Fidelity Connects

Financials in Focus

Matt Egerton, Analyst and Portfolio Manager

Pamela Ritchie, Host

[voice-over:]

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

We're looking at financials today, posing the question how banks and asset managers are navigating through the current market environment. Also, where are the immediate and long-term investment opportunities across financials in North America?

Analyst and Portfolio Manager Matt Egerton joins us to discuss the latest on the financial sector and to share his equity research findings.

This podcast was recorded on August 25, 2022 and was initially presented as a live webcast, with Matt also sharing some perspectives on the U.S. Federal Reserve and Jackson Hole summit that was taking place at the time.

One more note before we get started. If you're looking for more market insights, circle Thursday September 8 on your calendar. Fidelity's Vivian Hsu, Director of Product Innovation is hosting a Reddit Ask Me Anything event from 12:00 to 2:30 pm EST. All are welcome to stop by and ask their questions about markets and investing. Head to the FidelityCanada subreddit to participate. That's reddit.com/r/FidelityCanada.

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Pamela Ritchie: Great to see you, Matt. How are you?

[00:02:00]

Matt Egerton: You too, Pamela. Really good to see you.

[00:02:02]

Pamela Ritchie: Matt, let's begin with the discussions of what everyone wants to know about what Jay Powell may or may not say in his comments tomorrow at the Jackson Hole summit. What ultimately are you sort of gleaning? What might you expect? What are the possibilities?

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Matt Egerton: This is an important week for financial markets and for my sector in particular. You have to start with a bit perspective here. This year, in terms of Fed rate hike, has been the fastest rate hike since the 1980s. We go back a couple of months, I think this is important to sort of lay out the set-up here. Around June, July, the market was kind of getting worried about whether the economic wobbles might mean that maybe some of Jay Powell's comments interpreted a little bit more dovishly, so maybe we're close to the end of the hiking cycle than something that's perhaps more prolonged. And with that, people kind of think, well, maybe we got a rate cut in 2023. That was kind of that thinking. So over the summer, we've had kind of various Fed officials come out and sort of push back on that, take a bit more kind of hawkish tone. We've seen the market respond as well. The U.S. 10-year back above 3% and that initial kind of rally of tech names in through July kind of stalled a little bit here.

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When we think about where we are right now, Powell has kind of got three options as I see it. The first choice is to kind of double down on what his colleagues have said, lean hawkishly, that would be seen, I think, as bad for the markets. It suggests the Fed is going to push harder to get inflation and maybe *[indecipherable]* inflation stickier. The second kind of option is to perhaps lean against his peers and become a little bit more softer in the approach, a little more dovish. That kind of will be a reflection of what we've seen over the summer. We'll see. But there's also a third option and that I would characterize as kind of like a punt, it kind of punts, and that would kind of be around a conversation on data dependency. We'll see how things go essentially.

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That's probably the path of least resistance, not to get into predictions so close to the event, but that's probably a path of least resistance. Given the Fed has done a pretty good job shepherding markets in recent weeks and if we kind of zoom out to very high level or longer term perspective, we're really in unprecedented times when it comes to monetary policy. We've had QE, we're talking about QT, we had the financialization of new asset classes, negative real rates. These are pretty recent phenomena. Given all of that, the transmission mechanisms in the playbooks are less clear than perhaps history can tell us. The way that the economy will respond to changes in rates is not obvious and particularly around the transmission mechanisms there, so maybe an approach of really kind of driving slow through fog, that kind of analogy is the way it might go. Maybe with Powell, the S&P 500 is still close to all-time highs, unemployment in the U.S. is still low at 3.6%. You've still got a nice degree of kind of air cover for Powell if he chooses to take it. We'll see what happens.

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Pamela Ritchie: That's fascinating. As you get those different perspectives, it makes me want to ask what's the reaction to each of those three possibilities? Maybe we'll drill down into that. You cover U.S. financials, let's talk a little bit about the obvious discussion of financials in a rising rate environment is that banks make more money, so that was going to be helpful. There are a lot of other pieces in there that fit with the overall economic outlook. Where do U.S. financials stand given what you've just said?

