ETF Exchange Podcast

Episode 31 Rough Transcript

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

In this episode of the Fidelity ETF Exchange, host Étienne Joncas-Bouchard and guest Andrew Clee sit down to recap notable trends and headlines in the Canadian ETF Industry for Q2 2022.

The Canadian ETF industry saw a rare month of outflows to cap off the 2nd quarter of the year, the first in 3 years as investors sold equities to buy bonds. Total year-to-date flows remain strong at $16.9B as of the end of June. Key topics also covered today include the resurgence of flows in fixed-income ETFs, the impact of interest rate hikes on the Canadian ETF industry, as well as a recap of equity factor performance.

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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 I'm very glad to be back in my little home studio here. We took a nice little couple week break as we hit these mid-summer months. And I really hope you, our audience, are enjoying this beautiful weather, getting outside and kind of mixing it up, because I'm sure everybody has been trying to maybe get away from discussing markets, looking at markets. It's been a very difficult year from a performance standpoint, as much for risk-on investors as kind of those risk-averse closer to retirement investors in which fixed income has been a really, truly difficult space to invest in so far this year.

But today, the objective of our episode is to recap what's happened in the second quarter from an ETF flows perspective, also from a market perspective. So, I decided to bring in a special guest here internally from Fidelity, Andrew Clee, who is now, I guess officially, a recurring guest, because it's the second time that Andrew's joining us. So, Andrew, glad to have you. How are you doing?

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Andrew Clee: Good. Thanks for having me, EJB. Appreciate it.

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Étienne Joncas Bouchard: Yeah, I think this is going to be good to get your perspectives. And I know you have the opportunity also to speak with some of our external partners on the ETF side, on the asset management side also. And to get your perspectives on some of these key headlines that I've noted a few and we're going to kind of run through this more as a conversation than like a Q&A, which we tend to do when we have a specific subject or a specific guest.

But before we get into today's topic, just a quick recap of our last episode that we did, which was with my good friend and colleague Andre Bruno, in which we discussed pretty much all the ins and outs of ETF market making and kind of the whole, I guess, behind the scenes, if you will, of the ETF world. And that obviously includes the capital markets sides of trading, pricing, differences between price and NAV. Why do you see potential deviations there? Liquidity, volume versus liquidity? So all those different little topics that I think are very good for anybody who's relatively new to the ETF world or those that kind of want to refine their knowledge on that side of things. So, that is available on fidelity.ca. It is available on your favorite podcast app under Fidelity Connects under the Fidelity ETF Exchange.

So, Clee, let's get into it. Some of the key points that I noted from a flows perspective and some numbers we're going to throw out, but I'm going to make sure to be precise and hopefully be precise, some of them are looking at like the last month or the last quarter. And then we're going to kind of look at the year-to-date numbers to do a recap on where we stand.

The first thing I think that's not alarming, but surprising maybe is the fact that June was actually the first month in three years where we saw net outflows in Canadian ETFs at around $680 million. That was led down by equities, which were negative by about 2.2 billion. Fixed income was positive at around the 2 billion rate. And cryptocurrency, which had been a really strong source of growth from an asset-gathering perspective over the past couple of years was actually down 700 million, making it completely flat on the year. So those are just ... before I get into the different categories, do you have any comments on just those three main ones? You know, obviously equities, fixed income and crypto, which is kind of that third bucket now.

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Andrew Clee: And I think this is where it gets interesting. So, I'm actually not surprised at where the fixed income flows went and fixed incomes have kind of been the dog this year. I think I saw some stats that it's the first time that the bonds, I think we have to go back to like 1978 to see a quarter of bond returns this negative. So we're talking about times that we haven't really experienced for anyone working in this market to see that kind of negativity or those negative returns on the bond market. But what's interesting is if you look where the market's pricing in the terminal rate and kind of where fixed income flows turned around, the high on the U.S. ten-year yield was 3.5%. And that hit at about June 14th or June 15th. And then we also look at where the market's pricing and where is the Fed going to stop hiking interest rates. And that number is also 3.5%. So I think that a lot of the market viewed that 3.5% level in mid-June as a time to kind of back up the truck and start buying bonds again.

