Fidelity Connects

Sector Watch

Denise Chisholm, Managing Director of Quantitative Market Strategy

Pamela Ritchie, Host

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

Director of Quantitative Market Strategy Denise Chisholm is back on the program to lay out the economic factors driving the markets and share what indicators she's keeping an eye on.

Denise talks about the indicators on the money supply side of things. She shares what she believes was the driving force behind inflation. She lists the unemployment rate and supply chain disruptions as the main issues. Furthermore, Denise says she believes the pandemic and governments giving money to a mass amount of people also caused high inflation. Historically, the more money the US consumer gets, the more likely inflation will accelerate.

Denise also talks about value, growth, and the tech sector and how inflation fits in. She believes inflation isn't as sticky as many investors think. She says until we get back to relative valuation levels, inflation is going to decelerate rapidly.

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Pamela Ritchie: A cacophony of voices from central banks around the world. You believe them?

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Denise Chisholm: We've certainly seen a downshift in terms of how much they're hiking but I do think the rhetoric caught the market a little off guard in the sense that it was much more hawkish than maybe many investors expected. That said, I would not, as an investor, want to invest based on what I think the Federal Reserve or the ECB is going to do. This was, remember just a year ago these two teams were sort of team transitory. They got the forecast pretty wrong. Right now, both central banks are really sending a message to the markets and saying, hey, we think inflation is stickier, we think we're still going to hike, albeit at a slower pace. Do we trust them or not?

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I think that the answer is more in the data that you see in terms of from an investment perspective what you'd be willing, or what I would want to be willing, to bet on versus what they say because we know that last year, again, if you fast forward, you have a one-year time horizon, what they said they were going to do didn't match what they actually did. Are we in the exact same position starting 2023 with what they say they're going to do – we're going to be quite hawkish – versus what ends up being the case that they do. I think that that's where we need to focus more on leading indicators for inflation rather than what the Federal Reserve is saying.

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Pamela Ritchie: Let's talk about some of those. Do we talk about leading indicators specifically on the money supply side of things, taking a look ultimately at what's coming out of the market, really, which is the whole purpose of this large experiment?

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Denise Chisholm: Yes. It is, in some ways, a large experiment. I suppose it always matters what you think was the driving force behind inflation. We can talk about the unemployment rate, but I don't think that that's it. There's certainly been supply chain disruptions that we can watch in terms of supplier deliveries and that is largely unwound, or is in the process of unwinding. But the third, and I think that the real issue that the pandemic highlighted, was we gave a bunch of money to a whole lot of people and it was in proportion of GDP – I think it was like 8% entirely – and that led to inflation. You can measure that in money supply. That's really what made this cycle different and that's really what made inflation different this time. It's a real monotonic correlation.

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Going back to history, the more money the U.S. consumer gets the more likely inflation is to accelerate. This is really the flip of where we were, exactly where sort of team transitory got it a little wrong. Even though money supply was actually accelerating quite rapidly, they're like, we think that this is going to blow over and it may actually blow over but in a different timely fashion that maybe they were estimating because it is a very strong correlation. But now, where we are currently, the starting point matters. We are, over the last six months, at one of the steepest contractions, the only contraction really, ever seen, certainly of this magnitude, going back to 1950. I think that this was one of the key drivers behind inflation.

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If history is right, what this translates into is monotonically lower inflation. The overall rate, this is historic rate, but you can show acceleration which would lead to a sharp deceleration in the CPI. I think a lot of the drivers that we have seen throughout the course of the last year have now reversed and it's just a matter of when those lags hit the overall CPR. We're already starting to see it. What we saw was a little bit of a juxtaposition between the lighter-than-expected CPI and the hawkish Fed. But net net of the two things, rate expectations are actually lower. I think that that's the right market interpretation because ultimately the Fed will follow the data.

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Pamela Ritchie: The Fed will follow the data. Investors watching the question of liquidity, what are they meant to do? As you say, that amount of money was put in short order right into the economy and it is being taken out now. Does that leave us about even or do we look at a liquidity crunch?

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Denise Chisholm: Yes. No, it's funny because a lot of people do translate this money supply into liquidity for the market. I have to say, Pamela, it's a really interesting thing because when I look at the data it says exactly the opposite, meaning that this money supply, I think that there's again, I get the theory, if there's excess money supply sloshing around people are going to invest in the stock market, that's going to drive stocks up so therefore, if money supply is contracting there's less access money sloshing around. I get the theory.

