Fidelity Connects

New Year, New Trends: Canadian Markets in 2023

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

We're joined today by Fidelity Director of Research and Portfolio Manager Joe Overdevest, for a look at the Canadian market across sectors, and how rising rates could impact the markets this year.

Speaking of rates – we look ahead to the next Federal Reserve interest rate decision on February 1st, and wonder what moves are next. Central bankers from around the world gathered in Sweden this week to discuss the health of the global economy, including a focus on climate change and the green transition.

Investors are also pondering what big themes to look out for in 2023, which Joe unpacks today with host Bryan Borzykowski. Joe also shares his thoughts on where he sees energy going this year, housing and mortgages, earnings expectations for 2023, and also details some conferences the Fidelity portfolio managers and research analysts have been attending lately.

Today's podcast was recorded on January 10, 2022.

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Joe, thanks for being here.

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Joe Overdevest: Thanks, Bryan. Excited to be here.

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Bryan Borzykowski: It's been not a bad start to the year so far in markets. It's small sample size, but the U.S. and Canadian markets are up a little bit. What is your outlook for 2023? What are you expecting to see right now?

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Joe Overdevest: I think what we had last year is ... first of all, context with setting up this year. Last year was all about interest rates, right? The amount we're going to increase was the debate throughout last year and now we're at the point where we're not really debating the increases; we're near the end. That's the hope. Now, the real debate ... and I think sometimes we look at this at Fidelity, what's front page news and what's page 16? I think maybe page 16, which should probably maybe move up a little bit in the newspapers, how long do these interest rates stay high? I think this is the debate when you see the markets. The markets are pricing in; we're going to go a little bit near where we are here, but we're going to cut soon. I think just for all investors, we have to understand that what's the probability of that actually happening versus the expectations? That could be where the big debate is as this year goes along.

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The analogy I would say to the audience is that last year... if you're driving your kids to Disneyland, they would say, are we there yet, are we there yet, are we there yet? And now you can tell them you're probably within about an hour of Disney. They're getting a little excited. And then you get them out of the car, and they go "okay, I want to go in Space Mountain; I want to eat chocolate". You're like, "you're going to eat carrots and we're going on the teacups". And they're like, "well, that's not fun". And we have to understand that we've gone through a good time where financial conditions were very accommodating, very low rates, quantitative easing... we might not have that benefit as much going forward.

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So, yes, we can cheer that we're here; we can cheer that rates are probably not significantly going higher, but also, they might stay longer at a higher level than we're maybe used to in the past. It will include headwinds for the consumer, includes headwinds for the market and it probably leads to a gyrating market that, at the top end, as soon as everyone gets excited, the Fed will probably make us pause and say, "you know what? we're keeping rates high or even moving rates higher than you think". Also, with a gyrating market near the bottom ¬–what helps us a little bit– we've had a tougher market the last, probably, 6 months, 12 months in particular, so some of this is already priced in. Again, we're just not used to this, but sometimes it could be a seesaw market until we find that equilibrium.

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Bryan Borzykowski: I think the Disney analogy makes me want to go back on vacation, but I guess not for a while.

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Joe Overdevest: Maybe no carrots, but we love to eat the chocolate.

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Bryan Borzykowski: Just on the interest rates. I think you're right. I think people are sort of anticipating things slowing down, but then you see last week Canadian job numbers, 104,000 jobs added. Instinctively you sort of want to say, "great, good to see jobs", but then you sort of feel like maybe we're not at the end of this. Why are jobs still growing and what is the impact of that maybe on that January 25th rate announcement?

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Joe Overdevest: I think that's what's amazing about the markets. It's very dynamic. You have a lot of behavioural –almost economics here– going on. It's not just Excel sheets. Naturally, you would say "why are we not in a looser job market at this point in time?". I think there's some qualitative things have happened. There's a large part the population in the older segment and in the younger segment that have left the job market. The younger segment… it'll be interesting if they come back because where they are in their lifespan, they probably should come back for their benefit and, in particular, the parents' benefit to get out of the house. There's a stickiness there that you can just see that the participation rate is not where it should be, so that's part of why it's sticky.

