Fidelity Compass

Fidelity CIO Perspectives - What's Next for Canadian Equities

Andrew Marchese, Fidelity CIO and Portfolio Manager

Bryan Borzykowski, Host

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Bryan Borzykowski: Hi, and welcome to Fidelity Compass. I'm Bryan Borzykowski. As we enter the last quarter of 2023 and soon dive into a new year, now is a good time to reflect on what's worked and what hasn't worked this past year. Currently Canada's inflation rate sits at 4%. The hopes of any real relief could be a ways away as the BoC remarked that it could raise borrowing costs again should inflationary pressures persist. What might this mean for consumer lending and what are some of the risks and rewards going forwards? Joining me today to share his thoughts on how 2023 has shaped up and how it's impacting his positioning as we approach 2024 is Fidelity Chief Investment Officer and Portfolio Manager Andrew Marchese. Andrew, thanks for being here.

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

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Bryan Borzykowski: We've a lot to get to in the next 25 minutes or so but maybe we can just start on kind of what's going on in the bond market. Earlier today the 10-year Treasury hit its highest yields since 2007. Explain to everybody listening in what does that mean and what's going on?

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Andrew Marchese: It's probably the most important topic that's going on in the market right now with respect to valuing risk assets. I think the consensus at the start of the year was probably that we had seen the highs – market consensus, that is – we had seen the highs in 10-year bond yields in kind of September, October of last year. There was some decline and policy was restrictive enough. As we got into this year, people were worried about a slowdown in general but as the year progressed, I think the consensus moved from talking about a recession to talking about a soft landing. I think that was generally true if you look at it through about July and yields have just persisted to go higher.

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Monetary policy on the short end of the curve in the U.S. and Canada has remained more restrictive. I think those who were forecasting back in the spring that the Federal Reserve and other central banks would cut in the back half of the year have been proven incorrect. In fact, they've flipped the other way. Part of this is related to – you talked about a little bit of persistent inflation, our asset allocation people here at Fidelity have talked about the fact that it would probably be very easy to take inflation from 8% to 4%, the heavy lifting will be to go from 4 to 2. That still needs to be borne out.

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Secondly, there is an abundance of supply of fixed income instruments through quantitative tightening, so you're flooding the market with supply, obviously that will keep yields elevated. That has a negative impact on equities from a pricing

perspective. If you look at the P/E multiple of, let's say, a broad market like the S&P 500, compare it to whether you want to talk about 3-month interest rates or you want to talk about the 10-year yield, some proxy for the equity risk premium, the equity risk premium is low. Some would argue too low. We would have to go back to about 1999 to find a similar proxy for the equity risk premium in past markets. So, you get a repricing mechanism for equities. In other words, the P/E multiple is too high for equities and so they must be priced a little bit lower. That's why a move up in the 10-year yield is kind of deleterious to the price of equities.

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Bryan Borzykowski: Although we have seen equities, the S&P 500 is up here on my screen, it's up quite a bit over the year. So, why have we seen equities rise, and does that mean, do you think, that that increase might decline over the coming months if bond yields remain high?

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Andrew Marchese: Well, I think when you're talking about a broader market like that, you've got to kind of dissect it and peel back the onion a little bit. If you look at it, one of the things that's been going on is the market breadth, the big winners, it's very narrow. We've had on a thematic basis a lot of talk about artificial intelligence, that's really buoyed for large semiconductor companies but it's also manifested in very strong earnings as those companies. So, it's a real trend, it's not just sentimental talk. That's one. There's some other large-cap companies that were repriced lower in 2022 that earnings have stabilized in those companies and have moved at least a little bit better than consensus and they've also benefited a little bit from multiple expansion.

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If you look at the equal-weighted market, if you take out the market cap of it all, it's basically oscillated dating back to about June of last year around kind of an average. Depending on the month you measure it, sometimes it's above the line, sometimes it's below the line. The equal-weighted stuff hasn't gone anywhere. The small-caps, which are generally illustrative of a strong and thriving economy, have actually continued to lag. While bond yields have gone up, they've actually been priced downward too. They never really participated much like their kind of large-cap, particularly growth-tilting U.S. equities. The U.S. has done better than the rest of the world, generally speaking, in that very narrow breadth of stocks. So, looking at the whole market can paint a little bit of a different conclusion. If you look at the entire market and you kind of look underneath, it tells us a slightly different story that is probably more emblematic of where we are at this point in the economic cycle.

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Bryan Borzykowski: Let's dig into that a bit. What is that story? Where are we on the economic cycle and what can you glean from maybe some of the winners and some of the types of companies that haven't seen those returns yet?

