Fidelity Connects

Live from London: Global Market Briefing

Tom Stevenson, Investment Director

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.

Today, we welcome back a reoccurring guest to the show – Tom Stevenson, Investment Director at Fidelity International, based out of London.

In speaking with host Pamela Richie, Tom provides us with his up-to-date outlook on global markets amidst the market volatility and high inflation we've seen of late.

Diversification continues to be important during times of crisis, and Tom shares what he is seeing on the ground in London, and observations on global markets.

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Pamela Ritchie: It's interesting, and you've pointed this out because you've just done a full second half of the year outlook report and we'll go through elements of that, how quickly have things changed, though, for you as you were writing it, as the machines were working to put this report forth? We had quite a month of July.

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Tom Stevenson: Yeah, absolutely. I mean, the half year point actually marked I would say, probably sort of peak gloom about the investment landscape. July was a pretty positive month by comparison to the first six months of the year. Now, it would have been difficult for it not to have been positive compared to the first six months because as we know, the January to June period was the worst start to the year since 1970 on some measures. It was a 20% fall in the S&P 500, more than that in the NASDAQ, it was a difficult start to the year. But interesting how July picked up, there's a bit more optimism around interest rates, there's a bit more optimism maybe about inflation. I do think we're at an interesting watershed moment in markets at the moment.

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Pamela Ritchie: It's very interesting. It comes back to the question of what's been priced in. Let's start with what's been priced in on the interest rate rise story. I think you mentioned it when we were off air. It keeps going.

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Tom Stevenson: I think what probably has been priced in is a shallow recession. The question, are we going to have a recession, are we not going to have recession, I think we're probably answering that question. I think we probably are going to see recession in many parts of the world on both sides of the Atlantic but, I think, the key question is, is it a shallow recession or is it a deep recession? I think the market has probably priced in that shallow recession. What it hasn't priced in is a more profound slowdown. We're starting to get hints of that with the earnings season. We're in the middle of earnings season, we're probably more than half-way through earnings season now and I think it's been better than expected. I think earnings have generally exceeded forecasts. I think that as we entered earnings season there wasn't a huge amount of conviction about that. People were not super confident that that was going to be the case. I think that's been very encouraging and I think that's part of the July market story.

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Pamela Ritchie: It's so interesting. I guess then we move to the question of just the July market story where, I mean, equities have been beaten down mercilessly in some parts of the market. Can something like July sustain itself? We have geopolitical discussions that we can get into, but what did that feel like to you in terms of July and what you're looking at, what you're measuring?

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Tom Stevenson: I mean, if you look at the historical record, markets do not move in one direction consistently. Even in a strongly trending market, whether that's an up market, a bull market or a down market, a bear market, you very often get a number of counter trend movements that can be quite dramatic, but they can also be quite short. I don't think that anyone should get overexcited about the rally in July. It did feel to me like a bit of a reassessment, a look at the results, a look at the expectations for how far interest rates are going to go. They're probably not going to go as far as people thought. Maybe inflation is beginning to peak out in some areas. But it doesn't feel to me like a resumption of a bull market, that feels to me like a bear market rally. It's been a good one, but it feels like a bear market rally.

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Pamela Ritchie: Yeah, sort of a relief rally of sorts. When we go through these steps, it sort of takes you back to the question of the cycle, doesn't it, and where we might be within that cycle. We certainly can see what the central banks around the world are ... they seem to be extremely focused on what they're doing and market participants are interpreting that sometimes dovishly, sometimes less so. They are in a position to keep these hikes coming at this stage, what does it say about the cycle to you?

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Tom Stevenson: The interesting thing about the cycle to me is that it's different for different asset classes. If you look at the equity market, if you look at the government bond market, tends to respond very early and very quickly. We saw government bond yields rising up to the sort of expected level of interest rates pretty quickly. We saw the stock market correcting itself pretty quickly over the first six months of the year. If you look at the corporate bond market, it's slightly behind the government bond market in that respect. Behind that is the commodity market, which is more of a late-cycle asset class. Then I think you get to other asset classes, I'm thinking particularly of commercial property and also some of the private equity markets where the bad news has not even yet been properly factored in. So thinking about the commercial property market in particular is very interesting.

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Pamela Ritchie: You did an article on this about lag. It was in the Telegraph.

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Tom Stevenson: There's a real lag to what's going on in the real economy because what you get is, you get a lack of transactions. You get no activity in the property market. So you look at prices and you think prices are holding up pretty well, but the reality is they're not. Where you need to look to see what's really going on is in the publicly quoted property market, the REITs market, the retail estate investment trusts. That's where you see what's really going on. If you look there now, you see that a lot of those REITs are trading at very big discounts to the stated asset values. What that's telling me is the property market hasn't yet got to where the equity market and the bond market got to quite a long time ago. It's a lag and it's a kind of rotation.

