Fidelity Connects

The Global Macro View

Jurrien Timmer, Director of Global Macro

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.

Director of Global Macro, Jurrien Timmer, is back on the show to share his macro and markets update with us.

Jurrien discusses many topics with host Pamela Ritchie including the continuing currency story, how China's reopening will affect global markets, and the rise of emerging markets this year.

Jurrien speaks further about the dollar and how it's making new lows in this particular cycle. He says one thing to remember is that there are periods in the market cycle where the different regions in the world are highly synchronized, but there have been many periods in the past where that was not the case. This gives some thought into a possible recession. It's very plausible we are in a desynchronized cycle with Europe languishing.

Jurrien points out EM could be the rising star again especially with China's reopening and how that could affect global commodities as well.

Jurrien also touches upon a variety of other topics including the supply chain story in 2023, the current headlines of the U.S. political system, and his thoughts on value investing.

Stay tuned for this and more. Also per usual Jurrien will be sharing some charts so, please head to @TimmerFidelity on Twitter to follow along.

Today's podcast was recorded on January 9, 2023.

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Pamela Ritchie: So, that was quite the melt up there and we still seem to be having that be okay at the moment.

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Jurrien Timmer: We're still melting up today, yes. And everything is kind of falling into place for now for the bullish case. The dollar is down, real rates are down, credit spreads are well behaved and, obviously, the payroll number on Friday was the catalyst mainly that average hourly earnings had now the second month in a row where the numbers were better than expected. You can see how that's an important thing because we see that the inflation data have been improving.

The CPI peaked last June at 9%. It's coming down. But, of course, the Fed is focused on the labour market. We know oil prices are down and copper and home prices and used car prices, those are all starting to come down but that's not what the Fed's focused on. The Fed's focused on labour. So, the fact that average hourly earnings are coming down, even though the payroll data itself were still pretty good, I think for the bullish case that was kind of a key thing because that further allows the narrative to unfold that the Fed could actually be pivoting soon, maybe still going to 5% but then kind of pulling a Greenspan from back in the 1990 days. I have my doubts as to whether that will play out in the way that the bullish narrative kind of has but for now the markets are voting with their wallets and that's what's going on right now.

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Pamela Ritchie: Yeah, it was interesting the way you said that. It's "allowing" for the bullish case. There's a lot of people on both sides and I don't know if you call it conviction but there do seem to be two very clear cases on each side or one on each side.

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Jurrien Timmer: A lot needs to go right for that to happen because the earnings estimates, and actually we can pull up slide 16.

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Announcer: And that slide, Earnings Peaks, was tweeted by Jurrien on January 12th.

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Jurrien Timmer: The earnings estimates for this year and next year, for this year they're pretty muted, maybe +4%. So not a big robust move. It's clear that earnings have peaked for the cycle. We don't know if it's going to be a hard contraction or just a slowdown in growth. But it's one thing if investors were really bearish on earnings and then you could easily say, well, if the narrative pivots to just slightly better than that, then you've got this pent-up kind of energy. The estimates are already pretty lofty and at the same time, the expectations for the Fed are already that the Fed is going to pivot, right? I mean, the Fed's going to go to 5%. Jay Powell and other Fed members are getting blue in the face, saying like, listen, stock market, you can't rally because that will loosen financial conditions and we're not going to pivot as fast as you think.

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But still, the market is believing that. That's what the market expects the Fed to do, which is to go from 5% back to 3 very, very quickly even though the dots, which were just updated a few weeks ago in December, say that the Fed is basically not going to cut rates at all this year and is going to continue to raise them for the first six months or so. The bullish narrative needs everything to go right. It needs for earnings to go up as much as already is expected and for the Fed to pivot pretty hard into that scenario. That doesn't mean it can't happen but to me, it's not a no-brainer that everything is going to unfold in that way.

