Fidelity Connects

Sector Watch

Denise Chisholm, Managing Director of Quantitative Market Strategy

Pamela Ritchie, Host

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

U.S. September CPI data came in hotter than expected, rising 8.2% year-over-year compared to the 8.1% expected by economists. Areas such as food and energy saw a core consumer price index rise to 6.6% from a year ago, marking its highest level since 1982. So, what should investors keep an eye on in the weeks ahead?

Director of Quantitative Market Strategy Denise Chisholm joins host Pamela Ritchie as she shares what recent numbers mean for earnings and where advisors should look for opportunity in today's market cycles.

Denise says in terms of sectors she's keeping a close eye on consumer staples, healthcare and industrials. She says although investors are worried about a possible recession in 2023, historical quantitative data shows that even if stocks go down, it doesn't necessarily mean the market will go down. She says lows in the markets can also give way to opportunities for investors.

This podcast was recorded on October 13, 2022.

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Pamela Ritchie: Hello and welcome to Fidelity Connects. I'm Pamela Ritchie. Denise, so happy to see you always, So, kind of some interesting market reaction actually.

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Denise Chisholm: M'hmm, but in some ways unsurprising with volatility. When you think about macro variables and when you're convinced macro variables are the driver, oftentimes something else is. You see this oftentimes in history of buy the rumour, sell the news and I think that this might be a situation where that's exactly playing out. In some ways, the way to think about it who didn't know that inflation was sticky.

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Pamela Ritchie: Well, the expectation was 8.1%, as you say. It was 8.2%, so it's not too far off what was being at least expected and priced in, I guess, on some level. I mean, it's quite something to see how long the Fed will have to stay at this level.

There is so much uncertainty. I know that this is something that you've put into your research of late and shared, can you share this with us: the uncertainty of really what the heck the Fed needs to do to get this down and what it's going to do, ultimately. What do we need to know on that front?

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Denise Chisholm: Yes. Let's talk about the quirk in the data and then I'm going to talk about CPI in a second and then talk about what uncertainty usually means [audio cuts out] and why.

The first sort of quirk in the data when the CPI came across is the real big delta in terms of the upside surprise has been driven by shelter. If you remember, of the CPI, the shelter costs are 40%, which is a big number. So, it's a little bit of a wonky calculation. What you're seeing is not just like a price rise but a continued acceleration. I think it was from 7% to 8% on a month. Anyway, one of the reasons why I really don't like to talk about government data – whether it be payrolls, whether it be CPI – is because they tend to have very quirky calculations that are only predictive in terms of the market over long, sustained periods of time.

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When you start to look at them on a microscopic level, it tends to fall apart from a predictive power. I think that that might be one of the reasons why the market is reacting this way today because all of the house price data that we actually have on a live basis suggests that housing is decelerating in the U.S. and decelerating rapidly. I am not the only one who sees this. I'm sure the Federal Reserve sees this and has a Denise Chisholm on their staff somewhere going, hey, this looks like a quirk in the data.

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Pamela Ritchie: No, not you. They wouldn't have a Denise Chisholm. They have someone else.

[00:04:41]

Denise Chisholm: They probably don't have a Denise Chisholm, they have somebody else. I think that there's a quirk here that I think that they're not just sort of leaving by the wayside and they're smart enough to recognize that, we say it all the time, CPI is a lagging indicator. I think when you look at this microscopic data, you see things like that. That's sort of the ins and outs and what I see is the quirkiness of the data in the CPI.

Again, we have at the overall level a deceleration, certainly not quickly, certainly stickier than I would have expected, certainly stickier than the Fed has expected but still, maybe, you can still see the path from, not a pivot. We don't need them to stop hiding. In my opinion, a market driver would be pivoting from the 75, getting off the 75 train. That might be what the market needs to say, okay, you're basically taking your foot off the market's throat.

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I think what's more interesting is, so what do you see, again, this sort of buy the rumour, sell the news, why do you see things like this? Because oftentimes at peak levels of, let's call it, uncertainty, that's the opportunity in stocks. To me, the best part about being an equity market investor is that I'm kind of comfortable getting uncomfortable because usually when it's very uncomfortable in the markets, that's where there is opportunity. The higher the levels of uncertainty are, the higher your average returns in equities over the next 12 months. You see 27% when policy uncertainty is high and we're in the top 5% of history and I'm sure even higher today, this is usually a daily number, when you see that uncertainty, while most equity market investors get uncomfortable by that, I actually think that there's an opportunity.

