Fidelity Connects

The Global Macro View

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Pamela Ritchie: Hello and welcome to Fidelity Compass. I'm Pamela Ritchie.

It continues to be a tale of two markets. As our guest today notes in his latest market commentary on the one hand the S&P 500 cap-weighted index is up more than 23% on its one-year anniversary and is holding support nicely at 4,200. But the equal-weighted index remains stuck pretty much in limbo and is near the bottom of an almost two-year range.

How might market leadership unfold as we get closer to 2024? Joining me this morning to unpack his latest market thesis and what it means for you is Fidelity Director of Global Macro Jurrien Timmer. Hi Jurrien, great to see you again. How are you?

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

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Pamela Ritchie: Great to have some time with you. We'll invite everyone to send their questions in here, go ahead and do that, there's a Q&A function for you to do exactly that. It's a year gone and the cap-weighted, we know what it's done. We mentioned it there. It brings us back to sort of where the 60/40 begins. I see you have many any slides on this. Should we begin with sort of the options that are on the table at this point?

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Jurrien Timmer: Maybe we pull up slide 17. We're more or less at the one-year anniversary of the low for, I think it's the S&P 500, and the market's up 23% or so even after a correction over the last month or two, holding support at 4,200. Chart looks pretty good here. At the recent low, only 9% of stocks were above their 50-day moving average which is a legit oversold signal. If I only knew this one chart, I would say that's a good pullback to buy. But if you then look at the exact same chart but equal-weighted S&P instead of cap-weighted (that's slide 23), it's a completely different story and it just highlights that the market is in the hands of what used to be called the FAANGS. People are calling them the Magnificent Seven. I call them the Nifty 7, the new Nifty 50. This chart shows, again, this is the S&P 500, but equal-weighted, it shows that it's a market that continues to be in limbo. We are at support but for almost two years this market has either been correcting or consolidating. That's a pretty long time for the market to not declare itself.

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If we think about this through the lens of the discounted cash flow model which is a good model but it's both elegant and frustrating because there are many variables in that model and we cannot possibly solve for all of them at the same time. If you think about what's been driving the markets, you've got earnings in the numerator, you've got the payout of those earnings via dividends and share buybacks also in the numerator and then in the denominator of that formula you have the risk-free rate which is the 10-year Treasury yield plus the equity risk premium and together that makes up the cost of capital. Basically, the fair value P/E is the present value of future cash flows. For the S&P, the Nifty 50 does play a role in that because those are generally the companies that are buying back their shares and have the best earnings so in the numerator, that part is elevated.

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What we've seen over the past year or even two years is a bunch of these different variables just offsetting each other. Obviously, rates have risen, cost of capital has gone up but the equity risk premium, at least from a year ago, has more than offset that and as a result this market kind of hangs in a delicate balance.

If we go to the next slide, just to give you the other side of this, if we look at the Russell Microcap Index which is the bottom half of the Russell 2000, that actually is making new cycle lows. This is a very, very bifurcated market and one in which we need to tread carefully.

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Pamela Ritchie: When we take a look at what's been moving through the bond market, and I think you mentioned in your words that the bond market's no longer sort of an insurance policy, it's much more a bona fide asset class as it used to be, but it's returned to that. That's a big part of what's going on in the equity market as well because there is this other option.

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Jurrien Timmer: Yes, for sure. If we pull up slide 11, the bond market's come a long way. We had this long period over the past, let's say, decade and a half where the term premium has been negative. Actually, let's pull up slide 5 first and then we'll go to this one.

The term premium is like the equity risk premium for bonds. If we deconstruct a yield, so let's say the 10-year yield which is the grey line there, into two pieces, what we call the risk-neutral yield which is that part of the yield that can be explained by the business cycle, monetary policy, the forward curve — because remember, the 10-year yield, it's just a series of strips of one, two, three, four, five, etc. maturities. That orange line is that risk-neutral curve so that's the part that can be explained by economic fundamentals. And then the purple bars in the bottom is the term premium and that's what goes usually on top of that to get to the nominal yield.

