ETF Exchange Podcast

Episode 45 Rough Transcript

Announcer: Hello and welcome to the Fidelity ETF Exchange – powered by FidelityConnects –connecting you to the world of investing and helping you stay ahead.

In this episode of the Fidelity ETF Exchange, host Étienne Joncas Bouchard welcomes Andrei Bruno back to the show. Andrei is director of ETFs at Fidelity Canada and he sits down with Etienne and reflects on the notable ETF industry trends of the past quarter. They highlight how flows in the Canadian ETF industry continued their strong momentum in Q3, bringing the year-to-date total to $30.1 billion as of the end of September. Some other notable headlines include weakening demand for U.S. equity ETFs in favour of international equities, continued appetite for cash alternatives ETFs, as well as a rebound in the ESG category.

This podcast was recorded on October 20, 2023

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Étienne Joncas-Bouchard: Hello, everyone, and welcome to the Fidelity ETF exchange. I'm your host Étienne Joncas-Bouchard a.k.a EJB and we are back with another episode. Today we are doing our quarterly recap of the Canadian ETF industry. We're a little bit behind, but we've been busy with some live events at Fidelity here.

My co-host and I actually just got back end of last week from our great event in Palm Beach, Florida, where we heard a bunch from our portfolio managers. We talked to ETFs with some advisors. We had a specific lunch and we talked about various topics that we'll get into a bit later. But obviously we do want to recap what's happened in in the past quarter. Before I get started on that quick recap of our last episode, it was a really fun one to do. I had the opportunity of hosting one of our analysts that's been on the team for for a very long time. Audrey Kim and we talked about the Fidelity's five year ETF anniversary. So we actually launched our first products in Canada back in September of 2018. So obviously September 2023, that meant we had some some milestones from from a time standpoint, but also from an asset standpoint. We're now at around 4 billion in assets with about 40 products. So that was a cool episode. And we also discussed some ETF trading tips and myths that we debunked five of them, five of each to stay on theme there. So that was the last episode. You can catch that on Fidelity Dossier or on your favorite podcast app if you would like to have a listen.

So let's get to today and joining me for a four hour episode is our director of ETFs here at Fidelity Investments Canada. Many of you heard from him on the podcast before are you've probably seen him at Fidelity Connect. CS Oh, he's a bit of everywhere at Fidelity, a man who can do many things. Andre, thanks for joining us again today and really happy to have you on.

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Andrei Bruno: Always great to be here. JP You know, you referenced our our conference there in Palm Beach. It's been a tough change of scenery for me coming from the sunny shores of Florida, too. It's quite cold and rainy here in Toronto today. So dreaming of those beaches, although we didn't get we didn't get much beach time because we were we were quite busy at the conference.

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Étienne Joncas-Bouchard: Absolutely. Yeah. It would have been nice to get a little bit more outside and take advantage of it now that we're back in this fall. Kind of rainy weather. But I'm not going to shed too many tears because I think you're covering our event next week in Scottsdale. So you're going to be back out in the sun with another group of advisors. So I guess I'll be missing out on that one. But that it was good events and it's great to see all advisors join us and, you know, really get to hear directly from Fidelity, PMS and stuff. So we'll definitely have a chance to talk about that.

But Andrei, I guess, you know, where I'll start is just kind of an update on flows and you know, the quarter as a whole albeit market performance was. Pretty difficult. You know, you saw equities across the board in bonds, pretty much across the board being down on the on the quarter. But flows in the Canadian ETF industry were were very positive. You saw about 8 billion in net new assets in the quarter as a whole, about 1.6 of that going to equities. 6 billion going into fixed income. You know, a few other key points there that I highlighted, ESG is actually coming back slightly. So about 1 billion in net new assets in the quarter. That's almost good for 50% of the total for the year. So a little bit of interest going that way.

We saw in in the fixed income category, cash alternatives continue to rake in a bunch of cash, more than 3 billion in net new assets there, just relentless buying of of an asset class that obviously has no duration but is yielding quite, quite a bit. And we can talk about fixed income a bit later, but those are some of the main headlines that I mentioned. I guess bringing the year to date total of over 30 billion. And to put that in comparison, last year we ended at 35. So we're likely going to, I guess, finish the year off with stronger net inflows than we did last year. So, you know, just off the hop, some stuff that I mentioned there, is there anything that stuck out to you or maybe comments that you have around some of those key headlines?