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What you've seen historically, I say it all the time, the market is a discounting mechanism and that means more often than not when the bad headlines are so visible that who doesn't know that the CPI is sticky or that inflation is sticky, that usually tends to be the contrarian indicator and the market maybe has already discounted some of that bad news.

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Pamela Ritchie: What's really interesting is when you see in the markets things coming back and parts of the market coming back, there's sort of this discussion of whether you see a bear market rally and what's going on and which sectors ultimately are in there. Speak to the sort of larger rotation, if you will, that you've been pointing out for some time now. Does it continue here?

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Denise Chisholm: Yes. I think that the rotation continues and I think it's driven in two parts. The one part that I've talked about before, and let's definitely talk about it again, is that defense is expensive. You can measure that on a factor level with low volatility. You can measure it on a sector level with … I'm going to pick on consumer staples, but I'm going to add in health care and utilities. If you aggregate those together, they've only been more expensive 4% of the time historically. That changes your margin of safety as an investor. That's why I think what we're seeing is if you were really worried about a global recession or a credit crisis, banks are actually holding in much stronger than you might expect, as is beta from a factor perspective. Why is that?

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Pamela Ritchie: And they report tomorrow. It's sort of an amaz-, anyway, to me, that probably doesn't surprise you. But it's interesting.

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Denise Chisholm: Well, you usually do statistically see them underperform going into the reporting. Yes, it is a little bit off cycle and I think one of the reasons, or at least in the work that I've done, that I think that financials are so interesting right here is because I think that the market's tipping their hand of how strong valuation support is. We are in the bottom decile of price-to-book, relative price-to-book going back to 1962, same bottom quartile, at least, maybe bottom decile of relative forward P/E.

When you see that, even in the top bottom three quartiles of unemployment rate change, the unemployment rate's going up. We're worried about that as investors, worried about a recession, so when you see that your risk reward is still positive for financials when you're at that valuation level.

In some ways, your risk reward is the worst if you think that the unemployment rate is going to change such that it will within a year be in that top quartile level, that's 8%.

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That means you as an equity market investor have to think that the margin of safety isn't sustained enough in financials and you're betting on an unemployment rate over the course of next year going from 3.5 to above 8. So, if you are worried about that, then I think that maybe financials isn't the right risk-reward for you. If you think that maybe we can sort of have a softer landing than potentially that, I think that financials have more valuation support than the average equity market investor thinks. I think that that's why you're seeing a rotation away potentially from defensive areas of the market to, I'm going to call it, economically sensitive areas of the market like consumer discretionary, like financials.

But you're also seeing another rotation as well, which is in technology. And I think that those high P/E areas in the market still have some relative derating to do because when you look at the relative forward P/E of technology as a sector, going back to 1962, we're still in the top quartile. Even if you are there on P/E and the market potentially goes higher, it might not be led by high growth stocks. It might be led by those cheaper, economically sensitive sectors.

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Pamela Ritchie: Is it time to buy utilities? I just sort of wanted to get your emphatic, which I think is the answer, no but you'll tell us.

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Denise Chisholm: My objective is total return, right? If you think about what does Denise Chisholm do: I try to beat a market. The S&P is my benchmark and we're talking all about what will likely beat the S&P over the course of the next year. Utilities do two other things for investors. They do provide downside protection, which you have seen over the last year. They do provide income which you have seen over the last year. To the extent that your investment goal is to do one of those two things, I think utilities have a place in your portfolio and regardless of their relative valuation level. That said, do I think that they are likely leadership in the market over the next year? I do not. That is emphatically because their starting point on valuation is the most expensive they have ever been on earnings.

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From that, your odds go to something like 10%. Your odds for utilities beating on an ongoing basis to the S&P, I think is only 35 but those odds even slip further when they're expensive, which they are now. Let's call it 15. I think that that's not a good risk-reward and I actually like areas like consumer discretionary and financials and I'm increasingly doing work on industrials, but down the cap spectrum.