And then when you look at the opportunity set, where did that money get funded from was equities. So if you look at it, you touched on it earlier, 2.2 out of equities, 2 billion into bonds. Those kind of perfectly offset each other almost identically. So, I'm just speculating. So, we don't actually see that the real numbers behind it, but the time to buy bonds was funded out of your stocks because the return opportunity was pretty good. And just for context, that ten-year yield is now down to 3%. So that's a pretty juicy return right there when you're looking at the duration bet. So just for reminders to everyone, every 100-basis point move in the yield curve on a ten-year yield is a 10% return, right? So the bonds have kind of rallied 5% off of that three and a half year high.

Where we go from here, I think is the question. So sitting at 3%, rather than heading back to 3.5 or heading lower. And that's all going to be dependent on the Fed and inflation. I don't think we've got that right at all year to date. I saw Canadian CPI this morning came in lower than expected, but in the U.S. it was higher than expected. So, it's a bit of a mismatch there.

And then as it relates to crypto, that was an interesting month. It was contagion. And so for anyone that wants to go through time and think about how this relates to other asset class, this was a de-leveraging event and there was a lot of exposure of counterparty risk that I think the market underappreciated. So we saw a lot of exchanges halt redemptions just because they have liquidity issues due to some key counterparties that were over levered going under.

And it kind of brings me back to long-term capital management. If any of you recall that in the late '90s, it was a hedge fund that was essentially levering up credit spreads and eventually got levered up 101 to 1 betting on credit spreads tightening. They actually had to get the Federal Reserve involved in bail outs and banks and discussions. They ultimately wound down that fund. But it was kind of the contagion that spread through the derivatives markets in the '90s. And I think we went through a very similar event for the crypto markets just in the month of June and even before that in May, which kind of brought the sentiment down. So, it was interesting because it truly was a counterparty and overleverage type event, kind of what we saw similar to derivatives in the 90s.

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Étienne Joncas-Bouchard: Those are all really great points. And I think a few interesting comments that I just retained from what you said there is that overall theme of just reducing risk, right? Almost like as much on what you said on the crypto side, as you said on like if you look at just from an asset class perspective, it seemed like bonds, obviously that events in '78, I think of that, I saw the same thing where it was like the worst quarter and also the worst 12-month return since 1980 or something like that. So, the whole ETF industry had not really felt that. And what's quite interesting is that the large majority of assets in fixed-income ETFs is in long-duration type portfolios, right? Like you think of those ag index type products, especially here in Canada, where if you're buying kind of a passive-based ETF that's replicating the FTSE Canada Universe Bond Index, you have a duration of above eight. It seemed like that was somewhat the way to go as yields were starting to show signs of potentially topping out given where the terminal rates were setting up and kind of seeing that already start to take place.

What's really interesting also, though, is that I think the second quarter was also characterized – and this is kind of just more of a, I think, maybe a sentiment thing – is that the market started to realize that like I think the first quarter is what we're expecting things will eventually slow down. But in the second quarter people were like, oh, things are actually slowing down. And you saw central banks hiking into that kind of economic activity weakness that we're starting to see, which really caused maybe a little bit more panic or maybe pricing in a higher probability of a recession. So it is that also what dictated a little bit more of a move to the fixed income is that, regardless of where rates are expected to go, if we do see a significant slowdown in economic activity, that should push yields down.

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Andrew Clee: Yeah, this is one of the weirdest environments that I think we've been in. I've never seen such general consensus that we're heading into a recession. Like it's pretty shocking. Like if you look at the pessimism indexes and whatever you want, it's like we're at all-time lows in the sense that people have never been more pessimistic, like in the history of the data that we've collected.

And the worry here is, and I'll say this in twofold, the consumer is the most important thing to North America in terms of GDP growth. Like we're talking over two thirds of GDP comes from the consumer. The consumer is actually not in as weak a position as we've seen in historical recessions. Like if you think about what COVID did, it actually ramped up a lot of people savings because they weren't able to travel, they weren't able to do the things they like. And so we're talking about a recession. And this is more so for the American consumer than the Canadian consumer. They're actually pretty

strong in terms of where they are right now. The Canadians are much over-levered compared to a U.S. consumer. But when you talk about Canada's reliance on the U.S., it's actually important to note that we're heavily dependent on the growth of the U.S., just given that we export a tremendous amount of our exports to the U.S.A. So, if they're strong, we can be strong as well.

So, I think what's interesting, like, I don't know if any of you watched the retail sales last week. The whole market was expecting retail sales to decline and they actually grew 1%. So you kind of sit there and go. The consumer's still spending. We have decent balance sheets in the U.S.A. This could be a scenario where we actually talk ourselves into recession because if every CEO and consumer expects it, they might line up like we've heard about the tech companies slowing growth. They're not cutting jobs next year, but they're saying we're not going to hire at the pace we did. The concern here is that we talk ourselves into recession, even though we might not have to head there.

