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. Tomorrow, the Bank of Canada will announce its seventh interest rate decision of 2023. The BoC is expected to hold its key interest rate at 5%. As rates remain elevated, where does Canada fit in a portfolio today and where does our next guest see opportunity for investors as we head into the new year?

Joining me now to discuss the Canadian market across sectors is Fidelity Portfolio Manager Joe Overdevest. Joe, thanks for being here.

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Joe Overdevest: Glad to be here.

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Bryan Borzykowski: Joe, big news coming up tomorrow, maybe news, we don't know yet. When you look at kind of what's gone on over the last several months where do you think the Bank of Canada might, where their head might be at going into tomorrow?

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Joe Overdevest: Luckily, we have lots of great macro people here who help us as equity investors who are macro aware but it's not a big driver, obviously, of our process. It looks likely there will be no interest rate change again but who knows? I think the bigger debate, we take a step back as investors in the market is we're probably closer to the end than the beginning of this rate move.

As you and I have talked about last time, when you take inflation 8 to 4, that's generally an easier part. This last little bit, 4 to 2, is a tougher part. We call it the echo effect now. They've raised rates and even themselves are saying publicly, central bankers around the world, they have to let this play out because it doesn't instantly take effect into the economy and we're watching this as a delayed reaction of what's happening and probably means definitely headwinds or growth for sure.

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Bryan Borzykowski: The retail sales numbers came out last week and those are flat, GDP has been flat, employment kind of up and down a bit. Based on sort of that economic data, do you think that finally those rate hikes are starting to work their way through the economy, we are starting to see slower growth?

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Joe Overdevest: I think you're seeing the early signs of the interest rate effects. I would say, people use all these different names like soft landing, hard landing, right now, it feels like a soft landing. Again, we can debate exactly what level but what it means by that is that one of the most interesting things, inflation is still stubbornly high. People still see grocery bills that are not what they would like. In labour, inflation is still up, you see publicly certain unions are getting some big increases. But what's also happening is jobs are still very, very tight and that's what's keeping the economy going. So, you had this anemic growth.

I would say the biggest thing, though, for the Canadian economy is the interest rate, it's probably for the Canadian consumer is their mortgages. Most, obviously, 5-year mortgage, big difference with the U.S. with 30-year mortgages. So, yes, we're seeing the effect but every year for the next five years you're going to be seeing more of the effect of it and you're seeing early signs of that. It's an adjustment, right, because all of a sudden your mortgage changes, you can't change certain things like groceries or your car payments, so you have to make other very tough decisions, in some cases potentially even selling out of your house or moving to a different kind of location.

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Bryan Borzykowski: How big of a threat do you think this is? It feels like a lot of people are thinking this could be a big doomsday scenario here, everyone renegotiating their mortgages and going up by a lot. Is this a big concern? How do you kind of look at this in terms of the impact it could have on the Canadian economy?

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Joe Overdevest: I think, first of all, from the portfolio perspective, it's the banks obviously, definitely we have probably more caution with other parts of the cycle for Canadian banks. Doesn't mean they're all going to have the huge headwinds but they're definitely going to have headwinds. Also, on the consumer side probably being making sure that we're not in too many economically sensitive names, maybe more dollar stores, for instance, or grocery stores versus some of the more economically sensitive. The actual change on mortgages, though, I would say just to clarify for everyone, our regulators, our government and, of course, the banks themselves do not want a major issue, as in they don't want everybody losing their homes and foreclosing. It's not in anyone's best interest. We've seen the actions of all three of them, especially the last few years during the pandemic, take actions, in some cases historical actions, to make sure people are not feeling too much in terms of pain.

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But I will say there is an adjustment. Debt is a real thing and someone has to pay for it and unless the government wants to take over your mortgage, it will be an adjustment period. I think the bigger thing probably when we look at this, just like we talked about interest rates last time too, is it's not just the amount of the interest rate move it's the speed, and it's been quick. So, for mortgages one of the things that potentially you could do as a bank, you draw it out as much as possible. You try to work with the homeowner and try to draw out as much as possible as opposed to – they do not want to force transactions. It's never good for anybody. A lot of transactions on the market would bring down pricing pretty quickly.