[00:05:20]

Matt Egerton: You're absolutely right. Typically, people think about higher interest rates being very good for banks, within financials. Typically, a bank will earn revenue on a mortgage rate or on a credit card. The higher that rate can become, the bigger the opportunity to make a spread when we think about the cost of that really being the deposits or the savings rate. As rates rise, what we call net interest margin expands, that's good for banks. But there's a piece of the cycle where you have the yield curve starts to invert and that's where the short-term rates are the same or above long-term rates. So banks are, in simple terms, not making money from a loan *[indecipherable]* at that point. When that happens, the focus of the market, investors like myself, was really about credit risk. So interest rates are rising, how far can they rise before that becomes a sticking point for businesses and consumers? When do you start to see the credit cost on the other side of that tailwind of rates overwhelming that dynamic?

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Typically, what you normally see is banks rally hard as rates rise and then at some point they will start to perform well when rates start to come down. We actually saw that in July. During the July kind of dovish tilt or the pivot that some people talk about with Powell, banks outperformed the S&P 500 during that period. That was all about a view that a soft landing was much more likely if they step off the rate pedal. That's the point. For banks in particular, you really want to own banks when the rate cycle has peaked and we're kind of very early in a recession and all that bad news has been priced in. That's typically the buy signal starts to flash. We are there in many cases, but the fly in the ointment for my end is that this has been a very, very well anticipated downturn. Everyone is pretty bearish. I would say, in general, we've not yet seen that replicated in valuations of all these banks.

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Pamela Ritchie: You mean an actual downturn/recession has not actually been...

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Matt Egerton: This weird dichotomy where you have this anticipation for a slowdown, but the banks are not yet pricing that in fully. I think that's where you're kind of trying to pick your spots on the risk-reward. The playbook would say now is the kind of time you own financials. The sticking point is that on valuation to my mind.

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Pamela Ritchie: I want to pick up on valuation in just one second, but let's just go to exactly what you're talking about, where the rate cycle peaks because this is where you've had the army of Fed officials out over the last couple of weeks trying to walk back or whatever you want to call it. Ultimately, you've got Esther George saying it could be 4 or 5% in terms of interest rates where they ... there's sort of these things being thrown out where it looks like we're pretty far off. How does that piece play into either the uncertainty or just where U.S. financials find themselves?

[00:08:07]

Matt Egerton: Yeah, absolutely. *[indecipherable/That's the debate I have every day]* Really the point there is about, I think, about real rates. That is the nominal rate of inflation we see on the screen minus the inflation. As we all know, inflation is high at the moment, but that it's trending lower and it should trend lower over time as you have these base effects. You're annualizing off a higher base, so that should come down and help provide a tailwind for lower inflation and, in theory, help ease the pressure on the Fed to raise rates more rapidly. The challenges, and history would tell us, that the Fed don't typically raise rates in a period where data is getting worse or inflation's improving, but we're in that kind of environment. It's a strange one where you're having this inflation rate well above trend, 2% targets as well, but the data is getting worse. So that's interesting.

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I want to come back to the real rate. How I would think about the long-term rate is to say, okay, what should a real rate be and then add on some inflation number that I think is steady state. If we believe in 2% or slightly above 2% for the U.S. 10-year over a long period of time, and you believe in a sort of zero to positive, let's say, 0.5% real rate, the demographics of the U.S. would support that kind of thinking and the productivity gains and that sort of thing, you're really in a realm of kind of 2.5 to 3% on a kind of long-term U.S. 10-year. We're sort of in and about that now. When people talk about 4 or 5%, in my mind it implies if you anchor off a real rate that's around about zero, it implies we're in a structurally higher inflation *[indecipherable/environment]* of 3 to 4% or even more. To me, I'm not quite in that camp, that's just not where I'm at, but when we think about the range of outcomes that's how I think about it.

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Pamela Ritchie: Very interesting. Let's go back to the valuation discussion. We all know that we saw through the rally in the summer a retracement of what had been lost through the early months of the year and financials as well ... are financials cheap at this point? What would you say about valuations based on what happened through the summer?