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Pamela Ritchie: Down the cap spectrum. Can you tell us a little bit about that? You've told us about consumer discretionary and we'll talk about it again but why do you want to take a look there?

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Denise Chisholm: Let's talk about small- and mid-caps versus large caps. We're seeing the two things that I like to see specifically in mid-caps, less in smalls because they just have less earnings, but mid-caps are sort of a sweet spot in where the two indicators that I watch, valuation spreads being wide and relative valuation being cheap or low, which is predictive. That's what you're seeing right now. You're seeing top decile disconnects.

Relative valuation spreads being very, very wide which, again, is that expression of fear, investors are selling anything they think is risky. They're buying anything they think is safe, that bids up that gap. You usually want to sort of hold your nose and buy and look forward a year and usually, most of the time, 90% of the time, that makes you money with double-digit returns. So, it's a really compelling risk-reward.

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The second area that we haven't seen since, let's call it, around the pandemic lows, was that valuation gap between specifically mid-caps and large caps is now top decile wide on earnings on book yield. I think that that's very attractive. You are seeing that the most of all the sectors in the industrial space. That's where valuation spreads are wider, fear is pervasive and that's where relative valuation is really supportive. I need to do more work on that but I am very interested in that sector down cap spectrum.

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Pamela Ritchie: That's fascinating. You also spoke about the uncertainty and that had to do actually more with, I think, the Fed and the uncertainty of where rates are going. There's a lot being discussed today about this being the last inflation report before the midterms in the United States. Again, kind of run through ... I think most people sort of gather that it usually flips from what it was before at this point but does this number really put that into sort of some kind of stark relief one way or the other?

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Denise Chisholm: We've certainly seen the polls narrow over the last five weeks, which is not really a surprise to, at least, our political commentators internally, so probably not a surprise to our clients who've been listening to us. What you do see, I think since 1980, 80% of the time, something flips in terms of control. I think the base case is that you will likely see the Republicans take the House. The Senate is a little bit more of a question but as long as one of the two areas is flipping control, then there's basically, let's call it, gridlock. I think that that's the base case. Uncertainty tends to happen around midterms. I don't think this time it's caused necessarily by midterms – that's part of it – but certainly I think that we're seeing it around the Fed and inflation.

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What you see is this really unique pattern, because I'm not a big speaker on the four-year cycle because I think that there isn't really consistency in each of those four years when you look historically. From a pattern recognition perspective, an equity market investor, I think, has trouble playing that four-year cycle and coming away with any alpha or odds associated with it, with the exception of the one year following midterms. If there's sort of a rhyme and a pattern within this, it is that uncertainty traditionally peaks around the midterms and is lower the year following and that leads to higher-than-average returns in the market, a lower variability of outcomes and 94% odds historically, which is very high of that point in the cycle, of an equity market advance.

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I think that you're seeing this rhyme around the midterms for potentially different reasons. I think that it's not just the election that is uncertain. It's the Fed and inflation and other things. But that peak might be the pattern recognition that equity market investors might need to predict the next year's returns.

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Pamela Ritchie: You mentioned utilities in the context of what may or may not be leadership. I think there are a lot of people still trying to get through right now rather than look to leadership, but what is falling away as what will probably or likely not be leadership? You mentioned one. Any thoughts on sort of the winnowing out process here?

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Denise Chisholm: I think that in some ways it's the relative valuation rotation. In fact, maybe we should name it that over the next year. That's what I see. It's the relative valuation rotation. It's not necessarily going to be growth to value. It's not necessarily going to be low beta to high beta, but I think that what you're seeing is anything that's expensive on a relative basis, and that's the thing, it's got to be a stacking rank order within the S&P 500 sort of has a negative skew in terms of risk-reward. I think that there's more valuation compression that might actually happen versus upside for earnings. I think when you see that as a, let's call it, a pattern to recognize, I think the three sectors of risk are utilities and I'm going to add in consumer staples that I'm actually going to downgrade, I think at the end of this month on my webcast, the investment research updates, so tune in for that. I think that that's definitely number two in terms of relative valuation. I think three is real estate.