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Number two it's also just sticky in that, again, we forget, but CEOs and CFOs are men and women, they go to work and they're human beings. They have emotions too and they were scared the last few years to find people. So, just to tell them, "oh, yeah, you should lay off a whole bunch of people or not add people", they're still erring on the side ¬–for some sectors, you're seeing in tech, though, and even some of the U.S. investment banks recently are cutting– but for the most part people are still erring on the side like we maybe might want to keep more workers than less just because I had that recent bias, that fear that happened the last few years.

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I think this is one of the toughest things; maybe we will get into it with inflation, is that we have to understand that it's not one-for-one. If we move inflation, or the Federal Reserve or Bank of Canada does, from eight to four. Well, four to two, eight to four might be easier than four to two. This is one of the toughest things where the equilibrium will be. We talk about different inflation. We'll talk about goods, we'll talk about labour, we'll talk about commodities. I'm sure we'll get into that. But you brought up labour… labour is the sticky one. The other thing about labour is that are you going to tell someone who got a job increase or pay increase last year, you're taking their money away? No. So, there's a stickiness to that labour part of inflation and that's where it's probably going to be the toughest. The market will cheer inflation going down, but if all of a sudden, we just start seeing, well, it should automatically go from four to two just as easily, that might be the tougher part and that's where the heavy lifting will be about the longevity of that terminal rate.

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Bryan Borzykowski: Let's move on to inflation. We're moving into kind of a time where you're starting to get the year-over-year now from last year was year-over-year from these big numbers from a lower inflationary time to a higher one. Can inflation continue to rise by 6¬–8%. What are your expectations for this year?

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Joe Overdevest: We look at inflation; there's probably three big buckets. Number one is goods and probably goods; the biggest thing was probably actually supply chains of delivering the goods itself. But let's say goods, let's say commodities and let's say labour. On the goods side, there's already a lot of good news there in hard goods. The prices are coming down. You're seeing that with the consumers reporting that we're actually having sales. Last year you would talk to consumer discretionary companies like the Aritzias of the world, the Lululemons of the world, "we're not having sales; we actually eliminated sales because we can't get inventory". Supply chains were too tight; that was not normal. Now you're actually seeing, probably on Black Friday, Boxing Day, wow, there's actually sales. This is a new phenomenon, but it's actually just the old way of going about things. That is good; supply chains are easing.

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With the commodity in the middle one; this is the interesting one. Again, I'm sure we'll dive into this with questions. Commodities, you look at the outlook ¬–we just met with all the global CEOs of energy companies last week at a big conference– if commodities come down it's not going to be supply driven. What I mean by that is this is not normal. Again, we still keep talking to the energy companies. You've heard me say this last year at least; it's a boring time right now to be a commodity CEO or energy CEO. They're not really adding any supply; they're not adding any capital expenditures, very little exploration for a number of reasons. Normally, when you see commodity prices where we are, you would see a supply response. You are not seeing it. If commodities do come off, it'll be demand driven.

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China, which, again, I'm sure we'll talk about… you've got a billion people opening up. There will definitely be puts and starts there. As we all see in the news –and I'm sure there's more we're not seeing– there's a lot going on there that it is very tough on a human toll basis and there's going to be not a clean run right from the start, but, still, a billion people opening up over time is definitely a positive driver of global GDP, in particular, commodities. I think the concern for commodities is that if we do go into some kind of recession, it will bring down all goods, not just commodities. But right now, the commodity outlook is probably a little bit more stable on the margin with the positive being China.

