Fidelity Compass

CIO Perspectives: Mid-Year Outlook

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Pamela Ritchie, Host

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Pamela Ritchie: Hello and welcome to Fidelity Compass. I'm Pamela Ritchie. The Federal Reserve is holding steady, and the Bank of Canada has started to cut. We have seen this divergence before. How long might this continue and how might this influence the outlook for corporate earnings going into 2025? Happy to say joining me here to discuss his latest market thesis including possible investment opportunities for institutional investors is Fidelity Chief investment Officer and Portfolio Manager Andrew Marchese. Hi Andrew, nice to see you.

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Andrew Marchese: Pleasure to see you as well.

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Pamela Ritchie: Glad to have you here. We'll invite everyone here to send questions in for Andrew. Let's begin with divergence. We've got lots of eco factors to fit into this that have come to light recently. The world is diverging in its interest rate policy. What does it mean overall?

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Andrew Marchese: One, I guess we can start, it's not a surprise, to me at least, to see the action by the Bank of Canada, the ECB and now the Fed. We're starting to see signs of divergence if you look at what market consensus is starting to price in, three cuts for the Bank of Canada through year end and then possibly one in the U.S. The question is...it really comes down to what is the magnitude now over the course of that rate easing cycle and the speed at which it occurs?

I think the biggest implications, once you get past kind of the consumer and a reset or a repricing of interest that's paid on debt, for corporations it really is going to come down to a big concern for us would be currency, particularly with our biggest trading partner being the U.S. For Canadian companies who may be manufacturing here and selling there, that's obviously a good thing if we cut more than they cut. But the implications are greater across the globe.

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One of the things that if this interest rate disparity picks up steam in magnitude in the quarters ahead, then I think it's incumbent upon us in trying to evaluate companies profit and cash flow stream going out into 2025, 2026, the implications for currency in those profit and cash flow streams. I think that's one area that history has told you that you have to pay a lot of attention to.

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Pamela Ritchie: If you're looking at equities across the Canadian sort of landscape you're really looking extra closely, I guess, at companies that are selling into the U.S. dollar, or able to price things, even commodities.

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Andrew Marchese: Oil would be a classic example of that. If all the oil is coming out of the ground in Canada and your revenue is denominated in USD globally that's generally a good thing, provided, there's a flip side of that argument though too, provided that demand and the price of oil remain kind of more or less the same.

Now, historically, a strong U.S. dollar relative to global currencies is synonymous with a weak global economy. The U.S. dollar being the reserve currency of the world, it tends to be a low beta currency. It will strengthen relative to other currencies but in time, in quarters ahead, it may be more synonymous with a weaker economy than necessarily just an interest rate disparity.

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Pamela Ritchie: This is a global weaker economy.

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Andrew Marchese: Yeah, so something we'll pay attention to globally.

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Pamela Ritchie: We've seen parts of Europe go into recession. I think we could say it doesn't have to be a global recession because some parts have and China's going through its own moment. Again, sort of the divergence story for economies going into recession, just sort of bring us back there. Some flashing lights and indicators say that it could be there.

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Andrew Marchese: I think there's clear indication that the global economies continue to slow. We've seen some things on the manufacturing side that denote slowing. We've seen some things on the service side that actually show some kind of acceleration. I think if you're going from point to point, data point to data point, it's probably not a great methodology to gain either confidence or get more pessimistic.

If you look at the trend generally, I think we're kind of flattening out towards the bottom with possibly kind of a little bit more sinking to go. Rather than get caught up in the definition of a recession or a soft landing or whatnot, we're really trying to draw it back to corporate profits. Between Q4 2014 and Q1 2016, global economies were weak but did not meet the definition of a recession, but corporate profits did. There were a lot of things that went into that. To me, it's always more important to denote the environment you are in relative to global profits, cash flow, than to necessarily look at GDP or other economic indicators to somehow define the economic backdrop.

