Fidelity Connects

Global Equities: 2023 Outlook with Patrice Quirion

Patrice Quirion, Portfolio Manager

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.

Fed Chair Jerome Powell recently signaled a slowdown in the pace of interest rate hikes as soon as this month. Have we officially reached peak inflation? And what are the implications?

We're joined by Portfolio Manager Patrice Quirion today to discuss global equities and where he is allocating geographically as we enter 2023. For Canadian investors, Patrice manages Fidelity Global Concentrated Equity Fund and Fidelity International Concentrated Equity Fund as well as private pool strategies.

Today, with host Pamela Ritchie, Patrice explains how he takes a very contrarian approach to managing his portfolios. This means that he enters parts of the market that have been out of favour, where the market likely overreacted to the downside from perceived risk, or just trends going the wrong way. For the past few years, it meant being more exposed to the financials sector, as well as more geographical exposure to Europe and to China at the detriment of large underweights in the U.S. Also, reflecting on the U.S., Patrice believes the U.S. dollars strong performance has peaked.

This podcast was recorded on December 1, 2022.

And for anyone interested in French content from Patrice, please check out our "DialoguesFidelity" French podcast channel. Patrice also spoke with Charles Denis, VP Regional Sales Quebec, and that discussion will be featured on that podcast channel.

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Pamela Ritchie: There's a lot of noise out there, for sure, in markets, there has been for some time but, actually, are you finding, perhaps, some of that noise is shifting to the side just a bit?

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Patrice Quirion: Yeah, the past few years have really been so driven by macro, geopolitics, stock picking maybe fell aside a little bit in terms of importance. It is still incredibly important at this stage, in my opinion, but the direction is potentially changing. I think if we just reflect back a little bit on 2022. If there is one thing the market really dislikes is to have to deal with just large amounts of uncertainty. We've had a lot of that, especially since the conflict in Ukraine that basically propelled the inflation fears and the inflation dynamics to whole different levels, given commodity prices

exploded to the upside. That led to inflation sort of instead of grinding gradually higher to spike higher. I think we are at a stage where we can start to make a pretty strong case on that abating, and the debate is still open on do we revert back to 2 or do we go down to a level that is maybe a little bit higher than 2%.

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The direction of travel has changed. I think that in itself is removing some of the uncertainty. I think steps like inflation missing, going back like a month ago, the Powell speech yesterday, the commodity prices coming off from a still good but slowing global economy, I think all of that is starting to address a picture that as we go into next year, I think the direction of travel might still be towards a slower economy but I think that the range of outcomes of just not knowing where does inflation peak, how high do rates need to go before activity slows down, how controllable is all of that going to be? I think we are starting to remove some of that uncertainty and because the market has a tendency to overreact, especially in periods where there is heightened level of volatility, if we can start removing those extreme tail risk kind of market events or uncertainty, I think that on its own is probably starting to project a different mindset of the market and I think this is reflective of what's been going on for the past few months and in all likelihood can probably go a little bit further here.

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Pamela Ritchie: Interesting. How, ultimately does that affect what you're doing? How does opportunity look to you now versus two months ago or even six months ago?

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Patrice Quirion: Just as a quick reminder, if I may, my approach is always to take a very contrarian approach, so go in the parts of the market that have been sort of out of favour for an extended period of time where the market likely overreacted to the downside from perceived risk or just trends going the wrong way. In my case, really for the past few years, it meant being more and more exposed to Europe, more and more exposed to China at the detriment of fairly large underweights in the U.S. From a sector perspective, it meant more into the cyclical part of the economy at the detriment of the growthier parts of the economy and the very defensive parts of the market.

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And as the aftermath of the Ukrainian situation really hurt that positioning, I've actually increased that to basically as far as I was comfortable. I will never put all our eggs in the same basket in the portfolios that I manage but I'm willing to deviate quite a bit. Those are concentrated portfolios where we really try to express where we think or where I think the biggest disconnects are between market values and sort of values that would be based on a normalized environment on a longterm average environment for businesses. This is really where we found those.

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Pamela Ritchie: In Europe and in China particularly because you mentioned those. I'm just curious sort of ... it looks really bad for a long time and maybe it still does but the question is, what do you do with that?

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Patrice Quirion: In a way, the fact that the trends have been so bad has created the opportunity. The market has, in my opinion, overreacted and really discounted a lot of these securities significantly versus what fair value or normalized earnings in a normalized environment looks like.

In the case of Europe, it's been, to a large extent, from the result of the uncertainty around energy supply going into the winter. I'm not saying there's zero risk but I think the risks are very small that there is an actual shortage of energy. There is the impact on price, but I think this is very well understood by the market and there's been a lot of very severe reactions, especially in Germany.