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Andrei Bruno: Yeah, I mean, I think the the cash trend has been a strong trend we've seen all year. So there hasn't been a massive shift in that trend whatsoever. I mean, we are starting to see a little bit more interest in and I'm looking at just kind of flows from last week. We're starting to see a little bit more interest in some duration products. And I think that's potentially a trend we might see going into kind of year end here.

While, you know, obviously, you know, when you take a look at central banks, whether it's the BMC or the Fed, you know, especially especially on the back side, looks like we're probably done here in Canada. We've got a pretty favorable CPI print this week. It looks like the Fed, you know, might get one more in, but it looks like we're pretty close to the end of the line from a monetary policy perspective. So, you know, overlaying that again, with the macroeconomic headwinds, obviously there's a lot of talk of, you know, recession. So putting those two things together, I think the the duration conversation is happening now, and I think we'll see a shift at some point again here in Q3, Q4 this year.

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Étienne Joncas-Bouchard: Yeah, that's a really interesting point because it is it is very tempting to go on that short end of the curve. And with what the yields were at, they're out now for those cash alternatives, you know, north of four and a half, you know, probably north of 5% at this given point, given where the curves are in the U.S. and Canada, it does seem attractive as a place to park cash in the meantime of having some conviction one way or the other. Right. And I think that's kind of what was interesting so far this year is that there seems to be a lot of inflows, but there hasn't been like a very high conviction move. And one way or the other, given bonds and equities are pretty much even if you take out the cash component from a flows standpoint, one that I thought was interesting because if you look at year to date numbers and let's I'm going to just for the audience, you know, I'm talking about end of September data because you know that we are recapping the quarter. S&P 500 was up about 13% in Canadian dollar terms. Nasdaq was up 2520, let's call it 25 to 27%.

You know, those numbers are pretty solid, but you're you're seeing outflows from U.S. equities. So so it's kind of the opposite of what we usually see, where it's kind of we see maybe we'll see flows come in, I guess, as we move forward. But it seems like a lot of investors and advisors are somewhat taking some of those gains and reallocating specifically to areas like international, which are actually if you look at the IFA index, it is positive on the year. So about 7% as of the end of September, but it's definitely lagging the U.S.. Is there any any reason to that you think rebalancing or some people maybe moving away from a market that's trading at a premium, obviously the U.S. market being that one versus, say, international or even Canada? What's the dynamic there?

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Andrei Bruno: Yeah, I mean, I think I think equities have been are kind of tricky right now. I think a lot of people are don't really know what to do with equities. Right. Again, again, on this backdrop of, you know, are we going to come into a recession and people are in a bit of paralysis mode. And then again, if you know, we discussed this a little bit down at the conference, but, you know, if you take a look at kind of the breadth of gains in the S&P 500, well, there really isn't the gains. It's true. And what are those? Obviously, obviously, you know, everyone's been talking about the Magnificent Seven, which is more or less been when bringing up the S&P 500 this year. If you look at an equal weighted S&P 500, it's I think it's what, like flat on the air, maybe slight positives. Yeah.

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Étienne Joncas-Bouchard: Somewhere around October, it's flat to nothing. And in September it was up like a couple of percent.

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Andrei Bruno: So Yeah. So so in reality you know there there's not there's again there's there's only a handful of names that are pulling up the market. So yeah, again I think I think folks are just kind of in a bit of a, you know, a wait and see mode in terms of what's going to happen with the economy here. So, you know, I think I think people are, you know, maybe narrow, they're not shifting totally defensive in terms of their equity allocations, but they're certainly thinking about it.

They're certainly being cautious in terms of the shifts to international. You know, it's you know, there's certainly some headwinds for international markets as well. Obviously, Europe, there's some headwinds there from from an economic front there. There is they're still a little bit behind the ball with regards to inflation. It's still running a little bit hotter there relative relative to North American markets. There's certainly a valuation argument that can be made. Obviously, you know, historically, international markets typically trade at a discount to, say the U.S. markets. But I think that that discount is is a little bit wider than it's historically has been. So I think you're certainly seeing some interest from a valuation perspective, and that's why you're seeing some dollars flow in in international markets.

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Étienne Joncas-Bouchard: Yeah, that makes a lot of sense because the valuation one, I feel like it's one we've been talking about for the past 12, 13 years and the discount been there for a long time now it's obviously larger. So actually I was I was looking this up until during the month of July, actually at the end of the month of July was the largest gap in valuation for U.S. versus international markets over the past 20 years at around 6.3 of a PE. Now it's come down a little bit, but still that that gap that you were mentioning is there.