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Pamela Ritchie: So interesting, and specifically the commercial. I mean, you're talking everything across the commercial spectrum, but including office.

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Tom Stevenson: I think the office market is where it's particularly intense at the moment. The office market is coping with a lot of things. It's coping with rising interest rates. That's not good news. It's coping with this whole changing landscape of how we work, this whole working from home thing. I was in the office yesterday. It's a Monday, many offices are half empty on a Monday. That's not great news if you're the owner of a property asset. The third element about property is this transition to a more renewable energy landscape. Most of the offices in which we work are just not suited to the climate change ambitions which we have as countries. Huge amounts of money is required to be spent on upgrading the office infrastructure. If you're the owner of a property, which stands the risk of being stranded by that process ... and many properties will be stranded by that process ... that's not a great place to be. I would say of all the asset classes that I look at in my quarterly investment outlook, the commercial property market is the one where I have changed my mind most clearly and become more negative on property than any other asset class.

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Pamela Ritchie: That's fascinating. Let's just go through some of these asset classes. Commodities, I mean, we've seen obviously the oil price come down, but there's lingering issues across the board. What does that mean to you and the outlook for commodities?

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Tom Stevenson: I think the outlook for commodities is quite mixed, actually, because you need to distinguish between different commodities within that complex. I think the oil price remains elevated. I mean, it is off its highs. We're looking at $100 a barrel rather than $120 a barrel. It feels like there's no real sense that it's going to go much lower in the short term. The industrial metals complex, and I'm thinking particularly about metals like copper, for example, is in a very different state. I mean, we've seen a big pullback in that and that is a clear reflection of anxiety about economic activity in the world. I mean, it's not called Dr. Copper for nothing. It is a measure of the health of the economy and it's a measure of sentiment about the health of the economy. I think you need to distinguish between metals and energy at the moment.

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Pamela Ritchie: Okay. Very interesting. Let's go a little bit around the world ...well, let's just ask about this other asset class, cash. Good to have some cash on the sidelines? Is there cash on the sidelines? Is that the right thing at this point?

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Tom Stevenson: I always say have some cash in your back pocket, because when you get volatility in the market, if you don't have any cash then you're not in a position to take advantage of the volatility. When markets dip you need to have some dry powder to buy back into the market. My point about cash this quarter was if you're not using your cash now, when are you going to use your cash? After a 20% fall in the stock market, if you're not going to use it now, then effectively any cash that you hold in your portfolio is just sitting there earning nothing, losing money in inflation-adjusted terms. I guess it's a sort of encouragement to people to think about their cash holdings as real dry powder. It's there to be used and it's there to be used when the opportunity arises. I just think that if the opportunity hasn't arisen now, it's hard for me to think when it will.

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Pamela Ritchie: Interesting. Let's go to the geopolitical situation and maybe we'll make sure that it's within a market's context because there's not much anyone can do beyond that. Let's look at Europe. Ultimately, Europe is having all of the issues that go along with the invasion of Ukraine, which has gone on and on and on and continues. Another huge buyer of European goods, services, everything, of course, is China. That's been difficult because of the U.S.-China relationships. What do you think this step in geopolitical tensions means for the U.S.-China relations and then ultimately the friends of both sides?

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Tom Stevenson: Yeah, absolutely. Something that concerns me a little bit is that both sides have kind of painted themselves into a bit of a corner here. It's not really necessary for them to ratchet up the tension in this situation at the moment. I don't see the benefit to anyone in doing that. That does feel like a bit of a concern. We saw that overnight in the markets, particularly in the Asian markets. Shanghai and Shenzhen were off. Hong Kong was off, but also Japan and other Asian markets. Now, interestingly, as we moved around the world the effect sort of dissipated. They were sort of 2 or 3% falls in Asia, by the time you got to Europe, it was much less and ditto by the time the American markets opened just recently. It sort of petered out. I think that's encouraging, but it does show that locally there is a lot of anxiety about this situation.

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Other countries, you mentioned Europe. Europe is a big exporting region. It's very dependent both on the U.S. and on China. It sits in the middle, sits between the two of them. It has to play its cards quite carefully. At the same time, it is sitting on the front line of the Russia-Ukraine situation. So Europe is not in a good place and it's no surprise that Europe was the worst performing region in that first half of the year. From an investment perspective that starts to look quite interesting because there were lots of great companies in Europe, but there's a lot needs to happen before I think anyone's going to get very excited about Europe. The first thing that needs to happen is we need to get some kind of resolution in Ukraine.

