Fidelity Connects

Fall ETF Trends

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Voiceover: Podcast Intro –Andrei Bruno Podcast

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

One of the most common market questions being asked is 'have we reached the bottom?' With yet another rate hike recently, one emerging view is that 'we may be getting closer to the end.' So, with this view in mind, what are the market expectations at this point in the cycle? What role do ETFs play and how should investors position their portfolios moving forward?

ETF Capital Markets Director, Andrei Bruno joins us today to share insights on the latest market action, leadership in the ETF landscape, and thoughts on current and long-term portfolio construction.

Additionally, with host Pamela Ritchie, Andrei shares today that he believes, as we get a little bit more clarity into the inflation story and what the Fed and the Bank of Canada are going to do, it is time to start looking at fixed income. Andrei also notes that the upcoming earnings season is going to be very important for the equity outlook. Stay tuned for this and more.

Today's podcast was recorded on September 23, 2022.

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Pamela Ritchie: Welcome, Andrei. Great to speak with you.

[00:01:56]

Andrei Bruno: Thank you for having me and thank you all for joining us.

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Pamela Ritchie: It's great to have you spending some time here with us. Actually, what I'm going to start with because the markets —once we get into those— I feel like it's going to be one long conversation. Just tell us a little bit about your title. What does it mean? What do you do with your hours and days?

[00:02:16]

Andrei Bruno: Yes, that's a great question. Overseeing the ETF capital markets side of the business here for the ETF space; specifically, what I look at and what I take care of, what my day-to-day is like. I'm focusing on kind of the primary and secondary markets in terms of our ETFs. What does that mean? We take a look at, and we monitor how our ETFs are trading in the market, ensuring there is ample liquidity, ensuring bid offer spreads are staying within reasonable margins. With regards to primary market activity, if we think about ETFs and to contrast them with equities, equities typically have kind of a stable shares outstanding. Obviously, there's some secondary offerings and share buybacks, but generally speaking, equity markets... the equities have a fixed shares outstanding. An ETF market, that's very different. The amount of shares outstanding for ETFs are changing all the time. There's consistently being creations and redemptions from our market makers. That process is overseen by my team, and we ensure that that process is smooth, our market makers are getting everything they need in order to make markets in our ETFs and ensure that trading is very smooth in the secondary as well as the primary market.

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Pamela Ritchie: Fantastic. It's great to just sort of put some context around the title itself. You look across the markets right now; we can obviously see what's going on with equity markets. Yesterday was a massive move in bond markets, or it certainly got things kicking out of the Fed decision. Is there some reason to be quite actually optimistic on the fixed income side of things? What do you think?

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Andrei Bruno: There is a couple of things to look at. Obviously, we had the Fed move as we expected on Wednesday. We had Powell speaking. Chairman Powell didn't say anything too out of the ordinary, but I think what was most interesting about the Fed meeting is taking a look at those dot plots. Again —just as a refresher for everyone— those dot plots are what each Fed member expects terminal rates are going to be. They take a look at it over the next three years. We like to focus on the next year, obviously, because going out further than a year is a bit of a hit or miss in terms of projections. What we've seen is that, with regards to dot plots, is things are looking a little bit more hawkish with regards to what the Fed and the Fed members are thinking. I think that's kind of what you're seeing from markets and that's why you're seeing yields react a little bit violently actually here.

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In terms of looking beyond and a little bit of a positive note here is ... because again, this all ties back to inflation. So obviously, inflation has continued to run in a little bit hot — I shouldn't say a little bit hot, quite a bit hot, frankly. That's what has market participants and the Fed a little bit concerned. That's why they've been a little bit more hawkish this year than they were expecting and, frankly, the market was expecting coming into this year. But if you take a look at some inflation metrics, on the U.S. side, the most recent print is a little bit hotter than the market was expecting. If you take a look at import and export costs in the United States, they have turned down, but there is a little bit of sign of some easing there.

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If you take a look at our side of the border, up here in Canada, we posted a -.3% month-over-month CPI print. So, a little bit of positive; starting to see a little bit of light at the end of the tunnel from the inflation story. You can tie it back into commodities. Commodities have been coming down; just looking at broad-based commodity indices since June have been coming down. So, there are some hints of hope there on the inflation story that things are going to start to come back towards the 2% target. Obviously, as that ties into the Fed and the BOC, ideally, I think what the market is hoping and wishing is that we're likely closer to the top end of where rates are going to end up and that, perhaps this rate hike cycle, we might see an end to it sometime over the horizon.