The other point being is like the reason you're buying U.S. markets for more is you've had better earnings growth and you've had on average companies with stronger margins and more, more stable margins. Also, you don't you're not seeing that necessarily right now. And it was in the underlying numbers. If you look at Bloomberg estimates, for example, over the next 12 months, earnings growth is actually expected to be slightly higher in in developed international markets at around 3% in the U.S. is around 1.6.

Now, that can change very quickly because if we go back six months, it was actually seeing negative four for the U.S. and slightly positive for international, whereas in Canada, though, we've actually seen that take off quite a bit. It's down to 12 month expected earnings growth of around nine -9%. And maybe one of the reasons why Canadian Canadian equity ETFs slightly lagged international also on a relative basis, but just a lot of stuff I think that's happened over the quarter. That's that's really. Put us back a little bit, said, okay, what are what are we? What are we trying to do here the next 12 months? And I think the last leg of that and maybe now I'm cheating a little bit, I'm going ahead into a bit of October.

But if you look at the yield curve in in the U.S. now, it's it's flattened out a lot. Is that something that you've that you've been keeping an eye on? Because, you know, we mentioned the duration trade, but it seems like long rates really have picked up recently or as the short end has been kind of now saying the Fed is close to done, how does that impact, you think, on a go forward basis, positioning of, say, fixed income portfolios or at least on the active side, right, where they have the flexibility to adapt? Because if you're buying an index, I mean, you're getting what you're getting the the you know, the the yields yields are decent durations around six and a half, say, for the U.S. AG for candidates a bit longer. But as an active portfolio manager, does this impact positioning on a go forward basis?

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Andrei Bruno: Yeah, I mean, I think it I mean, I think it makes fixed income a hell of a lot more attractive, right? It's it's a it's a lot better investing in a flat, ideally, positively sloped yield curve, but it's certainly better investing in a flat yield curve than a negative than a negative sloping yield curve. You know, if you just think about the role yield, it's obviously you want to get a positive roll yield and best case scenario, which you can get with a positive sloping yield curve. So it's definitely going to make bonds more attractive, I think.

I think there's a few things at play there. Obviously, you know, as we know, the Fed is in quantitative tightening, so they are reducing the size of the balance sheet. There is some selling pressure from international markets just with regards to treasuries. You know, China has been a net seller of treasuries since I think about 2014, 2015. So there are some pressures there on the yield curve that's pushing kind of the belly in the longer end of the curve back up so that things are, you know, a little flatter along the yield curve there. But again, I think it's it's it's it's adding to the attractiveness of bonds on a go forward basis. I think we're getting to a level where the 40 side of your portfolio is actually going to give you some yield and actually it's going to provide some some potential upside, you know, just a shift to the Canadian curve.

I think the Canadian curve is going to have a lot tougher time flattening out relative to the U.S. curve. I think there's a lot of I think the headwinds in Canada are a lot higher relative to the U.S. And I know we've talked about this many, many times before, but it's it's worth repeating. You know, the Canadian economy, when you take a look at the consumer, is just super, super levered, just just on a consumer debt basis. And then when you add in kind of the structural differences in the mortgage market in Canada relative to the U.S., given we've got a much higher proportion of floating rate mortgages or variable rate mortgages, I should say, as well as the term structure of our mortgage market, is much, much tougher than the U.S. In the U.S., there's a lot of 30 year terms, a lot of people refinance that, you know, 2%, 3%. So in Canada, even those folks who are fixed at lower rates, we're going to start to see some of those roll off.

And if you think back to 2020 or even 2019, when rates were super, super low, obviously 2021, they were still low during COVID. You know, those are going to start to roll off, you know, 2025. And, you know, even even even folks who fixed, you know, earlier that 2018 is still super, super low rate. So the Canadian consumer is going to continue to feel the pinch. There's going to be a lot of sticker shock of folks when they refi their mortgage and, you know, realize they've got, you know, several thousand dollars more of outlays a month. So obviously that's going to trickle down into consumption. People think of your consumer discretionary names. People are going to start to cut back. You know, think about, you know, eating out, going to the movies. Folks are going to start to cutting back on those those types of things.

