Fidelity Connects

Live from London: Global Market Briefing

Tom Stevenson, Investment Director

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.

Today we welcome Fidelity International Investment Director Tom Stevenson to the show as he reflects on the year that was and what we could expect in the global markets heading into 2024.

Tom believes Europe including the UK is in a recession or showing signs it will be going into a recession, but he says it will be a much a shallower recession than expected.

That being said, in terms of sectors, what looks interesting at this point, one must look no further than government bonds. For him, the principal driver of the turn of the markets is bond yields. He believes the focus at the start of the turn will be in the bond market, specifically in the government bond market.

He says the market is bottoming out sequentially. Tom says inflation and geopolitical issues continue to be risks to the market. But, in his mind, 2022 was the year of anticipation and 2023 is looking ahead to a better 2024.

Tom also touches on green energy, U.S.-China relations, and the commodity super cycle and what that could mean for the UK.

Today's podcast was recorded on November 23, 2022.

[00:02:07]

Pamela Ritchie: Actually, I would love it if we could just go directly to the PMI data that's come out. Ultimately, everyone is watching this because of the response of where interest rate policy may go out of central banks. Give us a little bit of the lowdown of where we're seeing contraction and, ultimately, what that means, really, for the rate story.

[00:02:24]

Tom Stevenson: We have PMI data today both here in the UK but also in Continental Europe. Both economies over here are going through a pretty sticky patch at the moment. Indeed, it was the fourth month in a row that the UK-composite PMI number was below 50, so that dividing line between expansion and contraction. Over in Continental Europe, it was the fifth month in a row. I would say if you sort of read between the lines the sort of mood music of those announcements, the European one felt a bit more positive in terms of the commentary around cost pressures and those kinds of things. It just feels like Europe may be pulling through the worst. I think things like the energy prices, we've had quite a significant fallback in energy prices in Europe. That sort of crisis that we've been in, really since the spring, since the invasion of Ukraine, seems to just be easing back a little bit.

[00:03:40]

I would say that both here in the UK and in Europe we're definitely in recession or going into recession. I don't think that's going to be avoidable on this side of the Atlantic but maybe it's going to be a shallower recession than maybe we thought. I would say more so in Europe. I would say, here in the UK, we've got quite a few sort of home-grown problems. We had an autumn statement, a kind of budget, last week which really cranked up the pressure on personal taxation, for example, not just personal taxation, corporate taxation as well. I think that's going to feed through a tougher recession here than in the rest of Europe.

[00:04:26]

Pamela Ritchie: I was reading one of your Telegraph articles, just a recent one, but there is a real sort of tone of optimism for your outlook for 2023. I guess, this PMI latest data sort of tells you where you are but where are you going?

[00:04:45]

Tom Stevenson: I think my optimism arises on two fronts, really. The principal one is central bank activity. The thing about markets is they are discounting mechanisms. They are designed to look through the current headlines to what's coming down the track. I think that markets are already beginning to focus on a likely peaking in inflation. Saw that in the US, I think it's probably closer to the peak there than it is here in Europe, but we're definitely getting to that stage where this move into recession is going to lead to lower inflation and that, in turn, is going to take the pressure off central banks to raise interest rates further than they thought they would have to, even quite recently. I think the key trigger for the markets next year is going to be that perceived peak in monetary policy squeeze. I think that we're going to get there maybe a little bit sooner than we think.

[00:06:00]

Over in the U.S. I see a peak in interest rates maybe in May. We're not going to get any more big jumbo rate hikes. We've had four, we're not going to get any more. It'll be half a percentage point then a quarter and then I think it stops altogether in May. I think that, in turn, will take the pressure off central banks over here to do the same thing. As we move into recession, they'll really be looking for that cover to stop the squeeze on interest rates. That, I think, is going to be very positive for the markets. I think markets will turn a long time, months before the economy turns.

[00:06:31]

Pamela Ritchie: Markets will turn, equity markets versus bond markets, and maybe we can talk a little bit about the sectors because there's a lot of discussion about where does leadership come from. It seems to maybe be too early to tell. What, again, starts to look pretty interesting soon or soonest?

[00:06:53]

Tom Stevenson: Let's start with that equity bond question because I think that's very, very interesting. I think that this bottoming out of the market will happen sequentially. It's not all going to happen at the same time. For me, because the principal driver of the turn in markets is bond yields, I think that the start of the turn will be in the bond market and specifically in the government bond market. That's where I think we start to see the upturn, first of all. Really, I'm more optimistic about the outlook for government bonds than I have been in a very long time. I think when you look at corporate bonds, they're a kind of hybrid investment. They behave a bit like government bonds and a bit like shares because there is an element of company-specific risk in the valuation of a corporate bond. I think they come a bit later in the process because as we move through the recessionary environment, it will take a bit longer for the corporates than the government bonds to respond. Finally, I think we see the turn, maybe in the middle of the year, we see the turn in the equity market. I think that will be the last the count to come out. That would be the sequencing of the turn in the various different asset classes.