[00:05:52]

Pamela Ritchie: Ergo, good for bonds.

[00:05:54]

Andrei Bruno: Exactly. As we know, higher rate, lower prices. What we're looking for now is just for rates to take a pause at some point. The market is pricing a little bit of easing some time. I think that's going to start to get pushed out a little bit now, but the market has priced in a little bit of easing down the line there. Obviously, easing would be quite good for fixed income, but just taking a look at where yields are currently sitting out right now, very attractive levels. Again, hopefully we're closer to the top than we are at the bottom for rates. I think the market is expecting that and I think that's kind of the base case.

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Pamela Ritchie: But it's just so interesting when you think of … we're doing a lot of last decade, decade going forward, differences… and there is a little bit of a night and day effect there. Just to sort of hit home the fact that bonds were not a place that people were interested in because there just was nothing there, ultimately, on the income side of things. How different is the picture at the moment?

[00:06:52]

Andrei Bruno: Well, that's just it. If you rewind back to last year, we were at kind of the lowest yields, the tightest credit spreads that we've seen in quite some time. In terms of the amount of juice you get out of the bond market, there wasn't a heck of a lot. From an income perspective, coupons were historically low. That narrative has shifted quite a bit this year. The bad news, obviously, is portfolio has been getting hit because duration has been moving. But, on the flip side, as we're starting to see new issues come to market, they're getting issued with higher coupons. So, kind of the income outlook moving forward has certainly ameliorated over this year even if at the expense of a little bit of pain in our portfolios.

[00:07:29]

Pamela Ritchie: Let's go to the portfolio construction. I think people watching markets today —they've been watching for the last probably 72 hours what's been going on— and the question is, where do you go right now? Where's the balance found? In the portfolio construction that you look at, that you take leadership in. I'm assuming that bonds are looking like a bigger piece of that. Give us the bigger picture in the scope of what it looks like right now on a portfolio construction basis.

[00:08:00]

Andrei Bruno: Yeah. We'll take a look at the fixed income side of things first. Again, as I mentioned, yields are looking a lot more attractive now. Again, if you take a look at the U.S. agg and take a look at where that's trading right now —the U.S. aggregate bond index—, yields at this level, we haven't reached yields at this level since 2018. Prior to that, it was 2009. You look at the global agg and the Canada agg, we haven't seen yields such as this since 2011. From a yield basis things are quite attractive. Now, what clients get a little bit worried about is, again, this continued inflation story. What's the Fed going to do, what's the BOC going to do? Are we still going to get hurt a little bit on the duration?

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Obviously, there's still quite a few more hikes priced in the market for both the BOC and the Fed for the remainder of this year and a little bit into 2023 as well. So, there obviously is some rest or duration going into year end. But, also, when you take a step back and you think of a 5-year outlook, again, yields are good. You can get fixed-income ETFs or fixed-income funds; some are between 6 and 7%. So again, that's quite attractive, over a long-term basis that makes quite a lot of sense. If you're a little bit hesitant, maybe you want to wait a month or two until some of the *[indecipherable]* players in the market to get a little bit more direction. But again, fixed income and bonds generally look quite attractive right now.

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When we take a look at the equity side of the coin, just given that there's still tons of uncertainty, whether that's economic… there's mixed signals from the economy whether or not are we going to get into a recession, are we not; it is going to be a soft landing, is it going to be a hard landing. I think earnings coming up is going to be very, very important for the equity outlook. But right now, just given how there's just so much uncertainty, I think number one, that diversification is always the name of the game and is always going to be your friend in uncertain times. But what we're looking at is we're looking at low volatility and quality in terms of factors. Just again, when there's a lot of uncertainty here, when there's potential downturns, those are kind of the factors that we gravitate towards.

[00:09:55]

Pamela Ritchie: Fantastic. So great to get some of your thoughts on that. Circling back to what you mentioned right out of the gate, the commodity story. We've certainly seen oil prices rerate. It looks like, ultimately though, the story in Europe is still happening; it's still very much alive. Is it possible the energy story can be kind of contained to Europe with price, energy, of course, in dollars? But, I'm just kind of curious how you see ripple effects.

[00:10:21]

Andrei Bruno: That's certainly a concern right now. I mean, if you take a look at nat gas prices in Europe, they've still remained relatively high. Anecdotally, you're seeing folks posting pictures of their energy costs in Europe whether that's the U.K. or mainland. So, the consumers over there certainly are feeling the pinch. Obviously, this is entirely exacerbated by the Russo-Ukraine war. Obviously, the flow of gas from Russia has effectively stopped going to Europe. So, they're feeling quite a pinch over there. Now, again, when you take a step back and you look at North American prices, they haven't been getting hit quite as much. I think there exists that risk that there will be potential spillovers. We haven't seen it just yet. It, obviously, is a bit of a concern. But again, as I mentioned, we are getting some positive news out of North American inflation prints. [crosstalk]

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Pamela Ritchie: You mean, the Canadian one?