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Matt Egerton: I think one of the challenges ... and I'm a portfolio manager on our ESG strategy as well, so I look at non-financials as well and it gives me a perspective how to compare between the two. Because of the impact of rates rising so rapidly you've really seen that crunch, as everyone will know, on the technology names and growth names. What you're having here is this interesting time where ... I've described it as TINA, I think, on a previous call here, there is no alternative within financials. Financials at least have had the tailwind of rates. You can make the case that the economic environment has been pretty good and still is pretty good, so you can make those arguments. The way I think about it now is on relative valuation. That, to me, is the most important part of where I'm thinking about it right now. The U.S. banks have held up fairly well this year and in the last 12 months because it had tailwinds from rates. The economic environment supportive at the very least and you've had that headwind to high-growth tech because of rates. Now, you're getting to a point now where we're all just trying to ... this is why Jackson Hole is important, when do we peak out on rates and perhaps we can get a little bit more constructive on some of these growth names to say, now the discount rate has peaked and maybe over a cycle, over the long term, you start to get a tailwind back again to some of these multiples on high growth, or at least you're more relaxed about the multiples and these companies can kind of grow into their earnings. That's when you start to see these leadership changes within the market. That's why Jackson Hole is so important, why the rate hiking cycle is so important. I'm starting to see value in some of the technology names relative to financials which have generally held up fairly well and generally, look good but relative to other things, there are other areas in the market as well that look interesting.

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Pamela Ritchie: Interesting. What about that TINA discussion but on a more global basis? You've got U.S. financials, you just discussed where they are ultimately in sort of a cyclical story, but also based on where you've seen some valuation changes or something that would or wouldn't look attractive. It sort of depends on how you want to look at it, your time horizon. Globally, we can't really not talk about the U.S. dollar, which is also tied to Jackson Hole and the discussion of interest rates, of course, but here you have U.S. equities being a discussion just amongst themselves because of the dollar. How much of that comes into the overall story for you?

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Matt Egerton: I don't sort of try to forecast the dollar specifically. I see it more as an output and *[indecipherable]* kind of take it from that level. At the moment, the U.S. looks like a huge bastion of strength. We don't get into the detail on China and, obviously, the tragic situation in Ukraine and Russia. Something that Jamie Dimon, the CEO of JP Morgan, talks about is the benefits of the geographic location of the U.S., the friendliness of the neighbours including Canada. We often take that for granted in various cycles. Unfortunately, we're in a situation now where that is clearly a very strong tailwind and on a relative basis relative to other opportunities, both financials globally and talk about Europe, we get into that, the U.S. looks very attractive and even if we look through the immediate term set-up, over time there's still demographic tailwind, there's still an opportunity for population growth, it's still a centre of innovation. Those things are really important. As my colleagues remind me too, some of the PMs in the team, economic growth is the core driver of bank profitability. For the U.S. financials in particular, that is one piece of economic growth is kind of a way to grease a lot of the issues and smooth over a lot of the wrinkles that you have over time. You always want to be in geographies where economic growth is constructive and the U.S. certainly has that. When it comes to kind of the credit piece, and that is obviously a very important part of the story and it's getting lots of attention today … I sort of mentioned it slightly earlier on, the U.S. banking system is positioned for a mild recession. Banks have taken allowances for credit losses in line with a sort of mild downturn. Now, obviously, things can be worse than that. We'll find out in not too long. The moment that the credit risk profile *[indecipherable]* the allowance risk profile is there, so the earnings basis of banks generally reflect a mild recession, which is generally a good thing. You want to have banks anticipating the challenges ahead. That's probably the set-up there, and so it's generally constructive.

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Pamela Ritchie: It's generally constructive. Interesting. You also cover the asset managers, why don't you just take it in that direction a little bit? Noting that, obviously, Fidelity is an asset manager, but we're talking about the publicly traded, how are they looking right now in terms of valuation? Let's go back to that.

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Matt Egerton: It's a tough one with asset managers, as we all know, and same as the advisor business. The revenue line moves around with markets, so you're kind of constantly trying to second guess where markets sit over time. I would say, in general terms, what matters for asset managers *[indecipherable]* advisory firms, the valuation really links the organic growth number. It's whether you are positive or you're negative and *[indecipherable]* point in the cycle you're more likely to be negative or positive. At this point, just given we've seen some slowdown, we've seen things like flows and net flows, which is generally the proxy for organic growth, have been softer. I think we all see that as clients are a little bit more uncertain as to how to think about asset allocations and things like that. That generally puts pressure on the valuation of asset managers.