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Pamela Ritchie: Is it investable through the second half of this year or are you looking longer out?

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Tom Stevenson: I have to be honest. I don't think that I would be rushing into that opportunity. However, kind of motto that I have for investing is that you should not get more bearish as the market falls. I think that's a really important concept because it's so easy to become negative when you look at the news flow, you look at what's happening, you look at the uncertainty but that, of course, is what creates the investment opportunity. Europe has got some great companies which are trading at very cheap valuations. It's not the only place where there's opportunities, but it's a particular case.

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Pamela Ritchie: You were on the BBC this morning, you were saying, and it's an interesting story. It's the story of one of the social media players just getting taken out of the kneecaps in terms of valuations. But then, of course, that's when many start to look at that as an opportunity.

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Tom Stevenson: This was Pinterest we were talking about, the social media platform. It's a really nice sort of real example of what I've just described in theoretical terms. Pinterest was one of the great beneficiaries of the working from home lockdown situation. Shares shot up to $90. In the last year, it's fallen down below $20. It's been an absolutely spectacular collapse. It's kind of been emblematic of what's happened to those technology stocks all around the world. But what's happened today is they announced really not very exciting figures. The revenue growth was a lot slower, the costs have risen. They announced a loss when they were expected to deliver a profit. But this activist investor, Elliott Investment Management, has moved in. It's announced that it's got a 9% stake in the company. So it's a really good, real-world example of how there is a price for everything. Unless Pinterest is going under, and there's no sign that that's the case, then at less than $20 compared to $90 a year ago, starting to look quite interesting.

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Pamela Ritchie: So interesting. What role, if any, does emerging markets play in an investor's portfolio? I'll note just in your report, you look at Asia/emerging markets because Asia is such a huge part of the emerging market story.

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Tom Stevenson: I think that that's the key point about emerging markets. It's very difficult to generalize about emerging markets because what is driving China is very different from what is driving, for example, a Korean market or the Taiwanese market, which are essentially technology exporters to the rest of the world. They are very much dependent on the health of the global economy and that's a different dynamic from China. Then, of course, you've got other emerging markets, which are really essentially commodity plays, a Brazil or a South Africa. I think it's quite unhelpful in a way that people talk about ... and we all do it, we all talk about emerging markets ... it's not really that helpful because there's so many different moving parts.

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Pamela Ritchie: That's a rating based on sort of the maturity of the financial system but it does miss a lot of things. What about Japan? I was so interested to read your note about Japan. It's not had the easiest time and the currency, of course, has been front and centre in terms of headlines, although many currencies have been front and centre in terms of headlines, but certainly the yen has.

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Tom Stevenson: Interesting how the yen has bounced back in the last year. It's been a very significant ... again, we were talking earlier on about how easy it is to be just slightly behind the curve. You talk about these things and then you look and you realize the market has moved already. The market is way ahead of you on these things. Japan is interesting. Japan has had a difficult year. It's had a difficult situation with COVID. It's had a difficult problem with the currency. I mean, keeping its interest rates at rock bottom has really dragged the currency down. Historically, that's actually been good news for Japan because it makes its exports more competitive in world markets. I think what we've seen in recent years is Japan has moved a lot of its manufacture outside Japan, so it actually benefits less from a weak yen than it used to. What it does do, of course, is it cranks up the cost of imports of food and energy and Japan imports a lot of food and energy. A weak currency is not really that good for Japan. It's had lots of headwinds, the consequence of those headwinds is a bit like Europe. The Japanese market is super cheap. The Japanese market valuations are very, very low. I just think that unless things are really bad, Japan, I think, looks very interesting.

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Pamela Ritchie: Layer on top the geopolitical tensions. Does that fit with really bad or you're talking more about a recession on/or the growth picture?

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Tom Stevenson: I think all of that together. I think it would require all of those things to not go well to justify the Japanese valuation at the moment. I think it's a good value market.

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Pamela Ritchie: Let's go back to real estate, lots of interest in this. When you say commercial real estate, does that include apartment rentals, for instance? What are your thoughts on apartment rentals or residential real estate kind of across the boards?

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Tom Stevenson: I was talking to our property experts about this. They were quite nervous about the residential rental market, particularly in Europe, actually. Interestingly, here in the UK, we had some property sector data out today, which was very positive, 11% rise in house prices over the last year. Now, people have been talking for months about how toppy the UK residential market feels. You know what, people have been saying that the UK residential market is toppy for as long as I've been an adult, which is quite a long time. I think that it's entirely possible that the residential market holds up at current levels. I was quite surprised to see that 11% rise over the last year, been very, very strong market.

