## Fidelity Connects

**The Global Macro View**

**Jurrien Timmer**, Director of Global Macro

**Pamela Ritchie**, Host

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Podcast Intro - Jurrien Timmer - Nov 14

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

We're joined again today by Director of Global Macro, Jurrien Timmer, for his weekly global macro and markets update. On today's episode, Jurrien comments on the effects of the US midterm elections on the market, he also speaks to the latest CPI report and the recent meeting between US president Joe Biden and China's president Xi Jingping.

In regards to the midterms, Jurrien presents a chart showing the 4-year presidential cycle. He says the first and second years tend to be the weakest and the third and fourth years, the strongest. He says if you take a look at the years for the midterm cycle, where the markets were down, there is a very pronounced cyclical and seasonal pattern. He says continuing with this pattern, it might hint that maybe things have gotten as worse as they are going to get.

Among other insights shared today with host Pamela Ritchie, Jurrien discusses inflation, commodities, and comments on a 60-40 portfolio construction for investors.

Stay tuned for this and more – also per usual Jurrien will be sharing some charts, so please head to @TimmerFidelity on Twitter to follow along.

Today's podcast was recorded on November 14, 2022

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[00:02:04]

**Pamela Ritchie:** Great to see you, Jurrien. It's been a really astonishing week or so. Some of it played out in that powerful rally last week, kind of your textbook. Like, not the textbook, but the Timmer textbook. You have been talking about that for some time.

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**Jurrien Timmer:** Goes to the point that we've been making that, yes, the market was trading above its sort of rate-based fair value. We pull up slide 1, you can see that.

[00:02:32]

**Voiceover:** The first slide we'll look at today is 'Equity Valuation', tweeted by Jurrien on November 16 and that's on @TimmerFidelity on Twitter.

[00:02:41]

Even though that suggested the market was not out of the woods… and maybe it's still not out of the woods; we don't know that now that we have a confirmed bottom just because the market ran so hard last week. You saw that spread between kind of the fair value based on where the 2-year yield is, where the 10-year real yield is, where the Fed's going, and the market had kind of persistently traded a couple of points above that. The caveat was always that that fair value; it's a snapshot in time, it's all based on how far the Fed's going to go and then how quickly it will then revert to something resembling a more neutral policy and that it was kind of too late to be super beared-up on that basis alone.

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Lo and behold, if we go to slide 3…

00:03:33]

**Voiceover:** The next slide is titled 'The Fed and the Market', tweeted by Jurrien on November 14.

[00:03:39]

We had the CPI report last week, that we were all hoping for for months now, but it was always elusive until last week where the number was decisively softer than expected, both on the headline and on the core. What you can see in this curve, in the Fed forward curve, is a notable change. The terminal rate, the point at which the Fed will peak, will stop tightening, only went down a little bit from 5.11 to 4.85. That's basically…

[00:04:15]

**Pamela Ritchie:** There's something about that  though, it has to be psychological *[inaudible]*.

[00:04:20]

**Jurrien Timmer:** The market only unpriced one 25 basis point rate hike but look at the back end of that curve. It's dropped by 50 basis points and the market now expects the Fed to cut rates after it's done tightening by about 150 basis points. That market could be completely wrong, of course, but this speaks to what we were talking about last week where that gap between the fair value and what interest rates suggest should be the fair value… sorry, the gap between the actual P/E and what the fair value is, I think can be explained by the fact that the market is looking through a peak Fed —if we can call it that— onto a more normal, neutral policy. That kind of line of thinking —if that's indeed what the market was thinking— I think got a lot of vindication last week. You see that by how much that curve has dropped and, all of a sudden, the math makes more sense that way. I think that that's kind of been what's going on. Obviously, that number last week was a big vindication.

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I think technically speaking there was all kinds of shenanigans going on as well. The non-profitable growth stocks… they rallied in two days after the CPI report; they rallied 25%, in two days. That's not normal. It just shows you how much everything was tied down to the Fed. As I said last week, I can sum up the market narrative in 14 words. One, the Fed is solving for 2% inflation and two, the market is solving for the Fed. It just shows you how much everyone is sort of hinging on that narrative.