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Pamela Ritchie: Now I'll ask you questions exactly what you say we don't need to look at. Just looking at the labour story, looking at the numbers that we got last week and how they play into everything it is a question of earnings. If you see a labour story that's softening at what point does it become a labour story?

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Andrew Marchese: In the United States typically a situation where you move off the bottom in terms of unemployment to the tune of about 50 basis points has generally meant that you don't stop at 50; you get at least another 150 on top of that in there. That would imply that you go from about 3.5 in the U.S. to about 4, that would imply like maybe if history is any guide and it rhymes, maybe 5.5% unemployment rate. Now, that is also synonymous with weakening corporate profits.

Now, historically that has a greater correlation to a manufacturing-based economy. We have become more of a service economy. So, you have to take those overarching kind of 30,000 foot macro data with a little bit of a grain of salt but it still should alarm us to the extent that we better really sharpen our pencils to kind of understand there probably is some pressure under corporate profits and we just got to hone in on what companies and/or industries that is most pertinent to. That's generally the way it works.

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But, the Federal Reserve at that point will be looking at the same data and they will be cutting along the way most likely. If they start cutting, at some point the market will look forward past that kind of cyclical peak in unemployment and be looking forward to the next cycle. Again, dwelling on it for too long and not looking at the response out there may cause you to miss investment opportunities. That's what we're more concerned with.

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Pamela Ritchie: Fascinating. So, looking a little bit further out perhaps and the asset allocation discussion most of the people joining you here today are going to be very cognizant of how things are being allocated with their overlay. Give us a bit of a sketch of sort of how you see different options on the equity side particularly.

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Andrew Marchese: On the equity side, I've said it feels like an idiosyncratic year and a year with normalized, historically normalized type of returns. If you look at EM MEA, you're talking about mid-single-digit percentage gains so far this year. Canada is about 0 to 1%. The S&P is 13+ but it's being driven by the NASDAQ, so tech-heavy names which are up about 17% year-to-date. Asia is kind of in that low to mid-single-digit return. Most of the world is normalized and I think to get outsized returns or active returns beyond the passive benchmarks, it's an idiosyncratic year around stock selection and I think that is coming to fruition. I think from an equity allocation standpoint, from a regional perspective nothing really stands out.

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Pamela Ritchie: I was just going to say, what about U.S.?

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Andrew Marchese: I've always been pro U.S. but when I get the feedback or the rebuttal that it's expensive I don't disagree with that. I think the reason it's disproportionately expensive relative to the rest of the world is a pretty simple one. One, the quality of the companies are higher, as a general statement. Two, the return of cash to shareholders in the form of dividends or share buybacks is the highest in the world so they have the best capital allocation policies. In my mind, and they have a little bit of room to go on that front too. In my mind, that probably deserves a premium in terms of valuation so I can justify it quite simply and not have to really stretch to do so.

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I think in terms of geographic allocations what you have is probably what you should keep. Nothing really stands out. Where you start to get opportunities, if you get into a bust-like scenario, as I always say, you don't get a boom without a bust and there's never any clear opportunity for rotation unless you get kind of a, I don't want to call it crisis, but kind of a distressed situation where the relative valuation and the relative earnings growth backdrops become obvious, and then you can allocate the capital accordingly. On the fixed income side, I said back in April, I like the belly of the curve, kind of of that five to seven-year area. I continue to like it.

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Pamela Ritchie: You think it's more stable.

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Andrew Marchese: I think it's more stable. The yield's got a little ways to fall there. Over the course of the next, I don't know, call it 18 to 24 months, will hopefully dis-invert. Hopefully that's the goal. We'll see if we get there.

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Pamela Ritchie: When you take the equity side of it and look at opportunities within private markets, that's also very popular right now, it's been interesting for many. I wonder if you can just sort of take us through that because that also can be quite a relative story sometimes.