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Bryan Borzykowski: We're going to get into all the different sectors but before we do, if I was the head of the Bank of Canada, and this next comment is going to disqualify me from ever getting that job, I'm sure, but I might be saying, "I am so frustrated. I can't get it down to 2%. I'm just going to leave it at 3%. That's going to be my target."

It feels like maybe some of that chatter just outside, people are saying, well, why doesn't the Bank of Canada just raise their target rate? Can they do that? Is that a possibility? What would that look like?

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Joe Overdevest: I think in the last few years you've seen that central bankers can do a lot of things that no one thought they could do. I think I would, for the audience though, just remind everyone that central banker is very tough job. One of the things that's tough about is that it's not just their actions, it's their words are very, very important. All of a sudden they say, even they say they stop today and say, you know what, we're happy where things are, we're happy where inflation is. Even though they were targeting 2%, they probably have failed the number one job of a central banker, and that's controlling inflation.

The reason why that's the number one job for most central bankers is if you don't control that then you get people expecting inflation, and when you get expecting inflation it just plays on itself and it becomes a bigger issue and in some cases the litmus tests the last few years. Everyone just accepted pricing was going up since 2020 as we came out and that's not good because then it leaks into everything else from labour, labour goes, well, I want higher wages. Companies say, I want higher... in terms of selling their goods. Everyone just starts accepting it and it becomes a vicious cycle.

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Fighting inflation, and you look back in the history books, we've been taking it for granted probably as part of a G7 country that this was just something that just laid in bed and never got up. It's a monster, you don't want to let it get up, number one.

Number two, you made a good comment about just words. One of the biggest thing with central bankers, their actions but also their words. They can jawbone things. Historically, maybe they go different massaging of things. So potentially, if they wanted to, they could massage just saying, you know what, we're at 3 and we're on our way to 2. Maybe that's how they get their way out of it, but you want to make sure what words you choose very wisely because there's huge ramifications for expectations going forward.

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Bryan Borzykowski: Is there anything that needs to happen to get to that 2% that either we're not seeing yet? Put it another way, how do we actually get to that 2%? It is a struggle to get there, it seems.

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Joe Overdevest: It takes multiple parts of the economy. Labour, in particular, is probably one of the stickiest right now. Number two is, luckily, energy costs are not a big headwind but if something major happened geopolitically or demand maybe really surprise people, that could be an issue. Again, that was issue probably a year ago. That's less of an issue.

Lastly, probably just in terms of homes or housing, the inflation that would be driven from just shelter, that should be getting better. Again, to sum all this up, it just takes time because actually it's just the year-over-year effect of some of what's going on. Again, it's delayed effect. We're seeing a delayed effect of these rates where people are actually changing decisions. Maybe companies aren't hiring as much. The Canadian banks in particular recently were starting to lay people off and we haven't seen those kind of announcements in Canada in a long period of time.

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Bryan Borzykowski: Let's talk about the banks and we'll talk about some of the other sectors too but maybe starting with the banks, what are you seeing now? You just mentioned layoffs. That has been interesting to watch. Where does that go into 2024?

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Joe Overdevest: I think with the Canadian banks, I think you probably will see some more in terms of potentially some more layoffs because for a long period of time there was none. What they're actually seeing in Canadian banks, it's a small part of the whole economy, you're seeing in other parts of the economy with hybrid work more people are staying at work. They're not quitting, they're not retiring goes as early because they're like, you know what, I didn't have to go on the train five days a week, this is pretty good.

The actual turnover of people pulling themselves is lower, so they're probably going to have to lay more people off than normal. Also, I think it's a sign that Canadian banks see slowing growth and they probably see slowing growth in their revenue and probably will be more *[indecipherable]* sales or more credit losses going forward as people feel the pinch of higher interest rates. I think the Canadian banks as a whole, we probably see some better investment opportunities outside of the Canadian banking sector than we have maybe historically.