[00:06:10]

**Pamela Ritchie:** Would things have been different if the U.S. midterms had been different? Would we be solving for anything else in the market?

[00:06:17]

**Jurrien Timmer:** The midterms help. I just created a couple of new charts. The election cycle is one of those things where every four years I go deep and I go back a couple hundred years and I create a whole set, but then you don't update it very often because it's only an election cycle. Then another election comes and it's "like, oh god, now I've got to wrap my head around this again". If we go to slide 19...

[00:06:42]

**Voiceover:** The 'Presidential Cycle' slide was tweeted on November 17.

[00:06:46]

The seasonality of the midterm election cycle certainly helps as well. Obviously, we have the outcome, which is not as red as maybe the political strategists expected, but it looks like the House will flip. There's still a few races that are being counted, and it looks like the Senate actually will stay at 50/50, which means that Vice President Kamala Harris will get the tie-breaking vote. Either way, you're still in a gridlocked type of situation and the markets tend to like gridlock. That's not a not a political statement, of course, but the markets tend to prefer that the government stays out of their business by regulating less. We have some tax proposals on the table from the Biden administration, including the 1% tax on share buybacks; all of that stuff is now not likely to happen at all.

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I think from the market's point of view, that's good news. I think also the Fed is still kind of cleaning up ... I don't want to say the mess, but it's cleaning up from this kind of very large fiscal monetary impulse that clearly stimulated the economy as it was intended to, but also created inflation. The fiscal side now being kind of removed from the equation for the next couple of years, other than a few maybe scary headlines about debt ceilings and fiscal cliffs; but we've seen that before and we'll see that again. Other than that part, I think this gives the Fed a little bit more of a clear slate to be able to focus on monetary policy without having to worry about whether fiscal policy is getting in the way of that, which would happen if there was more stimulus, for instance.

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In that chart, sorry —I kind of led it up and then I didn't speak to it— in that chart that was just shown, you see the 4-year presidential cycle in purple. That shows that the first and second years tend to be the weakest and then the third and fourth year tends to be the strongest. The thinking historically has been that at that point the party in power wants to stay in power, so there's stimulus, there's fiscal, maybe even monetary. That's been the thinking over the centuries, but if you look at just years for the midterm cycle —which is this year, where the markets were down— you see a very pronounced cyclical or seasonal pattern which we already have. We already have the pattern where August, September and the first half of October tend to be the weakest and then from November to April tend to be the strongest. That pattern is emphasized during these years where you have a down year during a midterm election. That's the pink line. You see that the market has basically bottomed right in line with that. Again, the caveat's always all else being equal and all else is never equal, especially right now, but it's one little hint that maybe things have gotten as worse as they're going to get.

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**Pamela Ritchie:** Let's move to whether we look at the crypto story of last week as sort of one large step in the maturing of a new area of the market. If you look back at other blow-ups that are similar, is it that same idea that the strong will survive?

[00:10:17]

**Jurrien Timmer:** Yes. It's pretty unbelievable that these things continue to happen. For the hardcore Bitcoiners, the Maxis, this is only vindication that you should never be anywhere other than Bitcoin because all the other stuff is too Wild West. I'm not going to weigh in on that opinion. We've had crypto winters before, of course, after 2017 with the ICO boom, the initial coin offering boom, which was, I hear, in many ways far worse than what we're seeing this year with Celsius and now FDX and others... LUNA, and all that stuff. In 2017, when that market peaked and we went from boom to bust, from summer to crypto winter, I think there were a lot fewer people paying attention because Bitcoin wasn't really mainstream yet. The ICO boom and crash was kind of like a story for really the die-hards. This year everyone is aware of it. Crypto became a $3 trillion industry and the eyes of the regulators are on that space. This happening this year with these very big players, these kind of gold-standard players —no pun intended— is big news. I think at the end of the day they will all get shaken out.