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Pamela Ritchie: But Jurrien, take us to the sentiment. The headlines from Friday were exhaustion with selling, right? I mean, these were the types of sort of descriptions you got of what type of buying that was. I mean, where does that take you, the sentiment piece, the momentum piece?

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Jurrien Timmer: Well, this is a hard thing to try to unpack because so much of the market action is driven not by regular investors saying, okay, it's time to buy or sell, but by machines. A lot of the action is kind of algorithmically based. We know, for instance, now that a lot of the options in the S&P 500, a lot of the volume in those options actually have less than maybe 48 hours until they expire. We used to never see that. It used to be months out.

I don't know how much of this move higher in the last couple of days is just the result of machines playing on an algorithm saying, the Fed's going to do this or that, or whether it's actual real investors. We saw that in October off of the lows as well. Remember for those two days the non-profitable growth stocks were up 28% in two days. That's not normal behaviour. I think it's important not to get caught up in these short moves because, ultimately, it really comes down to earnings and liquidity.

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We'll show slide 7 here for a moment.

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Announcer: And that slide he's referring to is the Liquidity Chart Jurrien tweeted on January 10th.

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Jurrien Timmer: This kind of notion of the overall liquidity environment and how much that's driving the markets, this chart shows the Fed's balance sheet minus reverse repos, minus the Treasury general account as a proxy for how much liquidity is sloshing around in the system. You can see that orange line has done a really good job explaining the S&P 500. For the S&P to really make a sustainable new high, and I can see over the short term how it would be the ultimate head fake to take out those highs from about a month ago, because not many people would expect that.

But for that to be sustainable you need that orange line to go up and make higher highs. That would mean that the Fed would have to significantly pivot here. I think that's just premature. I think even if the numbers are continuing to improve as they currently are in terms of inflation, that's far away from the Fed actually not seeing through to raising rates to 5 and to then cutting them. The Fed has made it pretty clear that it needs to see 2% inflation, not just falling inflation for it to really bring rates back to neutral. Again, there's a lot of hurdles between here and a new bull market in my view.

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Pamela Ritchie: One thing that we are seeing certainly change is as the Fed, perhaps, doesn't get closer to cutting or coming down the other side, it does seem like the dollar has peaked. The dollar has sort of made this decision that it can see enough to sort of track back. We're seeing a real move in EM right now. Tell us a little bit about that and the sustainability.

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Jurrien Timmer: Emerging market equities are doing very, very, very well. The dollar, as we speak, is making new lows for this particular cycle. I think the average hourly earnings numbers from Friday's payroll report just indicate that the worst-case scenario may not have to happen, which means the Fed raises rates to 5 and then kind of keeps going. Some people are talking about the Fed going to 7%. That would be something.

But one thing to remember is that there are periods in the market cycle where the different regions in the world are all highly synchronized. You think about the financial crisis, for instance, everything was synchronized on the downside then on the upside. But there have been many other periods where that was not the case. Think about the early 2000s, for instance, which was EM's heyday and now we have China reopening, even if that comes at a human cost in terms of people getting COVID, etc., and then travelling. China is reopening. EM has been dead money for a long time and the U.S. is slowing and quite possibly going into a recession, if you trust the signal from the yield curve.

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And so it's very plausible that we are in these desynchronized cycles where the U.S. is either slowing or going into a contraction. Europe is kind of languishing, Japan a little bit as well but EM could be, finally, the rising star again led by a China reopening. Remember, China hasn't really reopened since COVID. Everyone else has, right? You can imagine the pent-up demand for Chinese people consuming stuff and travelling. There is a real fundamental story there. If you get a weaker dollar on top of that, then that's just icing on the cake because currency translation is a very big part, not only of the relative performance of these regions but also relative earnings. Again, you don't have a single currency to look at when you look at non-U.S. or non-Canada or non-developed market economies, so everything gets translated into dollars and so the dollar going up or down has a material impact on that.

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Pamela Ritchie: I was thinking about that and just companies that are multinational companies and their story within and also the trade story and supply line. We know that China won't open on a dime and it's going to take longer than sort of this week, next week but what does it mean actually for global companies? The supply chain story really should improve significantly. Is that priced in?