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As you can see, normally speaking the term premium is positive, as it should be, right? For long duration assets, investors typically want to get paid, compensated either for credit risk or inflation risk or what have you but for the past decade and a half it's been negative and the reason is very simple. Central banks in the U.S., but around the world, including Canada, Bank of England, ECB, Bank of Japan, had a very heavy hand in terms of their control over the bond market.

If we actually briefly go to slide 2, you can see that, especially during the pandemic so starting with the financial crisis, before then central banks didn't really use their balance sheet as a monetary policy tool. That's, of course, changed with the GFC and since then the balance sheet went from basically 12% or so — there's always some bonds in the balance sheet for operational purposes — but it went from 12 to 28 in 2016, then you had that quantitative tightening period of that era but then COVID changed all that. We went from 25%, this is the six largest central banks' balance sheet as a per cent of global GDP, it went from 25 to 43% and now that tide is going back out to sea.

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As that happens and as we turn to a phase of, let's call it fiscal dominance where fiscal policy is becoming very dominant just like it was back in the 1940s, the central banks have needed to be more restrictive because the economy, at least here in the U.S., refuses to listen to the Fed and to the yield curve and so the economy remains pretty robust and inflation has proven to be somewhat sticky.

If we now go to slide 11, we can see the result of that, of course, is that the term premium has gone up. That rising cost of capital which, of course, was the big story last year and again in the last few months or so has suppressed the valuation not only of bonds but also of equities.

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The good news is that if you look at this chart, here I express the bond yield in the black line as a P/E which is very simple, you just invert the yield and you get essentially the price you pay for future cash flows. In 2021, that was at almost 200. So, imagine buying a stock and paying 200 times earnings. That's more or less what investors were doing in the bond market. The reason for that is that central banks were leaning heavily on bond yields and now we've had the other side of that phase. You can see that that P/E has gone from 189 at the peak to 20.8 today which is very competitive with equities. Equities are at 19.8 or so.

The good news is that normalcy has returned to all the markets and bonds are no longer, at least not currently, negatively correlated to equities. That was certainly a painful lesson last year. But at least they've become a somewhat viable asset class. If you're paying 20 times future cash flows, that's a yield of close to 5% and the term premium is now positive which is good news.

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Just the bond math, the risk-reward of owning bonds and seeing what happens if yields go down 100 basis points or up is very compelling now. For the Bloomberg Barclays Aggregate Index which is the U.S. investment grade bond index, it has a duration of 6.2 years and a yield of 5.5%. That means that if yields go down 100 basis points, you make close to 12%. If yields go up 100 basis points, you lose about half a per cent. Now, those are some good risk-reward characteristics. We don't currently get that negative correlation but, in a way, we don't even really need it because as opposed to a few years ago when you had to pay a very big premium to buy that insurance now you're actually getting paid, even if it no longer is that insurance at least you're getting paid and it's a viable asset class on its own. That's kind of the evolution of the bond market over the last few years. Maybe we should call it a revolution not evolution.

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Pamela Ritchie: It explains why, well, does it explain, why a number of sort of so-called bond proxy equities, they're just not as attractive because you've got this other option. If you go back to your cap-weighted versus across all the caps, does that sort of bring us up on why a number of utilities, for instance, or any of those types of sectors have just crashed?

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Jurrien Timmer: Yes. Actually, just to do a little mental illustration, the two leading sectors are, ironically, tech and energy. Not ironic but it's an interesting couple to be in the lead. The losers are what you would expect, the bond proxies, real estate, utilities, etc. Just a mental exercise, if the S&P was entirely comprised of tech and energy, it would be at around 5,600 right now. The S&P actually is at 4,300. If it was entirely comprised of utilities and real estate, it would be at 2,600.

That is a really, really big gap between winners and losers. You see the same thing with cap-weighted versus equal-weighted, value versus growth. It's a very bifurcated market and it all really does come down to that Magnificent Seven or that Nifty 50. As long as they lead, this will likely continue.