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Andrew Marchese: In the developed world, we're pretty much in the late cycle and we've been there for, I would argue, probably the better part of a year. It's been a slow kind of migration and I think people talking about this soft landing outcome rather than getting into the traditional economic definitions of a soft landing versus hard landing what you really need to do is look at profit forecast, in this case for 2024, and are there risks there. They're either too high or too low or maybe they are just right. Part of the reason why the market kind of did okay this year is the fact that the 2023 earnings estimates got negatively revised in 2022. We're always looking forward, the market's a forward-looking discount

mechanism, and they didn't get worse than that. So, basically Wall Street and Bay Street kind of got it right. They weren't materially better than those forecasts but they weren't materially worse.

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Now you have to forward the clock again and look at what do the 2024 estimates look like. For the S&P 500, it's about 11% earnings growth. If you decompose that you see strong double digit earnings growth forecasted in the financial sector, almost 10% in consumer discretionary, so very kind of cyclical early-cycle industry. What we have to ask ourself is, are those sector forecasts correct and if so, how do those sectors and generally the economy as a whole reaccelerate from this point because that's what the consensus expectations are on Wall Street and Bay Street. So, you really got to kind of ask yourself those questions. We're in the late cycle, there's people believing that that will occur. There are other people believing that those estimates are too high, that the traditional economic metrics that we look at, and I can rhyme off a dozen of them, are all pointing to an environment where economic growth will not equate to kind of that 10, 11% earnings growth in the U.S. and probably other developed markets.

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Bryan Borzykowski: Now, of course, we don't know what's going to happen in the future but what's your view? Do you think those early estimates are too optimistic right now?

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Andrew Marchese: You've got to break it down on a sector-by-sector and obviously kind of case-by-case, stock-by-stock basis. If you approach it from a purely macro lens, you look at it, the yield curve has been inverted for the longest duration it has been in the post-World War II era. Its magnitude of maximum inversion was about third of the third most of all the inversions we've seen. These things are meaningful because the tightening of credit with the bond markets, the tightening of credit naturally has knock-on ramifications for consumer spending and business spending.

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If you look at other macroeconomic indicators, leading economic indicators, they are more commensurate right now, if you were to kind of freeze it right now, with about 1% real GDP growth. Not the textbook definition of a recession but as I said earlier, that's not really what I'm concerned about. I'm looking forward to profits. If you think about 1% earnings growth or sorry, 1% GDP that is usually, if you look back in history, consistent with cutting of capex which can have negative ramifications for profits in certain industries and it's generally with a slowdown in demand for stuff, for goods, both from a business perspective and a consumer perspective. So we have to think about those things.

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We also look at another indicator about where we are here in the economic cycle. The most lagging of economic indicators is unemployment. If we look solely at the United States right now, it troughed at about 3.5% earlier this year. It's moved up 40 basis points since then. Certainly nothing to be alarmed about in a real time sense but you have to ask yourself, that is historically extremely low. If the profit backdrop doesn't look strong for next year do businesses increasingly…they can have productivity gains, efficiency gains through technology and spending and elsewhere but do they eventually kind of just cut back workforce and then that kind of feeds into itself.

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In the definition, the textbook definition of calling a recession, the one missing ingredient right now is unemployment actually is still very low. Employment is very strong. You have to ask yourself, will that persist? If it starts to move up appreciably, that's a really bad sign for future profits historically. Historically that would be very true and then you ask yourself, the next stage, is where I think what we should be talking about as investors is does that catalyze some change in central bank behaviour, so do we go from a tightening regime to a cutting regime? What does that mean for long-term bond yields? What does that mean for asset allocation and rotation within the market by sector or geography?

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Bryan Borzykowski: Just to pick up on that, when you and I had talked on these webcast before, there was an expectation in 2023, a few months ago, that we'd start seeing rate cuts even before the end of this year, for sure into next year. Now the Federal Reserve comes out and says they think they could certainly increase rates again, so I guess where are we with interest rates? Do you think rates could increase again and where does those cuts happen? Clearly not in 2023, I don't think.

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Andrew Marchese: I made the statement back in May that I think market-implied policy rates by consensus forecast was for three Federal Reserve cuts in the back half of 2023. I just simply said that was my opinion and my opinion only. That was too optimistic. The data didn't warrant it. Judging by the Fed speak, it seems like they're very determined to keep things a little bit more restrictive for longer. The theme in the markets today, and it feels like every day for the last month or so, is higher for longer. If you are a student of history you will say that central banks won't act the other way until there are signs of distress, not necessarily a crisis but distress. That could come in the form of more layoffs, it could come in the form of credit and so the higher-for-longer mantra is gaining acceptance in the marketplace which is in turn causing the repricing of risk assets.