[00:11:15]

Andrei Bruno: Yeah, the Canadian one specifically but again —tying it back to import and export prices in the United States, which they themselves have ticked down as well—, those particular metrics are nice to look at as well. They aren't hedonically adjusted like the CPI, so they kind of give you a very raw point of view of what inflation's doing. That is a bit of positivity there on the U.S. side of things. I think it's going to be tough for Europe, though. I think Europe is going to have a tough winter. From a geographic perspective, it might be an area to take another look at and have some caution with moving forward.

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Pamela Ritchie: Interesting. Maybe at some point a place to take a look at. Really interesting. Let's put this to you now because you were addressing it a minute ago; Andrei, how strongly are bonds and equities correlated right now? That is part of the story, isn't it? How, ultimately, do you want to add that into the overall calculation of how you put them to work together in a portfolio?

[00:12:08]

Andrei Bruno: That's a great question. As we know, typically in equity market downturns *[audio cuts out]* bonds rally a little bit, and we haven't really been seeing that this year. This year has been kind of that perfect storm where nothing's been working in your 60/40; your equities are down, your fixed income's down. Obviously, on the fixed income side that has been predicated towards the duration side of the coin. Credit's been a little bit wide this year as well. I think, still, —and this has been shown time and time again—, when we do get those kinds of recessionary environments and those economic downturns, if you look at Canada, we haven't really got that economic downturn just yet in Canada. United States, they did get that little technical recession in Q1, Q2 there with negative GDP growth.

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But again, the correlation probably isn't working quite as well right now as we're typically historically used to seeing. Again, if we do get a recessionary environment, we do get a double-dip scenario in the U.S. where we do start to see layoffs; that will be the scenario where you will see your duration perform. Typically, you do see your duration perform well as … in a recessionary scenario, the Fed won't be able to hike any further, the BOC won't be able to hike any further. Rates typically head lower in those scenarios and your fixed income works for you there.

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Pamela Ritchie: Tell me your particular thoughts, your opinion based on what you're looking at, on how inflation does come down. Do you see it coming down very quickly? Do you see it coming down sort of at a steady pace and then getting stuck somewhere? What do you think about the inflation story?

[00:13:45]

Andrei Bruno: I don't think it's going to be a super quick, straight to the bottom as much as I think everyone would love to see that. I think you're going to slowly see a trickle down towards the 2% inflation target. The million-dollar question is, when are we going to see that? When are we going to get back towards 2%? I think it's still going to take a little bit of time to get down there. I think over the next, let's call it six months I think is kind of the time it's going to take to slowly head down. It could take a little bit longer because you think about how long it took to hit peak inflation. It did take quite a while on the way up. I don't suspect it'll be a jagged, quick way on the way back down. I hope it does for all of our sakes, but I don't see that happening overnight.

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Pamela Ritchie: You mentioned diversification as the best policy in markets where there's lots of volatility, make sure it's spread out, but what does maybe short-term batten down the hatches but look cautiously, optimistically, perhaps to the future? What does that look like?

[00:14:49]

Andrei Bruno: I think I alluded to it a little bit there with regards to the equity sleeves as well. I'm staying a little bit defensive right now just until we get through this fog. I think the end of the year... it's a high chance of probability we will continue to see volatility. I mentioned your earnings as well. I think there's been a lot of data points that you have to pay attention to. Earnings was going to give us kind of an input into what the economy is going to look like in Q3, Q4. On the fixed income side, obviously, the big question mark there is what's the Fed going to do? What's inflation going to do? That being said, on the fixed income side, you're still getting tons of yield, so things are looking good there.

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If you're currently super short duration, I think it might be good to start to look at that over the next couple of months as we get a little bit more clarity into the inflation story, as we get a little bit more clarity in terms of what the Fed and the Bank of Canada are going to do. I think it's time we start to take a look at that, if not for performing that insurance function in your portfolio if we do get that equity market downturn. Again, on the equity side, pay attention to those earnings, pay attention to those retail sales. If it does look like we're heading towards that recessionary environment, those defensive stocks are going to be your friend on the equity side and on the fixed income side duration is going to start to become your friend in that scenario.

