Fidelity Connects

Navigating Uncertainty: A Look at the Future of Global Equities

Jeremy Podger, Portfolio Manager

Pamela Ritchie, Host

Announcer: Hello and welcome to Fidelity Connects – a Fidelity Investments Canada podcast – connecting you to the world of investing and helping you stay ahead.

On today's show, we welcome Portfolio Manager Jeremy Podger as he joins us on the program to discuss how to navigate the global marketplace.

With over 25 plus years' experience, Jeremy manages the Fidelity Global Fund which aims to

uncover potential investment opportunities among high-quality businesses, undervalued securities and companies undergoing positive change.

Jeremy says 2023 so far is looking positive for global markets compared to last year and that's because of a few major turning points, which includes the bond market, currency, technology and the value versus growth story.

For the Fidelity Global Fund, there is a full-circle outlook in terms of its allocation. He says the fund is back to being overweight in Europe and Japan, overweight in healthcare and financials, and there is a bit more caution towards communications and technology.

Jeremy also discusses the reopening of China and its economy, European Central Banks, and how he's looking at emerging markets.

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Pamela Ritchie: Let's take a look at the relative story, ultimately, for investors in North America looking to other places around the world. A lot actually has changed with the changing of the year, hasn't it?

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Jeremy Podger: Yeah, it's quite remarkable when we think how far we've come in just a couple of months. Going into the third quarter, people were desperately gloomy. There'd been a fear that Europe was going to be plunged into recession. People didn't know what was happening in China. And suddenly we find ourselves now in a positive market condition with everybody looking through the apparent current downturn to better times ahead. So, yes, certainly there's been a huge change in sentiment.

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Pamela Ritchie: When you look at sort of, pivot is a loaded word this year, but there were other areas around the world in terms of markets and things that changed within the global marketplace. What were those turning points that perhaps have us turning attention back to Europe, actually?

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Jeremy Podger: We can look at the short-term turning points, but I think 2022 was really significant in terms of long-term turning points and certainly shook up, I think, quite a lot of investors through long-term assumptions about what works in investing. I think they're really related but the four most important ones are clearly the bond market backdrop, the end of the 30-year bull market in bonds would be the first turning point. Then the dollar, which clearly turned in the fourth quarter from very extended levels in terms of purchasing power. That has removed the relative support for the U.S. market compared to others. The third turning point, I think, is technology. We haven't really seen a turn like this since the tech bubble of 2000, 2001. Finally, which is kind of related to these points, is the turn in value versus growth. A lot of investors had become naturally very growth-biased and I think that assumption was very much shaken up last year.

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Pamela Ritchie: Fascinating how that has worked out. On the European front, and, I guess, you'll acknowledge for us that this has been quite a month to start the year. But that said, getting past some of the nervousness on the energy front for Europe was also a huge piece of the story, the relative story.

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Jeremy Podger: That's absolutely the case. It was really probably September, early October, that we started to realize, ahead of the worst potential weather in winter, that gas stocks were being rebuilt faster than normal. Europe's done a good job on the supply side getting in more LNG, for sure, to replace Russian gas. But on the demand side, that has fallen enormously, much more than people thought it would do. Industries have switched their fuels. Households have been using less gas. So, really, those gas inventories were rebuilt. It meant that through the fourth quarter, people stopped worrying about a crisis at the end of 2023, caused by gas, and obviously we've seen very sharp falls in gas prices as well. That meant better growth for Europe. It meant that the ECB could raise interest rates to control inflation without people worrying too much about tipping into a really deep recession. I think that that largely explains some of the relative performance that we've seen out of Europe in the last three months.

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Pamela Ritchie: It's been really fascinating. When we spoke to you, I can't remember exactly when it was, but it was a few months back and you still had, maybe even a year ago, tell us how you're allocated now, how differently things are. The tech story, as you mentioned off the top, has been a big change, ultimately. Tell us a bit about your allocation in the fund.

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Jeremy Podger: Geographically, we've sort of gone full circle really, compared to a year ago. Obviously, we weren't anticipating the Ukraine situation and that caused us to reduce risk from the end of February last year. Later on in the year we rebuilt the exposure, so we are back to being over benchmark weighted in Europe and also actually in Japan. As far as sectors are concerned, if you look at the broader tech sector and you include communication services as well, then moved basically we moved below bench about a year ago. That's pretty significant for us because we have been for many years over benchmark in tech. We're not giving up on it by any means. It's such an interesting broad sector, there are always opportunities but from a top-down point of view, from a relative valuation point of view, we are more cautious. We continue to be relatively cautious, in fact, on that sector.