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Pamela Ritchie: I think every year we have this conversation of when it's going to switch to ex-U.S. and certainly most central banks around the world that are grappling with inflation are trying to follow in some manner what the Fed is doing. Has that translated yet into... what point do we sort of see a currency reaction coming through that might be interesting in terms of a trade as well?

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Jurrien Timmer: The dollar has, of course, been strong and some people point, and if we pull up slide 3, some people will point to this curious combination of fiscal dominance and monetary restraint which is a new regime. In the past, the financial crisis and since then until COVID the dominant factor would be monetary policy, zero interest rates, negative interest rates, large balance sheet expansions. The fiscal side was kind of taking a back seat. Now you see here in the purple bars at the bottom the deficits in the U.S. and how massive they got obviously during COVID. That's understandable. We had a global economic shutdown, but even now deficits 8.5% of GDP during an expansion, Keynesian economics tells you that you're supposed to be running deficits only during recessions but our folks in Washington did not get that memo, apparently.

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So, what you see is large deficits and I think they're only going to stay large because if you think about the composition, and actually let me pull up slide 19 for a second here that really. Illustrates this, but if you look at the deficit, most of it is not really discretionary. The Republicans and Democrats can haggle over spending, but most of it is entitlements, Social Security, etc. A big chunk of it is defence and an increasingly large chunk is interest costs, debt service. Those are not really things that are — I mean, defence technically is discretionary but I don't think anyone's going to really touch that. The piece of the pie that truly is discretionary is so small that no matter what they do it's not really going to move the needle. The bigger question is, what does that mean for the dollar? Certainly, it's a popular theme, dedollarization, and clearly the dollar has to give if there is such a lack of fiscal discipline in the U.S.

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I'm not sure that I buy that. Certainly the U.S. is not alone in having a poor balance sheet. Japan. China, Canada, the U.K., Europe, they're all somewhat equally guilty but it does raise the question of who's going to buy all these bonds.

Look at this chart here: this is the change in the Fed's System Open Market Account since COVID, the SOMA is that part of the balance sheet that deals with QE and QT so it's most of the balance sheet. The pink line is the change in the government debt here in the U.S. and that gap is just getting bigger and bigger and makes you wonder who's going to buy it. Of course, there aren't a lot of buyers out there which is why the term premium is widening.

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Back to the dollar for a moment, it's interesting, I just spoke to a lot of Canadian investors at a conference last week and they reminded me that...

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Pamela Ritchie: They're all happy to see you.

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Jurrien Timmer: They were, absolutely, but they reminded me of an important fundamental distinction between the U.S. and the rest of world. In the U.S., we're scratching our heads, why is the economy still so resilient even though the Fed is so restrictive in its policy, and I think part of it is that consumers here all refinanced their mortgages back in 2020 and '21 and they termed it out from adjustable to fixed. They've locked in a 3% rate so unless they have to sell their home, they're feeling pretty good.

But in Canada and in Europe and elsewhere in the world that dynamic doesn't really exist. People have adjustable rate mortgages. I think in Canada I was told that it really is no more than five years. If this rate reset eventually does bite and has an impact on the economy the Bank of Canada, the Bank of England, ECB may be in a position where they are going to need to cut rates much sooner than the Fed will because in the Fed this very large chunk of the economy remains somewhat less sensitive to rising rates.

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That means that this policy divergence that we have had, and I'm not sure – I think I might have a slide but I can't find it so quickly – that the policy divergence that we have had between the U.S. and the rest of the world in terms of monetary policy may very well continue. That's a very long way of answering the question about the dollar. The dollar is driven by many things, capital flows, etc., [indecipherable] quality, but it's also driven primarily by interest rate differentials. If the U.S. is going to remain more restrictive than the rest of the world, in part because of the dynamic I just mentioned, that probably means the dollar's going to stay bid even though our fiscal house is not in order.