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Bryan Borzykowski: Everyone's always scared, or the fear of something happening to the banks when there's a crash, they're laying people off but we've got five big banks that are doing pretty well still. Is that fair to say?

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Joe Overdevest: Yeah, I think the Canadian banks in particular when you look – especially, as Canadians, it's so easy to take for granted the strength of those Canadian banks. It is a pretty strong group. More importantly, they have a pretty strong backing generally. As you can imagine, there's always puts and takes with the government and the regulator but generally they're very much on the same wavelength. The litmus test, when one does something they all match it, or very closely match it. That's generally a reflection of an oligopoly-like environment which leads to higher return on equity over time.

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Bryan Borzykowski: You did say, I guess, there may be more opportunities outside of Canada in the financial sector. When you look at banks what are the kinds of things that you look for to say, hey, this is a good opportunity?

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Joe Overdevest: Just to clarify more, other sectors within Canada had stronger maybe in terms of outlooks right now than some of the Canadian banks.

I would say when we look at any kind of company, I would say there's three big things. Number one, is this a good business in terms of high return on equity, strong free cash flow? Number two, is management well aligned with us? Number three, is valuation attractive? The last is probably more just when we look at some of these companies, we do a lot of our own work on our own estimates of what do we think earnings. Are they too high or too low versus expectations?

In certain sectors right now in Canada, we think maybe expectations need to adjust, just like any kind of part of the cycle, and that's the benefit of being a stock investor is you're always trying to look where there's a mispricing opportunity. I think just we have to respect, in particular for the Canadian banks, there might be some more headwinds than there were historically.

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Bryan Borzykowski: Speaking of other sectors that may have better opportunities or different opportunities: resources, obviously another major one in Canada, how do resources look today given all that's going on?

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Joe Overdevest: With the resources, usually just two buckets. You've got materials, you have your energy. Energy looks better than materials right now. Simply the biggest thing is probably China. Again, there's another analogy I would say is watch what they do, not what they say. They say China's growing but their actions are saying it's tough and that the economy is still not going the full tilt they want to because it's still doing a lot of in terms of injecting money in the system or stimulus of some point. That is not what they were originally planning a year ago, for instance, for China. So, that's more a headwind for our fertilizer stocks all the way to our, in particular, copper and coking coal stocks.

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On the oil side, it's more North American driven. We're definitely seeing more demand tailwinds at the very least probably for the North America side versus, say, Asia side of things. Oil, in particular, one of the things it has still going for it is still supply. Oil rigs right now in the U.S., the oil rigs are actually down year-over-year, which is pretty amazing. When you see a graph going down and oil price actually has been going up, a lot of it is just ESG and, in particular, investors telling their CEOs, we don't want growth, we want dividends and buybacks. You saw that even recently. Two major acquisitions, Chevron and Exxon both took out two of their competitors. That's usually a sign that, to some degree, they could have done more drilling and they're actually just consolidating the actual industry.

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Bryan Borzykowski: How does the transition to renewables impacting the space here, and in particular, the IRA, a lot of people have said how great it is in terms of giving investment. It's a green energy. We tried to match that here in some ways in the last federal budget. Is the IRA impacting investment here and how does the future of renewables look in Canada?

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Joe Overdevest: Yes, Inflation Reduction Act is affecting us because much like many things we do here in Canada, we're so close, we have to respect what they do because if we don't, it will have adverse actions as in capital move across the border.

The Inflation Reduction Act is more aggressive and more attractive generally for many companies that would invest in North America. For renewable reasons, it's still more attractive in the U.S. They're ahead of us in terms of, in particular, rebates and incentives. I would say one of the biggest changes when you look across the border is that the U.S. has decided to help oil and gas companies do carbon sequestration so essentially injecting carbon into the ground. They have huge benefits for them. You're seeing investment change in terms of their increasing investment. Whereas Canada, we've been giving incentives but for pure play renewable companies. We have not stepped across yet to say we'll help the oil and gas companies with oil in terms of sequestering the actual carbon.

