Fidelity Compass

Portfolio Perspectives

Joe Overdevest, Portfolio Manager

Bryan Borzykowski, Host

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Bryan Borzykowski: Hi, and welcome to Fidelity Compass. I'm Bryan Borzykowski. This month marks one year since the Bank of Canada raised its benchmark interest rate for the first time since 2018, and the U.S. Federal Reserve followed suit shortly after. Now, a year later, differing messages from the BOC and the Fed have investors closely monitoring what a potential pause and raise could do to the markets. Are raising interest rates the biggest overhang, and how might lower inflation expectations play out in 2023? Joining me today to discuss his outlook on Canadian and global markets and the sectors he's most excited by is Fidelity Portfolio Manager Joe Overdevest. Joe, thanks for being here.

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Joe Overdevest: My pleasure, Bryan.

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Bryan Borzykowski: One year. I can't believe it's already been a year since the great rate hike of 2022 happened. How would you looking back characterize the moves and where does that leave us today, a year later, at a much higher rate?

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Joe Overdevest: I think the further you go back, one of the biggest things I would take away is how the market, the media, maybe just generally investors put everything in extreme. The old days it was like interest rates can never go higher and then all of a sudden inflation, well, it would be transitory. Now it's like, well, inflation isn't coming down and rates aren't going be coming down for a while. I think you have to watch when you put things in extremes and capitalize it forever.

I'm sure we'll talk about this but yes, interest rates have moved up. I think it's a resetting of expectations. An analogy we've used before is you're going on a trip with the kids and the last year and a bit have been are we there yet, Are we there yet, are we there yet? The kids want to know are we there yet. Are we done with actually the raising of interest rates? Canada, of course, is closer, it seems like, at least their public comments are that we want to pause here.

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I think the only thing I would just frame it's much like with the kids, when we get to Disneyland and we get out of the car and they're very excited, they want to have all the sugar treats. We might be eating carrots and some more healthier foods because rates are also going to just come back down to zero. We had some very good times there, does not mean you can't have companies that compound some great equities over time, great businesses that grow wealth. You just have to understand there was a lot of tailwinds, especially for interest rates and liquidity in general the last few years.

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Bryan Borzykowski: This brings us to a year later, March, the Bank of Canada is going to make another announcement very soon. They have said that they are considering pausing yet the Fed has said they might increase rates. Do you see sort of a divergence of policy happening now? Do you expect — it's hard to predict what's going to happen with the Bank of Canada always — but do you think that pause, they actually will pause in March?

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Joe Overdevest: I think the Bank of Canada wants to pause. I think one of the biggest things is just understanding the differences in the two economies. One of the biggest things that a central banker worries about is probably the actual end user of especially a mortgage because that person, it's tough to avoid that product. A company can say, well, made we won't lend, maybe we won't do this expansion of a project but mortgages are a big thing. The biggest difference you see, of course, in the U.S., 30-year mortgages. Here in Canada, 5-year mortgages. That's a big, big difference when all of a sudden they realize that if you start increasing interest rates as they have, the Canadian consumer in particular is way more sensitive than the U.S. So, I think the Bank of Canada would like to. I think the biggest thing probably their concerning is obviously their economy but as you said, they are also very much connected to the U.S. If the U.S. keeps raising rates, it almost draws you into it. Otherwise you have an issue with your currency because the currency resets things and your competitiveness goes against you, you might have to follow suit.

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The biggest thing too about the markets these days: are we done yet, are we done yet? I think the biggest thing also is to take a step back. We're definitely closer to the end than the beginning. When we look at investing, often we get asked where's the bottom, where's the top? It's just not that simple, especially with what we're talking about now. We have to take a further step back. This interest rate talk even, the magnitude and the speed of it, when you look back in the history books, it's its own chapter of what is uniquely happening here. So, trying to say with definitiveness, oh, this is the end, this is the beginning, I think we have to know more. We're closer to the end. What that means is taking a step back and what's the next 1, 2, 3, even 5 years look like for some of our companies and not just focus on, okay, what's the next Fed rate decision, and that 25 basis points or it's 50, we're in or we're out, as opposed to what's the upside/downside. There's some of our companies looking more attractive.

