Fidelity Compass

Market and Portfolio Update with CIO and Portfolio Manager Andrew Marchese

Bryan Borzykowski, Host

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Bryan Borzykowski: Hi and welcome to Fidelity Compass. I'm Bryan Borzykowski. Volatility continues to roil markets at home and around the globe. The latest production cuts from OPEC and weaker U.S. job data are some of the latest factors weighing on equities. What does today's market environment mean for your portfolio and how should you navigate these investment hurdles? Joining me today to share his thoughts on recent market events and how it's impacting his positioning is Fidelity Chief Investment Officer and portfolio manager, Andrew Marchese. Andrew manages several strategies, including Canadian Systematic Equity, Canadian Disciplined Equity and Canadian Core Equity. Andrew, thanks for being here.

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Andrew Marchese: Hi, Bryan. Great to be here.

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Bryan Borzykowski: Always a lot of news going on all the time it feels like today and I think it's confusing a lot of people as to where we are exactly in the cycle. My first question to you is just that. When you look at the evolution of the cycle where are we at? What are you seeing?

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Andrew Marchese: I think on a global basis, if we start in North America, we're clearly in the late stages of an economic cycle. We had a lot of tightening by central banks in both Canada and the United States last year. That should manifest itself in continuing kind of deteriorating numbers in both housing and manufacturing. We've seen that in kind of like the PMI numbers and the housing numbers. The question then at this point is, is the tightening sufficient then to address some of the inflationary concerns that the U.S. Federal Reserve has with respect to inflation in the service sector, in particular of the U.S. economy. If you kind of go over the pond to Europe, they're still in a tightening regime over there from a central bank perspective, so continuing to see slowing in that economy again. The manifestation of global economic growth slowing has so far shown up in many ways in the form of consumer behaviour slightly, in the form of manufacturing. I think we're still waiting for some other things to possibly show up from a service sector perspective.

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Bryan Borzykowski: The banking crisis in the U.S., regional banking issues certainly dominated news headlines for a while. How has that crisis or issue impacted, do you think, the Fed's behaviour going forward? Some people think there could be rate cuts in 2023.

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Andrew Marchese: If you look at Bloomberg right now, the consensus is for rate cuts in the back half of the year. That's kind of the market general consensus viewpoint. As it pertains to Silicon Valley Bank and U.S. regional banks in general, I actually wasn't too fussed about that. The situation got contained by, I think about Sunday night and it started kind of on the Thursday, Friday of that same week. So, within a relatively short order the situation got contained. It's not unprecedented. We've seen this in the traditional savings and loans crisis back in the '80s, in the U.S. Orange County crisis. I think there's been a lot of ink spilled about the whole topic, but I would say that, you know, it's a garden variety asset liability mismatching and a few institutions made their bets on rates and the yield curve incorrectly. Once confidence is breached from the bank itself and deposits flee, it becomes a self-fulfilling prophecy. I am not that fussed about that whole situation.

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The concern I have going forward is what do corporate profits look like for the remaining nine months in the year and then what it looks like in 2024. I don't think it's too early to be looking out even further than the remainder of this year. That's what we're really focused on here at Fidelity. For the purposes of my portfolios, that's what I'm really focused on to understand has the worst case scenario from a negative earnings revision been priced into the securities I hold. If it's been priced in, I feel pretty good about the upside, downside, or a risk reward scenario. If it hasn't, I need to be cautious and ask myself, should I be in those stocks in general? Similarly, are there any names I currently don't own where the risk-reward is skewed so favourably towards reward whenever the next economic cycle shows up that I should start buying the security today. Those are the things that are really going through my mind and I would say most of our investor's mind here within the team.

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Bryan Borzykowski: When you're looking at the risks, what are some of the key risks that you're looking at and to your point, are those priced in or is it on a sort of company by company basis?