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Étienne Joncas-Bouchard: And I guess to further your point, if we are to be on the optimistic side, which I think, you know, why not? Let's do it. The labour market's quite outstanding also in the sense that, like, we're at historically low unemployment levels. Wages are growing, maybe not as fast as what we've seen from a consumer prices standpoint, at least not obviously matching that. But it's not bad either. So you haven't seen kind of that deterioration in the labour market, which is generally speaking, obviously a kind of a lagging indicator. But I think where some are making maybe a stronger assumption that there will be a recession, if I flip to the other side, is some of the leading indicators and like for example, new orders or if you look at inventory builds. Those are some things that could be slightly worrisome.

And from a fixed income perspective, the markets, the way that they've reacted to maybe some of that pessimism is that spreads have started to widen again. Is that something that you expect could continue? Because that was also something that happened obviously in Q2, is that spreads are, if we look at triple B's, double B's, triple C's, they're the widest they've been since March 2020. They've come down a little bit now over the past couple of weeks. But if we look at Q2 in general, that was something that did occur and kind of offset that maybe a little bit of a squeeze we saw on the Treasury side, for example. What do you see there?

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Andrew Clee: Yeah, I think this is ... I'm going to answer two questions here because I think you had a really important point on inventory build before. But as it relates to credit spreads, so high yield typically trades at 400 or 700 over treasuries. We're kind of trading that range 550 to 600 right now, which is, I would say is no man's land as it relates to high-yield spreads. So 400 is times are good, spreads are tight, 700 times are poor. We're worried about it. We're kind of playing that teeter totter right now. You touched on March 2020. We got to 1100 or 1200 over. That was a liquidity crisis. There were zero bids on bonds at that point. And I don't think we're heading back there just because we do have more guidance on how we're going to get out of this and the impact that Omicron is not as severe as the original wave or alpha or delta. So I don't think we're going back there.

I think to your point that what we need to watch out is rather going back to 400, we're going back to 700. I'm not saying that credit is a screaming buy here. I'm not sure which way we go. But when you're looking at yields as it relates today, let's take, for example, our multisector bond fund. It yields over 5% on its coupon. It runs a five-year duration. We've got a yield curve that's sitting at 3%. And so in order for that to be in a negative return territory, you need the five-year yield to go to 4%, right? And we're break even in there. So 100 basis points up means that we're going to lose 5% on capital appreciation. So a capital loss of 5%, but our coupon is 5%. So the total return proposition is zero if you think that we're going to 400 basis points on the five-year yield, but then when you look at what the terminal rate expectation is for the Federal Reserve, it's currently sitting at 3.5%.

So I would just buy something diversified. I don't think that you can make the call on high yield right now because I think it's no man's land. But I think when you're looking at something diversified that invests in high yield, floating rate, investment grade and government's like multisector bond, fixed income is a really attractive proposition when I look at it compared to the equity markets, which I can touch on a bit. But then as it relates to your inventory and your capital, your new orders, for example, so we're talking about inflation, right? The Fed needs to fight inflation. And a lot of the retailers got demand very, very wrong. And because of the supply chain issues, they brought forward a ton of inventory. And I think you saw that in the target earnings in Q1 and you saw that across stores, your Walmart and Amazon. Too much inventory. And the reason the Fed has to hike potentially up to 400 on a terminal rate is because of inflation. But what isinventory demand of retailers? It's not higher prices. There's only one way to get through inventory and that's to lower prices.

So you actually sit in a situation where we're probably looking at price cuts on consumer goods because there's so much inventory sitting there and you're probably looking at, and we've been talking about this, but the supply chain eventually has to resolve itself. So then your bogey becomes energy and food costs. So I do think that inflation and I'm not willing to call the month, but it's going to roll over at some time before the end of this year. And I think some of our analysts down on the fixed-income team believe you could see a 4% handle by December just because of base effects, right? So that kind of relieves the Fed from having to go to 4%. So when I weigh the risk, when you look at 3% yield right now, the risk of going to 4%, which is where you get to a break even proposition, it's not a terrible place to be.

