Fidelity Connects

Sector Watch

Denise Chisholm, Managing Director of Quantitative Market Strategy

Pamela Ritchie, Host

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

Denise Chisholm, Director of Quantitative Market Strategy, joins us again today. We've seen a lot of volatile market activity of late and Denise will keep us focused on the sectors and factors making headlines.

All eyes are on Fed Chair Jerome Powell after his latest commitment to raise interest rates in the fight against inflation pressures. What will higher interest rates mean for the bond market? And with energy prices down and the markets looking for relief, is crude oil the key player in solving the inflation crisis?

Denise is a student of history who uses historical probability analysis when looking at the markets and today she'll share the trends and underlying indicators investors should be monitoring to evaluate the strength of the markets.

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Pamela Ritchie: The CPI was sort of unbelievable in the reaction itself. We're going to talk about oil but I wonder if we begin with CPI, maybe actually where oil fits in that story.

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Denise Chisholm: I think that oil in some ways is the leading indicator. CPI is the lagging indicator. When you think about all the government numbers that people watch, it's funny that we focus on the CPI and non-farm payrolls which are the two indicators that we know statistically are lagging. The markets do ultimately focus on the leading indicators like crude oil, which we'll talk about. But certainly the market was caught offsides by the CPI which missed expectations. It was less of a deceleration than the market expected but still a deceleration.

When I look at the data, that's the first thing that you take away, is that trends matter more than individual data points. That trend of deceleration that remains intact is the key thesis for ultimately over the course of the next year. But you've heard me talk about, especially when individual days can get aggressive, we saw 5% downside on the NASDAQ 100, you can look at the internals of the market, sometimes offer a clue for the leading indicator...

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Pamela Ritchie: This is from the CPI reaction, ultimately *[crosstalk]*.

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Denise Chisholm: Yes, whenever that was. I'm sort of blanking on the weeks.

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Pamela Ritchie: Tuesday.

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Denise Chisholm: Tuesday, thank you. I'll give you three interesting indicators. What you saw is, again, the interplay between credit spreads and equity valuation spreads. Is the equity market more fearful than the credit market? That's usually a better signal for equities going forward, and it was. Check number one. Check number two was actually, if you look at cyclicals versus defensives, we didn't see very much of a spread. In fact, what you saw was consumer discretionary, actually relative highs what you saw yesterday and banks really hung in, so if it was really that bad from a long-term perspective, you would see cyclicals underperform much more. That was checkmark number two, meaning a positive sign for equities.

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When you look at, I would call it panic selling like that, when you look at the internals, I think that there was only a handful of times in the last 25 years where every member of the NASDAQ 100 was down and that's the situation we just saw. If you look one year later, 100% odds of a market advance over the course of the next year.

There's a lot of internal indicators that does seem to suggest that that was a panic situation. When you step back and look at the trend and look at the leading indicators like crude oil, those are more predictive for a deceleration of inflation, positive for the market and I would say specifically positive for consumer discretionary.

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Pamela Ritchie: This is sort of the sector discussion of where we get into this. As you say, leading indicators because CPI is absolutely not that. It's pretty fascinating, the positioning going into that when you think about it. Clearly, there's a lot of positioning going into that. As you say, it's not a leading indicator.

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Denise Chisholm: No, it's definitely not. As much as it certainly moved Fed funds futures and odds of a 75-basis-point move, what you see is that ultimately over the next year, the CPI is not likely to be determined by interest rates but it is more likely to be determined – and I mean this statistically, maybe it's not as causal as correlated – but by energy prices even more so than wages. If you think about some of the narratives in the market are wage inflation is sticky. That is going to keep inflation sticky and therefore the Fed is going to have to go further to hike the economy into recession, crush the labour market to really crush the back of inflation. I just don't see that as being a narrative that has been consistent throughout history, meaning that wages are much less correlated to overall inflation, even core inflation, and energy prices.