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We have to really, like I said before, understand you are probably in a higher interest rate environment than you were in the past but again, it's like the bigger question you're probably going to ask me is inflation too. We obviously had super high inflation. You had 8%. I think, for everyone in the audience here, there's three big buckets that were driving it. There was labour, there was supply chains, there was probably commodities.

We'll go backwards. Commodities, one of the biggest one is oil. Luckily, that's coming off. I'm sure we'll dive into oil. Supply chains are definitely getting looser. Anything like port data, just to ship anything across the seas, significantly lower year-over-year. Lastly is labour. Labour is definitely the stickiest right now. You are seeing some job losses but most of it actually is in white collar which is good because white collar labour is generally easier to move once they lose a job. Some of the tightest is actually in the blue collar labour right now which is good because those are tougher sometimes to find a new job.

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So, labour could be sticky. When we go from 8% inflation, we might see some nice numbers and we're seeing that already. There's some puts and takes and always some noise month to month. December, January data, there's a lot of revisions and estimates. When you come 8 to 4, just for the audience, just understand we might go 8 to 4 but 4 to 2 might be the tough one. That will be very interesting how the central bankers act in those environments at 4 to 2. Do we get close to three, some jawboning in the market, saying, well, we're closer or our target is massaged? Well, it wasn't really 2, we thought we'll average 2 over the next two years. That's where it becomes dangerous when you're saying, I'm just going to wait exactly when they're done. The market might start sniffing out we're closer to the end. What happens if they start sniffing it out, multiples will start expanding. The three biggest things in any market is valuation, liquidity, of course, and earnings. Right now, one of the biggest things is liquidity is being drained from the system, especially what's going on in the U.S.

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Bryan Borzykowski: Given all that you've said, and the last couple months of the market, it's already March 1st today. It's hard to believe it's already March. Where do you sort of think maybe markets could go over the next year? Will it continue to be volatile? Will things settle down as inflation numbers potentially decline? How are you positioning things?

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Joe Overdevest: The conclusion first, it looks like more an up and down market. It doesn't mean we even can't be a little positive or maybe a little negative. But I just warn the audience, there could be a lot of ups and downs. You've seen that in the first ... Bryan's alluding to ... you've seen only two months. It feels like it's up and down within those two months and we're only two months in. It makes sense.

Again, let's review the big ones. Liquidity is being drained from the system but again, that could start pausing as we get 12 months out or a little further out in the year. Number two is valuation. TSX around 13 times earnings, S&P 500 was around 17 times earnings. It's okay. It's not a huge pillar of like, oh my, that's super green so it's okay. The last was earnings. Earnings growth was probably closer to almost high single-digits and now it's almost 0% for this year, 10% for next year. I'm using the S&P 500 just because it's more broad based. For the TSX, you'll see similar drivers of what I'm saying.

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So, expectations for earnings have come down. I think earnings are not really a tailwind at this point in time. They're probably more of a headwind. When you look out to the year, you don't really have earnings helping you out. You don't really have valuation helping you out. Liquidity is being drained a little bit. But the thing you've got to watch is that you just don't get too negative. As we go forward the biggest overhang is interest rates. Let's be honest. There's many overhangs or tailwinds in the market at any point in time but one of the biggest ones is interest rates. As the year goes along, though, and central bankers start getting closer to the end, you start looking out a year, yeah, valuation is inexpensive, the liquidity maybe becomes less of a headwind, but more importantly earnings growth grows off a flat base and you actually have some earnings growth into 2024. You could have a good environment.