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Last one is the labour, which we already discussed. That one probably is a little more stickier. Again, we should start seeing just the year-over-year comps getting better for inflation, but it will be the last 200 basis points … and this is the interesting thing too if you really want to get into the market debate … the Fed, in particular, has a dual mandate: jobs and inflation. You get to 4% and then all sudden you have to go four to two, which is what they want to do, but all of a sudden, the job market doesn't do well. Also, unemployment, which we have been very blessed with great employment market –especially North America– changes and they had to make tough decisions. What is more important, jobs or inflation? The audience will probably ask this, if you all of a sudden pause and say jobs are more important and you accept higher inflation, then you have a knock-on effect on bonds, on gold, on commodities in general, so they become very accommodative of higher inflation rates. Right now, they do not want to do that but that is the tough thing when you have a dual mandate.

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Bryan Borzykowski: On the recession, it's impossible to predict what's going to happen, but there are now sort of differing opinions on a bigger recession, a small one, maybe no recession. Based on the indicators that you're seeing and where we're talking about inflation and interest rates, how are you sort of planning for this year? Do you think there'll be a bigger recession? What are your thoughts on where that could end up?

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Joe Overdevest: What I really respect about Fidelity, obviously, we're bottom-up stock pickers, but more importantly, look at more like the probabilities of things happening. I think it's very dangerous when you say, "oh, for sure this is happening". I think people who say that love to give headlines; they love to be in the news. But in reality, a lot of this is grey and it's not black and white and it's probabilities. I think you make a great point. Right now, there's a lot of talk of recession, but let's be very honest, the data right now, we are not talking about recession. These job numbers are very robust. Consumer spending is generally decent. It is maybe getting a little slower, but it's still very positive. If we were in a recession, these stats would look a lot different. We would not be debating it; they would be definitive.

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Right now, it seems more just in terms of where we are in the calendar year and the benefits we're still seeing in the job market, in particular it's probably more the second half of this year you'll see slower economic growth. Really, the debate now is you can just see anemic growth. Everyone has to understand that a recession sometimes is just a little negative. It doesn't have to be the end of the world negative. The stats, the amount of wealth, the amount of cash in actual deposits in the banks, and the actual job market would point to probably it's more anemic growth and a shallow recession.

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Again, let's be very honest –and this is for the audience too– I think they can understand this, it's a very unique time. Normally you don't have quantitative tightening and interest rates rising in the same period of time. Even the Fed will be honest with you; they're very data dependent. As we go through this year, that economic outlook can change quite drastically if they raise rates too fast. This is the other debate too that some would say, is the Fed raising too much because they were too late and maybe they should pause a little bit and let the ramifications happen? Usually when you have that much tightening, there's a delayed effect. They're looking at data today making decisions, but they might need to pause a little bit because the actual effects might take at least six months to actually go into the system and people realizing, "oh, my mortgage rate has gone up this much, this is how much it costs to finance my car". Right now, it looks like more of a shallow recession as we go out, but, again, the Fed, we must respect, is the biggest driver where that could toggle one way or the other.

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Bryan Borzykowski: You cover the Canadian market and energy, in particular. Last year energy helped the Canadian market. Our market was down, but not nearly as much as the S&P 500. Where do you see energy going this year? What are some of the forces or trends that you're looking at in the energy sector today?

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Joe Overdevest: I think with energy, again, supply... there's not a real supply response. Again, we have to respect the CEOs of these energy companies, so what they're being told by the investors is don't grow. Give me dividends, give me buybacks; be a boring company. Number two, they're being told by the governments themselves that regulate them that "we don't really want you to grow". Right now, in Canada, if you were going to say, "we're going to build a new oil sands mine", that would be very, very, very difficult. The Canadian government would give you a lot of roadblocks to even have that happen.

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Number three, I think the boards themselves are questioning "how much capital do we really want to put in here? There's so many uncertainties". Even just for Canada, one of the biggest uncertainties is carbon capture. The oil sands companies in Canada want to do carbon capture. It's a great spot to do it, Fort McMurray. It's very aggregated together. You can do carbon capture there and they're essentially waiting on the Canadian government –provincial government as well... to come together to say, "well, what is going to be the tax benefit to do this?" If you do carbon capture facilities it costs a lot of money and right now they haven't got a definitive answer.