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It sort of gives you pause. We actually saw this in the 1970s as well. When you think about stickiness, I know that your gut reaction is, well, it's gotta be wages that are sticky and that that's what ultimately translates through to sticking this core CPI but really, historically, the sticking point has been energy prices. That's really where the bulk of the pass through comes from corporations. They say, well, if my input costs are going to stay high through energy prices then I'm going to pass it on. It's not really that wage increase. We'll see what the market is today in terms of gasoline prices... are down almost 50% from the peak. If you think about rolling three-month correlations from core CPI, again, this is core ex energy and food, versus crude oil and versus wages and salaries. It shows you what really is much more dramatically predictive of underlying inflation ultimately. This is potentially what got us into this mess and that decline might be potentially walking the U.S. consumer out of it as well.

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Pamela Ritchie: I think the word of this conversation is going to be stick, stickiness, whatever we want to turn that into. You have said in the past that, in fact, this is when I think a lot of people were hoping we're on the way back out of recession after COVID, that the stickiness would be the wage story. I feel like there's lot of people who think that way and it makes a lot of sense but perhaps the numbers don't align. I mean, that's what we're sort of stuck with.

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Denise Chisholm: We'll see. I think some stickiness is actually a good thing, right? That's actually what I think. I think inflation was too low over the last decade. To me, 2.5 to 3.5 to even 4% is not a bad inflation level. We'll see what the Fed says about that but ultimately, that's not been a bad inflation level for the overall markets. It's not been a bad inflation level for the Fed either or for the overall economy. So we'll see how that sort of narrative translates through time.

But I have said that that stickiness is more likely this time going into this although I think that based on what we're seeing in a lot of commodities input ... remember, services are only 60%, 40% is in goods and that goods is linked very clearly to those commodity costs. I think that you have to be open minded as much as there are going to be portions of overall inflation that are sticky, there are going to be some that may actually be deflationary for a temporary period.

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Look, there's a big error model when we debate statistics but if you said, if I had to pick one variable and pop it into CPI and I picked gasoline, right, you get a wide variable model in terms of you got one variable *[audio cuts out]* high standard error. But if you use that and you said, okay, gasoline just did what it just did, what would core CPI be in February of next year? It would be 2%. I think that that shows you just how much influence commodities can actually have on goods inflation which can offset service inflation. I'm certainly much more open minded than I was maybe a year ago to inflation might actually be lower than you think over the course of the next 6 to 9 months.

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Pamela Ritchie: That is so fascinating. Then where does the rate story go at this stage? I mean, are we there yet or sort of some are pricing in a 1% move next week by the Fed. Is that going to be, in fact, are we too late, are we over the hurdles at that point, we don't need it? Take us into the rate story.

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Denise Chisholm: Let's talk about rates. First of all, I think that my base case on rates says we can tolerate a lot more than you think. I think that there's a narrative in the market that says, it's 3.5, are they going to go to 4, is the terminal funds rate going to be 4.5? We can handle that. Debt service as a percent of disposable income is at all-time lows. Not bottom quartile, not in the bottom half, all-time lows and that's after the rise in Fed funds rate. So, we're dramatically under levered on the consumer side from a debt service perspective.

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Pamela Ritchie: In the U.S. Unfortunately, Canada is a different story.

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Denise Chisholm: In the U.S., As is corporate America with free cash flow. So really we're much less rate sensitive. When you think about the way that the market reacts or even the U.S. consumer reacts to the shock of higher interest rates, it's really a run rate phenomenon meaning can you withstand 350 basis points in a given year? We have historically. We, so far, seem to be able to do that this year. As we roll forward into next year, that 350 goes to 50 or 100 when they raise 100 more. So if you've already tolerated the 350 basis points in one year, you will be able to be easier to tolerate that 100 next year. I will say that my base case is we can handle much higher rates than I think people think. Whether or not they go up or down here from right this point I think is a little bit unknown.

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That said, I think that the fact that we'll move in a stair-step pattern and interest rates will rise but at a slower pace. It would not surprise me at all if, given the interplay between where rates are right now and inflation expectations which have already cratered and all the leading indicators, if you're seeing peaks in yield for at least a temporary position over the next 3 to 6 months, that would not be shocking to me at all.