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I don't know where that's going to leave Bitcoin, whether the low is in or whether it's still coming, but my sense is that this really drives home the point that the space really does need to be regulated, hopefully in a prudent, reasonable way. My guess is that regulators in Washington are looking at FDX to say "yeah, yeah, we really need to start getting going on this". There are a bunch of bills in there that are being discussed. I don't know if the midterms will accelerate that or slow it down, but my sense is that there will be another wave. There always has been; this is the third crypto winter in 10 years or so, and my guess is that that next wave will be the one where the whole space is now regulated, or it will be by then. And I think that will create the kind of level playing field where institutions feel a lot more comfortable saying "okay, now it's time to get involved". I think they were ready to get involved maybe a year ago, six months ago and then these blow-ups happened and now they're like "I'm going to wait for the regulators to step in so I know what I'm doing".

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Just one other thought is that it highlights that there's a difference between the technology —the blockchain protocol— and the tokens. It reminds me of the tech boom and the dot com period in the late 1990s that the promise was about the internet. And that certainly came true, but there were a lot of bad companies that went up 10-fold or 50-fold that ended up crashing. There's also companies like Amazon and Google that flourished and are still with us today. I think crypto is going through exactly the same thing. There's no question, I think, in anyone's mind that blockchain is going to revolutionize the world, at least the financial worlds. Those rails, those decentralized rails... in order to get on there you need to get into the tokens, which have these very boom-bust kind of characteristics. That's the rollercoaster that has had to be navigated.

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**Pamela Ritchie:** An area totally unrelated, but just in terms of some wild rides, in terms of momentum that we've seen in either direction —volatility that we've seen— where do you see momentum in the markets right now? Do we go back to commodities for this?

[00:14:27]

**Jurrien Timmer:** Let's go to page 15.

[00:14:30]

**Voiceover:** The next few slides Jurrien refers to is 'Rotation' and 'The USD", retweeted on November 15 and November 14 respectively.

[00:14:40]

There was definitely a momentum shift that's already been brewing. We know that energy stocks have been very strong, but when you look at the winners after the CPI report and, since the dollar has peaked, which is another chart we'll bring up in a moment, the leadership has clearly changed. The momentum now is in not only energy, but commodity sensitive in general; industrials, things like that. In this bottom panel on this chart, I show the 12-month range that these various groups are trading in, which are shown on the right. These are the value side, the small-cap side, the industrial side. These are all the ones that are getting legs. Let me see where the dollar chart is… the dollar chart is 14 and the dollar, obviously, plays a role in that. I think we showed this chart last week. The dollar was hinting at something because it was diverging against higher lows in the terminal rate, which is, again, the rate at which the Fed is expected to end tightening and, so, the dollar was making lower highs; the terminal rate was making higher highs and now, with the CPI report, the dollar has really, really come down. You can imagine the kind of animal spirits that that creates in terms of value, international, small-caps, commodities in general.

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This is kind of the new rotation. This is happening at a time… if we can pull up slide 24, when the leadership of the FAANGs —of the large-cap growth or the Nifty Fifty, as we've called them— has clearly reversed. I just had this chart updated; this is my Nifty Fifty study. It's a custom study that I've done looking at the 50 largest companies in the S&P 500. I look at their valuation, their earnings growth, etc.

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**Voiceover:** And the last few slides coming up are titled 'Top 50 vs Bottom 450', tweeted on November 16, and 'Commodities', tweeted on November 15.

[00:16:53]

The original Nifty Fifty, of course, was in the early '70s. That was the period where, after the recession of '68 to '70, institutional investors were the only players left in the stock market because retail got wiped out and they only wanted to buy the tried-and-true companies that will produce earnings no matter what. That was the original Nifty Fifty; companies like IBM and Xerox and Colgate… blue chips, basically. Then we had a second wave in the late '90s. Those were the big tech stocks. Then we had a third wave just over the past ten years or so; Apple, Google, Amazon, etc. You look at that chart, though, there's a lot of symmetry there and it looks like the relative outperformance of the mega-caps has ended.

