Fidelity Connects

CIO Perspectives: Looking Ahead to 2023

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Bryan Borzykowski, Host

[voice-over]: Hello and welcome to Fidelity Connects – a Fidelity Investments Canada podcast – connecting you to the world of investing and helping you stay ahead.

As we wrap up the last quarter of the year, Andrew Marchese, Fidelity Canada Chief Investment Officer, and Portfolio Manager, offers his thoughts on various Canadian sectors and key themes that may shape the markets in 2023.

He comments on the rallies in the market as of late. He says we have entered bear market territory and if you look at historical precedents, bear market rallies in double-digit percentage points are not uncommon.

Andrew also discusses the potential of a recession in 2023. He says at this point it is at least highly probable, but not necessarily certain. Where we go from here and how does the Fed and Bank of Canada navigate from this point forward is what we should focus on.

Today's podcast was recorded on November 2, 2022.

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Bryan Borzykowski: I want to start off with sort of the big October news. Halloween was just around the corner, but we actually did not have a scary month of the markets. Out of all the sort of the bad news that has been building up October was actually the best month, at least for the Dow Jones, since 1976. What do you make of that? What does that mean?

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Andrew Marchese: Well, as everybody knows, we've been kind of in a bear market for this year. We've entered a bear market territory and if you look at historical precedents, bear market rallies of double-digit percentage points are not uncommon. I think part of it may be seasonality, part of it may be with an outlook 12 months out from here. You start talking about Q4 of 2023, people thinking maybe things might look better by that point in time. So one, bear market rallies are commonplace and sometimes double-digit percentage rallies and from a seasonality perspective, as well as the fact that we got kind of oversold from a technical perspective in the market in the latter portion of September, it's not surprising to see kind of some reversal in sentiment. The true test will be if that will persist going forward.

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Bryan Borzykowski: My intro mentioned the Federal Reserve rate announcement, which is happening later this afternoon. What are you expecting from that? How could that impact the markets today?

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Andrew Marchese: As you said, market consensus is for a 75 basis-point hike. I think really what the market's going to be focused on is what is the language they use for future interest rate hikes, their viewpoint on both inflation, employment, factors they're considering. Any change in language whether it's positive or negative from previous Fed meetings I think is really going to be under the scope of investors' focus. I don't, never have, made predictions on what interest rates will be or where they will go. We're just looking at a lot of data day in and day out and trying to really see what the impact is going to be for the securities that we want to invest in as opposed to worrying too much about Fed speak.

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Bryan Borzykowski: A lot of investors are wondering now if a recession is coming, when will that happen, how will that affect my stocks? Usually, the stock market does kind of decline before the economy declines. For investors who may be worried about a recession, what is your message to them?

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Andrew Marchese: Well, as you said, the stock market is a forward-looking discounting mechanism. If you look at history, you can go back 120 years and look at history, some common metrics that we're going to look at, inversion of the yield curve basically over every timeline, reduction and negative growth in the monetary base. Historically, these two factors in particular have the highest predictive ability about a future recession and they're both flashing negative right now. When you have both of them flashing negative concurrently, at least historically, they've predicted a recession. Now, the past is not always a predictor of the future, but I think most investors are coming to grips with the North American recession has to be deemed at least highly probable, not necessarily certain. Where we go from here is, how does the Federal Reserve and the Bank of Canada, for that matter, navigate from this point forward. That's what we're really going to focus on.

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Bryan Borzykowski: When you look at where the stock market is at today, how do valuations look? Could they decline further? Given that they've already fallen so much, where do you see valuations going?

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Andrew Marchese: I think much of the decline in the market, if not all of the decline in the market, and we'll call the market the S&P 500 because it's the broadest, deepest kind of market out there to examine, most of the decline this year has all been about a valuation derating on the back of higher interest rates due to higher than expected and more persistent inflation. We've seen multiples across the board compress. Those that were the most expensive stocks coming into the year have compressed the most, i.e., largely speaking, growth or technology stocks, large-cap growth in particular has really kind of compressed.

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Where we are today from a valuation standpoint, the S&P 500 is trading at almost 17 times earnings, call it about 16.8 times, which looks a lot better than it did coming into the year. Now, that being said, if you kind of correct for where interest rates are and use time series or history as a guide, one could make the argument that there's still maybe another 1 to 2 points of P/E multiple compression that needs to occur based on where interest rates are. I think that might be getting a little fine but that's kind of where we are. The one caveat in all that or the one thing I find a little perplexing is

that the equity risk premium for the market hasn't budged this entire year. It's sitting just above 2%, which is historically low despite the move up in interest rates. So we have to monitor that. That will get affected if the earnings revisions in the market place by Wall Street and Bay Street become deeper or more prolonged. I would imagine. That should be the knock-on effect that we should see the equity risk premium rise a little bit if earnings revisions have to repeatedly come down in 2023. It's one thing to note from a valuation perspective on the market.