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Andrew Marchese: It is. For a lot of investors, they've been piling in to the private markets for the better part of 15 to 20 years. What I find really intriguing about that, and it's probably a better argument just about 18 months ago, but I think it still holds. A lot of the private investments like the public investments, you know, 8 times EBITDA, went to 12, went to 16, went to 20, you got kind of to the top of the cycle and the private markets don't reset in valuation. They don't reprice.

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Pamela Ritchie: They're still there.

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Andrew Marchese: They're still there all while the public stuff kind of reset. If I look kind of on an apples-to-apples basis, it's not perfect but it rhymes, the relative valuation disparity is actually in the public markets now, not the privates. Obviously, some investors have a very long-term horizon, and they have a fixed percentage of allocation that they want to make in terms of privates as their overall book, so they'll probably keep going in that direction. But I think purely from an opportunistic standpoint, in my estimation the relative valuation argument lies on the public side, not on the private side.

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Pamela Ritchie: It's really interesting. Looking at like a REIT, if you're going into the real estate sector or something.

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Andrew Marchese: Once those markets kind of reset to a better degree then you take stock and you invest accordingly.

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Pamela Ritchie: Fascinating. We've been talking a lot about sort of if we are going into a cycle or not, and that may not be the big story, but as we march into a world that seems to be, you know, there's a reshoring element. We know that's true. The world is sort of shrinking to an extent. We're next to obviously the superpower in terms of economics so that that helps us to a degree. Is it also though, reshoring, inflationary? It takes us back to sort of what the central banks need to battle on many different fronts.

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Andrew Marchese: It can be. Certainly in some industries it definitely can be. We're seeing it in technology in terms of whether you're talking about semiconductors and microchips and it's a matter of global security, manufacturing of certain things, bringing it back onshore has implications for cost of goods sold, has implications for power requirements so it might have long-term implications for utility companies, and commodity companies in there as well. We have to pay attention to all that.

Pursuant to your comment about inflation, yeah, I mean, to the extent that it impacts both cogs, labour inflation and then inflationary stance in certain hard commodities. Yeah, it's a real possibility. Probably from there, and it all depends on how global politics unfold over the coming years and the divide that's happening between the West and kind of the Russia-China alliance and whatnot, and if that gets more heated and more contentious, certainly it will change an element that has been in place basically from the '90s through 2020.

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Pamela Ritchie: Like sort of the global market--

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Andrew Marchese: Globalization, yeah, exactly.

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Pamela Ritchie: ...for goods, for commodities and so on. With that, let's sort of stick with kind of the oil, gas, very Canadian story. We're in the midst of an energy transition. We know this. The length of the transition nobody seems to know. What does it mean for investing in sort of oil and gas in that? We're going to be sticking with this for a while, it looks like.

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Andrew Marchese: I think despite a lot of rhetoric that we hear in the media on behalf of various parties and whatnot, the transition away from petrochemicals is exceedingly difficult.

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Pamela Ritchie: Because it's cheap and it works.

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Andrew Marchese: It's cheap and it works. I often try to remind people the United States, the Industrial Revolution was built on the backbone of cheap oil. If we start with that very kind of basic statement, you ask yourself in terms of renewables, do we have something that cheap and that efficient that's ready for prime time? The answer unequivocally to that question is no. Will we get there someday? I hope so, but we're not anywhere close to that. Despite the fact that we want to get away from fossil fuels and what have you a lot of these renewables source a diffuse source of energy in a very inefficient way that is still cost prohibitive. Full stop. Start with that statement.

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You look at other things out there and one that's getting a lot of notoriety is the re-emergence of nuclear which has basically been reemerging since about 2018. It is a very efficient, dense, not diffuse but dense source of energy. Now we have to get, I think, over some other hurdles namely like not in my backyard kind of thing but that could be an opportunity not only for investment but by changing the shape of how we source and meet increasing power generation needs not only in the developed world but the emerging world.

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Pamela Ritchie: The increase, I mean, one piece of the big story that we keep talking about is AI and ultimately the data centres that need to be powered to power that transition itself and nuclear keeps getting brought up because other, I guess, other ways are sort of carrying the heavy load already and this would be something new to plug in, literally, to the data centres. Is that going to happen overnight though?

