Fidelity Compass

Portfolio Perspectives: Finding Unique Opportunities in Canadian Equities

Joe Overdevest, Portfolio Manager

Pamela Ritchie, Host

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Pamela Ritchie: Hello and welcome to Fidelity Compass. The price of oil is climbing, Treasure yields we've seen inching higher and the NASDAQ has certainly hit an all-time high. When we consider all of these things alongside things like inflation data showing a resilient economy, how are the pieces of the proverbial market puzzle fitting together to work for you?

Joining us today for a conversation about the markets broadly, commodities maybe a bit more specifically, and where he is seeing long-term opportunities for institutional investors is Fidelity Portfolio Manager Joe Overdevest. Welcome, great to see you.

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Joe Overdevest: Thank you Pamela.

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Pamela Ritchie: How are things?

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Joe Overdevest: Oh, very good.

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Pamela Ritchie: Good to see you here in studio and in person. We'll invite everyone joining us here today to bring their questions to Joe, send them in over the next half hour or so. We're going to look at a lot of different things that are happening in the markets and maybe look back a few years as well. We're in the midst of earnings, so let's talk just a little bit about what's the message, particularly financials because that's what we're seeing come out right now. What's new and messaging and sort of the nuance of the narrative right now?

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Joe Overdevest: Right now, earnings season went quite well for US in Canada. [indecipherable] for maybe Canada. Tech has generally done well if you're a consolidator because you're competing less against private equity for acquisitions. The energy companies are boring, and the resource companies doing definitely dividends and buybacks. Gold is definitely, in terms of commodities, is bubbling up. The industrial side we're seeing, I'm sure we'll get into it, is pockets of strength depending on where their end markets are, engineering companies especially helping with maybe development of electrifying the grid. Financials, you mentioned, we'll end there. Two of the biggest banks just reported, one this morning. Banks are really a levered play off the economy. When the economy does well banks do well because they lend more. They make more off the asset management side of the business.

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Right now you have anemic growth in Canada. Probably one of the bigger takeaways the audience is probably asking, mortgages. We had one of the biggest banks this morning report and they said that the variable rate mortgage owner is seeing 10% less than they're spending, which makes sense because the variable rates are moving instantly. What was interesting is the fixed-rate owners of mortgages are also cutting their spending 5%. So, they're already starting to adjust even though their mortgage rate actually hasn't moved yet. It makes sense then why we're seeing anemic growth for the Canadian economy. Higher rates are probably biting into a significant part of the population.

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Pamela Ritchie: Yeah, interesting. The profitability of the banks, we're seeing some provisions for credit losses getting piled in there as well. That's interesting about the mortgage story because it does feel a little bit like a slow-moving train that we all know is coming and we're kind of all on it together in terms of the economy but that's where the spending is starting to crunch a little bit.

We'll come back to some of the different sectors, but I want to get into the commodities story and almost this idea of capacity. We have a lot of commodities across this country. You've been investing in them your entire investing life. This has been a big part of the story of what you look at. What's different about this time? Are we in a supercycle? Is it the same as last time?

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Joe Overdevest: You're starting with a loaded question first. I think it's a great question. I think, especially for this audience, it's something that you have to keep in mind. If you want to know what are we talking as a group, we joke we hunt as a pack. The pack has been talking a lot about resources probably the last almost six months now. The reason why is you actually have to go back to '02, '08 when you and I were doing those calls then. That was a different time, and a different time in that China in particular, some of India and other BRIC countries, you had central government saying, we want to grow the middle class. They were forcing a movement from the top down. They didn't care about the copper pricing, didn't care about the oil prices, didn't care how much the buildings cost, just build it. That was a big move and that was demand-driven.

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This is totally different in that demand is okay for commodities but what's happening right now in particular is supply side. The supply side is not reacting. Oil prices are $70, $80, at #65 we should be seeing new supply come on, particularly in Texas. We're not seeing that. Why? They're being told dividends and buyback from shareholders. Certain governments, in particular in Canada, are not being open to new expansion of new oil sands in particular, so they're just not getting the green light or the ability to grow production. On the copper side, in particular, where the new mines are are generally pretty politically unstable countries. You may build the mine which you may be excited but the worst day is day one when actually the mine comes on, the government comes in, well, you know what, we would like more money, or we want a piece of the mine.