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One of the biggest things you probably have heard about, it's called Pathways. They have the mechanics involved to do this in Canada, especially in the oil sands. They're really waiting for right now the federal government to sign off on it, at least accept some kind of terms. The Canadian government right now has not wanted to do that. They're very much again helping the renewable companies but not the oil and gas companies. So, if we really want to solve carbon we might have to get all parties involved.

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Bryan Borzykowski: Moving to different sectors, the utilities, telecom, interest rate sensitive sectors, which is very interesting now because of how much Treasury yields have gone up, bond rates in Canada, where you can get a bond for 5% or so where in the past you might buy a utility giving you the same dividend. How have interest rate sensitive sectors been impacted by the increase in bond rates?

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Joe Overdevest: The interest rate sensitive sectors generally have been down and actually been some of the biggest underperformers year-to-date in the market be it utilities, telecom, energy pipelines. The reason why is because when rates move up to the amount, especially the amount they've moved up, there's three levels of effect. Number one is stocks generally become less attractive from when the cost of equity generally goes up, in particular high dividend paying stocks because just like you said, they often will be trading relative to say, a 10-year yield. Number two is actually highly leveraged companies. People start worrying about, oh, can you roll the debt or what's the actual debt cost, especially if you have a high dividend payout ratio and you don't have a lot of wiggle room. You have a lot of debt. Also, those interest costs have to eat in somewhere. Do you have to cut the dividend, do you have to slow your dividend growth?

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Lastly is probably the consumer which we already talked about. Those dividend stocks we talked about you really have to watch your stock picking. Again, low rates, everybody seems to win with higher rates, now you're seeing a differentiation. A strong balance sheet is definitely winning out. If you have a weak balance sheet and you're a high dividend paying stock that is not a great combination. We're seeing that in the last, I would say, at least nine months. The market is sniffing those out saying that these could be potential issues as debt gets rolled over and the obvious is just they're not as attractive versus bonds.

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Bryan Borzykowski: Do you find, though, if those valuations have fallen and stock prices have come down, are there more opportunities in those sectors or is fixed income the better place to be?

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Joe Overdevest: I think with everything the magnitude, degree is really the opportunity. What I mean by that, it's not just a blanket yes or no. We do go into those sectors and we go, okay, just like any sector, if something's down is it still being mispriced? I would say one of the things I know I look for is leverage. You always worry about leverage, leverage in terms of individuals or stocks. The reason why is because a lot of bad things can happen. Cash flows can go up and down and subsequently market caps can go up down. Debt doesn't move. Interest costs don't move because a bank always wants you to pay them off. If anything, interest costs these days are going up, not down.

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If you go into those situations the first thing we actually do generally is the balance sheet. We actually, a lot of times, bring in the high yield team we work with on our floor to make sure is this okay from a leverage perspective because if it isn't, as an equity holder I will be the last in line and I will be hurt either with an equity issue or dividend cut. Ironically, some of those situations become very attractive actually when they cut the dividend, when they issue equity and when they clear the decks. Before then, you really have to watch because even some of those stocks are highly owned by the retail market and sometimes the retail market will wait right to the last minute until there's actually a dividend cut. There'll be a lot of selling pressure at those moments.

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Bryan Borzykowski: That's interesting because most people think a dividend cut is sort of the end, the last thing you want but you're saying maybe there's some opportunity there.

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Joe Overdevest: Sometimes, sadly, in the extreme people just don't worry about any valuation of fundamentals and they'll just totally sell out, especially if they're actually fixing the balance sheet, maybe with an equity issue, for instance. You sometimes have some strong opportunities. Again, the opportunities there were probably in early 2009, even during the most recent 2000 period you sometimes had companies make a big decision that were very negative if you're holding the equity but if you weren't, coming as a prospective investor it could be a very big opportunity.