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Pamela Ritchie: We're sort of not far off the June lows as we sit here, we're kind of sitting there roughly. What then begins to look attractive potentially on the equity side?

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Andrei Bruno: Again, it does come down to ... I think all eyes are still on the Fed right now because obviously, growth hasn't been your friend this year. In a rate hike cycle, it typically doesn't perform well for you. I think in that scenario where we do get kind of a soft landing and, potentially, the economy doesn't get hit so well, we take a pause on the rate side of things, I think you might see growth come back into favour in that scenario. But on the flip side, as I said, if we're leaning a little bit towards that hard landing scenario, perhaps a double dip recession in the United States; perhaps a recession here in Canada or possibly in Europe as well, then I think you're going to want to stick to your defensive names and lengthen up your duration on your fixed income side.

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Pamela Ritchie: Do you think we're watching markets price in a higher inflation print? How do you think that, now that we've had this week... It's still going on, but now that we gotten through this piece, can you tell at this point how market players are lining up on pricing in another big inflation print or not? What do you look at for that?

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Andrei Bruno: The main thing I'm looking at is, again, yields. Inflation is driving the Fed right now and they're very set on taming down inflation. When we did originally get that inflation print –I believe it was a couple of weeks ago in the United States– we immediately saw yields respond. We immediately saw markets price in another hike from the Fed. I think that next inflation print and every inflation print moving forward is going to be super, super, super important. What I would expect is if we continue to see inflation, perhaps, remain, even remain at these levels if not kind of tick a little bit higher, you're going to continue to see more hikes priced into the market from the Fed. The BOC got a little bit of a break. We did get that little bit of a cool down on a month-over-month basis, so our yield curve's been a little bit calmer than the U.S. one, but it's the same story in Canada. If we do see another hot print in Canada, I would expect markets to start pricing in more [hikes?].

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Pamela Ritchie: What do you do with the questions within a recession, whether there's a default cycle? A lot of people say in the last recession because, obviously, we were flooded with liquidity, we kind of skipped the default cycle in a way. What do you see on that front here and possibly how to invest it? What is the high yield story here?

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Andrei Bruno: What I've been hearing from our high-yield managers, something that's been kind of pushed out is the maturity wall. There was a lot of refinancing from high-yield names who pushed out their maturities, so kind of that debt wall got pushed out two or three years. In terms of this year and next year, I think the default risks are a little bit muted relative to, maybe, historic norms. [It] is certainly something to be concerned about. If you still are in those high-yield names, they may not default necessarily, but, if we do get a recessionary environment, you will see credit spreads widen in the high-yield names, of course, but from a capital appreciation perspective you're going to feel that in your funds one way or another. In terms of worrying about defaults, our high-yield managers aren't super worried about that given that those maturities have been pushed out several years.

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Pamela Ritchie: Interesting. Fantastic. Thoughts on certain types of styles, factors? You mentioned a couple of those, value, quality. Do you want to just circle back?

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Andrei Bruno: Given how much uncertainty there is we do like those quality names. Those quality names are those good cash flow, those high earning companies, and we're liking those right now. We have seen earnings compress. That's typical of an inflationary environment. If you take a look at earnings last quarter, earnings weren't terrible, but, once you stripped out the energy names the earnings story was less rosy. So, just that, coupled with the uncertainty, we are preferring in this current environment, still the quality names, still the low-vol names at least until we can get a little bit more clarity on markets, whether that's what the Fed is going to do; what the economy is going to look like. Right now, just given how much uncertainty there is, we prefer to be in the high-quality area of the market and the low vol area.

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Pamela Ritchie: Perfect. Do you see, perhaps, a prolonged period of stagflation? Many will say that we've already been in that for a little while. I don't know. What do you think?

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Andrei Bruno: There's certainly an argument to be made; are we currently in a stagflation? We get the data months after things happen, so it's possible that we're currently in one of those. I think the thing is, though, what can really control inflation is a recession as well, as we know. There's a precipitous drop in aggregate demand; typically that will portend to lower prices as well. I think one way, or another inflation is going to come down. I think what everyone's hoping is that all these hikes that the Fed and the BOC have done over this year are slowly starting to make its way into the economy and, ideally, we see prices come down and we do get that bit of a soft landing. There is also that risk that the Fed or the BOC hike us into a recession in which case, again, as I mentioned, you'll see aggregate demand come down and typically that portends to inflation following suit.