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I think the supply side is definitely scarier and tighter. This is where it's different from '02 to '08. We're early in this cycle. History will determine if it's a supercycle or not, but the ingredients are there for the potential and it's different. It's more like a gas leak. It's coming very slowly just because supply isn't responding like it should. The problem with that is that as a country—

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Pamela Ritchie: It doesn't sound good, actually.

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Joe Overdevest: - the country will benefit us, yes, because we don't allow resources but for a lot of people in the world it could be painful because all of a sudden why is oil prices so high, why is gasoline prices so high, why copper is so high? Because we haven't addressed supply in a long time and a lot of these things need years to actually solve, and we're not solving it right now.

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Pamela Ritchie: We're not solving it right now. I do wonder what sort of the story of capacity means. I mean that because you can become almost, lazy isn't the right word, but you know it's in the ground, if you need it you'll get it out. But as you say, there's a lot of years that are required to get that moving. What does capacity mean now? Because sometimes you'd be like, oh, we're fine.

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Joe Overdevest: Well, an example probably would be the headlines. You hear a lot about hyperscalers. You hear about the Mag Seven. I think what a Fidelity person likes to do ... [indecipherable] get excited not by page 1 but page 12. The audience may remember it or not, probably about a month ago big hyperscalers said, we're doing a nuclear deal and we're doing it direct with the utility. That for us as a group, that was the discussion point. Obviously, we talked to the hyperscalers as well, we have global research.

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Pamela Ritchie: Hyperscalers, we're talking about a Mag Seven company, essentially.

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Joe Overdevest: Yes, definitely a Mag Seven. Someone who says, you know what, I'm AI, I'm cloud-driven, I'm very tech driven, and I'm going to need a lot of power to do these big centres to store all the data. If I'm going to do that ... these take for granted the power or energy is going to be there and now they're starting to plan this out going, wow, this is not there. It's a crazy stat but over the last few decades in North America, energy demand has actually been flat. It's actually a good thing. We've been growing the population but we're becoming more energy efficient.

The problem is, though, the world, in particular in North America, it's just used to like, oh, the power is always going to be there because we just became more energy efficient. Well, what if actually power demand goes up? Supply sometimes takes two to three years, sometimes longer, to come on to build an actual power plant. You just can't steal it from Pamela's family because you want to build some kind of centre for AI. I think we... you can't just plug in and steal.

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Pamela Ritchie: You can't plug the company into the provincial power company because, as you say, Granny won't have power, or the price will go up or whatever it is. So they're building their own, or this is the discussion.

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Joe Overdevest: This is the discussion. They're trying to build their own.

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Pamela Ritchie: What kind of ones? Nuclear is one, what else might they build?

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Joe Overdevest: This is an interesting thing too. Everyone wants to be carbon neutral and if you wanted to do that from a government perspective, especially some of these technology companies, nuclear is probably some part of the option. Again, that takes a long time. Then it becomes a bigger debate: do you do solar, do you do wind, hydro, there's very few options out there. Solar and wind take a pretty good amount of time. Then you do natural gas, that's why it's called the bridge commodity, do you use it before renewables totally come on and if so certain countries, one of them being Canada, is not the most maybe welcoming to new oil and gas investments. But if you don't, you're going to be waiting a while for some of these other renewables to come on. It becomes a discussion point of how bad you want it, and more importantly is now capitalist companies are now working with governments going, we need this. We never had to have those discussions before.

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Pamela Ritchie: Let me ask you this, as a bridge energy, for instance, what's going to move the needle on that? Some version of domestic, and I might include U.S. demand in that because it's next door, or is it the export piece of this where you're going to get to the LNG because Europe really needs it, or somewhere else really needs it and they're willing to build a terminal and get it out there. Which one would move the needle more do you think: the international export or a more domestic story?

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Joe Overdevest: When we look at the commodities right now probably copper's near the top for supply and demand, oil and then natural gas is near the bottom. You're exactly right, the drivers of natural gas are ... LNG is definitely coming on, there's some new facilities opening up in North America in the next 12 to 18 months. A few of them have been delayed. That will pull gas prices higher. Now the bigger question, like you said, is all of a sudden you have a lot of these technology companies building out and they need power, this natural gas, also it can get pulled up with it. When we've done the math — again, this is very early on and these numbers are changing daily, it probably is not a meaningful amount yet. The reason why is actually there's just so much supply that can respond.