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Bryan Borzykowski: Maybe talk a bit more about that. Revising to the negative is what you're saying. Have we been seeing that? I guess, maybe why are we seeing some of that right now?

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Andrew Marchese: If you look at earnings growth for the S&P 500, I think Wall Street consensus right now for next year is about 1.5% growth, but it's really kind of lifted by the energy sector. We all know that energy fundamentals for oil and gas companies have been very, very strong. Utilities are contributing a little bit to that. The rest of the market seems to be in a negative growth, at least from a consensus perspective prediction standpoint. The question then becomes, will we see more of that? In other words, has consensus adequately discounted profits in the face of what we saw over the last 12 months, which was rising commodity prices, rising labour costs for corporations, higher interest rates, which obviously increases one's debt service burden, and all that kind of is impacting profits.

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The question now becomes, with interest rates having moved up so much, how will demand for various goods and services be affected in 2003 [sic]. A lot of what I just mentioned is on the cost or expense side of the equation, the next point is, obviously, interest rates going up will have a negative effect on demand for goods and services. How much, how much will the demand kind of weaken over the course of next year? That will gauge whether we have an accurate handle on that, that will gauge if earnings have been sufficiently discounted either by predictions or by price in the market. Once you have either of those, and most hopefully it's usually price for all the reasons we mentioned earlier around the market being a forward-looking discounting mechanism, then the market can kind of take-off from that point and not wait around until everything kind of gets better.

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That's where we come to play at Fidelity. We have just an inordinate amount of resources located globally that are doing fundamental due diligence on publicly traded companies and trying to see if consensus estimates are too optimistic, too pessimistic or just about right. And then understanding full well what the intrinsic value is for each of the securities that we're conducting diligence on. When you get your price trading below your intrinsic value, you're going to want to act and you're going to want to act with conviction.

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Bryan Borzykowski: Interest rates rising, as you said, could impact demand for goods but what about demand for stocks, especially maybe some of the defensive sectors that, historically, people gravitate to when times are tough, but now you can get a bond with a decent coupon. How does rising rates might impact some of the opportunities in the market?

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Andrew Marchese: You just made an interesting point about fixed income in the sense that when we came into the year fixed income, if you invert the yield, was trading at about 175 times. It would be kind of like saying the P/E of a fixed-income instrument. Now you're down to 25 times so, relative to equities, they don't look as bad. I guess what you have to kind of determine in that is are we close to kind of yields peaking out at some kind of duration, so somewhere out on the curve. If so, if we get a slowdown, a further slowdown in the North American economy, will 10-year yields then begin to fall which, obviously, fixed income will look better from an investment perspective.

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I think you're right that people tend to invest into defensive securities and groups, consumer staples, utilities, as the economy becomes a little bit squishier and you want to avoid cyclicality, that's the usual playbook. I think what you want to do right now is do a lot of homework, not on the defensive stocks because for most people you should have been there, at least in part, at the start of the year and probably more so as the year transpired. Now, you want to look at the stuff maybe that has been really beaten down and that you've managed to avoid. That doesn't mean you need to buy it today or tomorrow, but you do have to have a working plan to kind of understand what your prices for these securities.

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That's where we're dedicating a lot of our efforts. We're really sharpening our pencils on the front end of the economy again. Again, doesn't mean we're going to invest today or increase positions in those kind of stocks today or tomorrow. We just need to do our homework because quite frankly, we know since the start of the year, many of those securities have been the places you wanted to avoid. Now you need to revisit them given that the correction in prices have been fairly significant in some cases.

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Bryan Borzykowski: What are we talking about? What sectors look interesting maybe for a bit of a more risk-on attitude that investors may want to take?

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Andrew Marchese: Back in September, I talked about at some point, maybe in the second half of 2023, if the Federal Reserve and central banks can kind of get inflation under control, we further slow down, but maybe at some point there will be the opportunity late next year to add risk in a consistent manner and prepare for a new economic cycle. When you talk about a new economic cycle you're looking at the front end of the economy, which generally means consumer discretionary stocks, transportation. You may want to revisit technology even before that because a lot of these companies can grow with or without an economic tailwind provided the price is right. So it makes sense from an investment perspective based on valuation. Financials are typically, historically, front end of the economy stocks. We have a ways to go here to work out what is the extent of the economic slowdown. Rather than using the term recession or not recession, hard landing or soft landing, there's an economic slowdown coming. We need to determine the depth and the duration of it to have a better handle on kind of when to reorient the product towards more early-cycle stocks. That's the kind of homework we're going through right now.