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It's really a big debate right now too because the U.S., with their new tax incentives for carbon capture, makes it very attractive to do carbon capture in the States. Whereas, here in Canada, we haven't come up with a clear resolution. This is where it also becomes a debate that if we don't do something we won't be as cost competitive and maybe an oil and gas company, which many are, go across both borders, go," you know what, we're going invest in carbon capture in the States". That would be a would be a negative for multiple reasons, for job growth, economic growth, but also lowering emissions. Right now, I think the U.S. government has been a little more pragmatic, if you're going to lower emissions, you probably have to work with the oil and gas companies.

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The Canadian government right now is debating that. If you watch closely, they've been very big on green hydrogen or renewables, but not really benefiting anything that helps the Canadian oil and gas companies directly or indirectly and one would be carbon capture. But the problem with that, if you want to lower emissions you probably have to have them at least sitting at the table for a solution. I think you're going to see some boring things going on with dividends and buybacks until we get more resolution on these issues.

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Bryan Borzykowski: The U.S. Inflation Reduction Act; that's where those big tax breaks are in. Do you think the Canadian government, industry, will they have to keep up with that? Do you think they will have to match it in some way?

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Joe Overdevest: I think the way the capital markets go, it will find a solution if you don't want to find a solution. It means by that is that if you don't want to give us the tax benefit and our neighbour does, well, we will move capital there and you'll see the benefits or detriment of that. I think the Canadian government will understand that. I think they've been pragmatic in the past about that. But at this point in time, they're not moving as fast, definitely, as the U.S. and they have a window here they have to execute on or otherwise capital will move to, again, the United States, in particular.

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Bryan Borzykowski: On energy, specifically on oil prices, what are your thoughts on oil prices? What factors could affect it going up or down?

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Joe Overdevest: Let's review what happened last year. What happened last year is that, obviously, Ukraine crisis in the beginning drove up the risk premium, I would say, in the oil price itself because people worried about disruptions. As you went further in the year oil came off and what happened there was the risk premium was probably too high because Russia found other outlets, in particular, China and India. Probably unofficially, and sometimes in public matters, said, "we will take your oil" whereas other countries said, "we will not take the Russian oil". They found outlets to not actually disrupt as much as maybe the market was expecting for oil, number one. Number two is China's slowdown and number three, is the U.S. Federal Reserve. Raising interest rates, to a large degree, slowed down global GDP, has slowed down commodities as well.

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As we look out to this year, as you can see, let's view the big buckets. The Russian threat is still there. Let's just say that's neutral. But I would say there's probably a little more friction this year is that you get price caps are now being enacted from certain countries. The other one was China; China now is opening up. Then the other one is Federal Reserve probably getting closer to actually, at least year-over-year, less of a negative headwind on the U.S. Federal Reserve. Lastly, I would sum the other one up that was probably different since last time I talked to this group, was the U.S. SPR, Strategic Petroleum Reserve in the U.S. was dumping oil in the market, especially late last year. Now has actually come out and said publicly, "oil prices near where we are, we will be buyers of oil". A lot of these factors are changing for the better. We're not really seeing a supply response. To sum it up, unless we have a major recession you have a number of positives here for the oil price from where we are today.

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Bryan Borzykowski: Great. Another question, what sectors in the Canadian markets do you see opportunities in?

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Joe Overdevest: We can talk about probably more idiosyncratic sectors. Consumer staples are still seeing a benefit. Some of the names would be inflation in the grocer space is benefiting. Grocers have a very small net margin, so any inflation is really beneficial to them. Number two would be the industrial space. Our rails are still getting pricing. This is very important these days. It's still a very inflationary environment, as you know, so companies are getting the ability to pass along price, and some are not. The rails are still seeing them. I'd say those are two probably areas that are seeing some kind of benefits. We can talk about some that are seeing some of the tailwinds as well, or headwinds.

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Bryan Borzykowski: Just on the sectors, you had mentioned when we were talking a bit earlier, you had some big meetings with some bank CEOs. That was yesterday. What are banks CEOs saying and what are you hearing from both? And you're meeting with energy sector CEOs as well, from both of those groups?