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Andrew Marchese: Not overnight but I think with a concerted effort ... What history will tell you is some of these things, it's always the way, certain things will move faster than expectations; certain other things will move slower. I think the movement away from fossil fuels will be slower or more specifically, the movement away from fossil fuels to those other renewables will be slower. Nuclear is proven. It wouldn't shock me at some point in time if that moves a little quicker than we all anticipate. But time will tell, time will tell.

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Pamela Ritchie: These are all sort of new pieces of the market. Back to sort of the story of cyclical and where we are and so on. The market leadership and maybe the evergreen is technology and has been tech for a while. Any thoughts on what, if we were to go through something of a dip what new leadership might emerge? Do you get some hints?

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Andrew Marchese: If you look at 100+ years of market history, and we'll take the S&P 500 as kind of like the study, the map of that over 100+ years, what generally wins in the marketplace is relative earnings growth.

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Pamela Ritchie: So, something that's been absolutely clobbered.

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Andrew Marchese: What you need is for the other stuff ... valuation by itself can tell you how much you have to gain or as much as you have to fall but it's a very poor predictor of timing. You can't use valuation as a timing mechanism. If we believe, and certainly it's my personal belief that we're in the prolongation of a late cycle here, to have rotation away from high quality, high free cash flow, largely speaking technology or growth securities to other more cyclical areas of the market that have been beaten down you need kind of that reset and it will generally follow interest rates.

If interest rates kind of continue to get cut and those more consumer-driven cyclical companies, those stocks underperform, then there's a bigger relative valuation gap. And then in the years ahead, the quarters and years ahead, the relative earnings growth, and it could be fleeting, it could be just a year or two, but we'll probably be in those cyclical companies relative to technology. That's how you get the change in leadership.

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But on a secular basis, as we know, other than 2022 and may have been one other year in the past decade, large-cap growth, large-cap mega-cap tech has worked but it's largely because the earnings growth has been better than everything else, and it goes back to the fact that they've been buying back shares like crazy because they're just free cash flow machines. They had nowhere to deploy it. They buy back shares. Your earnings growth looks even better. It just feeds unto itself. While people will say they're expensive in traditional valuation means I don't necessarily disagree with that. All that tells me is how much they could fall if earnings growth ever becomes normalized.

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Pamela Ritchie: Normalized, not even ... just normalized.

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Andrew Marchese: Right. If the market's a relative ... If we're looking for active returns and we're speaking in terms of relativity, you need a really sharp drawdown or a meaningful drawdown in the other stuff coupled with the fact that because interest rates eventually get cut it will refuel a new cycle, a new economy and the relative earnings growth will be in those names not tech.

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Pamela Ritchie: In that is it going to be consumer discretionary because we know the story in Canada: the mortgage story leads to the consumer therefore eventually consumer discretionary.

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Andrew Marchese: In Canada it's a little awkward only because we have some consumer discretionary companies that are auto parts, it's really more global. We have some retailing stuff. If you look at the U.S. that should kind of ... the traditional playbook is you get about halfway through a rate-cut cycle, economic data will continue to look bad. But the early cyclical stocks which are traditionally things like transportation, so trucking, rails. Consumer discretionary like hotels, restaurants, retail, even banks in the old savings and loan days, now they're a little bit more diversified so it's a little more complex than that, but those start to work halfway through the rate cut cycle and then when you really hit bottom they really start to take off. You also get small-caps working because small-caps are generally a domestic-based business. You're here and you're selling here. Generally speaking, the interest rate cut cycle is most meaningful for small, medium enterprises.

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Pamela Ritchie: And we're not there yet.

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Andrew Marchese: Not there yet.

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Pamela Ritchie: We've had one cut.

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Andrew Marchese: Small-caps have been beaten down for a while and we'll see if they get any worse from this point on or they just run flat from this point on.