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Pamela Ritchie: Let's bring in sort of where you are more overweight. I mean, which sectors, first of all, are those?

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Jeremy Podger: Our two favourite sectors in that way are health care, which I know has been a place for a lot of people to hide but we still think it's got a lot going for it, and financials as well. That has kind of evolved over the last year from being more of a focus on diversified financials and insurance and progressively through the increasing to banks where we've gone from below benchmark to over benchmark.

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Pamela Ritchie: When you go back to the years of sort of the European debt crisis and the consolidation that we thought was going to take place, bring us up to date on that story? Is that still something that's sort of being discussed or have we moved past that?

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Jeremy Podger: Europe has done a reasonable job coming through the pandemic period of building funds which still, to an extent, have not been dispersed. There is less concern now about fragmentation and sovereign debt issues in Europe. But if we think about investing in financials, particularly in the bank sector, there had been a bit of a two-way pull, really, in banks in the early part of last year. Think back to the Ukraine situation where people were very focused on potential credit risk. But then as the economic outlook improved and interest rates were raised, then the benefit that banks get from being able, finally, to make a margin on deposits, it significantly outweighed any concern about the credit cycle. We were then left with, for example, a European bank sector which was trading at roughly half book value with potential to earn, in this interest rate environment, significantly above cost of capital returns on that book. So, unsurprisingly, we've seen an upward revaluation and in the fourth quarter, for example, we added it to a high-quality Belgian bank. That continues to do well. I think there could be some further mileage although you have to be a bit more selective within the sector now.

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Pamela Ritchie: You spoke about the energy situation, where things have landed, ultimately. What about industrials, ultimately, that have to use those inputs?

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Jeremy Podger: Industrials, that's been an area of focus for a lot of people. 2022 was actually quite a strong year for capital expenditure. We have some background stories there to support that. Traditionally, the energy sector and the mining sector have been very significant contributors to CapEx. On top of that, we have the Inflation Reduction Act and thoughts about all the CapEx that is needed to decarbonize the economy. Now, the situation this year, I think, is that because economies are slowing, PMIs have been falling, so traditional CapEx is likely to decline. I think the long-term arguments around decarbonization are still there, but I think we could get negative surprises on CapEx and that leaves a lot of the capital goods companies looking actually quite expensive in relation to these PMI indicators. It looks like the market is being far too optimistic and looking through the current downturn, so our preference, really, even though we are, in fact, slightly over benchmark in industrials, is to focus on those areas that we think have good near and long-term prospects in the transition economy, moving away from carbon and some automation exposure as well.

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Pamela Ritchie: That's interesting. Automation, we'll come back to that. It just makes me think of the reopening of China. Much discussion about the European economic, the benefits, ultimately, from China reopening, travel, business, everything getting somewhat back to normal. We all know having gone through various reopenings that they're not necessarily smooth, but it must, ultimately, be bullish for Europe.

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Jeremy Podger: Yeah, absolutely and obviously, for some stocks more than others. So, if you're thinking about China travel and the China consumer, then one sector that's done really almost as well as the banks recently within Europe is the luxury goods sector. Europe is very good in this industry. We have an exposure there to [indecipherable] which we added last year and that's been very strong recently. I think valuations are still okay and rather, as we saw in the U.S., the Chinese consumer is sitting on a lot of excess savings right now. That is certainly one angle that we look at. But as far as the more general question of China opening up is concerned, yes, I think it's a big deal. There are still lots of problems, particularly in the property sector, so we're not going completely mad for mining companies supplying construction in China. But on the other hand, I think that's good for Japan and Japan trade with China in general as well. So, a number of the companies that we own in Japan are well geared into that.

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Pamela Ritchie: That's very interesting. So, Japan is sort of an exposure even more than usual?

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Jeremy Podger: Europe is slightly more of a tilt than Japan but I think, you know, we've got a list of stocks that we look at on a quarterly basis, there are a lot of Japanese stocks that we want to re-examine, actually, quite a number, I think, of potential opportunities.