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When you plot it out, going forward, when money supply is deeply negative, when you think there will be this massive withdraw of liquidity, that's actually the highest odds for market advanced, 84%. When you have that excess money supply sloshing around, that's actually the worst time to invest, 62% odds for market advance. What you see is it's actually the opposite of what you think because usually if there is a lot of excess liquidity in the market, it's because growth is so poor and if there is a liquidity market decline, it may be that at that time growth is reaccelerating, in part because maybe the Fed doesn't need to be as hawkish as it is.

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Pamela Ritchie: Interesting. Although, of course, it's still talking very, very hawkish. Just one more point to what you were just saying there. Are the odds of having a market advance tied up with the fact that we've already gone through the pain? Is that sort of the *[audio cuts out]* at this point?

[00:07:26]

Denise Chisholm: Yes. I think this is the tricky part because I get what strategists are saying, which is, look, this would be the first, if we're approaching a recession in 2023, which we may well be, there's been never a point in history, there's been no point in history where stocks had bottomed before the recession already happened. True statement. Also, a true statement is at the cusp of any recession stocks have never gone down peak-to-trough 30% either. Then the question remains is, can you discount a recession before it actually happens? I would like to lean on the fact that there are many indicators that are indicating recessionary levels meaning that it's sort of, like, I want to call it visible. One way to define it mathematically, and I'll put all these charts up on my charts of the week, I actually just presented it yesterday, if you say, okay, I have perfect foresight, I know payrolls are going to contract next year, so we will finally get an NBER-defined recession. That's the way they define recessions. They will call it at some point. Usually by the time they call it, it's over and usually that's the time you want to buy stocks anyway. But that's beside the point.

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Let's just assume that that actually happens next year. So you say, okay, if I knew that that would happen, what are the odds that stocks go up? It's actually not as bad as you would think, 50/50 odds, 1 to 2% advance on average, again, a wide dispersion of range. It doesn't really tell you whether to buy or sell. You could argue that it's below average returns but two things you need to know out of that dataset. One, the more stocks have gone down the year before, the more likely it is, despite the fact that payrolls go down, that stocks actually go up. With our peak-to-trough decline at 20 to 25%, you're at 90 to 100% odds of a market advance, despite the fact that payrolls actually might contract.

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Point two, and I think that this is an interesting one, there are a whole lot of indicators out there at the bottom quartile. This is one of the reasons why people say this is the most forecasted recession in history. The LEI is negative, Napa is below 50, consumer confidence is at bottom decile level, CEO confidence is at bottom decile level, the yield curve is inverted, I could name 10 more, all of them are at their lowest percentile ranks in history. If you said, does any of that matter? If you have all these indicators that are saying ding, ding, ding, there is going to be a recession but payrolls haven't contracted, that's actually happened a third of the time, historically.

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At that third of a time, remember, if you knew payrolls were going to contract you can say 50/50 market odds, 1 to 2% advance in the market, all of a sudden those 50/50 odds go to 80%, market returns go to 11%. So, all the data that I just told you, one) two things matter whether or not payrolls ... payrolls may contract next year ... it matters how much you went down the year prior, it's been a lot, two) it matters what other leading indicators have already contracted. The more visible the recession is the more likely that stocks are to have already discounted. That might mean that we end up in a recession in 2023 but it wouldn't surprise me, based on that look of history, if stocks actually advanced further.

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Pamela Ritchie: And it is already priced in or there are certainly indicators, there is a good chance that it's already priced in. Can we go from that to what might work? This is all sort of question of sector leadership, of what looks interesting coming down the pike and how different is it from, perhaps, the last 15 to 20 years? How different, actually, is it, do you think?