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Jurrien Timmer: I think that is priced in to some degree. The notion of reshoring, especially with semiconductors, and that's part of the Biden agenda, of course. I think that's kind of unknown. I think just the demand factor of over a billion people in China and therefore through EM starting to spend again, and build, of course. China is also stimulating policy which is something the U.S. is on the other side of. We have complete gridlock on the fiscal side. Just look at the fiasco we just had in Congress with just electing a speaker. It's very unlikely that anything will happen in the U.S. on the fiscal side. Of course, we know where the Fed is on the monetary side, that a pivot, I think, is not coming anytime soon.

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But at the same time you have fiscal and monetary stimulus in China. They are building things again. You can see kind of like a mini-2009, if you will. Remember, after the financial crisis it was China that got the whole thing going again because they did this massive stimulus, which they're not doing to that degree today, but just the rate of change of economic activity, that was enough to kind of get the whole thing going. I think it will be more of a regional, fractured thing and not a global thing but after many years of disappointment, EM is having its day and, by extension, value as well. Today it's the large-cap growth names but that is more an exception rather than the rule.

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Pamela Ritchie: Fitting into the overall story of China reopening, of stimulus being available, does that take commodities along with it for the ride?

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Jurrien Timmer: I think so. It's interesting, if we're going to slide 1, commodities were the number one bestseller, if you will, in 2022. This is my periodic table

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Announcer: Jurrien is referring to the Periodic Table of Investment Returns he tweeted on January 9th.

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Jurrien Timmer: Commodities, cash and gold. Interesting group of asset classes. Not the most practical things to invest in but certainly noteworthy. I think commodities, the question is, are they in a supercycle? A secular bull market? I think that they are. I think commodities and value and non-U.S. driven by emerging markets, I think those will continue to be kind of driving the story here.

We talked about this last week, my sense is that 2023 is going to be kind of a year of frustration, if you will, frustrating to both the bulls and the bears because I think neither of them are going to get their way. The bearish scenario is not as obvious as it seems because a lot of this has already unfolded. The P/E ratio in the S&P 500 was down 31% last year. That's a very large derating. Even if earnings are the other shoe to drop, a lot of that is already priced in to some degree even though the earnings estimates are holding up as we talked about earlier.

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To me, the bearish scenario of earnings are going to drop, therefore, the market has to go down, it could happen. It's certainly not implausible but it's also not a slam dunk. But at the same time, the bullish scenario where everything is priced in, be a contrarian, the timeline doesn't always line up in terms of price and earnings moving in the same direction. That's certainly true. That also, I think, is a little bit too easy to say, let's just be a contrarian, it's all priced in because if earnings do fall and the Fed does not pivot, those are going to be headwinds as well. My sense is that it's going to be neither of the two and that what's in the middle is kind of a choppy, sideways move where you're going to see large swings in both directions.

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To me, the way to make money in 2023 is less about the beta, the movement in the overall asset classes, and more about the alpha, about those second-order asset allocation moves, for instance, in commodities or gold or EM versus other markets. I think that's where the action is going to be. My sense, it's going to be more of a flat year as they continue to kind of crisscross each other and that the money to be made is going to be at that second order level.

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Pamela Ritchie: How then do we think about the 60/40? That's not as much about commodities, is it?

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Jurrien Timmer: The 60/40, we see this in the bond market right now. The 10-year yield – I'm glancing over here on my Bloomberg – is down, it is 3.51 now, so today, actually, both the 60 and the 40 are working well. In a way that kind of makes sense because neither of them did well last year, so it's kind of intuitive that maybe they either neither do well or they both do well. My sense is that if earnings are the next shoe to drop and the Fed does not pivot the way the market expects, then the 60, I think, will be under pressure, not to new cycle lows but in this choppy, sideways range that I was just describing. I think bonds, after having a horrible year in 2022, could be the port in the storm again.