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Andrew Marchese: I think a lot of the work we're doing is really on an idiosyncratic basis right now. It's really trying to understand what will be any headwinds towards revenue for a company in question or an industry in question. Is there some lag effect in terms of inflation that will further crimp profit margins in the quarters ahead? How long is that durable for? In other words, not only the magnitude that we may need to adjust earnings by, but for how long, duration. You know, typically, interest rate hikes take about at least 12 months to start working their way in through the system. So, I don't think from a general economy standpoint, we've seen the last yet of a hit to aggregate demand for a lot of goods and services. We have to be very considerate, if you will, of that when we're really doing our diligence on each industry and each company within that industry.

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Moreover, I think as you've seen, interest rates going up as much as they have, we really have to understand the balance sheet risk for each of the companies that we're investing in and making sure that there are no covenant breaches potentially to come, liquidity issues kind of going forward, how termed out is the debt, etc., etc., so we have a better understanding of what their capital needs are, which also has implications for what their capital allocation strategy may be in both the near-term and mid-term.

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A lot of things going through our head right now as it relates to corporate profits and health of balance sheets. I think, ultimately, the best crutch in this type of environment as we get through the late stage of the economy is really price. If you pick your price well, if you buy smart, that's really the best thing to do and then wait. My portfolios in general don't actually look that different than they did, say, 12 months ago. But we do a lot of homework between that. We're just making our shopping list and checking it twice, so to speak. That's a lot of the work that's been going on over the last six to nine months.

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Bryan Borzykowski: If the optimism is there currently that earnings are going to be okay, and if you're thinking that there could be an earnings hit here going forward, what does that mean for stocks? Just broadly, are we going to still see markets then decline?

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Andrew Marchese: I think the environment we're in, when we do our homework through the major sectors, the GIC sectors of the market, I can point to a number of securities where they would otherwise be traditionally more in the front end of the economy, which is not a great place to be right now where we are in the economic cycle. But they've actually been discounted quite significantly. Other securities in possibly that same industry have not. It's really a case by case basis. When you look at market bottoms like March of 2003, March of 2009, you had that kind of holistic buy risk, buy the market, buy beta. I don't think we're in that environment for 2023.

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That being said, I think what we're trying to do is selectively add to individual securities where the risk-reward is skewed in terms of reward. That doesn't necessarily mean it takes on a defensive stance. They may actually be more cyclical companies. It's really case by case. I can point to things that look very attractive, things within the same industry that don't look attractive because the price is not right and risk-reward hasn't necessarily been adequately priced in and you don't have that margin without that margin of safety for us.

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Bryan Borzykowski: Why would that be? I mean, that's interesting. Why is it different this time? Why are you seeing it that way?

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Andrew Marchese: It's a good question. For the better part of nine months, there's been a lot of disagreement, if you will, in the market in consensus about the trajectory of the economy. As recently as January 1st, you had a real group of people saying there was going to be no landing. And then some people saying soft landing and others saying hard landing. Over the course of my career, I don't remember it being as split, at least from a top-down perspective. Some of those folks who were in the no landing, soft landing camp since January 1st have migrated over to the hard landing camp with the events of the U.S. regional banks, with interest rates continuing to move higher in the United States. I don't know why it is as such but it's actually not unprecedented. You can look back to the market cycle, the dot com and NASDAQ cycle '99 and 2000, how that kind of eroded over the better part of three years.

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There are some similarities, too lengthy to mention over the course of this call, but there are some similarities to that kind of environment. That's fine with us. We pride ourselves on being in an active management shop. We invest a lot of time and resources in doing idiosyncratic security due diligence. These are the types of environments where we need to work harder and really uncover some really good investment stories, and looking out on a multi-year basis. I think if you become too myopic and are just thinking about the next 6 to 12 months, I think you'll miss the boat. So, you just have to look out longer and be patient.

