Fidelity Connects

Looking to the Fall: Trends in Canadian Markets

Joe Overdevest, Director of Research and Portfolio Manager

Pamela Ritchie, 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.

Joe Overdevest joins us on today's podcast. Joe is director of research and portfolio manager at Fidelity Canada. For Canadian investors, Joe co-manages Fidelity Global Natural Resources Fund, as well as private pools, strategies for institutional clients, sub-portfolio manager on Canadian Asset Allocation Fund, and equities subportfolio manager on Fidelity Inflation-Focused Fund, a fund launched in September 2021 that aims to invest in securities collectively resilient to inflation. As Director of Research, Joe oversees a team of equity research analysts who focus on specific sectors, providing research and analysis to portfolio managers.

Today, with host Pamela Ritchie, Joe looks ahead to autumn 2022 and trends in both Canadian and global markets. Joe reflects on different sectors and how rising rates and inflation may affect markets in the coming months.

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Pamela Ritchie: So delighted to see you. Happy August.

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Joe Overdevest: Great to be here, Pamela. Happy August as well.

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Pamela Ritchie: Here we are, right in the middle of it. We have to sort of absorb all this right now. Speaking of dates, if we were having this conversation 12 months ago, talking about what companies are up against and what might be coming up for the fall, pretty different environment.

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Joe Overdevest: Oh, totally different. I would say it was a Goldilocks scenario. I mean, you had monetary fiscal policy positive, a lot of money in the system then, everyone had a job, no one went bankrupt because the country said no one could go bankrupt in this environment because of COVID. You had people with a lot of money. Their housing prices went up, their stock values went up and they only could buy certain things, we'll probably talk about this, and so they're [indecipherable], they're buying, buying, buying, they're clicking on things on their phone. That was a good environment. But as you kind of walk through now, you have some of that reversing and you have all of a sudden rates are moving a little higher, now all of a sudden, it's inflation that's starting to show up in the system. Now, potentially, we might have bankruptcies, you might have a credit situation. We haven't talked about credit situation in a long time.

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Pamela Ritchie: We haven't. There has been some consolidation, but not that much, really.

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Joe Overdevest: No, exactly. *[crosstalk]* took for granted you could get money whenever you wanted personally and company wise. I'm sorry to say, that is not normal and at some point in time, strong companies will do better, weaker companies will do less well.

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Pamela Ritchie: It's so fascinating, honestly, to take a look at this. You sort of wonder what kind of help... so companies themselves are trying to figure out where their balance sheets need to be and investors are looking at those more closely. Investors too, though, just need to sort of be thinking about a different set of things. I mean, how much harder is it basically to pick a winner at this point? It's got to be trickier.

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Joe Overdevest: I think right now it seems like old companies are doing well. I think we're about to hit rubber meets the road. One of the things you have to watch, too, is what we're hearing from companies. Maybe for the viewers here, you might say, well, the companies said earnings are fine, earnings are fine. We have to understand, we went through such a great environment, no one wants to put their hand up first and go, you know what, things are really bad for our business. If you're the first person to put your hand up, that means you're the weakest company. You're only half-way through the year, you're going to put it off, you're going to put off as long as possible. I think for people watching, I know us, as an investment team, we're doing our due diligence. Just because a company says X, doesn't mean we should accept that.

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I think rubber will really meet the road when Q3 and Q4 come out and companies have to start actually making forecasts for next year. In interest rates rising *[audio cuts out]* delayed effect in the economy, too, right? We have to understand that. Even some of these commodity prices moving up, there's a delayed effect, and so Q3, Q4 will be more telling. Again, I reiterate, don't actually listen to what they are saying, but watch what they're doing. One of the things the CEOs of many of these companies are doing are laying people off, small, but they are actually for the first time almost in a few years, laying people off or at least saying, we're going to slow hiring. That is very strange. The last few years, no one said that, and that's an indication where they potentially think their business is going.