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At this point, on a short-term basis, both asset classes are positively correlated but on a 5-year basis they have no correlation at this point. I don't think that that will last. My sense is that 60/40 will work again this year. I just don't know which side will work. Maybe both will work but I think at least one of them will work. I think, in that sense, '22 was the exception rather than the norm.

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Pamela Ritchie: What do Canadian investors need to take away, if anything, from, as you say, there is some chaos in the U.S. political system, particularly on choosing a speaker, is it just the gridlock story? Is that actually all you need to know?

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Jurrien Timmer: Certainly on fiscal policy it is going to be gridlock because even the Republicans can't decide among themselves. This was entirely a Republican story. I'm sure the Democrats had a good chuckle over all of this. This is about Donald Trump and how much influence does he still have. Obviously, the fact that Kevin McCarthy, that it took, what is it, 14 rounds to get elected as a speaker, chose his influence or the infighting because that was actually Trump's candidate but these kind of hardcore MAGA people did not want him. I think overall it means no legislation, gridlock. Markets tend to like that. A lot of stuff was already passed the last two years. I don't think there's anything super urgent that is going to fall victim to that.

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But the inevitable thing that's going to come up again, as it always does at certain points in the cycle, is the debt ceiling. You wonder how that's going to play out. The debt ceiling, we've talked about this, it's something that everyone always worries about when it happens and the can always gets kicked down the road and inevitably the two sides will meet because basically everybody loses. It's not like the Republicans are saints when it comes to fiscal spending or not. Trump was just as bad as anyone else in terms of deficit spending and things like that. It's inevitably going to come up and maybe because the GOP is more fractured that McCarthy will not have the power to kind of pull the Republicans together on making a deal, so it could get messy. But the debt ceiling has always been resolved and I don't doubt for a moment that even after some pain, it will get resolved again when it comes up.

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Pamela Ritchie: When you see these spikes in the market, you mentioned which companies did well and sort of the mega-cap, that kind of story, how do you, again, see that working out through the year? The question is always sort of, do you come back into tech right now? Do you wait? Does it go sideways? Give us your broad view on that sector.

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Jurrien Timmer: I tend to look at more like the big growers as a group, that's mostly tech but not exclusively tech, but what we've called the Nifty Fifty, and we've talked about that in the past, it looks like it ended an 8- to 10-year run relative to the rest of the market and that 2022 was kind of a mean reversion year, in a way the same thing that happened in '01 after the dot com boom and then bubble. That was the end of an era and it led to massive mean reversion into value, into small-caps, into international and in many ways that's what we've been seeing over the past year. I suspect that that will continue. The big growers still have the same things working for them, financial engineering and high margins and low interest rates but rates are higher than they were and I think it would actually be good for investors and good for active management for that pie to kind of get a little bit bigger. We see that play out in EM, as we were talking about earlier.

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Pamela Ritchie: Any other parts of the international market that are of interest? Japan is obviously something … I don't know what you think of that but watching interest rates rise in Japan just even a little bit was kind of a big piece of the end-of-year story.

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Jurrien Timmer: It's interesting that the Bank of Japan, I think, last week was in buying record amounts of bonds to protect the higher band, right? So, it raised the band and it still has to do all of this QE just to meet that. It just shows you how difficult it is to kind of repress the financial system. We talked about this, maybe a few years ago, that it's holding down rates artificially through quantitative easing and policies like that, it's like holding a beach ball underwater. It wants to come up. I think the Japanese are going to have an issue with that.

But at the same time, it's good for the yen, which has been very weak recently. Again, it comes back to the currency translation. The currency translation, it's not the end-all, be-all of international asset allocation but it plays a big role. If the dollar goes down and the yen goes up and even if the cycles are kind of similar, you can still do well. Of course, Japan … and actually I have this chart here.

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Announcer: And that chart he's referring to is the Global Earnings Cycle he tweeted on January 12th.