[00:08:21]

In terms of sectors, again, I think because I'm expecting the turn in the equity market to be a bit later on, I think there is an argument in the early months of next year to still remain quite defensive. Again, you've got to be a bit careful because some of the defensive sectors are actually quite expensive. If you look at the utilities, for example, they're actually quite highly rated. I think there are other defensive sectors, the consumer staples, the consumer durables, the telecoms, which I think might be a pretty sensible place to be in the early part of next year. Then I think that you crank up the risk appetite as you move through the year.

[00:09:04]

Pamela Ritchie: Fascinating. It's so interesting to sort of see where some of these bright spots might begin to show themselves. I don't want to pour cold water on it, but I just want to get the sense of the balance of risks that are still out there for Europe. People will point to the weather: how much does everyone need to spend on heating. Prices have come down, so that's helpful. The balance of risks, the war that is ongoing, what should investors sort of be thinking about as these pieces still exist?

[00:09:37]

Tom Stevenson: I think all the same risks exist. I think we're just getting a bit more used to them and the markets are starting to price those risks in. Clearly, there is still an inflation risk and until that inflation risks is seen to diminish, there is an interest rate risk as well. There is also, clearly, a geopolitical risk at the moment. If we look at the situation in Ukraine, there is no obvious end to that situation. We seem to have moved into a sort of position, a grind forward there. I think that as we move into the winter months, it's easy to see that sort of getting bogged down and not really improving.

[00:10:24]

I don't think that my essential optimism and bullishness about the markets is a reflection of a particularly good situation either economically or politically. It's really a matter of timing. The fact that, I think, what many people underestimate is the predictive power of markets. They move well ahead of general improvements. I think that we will see that again in 2023. I think 2022 was the year of anticipation. That was the year in which markets looked forward to a difficult 2023. We saw some pretty heavy losses. 2023, for me, will be the year in which the markets start to look forward to a better 2024.

[00:11:11]

Pamela Ritchie: I think there's a ballad in there somewhere, Tom. I think you should write it. I think there's something about that, the year of anticipation. I love that.

[00:11:20]

Tom Stevenson: Yeah.

[00:11:22]

Pamela Ritchie: Tell us a little bit about the discussion of the U.S.-Chinese relationship. It's actually been fascinating, just the sort of armchair view of it, but I'm very curious what you think about it in terms of opportunities within Asia. China has obviously got through this very interesting part in its own political history. It's made its own history. The COVID situation is still very much there, but it does look like policy is going to start to open up. What does that mean for investors one way or the other?

[00:11:53]

Tom Stevenson: I think the situation in China has been very interesting in the run-up to the Congress. There was a lot of anxiety about what would actually transpire. People thought they knew what would happen. I think people were sort of sitting on their hands and just not really wanting to do anything. At the end of the Congress, I think there was a bit of anxiety about whether the focus was really on economic growth or on common prosperity. I think as the dust settled, markets became a bit more relaxed about that and they thought this is a pragmatic regime which is going to focus on economic growth and it will focus on the two things simultaneously.

[00:12:43]

I think more recently we've had a bit of a downward turn in sentiment which is largely to do with the COVID situation. If you look at the figures on COVID infections in China, we had that big spike in the spring, March, April, when Shanghai was shut down. You look at the figures now, they're right back up at those peak levels. If anything, it's a bit more concerning because it's more widespread. There are many cities which are in partial lockdown as opposed to one or two cities in complete lockdown. I think that's quite debilitating for the Chinese economy. I think we're going through a period of ups and downs with regard to the outlook in China.

[00:13:30]

In terms of the U.S.-China relationship, obviously, that also has its ups and downs. There's been a lot of commentary and speculation about the Taiwan situation. My feeling is that both of these countries are extremely pragmatic and they will do what is needed to maintain their common prosperity between the two countries, let alone within China.

[00:13:58]

Pamela Ritchie: That smile and the handshake, it was a photo op for the ages. I think a lot of people breathed a sigh of relief, at least temporarily. I mean, whether it means anything is hard to know.

[00:14:08]

Tom Stevenson: Absolutely. It's not in either side's interest to upset that mutual relationship.