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Pamela Ritchie: I think we'll probably talk about that further because it is such a big topic right now. We had the pleasure of speaking to a lot of people that you work with on the team, a lot of the equity analysts joined Fidelity Connects last week, through the week before and so on, and they're obviously actively doing what you just kind of pointed out. You're the director of research, so you work with them very, very closely and they pass things up to you and you pass things around. Do you want to just kind of go through what's going on right now in anticipation for the fall? I don't know what kind of detail you can give us, but this is an interesting time. Surely, you've got firing on all pistons here.

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Joe Overdevest: Yeah, the analysts' team is all around here, obviously. We joke, some of these days we try to avoid walking behind because we said we have to actually make it look like it's a full place. It's more active than you think. There's nine Canadian analysts and 350 investment professionals around the world that we can lean on. What are they doing essentially, what they've always been doing, essentially turning over rocks. There'll probably be almost every 30 minutes of the business day a CEO meeting. The analysts will host that. I have a number on my phone here where I'm going to be going to later today with CEOs from companies from resources, technology, and financials. They'll host a meeting. They'll come back. They'll write a research note, discuss with us, does this strengthen, does this weaken my thesis, does it change my numbers? They'll have an income statement, balance sheet, cash flow statement, forecasted out at least the next two or three years. They'll have upside, downside and target price. They'll then say to the team, should we be adding, should be decreasing our position, should we keep it the same? They're always trying to test that thesis. With every stock, they actually write on the research note 3 to 5 points why this is a buy or sell.

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Some people may have heard me say this before, but this is back to the Peter Lynch days, if you can't explain it to a five-year-old, you don't know what you're talking about. So every note, even the very complicated companies, will have 3 to 5 points why this is a buy or sell. So it's very good in terms of times like this, you're always going back for the analysts testing that thesis. Is something changing, is something getting better or is something getting worse? Essentially, keep turning over rocks. Even today, we have meetings with companies that we don't own. We have meetings with companies from the U.S. You're always just trying to find that ecosystem, trying to figure out what's going on because I do think the bifurcation will start happening. Right now, it seems like the last few years has been ... you should never say easier times, but they were good times for the financial markets. When capital starts getting pulled out of the system, rates start going higher, usually there's a bifurcation of the strong and weaker companies in every sector. The analyst team here, elite group, they're doing an amazing job, making our jobs a lot easier as portfolio managers.

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Pamela Ritchie: Let's talk a little bit about the idea of how that research, again, furthers the idea of sort of a false positive. I think that's basically what you're saying. It's what a company would say and their remarks after the earnings season and so on. What are the pitfalls at this stage in the market?

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Joe Overdevest: I think that one of the pitfalls you have to watch, I think we're all used to sometimes these ... okay, we had bad times and we have a V-shaped recovery, right? If you look back the last two major drawdowns in the market, the one that probably sticks in people's mind a lot is 2020, is like, oh, we'll go down and go right back up. Sorry to say, but some of these downturns are not a V-shape. They were an L or they were basing. The economy needs to find its base, the market needs to find its appropriate valuation before we grow again. Usually during that time, though, there actually is some big winners and some big losers. That's where you really have to do a lot of work. For the analyst team, that's where the research notes are amazing. They do a great job and they're very humble when they come on here. They'll write in the research note, this was the feedback from the CEO, he or she said this, this is my view.

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And that sentence there is worth its weight in gold, where the actual analyst says, my judgement is, I think, that they're being too conservative or maybe being too aggressive. I think that's very, very important. That's one of the toughest things … we're very lucky to get the best of the best when it comes to some of these students coming out of these schools … it's one of the toughest things when they get here is using that judgement. Investing, a lot of it is a grey area and even judging CEOs and CFOs, are they being too aggressive, are they being not aggressive enough in what they're speaking about their business, and judging people. Over time, the analysts do a great job with that. That's where sometimes you start making your positions before the CEO comes out and says, you know what, things are really tough, we're lowering guidance 30% and the stock's down. That's not so helpful. It's more we want less reporting and more actual analysis.