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Bryan Borzykowski: I was going to ask you about that because we have an institutional audience who generally are taking a long-term view, except you're getting constant hits of all the things going on in various parts of the world. I'm curious, for you, how do you kind of stay that long-term approach when there's so much news happening and people like talking about the short-term and like talking about each economic move? How do you balance the short with the long?

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Andrew Marchese: One clear way, you don't listen to the news. You turn that stuff off first and foremost. That's not helpful. It's not constructive for anybody on our team. Turn that off. Have a lot of faith and trust in the work that you and your teammates are doing. Have the discipline around it. You know what you're looking for. We've been doing this a long time, we know what we're looking for. It's just about doing really, really, really strong analysis and then having the discipline to take the action when appropriate and trusting all that homework that you've done. I think that's it. I think every year that goes by we have more noise in the financial services industry. We have more media outlets, more sources of information. It seems there's no shortage of opinions about just about anything. I'm not so sure a lot of it's actually relevant and it's topical and, as I said earlier, constructive, so you just tune that out. Do what you do. Have a game plan and execute the game plan.

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Bryan Borzykowski: Good advice. Let's talk about sort of the opportunities you're seeing. Again, it doesn't sound like it's just full sectors you're going into but with the companies that you are watching or perhaps investing in today, what characteristics do they have? Are there parts of the market where you're maybe finding more opportunities than others?

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Andrew Marchese: The shared characteristics of the companies that are in my portfolios, I think, generally speaking, they have a lower earnings variance to them from year to year. Generally speaking, kind of within the same sector itself, less cyclicality, if you will. They probably have a little bit better debt coverage and interest coverage. Speaking about the balance sheets that I mentioned earlier, they have those kind of characteristics. The opportunities I'm looking for are actually securities in each of the GIC sectors, 11 GIC sectors, who may have more earnings variance going forward. They opportunistically play well as you come through a slowdown in the economy and then when you start emerging from that into recovery and early cycle mode you generally want stocks with a little bit more earnings variance to them. The best thing that can help you by buying them right is just simply price.

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That's where I find myself doing a lot of the homework with the analysts and whatnot and asking questions, doing sensitivity analysis on our financial modelling, stuff like that. The constituency of the portfolios generally tend to be slightly more lower beta, less earnings variance related. More of the homework is being done on the other side, however. It just speaks to you want to be opportunistic on the things you currently don't own when the time is right.

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Bryan Borzykowski: Let's talk a bit about stocks and bonds. Bonds wasn't as maybe as big of a conversation in the last ten years when yields were low but now it's back. How are you positioning or Fidelity positioning itself in both of these asset classes? How have they changed when it comes to portfolio construction today?

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Andrew Marchese: With respect to fixed incomes, obviously we haven't seen a year like last year in the fixed-income industry or segment of the market, the asset class itself, in a very, very, very long time. That being said, I think on a selective basis, obviously there will be some corporates out there that look appealing. Treasuries, obviously to me look very appealing for a lot of ways. That being said, I think this inflation topic, it kind of ebbs and flows. It gains a lot of steam and then it kind of backs off a little bit. We all know inflation is kind of like a lagging indicator, but I think the question for us is what we ask, and this has implications for your asset allocation decisions, I think it's not that inflation won't come down, and it has come down, it's where does it level off at?

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Subsequent to that, how do central banks think of interest rate policy thereafter. This goes back to your earlier comment about the consensus for the market is to cut rates in the second half of this year. I think if you look at the post-World War II era, on average it's about 3 to 4 months. This is an average. There's a danger in speaking in averages, but on average, the first rate cut happens about 3 to 4 months after the last rate hike. I think there's a lot of people taking that kind of math or correlation, if you will, and kind of applying it going forward. That might be a little presumptuous because nobody disagrees that inflation is coming off, it's just where does it level at this current level of interest rates?