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Bryan Borzykowski: When you're looking at opportunities going forward, where do you see, where are the opportunities that investors can look at?

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Andrew Marchese: If you look at this year, it's been a year surprisingly, technology has kind of led here. I mentioned the narrow breadth particularly on the large-cap side. Small-caps have not been interesting from a return perspective. The more defensive areas of the market, consumer utilities, telecom service stocks, they've been underperformers. Now, part of that is related to yields, directly related to yields but because growth has been a little bit better this year than most have forecasted then I think some of the more cyclical or offensive sectors, if you will, that play on the economy tailwinds have outperformed but those in turn tend to be the more expensive areas of the marketplace.

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I think there's a two-step playbook kind of going forward. We have to think about how the late cycle kind of looks. Do we indeed avoid a dramatic profit downturn and we kind of maybe have a little one but nothing material, nothing really to write home about. I would be looking at the more inexpensive, higher quality, lower earnings volatility sides of the market. So, any securities and/or sectors that kind of fit into that thematically, if it's inexpensive with relatively high earnings visibility, traditionally low earnings volatility, and high-quality balance sheets because the other thing that has been out of

favour this year which has really hurt industries and sectors like the pipelines, utilities, telecom services is these tend to be highly levered industries, so the repricing of debt gets more expensive for them.

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Actually, if you look at the S&P in general the worst performing factor has been high debt. Strong balance sheets were necessary as the market is kind of repricing interest rates here and future debt obligations. The converse will be true if and when we get into a scenario that central banks need to cut to stave off a very slowing economy in which case if you're repricing to the downside, some of those high interest stocks, securities with high interest payments or just obligations in general will de facto look better. They also happen to be the ones that are being repriced down the fastest this year. So, it always kind of works in a two-step process. You're kind of looking for cheap stocks: why is it occurring and what is the catalyst that will maybe cause these things to get repriced upwards?

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That, to me, is the more interesting area of the market, the stuff that's actually lagged. What we always do, obviously, is on an idiosyncratic basis, a stock-by-stock basis, really trying to get a better sense of what profitability is going to look like not only over next year but on a multi-year basis. There will be stocks that maybe trade at a slight premium but their earnings forecast for the next 3 to 5 years is so strong, their higher-than-usual multiples are maybe justified in this environment because the quality of the company, maybe the competitive edge they have in their particular industry, pricing power, etc., etc., is very unique to them.

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Bryan Borzykowski: We've been talking about small-caps a bit this time and as an area that has lagged but in a changing cycle could pick up, is that an interesting spot to be in? I guess, when do you sort of maybe make those moves in anticipation of a changing cycle?

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Andrew Marchese: I'll give you the answer based on history. If you look back at pretty much every market cycle what typically happens is a collection of small-cap stocks that are generally speaking, their businesses are weighted to the front end of the economy. So, think about things in transportation, traditionally restaurants, hotels, travel and leisure, front end economy stocks. Even in the old days kind of thing, banks, financial institutions, they actually start working as stocks on a relative basis about halfway through a recession. It's kind of odd to say that the economic news that you'll be consuming via the media will be very negative but somewhere around the halfway mark they actually as stocks start to outperform from the defence that kind of leads you into it.

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Small-cap participation in a high volume way in the market has historically been a very strong predictor of a new and durable market cycle. Without small-cap participation confirming it you've never had a real lift-off in terms of a new market cycle. It's kind of interesting. Again, if past is prologue one of the things you're paying attention to is…we did a deep dive study on consumer durables or I'm sorry, highly consumer discretionary stocks, particularly those in the small-cap vein years ago and we looked back at other market cycles and it was kind of odd that the things that would require the most discretionary spending, so it's only after you've taken care of everything you need to in life you would buy these things and so future revenue would rise.

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But the market being forward-looking, actually the stocks started working almost exact-... if you had a crystal ball and said, Federal Reserve's got to cut interest rates by about 200 basis points and they're going to do it over 8 cuts of 25 basis points apiece, you would start buying these stocks about the third or fourth interest rate cut. The market would already start discounting the future. We've done similar analysis with different industries, sectors and how stocks get repriced on a valuation basis but it was very interesting to observe that pattern that the most discretionary of all spending, the securities are actually starting to work in the middle of a recession and then they work chiefly very, very well in the first year of an economic recovery and then their gains are mostly had, oddly enough. Those early cycle stocks, if you're not there when times — you buy when things look bad or you're fearful, you'll enjoy then all the upside and when everybody finally piles on to it and things don't sell [indecipherable] get any better usually you're justified in selling.

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Bryan Borzykowski: Interesting. You've mentioned recession. We've been talking about the R word a few times but I feel like it hasn't been maybe as expressed out in the news as much or from companies as much as it has been in the past. From what you're seeing when it comes to CEOs talking, are people still talking about a recession or has that maybe tempered a bit?