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Pamela Ritchie: What is the history here? What can be tolerated? We can go back decades and some points, a lot of people talk about the '70s and that a lot of people think that's not relevant at all. Take us back into history.

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Denise Chisholm: The way I always judge either recessionary impact or how much the U.S. consumer can tolerate is by judging things as a shock relative to income. You can add up what energy is as a percentage of income, look at the change, and you can look at interest, debt service, and add that up, which is a function of rates, as a percentage of your income. That's what's different this cycle versus the '70s. That's what's the cushioning part of it all, which is that wages have grown fast and they have been stickier than CPI really, which has been decelerating.

What you're seeing, and you're saying this already in the NFIB surveys and I want to put this on my LinkedIn feed this week, which is it looks like real wages are now going to rise over the course of the next year because it's the interlay between inflation and wage growth that's the issue. They're both likely to decelerate because the Fed's coming great guns for it but what you see is that interlay between the two is likely to see real incomes rising over the next year. I think that that's the positive impetus that I think people might be missing.

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Pamela Ritchie: And that ultimately says we can withstand what's here and possibly what's to come on this.

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Denise Chisholm: Correct. In some ways it could be that we've seen the brunt of it.

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Pamela Ritchie: Right. I mean, that's sort of the question, as you say, if things go up in sort of a stair-step fashion more slowly then maybe the hard work is done or is that, I mean, that gets into sort of have we or will we, the pivot story. What do you make of that?

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Denise Chisholm: I think that that's right. But in some ways always going back to the narrative that I think is incorrect in the market is that people seem to be under the impression that they need the Fed to cut. That's, historically, exactly not the thing that you want. You might want them to hike slower, for sure. That second derivative slowdown changes your odds in the equity market but a pivot, the stock market historically bottoms 9 to 18 months before the Fed actually shifts gears and cuts are associated with a weaker market, meaning that if they're actually cutting then you more often than not are headed into recession. Again, I don't mean all the time because that's not always true historically but I think that from a signalling perspective, this is not what I'm betting on. This is not what I want. And you can even see that lack of Fed put in the market. If you correlate and if you just looked at the S&P price action over the last year with what's called the euro dollar spread, which that's pricing in that cut that the bond market is actually forecasting over the next 12 months, the cut is actually coincident with the equity market decline. So the cut is the recession forecast in the market. To the extent that that cut unwinds, it unwinds with the recession forecasts. It wouldn't surprise me at all if that cut gets placed out of the market and that's coincident with actually upside.

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Pamela Ritchie: Particularly in consumer discretionary. Take us back to that. If we're paying less, ultimately, for commodities, for energy, and if we don't have to see prices rise on that front, we go back to the good story and the consumer discretionary story.

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Denise Chisholm: Yes. I think that this is the number one beneficiary of the deceleration of inflation, specifically in terms of energy. I mean, the consumer was certainly able to withstand in the sense that consumption didn't contract on a real basis. It was able to withstand the spike in energy prices that we've seen because really, at the end of the day, we were only bouncing around 5% of disposable income which in the '70s and '80s it was 9% of disposable income. It was a much, much bigger shock back then. The consumer was able to withstand it but it's hard to debate that this decline by 50% isn't going to be stimulus for the U.S. consumer. I think that that's a good thing.

When you look back historically and you say, okay, what works in that environment, it's consumer discretionary stocks that have 83% odds. This goes all along with real income which is being confirmed from the surveys. I think if you look back at just the macro indicators, which have certainly defined a lot of what we've seen over the last year, it's consumer discretionary stocks that keep coming up, positive checkmarks for me. That's not even including all the quantitative things that I see that usually have a good, solid forward look in terms of those odds as well.

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Pamela Ritchie: How have your views on gold changed over the year and what factors could influence its value going forward? This is taking a look at probably a more defensive way of looking at the markets.