Again, I think if we take a longer-term view, those energy prices are not sustainable over time. Renewables will get built, more LNG will get imported, it won't need to be at these kind of price levels. In the shorter term, I think the situation is likely to end up being more benign than what the market feared going back earlier this summer. Storage is full.

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Pamela Ritchie: We keep hearing about the weather, is that why or is that part of the story?

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Patrice Quirion: I think there's been a pretty meaningful capacity to reduce demand as a result of high prices. That's having an impact. There's been alternative sources of supply. I'm not saying it's an easy situation, but I think it is a manageable situation that the market thought as being an unmanageable situation. Those are the kind of disconnects that really impact sentiment, really impacts prices. When you think of buying these businesses not on the basis of the risk today or the prices they need to pay for natural gas today but on the basis of what kind of profitability can these companies generate once we are through this phase, there was some pretty large disconnects.

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Same thing in China. The story there is all about reopening. I know in the background there is a weakening economy, there is issues in the real estate market but truthfully, this is secondary to the impact and the weight the market attributes in terms of sentiment driver to the lockdowns from COVID.

Again, we can debate when are they going to reopen. Some would say it's coming soon, some will say it's March, some will say it's next summer. Truthfully, I don't think we really know but I think there are signs that they are embarking on a path to get ready to reopen and in a way like predicting precisely when that happens, if you're taking a contrarian longer-term view of investing like analyzing businesses and how much you pay versus normal earnings, the precise timing of it doesn't really matter. What matters is how big is the discount, how much is the upside potential once we get there. I think in the case of China, it is meaningful and that's why we've been building positions through that phase.

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Pamela Ritchie: You've sort of answered it here but just spell it out further. The role for GARP (Growth At a Reasonable Price, how does that look for 2023 versus maybe what's set up for 2022? I'm just sort of curious, is it looking particularly good and different. You've answered some of it there but what is the prognosis?

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Patrice Quirion: In my opinion, how we're setting up for next year is, and how it translates to my investment style and what I'm trying to accomplish in the portfolio, look at what is out of favor, what's contrarian, what is a reasonable quality within these contrarian parts of the market. Yes, I'm willing to take a bet on Europe getting better, the energy crisis not being as impactful as the market fear but I want to buy companies that, if I'm proven to be wrong, time is going to be

on our side. I'm not playing Europe through chemical manufacturers which are critically dependent on energy price and natural gas supplies. I'm playing it through a variety of other industries that would be a lot less tied to it. Think of the auto sector, software companies in Europe, for instance, that are fairly disconnected but it's been punished on that.

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Pamela Ritchie: Financials based on interest rates? Financials in Europe?

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Patrice Quirion: Financials is another area where I do have a fair bit of exposure, definitely very contrarian when we build those exposures through the course of 2021, starting to come our way a little bit on that. A lot of it is starting to come our way. I think the market is starting to appreciate the higher certainty on what next year looks like.

To answer your question on what's the prognostic on how to be positioned going into next year, I think we will be on a path to lower inflation. We could be on a path to probably a low inflation level, maybe not sustainable, but a lot of the issues that propelled inflation higher, which was the spike in commodity prices and in agricultural commodity prices that pushed food prices, all of that is going to be going from a meaningful year-over-year inflation contributor to actually a meaningful deflation contributor next year just given the large drop in some of these prices by the time we get to next summer.

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I think the inflation picture is going to look a lot more benign. I think we will have an answer to where does the Fed peak and I think it's much more likely to be around the 5% than maybe the fears of 6% that were tossed around earlier. I think the economy will slow but it will allow the market to start to have visibility on what the trough looks like. Once we get there, the market is going to change its mindset. Maybe we're already sort of seeing parts of that over the past few months. It will change its mindset from asking, where is the trough and how bad is the trough on the global economy to saying, we are not at the trough, we have discounted a fair bit of that, let's position ourself for the upcoming recovery because the market is, by definition, a forward-looking mechanism and the market tends to look 6 to 12 months out. I think over the course of 2023, there will be a point where 12 months out we will start to predict an economic recovery.

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I have decent conviction on that because the slowdown that we are through has been self-orchestrated, in a way, by central banks. The reason we are seeing an economic slowdown is not because the consumer was in terrible shape or companies were not spending, it's because inflation was too high and we had to increase interest rates. We will get inflation back under some control. I'm not saying precisely 2% but we'll get it in that sort of range, where, if things were to weaken more significantly or for a protracted period of time, the central banks will have the ability to basically just ease back on all the levers they pulled. I think there will be a pretty clear picture to expect a recovery without having to think this is going to happen three or five years out. I think in the shorter term and I think that could well be the story of 2023.