[00:14:16]

Pamela Ritchie: We talked a lot about China months ago about the property contagion. There's still swirling questions around that. To some extent it seems like there's been a ring fencing of that. Again, it's hard to know exactly where that all goes. Similarly, as money gets drawn out of economies around the world due to the tightening process, there are sort of these question marks about contagion and things. Crypto is the latest. We're seeing that, too. I wonder if you can comment mostly just to sort of the idea of contagion. I think there's some fear in the markets due to recession and the contagion builds on that. Do you see that as a major risk or, again, sort of a ring fence situation? How do you take that?

[00:15:01]

Tom Stevenson: It's a very interesting question, actually, this idea of contagion. I think there's a really good example of that here in the UK, actually, related to the property that you mentioned in China. What we had after that mini-budget in September was a lot of anxiety in the markets, rising bond yields. We had that problem with the pension funds who engaged in these contracts which were put at risk by sharply rising interest rates and they had to offload a whole load of government bonds in order to meet their collateral requirements.

I was reading just today there was a parliamentary session discussing this, a property sector expert was giving evidence to the parliamentary committee and saying that he estimated that £500 billion worth of bonds had been offloaded to meet these collateral requirements. Really, a very significant and systemically important offloading of debt.

[00:16:17]

The contagion issue, actually, is in a completely different sector. A lot of these pension funds also have big property holdings and in order to raise money to meet these collateral requirements, they've been trying to offload property. The commercial property market in the UK feels to me like an area of real concern. I think that there is a lot of anxiety. There are a lot of potential forced sellers in the commercial property market and the market has changed out of all recognition. Because of the pandemic, because of working patterns, there is an awful lot of office space which, frankly, will never get filled again.

I've been reading some quite alarming analysis of the commercial property market here in the UK. It's all connected and it is all about contagion. You get a problem in one area of the market, the fixed-income government bond area of the market, and it spills over into the commercial property side of things as well. That's definitely one to watch.

[00:17:25]

Pamela Ritchie: That's definitely one to watch. I think a lot of people worried and also sort of pointed to the fact that when this ... I mean, it was giddy money in there for a long time and so it is going to cause these various disruptions and versions of contagion.

[00:17:45]

Tom Stevenson: It absolutely was giddy money in the real estate market. Of course, when you get a very significant shift in financial conditions with rising bond yields you start to see, as the saying goes, you start to see who's been swimming naked. You realize that a commercial property, an office building yielding 2 to 3% makes absolutely no sense when government bonds are yielding 3.5, 4, 4.5%. You've got a super safe investment giving you a 4.5% yield and you've got, frankly, a much more risky investment which is exposed to all the changes in the global economy yielding 2.5%. Something has to give and what has to give is property prices.

[00:18:40]

Pamela Ritchie: It's fascinating. Where do you see ... oh, I just forgot, I was looking at something else and I thought I'm just going to ask you that next. On the asset allocation, essentially, for 2023, something along those lines but it probably goes back to what you said about bonds and those being interesting first next year. Do you expect to see different asset allocation strategies come to the fore?

[00:19:10]

Tom Stevenson: I think there's also a geographic element to this asset allocation question. I've been looking at various different geographies in this regard. The valuations that we're seeing around the world are very different. If you look at the look at the U.S. market, for example, there's been a big valuation reset there. Start of the year, we were looking at an earnings multiple on expected earnings of maybe 24 times. That's come down to sort of 15 or 16. That is still massively more expensive than, for example, the UK market where the FTSE 100, which you rightly said at the beginning, is actually trading at a recent high but it is still trading on 9 times earnings. It's on the single-digit P/E multiple which is a reflection of the problems that the UK economy faces.

[00:20:13]

As ever in investment, there is a price for everything and that's a very strong argument. Nine times earnings is just too cheap for a market which is considerably more stable politically than it was two or three months ago and, in due course, will come out of the recession. We're starting to see some quite interesting buying opportunities in various markets around the world. I'd include Japan in that, another very cheap market coming out of the pandemic, definitely include the UK. European stock markets had a very, very tough 2022 falling by 25, 30% in many cases. I think there are some very interesting valuation-based opportunities.

[00:21:02]

Pamela Ritchie: What do you see on the energy ... and I'll sort of say a more green energy, a more energy efficient story. Europe has had to move quickly on some of these fronts. It's hard to know how fast it'll all come together. What do you see? Do you see opportunities there at this stage?

[00:21:19]

Tom Stevenson: I think the renewable energy opportunity is probably the most interesting long-term investment opportunity. The scale of what needs to be done to transform the global energy economy, to make it more resilient, less reliant on potentially untrustworthy regimes, let alone the climate issue. If you put all those things together, there is no doubt that a huge amount of investment is needed to go into renewable energy. Now, it needs to be made more attractive because the rules of economics are such that if something is profitable, it will happen. That's a market question but it's also a government and a policy question. I think that once all of that comes together, we've just had COP27 and frankly, it was a pretty disappointing conference.