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Bryan Borzykowski: We talked about the consumer a bit throughout this. I wonder what you're seeing in staples, discretionary. Are those getting impacted by the slowing consumer spending?

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Joe Overdevest: I think the grocers actually are seeing less — we talk about inflation, they're still seeing inflation but they're actually seeing less inflation. One thing, it's a headwind for grocers. It's a very simple business but it's all about execution and they do really well when there's a little bit of inflation because it drops the bottom line. They have very small net margins. They're seeing it less in terms of inflation, so it's a little bit of a headwind for them. I think the dollar stores are winning on a big way in particular in Canada. They're seeing definitely the trade down of people not even going to a Walmart or other stores and going to a Dollarama, so they're benefiting. I would say on the consumer, *[indecipherable]* names, we're definitely seeing where people are starting to say, you know what, maybe I was financing a product, maybe the recreational products in terms of like Sea-Doos or in terms of 4x4s, those are definitely seeing some headwinds where people are saying, you know, if I'm financing this and the finance costs have moved a large degree, or autos, we're starting to see a slowdown there.

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Bryan Borzykowski: Big difference from what, two years ago when you couldn't find a Sea-Doo anywhere and people were paying above market price. Maybe now finally I can get one for cheap for myself. Industrials, we didn't talk about industrials. Tell us about what you're seeing in that space.

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Joe Overdevest: Industrials is a great sector always we find. It's very idiosyncratic in Canada. There's garbage companies that are actually seeing inflation. There's engineering companies. You talk about Inflation Protection Act – they're a big beneficiary. They do the engineering, so all of a sudden you want to build something in North America or the world, you need someone to do the paperwork and the actual engineer, that's them. There's also the rails. I would say the rails in particular add a very interesting outlook versus maybe the rest of the market. They're almost in a recession right now in terms of an intermodal recession. Intermodal essentially is you shipping goods back and forth via dollar stores shipping goods from Vancouver to Toronto or Walmart, for instance, that's called intermodal. There was a lot of inventory, as you know, and now everyone's been destocking the last year, so they've actually kind of gone through their own early recession, the actual rails themselves kind of thing. I would say in general for the industrials, for the most we're actually seeing a lot of tailwinds in Canada.

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Bryan Borzykowski: We cover almost all of our bases here and these are two small sectors in Canada but tech, health care, anything interesting going on there, watching those sectors as well?

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Joe Overdevest: Health care is still pretty shallow industry in Canada. It's not too much in terms of news there, I would say, in the last little bit. I would say on the technology side, again, one of the interesting things I would reiterate what I said last time is where there's pain, there's gain. We talked a lot about interest rates moving up but one of the benefits is if you have a great balance sheet, and we're seeing this in industrial space and the technology space where there's some companies that were competing against private equity, private equity has definitely pulled their horns in and we're seeing more M&A, in particular in the software space. Not the fast-growing software, you think of more the boring software that grows like 3 to 4% but they have great balance sheets and are acquiring their competitors are really the ones winning in that sector.

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Bryan Borzykowski: Do you think we'll see more M&A in general across sectors going forward? You mentioned energy, there were a couple of big energy acquisition a couple of weeks ago in Canada too. Will we see more of that?

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Joe Overdevest: I think you will see more of it. I think right now what you want to see is the appetite is there to do it, I think the one thing holding people back is rates have moved so much because a lot of M&A deals do involve some leverage or some maybe debt. Even just the confidence interest rates aren't moving up too much will help a little bit. I think sadly, when you see more slower growth environment people can't grow organically so they start acquiring and also some of their competitors who maybe have a high balance sheet will be in pain, they'll have to sell out, too.

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The other thing is private equity. Some of the private equity raised a lot of money and we've actually seen this in Canada. Companies that are public bought private equity companies because they have to sell because before they raise their next fund their investors, or the private equity plays say you need to actually first sell what we already gave you money for kind of thing in your first fund. We're seeing that, especially in the resources where there's not a lot of ability to grow. I think you also see a consolidation continue within North America.