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Pamela Ritchie: That's fascinating. Honestly, it is. Let's take a look with an eye to … general diversification seems to be a way forward, I mean, to traverse this. Is that agreed? There's sort of an opportunity to further diversify if investors are not already?

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Joe Overdevest: Yes. Yes, for sure. In uncertain times, you just don't know what will be in terms of strong or weakness, diversification at least gives you the benefit of surviving.

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Pamela Ritchie: With that kind of in mind, I want you to take us through the industries themselves, taking a look at the sectors. What ultimately do we see as sort of winners and losers within? Should we start with energy? It feels like the biggest newsmaking story really of the year for lots of good and very bad reasons. I don't know if you see this, is there a bit of the bifurcation of the discussion of oil and gas at this point? It does feel like they are two different markets now.

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Joe Overdevest: I think yes. Pamela, you make a good point. Normally, gas and oil move together. For a certain time … I'll review for people that gas didn't do as well a few years back when the Permian was really being drilled out because the gas was looked as almost like a by-product no one cared about and gas was pretty low. It's $2 or $3, then we kind of forgot about it. What's different now is gas over $7, oil is near 90, there's a number of things going on. One of the more interesting things, the Ukraine crisis, the awful situation there, is how Russia is responding. Russia right now, for the most part, seems to be weaponizing or threatening more with gas than oil. If you look at the chessboard, that probably makes sense. If you drive up oil prices it hurts, potentially, Russia's friends being China, India but if you all of a sudden weaponize or threaten at least gas, you're more hurting Europe, which is probably the region you want to back off.

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Again, they're not shutting off the gas, but they're just doing things like, oh, the turbine's not here or like, we need some maintenance. Essentially, it's like someone flicking the light switch. For a country that relies on you for a lot of things including energy, that's scary, right? Scarier times here, luckily, we sit in Canada, but Europe is openly discussing shuttering production or shuttering facilities. Essentially, what that means for people is like certain goods or certain jobs will be affected in the winter time because they're planning for potentially the lack of gas. We should be very thankful for where we are, but those are the times that are here right now. Natural gas has come up as definitely better in terms of where it sits, especially politically safer and it's North America.

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Pamela Ritchie: Fascinating. You expect to see prices reasonably high on this front through the next ... it's always a timeline question, but how do you see the price of both of those commodities moving?

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Joe Overdevest: I think with resources in general, if you did the buckets probably in terms of supply and demand the tightest would be oil, natural gas, then agriculture and then lastly, probably more the base metals. The base metals are more tied towards China and China still is doing, essentially, a policy of COVID-zero and that means a lot of shutting down and going on off and it's not very good. The metals in particular are more intensive for China demand. When you look at supply and demand, one of the biggest things we talked about even 12 months ago when you and I were doing this, or maybe six months, we do this quite often is just watch the commodities because no one was really talking about the commodities, is that it could be inflationary and, obviously, we didn't see Ukraine crisis happening but, obviously, that drove it even further. When we look at the next 12 months, one of the biggest things for commodities will be the same thing for the market, will be demand. The Federal Reserve in particular but all central bankers are trying to take money out of the system and trying to take liquidity out of the system. That is slowing demand. That's how you bring down inflation. So if you're bringing down demand, it's going to slow down all sectors and, of course, commodities is one of them. That will be the biggest driver.

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But for this audience here, I would say, when you look at the next two years, the bigger questions you ask ... we're meeting one of the biggest oil companies right now, here later today in our offices, in the world and one of the biggest questions we'll ask is supply. Almost everybody has given the same response, there's no supply response. We can give minutiae about little companies adding a little bit here and there but for the most part, there's not a major supply response across most of these commodities. If demand does not come off in a material way, we actually will have a situation. The situation will be demand destruction. You'll have to find a price that people actually stop using some of these goods in some way. But for sure, the global economy, that's the most uncertain thing right now, it's the level of interest rates and of course, subsequently, demand [indecipherable].

