Fidelity Compass

Institutional Webcast: 2023 Global Macro Outlook

Jurrien Timmer, Director of Global Macro

Pamela Ritchie, Host

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Pamela Ritchie: Hello and welcome to Fidelity Compass. I'm Pamela Ritchie. The U.S. Federal Reserve has been working hard over the last year to tame inflationary pressures while avoiding a recession. In other words, a soft landing. Now, after almost a year of seven consecutive rate hikes and six straight months of cooling inflation, are dreams of a soft landing, in fact, close to reality? Has, perhaps, a soft landing already been priced into markets? Joining me today to discuss his outlook on inflation and some of the macro themes that institutional investors might want to be keeping a close eye on for 2023 is Fidelity Director of Global Macro, Jurrien Timmer. Hi, Jurrien, great to see you.

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Jurrien Timmer: Good morning. Nice to see you, Pamela.

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Pamela Ritchie: Great to see you as well. I actually think I might see palm trees swaying in the background. You're somewhere beautiful.

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Jurrien Timmer: I'm spending a week in my home island of Aruba where I was born and raised. My parents fly from Holland to visit my brother, which is where I am, every year at this time. I always take full advantage because flying from Boston to Aruba is a lot easier than flying to Europe. My dad's 95, so it's not something I want to take for granted. I'm here taking over my brother's kitchen and cooking for the extended family this week.

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Pamela Ritchie: Oh, that sounds wonderful. I wish you a lovely time and catch up. Let's go to actually the subject of one of your most recent newsletters, your war report. The soft landing has been priced in then?

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Jurrien Timmer: I think so. The narrative clearly is changing. The S&P is back at 4,000 more or less. It certainly does feel like it wants to push higher. The last time it got there the 200-day moving average kind of kept a lid on it and we started to fall off and now, since then, we've had, of course, the payroll report, the unemployment report, a few Fridays ago, which was constructive enough with the average hourly earnings number soft enough to kind of revive hopes of a soft landing that the Fed can land the plane without crashing the plane and that the economy kind of holds up while inflation is defeated. The CPI report, of course, lended itself further to that narrative. We've had some more data, including today with the PPI, but even like yesterday with the Empire Report which showed a lot of manufacturing weakness.

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But when you look at the markets and where it's trading, you and I have gone back on this for a number of months last year, the market always seemed to be slightly ahead of itself in terms of what the P/E was, at which the market was trading compared to what really was justified based on where the Fed said it was going to take rates and where we thought maybe earnings would go in a mild recession type of scenario. By the market trading kind of ahead of itself the whole time, we never got that juicy contrarian buying opportunity saying, the market's underpricing what we think might happen and therefore you have a buy signal. We never got that.

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Maybe we go to slide 1 and we can set the stage a little bit. Just to back up a little bit, the market's driven by two factors, and it's always two factors. It's always earnings and interest rates and maybe sentiment or the liquidity environment. When we start with interest rates, this is a chart of the Fed funds rate, which is the orange line. The black line is the 10-year U.S. Treasury yield. The purple bars is the dot plot, the Fed's dot plot which is basically the Fed saying this is where we think rates are going to go based on the assessment of our individual FOMC members. And then the orange line is the forward curve, the SOFR curve. What's interesting is that the market is not believing the Fed.

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The market believes that the Fed will go to 5-ish%, maybe just below it, which is what the Fed has been saying. But the Fed has been basically getting blue in the face telling the markets like, listen, we're going to go to 5 and we're going to stay restrictive for a while. We're not going to pivot back down to a much lower yield until much further down the cycle. The market's not having any of that. The market sees this big kink in the curve back down to 3% or even below. That is part of the Goldilocks scenario that the market is believing even though the Fed is telling it not to believe it. That's one of the things that is going on. There are others as well.

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Pamela Ritchie: There's so many. I hope you'll take us through those with these different charts. I just have one question. If the Fed doesn't cut, doesn't that mean it's because the economy's okay? Isn't that bullish?

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Jurrien Timmer: The juxtaposition of earnings and interest rates, and let's pull up slide 2 just so we can complete the narrative here, the market is driven by earnings and interest rates. You look at a discounted cash flow model, you look at projected cash flows or earnings in the numerator. You discount them by a denominator, which is the cost of capital and out comes the present value of future cash flows. That's your valuation model. We just saw the rate side which is a rapid pivot from restrictive back to neutral, from 5 to 3, 3% is neutral, so that's one part.