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Denise Chisholm: Sort of yes and sort of no. You know what I always say about gold is that ultimately, at the end of the day, I know we want to think about it as a commodity and real rates and their intrinsic drivers but, ultimately, at the end of the day, it is a commodity and it does trade correlated with crude oil and other commodities. I think that that's been … I've preferred energy to any other commodity and I think that that's been true up until this point. Gold has obviously lagged energy in terms of the commodity story but I do think that what we're seeing in gasoline, if you were looking for a sell signal in terms of energy stocks, I think this might be something to watch. We still have valuation support along the lines of energy. I don't think it's going to be downside leadership over the next year but I do think that we are getting to a disconnect that is very, very wide historically, meaning that commodity prices over the last nine months are now down. The stocks have outperformed by 40%.

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Look, this is what we, as investors, were playing on with the bet that valuation was going to be much more supportive than the commodity and you didn't need to make that bet. But now going forward with the gap that wide, I think you have to be conscious of the fact that the CPI is decelerating, and we've seen a 50% reduction in gasoline prices, that we're seeing softness in crude oil, that we're seeing softness in demand. I would say that even in terms of we can talk about the SPR, we can talk about OPEC. OPEC cuts usually just increase spare capacity and it might solve an issue within the markets for a day, a week but when we look at it from a long-term single perspective, OPEC cutting is actually coincident with lower crude prices because they usually don't catch that inflection in demand. The SPR is just not big enough to move the needle. It's 1% of the supply.

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If I look at historically what that production growth has usually done, it's actually coincident with higher crude oil prices. So that kind of tells you the math that investors really want to do, which is I call it *[indecipherable]* math that you learn from Econ 101 is hold everything constant. It doesn't really work in the markets because nothing is constant. That's a long-winded way of saying, look, I think that the risk-reward is changing for energy, for energy stocks, and I think that risk-reward will change with gold as well.

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Pamela Ritchie: Fascinating. Here's general pushback to that story. Is China's demand being artificially either dampened by lockdowns? Ultimately, the question is, could demand for global commodities spike once we see some of those lockdowns actually behind us, which a lot of people will point to whenever we get through sort of October, November and President Xi is reaffirmed for his third term, why couldn't we see lockdowns lift and therefore demand rise?

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Denise Chisholm: We certainly could in the sense that that will lead to a more volatile commodity. But I think it's not just China from a demand story. I think it's the entire globe. We're seeing the impact of higher rates, which the whole function was to slow nominal demand, and that will happen in most of the globe over most of the rest of the year.

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Pamela Ritchie: But China is not most of the globe. China is a massive part of the globe.

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Denise Chisholm: For commodities for certain, a little less than they were in the '00s, we'll call it, where they were at some point 50 to 75% of incremental demand. It's less true than it was back then. That's certainly true and I think that will cause volatility, but I think that we might be past that peak recovery where every economy was recovering at an increasing clip and now we have many economies sort of softening what might be a demand impulse from them.

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Pamela Ritchie: Okay, fascinating. A couple of questions on supply chains going forward. Some of this could well be linked to the ultimate lockdown story, for sure. Does it help with the consumer discretionary story at all to talk about supply chains? We've heard at the margin they're getting better, some of the issues are getting better. What are your thoughts?

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Denise Chisholm: You can actually measure it in most of the surveys. The NFIB has one, certainly *[indecipherable]* has one, the New York Fed has one, all of them, the second derivatives are falling and falling rapidly. So that is a very positive impulse for deflation or disinflationary impulse at some time. So that's number one. Number two, that I would say is the market is a discounting mechanism and as much as there might still be some supply chain disruptions, we've lived through, in some ways, the worst of the supply chain disruptions. Each time the market takes its medicine early and then each successive cycle matters a whole lot less. You can study that with sort of war time influence, you can think about it with commodity prices, we did it with the '80s in interest rates. It's that first wave where the market really feels the impact and that each successive cycle of supply chain issues is much less of an issue.