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If you believe over time that markets normalize and the environment can get better over time, then organic flows should follow that. With that, today, you're seeing the market reflecting asset management valuations in a very poor light. You're seeing asset managers kind of trade down on multiples because as people extrapolate today's, some of the softness inflows into perpetuity and then apply a multiple, that if you believe over time that the environment can be constructive and demographics becomes very important there, then valuations could rise. If you think about the cyclical set-up for asset managers on valuation specifically, it also looks quite constructive. But you do need to see a market environment more favourable than today to really realize that upside.

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Pamela Ritchie: Fascinating. I feel like there's more to come back in here but I wanted to ask you ... because when we spoke earlier you mentioned that you went to a panel, a conference, I think at Cornell, talking about ESG. We've seen the Congress bill come through, we've seen things move a little bit on this front. It has to do with the overall way that companies conduct themselves and how investors ultimately want to or don't want to invest in them. What is sort of the temperature of ESG from either that and other ways that you look at it? You certainly keep close tabs on the ESG story.

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Matt Egerton: Yeah, it is super interesting. I got invited to speak at a panel with a couple of peers of mine, asset management peers, portfolio managers, about ESG. The discussion point was pretty varied. We come at a point where this conference was a combination of practitioners like myself and also the academic research is looking at the space. It's very interesting to come together and compare notes and see where the market's different, where the regulators differ and all those different pieces. I think what you picked up on there, is there's an elevated level of scrutiny. I think we saw that early in the summer. There was a real wave where it became kind of almost fashionable to bash certain elements of the ESG topic and industry participants. There's always/almost a competition of who can make the most noise on that. I understand when oil prices are high...

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Pamela Ritchie: We did see a sell-off, right? I mean, we did see a sell-off of a lot of the names that would be beneficiaries and so on of the ESG story, certainly on the energy front.

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Matt Egerton: Completely. Absolutely. Rates are obviously one part of that, but still there was an element of bubbling nature in some of these more go-to names, certainly. I think what's happened is oil prices have gone the other way, which has emboldened that debate further, which is fair enough. I think you're also seeing that the regulators are catching up with what's going on. There's been an immense period of growth and naturally, when you have U.S. regulators involved, it tends to get a little more political. I think that's where we are now. But if you kind of look at the longer term picture, I think, it's just a healthy kind of recalibration. I think what we're all realizing at various times is that ESG is a deeply personal topic and mutual funds and ETF providers for decades have offered the clients the benefit of pooled vehicles and ESG challenges some of that. You want to become more personalized.

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I think for us as asset managers, it's important we protect client choice, offering solutions that kind of go across the *[indecipherable/piste]* and not dictating what clients should believe in, but being very crystal clear on our philosophy, what do we actually believe in as this fund or this PM, crystal clear on the process and then being robust and delivering that time and again. As a PM covering this space in ESG area, I get more questions from clients about the sustainability credentials of the stocks that we own in the fund than I do about the actual fundamentals of the business. I think that's a real change and I welcome that because we need to challenge ourselves and our thinking on all these items.

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Pamela Ritchie: Yeah, that's fascinating. It's so interesting watching, as you say, sort of picking up steam and maybe on a new footing, perhaps. It's very interesting to watch. Going back to financials, discussion within the tech sell-off that we saw through the early part of this year. Fintech, obviously, is part of that. How does the fintech companies fit in with the more traditional financial companies that you take a look at? Is there a period of acquiring the fintechs, for instance, that were on the verge of ... what does that landscape look like?

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Matt Egerton: Yeah, it's a really interesting dynamic and it's evolving as quickly as the market is. Right now, fintechs have not really been present in the core lending and deposit gathering business of banks despite this huge wave of investments in recent years. It's been mostly present in fee line items, things like brokerage, mortgage, involved in payments. But on the deposit-gathering side specifically, regulation provides a very important and powerful umbrella for banks in the space. Same thing in Canada, obviously. I think people really do value that FDIC insurance against the deposits. What we've seen with fintechs is historically they performed well on deposit gathering when there was an element of rate, where they can offer an attractive rate on deposits to bring in those flows. We've not seen that for a long period of time. Now, it's coming back a little bit now, but the difference is these higher rates are coming with a pressure on fintech, on growth stocks to become profitable.