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The reason why I say up and down is just because financial conditions. The market is connected to the financial conditions. All of a sudden we get excited, we go too high, the Fed won't like that. What happens is financial conditions is a circular reference, CEOs get excited, their stock is up, they start hiring people again, they start expanding capital projects. That's inflationary. That is not good. The Fed doesn't want animal spirits going too crazy. Trust me, they will very quickly either jawbone the market down or just increase interest rates. So, you have bands at both sides a little bit. But again, I think you take a step back, especially the equity markets, if you find the best of breed companies in Canada, they grow earnings over time. The exact point you try to time it really won't be super beneficial as opposed to it's a great business with a high return equity growing over time.

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Bryan Borzykowski: Sector wise, let's dig into some of the sectors. You cover all of Canada, also global, and we'll get into global areas as well, but when you're looking at Canada, talk to me about the different sectors here. Where are the opportunities you're seeing? How are they looking this year?

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Joe Overdevest: I think we get all the different sectors. One of the ones I would say is industrials kind of sticks out in that industrials for Canada is very idiosyncratic. They are so many different kind of businesses in there. You have waste businesses, rails. You even have airlines. You have a very broad diverse group. The reason why it's interesting is because many of those companies sell into maybe the U.S., which might do a little better economically, but are usually more broad-based and their customer base is very broad. What's more important too, they generally have high return on equity and very low leverage. I think that's a very good combination, especially these days with interest rates moving up. I think that's one of the themes. not just for industrials but across the Canadian market, across the U.S. market as well, is M&A, mergers and acquisitions.

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The last 12 months, kind of quiet, right? What happens is it makes sense, interest rates moved so fast, equity markets are a little volatile, guess what happened? CEOs go, whoa, whoa, whoa. I don't know what's going on. I'm not acting as a seller or buyer. Now, we've had some time pass and the CEOs are feeling, okay, I feel a little more confident what's going on but more importantly, I think the differentiator will be who has cash as a weapon. Cash as a weapon means there's a lot of companies in Canada who have a great balance sheet, who don't need to rely on the debt markets and in particular, we're often finding they're going against private equity bidders and those private equity bidders are a little more gun shy than they were 12 months ago. Their cost of debt has gone up, obviously, as well. You can use cash as a weapon and especially if you work *[indecipherable]* private equity, some of the more patient buyers in Canada could have a very good environment in the next 12 months.

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Bryan Borzykowski: Great. Let's keep going through the sectors. What about tech? We'll do some rapid fire here.

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Joe Overdevest: One of the biggest things for tech is that there was a regime change. In the old days it was like, grow, grow, grow. It was almost like if you had earnings you were a bad CEO. What were you doing? Could you not find something to grow? We're not going to give you a high price-to-sales ratio, whatever ratio you want to use. Well,

obviously that changed. All of a sudden cost of debt goes up, cost of equity subsequently goes up and it's knock-on even from venture capital to the public markets. Everyone's now questioning what are you doing when you get free cash flow positive? I think what's really interesting, you're seeing it already, I think we're setting up for the next little while is who really gets it. You're seeing it in the U.S. and you're seeing it in Canada, some companies are really getting it.

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Some of our bigger companies in Canada were laying people off probably almost as early as June of this last year and making cuts, changing executive staff in some cases, and lowering their cost structure. We recently had meetings with CEOs and the first I heard from certain tech executives, free cash flow, EBIT positive even after share-based comp will have net earnings kind of thing. Even just that paradigm shift of acknowledging the difference from them internally is very positive. You're hearing a lot of words from them, prudence, cost cutting. I think what's really interesting, a lot of these tech companies, you had a reset of valuation already.

So, if you can get a reset of valuation at attractive level and they're focused on the right things and not relying on the capital markets, could be an interesting set-up. I do think in Canada in particular you have some big ones like Constellation Software and CGI Group, which could be acquirers and I think someone else's pain could be someone else's gain. Some of those tech companies that are smaller who are not transitioning properly, who do still rely on the capital markets, haven't corrected their cost structure, could be targets for some of the bigger tech companies in Canada.

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Bryan Borzykowski: You're coming on at a great time to talk about financials because a lot of the banks are reporting. I think all of them, except maybe TD hasn't yet. What have you seen from bank earnings?