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The other thing that I don't think enough people are talking about is respect to quantitative tightening. There was a lot of liquidity, a lot of liquidity injected into the financial system on the heels of COVID, actually dwarfs what was done during the global financial crisis. That needs to come out of the system. I think that's a long-term issue. I think monetary policy and how the Fed deals with, or the U.S. deals with its balance sheet are two things still acting in a de facto kind of tightening regime. Is it sufficient? Is it not sufficient? I think that's the broader implications for your fixed-income allocation. It's a tough one. I'm not so certain that there has been sufficient liquidity extracted from the system to say the Fed has won the war on inflation. I think that's to be determined.

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Bryan Borzykowski: Let's move to Canada a bit here because your strategies are focused on Canada. How is the Canadian market doing today? How would you characterize it in the global context?

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Andrew Marchese: Obviously, we've had a couple of strong years in Canada relative to the rest of the world. I think oil continues to hang in there. You mentioned earlier production cuts by OPEC, which has put a near-term kind of bid under oil and gas stocks recently. I think Canada's a small export-based economy. Its market reflects kind of the economy in a lot of ways. We have to be cognizant of that. As the globe continues to slow because of the tightening that was done last year, as it makes its way through the system, we have to be very, very cognizant of that. We do know at the consumer level in Canada, the Canadian consumer is definitely more levered than the U.S. consumer, principally to mortgages and real estate. That has implications not only for the consumer but banks themselves. If we are going through kind of a garden variety cycle here, what are the implications for low loss provision ratios at Canadian banks. We're trying to figure that out.

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Again, this comes back to sensitivity analysis and what has been discounted by the market already and what hasn't. Obviously, oil and gas and financials are the two big sectors people talk about within the Canadian marketplace. One's got some near-term fundamentals, tailwinds to it on the back of OPEC and the other, there are some risks associated with the garden variety economic cycle to it. That being said, you're not paying 15 times for the banks. There's been a meaningful kind of P/E multiple compression that started last year, it's been going on for the better part of 15 months. If they were far more expensive than they currently are, I would probably be a lot more concerned, but now it's just about kind of trying to get the earnings estimates right and what are we really paying for at the end of the day.

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Bryan Borzykowski: Real estate is also a big part of our economy. You've talked a bit about that. REITs recovered through the first bit of 2023. I'm just wondering how you might be approaching real estate within your portfolio.

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Andrew Marchese: I don't have a strong opinion as it pertains to publicly traded REITs. I don't have a real strong opinion on the group. I am still concerned about office space in the major cities and I think that's the one that could get worse. We're trying to do a lot of diligence about that. That, to me, of all the segments of real estate still is the riskiest. I think, if you want to invest there, I think it's going to require a lot of due diligence really to understand the situation, for obvious reasons. Broadly speaking, I don't have a real strong opinion either way on real estate, but within real estate if you break down the REITs, office space is the one to me looks kind of like that yellow, red flag. Not to say there aren't opportunities there, but you've got to really do your homework.

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Bryan Borzykowski: I was also wondering about gold. Can gold help manage inflation? We've seen the price rise a bit, any thoughts on that?

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Andrew Marchese: The price of bullion is most correlated with real yields that become negative, or go from positive and towards negativity. That's usually the correlation. As you know, real yields went up a lot last year, which is why gold didn't do particularly well. If you think that we kind of continue to slow at some point over, let's arbitrarily call it 12 months, that central banks will have tightened sufficiently and gotten what they want out of the economy, which is a slowing of the economy, prices being buried, unemployment going up, financial stability, they get all that, that to me means yields fall, yields become going towards, on a real basis towards negative and that historically, at least, has been positive for the price of bullion.

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Bryan Borzykowski: We were talking before about credit risk as well. What are you looking at when it comes to credit and what could the risks be there as the economy continues to evolve?