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Étienne Joncas Bouchard: I agree with you. I think there's a lot of investors that are now seeing bonds not only for its potential for capital preservation, but it is seemingly like a good opportunity. And that's such a great point, I think on inflation is, that it's probably, I mean, it is 100% a backward-looking metric. We're not taking into consideration the developments that we're seeing now and we've been talking about like that's the fundamental business activity side. But if you look also input prices are coming down too. Commodity prices have started to slow in Q2, energy prices. Obviously there's the overhang of the ongoing conflict in Ukraine with Russia is putting pressure on certain commodities, like, for example, oil and that, gas and others. But if you take a look at lumber and you take a look at some of that, like copper base metals, precious metals, those are coming. They have come down. Not to say that that necessarily continues, but I think you will see that eventually be reflected into CPI and PPI, the producer price index.

And it should alleviate some of those pressures on central banks, to say at least now they've maybe, I guess, frontloaded what they have to do probably in a longer time period because in Q2 we've also seen some pretty aggressive rate hikes actually get put into play like we saw in Q1 that get priced in. And then we saw them act on it, which a lot of people didn't maybe expect for them to actually deliver on those promises because of the way that they've acted in the past. They could easily as we go forward, if they do see inflation comes under control and then labour market maybe slowly starts to deteriorate a little bit, for whatever reason, put that back on hold. And then you see you find yourself in a very positive environment for fixed income also.

In equities, which maybe we can switch the conversation to equities a little bit, which from a factor perspective, which is also something that we talk about quite a bit here at Fidelity, given our lineup, which is heavily focused on smart beta investing or factor investing. In the first quarter, you really saw that value cyclical trade work. But in the second quarter, it really started to give up a lot of that benefit that it provided when inflation was ramping up and inflation expectations were ramping up. You started to see those defensive factors start to come back into play. Also like low volatility, high quality. Those are the factors that have started to work again. And I think as we kind of move forward in this economic cycle, I think we've turned the page already to a late-cycle type dynamic. Is that the factors that you're looking at in the coming quarters or you think value and kind of dividend which is also a bit more cyclical continue to have that leg up going into the end of the year? What are your perspectives on the factor side? Let's just put it that way and I'll let you kind of roll with that.

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Andrew Clee: Well, you and I have worked together through the entire launch of Fidelity ETF line ups. Quality was always like 95th percentile in terms of expensiveness, and now it's below 10%. So let's have a look at 10%. Relative to history, it means quality stocks have only been cheaper 10% of the time.

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Étienne Joncas Bouchard: But we also launched quality in 20.. or was it 2019, which was like it was in it's like three-year strong run, right? From 2018 to 2020, it was really the top performer or if not, if it wasn't a top performer, it was the second best performer. But you've had this reset to start the year because it was trading at that premium, being more sensitive to moves and rates and the cost of capital. But like you said, it's seemingly also attractive on a valuation front now.

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Andrew Clee: Yeah, so I'm looking at quality quite strongly. I still hold the value ETF suite and that's just comes back to the fact that that's my best hedge against inflation from an equity standpoint. And I'll admit I'm not good at forecasting inflation. I don't think the economists are very good at forecasting inflation, given how often we've been wrong through this entire year on getting inflation right. I think the Federal Reserve is struggling with forecasting inflation just given how behind the curve they were in the shift from transitory to more permanent inflation. So I like to barbell it right now between value and quality. And as we get a clearer inflation picture, let's just say decelerating inflation, I'm starting to move into quality, more overweight and increasing inflation. I favor that value.

Low vol obviously is the most defensive positioning. So if you're worried about the equity markets, low vol is the place to be. But the way to think about it, and I think this is the most interesting part of the market is pessimism is so low that you're probably like, I don't know where the bottom is. Let's put it this way: it takes 6 to 12 months for interest rates to make its way through the companies, at least from a bottom line perspective. So we're probably not there yet, but if you take where we're trading, so the entire fall of the S&P 500 from a price-to-earnings basis has been priced. We haven't really seen a rerating of earnings yet. So we're trading about 17 times forward price-to-earnings ratio.

So for everyone to think about, you have your P on your top and you have your E on the bottom. And the whole market decline right now is that E has been very stable. So it's just the price that's been coming down. Earnings expectations are currently sitting at about $230, just shy of $230 for the S&P 500, which gets us to the 3900 level we're trading today. So if you wanted to take, let's call it close to a 15% reduction in earnings estimates, because I think there is expectations that as interest rates go higher, earnings estimates should come down. So let's assume for our $200 earnings. So we're currently expecting 230 for the S&P 500. If we're expecting 200 for the S&P 500, that puts in a support level of about 3450. So let's call it 12, 13% drop from where we are today. So it's really the view of how pessimistic are you on earnings? That's the next shoe to drop if there is going to be a shoe to drop. If 200 is a reasonable estimate from 230, that's a pretty big rerating: 12% downside. I love bonds where we are just given the yield versus the duration bets where you are. But I also don't hate equities.