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Joe Overdevest: I think for the bank earnings right now, the first blush would be … we've had all of them except, like you said, TD okay. Okay, not great. What's happening with the banks is that you're seeing NIM, net interest margin, had been going up. The banks are a big beneficiary of when interest rates move up the deposits don't really move too much. People like you and me might say, you know what, I'm just going to be happy with 0% return in my chequing account while they're lending out to someone's mortgage at a very high rate. It's a spread, it's a net interest margin. But the problem is, over time, people like you and I and people on the audience go, well, maybe I should go to a GIC, maybe I should go to another product and you start moving your deposits out. It's also net interest margin starts getting pressure or at least stops going up. We're kind of at that level now from what's being reported. That's a headwind because the general investor was expecting maybe a few more quarters of net interest margin expansion.

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Number two, what's hurting the banks is expenses. They had a lot of labour inflation last year, two years actually, and in particular spending even on technology. Many of them are reporting very high costs, they're maybe surprising the street in general. Now, they're all promising that growth will slow in the second half, and many of them are talking about hiring freezes or definitely a lot less hiring than they were in the past. I think lastly is credit. That's probably on everyone's minds here. Let's talk of credit or PCLs. Credit in general, or credit provisions, PCLs, are actually very low. National Bank actually had lower quarter-over-quarter even, so very little in terms of credit issues right now in Canada. Obviously, all the banks think it will be a little higher in the second half but still very low levels.

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I think the biggest thing when you look back at banks in particular, when there's issues you have to bucket in two buckets. Is it a balance sheet issue or income state issue? Balance sheet issue is bad. There's a huge amount of credit losses, the leverage then subsequently is too high and they might need to raise equity. That's bad. We're not in that situation at this point in time. It's more of an earnings issue, earnings headwind. Earnings growth is subdued. Last few years have been very strong. We're slowing right now, mortgage growth is slowing. PCLs are slowly moving up but it's more of an earnings growth issue. Again, take a step back, these banks get, give or take 5% dividend yield. The P/E, price-to-earnings ratio, 8 to 10 1/2 times, not too bad. ROE is generally 15%. The expectations for the banks are pretty low. If we get a decent recovery in the economy, the banks are usually a good leverage on the GDP.

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I think that's the biggest thing too. We even didn't mention in our beginning but how this economy is a little different is jobs. Jobs are still very, very strong. It really translates when you talk to the bank earnings ... I was just on a call this morning, when they were talking is that if you don't lose your job it's very rare that you all of a sudden default on your mortgage. I think that's what's different about different slowdowns is the magnitude. If we don't see major job losses, the drawdown in the economy that many of the people are expecting later this year might be more shallow. Instead of someone losing a job, they may adjust their spending. But when all of a sudden you lose your job, everything goes out the window and your priorities get very, very strict to the bare necessities.

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Bryan Borzykowski: We're not going to make it through every sector but we've got to talk about energy and materials. Maybe we could start with Canada. You also have a global natural resources fund, so you could talk globally as well but let's start with Canada. Energy and materials: what are you seeing in those two sectors?

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Joe Overdevest: First, to give you a conclusion again, as always. First, the tightest supply demand will probably be copper then oil. Then you're getting lower into agriculture. Lastly, would probably be natural gas just because we have a very warm winter, a lot of supply. Copper and oil near the top. One of the biggest beneficiaries is China's opening. China's really been shut down for a while. China is about 20% of oil demand but it's 50%, give or take, copper. I would say though, take a step back on all the commodities, probably ask me about supply, I think demand right now is okay just because China is still just about opening up and the rest of the world is doing okay in terms of anemic growth.