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Pamela Ritchie: So interesting. Do you think that, related to all of the things you're talking about, the U.S. dollar has peaked?

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Patrice Quirion: I think it's quite likely we've seen the peak in the U.S. dollar. There's two things that drives it. It is, one, what's the risk aversion in the market. The U.S. dollar is a flight-to-safety type of asset and the risk aversion in the market has been severe, especially in the aftermath of the Ukrainian conflict earlier this year and then through the summer as inflation really spiraled, perceived as out of control. Inflation and the risk aversion has really propelled the U.S. dollar.

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The second thing is that brings the U.S. dollar into, or any currency, into relative movements is interest rate differentials. I should mention more precisely expectations around interest rates differentials. Because the economy has been stronger earlier in the U.S., it led to expectations of Fed rate hikes to be of greater magnitude than what we've seen in Europe, where we've seen some but it's been more modest and certainly like versus Japan, where we've seen none or versus China, where they're actually cutting rates. But now we're reaching a point where I think the market is finding that sort of peak in U.S. dollar interest rates.

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At the same time Europe will probably need to continue to increase interest rates. China won't be able to ease much further. There is a bit of a question mark on can the BOJ in Japan maintain rates at zero. I think the picture could actually turn the other way where rate expectations in the U.S. plateau, the rest of the world keeps going up, and that would be bearish U.S. dollar combined with greater risk tolerance or more risk-on appetite potentially in the market over the course of the next year. That would lead to a picture where the U.S. dollar peaked and that is quite beneficial, actually, to economies outside of the U.S. where certainly the inflation pressure they're facing eases, it moves capital back or stops the exodus of capital towards some of these regions and I think could go some way in reverting sentiment and reverting some fairly large discrepancies in terms of valuations across different parts of the world right now.

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Pamela Ritchie: So interesting. Companies at this point, and this is sort of a global question or within reason, have faced their own cost of capital realities at this point. There aren't many companies that haven't had to stare that in the face at this point. Is that fair?

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Patrice Quirion: Yeah. I think the bigger impact of higher cost of capital is more in the valuation of assets in the markets and therefore, how much are we going to pay for a given stream of earnings? Companies, the highly levered companies have definitely felt the impact. Even if their interest rates are hedged on their debt, the market's looking ahead. So, we've seen some very meaningful correction in the prices of companies that have what's deemed as high levels of financial leverage on their balance sheets. At some point, that will turn into an opportunity as well. I think we need to be careful because as much as I am sort of optimistic on the market having moved past peak inflation, that reverting down lower, I think there is still a question out there of, on a sustainable basis, are we getting inflation back to 2%? If the answer is no because of wages that remain maybe a little bit higher than what we'd like to see, maybe it doesn't allow the Fed to pivot.

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So, maybe we peak but maybe we don't get the rate cuts that the bond market expects over the course of 2024. I'm not sure exactly where we stand today but there's something like five interest rate cuts, I think, baked into the expectations right now. I am not very confident on that necessarily being the base case. If the economy is good enough and inflation persists, that may be a bit more than 2%, and maybe we don't get those rate cuts and cost of capital is maybe permanently a little bit higher than expected and that makes it difficult to justify a big valuation rerating thesis on the broad market and especially on the cost of capital sectors like growth, like really high quality businesses or like very highly financially levered businesses.

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Pamela Ritchie: Just looking at what's done well, what's, again, valuations of what's been sort of left because the concerns are there. Is there something to say on the size of companies looking at sort of the small-cap question versus larger?

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Patrice Quirion: I think it's a secondary impact, the market cap spectrum. In general, I would say that smaller mid-cap businesses had been more punished. They're usually seen as a little bit more of the risk-on asset class, so when we're in a risk-off market these tend to not perform quite as well. A lot of them are more cyclical. They're more economically sensitive because the large cap, the mega caps, there's more growth stocks. There's a lot of the big, whatever, consumer staples or the more defensive companies in the larger cap spectrum. I think there are more opportunities into that small- and mid-cap part of the market. I think the sectors where we play, the style exposure is really what's going to matter. I think value is still fairly well positioned.

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As I said, I think the rest of the world is certainly looking a bit better. But I would say all of that with a big caveat that when we go to inflection points in terms of what's leading the market, the moves can be very abrupt and I think we have seen some of that already over the past couple months and as a result, as a contrarian investor, I was already positioned on this more value, cyclical, ex-U.S. in a pretty meaningful way in my portfolios.