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Pamela Ritchie: When you take a look at the idea of breadth, when you look at sort of what's happened this year it's been a fascinating equity six months, eight months. It really did catch a bid. It happened, it did widen out. I guess the question is sort of for the rest of the year how do you see that story? Does it look like it's got enough wind in its sails?

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Andrew Marchese: If you look at the S&P again and you look at 10 of the 11 GICS sectors, and my math is probably a week old, but when I was looking at it 10 of the 11 sectors were within about 5.5 percentage points from each other. To your point the breadth has really kind of widened out. But within that what you noticed in each sector is quality and free cash flow has really outperformed massively. Quality is most correlated to return on equity. Again, it's an earnings story which feeds into ROE. While the breadth has widened out, to your point, and has gone across sectors the underlying borrow factor, the factor exposures are consistent across the marketplace.

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The market has done a job in where the economic outlook is a little uncertain. We're not quite sure about interest rate policy. Clearly, we started the year way too optimistic on interest rate cuts. That has been dialed back a bit. We're going to just pick the best stocks and we're going to lean on things that have dominant market share or low volatility streams of profits and predictable. Sure enough, that's kind of shown up in 10 of the 11 GICS sectors.

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Pamela Ritchie: So interesting. When you look back at the several economic pieces of the story in the last week or so there's that sort of adage of when bad news actually becomes bad news. Again, maybe we're just looking at a broader picture, but would you say that's happened?

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Andrew Marchese: Not yet. Oddly enough, triple B credit spreads are I think the lowest they've ever been, or near there. The VIX is really low. If anything, people are probably too complacent. At some point maybe if bad news does show up it actually means bad news for the market. People look past the interest rate cuts and go, oh, maybe this is a reset on corporate profits. Right now the year looks...

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Pamela Ritchie: It's just the cut, isn't it?

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Andrew Marchese: It's the cut but it's also earnings have been actually quite good. Right now the forecast by Wall Street and Bay Street, if you look at Bloomberg consensus numbers for next year, looking at about 12% earnings growth in the S&P.

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Pamela Ritchie: Which is what we have now.

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Andrew Marchese: Right, and we had that in the start of January. So nothing has changed. If you're wondering why the VIX is low and BBB credit spreads are really tight it's because the earnings outlook actually hasn't changed. and we're not raising rates anymore. In fact, some regions are cutting so we're good. That's what the markets do. At some point if something disrupts that calculus that I just kind of articulated, there might be some question on corporate profits not only for the back half of this year but into next year.

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Pamela Ritchie: Close us out with a bit of an asset allocation picture. We asked this a little bit at the top of the conversation. It is a big piece of relative within asset allocation, obviously, it's sort of the nature of the beast. What would you suggest is a good way to be marching through the next, I don't know, medium term here?

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Andrew Marchese: To me there's no discernible, for lack of a better word, lay-up in terms of like really pushing something overweight in terms of particular asset class or pushing something underweight. I think conventional wisdom around the split in the 60/40 or to the extent that there is private investment in that overall portfolio [indecipherable], I don't see any really light-flashing opportunities from an asset allocation perspective. I think there is a possibility in the second half of this year, depending on interest rate disparity, what it does to currencies, that may open itself up...

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Pamela Ritchie: For opportunities.

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Andrew Marchese: Yeah, yeah. But as we sit here today nothing's really screaming at me from a make a massive change to one's allocation.

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Pamela Ritchie: Steady as she goes.

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Andrew Marchese: Steady as she goes.

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Pamela Ritchie: Andrew Marchese, a delight to have a chance to talk with you. Thank you for joining us here.

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Andrew Marchese: Thank you, Pamela.

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Pamela Ritchie: That's Andrew Marchese joining us here today. As always, if you have any suggestions for future topics that you'd like to hear, guests that you'd like to hear from on the show please share your ideas with us. You can also stay tuned for more Fidelity Compass webcasts in the weeks ahead. I'm Pamela Ritchie.