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Denise Chisholm: It's always different, it's very different. It's different and every recession is very different and yet the patterns are very similar. So it's funny, when I look – and I do this – and I had three different takes of this data and all came up with sort of the same pattern recognition which is if you knew even payrolls were going to contract, cyclicals are modestly better than defensives, consumer discretionary is leadership with 70+% odds and energy and utilities (but we can pick on energy right now) is the laggard. That is true, more true, more straight in the data if you have the LEIs contracting, meaning if the recession was a little bit more visible. This is true when CEO confidence is low and this is a lot of the indicators that I'm seeing why I said starting in June, July defence actually got expensive. The margin of safety is really impacted by those relative valuation starting levels. As much as people are saying, well, it's all about the macro, to me, I see a very different pattern in terms of those relative valuations because at the beginning part of the year, defence actually outperformed quite substantially but starting from a really solid valuation level.

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That was when consumer staples was green on my scorecard, partly because they'd that valuation support and it's really made no really inroads since that time. We've had this market decline despite the fact that, obviously, because expectations for rates have gone up but yet consumer staples didn't provide you any more margin of safety. You might as well just have owned the overall index since that relative valuation starting point. I think the fact that that starting point, again, with the recession being, let's call it "visible" is going to impact what sectors actually work in 2023. I think that they're more likely to be economically sensitive. I would say the top two now, and I'm reranking, really probably in this meeting would be consumer discretionary, which keeps the top slot down on the cap spectrum.

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I think that there's more opportunity in small- and mid-caps across the board of the sectors but specifically in consumer discretionary. I'm actually now going to put materials, specifically metals and mining. I think that, again, that is that pattern to recognize and energy is acting increasingly like defence. When I look at that market playbook, it looks a lot like utilities, it looks a lot like consumer staples to me, it looks a lot like... Again, like 30% odds are not zero but when you have a whole bunch of indicators flashing only 30% odds, I don't think that you want to necessarily set that as your top position.

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Pamela Ritchie: Your view on value versus growth. I think you've gone into that somewhat, maybe you can answer more of it but I'll just put another one to you. Let's just go to the inflation and interest rates going higher for longer. Maybe put them both in your answer somehow.

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Denise Chisholm: I'll answer just separately because they're not as related as you think. I know that investors want to relate the two but again, starting points on valuation sometimes matter more than macro factors. We can talk about technology specifically. I'm going to answer it in three ways. First, value versus growth. Value has had a historic run especially the more you go down the cap spectrum, the more historic the run has been over the course of the last two years, really never been seen *[indecipherable]*.

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That said, even if you thought that inflation stays higher for longer, a little bit like energy, pretty rare. I think you could easily take a year off, maybe within a secular cycle but it wouldn't surprise me at all if value and growth was sort of a push or sort of neutral for the next, let's call it, 12 to 18 months. That's sort of what I'm seeing in my dataset. I think you need to pick your spots for value. I think there's more opportunities for growth, but you need to pick your spots there. If I were to pick factors instead of sectors, I would say value or growth, neutral, relative to each other but I actually like beta or volatility because it's that economic sensitivity. I think that that's actually where the opportunity is from a factor perspective.

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Let me translate that to technology and then I'll get to the inflation question.

Technology's relative starting point is massively different than it was in the last 10 years. In the last 10 years, it was bottom quartile or at least bottom half, price-to-free cash flow, and relative forward P/E. We are now, we're not in the top quartile anymore, we're out of it, but we're still in the top quartile. That's dramatically different. So, you can say, Denise, are you concerned that inflation is going to decelerate too rapidly? I am. Are you concerned that we're basically going to go back to exactly where we were before the pandemic? Yes, I am. But I'm not sure that technology in that situation is going to be leadership because the relative valuation starting point is massively different. When you think about, as an investor, do I care more about relative valuation or do I care about the macro factor of inflation? This is where historical data can help.

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So you can quartile it out and say I'm expensive or I'm cheap and whether or not I know that inflation accelerates or decelerates, what are my historic odds? What you find is when stocks are expensive you really get below 50/50 odds for technology as a sector to actually outperform or, let's call it, be leadership unless you think, and I don't, that inflation is going to be under 2%, well in the bottom quartile. If you think inflation is going to get back there over the next 12 months, then technology might be a top position for you. If you think it's going to take a while to get there, by a while I mean more than 12 months, I think we'll get in that range and I think that we will probably tip below 2% over the course of the next 3 to 5 years.

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I don't think that inflation is as sticky as many investors think. I do think that we're really, from a risk reward perspective, shifting back to that. I'm a little bit more nervous that the next crisis is going to be deflationary, not inflationary, and maybe the Fed potentially over solved. We'll see how that plays out but until we get back to relative valuation levels, I think that even despite the fact that I think inflation is going to decelerate rapidly, I don't think growth in technology is going to be your leadership sector.