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Pamela Ritchie: Let's go from there into the financials, the discussion of, for sure in Canada, it is what is tied to the housing market. There's lots of other questions within financials and how they make their money, too, but what do you see there?

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Joe Overdevest: It's actually almost what the market saw. In the beginning of the year, Canadian banks and U.S. banks did quite well. Rates were moving up and this is positive for net interest margins. Also, the Canadian banks, the U.S. banks have started to come off. It's that subtle Goldilocks or nice situation to a tougher situation and for the financials exactly, they like higher rates, but if higher rates are because inflation is too high and also, more importantly, is that the market starts pricing in that rates are going so high, it actually leads to loan losses, that's a bad thing. Normally, financials, everything is to what degree, to the degree we're seeing interest rates rise right now, you have to give some pause. I don't think it's a red flag at this point, but it's definitely a yellow flag for housing. We had such a housing positive market in the U.S. and Canada, it's probably going to take some of that bloom off that rose there.

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The next question you're going to ask me, is loans and losses. The other thing I have to remind everyone, we've built all these reserves in 2020 and then we're releasing them. It's like a cookie jar, we just keep giving them back and forth and that's great. The cookie jar is getting lower and I know we may actually get to a point where, actually, you have to take credit losses again and the opposite way and that means earnings would go down. Now, the biggest thing usually for that, though, is jobs. If you don't lose your job, you're probably not going to give up your home. So it probably means loan volume or mortgage volumes go down but actually taking massive losses, but we're not at that juncture yet, but that's probably the biggest thing you watch for where the yellow flag becomes the red flag. That's one of the positives of this market, of this economy, at this juncture, luckily, right now, especially in North America, jobs are still a positive for the economy.

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Pamela Ritchie: It's something you come back to, for sure. Insurance, the insurers have interesting things at stake as well. It's been a very interesting time for that particular area. Do you see them sort of through the end of this year? They sometimes have international exposure, which has been a bit of a question mark for the earnings season, certainly.

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Joe Overdevest: The insurance companies, again, normally they benefit from higher rates. I think the one thing you have to watch is insurance and banks, but especially insurance, they have a big book of assets and liabilities. There's been a lot of gyration in the markets right now. For a long time, there wasn't and now, you have high-yield spreads moving, you have currencies moving a pretty good amount, you have certain countries, like you said, not doing well, some doing better. Asia is going through shutdowns. You just have to really watch that book and you have to embrace that you're not going to go everything in that book, and this is where the analysts come in to say, we've done a lot of work, we went through all the book, we think these are the risks and then also we had to make a judgement call, is this management a good allocator of capital? We're an allocator of capital, we're steward of your capital, good to hand it over to someone else and you want to make sure you know everything, but you won't know everything that goes on behind a company. So you have to make a judgement, is this CEO or this chief risk officer someone who's prudent because now, as Buffett says, the water's starting to go out now, now we're going to see who actually has their shorts on.

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I think in the life insurance spot, you really have to watch the books and that everything's been fine, you've got to watch where the marks potentially could be. Also in the life insurance in Canada, some of the biggest growth was in Asia. That definitely is seeing some headwinds. This is an interesting thing, the winners and losers, though, in the bifurcation, there is some winners in insurance and one of them would be property and casualty insurance, *[indecipherable]* home and auto insurance and you're probably have opened your home and auto insurance and go, wow, that's a lot higher than it was before. They have pricing power. That's one of the biggest things right now, who has pricing power. They reprice their book sometimes every six months, but usually every 12 months, whereas the life insurance company, once they have you priced, that's it, they have to eat it. That's a big difference there. We're seeing some behaviour, and we'll see if this stays, of autos, people are driving to work less often and that helps auto insurance companies because we're getting less accidents.