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The higher rates mean a higher opportunity cost of ownership for investors and it's hurting fintech valuations. What you're seeing, this interesting set-up where the rates are there, so maybe you'd traditionally think fintechs could offer a bit of a carrot to new investors in the deposit- gathering business, but the other side is the pressure to become profitable. That's a real issue. The other side of it is the combination of stock-based compensation. I'm sure the viewers will have heard a little bit about this, but many of the fintechs have attracted employees through their private market years with stock and then crystalize that value upon IPO. What we're seeing now is many of these stock-based payments, maybe 50% of revenues for many of these businesses in dollar terms, so it's very onerous for a fintech to become profitable and support those kinds of payments. That's another issue to challenge.

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What we're seeing in the market now is firms, not to pick on certain names, it's more of a trend than anything else, but names like a Robinhood or Rocket Mortgage cutting employees by about 30% to try and bring this route to profitability. I think to your question about the fintechs and acquisition, the next question is really, are we going to see traditional firms acquiring fintechs? I think there's obvious complexity there in terms of the cultural fit and how you deal with employee retention when you have this stock-based issue that I just referred to at spot valuations. There's an issue for banks and larger financial firms deploying a large amount of capital at this point in a cycle, a late point in the cycle. I think to me it seems unlikely we'll see that just because there's not the appetite for banks and boards to lean into that and frankly, on a different level, I'm not sure banks want to be bailing out or writing a big check to these peers that have been eating their lunch for many years, or at least trying to.

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Pamela Ritchie: Fascinating. It's so interesting just to look at that and, as you say, how they cross over, line up and perhaps culturally don't fit. That is also a big piece of anything on that front. What would you like to leave everyone joining us here today with on the U.S. financials front, also the asset managers? This is a strange moment for markets writ large across the world right now, energy markets, financial markets, everywhere. What do you see, ultimately, as the set-up for U.S. financials, look down the road, say, 9 to 12 months?

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Matt Egerton: I'd love to come back in that time and see how close this gets. I think in general we are waiting for some kind of downturn. Internally, we're looking at the scenario analysis. What does a bad recession look like? What does a mild recession look like? Where are the financials within that kind of range of outcomes? How excited and when should we lean into these things? It's very much a question of when do you buy at this point in the cycle not when do you kind of ignore and forget about it for five years. That's not the way it is set up right now. The Fed's going to dictate that in the short term, but over the longer term, taking a more global or a high-level view, there's opportunities for growth even within financials. It's not all kind of the same. It's not homogenous across the sector. You're always going to get a quarter or two where a particular bank know, let say, blows up on a particular credit. That gives us opportunities to say, okay, we've been tracking this bank for 10 years, we know their credit quality has been excellent, we can lean into this now, this is an opportunity and that's the kind of thing that I'm looking for the next 9 to 12 months and Jackson Hole is the first part of shaking out some of the tree, perhaps on maybe some of these ideas.

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Pamela Ritchie: Ryan Reynolds, Canadians love to talk about the comedians that come from this country and I'm sure it's all connected to how cold it is but he has a connection, actually, to you, something I was going to watch on Netflix over the weekend. Tell us a little bit about that.

[00:24:13]

Matt Egerton: There is indeed, there is indeed. I was born in a town called Wrexham, which I'm sure no one's visited. I'd politely say that wouldn't rush to. Ryan Reynolds and Rob McElhenney is actually from the U.S. I don't remember the name of the show now but they've acquired this football club in Wrexham and so Ryan is...

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Pamela Ritchie: In Wales.

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Matt Egerton: In Wales, exactly. The documentary is on, I think, Disney+. *[indecipherable]* pitch it *[indecipherable]* doing some marketing work for him, but it's certainly going to be interesting and I'll be watching to see how they get on. It's very much a local industrial town, kind of trying to grow and really conquer the world. It's a great story and look forward to seeing how that evolves. That's a little pitch for the weekend.

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Pamela Ritchie: That's fantastic and also a pitch for Disney+ movies, don't cut your subscription. Lots of good stuff on there. Lots of Marvel things. Thanks for joining us, Matt Egerton, and really a pleasure to get some of your thoughts on Jackson Hole but also, ultimately, on what this all means for U.S. financials. We look forward to seeing you again soon.

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Matt Egerton: Absolutely. Thanks, Pamela.

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Pamela Ritchie: Thanks for joining us. We'll see you soon. I'm Pamela Ritchie.

[voice-over:]

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