At the end of the day, when you take a look at, you know, previous default cycles and credit events, when when when consumers start defaulting, the last thing they typically want to default on is their mortgage. So credit cards and auto loans are kind of the first thing to go. So, again, there's going to be a lot of pressure, pressure on the Canadian consumers as a result. You're probably see you're going to start to see some pressure on the Canadian banks as well. I know a lot of them have recently increased their provisions for loan losses. And so those those numbers, while they aren't solidified losses there, it's money that the banks have to put away, you know, in anticipation of potential losses down the line. And those do even those provisions, they do hit they do hit the income statement for the bank. So we've seen those steadily being pushed up, probably mostly as it relates to their mortgage books.

So, again, the Canadian the Canadian economy certainly has a lot more headwinds from a macroeconomic perspective relative to the U.S. So, again, you know, again, so for fixed income, you know, I don't I don't think you're going to see the belly in the longer end of the Canadian curve move quite move up as much quite as the U.S. curve. And then from the equity side, yeah, I think you're just going to see, you know, as as the as the uranium estimates are already suggesting, I think you're going to see some sort of contraction there.

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Étienne Joncas-Bouchard: Yeah. Now that's all really good points and you can really see it in just the shape of the curves right now. Like you said, we like the Canadian curve not so long ago is pretty much at par. If not, you know, yields were a bit higher in Canada. Now, you know, we're close to I'm looking at it now, U.S. ten years at 4.9 as of October 20th. Today came ten years at 4.1. That's that's a discrepancy that also leads to it's it's it's got an impact on currency, for example, which has definitely obviously hurt the Canadian dollar. And, you know, one of the main themes I think we've heard from our especially our asset allocation people in Florida last week, we also heard this from our director of Global Macro near in Tema from the CIO of Fidelity Investments Canada Investment Management. Andrew Markazi.

You know, the relative strength of the U.S. versus Canada, albeit once again we've talked we talked about the valuation printing, while all of a sudden it kind of makes more sense also when you're basically on the back of the U.S. consumer versus the Canadian consumer, while things are kind of getting a bit worse here, but not so much so in the U.S., a few other things I wanted to touch on, Andre, that I mentioned, ESG to start now is this you know, you have the opportunity also of talking with with market makers and kind of, you know, obviously dealers and a bit higher up, let's say, you know, talking directly to advisors and investors, is there just a new appetite coming for you or is this maybe just kind of not a fluke, let's say, but really a bounce back of something that was talked about so much in 2020, so much in 2021? And then with 2022, obviously a lot of that stuff was trading at a premium and was more sensitive as rates moved up and you saw some selling off there. But is there deep buying happening as all of a sudden now we we we want to reincorporate ESG as a larger part of the portfolio. Is there anything that you've rumblings you've heard there or maybe it's a nonevent?

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Andrei Bruno: Yes, it's it's a good question. I think you made a good point about, you know, is ESG names are, you know, typically been very sensitive to interest rates. So obviously, as interest rates have marched higher, the ESG names have got hit. You know, you mentioned some flows there recently. You know, I think I think I think I remember taking a look at that, some of those flows and they were pretty pretty large blocks, individual blocks. So it's not necessarily, you know, a lot of, you know, breadth in terms of the underlying buyers of this these particular these particular securities.

And just anecdotally, having conversations with clients, you know, it it hasn't been front and center, to be perfectly honest. You know, will it potentially come back if if rates come down and, you know, will we start talking about a little more? It's very well possible. Just the conversations I've been having right now have been not not necessarily centered around ESG, to be perfectly honest. People are just most of the conversations I've been having is have been around fixed income and rates and to a lesser degree, just about, you know, what do I do with my equities right now? Like, you know, if we are going to recession, what I do with my equities right now. So I'd say those two themes have been kind of dominating the conversations that I've been having with clients.

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Étienne Joncas-Bouchard: No, absolutely. And as much as, you know, the fixed income story feels like it gets better by the day and like the the risk return or the risk reward, I should say, not risk return risk reward of, you know, in fixed income right now seems like it's really, really good, like if yields go up another percent. You're not losing much. If they go down 1%, though, you could make a nice return on on the 40 side to say you're 6040. But, you know, you mentioned the equity side not being as clear. Does that also apply then to say, high yield bonds, which if you look at this year, you know, obviously it's a smaller category and you won't really see like distinct flows into individual high yield ETFs, Right? It's not a category that's very big in Canada anyway, is it?