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But the supply side is interesting. We're still not seeing major supply response. If anything, the average company in oil is growing maybe 3%, maybe 4, 5% if they're lucky and they're holding back supply because of ESG concerns. Governments around the world are not going to allow them the permit, in particular growth in our oil sands. Their shareholders don't want them to grow to add to their CO2 emissions. Even their bankers in many cases are telling them, if you get bigger I might not be able to lend to you. My loan book for maybe oil and gas can't get bigger so whatever size you're at right now, you're staying. Copper side, you're just seeing some more aggressive governments around the world making it very apprehensive for people making big projects, in particular in South American countries right now. I think places like Chile and Panama are having some concerns with their local miners. All this is holding back supply. If demand holds in, it could be an interesting backdrop.

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Bryan Borzykowski: Commodities are always a global industry but if you look beyond Canada, are there different opportunities there in the commodities and energy and materials space that you're looking at?

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Joe Overdevest: I think Canada has some of the greatest assets we have in terms of valuation. Some of the Canadian oil companies, you're talking 10%+ free cash flow yields. In the U.S. you're talking about more 7, 8% free cash yield. Still probably a little better growth prospects, a little better on the Permian, which is in Texas. But once you go out North America, it really falls off. There's not too many great prospects out there. Like I said, even politically, you've run into governments that may steal your mine or you have governments who want to tax you a large degree of your oil company. We look globally and the spectrum changes over time. The spectrum is very much some of the best copper, oil companies still reside in Canada if you want to stretch further into North America region.

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Bryan Borzykowski: Given all that, how do you think investors maybe should be thinking about their allocations to resource-based sectors given where we are in the market cycle?

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Joe Overdevest: Well, I think with resources, obviously it comes with greater volatility. One of the biggest things we look at next few years is supply demand. The supply picture, for the audience, is really simple. You think ESG has staying power and it seems it does. And ESG, the staying power of focusing, especially on emissions by many individuals and particular governments, will have a holding back pattern in supply, which will be positive. So, really the demand picture, if we stay in any kind of positive environment leads to a bullish environment for commodities.

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Bryan Borzykowski: Let's shift gears a bit to your approach. How do you consider the investment landscape? How do you pick stocks and build your mandates?

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Joe Overdevest: I think what I do with investing, I would say three big things I focus on. Number one is I'm a stock picker. I'm not trying to make a macro call of big essence and saying, we're betting on the U.S. consumer or betting on oil going from 50 to 150 and that's going to be the big driver of the portfolio. I'm a stock picker. Number two, I want to leverage the competitive advantage of Fidelity. That's the size and quality of the investment team. Investment team, 350 investment professionals around the world doing amazing job. Almost every 30 minutes of the business day there's a CEO meeting. It is pretty powerful, the information we can get globally just understand the mosaic of what's going on.

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Lastly, I have a very big focus on risk. Before we get to any investment think about the upside, downside, where it could be wrong. We embrace our own ignorance. We do a lot of risk at the portfolio level and at the stock level. These are the three big ones. The average day involves a lot of reading, a lot of talking to analysts, company CEO meetings, a few this morning already and some later today, public calls with maybe like an earnings call and time to just share ideas with PMs and keep turning over rocks to find the best of breed of Canada.

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Bryan Borzykowski: You're allowed to go off benchmark as part of your mandate. What does that mean and what does that look like to go off benchmark?

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Joe Overdevest: To go off benchmark means we're not sector neutral for Canadian focused equity product. What that means is that we have different products for different individuals. This one can be plus or minus 7.5% for a sector, over or underweight. They'll always be driven from a bottom-up perspective. We can, of course, own stocks that are not even in the benchmark. It could be an IPO or it could be a small-cap. We're encouraged to find the best companies in Canada, let's say 40 or 50 small-cap, large-cap value or growth wherever it may be or whatever sector it may be. I think one of the biggest things we try to do, though, is really leverage the investment team, like I said. An example would be telecom or utilities. Both are very similar in terms of interest rate sensitive. We'll ask our analysts, okay, give me your best one or two across those. We might only own one or two across both those sectors and not own the other sector. Again, we're just trying to find the best ideas. Instead of taking a macro risk we'll take a stock specific risk to drive alpha.