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Pamela Ritchie: Going back to some of the pieces of the valuation, the relative story, it certainly goes to the central banks. We've seen the ECB now get going. The Bank of England's had to get going for some time, but the ECB being able to really move on the interest rate front. Tell us a bit more about on the currency side of things and again just how much further it probably has to go.

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Jeremy Podger: It's extraordinary thinking how far we've come in terms of the way we perceive central bank policy in just a couple of years. Not so long ago everybody thought that even a half a point increase would just tip Europe into permanent recession. That's not the case. This has been about normalizing interest rates. I think that that is generally a positive thing. Obviously, the last rate rise slightly greater for Europe than for the U.S. and that supports the currency argument. I think on a purchasing power basis, the dollar is still looking quite expensive despite giving up about half of its gains of the year in the last quarter. The Japanese yen is kind of absurdly cheap on that measure, I think, at the moment. Central banks have found a new mission and one of the things that worries us is that, for the first time in a while, in recent months the market consensus and what the central banks are saying have moved quite far apart.

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The markets optimistically have been saying there will be a pivot, to use the word you mentioned earlier, around the middle of the year. Central banks said, no, we're going to stick with it until the job is done. History is more on the central bank side: they don't tend to cut until recession is upon us. The jobs report from last week in the U.S. probably supports the central bank's stance rather more than market participants have been saying. So, I think it's fascinating at the moment. The risk is that there is no pivot, we do see a downturn, and I think that's going to make markets quite bumpy over the next several months.

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Pamela Ritchie: Do you think international equities will have more upside than U.S.?

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Jeremy Podger: Well, yes. We've saying this for a little while. As I mentioned earlier with these turning points, a large part of the performance story for the U.S. has been rooted in technology where earnings had been very, very strong and clearly, were given a boost in the pandemic period. That's going to reverse. We're seeing the Q4 numbers come out now. Tech earnings in the States are about 10% down year-on-year in terms of the defined tech sector.

Where we are in terms of valuations, for this year we're looking at the U.S. market on more than 18 times price earnings ratio and that compares to 12 to 13 for Europe and Japan, a little bit lower for the U.K. Outside the U.S., valuations are kind of normal or kind of cycle average. In the U.S., they're still above. So, there's definitely a valuation argument on top of all those other arguments about sort of long-term change in momentum.

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Pamela Ritchie: Broadly a question on EM, on emerging markets, where that fits into the overall story for you. We'll start there. There's another question that's somewhat linked to it. What do you think on EM?

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Jeremy Podger: It's always difficult to completely generalize about emerging markets. One thing you can say in sort of defence of emerging markets is they did perform terribly badly. Also, the central banks in emerging markets were quite pre-emptive and had generally more aggressive rate rises than in the U.S. I'm putting China to one side for now. Now, valuations are reasonably attractive but as I say, you have to take it region by region. If we firstly take China, I think we've basically seen just about a 50% rise from the low. China, the valuation fell from about 18 times forward earnings to 8 times forward earnings. And we're now back to, I think, a reasonable valuation level. Our approach is to try and take advantage of any opening up in China as much through non-Chinese stocks, through developed market stocks, as through actual Chinese stocks. We start with the small China exposure that we had in Q4.

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Now, on other emerging markets, I think with the exception of Mexico, Latin America is looking a bit tricky at the moment. There are political and economic challenges. We have some small exposure but it's very, very stock specific. I think emerging markets is fine now, we're not as bearish as we were. There's a good asset allocation argument for China because it's uncorrelated. But I don't feel like we're staring a massive opportunity in the same way that we did back in 2001 before EM had a 10-year bull market. It doesn't feel like that.

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Pamela Ritchie: What does it feel like when you hear the discussion, within the sort of discussion of EM — which I always wonder if it's the right way to be discussing it but in any case — of India sort of replacing China as a growth engine of the world. There's been a big spotlight on India lately due to big investors, big stories to go with it. But just a general thought of sort of India taking over the growth story, ultimately, within EM.