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Bryan Borzykowski: Just more broadly, I mean, why Canada? Why does Canada fit in a portfolio? The people watching now, why should they be considering Canada to continue keeping into their portfolios?

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Joe Overdevest: When you look out a number of years we generally look at any kind of country is the big buckets will be number one, rule of law. It's very important when you're an investor looking globally, trust me, we should not take for granted what we have here in Canada. Number two is immigration. We can debate the government changes or the immigration rules change but generally people want to live here, which is great. When you have a growing economy, you definitely want that. Shrinking population leads to a shrinking economy to some degree. We're seeing this in other parts of the world. It is not a good way of bringing prosperity. Lastly is resources. We're generally long resources and again, that was a wake-up call probably for Europe the last year, when you're short resources and they move a large degree it can be very painful. Those are the three big tenants.

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Bryan Borzykowski: When you're looking at investments and opportunities are there any areas that look better than others today? How are you kind of looking at your portfolio as kind of the economic and market winds shift here?

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Joe Overdevest: Look, there's great stocks in every sector. Some of the more higher hit rates of some great stocks would be probably industrial space, consumer space, or information technology. Not as economically sensitive as you think because even those buckets, there could be some very, you know, dollar stores or some slow growth tech names and then probably, or maybe less, it's tougher to find names in the financial side, in particular the Canadian banks or even some of these energy pipelines or the telecom space. There you have to really watch the high leverage levels and high debt payouts.

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Bryan Borzykowski: We have a minute left, when you look into 2024, we're now in kind of late cycle. What does it look like when we come out of this and shift into an early cycle? What does that look like to you?

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Joe Overdevest: It all depends on the transition. Again, with some transitions like 2008 which we would hope we don't have something like that. You have a major transition, you almost have a shock event. Obviously, every central bank around the world, every government wants to avoid that, so you could see a scenario where you just have anemic growth where it's like instead of 0 to 1 it goes 0 to -1% and you just kind of like go along for a little bit and really time heals it. You almost need time to heal it where we don't have a major drawdown, people have time to readjust their mortgages, readjust their lifestyles and you're going to see the best of breed, the only few that are really going to grow, that select few will be smaller and smaller. It will be a great environment for stock picking.

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If there is a major drawdown, that something is triggered financially, hopefully not, like I said before, you actually lean on your high yield team. You lean on the entire group to say what situations can we really take advantage of that are totally being mispriced. Right now, we're not in that last bucket yet but we're very watchful of everything and just being very respectful of the cycle, being macro aware but very much stock pickers.

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Bryan Borzykowski: Do you have any view of 2024 as to kind of how things could potentially go compared to this year?

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Joe Overdevest: I think right now what we're seeing, it's much like a continuation. You have still strong jobs which is the very big thing. If that changed our conversation would change a lot, Bryan. But I think luckily the jobs are still strong. People, if they have their job, their decisions they make with their finances change drastically with or without a job. I would say that in Canada we do have some headwinds, in particular, with interest rate costs. I think that's the one thing I think we really have to respect, that there is probably an echo effect, just because it's not happening now doesn't mean that won't happen going forward.

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Bryan Borzykowski: I guess back to your point just that's why stock picking is so important because you said there are good companies and you've got to find those, obviously, in the volatility.

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Joe Overdevest: Yes, correct.

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Bryan Borzykowski: Okay, great. I will leave it there. Thank you so much for joining us today.

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Joe Overdevest: My pleasure.

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Bryan Borzykowski: Thank you, everybody, for tuning in to Fidelity Compass. As always, if you have suggestions on future topics or guests you'd like to see on the show, please share your ideas with us. In the meantime, stay tuned for more Fidelity Compass webcasts in the weeks and months ahead. I'm Bryan Borzykowski. Thanks again for tuning in.

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