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Andrew Marchese: As always, once you go through an interest rate cycle, there's things that come out of the woodwork that you don't necessarily expect. We're mindful of that. That's why we go back to kind of like understanding the balance sheets of our companies really, really well. At the bank level, if the economy continues to slow, you'll have loan growth slow and there could be delinquencies. We would expect loan loss provision ratios to go up, but it's the magnitude of the slowdown. So, it's kind of like does it look like a fairly shallow, modest recession? Does it look something more like the early '90s, or does it look like something like the early '80s? Those are very different kind of examples or analogues, so that's the sensitivity analysis we're kind of doing on that front.

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Bryan Borzykowski: It feels like there's still lots of uncertainty so I don't want to get ahead of myself here, but what do you look for when it comes to the next investment cycle? Are you paying attention to how things might change from where we are today to where we could be tomorrow?

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Andrew Marchese: We'll talk about the economy and the market. The market, generally speaking, when you have these kind of like the pin is in moments of the market — I talked about March of 2009, March of 2003, you had this unabashed buying of risk and the characteristics are kind of small-cap stocks, highly levered companies, high beta, low quality, what would be generally described as low quality companies, and stocks that kind of lead. But everything kind of goes up, it's just that those groups of stocks kind of lead more. What precedes that moment is usually a moment of panic. You get that kind of selling exhaustion and kind of that panic kind of blow-off. At some point it precedes those types of moments.

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Now, if you study the interest rate cycle, what you'll find that starts occurring is once central banks start cutting rates, the leadership in the market starts morphing from defence to offence in the early cycle, if you had a crystal ball, generally speaking about halfway through the rate cut cycle. So, if you had a crystal ball and you said there were eight rate cuts of 25 basis points apiece coming, you would really start to migrate your portfolio on the fourth, so to speak, if you knew with certainty that's where you were going. That's what history tells you. You can look back over 125 years and it always tends to work that way.

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This is why everybody, going back to your consensus, or my consensus statement about where interest rates are going and how the consensus is for cuts, I think this is why the market's not necessarily — China got off to a good start this year, beta was leading. I think people are trying to get ahead of the rate cut cycle. I think Jerome Powell and others kind of splashed cold water on that back in February. So, this is like the mechanics of the market cycle. This is how it typically works. When you start getting into a rate cut environment, the economic data typically looks really bad, like really bad. You need to be buying in the face of that. That's what you do. You should be buying fear. We're trained to buy fear. All that homework that precedes it, that's when you kind of just act. As I said, we're doing the homework today with the expectation there is at some point in the not too distant future we get to put all that into practice and execute.

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Those are the signs that we're looking for, are we going to be in a rate cut cycle? When does the worst kind of get priced in? How does leadership change thereafter? There are all these signs that have been these guideposts, if you will, that if you look back in history and many market cycles it always tends to rhyme like this. You have both the idiosyncratic work being done at the micro level by all our PMs and analysts. You're hoping that dovetails with the macro environment. When you've analyzed both of those two things correctly, there's a real good opportunity to buy smart and have really favourable, active returns over the course of the next investment cycle.

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Bryan Borzykowski: We only have about 30 seconds left. On that, you said before your portfolio looks the same as it did a year ago. Is it going to look different going forward?

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Andrew Marchese: I think it looks similar. I've made some selective small changes to it but it has to, by definition it has to look different as we kind of migrate here over a certain amount of time. How it looks different, how quickly it looks different, by what magnitude, in what particular sectors, time will tell. That's where we do the stock picking and so on and so forth. But by definition it has to be because we do have a sector neutral portfolio. The three that you mentioned are sector neutral or derivations of sector neutrality. But even within there, there is a certain degree of cyclicality within each of those sectors. We have to understand both at a micro level and a macro level where the cycle is going for the companies that a) we currently own and b) those that we don't own.

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Bryan Borzykowski: Great. Well, Andrew, I'm going to leave it there for now. Thank you so much for joining us today.

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Andrew Marchese: It was a pleasure. Thank you, Bryan.

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Bryan Borzykowski: 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. Thank you. I'm Bryan Borzykowski.

[end of webcast]

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