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I think that that might be one of the riskier sectors because it has that unique combination of sort of being expensive and having the most earnings risk even worse than, obviously, utilities, but even worse potentially than consumer staples. I think that that is sort of the area of the market that is the riskiest area from a relative perspective. It's ironic that those two of those sectors are usually the area where defensive sectors want to get defensive. That's why I think that … I've been sort of almost surprised by the level of support in terms of relative valuation, meaning as much as we want to say statistically, this is a macro [indecipherable] market, it's been all about inflation, it's been all about the Fed, nuh huh, not true statistically. Relative valuation has been much more predictive. Quality specifically hasn't provided any defense. Low vol hasn't nearly provided the defense that it does traditionally in down markets. I think that relative valuation has actually been more important than macro factors and I think that that tells us what we need to pay attention to over the course of the next year.

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Pamela Ritchie: That is so fascinating for anyone who dismissed that. Low vol and quality, just those factors again.

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Denise Chisholm: Low vol and quality, not being nearly as protective. Quality, specifically, underperforming dramatically through the course of this downturn.

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Pamela Ritchie: Let's talk about energy. Energy is just the wildest place.

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Denise Chisholm: It is and I have to say, I'm seeing less opportunities here. I'm getting a little bit nervous about energy. I'm sort of neutral but I think that it's actually neutral negative and I'll tell you why.

We've shifted really from the area two and a half years ago where it being real bright spot in the market, really strong indicators that you wanted to buy. Demand declines are usually when you want to weigh in, partly because you get massive multiple expansion as you look through any earnings declines.

Then we shifted to a place where energy companies are just more profitable than any investor ever thought that they would be, creating, again, like financials, very compelling valuation support. We were then in a situation where what you saw was a situation where valuation was so supportive that you didn't even really care what a commodity did. Where valuation usually provided upside on a relative basis due to the aggregate stock market where your risk-reward was still positive for [indecipherable] commodities.

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Pamela Ritchie: ...nothing in the way. They were just throwing money back at investors. There was just nothing blocking that.

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Denise Chisholm: That's right. That's exactly right. But now you've shifted to a situation where, one, demand is slowing and slowing potentially rapidly. Now, we can argue about OPEC and supply cuts trying to bring it in balance but it's a question of whether or not supply cuts can bring it in balance as quick as demand may slow. I think more importantly, you're now creating a situation where you've seen such a disconnect between the relative performance of stocks and the overall commodity that it lowers your odds regardless of valuation levels. Put differently, I think you're now clearly betting on a higher commodity and I start to get uncomfortable betting on a higher commodity in an area or in a situation where global demand is likely softer than expectations as the globe, and potentially even the U.S., shift sort of lower from a growth trajectory perspective.

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You always see the sort of oddness within the equities market, not necessarily the commodity, but the equity market where it's not necessarily the direction of the commodity which we just saw. The commodity was down and the stocks actually outperformed dramatically. It's more of whether or not it takes out the peak. It's sort of, to me, that the burden is on crude to go higher than 120 to really get to the outperformance that we need to see for energy stocks to be outperformers. I see this as a risky proposition historically. It doesn't mean that it can't happen. It doesn't mean I call it the clear short in the market where I'm banging the table, saying you've got to get out of energy. But I think that we have to be wary as investors that there are less opportunities in energy, more opportunities in other sectors.

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Pamela Ritchie: To add on to that, and you've been talking about traditional energy in this, I believe in this particular commentary. Are you seeing a valuation disconnect, actually, between renewable energy, that space, broadly speaking, and traditional energy? Is it starting to nibble away at eating its lunch?

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Denise Chisholm: No, no. There's still that valuation gap where renewables, just because the earnings trends are so much lower. I think that there is compelling valuation support within the energy sector still. It's very hard to get any sector that is that compelling based on the earnings trajectory that we've seen. Those disconnects still stand, meaning old energy is still dramatically cheaper with dramatic more valuation support than, let's call it, new energy or green energy.

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Pamela Ritchie: This question is going to the recession discussion. If there is a recession in 2023, do you see further lows between now and then? This is in the equity market.

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Denise Chisholm: I'm going to say no, to give you a crisp answer to that. Now I'm going to tell you why.