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Bryan Borzykowski: We're getting some questions in from advisors. There's a few on Canada here. Maybe just to start and I'll get into some of these is, what are your thoughts on the Canadian market and are there sectors within our market that you're seeing opportunities in?

[00:13:46]

Andrew Marchese: Yeah. I think when people think of Canada, they think of financials and energy almost first and foremost, particularly if you're an international investor in that Canada's held up a little bit better than the rest of the world this year, chiefly the United States. One of the questions we're having to ask ourself in the oil and gas sector is, I think, in my estimation, a fairly favourable kind of intermediate-term investment thesis around it. It remains to be seen if we have more cyclical headwinds in the economy if that sector can continue to perform well, particularly since the stocks have done fairly well over the last two years. We're really examining that sector on a case-by-case basis, not treating it as kind of a holistic type of group.

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I think the one thing people have to think about with respect to Canada comes back to the Canadian consumer. We are far more interest-rate sensitive than our neighbours to the south, so I think to the extent that interest rates continue to go up, we are more extended from a borrowing perspective, from a leverage perspective, chiefly as a result of housing and real estate, and that has a knock-on effect to spending. Will the spending slowdown be more material in Canada versus the United States and what impact would that have longer term on the currency? You might reach a level where you can't raise rates as much as a result. You might even, who knows, in the future get into more of a cutting stance before the U.S. does and that has a negative consequence for the Canadian dollar vis-à-vis the US dollar.

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These are all the things we're kind of debating in our head. I think on an idiosyncratic basis there's a lot of interesting, idiosyncratic stories in Canada in consumer, in industrial, technology, so we're really kind of paying attention to those things. From an international investor perspective, it always comes back down to kind of energy, financials and maybe to a secondary extent, materials. Think about gold or mining in general.

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Bryan Borzykowski: Of course, housing is coming up in some of these questions. Do you have any concern about Canada's debt levels in general and also our housing market?

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Andrew Marchese: It's one of the things you always have to alert yourself to the extent that Canadians are kind of overlevered, overexposed to housing, so you're kind of like balance sheet rich and a little cash flow poor. That kind of thesis becomes a little bit more concerning as interest rates move up. The knock-on effect in terms of spending in the economy, particularly if the slowdown continues to persist or get deeper, then you start talking about things like unemployment rates rise. One thing, when you talk about a recession, there's several things in any recession that look different except for unemployment rising. That's consistent, that metric is consistent on every North American recession that's ever been recorded.

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If you have higher interest rates and possibly higher unemployment levels, you do have to be worried about the extent of debt exposure and debt burden for Canadian consumers and then the knock-on effect in terms of spending and the economy kind of getting back on its feet. These are all things we think about very generally, but because there's so many moving parts and the spectrum of outcomes is fairly wide, what we prefer to do is really get down into the single security level and really examining the risk that each business model level to kind of spot where there's opportunities and differences between one company in an industry versus another company in the same industry.

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Bryan Borzykowski: You mentioned unemployment rates. They haven't really changed much over the last while. Why is that? If we're expecting to see that is it just coming or is something else going on right now?

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Andrew Marchese: I think there's a few things going on. It's the most lagging of all indicators, one. It's usually the last resort type of indicator that tends to move up. Number two, I think there are still several disruptions in supply chains, including certain areas of the economy are suffering from labour shortages, very much so. We've kind of hypothesized and talk amongst ourselves within the Canadian team about does the unemployment picture in this slowdown look a little bit different? You'd still expect the number to move up to some degree if it's truly a recession, but does it move up as much as you think it is because there seems to be kind of imbalances in the labour force themselves.

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It's one thing to monitor and it may mean that certain industries actually don't have to lay off and maybe in some sense that's a good thing. Other areas, the economy might be a little flat and so, naturally, over the course of the last decade, it drew workers to those industries for a variety of reasons. Maybe those industries will be more impacted than you would otherwise think. We really have to kind of do our diligence and talk to the companies in that respect to get a better handle on what companies and industries may be more or less affected.

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Bryan Borzykowski: One more question on Canada unless more come in but someone wants to know, what is the Bank of Canada's neutral rate and will we get back there or do you see it changing to reflect the new normal?