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Pamela Ritchie: It's so interesting because that relative discussion of, well, I mean currencies, everything to do with it is relative but yes, as you say, does the dollar then come down to actually the mortgage question?

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Jurrien Timmer: Yeah. It's just hard to see this notion of dedollarization. Actually if we pull back slide 3 for a moment. You have to go back to the '80s to get to a period of fiscal looseness and monetary tightness. That actually was a period in the early '80s, if you look at the top panel the black line is the JP Morgan Real Effective Exchange Rate, and the blue line is the U.S. dollar reserves as a percentage of all global foreign exchange reserves, and you had a very big divergence between the U.S. kind of losing some of its reserve status while the dollar gained. I don't have any way to prove this but there is a school of thought that that combination of fiscal versus monetary was a driver in pushing the dollar up until that divergence ended and then, of course, you had [indecipherable] then the dollar went back down but you see a similar divergence now with the dollar going up even though the dollar share of reserves has been slowly declining from 66% a decade ago to 59% today. Not a huge thing but again, this dedollarization that is such a popular narrative, it's happening in a way because the share of reserves is going down but it's not having an impact on the actual price level.

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Pamela Ritchie: There's a lot of discussions right now and certain headlines and reports about – you have a slide on the secular rotation – some bears looking into sort of the secular bear market. Are we moving into something that we can name it as that on the equity side of things? Can you break that down for us?

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Jurrien Timmer: Yeah. So, the stage is certainly set. If we go to slide 7, and it's a very busy slide, but it shows I think 200 years of history of the stock market's valuation in the top, that's the grey line – 1880, I lied, 150 years – and then the purple line is the long term inflation tend but on a reverse scale in order to show the relationship. You see these very long secular rotations, if you will, that higher inflation regimes produce lower valuations, and clearly that is happening now. I don't know how high inflation is going to be, maybe it goes back down, we don't have a crystal ball on that but certainly it's moving in that direction.

In the bottom, I show 10-year CAGR, so 10-year annual growth rates relative between value and growth, small-cap, large-cap, commodity stocks and international equities versus U.S. equities. You can see that this structural supercycle has a cadence of about three decades.

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Now, three decades is a long time so this is not a precise timing tool, it's not going to help us in the next 6 or 12 months but you can see that the stage is somewhat set here. This, of course, is the other side of the Nifty 50 or the Nifty 7 which I think is very meaningful because we are solving for that Nifty 7, when will that leadership rotate away from these meg-cap growers, and nobody has the answer.

I can't find the chart right now but the mega-caps have been leading for 14 years. The top 50 has a relative P/E versus the bottom 450 of about 40%. That's certainly a premium but it is not as big as what it has been in the past, so during the tech boom in the 1990s or the original Nifty 50 period of the early '70s. Those stocks which, of course, were different stocks at the time but that top 50 was trading at a 2X relative multiple.

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You need kind of the gun to be loaded, if you will, so you need that valuation extreme to be in place. You need for the trade to be crowded but then you still need a catalyst. In the early '70s the catalyst was these stocks were a safe haven during kind of a difficult period in the market and then the market hit a recovery and there was less reason to own them and then, of course, inflation came in and just completely annihilated everything.

The P/E of the Nifty 50 was 25 in the early '70s, by the end of the decade it was 7. Same thing happened in the late '90s. From 1998 to 2000, the top 50 which were mostly tech stocks, they doubled in valuation. They went from 20X to 40X even though the rest of the market stayed at 20X. Then that bubble just exhausted; it imploded on itself. The longs were crowded, the narrative changed.

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Remember back then nobody really knew what the earnings were because we were kind of doing pro forma earnings instead of gap earnings. So, that bubble burst but it was a different situation than the early '70s other than the valuation extreme. Today we don't have the valuation as extreme and we don't know what the catalysts will be. My guess is ultimately these stocks will become very pricey, the trade will be very crowded. AI is obviously playing into this, and there will be a change in the narrative maybe of relative earnings but we're waiting for that catalyst. You need the gun to be loaded and then you need the trigger to be pulled. We need both of those things to happen.