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Pamela Ritchie: Based on that, the Fed is in a position with rates high, at least going back for the last couple of decades, they can cut, they've got the ability to cut. You look at Christine Lagarde speaking today, the ECB, lots of hawkish talk there, almost shockingly some might say. They're in quite a different position because they haven't moved the interest rate rises as quickly.

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Denise Chisholm: It's exactly right. I think that when you think of what the next cycle that the Federal Reserve, or maybe even investors, should be positioning for what we learned from what the UK went through is that there will be no fiscal stimulus. There will be no 8% of GDP to save you next time, the U.S. consumer or any other consumer. There will be no government spending push. This will have to come … the cushion from the blow of whatever recession comes next will have to come in monetary policy. From the Federal Reserve perspective, the higher you were able to go, the more likely you are to be able to cut to cushion that blow.

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You're right, the ECB is in the exact opposite position in some ways that their inflation rate has been stickier, partly because of the energy crisis and partly because of the depreciating currency relative to the dollar. It has been more of a problem. They have been back on their heels not wanting to add to the stress of European consumers by adding rates to that push. But what they are finding is they're losing credibility on inflation which is staying higher for longer which, again, no real surprise given the currency dynamics over there.

As much as people are saying, well, Europe is in a recession, so they may be the early cycle play out and the U.S. is about to go into recession and they're the late cycle play in, I'm not sure if it's actually flipped because the ECB may need to do more and go further than the Federal Reserve has to do.

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Pamela Ritchie: Because if inflation sticks for longer. It's really interesting. Are we in a market not unlike, or like, 2000 to, say, 2003 or the early aughts where it was sort of a long crawl back upward?

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Denise Chisholm: The question is on price. I don't know. But if you say does it look like that when I look at the data, I'll say unequivocal no. The real problem in that recession was not the economy. The unemployment rate really went up but dominated by the tech sector. Consumption didn't really contract on a real basis. Jobs contracted only modestly. The unemployment rate went from, let's call it, 4 to 6 and I might be getting those numbers wrong, close enough. It was a mild recession. It was not a mild recession in the stock market for two reasons, one of which we know, that technology stocks were over-valued and P/Es went from 24 times to 15 times. Sound familiar?

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The second thing that happened was they had no earnings growth. None. Earnings growth declined by almost 50% in some of the numbers that I look at. We don't have that situation. Part of the problem with 2000 and what was ultimately reflected in that three-year downtrend for the market is that turned out to be no "there" there in terms of profitability of that section of the market. You can say, will this turn out to be the case this time? Maybe. But I'm not seeing anything like that in the data. I was actually around and investing at that time. It seemed pretty evident that these companies were completely unprofitable. I'm looking at the S&P cap weighted aggregate profitability and it looks pretty solid. Capex is all-time lows, free cash flow's at all-time highs. I wouldn't, at this point to me, I wouldn't want to bet against corporate profitability.

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In some ways if we're thinking about how it will look in terms of a massive margin compression or job losses, then I'd bet on job losses and less of a margin compression because corporate America has shown the ability to really retain their profitability over the course of the last 20 years which is dramatically different than what we saw in the global downturn. I think the profitability changes that equation and I think that that changes our peak-to-trough contraction in the market.

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Pamela Ritchie: The story, the backdrop is different too. What would you say now that everyone sort of chewed through the CPI number and also, obviously, the Fed decision. Taking a look at the PCE which I know you, I think you either prefer or also look at, when you compare the two is there anything that you might want to compare for investors? What do you see there?

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Denise Chisholm: It's interesting. The CPI, you can use some of the data from the CPI to put it into the PCE deflator so you know part of what's moving and I think that the estimates are now just under .2 so it would be in the .1 range which is likely to come in. Again, PCE deflator is usually lower than the CPI partly because owners-equivalent rent is instead of 40% in the CPI it's only 20%. But here's a couple interesting data points and I think that these are worth keeping your eye on. You've heard me say before that if you look at everything ex shelter, owners-equivalent rent, we're going to get to that in a second, you look at everything else in the CPI ex that, and you annualize it, you look at it at a run rate basis, we're at zero to negative on the last 3 to 6 months.