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Étienne Joncas Bouchard: I think that's a great point to bring up is that if we look at certain areas of the market, I mean, let's take away that kind of very high speculative growth stuff, that worked well in COVID that has taken a massive haircut. If you look at some of the ... once again, it really falls into that kind of high-quality space also. But the kind of the quality compounders, growers, the ones that are generating a ton of free cash flow, right? Which I think is going to be extremely important in the next twelve months, like you said, because if we see a reduction, for example, an expected earnings

per share because margins are coming down, because the producer prices they paid last year to build their goods and provide their services has gone up and now they're forced to potentially sell at lower because of that, maybe a little bit higher supply that they have and met with a bit lower demand. Why wouldn't you favour companies that are a lot more stable in their margins in the way that they manage their business, which is two screens that are used in low vol and quality? So I think those two factors, if we do see kind of what you're mentioning, maybe that drop in expected earnings eventually materializing, those are two factors that could potentially do well in that environment.

And to your point in kind of the peak pessimism, I was reading the results of the survey from Bank of America from among asset managers. And the percentage of asset managers taking more risk than usual is at -60% versus the average, which is the lowest it's been since 08. So basically, managers are getting defensive. And on top of that, going back to what we were saying and I just pulled it up here, that's why I'll point the stats out for audience. But we were talking about that consensus recession that we're walking into. Basically, it's kind of like running into a brick wall. More than 50% of participants think that we're heading into a recession in the next 12 months, which is the highest it's been since 2020. And then before that, going into '08 or actually after '08, which is [inaudible]. So it just seems like that's the expectation, right? But we'll see how it plays out.

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Andrew Clee: I agree with all those points. And I think … speaking of that B of A report, their economist switched to bullish yesterday. And so he was the most bearish guy on the street since January, and he absolutely got it right. He's actually kind of switched his view. It's a little bit founded in the pessimism case. I think it lacks kind of some of the earning downgrade risk, but…

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Étienne Joncas Bouchard: It's kind of like a contrarian call to a certain extent, right? It's that saying how much worse can things get type thing from an expectations standpoint? Not like an actual reporting standpoint, which we'll follow eventually.

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Andrew Clee: But if I had a short-term liability, I wouldn't be risking it in the market right now. But five-plus years, I think the average cost could point to the market.

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Étienne Joncas Bouchard: Well, Clee, we're already up to about 25 minutes. Is there something that I missed that you think our audience would be interested in? Something that you've noticed maybe over the last quarter that stood out to you, could be on thematics, could be … I noticed ESG flows were still fairly positive to start the year: 1.6 billion. That's quite interesting. I think, surprisingly, given it is a little bit more growth oriented, right? Is there something else that stood out to you?

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Andrew Clee: No, I think the key here is we saw a tremendous shift from growth to value. I think you're starting to see some of the institutions start nipping away back at that growth trade. And if interest rates are to go lower, the discount rates in which we value those future cash flows and I say future cash flows not for future revenue, right? So there's a difference between a company that has negative earnings and huge revenue growth and a company that has increasing

positive cash flows over the next ten years. As interest rates come down, so do those discount rates, which allows for the rerating of multiples higher. So I think it's time to start looking in that quality suite again. I think you're starting to see some institutional flows at that way.

And the other interesting thing is, as I've worked through the end of the last commodity cycle and when you speak to year-to-day flows, about 30% of Canadian ETF flows are going to Canadian equity. I've been working in the ETF market for over a decade and I've never seen Canadian equity since the last commodity cycle lead the chart this point in the year. So I think that home country bias we have is paying off and I'm sure all of you feel that in your portfolios, but it's interesting to see Canada back on the map. So I'm watching that long-term secular commodity trade.

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Étienne Joncas Bouchard: Interesting. Well, great, as always. Andrew, thank you so much for joining us. Until next time.

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Andrew Clee: Yeah, thanks Étienne, and pleasure to be here.

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Étienne Joncas Bouchard: Awesome. Thanks. Thank you, everyone. Have a great rest of your day.

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