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The other part is that in this chart we show peaks in earnings growth. The grey bars show the peak in earnings growth which happened exactly a year ago, in January of last year, and earnings growth has gone from +50% or so to basically zero this year when you exclude the energy sector but the estimates are that earnings will kind of tread water in 2023 and then start to improve again in 2024.

To answer your question, when you take those two things – the Fed going very quickly from restrictive back to neutral or lower, 2.7% is the current forward curve out a year from now, with the expectation that earnings are going to soft land, they're going to go from a positive delta to a neutral to zero back to positive. That is a soft landing if there ever was one. It seems that those two things are at odds with each other. If the Fed is going to pivot as far as the market expects, I would think it's doing that because it needs to because the economy is entering recession. If that's the case, then earnings should not be soft landing. They should be going down 15, 20%. That's, I think, where the market is trying to have its cake and eat it, too.

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Pamela Ritchie: Fascinating. What is it with the market wanting to see through this so quickly? I wonder if we can pivot at this point to looking at the market reaction to the global story. I know we'll come back, but it's just so astonishing to watch some of the rally that we're seeing ex-U.S. We've talked about the U.S. and North America too but it's really quite something. What's the strength?

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Jurrien Timmer: I think that plays a role. One thing worth noting is that the global economy is a lot less synchronized than it has been. You think back to the financial crisis, you think back to COVID, the lockdown, those were global shocks that affected all markets. For instance, after the financial crisis in '09 the whole global market rallied. After the lockdowns basically the same thing happened but the emerging markets were kind of left behind because, as we know, China basically never reopened until just now because it had a zero-COVID policy. I think what might be happening here is because the cycle is more fragmented that even if the U.S. is going into a recession, and certainly we have to respect the leading indicators of a very steeply inverted yield curve and the Fed going well into the restrictive zone, we can't dismiss history and say, well, the U.S. is going to soft land.

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Maybe it will. I'm not an economist but we do have to respect the signal of the yield curve and where the Fed says it's going. But if China, and therefore emerging markets, are literally on the opposite side of that cycle spectrum, the U.S. is going into a contraction maybe later this year, while China is finally emerging out of the COVID era. Maybe that creates enough cross-currents that it will look like a soft landing. It just will be a hard landing in one place and an expansion in another place. That actually is a good reminder that when we look at market cycles, and I'm guilty of this as much as any, we tend to look at averages or medians of different outcomes and that's how we aggregate that into a narrative, but every cycle is different. There haven't been that many cycles. Even if you go back 100 years, there's only a couple of dozen cycles. So, creating that average can be very misleading or it can only tell part of the story.

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I think what is happening this time is that a), you have this desynchronized global cycle and this is why EM and also Europe, because the dollar's coming down, have done so well. Also I think it's the confusion that comes from applying a linear lens to a nonlinear situation. We know that price leads earnings at inflection points, over the very long term price follows earnings. That's the mantra we have at Fidelity, of course, with equity funds ... you buy the companies that have that earnings potential and then the price will follow. That's certainly true. But during a cycle, price often leads earnings because everyone is anticipating the future and the market did derate 31% last year when you look at the P/E ratio and the S&P.

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So, it's plausible that if you do have a soft landing or a very mild contraction, maybe down 10% for earnings, that the market has already anticipated that, it already priced for it and it's already moving on. It's a delicate needle to thread because if we have something worse than a very mild dip and we do have a more traditional recession and it comes, let's say, the second half of this year, then the low, which was last October, seems premature at that point. That's why my overall outlook has been that 2023 will be kind of a choppy, frustrating year that will neither please the bulls nor the bears.

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Pamela Ritchie: Something to offend everyone, as they say sometimes. I have to ask this, and I know most of the institutional investors joining you here have seen many, many, many debt ceiling discussions, to put it generously. There will be another one this year. What if it coincides, for instance, with the slowdown that we're talking about in the second half of the year? What do they need to know one way or the other?

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Jurrien Timmer: This is a movie that you and I and probably everyone watching has seen many, many times. I know I get this question all the time whenever there is a debt ceiling, fiscal cliff. When I'm on TV, it's like the first question. It's a good headline grabber. My answer has always been very unsatisfying, at least to the audience, and that is that this is a situation that has literally always been resolved. The can gets kicked down the road. It's an opportunity for political parties to grandstand and may score points knowing that the situation isn't going anywhere. Everyone on either side of the fence knows that it will get resolved because it has to be resolved because the government can't function if it doesn't get resolved. But then for the next election they can score points saying, see, I was that person that stood up for principle and this and that. It's low hanging fruit if you're a politician because you can score points without there being any consequence. The matter always gets resolved sooner or later.