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Pamela Ritchie: That's fascinating. There's also a question coming in about the geopolitical tensions in Asia and just, ultimately, how that kind of ripples through. You kind of mentioned it here just in terms of the zero-Covid policy with China, the overall slowdown in dynamic. I guess, just layer on top of that, if you would, the geopolitical situation as you see it affecting companies, investors.

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Joe Overdevest: I think the geopolitics is interesting. You saw some headlines today of chip supply in the U.S. and President Biden, of course, speaking live. I think what's interesting about the Ukraine crisis, it was actually a wake-up call for a lot of countries. All of a sudden, who's my friend, who's not my friend and then, where am I getting this stuff? That was number two question. I think that was a real wake-up call, where are you getting your resources, energy in particular, where are you getting your food? And then number three, in the back of everyone's mind, where are you getting your strategic metals? Yeah, like copper and nickel, but there's a lot of these metals that we take for granted are in batteries or iPhones and chips. Where is even the chips being produced and where are they on the map? Are they in your friends or are they not in your friends?

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I would just highlight, it shows how sensitive this is where you have Nancy Pelosi just landing a plane and the whole world, especially China, was watching that very, very carefully. The sensitivities of this is some of the greatest I've seen in a long time. For companies, to your question, I think they're really watchful where their next plant will be and if anything, I know you're going to go to this, is there onshoring? I think onshoring is definitely on people's' minds for companies and, more importantly, countries more than it ever has been.

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Pamela Ritchie: Just the idea, it's not so much on onshoring but, as you say, just sort of counting up what you've got in your backyard and Canada has a lot of those things you mentioned. I was reading an article just about how the Canadian currency is ... you don't want to look at the U.S. dollar too closely next *[indecipherable]* but if you look at it, sort of in a G20 context, it's got some strengths. The Bank of Canada has been raising rates and so on. We have all those things that you just mentioned that people are wondering whether their friends have those types of things or not. How does Canada look, do you think, globally?

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Joe Overdevest: I think it's a great segue, Pamela, as Canadians, we're always very humble. We're like, oh, we have these issues, our interest rates are going up here and such like that, but when you look, essentially you said, the world right now, we're sitting pretty well. We should be pretty proud of where we sit. Obviously, we have resources. We're not talking about shutting down the steel mills come January like other countries. Our currency is very strong and we always look it versus the U.S., oh, it's not that strong, but versus other countries, we're doing very well. Our central bankers are at least being respected. Other central bankers around the countries are being questioned. The capital markets are responding in a positive way that the central bankers here in Canada are doing the right thing and doing it at the right speed. Yes, people have lots of, in terms of money in their bank account and, more importantly, jobs are very strong still. So Canada definitely stacks up pretty well in terms of what's going on in the world, for sure.

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Pamela Ritchie: How is then the Canadian consumer? We can look at this from a couple of different angles perhaps, but the idea of consumer discretionary, the idea of consumer staples. We are often told and reminded how much debt, household debt there is and how squeezed the consumer could be. What are you seeing so far?

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Joe Overdevest: I think it's one of those interesting things. The market, or maybe the newspapers, automatically want to think everything's binary, like everything's great or everything's really bad and probably we're more in the middle. So the Canadian consumer, much like even the U.S. consumer, or many consumers around the world, had a great time the last few years. I think it's just a little tougher and especially the lower income cohort, you really have to watch. Energy and food has really taken a lot out there. I think this is where, again, there's going to be a bifurcation. What consumer companies do well, what will not do well. You potentially would see trade down. You see people going more to dollar stores, more to discount items.