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Joe Overdevest: As PMs and analysts, we really appreciate and are humbled to be working at Fidelity. This January alone I think we'll meet with; I would say at least 30–40 different CEOs just of Canadian companies alone. We saw all the global CEOs on a conference last week. The Canadian Bank CEOs I met with personally with our team yesterday, the head of OSFI, which regulates the banks was yesterday as well. Lots of other companies are coming up in conferences or in-house. The banks, I would say that's one of the sectors that's seeing headwinds. If we look back, what are banks essentially, or bank stocks? Bank stocks do well because they are a play on the economy, essentially a leveraged play on the economy. The economy's doing well. We're spending more on our credit cards; we're buying bigger homes. Companies are spending more on hiring or capital expenditures; they need financing. The equity debt markets are benefiting, and the banks will benefit from this. They have their hands in everything, right? That, definitely, was a good time the last years.

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When we fast forward today, higher rates is choking a lot of this off. Higher rates, obviously, housing activity is falling. The spending, as you're seeing it, it's still positive because people have jobs but that's coming off a little bit. Capital markets and debt markets, the activity is very, very quiet. There's not too many companies doing any kind of bought deals or equity financing or even debt financing. Very, very quiet. If anything, the banks right now are probably– you're seeing in the U.S. first– starting to cut people or staff. That's a sign that already the banks are seeing some revenue pressures.

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We'll bring up housing just because it's a question I think we have to watch. In Canada, in particular, we have five-year mortgages. This is one of the issues that we have to be sympathetic to the average Canadian. Many of them have mortgages and some are variable, and some are fixed. In variable rates, there's really huge move up that the average consumer is not used to and their cost of borrowing. With a five-year mortgage, well, a certain percentage of those roll off every year and you have to, essentially, look at a new and higher interest rate and you have to make adjustments somewhere in your life. Your income probably didn't jump that much, so you have to lower spending somewhere else.

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For the banks right now, though, if I was to sum it up… we look at banks as investors, we say, "is this a balance sheet issue or income statement issue?" Balance sheet issue is bad. Balance sheet issue means there's a lot of bad loans and they might need to raise equity and you don't know what the book value is. We're not there. Right now, we're at more of an income state issue. An income statement issue means the revenue growth, and thus earnings growth, has headwinds, so probably you're more of anemic growth going forward. Again, some of that is already priced in with nine times earnings. We have to respect that these banks are seeing headwinds.

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Bryan Borzykowski: One of the conversations you had was about capital requirements related to the energy sector, which I thought was interesting –and I haven't sort of seen this before, so maybe some breaking news here, I don't know– but tell me about those conversations.

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Joe Overdevest: No breaking news here, sorry. I'll reiterate what Bryan's mentioning is OSFI, which regulates the banks, has been talking publicly saying, "one of the things we're debating internally is how do we look at climate risk?" This is a really interesting debate that has been brought up. Canada is just one of many regulators, especially in Europe, is looking at, "okay, if we're going to regulate the banks do we take a rifle approach or shotgun approach, essentially, to that risk?" What I mean by that is that we could, essentially, say, "well, as Canadian banks we have more exposure to the energy sector just in general versus other countries, so our capital ratios should be higher". It's a shotgun approach. Or do we do a rifle approach and say, "if you lend to oil and gas companies, you'll have a higher risk weighting on that capital when we do your ratios". Or we may do none of this, right? This is a debate.

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This is where I went back to why there's a supply issue right now is we're definitely seeing this in Europe and it's slowly coming into North America. The oil and gas companies are seeing their bank syndicates not wanting to lend them as much, or if they do, they're demanding a little higher cost. All that eats into, well, "maybe we won't spend as much, maybe we won't explore as much". So, OSFI, which regulates the banks, as I said, is looking into this issue and wants to come up with something maybe this year. I think it's a very big subject matter and, hopefully, they do it correctly because there's a huge knock-on effect, obviously, even provincially. If you really want to harm the oil and gas industry there's a knock-on effect to economic growth in certain provinces we have. They're sympathetic to this and they're debating it, but it's something I know even the bank CEOs are watching because it would change their behaviour as well.