[00:22:22]

Pamela Ritchie: There wasn't much there, was there?

[00:22:24]

Tom Stevenson: There wasn't much there and I think that that's a reflection of changed priorities. When you've got an energy crisis the focus is elsewhere. I think that accounts for the difference between COP27 and COP26 last year in Glasgow. It's really the war and the energy crisis. It's changed people's priorities. But we're not talking about the short term; we're not talking about a tactical thing. We're talking about a multi-year, a multi-decade investment opportunity. I think the transformation of the global energy economy is absolutely an amazing opportunity.

[00:23:01]

Pamela Ritchie: It's amazing. Now, I know, obviously, in the football game coming up, Canada versus Belgium, you'll be rooting for Canada.

[00:23:07]

Tom Stevenson: Absolutely.

[00:23:10]

Pamela Ritchie: That's a foregone conclusion. Tell us a little bit about ... the markets actually look reasonably quiet, I wonder if everyone's watching football. Maybe that's the American Thanksgiving effect, too.

[00:23:20]

Tom Stevenson: I have some evidence of that. I do an internal market report every Monday lunchtime. Unfortunately, this week's market report coincided with England's first game in the World Cup against Iran. I did notice disappointingly low numbers for my market. Hard to believe that watching England play football is more important than hearing me talk about the markets but apparently so.

[00:23:56]

Pamela Ritchie: Okay. Most fascinating moment thus far, we're only three days into this but I'm just curious if there's anything. I'm thinking of one particular upset. Is there anything, what struck you?

[00:24:08]

Tom Stevenson: In the football? We've had two big upsets, haven't we? Argentina losing to Saudi Arabia and then Japan beat Germany today. Amazing. It's a controversial game, we know that, but it's also shaping up to be an interesting one from a sporting perspective as well.

[00:24:32]

Pamela Ritchie: It's really quite fascinating watching in different times of the year and everything else. A couple of questions rolling in. I'll just get to these. They're follow-ups on things that you've been talking about and I think sparking interest. One is a question about Germany moving to coal, what it might mean for markets. I'm guessing you're going to say that's sort of the short-term strategy but maybe not longer term. It is fascinating watching some of this come back on the energy security side of things.

[00:24:59]

Tom Stevenson: Absolutely. I think coal is very interesting and I think nuclear is very interesting. Now, of course, nuclear is not something that you can just switch on. I think that certainly here in the UK we've seen an acceleration of approvals for nuclear power stations. For example, we have a nuclear power station being built on the east coast at Sizewell and that is definitely being pushed through and accelerated. I think in the short term it does change the economics of the energy market but I think it is a short-term thing. We're not going to be in this situation for years and years, but we will have a climate crisis for years and years.

[00:25:49]

Pamela Ritchie: Interesting. The UK market has always been, as has Canada's, somewhat tilted towards commodities. Lots of the global commodity traders are listed in the UK. Let's ask you about the commodity supercycle, what you think of that story, whether it's got legs itself and then, ultimately, what that might mean for the UK.

[00:26:32]

Tom Stevenson: I think the commodities supercycle does have legs but it's certainly, to labour the analogy, it's certainly limping along at the moment. If you look at the performance of many key commodities over the last year, it's been pretty shocking. Copper down about 15% over the year. However, I do think that, again, it's a bit like the renewable energy situation, the long-term story for many commodities, especially rare metals, the whole electrification of transport, it's a real driver of that commodity supercycle. I do think that that is real. It has legs and I do think it will be of benefit to markets like the UK and Canada which are heavily exposed to those.

[00:27:12]

Pamela Ritchie: It was fascinating to get the view and actually to see the shift because it does sound, from listening to you, that there has been a shift. Look forward to catching up with you, I'm sure, in the new year. If we don't see you till then, all the best for the holiday.

[00:27:25]

Tom Stevenson: Thank you so much, Pamela. Lovely to talk to you again.

[00:27:30]

Announcer: Thanks for listening to the Fidelity Connects podcast.

If you haven't done so already, please subscribe to Fidelity Connects on your podcast platform of choice, and if you like what you're, hearing leave a review or a 5-star rating.

Fidelity mutual funds and ETFs are available by working with a financial advisor or through an online brokerage account. Visit fidelity.ca/howtobuy for more information. While visiting fidelity.ca, you can also find information on future live webcasts, and don't forget to follow Fidelity Canada on Twitter and LinkedIn.

Thanks again, see you next time.