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That paves the way, perhaps, for a secular rotation. I'm looking up the chart as we speak here, slide 30… and that secular rotation benefits everything that's on the other side of that trade. As you can imagine, the mega-cap growth companies have dominated so much they ended up being two-thirds of the entire market. As that now starts to come down, not necessarily because those stocks have to go down, but because other stocks are taking over the leadership. That leaves room for this chart to start to materialize.

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This chart shows the commodity index at the top going back to 1871. In the bottom I show 10-year rates of change for value versus growth, small versus large, commodities versus stocks. As you can see, there's kind of a rhythm in that chart. Every 30 years or so, there's a pretty strong cyclical pattern. It seems that those markets are all kind of ready to start moving. All of these things together tell me that maybe going forward —and maybe that's in the next bull market— maybe there's going to be whole new leadership.

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**Pamela Ritchie:** That is so fascinating. If 30 years isn't secular, I don't know what is. That's completely fascinating. There's a number of questions coming in. Let's tackle this one. It's a big question; we need your big brain on this. With the Treasury General Account set to increase by year-end and reserve balances to decrease, can you explain the relationship between the Treasury General Account, reverse repos and the equity market? How will this tool be used by the Fed if there's a bit of a pause on interest rate rises?

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**Jurrien Timmer:** It's a great question. It's a very, very detailed question. I don't think it has a huge impact on the stock market, but it has a big impact on the plumbing in the money markets and also the bond market in general. What happened was, after the last election, when President Biden came to power, and then we had COVID, and we had all the fiscal policy response, the CARES Act, the stimulus plan from early last year, the 1.9 trillion… by that time the Treasury had a very large cash balance epithet. That's called the TGA, Treasury General Account. There was well over a trillion collars just sitting there burning a hole in the Treasury's pocket, but it was sitting at the Fed. The Treasury made a decision to use up that money rather than issuing new debt to pay for all the stimulus that came with the pandemic. That makes a lot of sense. If you have this money sitting around, why not use it.

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It created a lot of issues in the plumbing because all of a sudden Treasury is not issuing a lot of debt anymore. That debt is used by investors as collateral in the repo market. So, all of a sudden you have a shortage of collateral, and this is why this reverse repo account at the Fed got into the trillions. For most people it's a sideshow. It's just you're either getting your funding one place or another, but it did have a major impact. To the point of the question, when the Fed's trying to do QE or QT, that plumbing can get in the way. For instance, I don't have the numbers in front of me, but I think that last week the Fed's balance sheet actually went up instead of down. It's supposed to go down because the Fed's doing quantitative tightening.

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It's not because the Fed changed its mind; that it's secretly easing when it should be tightening. It isn't anything that juicy, but it's just that the ins and outs of the balance sheet are affected by these plumbing issues and this Treasury General Account. It's really mostly just a plumbing issue. At this point the TGA is pretty much depleted, so there's no more cash to be had. If there is more fiscal, which there likely isn't going to be now that we have the gridlock from the midterms, but if there were to be more fiscal it would have to be done through issuing debt. I think this whole story about reverse repos and all of this stuff, it was a story for last year.

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**Pamela Ritchie:** It's interesting, just to pick up on what you said there that there won't be more fiscal. What is that? You would think that ... I know there's gridlock, but you would think that with sort of, I don't know, a near-death experience; they held on to it. The Democrats held on to it; why wouldn't they want to spend more or has the inflation story actually hit them as well?

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**Jurrien Timmer:** They would like to spend more but without the House ... how legislation works is that usually something starts in the House of Representatives and then that gets discussed and voted upon. Then it gets sent to the Senate and then the Senate will discuss and maybe sometimes the Senate has its own plan that's different from the House. If it is a different plan, then it goes back to the House, and they meet together in the two chambers to try to hammer out something that everyone can agree on. If they do, and the President is of the same party, then the President then will sign it into law.