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We look at big basins like the Haynesville in the U.S., or here in Canada, Duvernay or Montney, but even for a lot of the audience, the Permian, we only hear about oil, when you drill a Permian well oil comes out and natural gas and so there's just actually a lot of gas in North America. We could see it definitely pulling demand up, but the supply response can probably consume that and more. So, the actual upside of the commodity is nowhere near like we would be with copper. What you're just talking about here, yes, you'll need some energy, you also need a lot of copper, and the copper supply demand leads to a tighter outlook than probably natural gas at this point.

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Pamela Ritchie: Wow. Within that, because you're saying at this point, just clarify sort of the long term/short term here because it does sort of sound like it's a little bit of a frog in boiling water type idea. Short-term things are kind of okay but as you say, it's the longer-term picture. How do you invest for that? How do people with a long horizon take a look at that?

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Joe Overdevest: Especially as Canadian investors you have to keep an eye on this because natural resources is such a big part of the benchmark, number one. Number two, it can affect our currency. For the longest time ... probably we haven't seen a lot of currency movements but we forget we've been...

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Pamela Ritchie: The oil dollar, our petro dollar. What happened?

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Joe Overdevest: Currency was a dollar and more. That could also move things drastically. Of course, number three, it just gives a tailwind to the Canadian economy if resources start taking off. Right now I think a lot of people are focused on the headlines in technology. Technology's been doing great, but slowly, and number two, depending on what period you're looking at, a lot of these commodities are quietly doing well, and just like I said before, it's kind of like a slow bubble up as opposed to some big shock. In some cases that's the worst because it surprises people when it's too late, and governments look and go, wow, we have not been investing and we need these commodities because commodities still remain a big part of our lives.

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Pamela Ritchie: How do you invest it? Do you go ahead and be early?

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Joe Overdevest: I think you have to understand where you have time on your side because the investing world, there's so many factors. We live in a very dynamic world. All these things we're talking about right now, about hyperscalers and the growth looks perfect. Look, come next quarter for whatever reason they all have been told by their investors to slow things down, they will slow things down. I think what you have to do is at least take a long-term perspective and do scenarios like "what if?" That's the benefit of our research and some of the people on our staff. We've lived through those times before.

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Pamela Ritchie: ...the research department. Tell us a little bit about what you guys are drilling down into, pardon the pun. This is what you're spending your time on...

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Joe Overdevest: A lot of it actually is doing industry reviews on resources. One of the things right now, we've been doing an industry review on recently banks as well, let's just do the energy one. The energy one was a lot of learnings that we had in '02, '08: how is this cycle different? To your point, one of the things I think you had to watch for, you almost had to break your mold in your mind because right now the mold, the mind is, well, commodity stocks, especially energy, the multiples are quite low. That's what they always should be. You have to break the mold and look back and go, when commodities are doing well and oil prices are doing well the multiples were a lot higher than they are today. Today we have 10% free cash flow yields, those days you had 5 or 3 or 2% free cash flow yields. To your point, because the narrative then was energy was going to be with us for a while. The narrative now is energy may have a limited timeline, and if that timeline, to your point, starts getting pushed out the multiples will start becoming higher, and we just don't want to be surprised by that. I think a lot of investing is just being front-footed and thinking two steps ahead on the chessboard and not just one step ahead. We're doing a lot of work of what if? Again, one of the best things we'll talk about, demand destruction.

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Pamela Ritchie: Let's get into that. The prices of some of the things that suddenly become scarce, the supply isn't there. Then what happens? How does the demand destruction come in this next phase? What do you think it's going to look like next?

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Joe Overdevest: One of the things that people will say, how did oil get to $150? It starts with just understanding Economics 101. There's three numbers you need to worry about with any commodity. You ask the Fidelity commodity analysts in the hallway out here, Pamela, you should quiz them on three numbers. What's cash costs? Cash costs are during like COVID times, what is the minimal amount when they actually start shutting down production because they just are losing money? That's the bottom, that's for where we are in the commodity, not today. Then there's the marginal cost of supply. For oil it's $65. That's when we get a rate of return that's attractive, about $65 for the Permian right now. Generally, over time commodities should move around marginal cost of supply. The reason why is because it makes sense. That's when people are making a decent return. Why did oil get to $150, or copper starts getting to like $5 or more? It's because now you're starting to price where is marginal cost of the demand destruction.