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You're seeing that in a lot of the consumer discretionary stocks that are very, I would say, bottom decile in terms of their relative valuation scores. A lot of that is priced into the stocks that are most vulnerable to that and I'm seeing still continued positive second derivative outcomes on all the data that I look at. Is it still back to normal? No. But it will take years to get back to "normal" and we'll do that through increasing supply chains over time and dampening demand, which will get to the place where it's really, it has not been as much of a supply chain issue then really demand was just outstripping supply, what can supply can do.

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Pamela Ritchie: We were locked at home, we wanted stuff ... now.

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Denise Chisholm: Right. 'Cause we had the same production issue in 2010, 2011, we just didn't have any demand.

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Pamela Ritchie: Can we talk a little bit about sort of where stock markets have gone? I mean, this is what we were talking about after the initial correction, you do see things being less bad. The unemployment stories, I guess, the other ... it's not a leading indicator, it's looking backwards, it's backwards in terms of where it brings us to, what do you think it needs to be at? I mean, there's much discussion about where the unemployment level needs to sit for the Fed to be happy.

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Denise Chisholm: Yes, no idea but I would say that instead of the two things that investors are debating, I see one of potentially three. Investors are debating recession or no recession. If recession, or in this case, what the unemployment rate has to be. I would say that there's a third option. I would say that recession, but we've discounted it. So unemployment rate at 4.5 but do we care? Do we care means we already went peak to trough 25%. That was more than the recession of 1990. That's almost what we saw in 1970 which was a steeper recession. So you start to say, I care less about what the ultimate rate needs to be than more likely I'm going to paint it with a slightly broad brush. If I know as an investor that the stock market can discount a recession from one month in, which we just saw with COVID, to 75% of the way in, then I care less about judging the recession portion and the magnitude of the recession than I care about whether or not stocks have discounted it.

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That's the part that I focus on. Valuations are still ride wide, valuations are still wide relative to credit. What you saw was a peak-to-trough contraction in the exact way you think to see it historically. Consumer discretionary only had a worst prior six months 1% of the time. So all of those tick off. Be careful, investors. The unemployment rate might go up and it might go to 4.5 and it might go to 5 and it might be that stocks have already discounted it. So that's the part that, look, I think that we all have to struggle with and that's the part that I think that investors aren't thinking of as much as they should because they're debating the recession, no recession.

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Pamela Ritchie: What are they not pricing in? I feel like this is going to tie back to consumer discretionary. What is not priced in?

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Denise Chisholm: Well, let's give the example of just how egregious news can get and what the stock market can do. In some ways, I think that that history is very appropriate to think about with Jerome Powell's recent speech, like we're coming great guns for inflation. Wait a minute, we've seen this movie before, right? Volcker came great guns for inflation. So we saw it and he did and he basically threw out targeting and it was very uncertain what monetary policy was going to be. We didn't even really know how interest rates were going to function at that point. It was highly uncertain. He was highly aggressive. What did we see over the next year? Rates were higher; hiking was aggressive; industrial production was down 6%; inflation was still sticky; the CPI at 12% annualized run rate; stock market was up 25, 25% it was up.

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If you say, well, then ultimately we had the other recession of 1982. Yes, we did and the low in 1982 was higher than the low in 1980. If you say, but, Denise, stocks were cheaper, not relative to bond yields. We're in exactly the same spot. So you have to tell me then that the Fed is going to like 7.5 or 8 over the course of the next year which I'm just not sure a) they need to based on tamed inflation expectations and the deceleration in terms of leading indicators that we see.

And if they don't, then you have to think that the relative pricing between what we see in the equity market and what we see in the bond market is about what we saw in 1970. Stocks can discount a lot of bad news and using a very dire circumstance, and I think highlighting, I would say that the '70s and '80s were much worse than we've seen right now, based on even what we talked about with energy and that stocks can still go up in the face of that, I think should give investors pause of just what stocks can discount.

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Pamela Ritchie: Denise Chisholm, thank you very, very much for joining us and for taking us through some incredibly different perspectives, frankly, than what you see out there. You are brilliant, so thanks for joining us today.

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Denise Chisholm: Thanks so much, Pamela.

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Pamela Ritchie: Thanks for joining. I'm Pamela Ritchie.

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