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Andrew Marchese: That's a good question. Not to be coy or anything but that's always a moving target and the Bank of Canada would probably tell you the same thing. The dot plot in the U.S., if you look at the Federal Reserve the terminal rate right now is forecasted to be, I think, around 4.8, 4.9%. We'll see after today's meeting. We'll have a little bit more news around 2:00 p.m. today to see if that's accurate and that's a consensus kind of number or if it needs to move higher or possibly even lower. The one thing that everybody keeps talking about from an investment perspective are the terminal rate for both of those central banks, which is why I said, and I said this back in September, the move that we've had in equities to the downside has largely been based on derating.

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We're getting closer to having a better tightening up that spectrum of outcomes from here, where it was in January about where interest rates could go, to about here. I think that's the important part. It's not about trying to determine is the right number 5, is it 5.5? You're reducing kind of the spectrum of outcomes and once you've got a better handle on the spectrum of outcomes, I think, you can have more information or better information to put in your calculations about what you want to actually pay for a security, whether it's an equity or fixed income or real estate or anything else for that matter.

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Bryan Borzykowski: Let's move across the border and look at global markets in the U.S. Is the U.S. still a safe haven amidst all the global uncertainty? Are we close to emerging markets looking more attractive?

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Andrew Marchese: Again, if you look at 120 years of history or maybe probably closer to 80 to 100, the U.S. dollar is the reserve currency of the world that is a low-beta currency in times of crises. In times of economic stress, it does better. This year is kind of a great example of that. The U.S. dollar has done better than just about everything. I think fundamentally it makes a lot of sense too. The question about emerging markets gets a little bit more complicated. I think because of that there are still some remnants of disruption as it relates to COVID going on that you see less so in the G10 type of economies. Complications with supply chain. Bigger picture issues like demographics and deglobalization. There's some people who postulate we've seen kind of peak globalization and we're getting more away from that and that could be debated, the speed and the magnitude thereof could certainly be debated.

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It gets a little bit more complicated in emerging markets. From an investment standpoint in emerging markets, what you do want to see is global synchronized growth. For anybody who's seen me present where we are in the economic cycle chart, we're definitely late cycle in kind of the developed economies. China has been in a growth recession for this entire year and some of the emerging economies are still down there in the contraction phase. What you need is to get through all of that. It's complicated by the fact that there are some structural imbalances and some demographic imbalances in place here that kind of muddy the waters a little bit. I think from my standpoint, and this is just my personal opinion, I've been very favourable on some things in the U.S. I do think the U.S. dollar has been justified and having its strength this year. We'll see how that kind of ferrets out into 2023 and beyond.

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Bryan Borzykowski: Another question coming in on dividends, the importance of dividends in 2023. What are your thoughts on that?

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Andrew Marchese: I think extremely important. I think cash flow and companies doing the right thing from a capital allocation perspective, including buying back their stock or paying out dividends, is going to be vital to outperformance. If you look at the payout ratio for the S&P 500, it's about roughly 85% of earnings, that's pretty good. That's generally speaking at the high end of the range, but a consistently high end of the range with low volatility, low variance. That's great to see. Share buybacks right now are about 6.7%. I think they peaked out at around 7, 7.1% in 2019. Really, for those

on the call who have heard me speak before, share buybacks had a lot to do in addition to lower interest rates about the appreciation of the equity markets and the outperformance of U.S. large-cap growth because a lot of those stocks were really free cash flow machines that ended up buying back their own stock. That actually catalyzed, in some part, a meaningful part, their outperformance against other equities.

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This will continue to be extremely important. I think we're still in the phase of the market where delivering high-investment quality companies, i.e., those with good balance sheets, those that are free cash flow positive that are managing their maintenance capex and growth capex and can continue to invest in their businesses accordingly and where they can't, they can buy back stock. All of that is beneficial to shareholders. Typically, at this phase of the cycle investment quality, high profitability and high free cash flow are factors that generally, historically have done very well in the marketplace.

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Bryan Borzykowski: You mentioned earlier that valuations could potentially come down a bit more. There's a question about just how much the markets have discounted the bad news. Could there be further to go and is there anything that you're looking at that could indicate signs of better things to come?