The problem with recessions as it relates to the equity market are, we know this, stocks go down into recessions but they bottom [indecipherable] throughout the course of recessions. We saw it in the pandemic, as little as one month into the recession. Stocks bottomed all the way through to 75% of the way through the recession and that was in 2009. So wide range, so even if you knew that you were going into a recession, you still don't know, if you're just looking at history, when stocks would bottom.

One of the situations that is very unique this cycle, we can certainly talk about the CPI being unique, the Fed being unique, yes, there is a lot of uniqueness. The other uniqueness is, if you knew that, let's say in 2023 [audio cuts out], let's just say in 2023, in April we're in recession. In those six months going into a recession, stocks go down by an average of 2%. Our last six months, we've gone down, what, 25%? You already have this disjointed notion that stocks have moved before the economy. You know Bullet Point 2 as an investor that sometimes stocks go up even if the economy gets worse. You know Bullet Point 3 as an investor is that the more stocks go down, the higher the odds the stocks go up in the future. You could be very much in a situation where, yes, we are likely to go into a recession in 2023 and the stock market already discounted.

The reason I am so open to that position is because instead of trying to predict all of that, I tend to rely on quantitative indicators that say exactly that. Defense is expensive. Risk is cheap. Valuation spreads are wide. That skews your risk-reward in the market three X, any other historic quartile. It actually limits your downside because stocks have already gone down and changes your upside to a higher skew.

I look mathematically at exactly those indicators and I am seeing that upward skew. That makes me wary of saying, yes, even if we go into a recession next year, stocks will likely be lower. I don't know if they're lower over the next three months. Usually you start to ... when you bring in your timeframe from 12 months to three months, it ends up looking like a coin flip. Usually what I say is the indicators that I'm looking at, if you are willing to hold your nose, look through any bottom of whatever it is, you usually have a significant opportunity over the course of the next year.

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Pamela Ritchie: Let's go back to the pivot just for a few seconds and sort of the absence of everyone expecting it in a month or in three weeks or at the next Fed meeting anyway. I don't know whether that's right or wrong but it seems to be an absence of that in the markets at the moment. There appears to be less of that. What if there is more of a version of sort of the quantitative tightening coming as a way of providing an undergird to the overall story? I mean, we are seeing this in the U.K. so that's why I'm asking. But you do wonder if things start to crunch and that piece of it, of the Fed doing some version of easing at the same time becomes more likely. What does that mean for equities if?

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Denise Chisholm: I see what you're saying. We see a pivot in the Fed funds rate but QT continues on. Is that what you mean?

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Pamela Ritchie: No, sorry, the other way around, actually, that actually they take the pedal off the QT and allow easing in that way while they continue the rate rise which is sort of what you've seen in England, where the Bank of England has gone into the market.

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Denise Chisholm: I think if we want to use Bank of England as a comparison, they were forced to buy. If the Fed is forced to buy, they will buy because they are the lender of last resort. That is their actual job. I think that we would probably have to be into a forced situation like a collateral issue as the Bank of England did. I think that there's still the emphasis on reducing the balance sheet at the same time as you are hiking interest rates. Whether or not that has an overall impact on the market, to me, when I see it from a liquidity perspective, it's specifically in mortgage. If there was a situation where QT lightened up faster than the Fed lightened up, the biggest beneficiary there would be mortgage rates or lower mortgage rates.

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Pamela Ritchie: Which have been sort of off the charts for most people who were in the middle of trying to negotiate new types of mortgages. Very interesting.

As kind of a final note on the macro story, obviously the inflation story, what are you watching very, very closely that probably will catch up with you on in the next couple of weeks?

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Denise Chisholm: Valuation spreads and credit spreads. I'm watching always the two things that I watch, valuation spreads and credit spreads. We'll see what my valuation spreads do because I get them daily the day after. I don't know what they're going to do now that the market's up. We'll see where we close.

Credit spreads, you're still seeing the same trend which is it's fairly muted today. We're certainly not taking out any highs. In some ways, when you have these big macro drops and you don't see real moves in the market and, to me, real moves is a change in trend, I think that that starts to tell you that a lot is discounted.

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Pamela Ritchie: Denise Chisholm, thank you for joining us. Great to see you. A fascinating look through the other pieces of the story today of which there are many.

[00:27:46]

Denise Chisholm: Always good to be here.

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Thanks again, see you next time.