what you pay for asset prices.

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Pamela Ritchie: Ultimately, if it's accommodative, what does the money that is still in the system directionally go towards?

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Andrew Marchese: That's a really good question. If you think about it, my comment just earlier about the last decade, the decade between 2010 and 2020, favoured growth securities because the economic backdrop was actually quite meagre relative to other decades. You didn't have those great growth tailwinds that you may have seen in the '50s and '60s. If that's true again, we're trying to find new innovation, companies that generate a lot of free cash flow, buy back their own securities or make investment capital allocation, whether it's buying other companies or make investments in their own businesses that further strengthen their lead or their dominant stature in their respective industry. I think if you believe in that kind of maybe it's a disinflationary backdrop then growth tendency, growth style securities might actually be back in vogue again for a long period of time.

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The flip side of that, not to talk about both sides of my mouth, but the flip side of that is if you don't really squash out inflation in the cycle and it just keeps percolating a little higher, do you run into a decade, which is a little bit more than just cyclical or you run into a decade because of the lack of investment, because of the inability to extract all the money supply … I don't want to say it's like the '70s, but it's maybe a little bit more akin to the '70s that inflation just runs hotter for a little bit longer. That kind of keeps what relatively outperforms, it changes the tune of that because you'll have a more … at least longer than a normal cycle but maybe not a secular case for an inflationary backdrop. I think it all depends on how central banks manage interest rates going forward over the next 12 months and how we deal with extracting all the liquidity that was injected into the financial system over the last 10, call it, about 14 years, really.

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Pamela Ritchie: Really fascinating. One of the obvious questions about directionally where we go, it does bring up the question of crypto, but it also brings up a lot of other innovation that's going on right now. Your quick thoughts on crypto.

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Andrew Marchese: On crypto. I think it's an asset class that everybody's going to have a differing opinion on. I think it is a diversification tool. The concept of a cryptocurrency, to me, is fascinating. To say one is better than the other or how you peg the price relative to the US dollar or any other fiat currency, that's a little bit more arbitrary at this stage of the game. It is fascinating from a utility standpoint. I think in the future, and we'll call it the mid to longer term, think about how it's being used as a diversification tool in a variety of backdrops and also kind of settings. Obviously, the value of a crypto instrument may have greater value to somebody living in some parts of the world versus others. I think from that standpoint there's kind of more evolution that has to take place in it. I think the most fascinating thing to me about crypto is not actually crypto, it's blockchain. It's the technology itself. How does that work into other aspects of how we live our lives and how we can, again, be more efficient, more productive implementing that technology going forward in this world. Crypto is just one aspect of what I think the real gem in the discussion is. It's actually the blockchain technology itself. That, to me, is what I'm more fascinated by than necessarily Bitcoin or Ethereum or what have you.

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Pamela Ritchie: The blockchain itself and the technology and what possibilities it presents. Fascinating. We'll have to check back in with you as soon as possible on some of the developments there. Andrew Marchese, thank you very much for joining us here today.

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Andrew Marchese: Thank you, Pamela. Pleasure as always.

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Pamela Ritchie: Great to see you. That's Andrew Marchese joining us here today. Thank you all for joining us here today as well. As always, if you have any suggestions for future topics, guests that you'd like to see on the show, please feel free to share those ideas with us. Stay tuned for more Fidelity Compass webcasts in the weeks and months ahead. I'm Pamela Ritchie.

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