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That CPI rating was the second back-to-back month decline in everything ex shelter and it will be more significant in the PCE deflator. We had never seen anything like this in the '70s and '80s. You didn't get a decline in everything else ex that until, I think, the early to mid '80s, I want to say '83, '85, somewhere in there. This is not looking at anything like entrenched inflation to me. When you look at that, and Powell did acknowledge this in his speech, I think that maybe investors really now have dug in on the owners-equivalent rent, it's a deeply lagged indicator relative to what real rents and housing prices are actually doing right now. Whether or not it's accurate, we don't need to get into but let's just call it deeply lagged the way the calculation. You can actually show it.

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There's usually about a 1 year to 18 month lag between when that accelerates and when it trues up to whatever is in the housing market indicators, that we can see in the housing market indicators that even in the U.S., and I know it's more in Canada, that just came out, housing prices are declining as are rents. Declining, not accelerating, at a lower rate.

Ultimately, that is going to true up to that number. What are you left with? You're left with a CPI and PCE deflator running around zero but the Federal Reserve, around five. So again, that math … we're not going to get to that run rate of zero instantaneously and that shelter isn't going to go to zero instantaneously, so it's going to be moving there but what does that tell you, that tells you the Federal Reserve may have room to decrease rates.

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Pamela Ritchie: Does it need to, could it, will it pull the lever on the QT side it's tightening, not, just letting the bonds run off, essentially. Is there any reason for it to reactivate on that side or has it got enough room in interest rates that it doesn't need to?

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Denise Chisholm: You could certainly see that where you sort of pause more on rates and do more on QT. That's all dependent on the mortgage market. I think investors have seen the chart that said the last time mortgage rates – when they were at peak and I actually don't know where they exactly are right now, I think that they declined by at least 50 to 80 basis points – but from the peak where they were, I think was at 7.30, or at least the one I look at, the last time mortgage rates were at 7.30, the Fed was at 6.5. That tells you what QT was doing.

QT was dominant in the mortgage market. They bought Treasuries before but we've never bought mortgages in this size. They own all the mortgages. That's really the differential that's going to allow this to sort of impact the long end of the curve as we progress from rate hikes and there might be a progression into QT to modestly maintain some more spread, meaning that if the Fed pause, you wouldn't want mortgage rates to come in that much. Do you want them to dip to four, do you want them to dip to five? Maybe not. Maybe you sell mortgages into that to sort of maintain that spread or continue to slow the housing market. That's definitely an option. I do think that they have more levers to pull that will slow portions of the market or portions of the curve as opposed to the one blunt instrument of the Federal Reserve.

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Pamela Ritchie: Potentially, as you've laid out for us, we've got a lot priced in be it recession, be it higher interest rates and, obviously, the inflation story plus you've got a Fed that has, as I understand it, far more tools in its toolbox than it's had actually in a long time.

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Denise Chisholm: Well said. Well said. In some ways I think that the problem last cycle was that the Federal Reserve never had rates high enough to be able to cut them enough to ever cushion any recession. That's, in some ways, what we were worried about all of the decade post the financial crisis. Now this might have reversed that situation. Again, we won't be able to have fiscal at our beck and call for the next recession but at this time it does look like, again, if I'm right on inflation and this math actually points to something that is durable and sustainable and not sticky, then we will have the ability for the Federal Reserve to cushion that blow by lowering interest rates.

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Pamela Ritchie: Is there anything else you just wanted to follow up with?

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Denise Chisholm: I have to say what I feel like I always follow up with a final statement on which is, why do you own equities in your portfolio? The reason you own equities in your portfolio is because on a compounded basis they're one of the best asset classes to be exposed to because they go up 8% a year. Again, these are broad averages and that's the problem with them. 8% does not exist. If you're an investor and you say, I would like my 8% this year, you will not get it. The only way to get that 8% is to look through 25% of the time a 15% downturn to be able to say 75% of the time you have an average return *[audio cuts out]*. You actually, to achieve that 8%, you need to be in for the wild ride.

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Pamela Ritchie: Denise Chisholm, it's great to have some time with you before the holidays. We wish you and your family a very good holiday and look forward to seeing you in the new year.

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Denise Chisholm: Thank you. You too.

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