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What we're going to have now is we're going to have a House that, I think, is going to be tilted to the Republicans, but the Senate will not. The Senate will be a 50/50. The Republicans will get all kinds of stuff going in the House, including things that are like oversight on Biden's family. It will be a lot of stuff like that, but it really won't go anywhere because the Senate will have the tie breaking vote from the vice president. Nothing will happen in the Senate, so that means gridlock and that means that some of the plans that President Biden had about infrastructure and taxation, raising taxes; that's all not going to happen at this point because you won't have all the power resting in the same party anymore. That doesn't mean that debt won't get issued. Obviously, the government still runs a deficit. There is still stuff that needs to happen but I'm talking about bold new bills that would have come out in the next two years that now will not see the light of day.

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**Pamela Ritchie:** There's been a very interesting shift on the geopolitical stage. We saw Biden and President Xi of China meet today with smiles, with a handshake. I don't know; I found that kind of surprising. Here's a question coming in, thoughts on the supply versus demand side of inflation. Will China potentially ending the COVID-zero policy have a meaningful impact in the next CPI print?

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**Jurrien Timmer:** I think part of the leadership we saw last week in terms of which stocks were going up the most, I think the China story is part of that and the dollar going down, of course, is part of that as well. It sounds like China is going to declare victory on zero-COVID and start to reopen. That's a big deal. China is the second largest economy in the world. I think part of what we're seeing in the rotation in the markets is the hope and the promise that China will start to reopen more. At the same time, that comes at a time when the dispersion between the U.S. and China couldn't be any bigger in terms of market leadership. And, from a deep value contrarian point of view, if the global cycle starts to turn here because China is finally joining in the recovery from COVID that already happened in the rest of the world over a year ago, then you have this very deep value play. China, I think, is trading at eight times earnings or something like that. In that sense what we saw that you alluded to about the two presidents finally meeting, obviously, that's good news because this was not going in the right direction for a while, especially since Russia invaded the Ukraine. Russia and China are seen as kind of allies on that front. Any kind of actual personal contact we see, especially with smiles, is obviously welcome. There's a few things going on with China and it speaks to the broader EM versus developed markets question.

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If you just look at EM rather than specifically China, it's basically the same story, but it's not quite as bad, but it's still the same story. When we go back to that chart that we showed earlier on small versus large, value versus growth, non-U.S. versus U.S. or EM versus DM, is kind of the same chart. Maybe this is the beginning of the kind of rotation that I think many, many people have waited for and hasn't happened yet.

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**Pamela Ritchie:** Let's finish, if you don't mind, on this question. Investor writing in; thoughts on fixed income including high yield, actually, are we getting back to the 60/40 is the question?

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**Jurrien Timmer:** In 2018 when the Fed was normalizing policy, nominal yields, which are the black bars there, went well north of real yields or inflation. And then, during COVID, of course, the Fed pushed rates way below where they should have been and rates were at 1/2%, 1% even though TIPS break evens were already getting towards 2%. That's the financial repression era.

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Now, because there really are no buyers —at least not until last week— in the bond market because the Fed is selling, the Bank of China is selling, the Bank of Japan is selling. Rates ended up pushing way through inflation expectations and the 10-year yield went to 4.3% even though the TIPS breakeven was only 2.5%. That is a significantly positive real rate and it's positive enough that, in my sense, the bond side has some real value here. We've talked about the 60/40 in recent weeks and my point has been that I don't know which half is going to work, the 40 or the 60, but I think one of them will. That's one more than we've had so far this year when none of them worked.

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Who knows, maybe both will start to work, and we get a very nice end to the year. I don't want to get ahead of myself. I think, at a minimum, the bond market, especially around 4% with inflation now clearly coming down as we saw in last week's CPI report, but still the Fed pushing rates enough that we could be in a recession next year. We don't have to dismiss that possibility. All of those things add up to me to say that at least the 40 has some real value. I don't think the 60 side is cheap, but maybe we've seen the worst. The 40 side, I think, actually has some real attractive valuation.

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**Pamela Ritchie:** Jurrien Timmer, thank you so much for putting this all together for us in sort of a fascinating time in these markets. It always is. We wish you safe travels and we'll catch up with you next week.

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**Jurrien Timmer:** Thank you very much. Have a good week.

[00:29:41]

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