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We probably talked on these shows before, some of my peers, high, big ticket items that people were buying at the Home Depots of the world, the Ronas of the world or maybe the next Sea-doo, maybe that is not as plentiful in terms of demand going forward as has been the past. I do think we will see, the cohorts are seeing different pains and definitely the lower cohort, and that's where stock picking definitely comes into play but overall, I think the Canadian consumer is doing okay, but they're taking some of maybe their growth off and just because they have to take it from somewhere and if you have energy prices moving up, you have food moving up, you have to take it from somewhere. And you bought a lot of stuff the last few years.

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I think one of the interesting things, too, is animal spirits. We talk about more in the market, but when the newspaper every day is talking about recession or inflation, it has an effect on people. I think on the margin, people get a little more cautious. They get a little more cautious about buying that next truck, for instance. I think you just really have to watch what your growth rates are going to be and you understand that some of this we pre-bought some the last few years.

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Pamela Ritchie: We pulled things forward. When you mentioned that, for instance, in comparison to Europe that has to make decisions about what it will or won't manufacture, for instance, do you see manufacturing actually coming back to Canada for a variety of reasons?

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Joe Overdevest: A lot of these issues like bringing onshore, bringing oil and gas back to your country, obviously, Canada doesn't have this situation. All these things that you want to do, they just take time. In many cases, they also take government sponsorship because of changing of taxes or changing of just rules. Sadly, usually the politicians sometimes need to see a lot more pain before they make that change. But we are seeing that. We're seeing corporations want to do that. But this will take time. Again, you just don't shut down factories, there's a reason many of these factories were not here in Canada, was a cost advantage. Really, you're then weighing off the cost advantage maybe versus certainty.

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Pamela Ritchie: Do we make any chips here?

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Joe Overdevest: Let's just say, it's not going to swing the needle. That's one of the issues. I think the U.S. is figuring that out as well that relying on a lot more people outside of North America for that kind of things.

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Pamela Ritchie: Feel like we needs a chips pill or something. That seems like so much fun for them to hack out in there across things. Take a look at the software space. Let's go to the technology side of things. We've heard a lot about where duration stops and starts, but we also have some home-grown, really good software companies. I'm just curious how that looks right now, if it's part of the diversification story.

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Joe Overdevest: I'll use again, where there's pain, there's gain. I think one of the themes ... we don't invest in themes, but one of the things I wouldn't be surprised that you and I talk about 12 months from now is more mergers and acquisitions. Maybe not right now, but you have every ingredient kind of going a certain way that definitely increases the chances. What I mean by that is cost of capital is going up, the multiples are going down, big companies that were maybe were very prudent and held back from buying these high-priced stocks are now sitting there with great balance sheets. There's a lot of big companies in Canada that can do that and that's where you'd bring up technology. There's definitely some pain and there's definitely some gain. The pain bucket is obviously probably more e-commerce and just the high-multiple stocks, but where there could be some gain is the consolidators. There's some big companies in technology, for instance, who have great balance sheets who could take advantage of this.

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Pamela Ritchie: And that's what the analysts are doing.

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Joe Overdevest: That's what the analysts are doing, right. You have vertical market software, some boring companies ... vertical market software means software that you probably don't even notice you're using at work, but it's very crucial to your job. You're buying a little less on your iPhone online, but you're still doing that work software. I do think there is going to be definitely a bifurcation. We've already starting to see that and M&A could be part of it as well.

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Pamela Ritchie: What do you think investors need to know right now, as sort of a final thought or point?

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Joe Overdevest: I think what investors need to know now is that you had a great scenario. Things are going to be tougher. Just watch, you just think this is going to just turn around instantly. Sometimes this takes longer of a basing of the market gyrations up and down, a little more volatility. Please understand that diversification can really help and we're here to help with, again, the 350 investment professionals around the world. We're turning over rocks and we think it's a very exciting time to find some great companies in this environment.

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Pamela Ritchie: Joe Overdevest, I hope you'll come back soon. It's great to see you. I hope you and your family have a great rest of the summer.

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Joe Overdevest: Thanks, Pamela. You too.

[voice-over:]

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