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Andrew Marchese: I think I saw somewhere in some bit of research somebody did about the mention of the R word, recession, over the course this year it kind of peaked in March with SVB and it's actually coming down. That's the media use of the word. If you look at the corporate use of the word in publicly traded securities, quarterly conference calls, it's almost layered on perfectly. The R-squared would be almost exactly one. I kind of chuckled when I saw this because the world is somewhat of an echo chamber, so if you're in a world where people around you are talking good you're more likely to talk good. If people around you are talking poorly about something, you're more apt to talk poorly about something.

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What I learned years ago as an analyst in that sometimes, particularly in cyclical businesses, companies aren't the best forecasters of what their business looks like out 1 to 2 years. If they're talking about something less, I take it with a bit of a grain of salt — or more for that matter — I take it with a bit of a grain of salt because human emotion and sentiment tends to feed unto itself. For us at Fidelity to do really good bottom-up due diligence and fundamental analysis, I think you get a better picture of the world by obviously researching that company in question but also talking to its suppliers, its customers, its competitors for a more comprehensive look at what's really going on. Otherwise I think you suffer from a bit of myopia.

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I can remember instances when I was an analyst, companies come in to talk to us and they really want to know what we're seeing and thinking because they don't necessarily see everything going on out there in the world. The lesson I learned from that is you will get answers to the questions you ask but maybe the questions worth asking are multi-layered and you've got to kind of survey the world. You can't just rely on one source to get an accurate picture of what may be going on inside industry or sector.

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Bryan Borzykowski: That's a good segue way to just how Fidelity and how you approach this. The world is confusing, it's hard to know kind of where to look, how to plan for the future, how to think long term when everything feels so short term today. What do you bring to the table? How do you make sure that you are adding the right companies and thinking in the right way for this environment but also for 10, 20 years from now?

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Andrew Marchese: I think it's twofold. I think, one, you have to have the resources to do all that kind of due diligence. I think that's really helpful to paint what you think is a comprehensive picture of what's really going on.

Number two, and equally, if not more important, is the discipline to stay to tried and true behaviours that generate returns over the long term. By that I mean numbers don't lie, patterns repeat themselves in history, not to the day and not to the month, and investing is a probabilistic exercise. When you can take both microeconomic and company specific information, marry that with macroeconomic research to get a good picture of what's going on in the world and have the discipline to buy it, sell around reasonable prices both on the low side and the high side, and you stick to that disciplined nature of doing so you're going to have a lot more wins than losses. That translates into better compounded returns, hopefully, for the portfolio in question and most importantly for your clients. That's kind of what we're trying to do. It's resources, the meritocracy and pay-for-performance nature of what we do here amongst the investment team at Fidelity and then also the discipline to put that into practice through portfolio construction each and every day.

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Bryan Borzykowski: We just have a minute left, just wondering if there's any kind of last takeaways as you're looking into 2024, in particular the pension audience that is listening in right now, what wisdom can you impart on them as we wrap this up?

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Andrew Marchese: I think the biggest question for those clients would be really on a multi-asset basis and thinking about bigger asset class tiltings in their overall portfolio within equities and maybe a look at different geographies that have a better equity risk premium than the U.S. The earnings yield of the S&P 500 and that of Treasuries are kind of overlapping right here, so that begs an obvious like is there an asset allocation decision to be made here on a risk-free basis. I think those are the biggest questions. And then monitoring that as time goes along, you mentioned about a 4% inflation rate, are we migrating closer to 2 over time or as the data comes in that 2% or the proximity, the direction of getting to 2%, does that look a little bit more challenging? That, obviously has implications for interest rates and then obviously, the traditional asset classes and the mix within the portfolio. I think those are the biggest questions to be asked.

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We're not in an environment where there's yet that high degree of certainty along a lot of those measures I mentioned. There's a quote, a famous quote about doing business, sometimes business is easy and sometimes it's difficult. I think we're in that difficult and we have been in that difficult environment in kind of the post-COVID world because there's so many different things going on from how we're working and living in society to just flooding the system with money as a result of the pandemic, how you unwind that, what are the natural consequences of that. We're juggling a lot of balls here to kind of figure it all out. We've got to keep doing the work and the outcome is going to have still in the kind of short to mid-term here, have probably some pretty big ramifications for asset allocation decisions.

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Bryan Borzykowski: Well, to be continued, clearly. Thank you, Andrew, for being here today.

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Andrew Marchese: Thank you. It's a pleasure.

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Bryan Borzykowski: And thank you everybody, for joining us on 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. I'm Bryan Borzykowski. Thanks again for being here.

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