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Having said that, we seem to have a particularly, let me say, toxic bunch in the House of Representatives this year. We saw that already with the election of Speaker McCarthy and how long that took and a few holdouts who really didn't seem to care about anything other than making a point. You do wonder if this year is going to be particularly spicy in terms of the whole debt ceiling showdown. We already see Janet Yellen on the tape saying we're going to run out of cash around June. So, it's going to play out this summer. Maybe there's a government shutdown October 1st and so we need to be prepared that with this particular Congress that the people in the House are not going to hesitate to take this all the way to the brink.

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But having said that, this is something that has always gotten resolved and it is political grandstanding. There will be bargaining ... the Democrats are already saying they want a clean debt ceiling passed; they don't want any conditions to it. That's, obviously, not going to happen. The Republicans are on the other side. Usually, they will meet in the middle just because there really is no choice; you have to operate with the government. Debt is a bipartisan thing. Donald Trump created a lot of debt, President Biden created a lot of debt, or the Congress under their watch. This is not a partisan thing, that has been around and it will continue to be around and the debt ceiling will be increased at some point.

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I think the markets will mostly look through it. There will be some shenanigans in the T-Bill markets, the T-Bills that mature right around the shutdown will have a spike in yield but then that will then pass and the yield curve will resume to neutral.

Again, for the market, for the stock market, unless there is a lasting impact on the economy and therefore on earnings, the market will always look through it. But, like you said, if this is happening at a time when earnings revisions are really getting hit and the recession scenario or narrative picks up steam, then it could be icing on the cake for a market that is already under pressure. Again, we're at S&P 4,000, so we're far from being in that place right now.

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Pamela Ritchie: I have to ask you, there's a term that we used to use all the time a couple of years ago, we just haven't used it lately, which is the dual mandate of the Fed. Talk us through the labour situation. It's strong. It's not doing what I think lots of people thought it needed to do for a recession to happen. It's part of the soft landing discussion, obviously. What does the Fed think of that? That is their dual mandate, what do they do with that piece these days? How do they fit that in?

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Jurrien Timmer: The Fed has a dual mandate of full employment and, certainly, they've accomplished that. The unemployment rate's 3.5 so by anyone's definition we are at full employment. When you look at the JOLTS report, which shows how many job openings there are, at full employment there are 10 million jobs open. Part of the pressure in the jobs market is the fact that close to 3 million people left the labour force during the lockdowns, right? I mean, baby boomers, about 2.6 million of them said, you know what, I'm out of here. That has created an imbalance in the labour market where there is not enough supply of labour. So, that's one mandate, the other one is price stability which is 2% core PCE at about a half a point for the CPI. So, you've got 2.5% on the CPI and, obviously, the Fed is very far from reaching that, although the numbers are clearly going in our favour now. I think core inflation is now below 6%, which is still very high, of course.

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The Fed has a dual mandate and the two mandates are at odds and they were at odds exactly in the opposite way that they were during COVID. At that point we had a massive spike in unemployment while inflation was plummeting because the economy was locked down. You remember Jay Powell saying, we want everyone back in the bus, we're not going to stop easing until everyone is employed. Now it's literally the opposite. The Fed is trying to thread the needle and the Fed's track record on needle threading is not particularly great. Greenspan pulled the rabbit out of the hat in 1994 but that's because inflation was never a clear and present danger at that time.

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I think what the Fed would like to do is, that 10 million open jobs, it would like to reduce that to zero without actually creating a spike in unemployment, because if you can recalibrate the jobs market so that there is less demand for labour while everyone who has a job keeps a job, then wage inflation will come down towards the Fed's target and everyone is happy and that's how you get your soft landing. The problem, of course, or the challenge, is that the Fed has extremely blunt instruments. It has interest rates and balance sheet, both of its mandates are lagging indicators and so the risk of an overshoot is always high but it's especially high this time because the Fed waited so long to normalize policy in the first place. I think the Fed would like to thread that needle, land the plane, take the excess out of the labour market but have everyone keep their jobs. What are the likelihood that the Fed can fine tune an outcome when it uses very blunt instruments following lagging indicators to get there?

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Pamela Ritchie: Take us to the overall story of the Fed keeping its eye on the equity market and where the equity valuation story is. You mentioned, kind of off the top the massive de-rating, obviously, we saw last year. Where does this leave us in order, again, for investors to take a look at this equity market?