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Jurrien Timmer: The thing about Japan and Europe and EM is that they're really cheap. That can be a value trap.

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If you buy something purely on valuation, it can be a frustrating experience because ultimately the relative performance is driven by relative earnings. But in this chart, a lot of squiggles going on, but the main part shows that the earnings cycle by country and region, and you can see that the U.S., of course, has outperformed most other places and you can see China in the red being way down there. Those cycles are starting to converge on each other and that's going to be bullish for EM and other non-U.S. regions.

Again, you look at the bottom right there, those are the P/E ratios. Most of the world is trading at around 11- or 12-times earnings. The U.S. is at 17. When you have a convergence in the earnings cycle at the same point that you have a big valuation spread, that is a pretty compelling opportunity. The non-U.S. or non-North America, maybe we can call it that, allocation, I think, is a story that hopefully finally will have its day, as it is right now.

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Pamela Ritchie: That's fascinating. Lots of questions coming in, actually, that you've answered. Maybe you'll just extend what you said there but thoughts on value investing in 2023. I think you've said a fair amount there, but anything to add?

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Jurrien Timmer: You look at the super cycles, and that applies to commodities, to value versus growth, small versus large, international versus domestic, they're all kind of the same thing. They all have these long waves spanning several decades. Of course, the Nifty Fifty, or the big growers which, of course, includes the FAANGs, have been driving the bus for the last 10 years and everything else has been sort of underperforming because they're on the other side of that trade, which is exactly what happened in the late 1990s. We ended up with a valuation bubble, lots of speculation.

The valuation bubble certainly wasn't as bad this time around, but the speculation, the meme stocks, a lot of similarities there and the market is now resetting itself but these cycles are long term and I think that they will have some legs. I do think it's going to be value and hard assets over financial assets and small-caps in international. There's going to be cycles going back and forth but I think the long wave, I think, is now in favour of all of those.

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Pamela Ritchie: That's fascinating. How do you walk the line straight down for risk? Everyone's going to fall in different places on that. But if you want to sort of be in the middle, your risk profile is there, what do you need to know? What do you need to do?

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Jurrien Timmer: Well, I'm going to sound like an idiot but sell high and buy low. Again, we come back to that. The liquidity environment, the market is hooked on liquidity and so changes in liquidity are probably, by far, a bigger driver than the earnings estimates. For that orange line to go up or down is going to depend on what the Fed is going to do. To me, the hurdle for the Fed to stop quantitative tightening and to stop raising rates, or at least to not start cutting rates, that hurdle is very high because inflation is coming down but it's still at a high level and it's not enough that it comes down. It has to come down all the way to 2%. And that's not to say that the Fed's going to stay at 5% until the CPI is at 2. It'll be pivoting before then.

If the Fed pivots too soon or allows the market to switch the narrative too soon, guess what's going to happen? Financial conditions will ease, the animal spirits will come back and that's why the Fed is going through great lengths to say, listen, it's like parents telling kids like, do you hear me now? I think that's going to be a thing that will hold the markets back. I would be a seller on strength but I don't want to overplay the bearish case either because we've had a very significant reset.

When you look at the year-over-year change in valuation, and I meant to say this earlier, you can see that at down 29%, it was actually down 31 on a day-to-day basis but the market has rarely reset more than that. I don't want to understate the fact that a lot of the pain has already happened and that's why I think 2023 will be kind of a base-building year, but not yet a new bullish year. I don't want to overstate the bearish side. I don't want to sell and just be in cash but I think it's going to be a choppy sideways here, which means you want to be somewhat neutral on risk and really emphasize, again, that second-order asset allocation of what regions and countries do I want to overweight and underweight rather than do I want to be overweight stocks or underweight stocks, if that makes sense.

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Pamela Ritchie: Jurrien Timmer, thank you very, very much for your time and taking us through incredible research that you bring together. We appreciate it. We'll see you soon.

Announcer: Thanks for listening to the Fidelity Connects podcast.

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