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For the ex-U.S. versus U.S., if we pull up slide 8 for a moment, it shows you that ultimately it does come down to relative earnings. In this chart, I show the MSCI U.S. versus ex-U.S., which is the grey line, and the purple line is the forward earnings U.S. relative to ex-U.S. You can see. Those lines are identical, more or less. These are MSCI Global Series, MSCI denominates everything in the U.S. dollar, so the U.S. dollar is going to play a role in this in terms of how the relative earnings are expressed but that also applies to the relative returns. So, I guess they cancel each other out.

In the bottom panel, you see the relative valuation. The U.S. in '09 was cheaper than the rest of the world. It had a 5% discount. Now it has a 54% premium. But that valuation alone is not going to change, is not going to be the catalyst. The valuation dichotomy will magnify whatever rotation is going to end up happening but it's not going to be the catalyst, in my view.

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Eventually, if we're talking about U.S. or North America versus ex-U.S., there has to be some change in the earnings story. Maybe just the mega-caps just kind of have done what they're going to do and the rest of the world is cheap and is showing better earnings power. Earnings are recovering outside the U.S. as well. This is just an example of there has to be a catalyst to change this leadership and it probably will come down to earnings or valuation or both. And then you have that secular rotation which is just waiting to be unleashed. Again, this can continue longer than we would all like but once it ends the pond in which we can fish as investors is going to get dramatically larger because right now it is really small.

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Pamela Ritchie: Right. Okay. Just fold in the liquidity discussion there. The entire purpose in what we've been going through in terms of the cost of capital going up and this normalization we keep talking about which is filtering through is because liquidity is going down.

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Jurrien Timmer: Absolutely. So, that's slide 18. So again, if you think about what's leading and what's not, the part that is lagging behind is smaller cap and value. If you take the Russell Small-Cap Value Index and you overlay against what we call overall liquidity, so this is the actual market liquidity so the Fed's balance sheet adjusted for what's happening with reverse repos, what's happening with the TGA, which is the Treasury's cash account at the Fed, all very technical, very plumbing-like, but when you kind of net them all out you can see what the net liquidity is.

Obviously, on the left side of the screen you can see how much liquidity improved during 2020 and '21 because of that fiscal and monetary impulse. It did create a little bit of a bubble in all markets because the cost of capital just went too far south. And then, of course, the Fed slammed on the breaks, Bank of Canada, ECB, BoE, all of them did, and that liquidity environment started to erode. Over the past year or so, it's been stable just because the Fed's ongoing quantitative tightening has been offset by these other factors.

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Again, this is the Small-Cap Value Index and that's the part of the market that is the most vulnerable to tightening liquidity because these are the companies with weaker balance sheets, with higher debt costs and so obviously, if interest rates go up and the term premium goes positive, which it is doing, these companies are going to feel the pinch.

The Magnificent Seven, even though they are long-duration high P/E stocks which should be affected by the cost of capital, and they actually were – they derated a year and a half ago in early 2022 in a pretty big way – but right now the market is kind of brushing that off saying, these are not cyclicals, these are secular growers and they can ride out whatever storm the Fed is creating here but these small-cap values cannot. We need to wait for the liquidity environment to improve which presumably would happen when the Fed pivots or at least stops raising rates. I do think the Fed is largely done but rates need to come down, the liquidity environment needs to loosen up, and that's not something that is imminent at this point.

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Pamela Ritchie: Jurrien Timmer, it's fabulous to have some time with you and to take us through your thoughts and these amazing charts. Thank you for joining us here on Fidelity Compass.

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Jurrien Timmer: Thank you. Great to see you.

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Jurrien Timmer: Great to see you as well. Jurrien Timmer joining us here today.

Thank you for joining us on Fidelity Compass. If you have any ideas for future topics or guests do get in touch. In the meantime, stay tuned for more Fidelity Compass webcasts over the next weeks and months.

Thanks for joining us. I'm Pamela Ritchie.