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That means that someone here at Fidelity goes, you know what, to their boss, I'm not driving in to work today. The gas price is so high, you need to raise my wages or I'm just not coming in kind of thing. What we do, at least the Fidelity work, we actually can graph commodities over time, we find out where the pinch points are, what countries. For oil, it's usually the U.S. because the US economy is very big but also it's very flexible. We actually have people who tell their boss, I'm not coming in, other countries you just don't have that. In copper, you see where there's substitution, where someone goes, in that battery that other metal isn't as good for using, but considering the price difference I'll accept it. Right now, if supply is not responding and enough time passes, you will have to go to demand destruction prices. That's where, again, try and be front-footed. We update all of our numbers to go okay, just so no one gets surprised, this is where some of these commodities could go. The timing of this is very uncertain but if supply doesn't come on in a meaningful amount you have to have demand destruction.

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Pamela Ritchie: So you're mapping that out, that's something that you're mapping out.

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Joe Overdevest: Exactly.

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Pamela Ritchie: It could well happen.

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Joe Overdevest: You don't want to be surprised.

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Pamela Ritchie: You don't want to be surprised. Really interesting. Let's go back to the tech story a little bit, maybe particularly in Canada, we can go further afield. AI is the only thing to talk about really but sometimes it seems to be some different, shall we call them legacy tech companies that surprisingly are AI plays now.

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Joe Overdevest: Yeah, exactly.

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Pamela Ritchie: Those are here, too?

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Joe Overdevest: They are here too, they're here in the U.S. It's funny, you're using the word networking companies, people have flashbacks.

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Pamela Ritchie: Like Nortel, disasters, yeah.

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Joe Overdevest: Nortel is no longer.

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Pamela Ritchie: But kind of that idea.

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Joe Overdevest: Yes. What happens is ... I think what's interesting about technology, last year has been software, software, software. Trust me, software still has a huge amount of growth potential but what AI has done is they need data centres. It gets to data centre needs, a lot of networking and just hardware. All the old companies...

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Pamela Ritchie: They need to plug into, and boxes.

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Joe Overdevest: Exactly. With Fidelity, we always get excited by these things. Whenever there's change, there's opportunities, someone's going to gain some, there's going to be pain somewhere. There we're seeing some of these old networking companies, their earnings been flat for 10 years, multiple has been 10 times earnings, all of a sudden, they're white labelling networking equipment for ... and guess what, they're getting calls from the hyperscalers saying, we need data centre here, we need a data centre there. Earnings go up 100%, multiple starts expanding again. That's a lot what we were almost talking about before. People sometimes get stuck in a mold, that's the multiple it's been for the last few years. It can be a lot different in better times. You're definitely seeing on the hardware tech side and you're seeing even little offshoots industrial companies are benefiting from this. We have a company we were just talking to and they do electricians. Guess what happens? They've been getting a lot of calls lately saying, we want to build data centres in Canada, we need electricians.

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Pamela Ritchie: Don't we have any? When I call an electrician, they charge me through the roof. We obviously need a little more on the trades side of things.

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Joe Overdevest: That's an amazing thing, you're exactly right. The trades in general for North America is definitely lacking. We talk to a lot of the industrial-type companies, hiring is still one of the biggest issues. A lot of these companies for a long time have been growing GDP-like growth and all of a sudden now if they're servicing a data centre of any sort and maybe they just give a widget or their electrician, guess what? The data centre owner, it could be one of the Mag Seven goes, I just want it to come on. We have a huge amount of money coming from this AI. I don't care if the widget is 5 or $10, just get it done. That's when we get excited because it means someone is having excess economic rent benefiting shareholders.

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Pamela Ritchie: When you look at some of the other components of the AI story, particularly in Canada, one of them is obviously the data side of things. It's not just any old data. I mean, most companies produce data, and the good ones produce really good data. There seemed to be a question mark at some point if whether because there is so much data out there a company that coined itself as a data company may just kind of get lost in the wash, but there's a quality piece to it now, isn't there? How do you look at that as an investment?