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Pamela Ritchie: That's fascinating. While we're on the topic, ultimately, sterling took a massive hit. We know that. What's the outlook for it at this point? It has a different story because of the UK, probably including its housing market, but just really the investment story for the UK is different to Europe. How do you look at the different currencies?

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Tom Stevenson: Interestingly, both the euro and the pound have really suffered in tandem against the dollar. I think what that's telling us is that really this is a story about dollar strength rather than sterling weakness or euro weakness. There's an element of that, but it's really about dollar strength and that, in turn, is a consequence of the interest rate differentials. The Fed is just moving faster on interest rates. Interestingly, we've been talking about what's been happening in July, this sense that maybe interest rates are not moving quite as far as they were has taken the edge off the dollar strength. It's at the margin, but the pound has definitely strengthened a bit against the dollar. The euro has strengthened a bit. I think we've had the extremes and I think we'll probably move back more into the range than we have been.

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Pamela Ritchie: The recession question is probably a question of whether it's shallow or deeper, rather than if it'll happen. Just to extend that a little bit, what would be the impact of a U.S. recession on Asia-Pacific?

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Tom Stevenson: The principal consequence of a U.S. recession is that the Fed will go into reverse and the interest rates will start coming down. That will reduce the strength of the dollar. I think, ultimately, that probably is a positive for the Asian market. I think what we're going to see over the next year, we've moved to quite extreme positions in investments and I think over the next year maybe we'll move back into the middle. So things that have done really well maybe will come back a bit, things that have done really badly will do a bit better. I think it's a sort of period of moderation, is how I put it.

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Pamela Ritchie: It is kind of fascinating. This is going back to the impact in the discussion around delisting of Chinese companies within the U.S., the so-called ADR discussion. It often can be, in the trade wars as well generally, a result of geopolitical tensions. Any sort of concerns there that you see?

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Tom Stevenson: You make the point there that this is actually very little to do with the actual situation on the ground. This is to do with the bigger picture. That's why I think that we should have our eyes on the bigger picture and the smaller things will sort themselves out. They're kind of pawns in this bigger story.

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Pamela Ritchie: Of trade and competition.

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Tom Stevenson: Competition, absolutely, of geopolitical competition. Everything else is a consequence of that.

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Pamela Ritchie: When you take a look at UK politics, I've left this to the end, we only have a few minutes, but I'm fascinated to know, you've got the two front runners in the Tory campaign, lots of discussion about tax cutting, which is interesting. Where will that go? It seems like that could be interpreted as stimulative and inflationary.

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Tom Stevenson: Absolutely. To understand what is being talked about in terms of tax cuts, you have to understand the process of how the election works for the Conservative Party leadership. It's basically the shortlist of candidates is whittled down to two by the MPs, by the parliamentarians, but then the decision between those two is made by members of the Conservative Party. Now, that's about...

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Pamela Ritchie: That's the same as Canada. It's exactly ... we do that too. We came from you in terms of the political *[inaudible]*.

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Tom Stevenson: Absolutely. It's only about 160,000 people. It's not many people, but it's a particular demographic and political slice of the population. These tax cuts that have been talked about by both candidates are aimed at that constituency. I think you take with something of a pinch of salt what they have to say about tax cuts because you have to think, well, once this process is over, how much of that will actually see the light of day? Probably not that much. But on the face of it, you're absolutely right. It is stimulative. It is inflationary. If the politicians are cutting taxes and raising inflation as a consequence, it just means that the Bank of England has to work even harder to get on top of inflation on the other hand. It doesn't feel like a particularly coherent system if the two are not working together.

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Pamela Ritchie: Final question, do you see a ton ... it feels like all central banks are kind of front loading, is that the same sense that you get and, ultimately, what does that mean?

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Tom Stevenson: I think all central banks are trying to get their interest rate hikes in while they can. I think they all want to have a bit of dry powder. They know that a slowdown is coming next year. They know it's going to be difficult next year. They want to get interest rates to a level where they can actually cut them to restimulate the economy. We saw the Australians today raising by half a percentage point again. We had the Fed, we've had the Bank of England, everyone's trying to get these rate rises in early.

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Pamela Ritchie: It's been fantastic reading your report. Thank you. I direct people to that and also to the Telegraph article. Tom Stevenson, thank you so much for spending your time with us today.

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Tom Stevenson: Thank you very much, Pamela.

[voice-over:]

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