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Andrew Marchese: If we think about the economic backdrop and we've all kind of said slow down with ... if you look at historical metrics, there is a high probability of a recession in 2023, you naturally go to where profits can go to. I have not found any precedent that suggests the market will bottom before you get to the recession. Not to say that couldn't happen, there's just no historical precedent for it, at least from all the research that I've conducted. Then the question is, in the typical playbook and historic playbook, generally speaking, the market on average bottoms about six months prior to the end of a recession. What we're looking for is you take the individual securities on a valuation standpoint — I talked about that kind of 16.8 earlier and you could justifiably, based on where interest rates are, maybe a slight move up in the equity risk premium saying that number could come down to the high 13s or 14. You take that, couple that with the macroeconomic factors and I think three things from a macroeconomic standpoint need to be monitored.

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One is manufacturing PMIs, service PMI's typically falling below 50. That should start to alert your attention that things are getting weaker. That's okay because that's going to mean investment opportunity. New orders getting weaker. They are below 50 right now. As those numbers converge towards the mid-40s or if it's a greater slowdown than when we currently think, it's the low 40s, that is a huge opportunity.

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The other thing that needs to happen from that standpoint is you have to get better comfort on the spectrum of outcomes from a profitability standpoint. In other words, do you think the largest extent of any earnings revisions, negative earnings revisions are largely done? Not necessarily every one but at some point, the market will have discounted that one, even though it hasn't been printed, and it will move forward. That's the second point.

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The third point is you need a change in rhetoric by central banks, an admission that they've gone far enough and even that movement to neutral, I think this time around might actually be a better signal than even waiting for the first rate cut. Historically, you start to see those front end economy stocks that I talked about, savings and loans banks, consumer discretionary stocks, varied discretionary stocks, start to move actually first. As the Fed starts cutting rates and the economic news sounds horrible, those stocks actually start to outperform because the market's already looking over the valley and to the other side. Those are the three things that I think you need to monitor and if they come together in a dovetail fashion, that's a very strong buy indicator for risk.

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In between there, I talked about bear market rallies earlier, the market gets very excited when they see a better inflation print and gets very disappointed when they see a worse inflation print. I think you're going to get a lot of that sentiment. To me, it's a lot more about economic activity going forward, PMI's, manufacturing and service, interest rate sentiment by central banks and then most importantly, valuation dovetailing with what you think is close to an adequately revised profit number for a variety of companies and industries. Get all three together, and that's why we're doing our homework now, you better act with conviction. If you don't, you're never going to quite believe it when it starts working. There will always be a reason to doubt yourself. You can't get into the doubt scenario because you'll miss the opportunity.

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Bryan Borzykowski: Great. We only have a minute left. I've got two quick questions. One last advisor question is just on Europe, what's your view on Europe and recent currency movements there? Could there be contagion in other international markets? I'll close with one other after that.

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Andrew Marchese: It's a good question. This is my personal opinion. I've kind of been negative on Europe for a long time and, unfortunately, with the war, manufacturing reliance on Russia from an energy perspective, demographic headwinds from a growth perspective, I've kind of viewed Europe from a very top down perspective as you can kind of see. Personally, I've been a little bit more negative on it than I would be, say, other particularly North American markets like the U.S. and Canada. That's kind of my quick answer on that one.

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Bryan Borzykowski: We've covered a lot of ground here. You're not travelling the world yourself and looking at all these places and analyzing every company. Tell me a bit about your team and how this is kind of a team effort at Fidelity.

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Andrew Marchese: We're back full steam, back in the office and travelling and meeting companies and going to conferences and having companies up here in our doors in Toronto and sitting down with them. We have those resources globally, Australia, Hong Kong, Japan, Continental Europe, the U.S., obviously, and Canada. We're all talking to each other about what we're seeing in the various industries and securities that we cover, comparing notes. It's an interesting world. It's more heterogeneous than probably it's ever been about people's perspective on what's going on in the economy, whether you're talking about supply chains, labour, sustainability, climate. You meet people from all over the globe. I consider myself very fortunate because I have the opportunity to meet people from all over the globe both

through Fidelity and outside of Fidelity. It's interesting to hear the perspectives on the world. By having more people on the ground, you get more perspectives. You're able to kind of just hear more perspectives. I always think that's very useful in trying to compose an investment thesis because if you kind of live in a vacuum or you don't spread your wings, so to speak, you will have a myopic view of what's actually going on. The more you can incorporate into an investment thesis, I think increases the probability that you'll have a comprehensive investment thesis, and therefore, increases the probability that you'll be correct in your investment decision.

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Bryan Borzykowski: I, unfortunately, have to leave it there. This was a great discussion. I look forward to chatting again at some point. Thank you so much for being here today.

[00:32:02]

Andrew Marchese: Thanks again, Bryan.

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