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Joe Overdevest: When we talk to the companies all the way from banks to consumer companies we ask them, what are you doing for AI? Really right now most are in the learning stages, but most are saying a few things. They want, number one, to trust whoever they're operating with. Number two, they want clean data. I think that's what's interesting, too. The ultimate trust is not just like you working with an AI provider, it's you allowing the AI provider to go behind your firewall and use all your data. That's a big trust thing that you're probably not giving to a start-up.

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Pamela Ritchie: That's got to be a partnership.

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Joe Overdevest: It's definitely a partnership. It's probably someone that you've trusted over time and they've proven their worthiness with you. We're seeing in Canada there is a few data providers, one comes to mind. It has lawyers' and accountants' data. You can imagine with a lawyer, we're doing a big case and needs to summarize a whole bunch of stuff, guess what? AI can do that really quickly, it can give you a quick summary. Do you think they want to use it for public knowledge, like just Google? No, they're not going to use Google for that. They're not going to use public data. They're going to use something that someone has checked all the data to make sure it's accurate, or otherwise it becomes a legal ramification for their client and for the firm.

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Pamela Ritchie: It's fascinating. That's sort of the quality data, obviously, but sort of the quality of it all. We're skipping back and forth between AI. They genuinely are kind of connected. Just going back to commodities for a second, one of the weirdest commodities, which sometimes [stammers] is gold. Just an astronomical time of it these days. Is this because it's... this is because it's a currency, right? That's the reason we think. What's going on there?

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Joe Overdevest: Gold is an alternative currency and it frustrates sometimes people in the market. How do you read it, how do you predict it? It's not a supply and demand. If we review just what's going on right now, the U.S. dollar has generally been strong, interest rates are staying higher for longer, the U.S. economy is doing great, the stock market's doing great, all those factors we should say gold should be down. Gold's doing extremely well. I think we have to sometimes say that time will tell the story of what is actually happening. One of the interesting things is it may be the butterfly effect.

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Ukraine crisis happened. I remember watching 60 Minutes. As a Fidelity person, it's very intellectually stimulating, you're trying to listen to different things, and some of these things just trigger. I remember they're saying, we're going to freeze the accounts of all the Russian assets. I was like, I understand why they're doing it but I remember thinking, this is a very historical decision because what happens is the ramifications for all of our partners, global partners for the U.S.

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Pamela Ritchie: It's like an infrastructure of finance being tinkered with.

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Joe Overdevest: I think what potentially happens is you have all these global players who would use U.S. Treasuries, U.S. dollars of some sort go, oh my, so if I do something and the U.S. doesn't agree with my politics or my actions, they will freeze my accounts? Potentially, what you're doing is going back to the old currency you used to do which is gold, and they're probably diversifying away a little bit from the U.S. dollar and going more to gold. Again, you won't see this in ETFs. Trust me, the sovereign nations are not buying ETFs. That's why...

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Pamela Ritchie: The gold ETF.

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Joe Overdevest: The gold ETF. You're actually seeing it in the ETF volumes but there's definitely a buyer in the market for gold right now. I think just in general, [indecipherable] aside too, you're seeing huge deficits around the world. So probably sovereign nations, but more importantly individuals are saying, do we have currency devaluation because to solve the deficit it's probably austerity, probably cutting social programs, increasing taxes. No one wants that. Probably currency devaluation to some extent, and that gets even Bitcoin involved too where individuals are buying probably Bitcoin and gold a little on the margin.

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Pamela Ritchie: It's a fascinating story watching that kind of take off. Do you find, going back to research, you learn from your colleagues? Actually, do you ever watch these shows?

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Joe Overdevest: Oh, we definitely watch the shows. We watch them live and we actually listen to the Fidelity podcasts on Fidelity Connects.

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Pamela Ritchie: That's good, there's lots of them.

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Joe Overdevest: For the audience, I'm sure the big ones everyone listens to is Will Danoff and Mark Schmehl and Darren. Probably for the audience, making sure you get also maybe the investors that are little less than tenured but very, very smart investors. Brett Dley, Connor, Dave, and Chris, very smart investors for sure. Definitely as a group we all listen to each other.

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Pamela Ritchie: Oh, that's great. I kind of like to hear that. Let's go to something that we haven't talked about at all which is rates, really, the story of sort of the macro picture. It does seem like so many other things are coming into the fore but within Canada we're going to talk about what rates might mean for the economy itself, whether we need to move in conjunction with the U.S. What's the rate story right now for you? Is it kind of a sideline story?