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Jurrien Timmer: Slide 6 shows three different measures of valuation that have served me well during this bear market cycle. One is your typical DCF modelling, your discounted cash flow model, that's the little purple line, and you can see that little bond bubble there. That was in 2021 when the Fed, through its balance sheet actions, really suppressed interest rates. The 10-year Treasury yield on a real basis was at – 1.5, -2%. That was a little bond bubble created by the Fed that then created excessive valuation in the stock market, because as we said at the top of the show, the DCF model is discounted earnings, so you calculate the present value of future earnings growth and if the discount rate goes down the present value goes up. So, that was a little bond bubble.

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The other two indicators are based on the two-year nominal Treasury yield, which is a good proxy for where the Fed cycle is at, as well as the 10-year real yield, which is a very important indicator for risk appetites and real economic growth. You can see that all of them have kind of gone in the same direction. The grey line, of course, is the actual forward P/E.

The story for the last year during that ongoing 28% decline in the S&P was that grey line never went below the other line. There was never that bell-ringing moment where you can say, ah, the market is cheap, it's underpricing or it's over discounting a bad outcome. Now, as you can see on the right-hand side of that chart, that grey line is at 7.55, it's trading at 17.5 times expected earnings and that's north of the other three lines.

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Now, if we go to the next chart, what I've done here is I've put in a few assumptions for the coveted soft landing. The Fed lands the plane, that allows it to pivot back to a neutral policy, which would be around 3%, and at the same time, earnings hold up. Right now the expectations are for earnings to grow 8% in 2022. That's behind us but fourth quarter earnings season is about to start, but 2% or 1% ex energy and then a couple of per cent in 2023 and then 10% in 2024.

This chart on the right, I put in those assumptions that the consensus is correct about both the Fed and earnings growth. But guess what? If that consensus is correct, the valuation that the market is currently trading at would be the fair value valuation. It's another way of showing or saying that the market has already priced in a soft landing, it's already there. At that point, the soft landing either happens, in which case it's already priced in, or the soft landing doesn't happen, in which case the market's over its skis.

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The only way that I can see for the market to keep rallying is for there to be a no landing scenario, that there isn't even much of a slowdown or there is a slowdown but it doesn't last long or it's offset, like we said earlier, by the China recovery. We can't underestimate the potential for that. To me, there is no clear opportunity to say, I'm buying it at a contrarian point here because a soft landing scenario is pretty hard to pull off. Even if the Fed can do it, it's already priced in. That's why I kind of stay with the scenario for 2023 that I think it's going to be kind of a choppy, frustrating year where neither bull nor bear is going to feel very satisfied.

Clearly, we're off to a good start and maybe that continues. Maybe we go the S&P 4,200 or 4,300 but I don't think that's the start of a new bull market. I think it's kind of still the base building phase of a market that is still licking its wounds from last year. But again, that desynchronized global growth story is something that we should really pay attention to because we haven't really seen that in quite a while.

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Pamela Ritchie: Just to sort of go further on maybe something moving sideways or getting to the point really where the best is already in in the market. That's sort of the same question in some ways. What about applying that to China? It's been extraordinary watching this rally, as we started out saying. EM, Europe, is that it?

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Jurrien Timmer: Let's pull up slide 12. It's interesting, we've had eight years, so since 2014, where the big growth companies in the U.S. have dominated, not only the U.S. markets, but therefore the entire global markets. The S&P is very growth heavy, much more so than Europe and EM, so if the big growers are leading the U.S., then that means that the U.S. is leading the rest of the world and we've had eight, nine years of that and now the U.S. clearly is heading for slowdown. The Fed is committed to doing that. The Fed keeps saying do not underestimate what we will do here to preserve our credibility. As a result, you see here the year-over-year earnings growth chart, this is the change in forward estimates, and you see that red line is the MSCI EM and they've been in a contraction.

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So, the U.S., at the top they all were growing at the same rate, but the U.S. has held up much higher, much better so far and the reason for that, of course, is that China basically remained in a lockdown well after the rest of the world got out of its lockdown. So, EM has lagged over the last couple of years as that happened. and now that the rest of the world, or at least the U.S., is slowing down and possibly going into recession, while China finally has that delayed reopening, you have a perfect storm of those lines converging. And I think that's really the story that we're seeing in EM.

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Pamela Ritchie: Point out for us the indicators that the institutional investors want to keep an eye on. We all know that reopenings, at this point we're all experts, can be messy. They don't all sort of reopen in lockstep like dominoes in some ways. What do we need to keep an eye on for a Chinese reopening, any reopening?