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Bryan Borzykowski: Just about expectations on earnings. Where do you expect those to go?

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Joe Overdevest: It's a great question. I think this is one of the toughest things. I think Jurrien Timmer does a great job on these shows talking about it and he has some great graphs. Last year it was all about the P. When you look at the P/E, the price has corrected to a large degree. When you look at earnings growth this year, it's hardly moved. It's almost like it knows it should move down, but it doesn't know where, and this is often what the sell side does; they're not going to move until they see more clarity. This earnings season, the next 30 to 45 days, is very important. Companies are going to come out with actual reporting. Again, these are men and women, CFOs, CEOs, you kind of forget, but they look at things in yearly basis. Last year, they're still worried about probably hiring people early last year, making sure they have good supply chains.

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This year is a totally different. It's a new leaf. Now they look out and go, "you know what, we're not going to spend as much on these things like travel or maybe we're not going to hire as many people as we were going to before because they're seeing revenue headwinds". I would not be surprised the earnings revisions will probably be more likely negative than they are positive at this point in time. It's the magnitude is the key thing. This is a tough thing for the average investor. Often the market will bottom before the earnings actually bottom. We've seen this in past cycles. So, we could see a scenario as we play out this year, earnings revisions happen and the market bottoms and actually moves up even with those revisions happening. It's because the price has already corrected a large degree. Really, we're now trying to find, the market's calibrating, has the price moved down enough for the earnings? The earnings that we see on the screen or the Bloomberg screen or consensus, on the margin is probably a little too high for some of these companies, but has it already priced in even a lower number and thus you could see a higher market further out?

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Bryan Borzykowski: Who knows where things are going to go? You never know. But it feels uncertain going into 2023. As a portfolio manager, how do you deal with that volatility, that uncertainty? What is your approach to looking at the market?

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Joe Overdevest: I think you look at a few big things. Number one is debt. You have to really scrub the portfolio the last probably year, two years, making sure that ... people were really complacent about debt. You don't want to have companies that themselves are complacent having high leverage and their model can work with higher interest rates. I think number two, you actually look at where you could get a benefit. Where there's pain, there's someone else's gain. Some of these companies that for a long time had great balance sheets, they weren't being rewarded; they were going to the M&A market. They couldn't buy anything because private equity was bidding it up, now are saying, "well, I have a great balance sheet; I have cash and these private equity players I used to compete with have a higher cost of debt than they used to, maybe I can gain somewhere there". So, there is definitely going to be some more acquisitive companies.

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Lastly, just summing up, we look at probabilities and the end of the day, if you have great companies with great brands and offer great service, usually no matter the macro environment they're going to gain share and they're going to be better and bigger companies coming out of this. Really, time is to your advantage. As opposed to going, "oh, certainly the recession will happen here, it will be this magnitude...", it's more just looking at, "okay, there'll be tougher times ahead but if we have the best of breed high-quality companies, we'll come out on top".

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Bryan Borzykowski: It's always, I guess, focused on the fundamentals, but feels a bit more back to basics, a bit more focused on what really matters to make sure that you're getting a good company.

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Joe Overdevest: Exactly. I think it's just reviewing with the 400 investment professionals around Fidelity, talking to them, what are the best ideas? Again, lots of CEO meetings. Especially in downtimes, I do know for sure we would talk to CEOs more than normal. I would say our meeting schedules usually fill up and in good times we probably have one or two CEO meetings an hour globally. When the markets get tougher, usually that number goes higher. We're just going to keep turning over rocks and there's always going to be some great ideas that come out of this.

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Bryan Borzykowski: Joe, we will end it there. We're at time. Thank you so much for this. I'm sure we'll chat again. Looking forward to seeing how 2023 unfolds. Happy New Year and thanks for being here.

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Joe Overdevest: Thanks for your time and I hope everyone has a great year.

Ending: [00:29:32]

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