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Joe Overdevest: It is a bigger story than it is in the U.S. just because we're a more high levered economy, especially with our mortgages. When we got the rates right now the market is pricing in for the rest of the year maybe one or two cuts, in the U.S. only about one cut, which makes sense, the U.S. economy is doing better than Canada. You're right, they are connected. If we all of a sudden get out of line with the U.S., it affects our currency and it's a knock-on effect and it can drive inflation up or down as well. So, you kind of don't want to be too far away from the U.S. The market is pricing Canada will go faster and probably a little bit harder, for obvious reasons. When we talk to the Canadian banks, you hear on their calls, the biggest concern probably for individuals is interest rates.

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I think for Canadians it will definitely help the average consumer with their auto payments, their mortgage payments. I think one thing we at least have some kind of comfort in a little bit is the reason rates are just generally stubbornly high is the economy is doing okay. Just rates cutting because the economy is in a recession, that is not a good thing. Right now, they're stubbornly a little bit higher than maybe the average consumer would like. It's because jobs are still very tight and the economy's doing okay. I think though as we move forward it feels like a glide path down which is probably going to at least alleviate some of the concerns for the average Canadian.

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Pamela Ritchie: Yeah, really, really interesting. I think the whole idea of short term/long term horizons, how everyone's going to invest, when you think of the U.S. election coming up it's the question of how you just invest straight through it. You don't try to invest for an eventuality in either way, what do you think about when you think about that, getting through this shorter term?

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Joe Overdevest: I think with the short term with President Trump and President Biden, I think one of the benefits we have, we've seen President Trump once before. One of the benefits he has is that you have the playbook right there. I think though what you've seen is that with either one of them they want to probably invest in the U.S. If they are investing in U.S., it's American first agenda. It will probably benefit Canada because we're just we're such a close trading partner. I think you listen, it's a very dynamic situation. Polls change, we've noticed this before, polls change, people make bigger promises. If they're behind they make a bigger promise.

One of the things you're actually seeing is Trump is less vocal than he was last time because in his opinion he's in the lead. You can see he's not making big dramatic comments. We'll see as we get closer.

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Pamela Ritchie: Really interesting just to sort of how people need to be [indecipherable]. Should we round this out with a little bit on ... Actually, you're always reading good books. You've made a couple of good recommendations over the last little while. What's of interest to you if you sit down with a book? How do you read a book, first of all, is that paper?

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Joe Overdevest: I do both. I do paper and I do audio as well. For the audience, I'll give you a few different ones. For books, an interesting one was the F1. There's a new book, the history of the F1. I really liked it because near the end it was the development of the current business model, how a lot of people who watch F1 or F1 fans have actually never seen an F1 race, but they consider themselves fans because they saw Netflix.

Podcasts for the audience, you want more business and the best capital allocators or, of course, Fidelity Connects. More recently, a new one that came to my attention was In Good Company. They just interview CEOs, it's just 30 minutes, it's really good. Another one, hopefully, for the audience is Founders. This is a good one to give to young people because a lot of young people don't want to read books. He summarizes an autobiography and he does it one hour. For young people, you're getting the books, it's like a small step, just listen to the audiobook summary. Founders will have Rockefeller all the way to Michael Jordan to Elon Musk more recently.

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Pamela Ritchie: What do you find they all have? There's always a few things that founders will have that's similar.

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Joe Overdevest: Passion. He has this quote he uses a lot of times that champions are built in the dark. It means the Michael Jordans, the Rockefellers, the hard work they do when no one's around is what makes them a champion.

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Pamela Ritchie: That's fantastic. Okay, Joe Overdevest, it's a pleasure to speak with you and to get so many ideas you just shared with us. Thank you very much and we'll see you and your team soon.

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Joe Overdevest: My pleasure.

[00:28:01]

Pamela Ritchie: That's Joe Overdevest joining us here today. Thank you for joining us on Fidelity Compass today. If you've got any suggestions for future topics, guests that you'd like to see here, go ahead and share those ideas with us. In the meantime, stay tuned for more Fidelity Compass webcasts in the weeks ahead. I'm Pamela Ritchie.