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Pamela Ritchie: As a broad comment, geopolitical issues are not often ... well, sometimes markets don't mind. It's often not great because it's uncertainty. It does seem from the Ukraine crisis, obviously, oil was kind of the outlet, the price of oil, for that and gas prices. We've seen that come down. How do things globally look? What would you say is a global snapshot right now? Maybe even pointing to currencies; I don't know, but the geopolitical thoughts that you could share.

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Andrei Bruno: I think, as you mentioned, markets typically don't like uncertainty. Obviously, there's tons of uncertainty with the Russo-Ukraine war. I think Vladimir Putin had a fairly hawkish speech recently hinting at the potential use of nuclear weapons. Obviously, that's kind of your extreme tail risk with regards to that geopolitical situation over there. Tying it into currencies, if you take a look at currencies this year, the U.S. dollar has been kind of the number one winner this year, certainly with regards to G10, certainly against their EM currency pairs as well. That's been kind of primarily a couple of things. Number one, obviously, the Fed has been hiking quite a bit, so that's obviously been helping the currency as well. A little bit of a safe haven bid as well from the U.S. dollar perspective. Obviously, the Russo-Ukraine, we don't like the uncertainty there. It's obviously a little bit more important for Europe given that it's right in their own backyard. I think that conflict will continue to plague the Europeans a lot more than us over here on this side of the pond.

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Pamela Ritchie: Really great to get your thoughts on that, ultimately. Do you think within the commodity story... what is some of the nuance within it? Oil, gas, it's a bit of a known unknown on some level and we have seen it, in fact, you've said, come down in terms of prices. Across the commodity spectrum, though, is there anything that you find interesting that you want to point out?

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Andrei Bruno: Something that's been kind of interesting is taking a look at fertilizer prices. We've seen those kind of jump up pretty aggressively as of late, as well. If you take a look at Europe, we've seen some fertilizer companies shudder just because energy costs have been so high it just hasn't been profitable for them to produce. There's a little bit of concern in how the trickle-down will be into agricultural markets. As of recently, we haven't seen the soft commodity —think grains, think your livestock—, we haven't seen a rally in those recently. Like I said, the whole commodity complex has been coming down since around mid-June there. It'll be interesting to see if we do see a trickle-down effect there. Generally speaking, I think there is some flexibility with farmers in terms of how much fertilizer they need to buy in. Typically, they stock up on the stuff and they don't necessarily buy 100% of the fertilizer that they're going to use over the next year in that particular year. It'll be interesting to keep an eye on that and see if there are any trickle-down effects into the commodity markets.

[00:24:29]

Pamela Ritchie: Fascinating. I know that you spent a few years of your life sitting on a bond desk. Is that right? I think you did. I'm going to ask you about quantitative tightening.

[00:24:37]

Andrei Bruno: The big question about quantitative tightening... how much are we going to get and how long are they going to continue this? I was reading an interesting report this morning just in terms of overnight liquidity in funding markets. Some people smarter than me with regards to funding markets seem to believe that the Fed should be able to continue their quantitative tightening into 2024. The theory there is you're taking a look at the Fed's reverse repo facility and how much money is just sloshing around the overnight markets. There's still a ton of liquidity out there. The thought is that, at the current pace of quantitative tightening, they should be able to continue that and reduce some liquidity in the markets without affecting overnight funding rates.

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Pamela Ritchie: Interesting. That's fascinating because that is a true unknown unknown. It's absolutely new, isn't it?

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Andrei Bruno: Absolutely. The thing with quantitative tightening... remember, the last time we did quantitative tightening, it didn't last too long before we were back. It'll be interesting to see how long this lasts. I think what's interesting as well is if we do, for whatever reason, do get back into a recessionary environment, it'll be interesting to see if the Fed maintains the size of their balance sheet, expands the size of their balance sheet or continues with quantitative tightening, but lowering rates at the same time. It'll be interesting to see how *[unintelligible]* their strategies is there. If I was a betting I don't *[crosstalk]*.

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Pamela Ritchie: I was going to say, what do you think?

[00:26:00]

Andrei Bruno: I wouldn't expect them to shrink the size of their balance sheet in a recessionary [audio cuts out]. In my experience, the Fed, and all central banks, typically tend on the side of "I'd rather a little bit more liquidity than not enough".

[00:26:11]

Pamela Ritchie: Create some cushion there somehow for, ultimately, the market. It's great to speak with you, Andrei, and I'm really glad that we were able to have this conversation. I wish you a good weekend ahead. All the best.

[00:26:23]

Andrei Bruno: Thank you, Pamela. Thank you so much for having me and thank you, everyone, for joining us.

Ending: [00:26:28]

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