There are definitely a lot more in the U.S. just because the market's a lot bigger. But, you know, positive on the quarter, positive on the year. At one point, at what point do does high yield maybe then start to reflect the underlying conditions we're seeing in equities where earnings growth cements but a bit weaker, you see an impact on margins from inflation. Default rates on the corporate side haven't trickled up too much, notably anyways, as our managers see it as because one of the main reasons the refinancing that happened in corporate, say in the corporate space in 2020 and 2021. But is there. Is there going to be maybe a bit of waning appetite as we head into the later stages of the cycle for or for high yield? Or is just the yield just it's just so good right now on a nominal basis, you know, north of 8% for for those types of products.

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Andrei Bruno: Yeah. I mean when you're taking a look at when you take a look at the high yield space so you know you dimension, you know, defaults have trickled up modestly, but I still think they're they're relatively low from a historical perspective. You know, one of the good points that I think Jeff Moore made down in down in Palm Beach was that, you know, a lot of these high yield names don't have anything a default to you don't really see that maturity. Well, we don't really hit that maturity wall till about some around 2025. You know, that being said, you don't you don't just need a high yield company, a default to lose money.

You know, obviously if credit spreads widen, you know, spreads widen, price goes down. That's obviously not ideal for your high yield as well. But, you know, there I would think that if we do get into a recession or environment, you could you should expect credit spreads to widen out. Now, the thing here is that's important as well is that there's just so much yield baked in. That, you know, your spreads are going to have to widen that quite a bit for you to kind of kind of end up negative on the year. So I think that's why it's still seeming relatively attractive and that's why, you know, you're still seeing quite a bit of money there and why we haven't seen a ton of selling. And as a result, we haven't seen, you know, market increases and credit spreads. So right now, it still seems, you know, relatively attractive. But, you know, I think what people have to be cognizant of is, you know, we we are potentially going into a recession. At some point, those credit spreads could widen. But again, as I mentioned, the yields are at least juicy enough to provide some cushion to cushion you from any potential defaults or from credit spread widening.

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Étienne Joncas-Bouchard: Yeah, that's a good point. Just to put in perspective, albeit yields are in the top decile for high yield, your spreads are actually in the bottom quartile. So exactly what you're explaining right, is that you do have some yield baked in, but credit spreads just maybe not so not really being compensated for the risk you're taking on. But that's going be interesting how it develops.

The last thing I want to touch on, Andre, and then and I'll let you go and is the multi-asset category. And I guess if Fidelity were you know, we launched some products in 2021, followed up with two others in 2022 are all in one ETF portfolios. Those have been real strong from a flows perspective. Anyways, here at Fidelity so far this year, our F value ETF, an F grow ETF being our second and third bestselling ETFs in house. Is that a category that continues to grow in popularity. The simplicity of it obviously you're buying like a it's basically ETFs an ETF of ETFs you know fully rebalance manage risk all these all these great things. Where is that category going? And I know it's it is historically was driven a lot by the individual investor. But now you're seeing that adoption a lot from advisors incorporating them in in their portfolios also.

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Andrei Bruno: Yeah you've certainly seen since around kind of Q3 of 2020 that that category has been kind of steadily growing in a um, it continues to see inflows. I mean I think there's just, you know, I include our products and there's a lot of good products that that are just resonating with advisors.

So, you know, you know, as you mentioned, we we've got a full suite of products all the way from all equity all the way up to, you know, a conservative mandate. So I think these kind of, you know, low cost, you know, multi-asset mandates are certainly resonating with with investors. And advisors are like, to your point, you know, initially it was, you know, driven by the DIY channels, but now we're seeing a large, large uptick in demand from the advisor community as well. You know, I think these portfolios just provide a nice, you know, especially, you know, if you think about a core and explore approach to portfolio management, it provides a nice steady core position where you're getting your allocation, your asset classes, your geographies in your well-diversified.

And again, you know, one of the reasons why we wanted to and why we created these these solutions was again, we wanted to give the investor a smooth ride over the entire investment cycle. Obviously, diversification is the best way to achieve that. So again, as I mentioned with the core and Explorer approach, you'll see folks buying, you know, a large chunk of the these asset allocation products. And then, you know, around the edges, depending on their market views, are some other goals they're looking to achieve with their portfolio. They can tweak some stuff around the edges to get kind of the portfolio to best meet their investment goals.

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Étienne Joncas-Bouchard: Oh, that was a great, great summary on that front. I think it's good category. This is going to continue to to grow as we go forward. But Andre, we'll leave it at that. Thank you so much for joining us once again. You are our most frequent guest on the podcast and you always deliver. So we'll definitely have you back on. Thanks again for joining us, everybody. We'll see you next time.

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