At the margin, what I'm looking to do is rebalance a little bit, take some profits we've had over the past couple of months and start to look again for the first time in a long period of time, like past few years, look again at some selective like U.S. tech companies, for instance, where I had no exposure and where valuations have really come off in a pretty meaningful way.

I think in my view of the world, I want to still be exposed to those exposures I had but maybe start reducing those bet sizes, rebalancing a little bit towards what has really not been working over the course of the past year.

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Pamela Ritchie: That's fascinating, some of the things. Just to go back to geographic, you mentioned the U.S. Do you want to just remind investors, your universe for various funds but broadly where you will look, where you won't look?

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Patrice Quirion: Just a quick recap. Global concentrated allows me to go anywhere globally and International Concentrated strips out North America. This is truly a Europe-Asia- Emerging Market portfolio. I'll comment on the Global Fund, I think it's more relevant. The U.S. is 60% of the world's market cap, much higher than historically, by the way. It

used to be they were in the high 40s or 50ish level mark. I am about 1/3 of the portfolio and the delta there, almost 30% underweight in the U.S. has been allocated to Europe and to China and some selective emerging markets like South Korea, for instance. Pretty big underweight in Japan in my case. As I mentioned at the margin, that positioning got pretty extreme. This is probably as far as I will go in terms of dispersion versus what the market has built.

At the margin, maybe looking to start rotating back a little bit in the parts of the U.S. that have been underperforming. I think it is still somewhat early days. I think, especially in the case of China, that remains really deeply out of favour at this moment.

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Pamela Ritchie: Europe's having a lot of discussions about whether they have to choose between trading with the U.S., China. How do you see that? Do you see that as noise as well?

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Patrice Quirion: I think there are pockets where this is absolutely real. I think the choice is not a choice. It is clear. They will line up on the side of the U.S. So, it's to be careful on the sectors where it is sensitive. I would put technology being one of those. We've seen what happened with semiconductors. I think this is not something that's going to get resolved. I think this is a new reality. Businesses that are either European or American that derive a lot of revenues from selling semiconductors to China, that part of the business is dead. I think more broadly there is an ongoing effort by Chinese companies to replicate industries that were historically held by U.S. or European or Japanese or South Korean companies. This is going to be more of a slow grind.

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Think of what's happening in the auto industry. At first it was to go after the mass market where the Chinese companies have done really well. Now, basically, the Fords and GM and whatever, like Nissan and Mazda of the world have really suffered in China. But at the same time, the Mercedes and BMWs and Audi and Porsche have been doing really well.

At some point, it will grow into a risk. I think this is not something that plays out over a few quarters. This is something that's going to play out over decades to come. I think we need to be mindful of these trends for companies that have a lot of exposure to China but I don't think it should be part of the investment thesis on the short term where the decision around when and how to reopen is going to be materially more important to the sentiment on these stocks.

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Pamela Ritchie: That's a big change, actually. That's a huge change. Do you think, Patrice, always there's big headlines often made when data is released. It's actually been this way for years, the data dependent phrase was even before the pandemic, as we know. That said, do you think there's a little bit less of the data dependency going forward? It's just these subtle shifts. Tomorrow is jobs day, we know that. Do you think that there's maybe just less all pent up in these data points?

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Patrice Quirion: Honestly, in the short term, I don't think so. I think that remains critical. The market really wants to see stabilization on the cost of capital and what matters most to that is inflation. What matters to inflation is commodity prices and employment data points. I think over the next six months it's unlikely to matter a great deal less. That said, as we move further into 2023 and we hopefully get that inflation narrative like easing interest rates, environment being sort of more stable, I think we will likely, assuming there's no other tail risk that surface, I think we will likely move to a early stage of the next economic cycle introduction.

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As we move into that, I think the typical view that the cycle doesn't last six months or a year or two, it lasts, I don't know, five or seven or maybe up to ten years. I think that will start to prevail. As a result, I think how companies perform with the investor's mindset that is, we are just in the early beginning of the next cycle. I think the macro noise should start to matter less and company-specific performance should start to matter more. I think there's hope to get there. That would help firms like us where we put so much effort on the stock picking but I don't think it's going to be the reality for the next few quarters.

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Pamela Ritchie: It's really interesting to catch up with you at this particular juncture and at this point. Patrice Quirion, thank you very much. All the best for the holidays ahead and great to see you.

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Patrice Quirion: Thank you very much.

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Pamela Ritchie: Thanks for joining us. We'll see you soon. I'm Pamela Ritchie.

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