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Bryan Borzykowski: A lot of people watching who are with Fidelity probably have their money in a Canadian mandate. Other people who may not be investing with Fidelity yet may have a Canadian mandate already. I'm wondering, why Fidelity? Why would somebody want to work with Fidelity on their Canadian stocks?

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Joe Overdevest: I think for Canadian stocks for Fidelity is just that competitive advantage. Let me even elaborate more on that. Here you have — this team is growing so probably 25+ people here just in the Toronto office that would reside, a big part of the Canadian team. The benefit is that that's a big team just in Canada. The size of that team is big and more importantly, the quality of the team, the metrics that team has done over the last two years, in particular that analyst team, are amazing. They make our jobs a lot easier. From a Canadian perspective you have 350 investment professionals around the world. Again, it's like OpenText does a deal and they buy a U.S. company. So, what do we do? Well, we have an OpenText analyst here. We have full coverage. Some of our competitors might not have full coverage of every company. Even if I own it or don't own it, we have analysts writing research notes every three months, talking to the company in many cases every three months. I'm joining these calls often. So, all of a sudden something happens, I'm not like brushing up on it, oh, well, what's the story? I know the story. I probably even know the CEO. The analyst also does the report on it.

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Number two is we have a high yield team that actually resides in our offices. The high yield team looks at the debt, gives their opinion of it. Guess what, they bought a U.S. tech company. We have, again, 350 investment professionals around the world. There's a U.S. tech team as well. What do we think of the target? Also too, we hunt in packs. We don't hunt alone. So, we have growth PMs, we have value PMs, we have small-cap, we have large-cap. We have different PMs looking at this, so we'll often talk and go, what do you think of this? It's sometimes interesting to hear different opinions, and in some cases the opposite opinion. But all these inputs together make us, hopefully, give the best decision on behalf of our clients.

I think that's important. It's not just one man or woman saying, buy or sell, it's using multiple inputs to increase our conviction. That's the difference between buying a company that's 0.5% of your portfolio or 5% of your portfolio. It's getting inputs from the equity analyst, the high yield team, some of your peers, the competitors or actual customers of that ecosystem, and lastly, having a management meeting. Again, we're very humbled by the management access we get but all these inputs together give you that conviction to have not just a position but also the size of the position.

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Bryan Borzykowski: We just have a couple minutes left. You've talked a lot about having those conversations with CEOs. You mentioned a little bit with tech CEOs, some of the conversations that you're having. Maybe something for people to think about, what are executives thinking about today in this environment? What are those conversations you're having?

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Joe Overdevest: As I said, M&A, they're thinking there could be more M&A. They're finding the private equity players are not as active. Number two, costs are still sticky, especially labour, but they're definitely not hiring as much as they used to and they're definitely not giving as many increases. The year-over-year comps are still sticky. Three, we're still seeing prices stick. What I mean by that is the strong companies are still able to price their product and receive customer feedback that's okay at this point in time. So, you're still getting some margin leverage which is good. Again, strong and weak, you definitely see a difference but the strong companies are still providing good pricing.

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Lastly, I would say, the CEOs a lot times will ask us, what do you see in the economy because they're seeing it's still resilient, I would say, and it's not weak. Again, we have to sometimes take a step back. There's a lot of media headlines. When you're in a recession, and CEOs will tell you this and our PMs will tell you this too, you'll know when you're in a recession. We're talking about cutting, we're laying people off, the CEOs are stressed. We're definitely not seeing this at this point in time. I think a lot of it is actually just the CEOs themselves bracing for potential slowdown as opposed to seeing a slowdown right now. So, they're taking the corrective action forward but the feedback they're seeing is generally a pretty resilient consumer at this point in time. The biggest thing most of them will come back to is jobs are still there and when you have your job you're still spending.

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Bryan Borzykowski: Perfect. We will leave it there. So much to talk about so plenty more in the next conversation we have but thank you so much for joining us today.

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Joe Overdevest: Thank you. My pleasure.

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Bryan Borzykowski: And thank you, everybody, 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 for being here.

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