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Jurrien Timmer: When you look at the price of raw materials, of course, copper, those are doing better. Oil is maybe slightly different just because that is a play on global growth as well but the industrial metals certainly are play on that. The relative performance of earnings estimates, and you can see it, I don't have the chart this week but you can see that the revisions for U.S. and developed markets relative to emerging markets, and certainly China, are starting to converge. The difference between the progression of earnings estimates in the U.S. and China has never been greater. The delta is like 50%, it's huge. I think the reopening will be messy.

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One of the reasons is, of course, a health reason, I'm no health expert, but my understanding is that the Chinese population is under-vaccinated relative to other parts of the world and that their vaccines maybe were not as good because they're not mRNA vaccines. So, there is a health toll that if you all of a sudden say, you know what – and literally the rule is by March there will be no restrictions at all so people are going to get COVID. It's going to potentially overload the hospitals. Maybe that will cause more targeted lockdowns within China.

Like you said, it'll be a nonlinear, messy path but it looks like the Chinese government is committed to do this and that means that activity will resume in a pretty big way and Chinese people will travel. There'll be revenge travel like we all saw on this side of the world. I think that's all happening now.

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Pamela Ritchie: Take a look at Europe for us. It's rallied off the bottom. There are lots of reasons for it to be at a bottom. However, where does it go from here?

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Jurrien Timmer: There's a couple of things here. The global allocation story, I think, is fascinating because there's always a temptation to buy cheap. The U.S. is trading at 17.5 times expected earnings. Europe, EM, Japan are trading at around 11, 12 times. There's a very big discount there. But valuation discounts can be a trap, we call them a value trap. So, ultimately, the relative performance between regions and countries will be the result of relative earnings. We showed earlier the convergence of earnings estimates now starting to happen. When we think about non-U.S. or non-Canada or non-North America earnings, we have to find a common denominator, which is the U.S. dollar when we aggregate those. There's no single currency. There is for Europe, of course, but not for like ex North America. The dollar plays a very big role in that as well. Ultimately, relative performance will come from relative earnings and then the dollar plays a big role in that. Right now you have all of those things working in our favour.

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On top of that when you look, I'm not sure if I have the chart here, if we go to slide 25, on top of that we have these potentially secular tailwinds finally starting to happen. We had this phase over the last … actually, let's go back one slide to 24, let me just set the stage here. We had this period where the Nifty 50, and we've talked about this, the 50 largest companies in the S&P 500. This includes the FAANGS, the big growers, the big free cash flow growers. To me, this is the relative performance of those 50 against the next 450. We've had three distinct periods over the past 60 years or so where they have vastly outperformed the rest of the market. One was the original Nifty 50 of the early '70s, one was the late '90s, the tech bubble, and the third one was, of course, the 2000-teens to just last year.

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To me, this looks like a trend reversal. If that's the case then the big growers have stopped outperforming. If we then go to the next slide, when you look at what happens next, obviously, if the top 50 are underperforming – that doesn't have to be in a down market, by the way, it can be in a sideways to up market – but when that happens that, by definition, means that everything else is then outperforming. This chart kind of illustrates that. This chart goes all the way back to 1880, so very, very long history.

In the bottom, I show the 10-year compound annual growth rate, or CAGR, of value versus growth, small versus large, ex U.S. versus U.S. stocks, and commodities versus stocks. You can see that this is a very, very long cycle that spans about three decades each, so it's not something we can micro time, but you can see that we're kind of due for a secular period of the leadership changing, broadening out to more value, to more small-caps, to non-U.S. stocks. So, it's possible that we're only at the first inning of a much longer period where it will be a more level playing field where you can actually do some really good active allocation and active management away from just that very narrow concentration of 5 or 10 stocks that have dominated over the past 10 years. It's a good story because it becomes a stock-picker's market.

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Pamela Ritchie: Fantastic. Thank you so much for your thoughts, your views and everything that you've brought here to show everyone in Fidelity Compass here today, Jurrien.

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Jurrien Timmer: My pleasure. My pleasure. Good to see you.

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Pamela Ritchie: Good to see you. That's Jurrien Timmer joining us on Fidelity Compass. Thank you for joining us. If you have any suggestions for future topics for guests that you'd like to see here, certainly share your ideas with us. You can stay tuned for more Fidelity Compass webcasts in the weeks and the months ahead. I'm Pamela Ritchie.