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Jeremy Podger: To a large extent, I'm/I buy it. I think that that's absolutely right. You've got more favourable demographics. The pandemic told us that a lot of business could be done virtually or remotely, which favours India and their technology sector which is really well developed and very highly skilled. At the same time, companies are trying to diversify their supply chains. We have Apple, for example, building up manufacturing in India. There's an awful lot more of this to happen and that's on top of pretty favourable demographics. The medium- and long-term picture fundamentally is, I think, fantastic. The issue has been more to do with valuation. Obviously, that's been some negative headlines recently, but I think we need to work through that. It's certainly a country that we're looking at. We have some exposure; it's not huge at the moment.

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Pamela Ritchie: What are your thoughts on, specifically on the China reopening but looking at the energy market, looking at the oil price globally?

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Jeremy Podger: I wouldn't claim to be an expert on the energy price. A lot obviously, depends on the resolve of OPEC. Our energy experts are pretty happy with oil around these prices and see more of an upside skew in terms of risk to prices from here. This was a spectacularly strong performing sector last year and we've got to be a bit careful when we look at parts of this complex. For a lot of last year, gas prices were squeezed higher, partly for the reasons that I talked about in Europe. Gas prices have collapsed more recently. Refining margins have been super high but they look unsustainable. So, we've got to be a bit more, I think, a bit more circumspect.

Our process is such that we tend not to be very heavily exposed to commodity-driven stocks because they depend on a variable that we much prefer to invest in companies with self-help potential and this kind of thing rather than being very dependent on that variable. We are below benchmark in upstream oil and gas. We quite like services. I think that that continues to look like a good area. So, oil and gas services, particularly where those companies are involved in carbon capture and part of the carbon transition story.

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Pamela Ritchie: Canada loves that story. Big story in Canada, carbon capture story. Something that you mentioned off the top is one of the huge turning points that sort of unfolded last year but just to get perhaps some more thoughts on that looking forward, is the value versus growth discussion globally.

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Jeremy Podger: We've seen a big rally in value. As I mentioned earlier, it started last year really kicked off by energy and materials mining companies and then really broadened out and particularly financials got taken with it. When we look across the universe of value companies, they still look cheap. That gap in valuation between value and growth is still unusually wide. For value to work from here you have to believe, I think, that bond yields are not going to go back down to super low levels, that there will be a certain amount of background inflation. But I think that we have seen the turn and my concern more this year is that it will be very rotational. We'll see people moving from value to growth. It's, I think, really important to have a balanced approach for this year. If I was betting on a 5-year view, I think value is more likely to win.

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Pamela Ritchie: Interesting. That's really great to get your thoughts there. Is style, you want to be balanced so that's interesting to sort of see which would pull ahead if you really kind of had to lay it out there. But when we apply, ultimately, some of those thoughts perhaps to Europe, because there's much discussion around this, the question is, does it have legs? How does it look from here on in? It has been an extraordinary beginning of the year.

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Jeremy Podger: It has, yeah. Europe up 30% from the low, the last quarter boosted by the strengthening of the currency against the U.S. dollar. Well, I think valuation is on its side. There are a lot of excellent companies in Europe. Europe is more of a value market rather than a growth market. That's certainly true. It's not just financials that we've been adding to. We have actually, somewhat bravely, added to autos which look really cheap with big backlogs, for example, for Mercedes Benz. Why does it have legs? Well, just very simply from an investor positioning point of view, two weeks ago we saw the first positive flow into Europe for 48 weeks. Investors have been taking money out since the Ukraine invasion and it's only just started to reverse. So I think it probably has legs.

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Pamela Ritchie: What is or what are the market risks that concern you, just for us to know what you're watching?

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Jeremy Podger: Broadly speaking, I think there's a certain tension between what bond market participants see and what equity market participants see. Bond market participants are happy investing in sovereign bonds now because they see a slowdown and a fall in inflation. Equity investors are trying to look through the downturn to the recovery. I think the biggest risk is we don't see pivot from the central bank. We do continue to see labour market inflation, labour market tightness and we see earnings fall. That could mean another period where both equities and bonds do badly. I'm sure that there will be a period like that this year and that, I guess, is my main concern. I don't think we're facing sort of existential risks at this point, fingers crossed.

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Pamela Ritchie: So, the balanced approach. It's so interesting to get your thoughts, particularly after last year, and to sort of see what everyone's gotten through and where we're going. Jeremy Podger, thank you for joining us.

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Jeremy Podger: Thanks very much.

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