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.

We're joined again today by Director of Global Macro Jurrien Timmer for his weekly global macro and markets update. On today's episode, Jurrien talks about the Fed's latest moves and looks ahead to the U.S. midterm elections. Please note this episode was recorded on November 7th, one day ahead of the November 8th election day.

Back to the Feds moves, Jurrien says its mandate is two-fold right now. He says the Fed is solving for getting inflation back to 2% and the market is solving for the Fed getting things done as soon as possible so we don't get a recession and instead we get a soft landing.

Among other insights shared today with host Pamela Ritchie, Jurrien discusses commodities, a potential rally for bonds, and the expansion story.

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

Today's podcast was recorded on November 7, 2022

[00:01:55]

Pamela Ritchie: Shall we begin, I wouldn't mind just talking about the midterm elections. Watching the dollar right now, which is... which is off. Hard to know whether that's pointing to some version of uncertainty about the election results or how the process might go. What is your take there?

[00:02:10]

Jurrien Timmer: We could pull up slide 21.

Announcer: This slide, "USD Chart," was tweeted by Jurrien on November 9.

[02:17]

Jurrien Timmer: I'm not sure what's driving the relative weakness in the dollar, if we can call it that. There is an interesting divergence opening up on the chart and us chartists are always looking for intermarket relationships, non-confirmations, divergences. What you can see here is that the purple line is the expected terminal rate for the Fed. Of course, we had the FOMC meeting last week where Fed Chair Powell moved the goalposts yet again and now the expectation is that the Fed will go above 5%, which you can see in the purple line there. Until recently, the dollar was in lockstep with that line for obvious reasons which is that the Fed is raising rates very aggressively, more aggressively than the major other central bank regions like Europe and certainly Japan, of course, also China, which are easing policy. That rate differential drives the dollar higher. That's all perfectly logical. At this point, the dollar is making lower highs even though that terminal rate is making higher highs. Usually that's a sign that the trend is getting more exhausted, if you will. That would be a hopeful sign that maybe financial conditions will stop seizing up.

[00:03:39]

Back to your question about the election, I'm not sure how much of that is related to that as opposed to maybe China finally reopening after this zero-COVID policy and maybe the U.S. getting closer to the end.

We do have an election, of course, this week and it does look likely that the Republicans will take the House of Congress from the Democrats, which is very typical in the first midterm after a new presidential election, especially when that presidential party sweeps all houses. I think at a minimum, the expectation is that the Democrats will lose the House and it's even possible that they will lose the Senate. For me, the biggest takeaway for that, is we know two patterns in the markets in terms of the election cycle. One is the presidential cycle itself which is, obviously, a four-year cycle.

[00:04:45]

What we know from studying history … I've gone back to the 1850s or even the late 1700s in studying election outcomes of the market is that the third and fourth year of a presidential cycle tend to be the strongest and especially the third one. Next year will be the third year. That's kind of a glass-half-full interpretation of where we are currently in the markets, of course, because it would suggest a better outcome next year, all else being equal, of course, which is a huge caveat that is especially true given all the stuff that's happening this time around.

[00:05:22]

Typically, the second half of a presidential term tend to be more favourable for the stock market because at that point the party in power is just trying to get re-elected, so they tend to make policy changes that make everyone feel happier economically. That's one of them.

The other one is that markets generally prefer gridlock over a very unified outcome. That's not a political statement. I'm not trying to be cynical but that's just studying several hundred years of election cycles the markets tend to do best when there is some sort of divided government. I think that's just the market saying to the government, stay out of my business, let me run my business, don't overregulate.

[00:06:11]

Think maybe that's kind of an overly Libertarian view of it, not that I'm a Libertarian but I think that's generally the sense. I think that's especially applicable today because you're in the U.K., you know all about the story there a few weeks ago or a month ago with the very short-lived Truss government trying to launch tax cuts that were basically not funded. Then, of course, the gilt market and the pound, the *[indecipherable/bob]* vigilantes reared their heads and made a quick end to that. I think it was the market saying too much fiscal, just leave it alone, stop doing so much fiscal.

And, of course, in the U.S. and elsewhere during COVID we had a lot of fiscal stimulus and relief which was necessary, of course, combined with monetary policy stimulus. I think there's a sense here as well as fiscal fatigue. (Maybe I'll come up with that as the title of the next report.) Just stop doing stuff. Two years of gridlock, if that's what we end up with after this week's midterm, would produce exactly some calm on the fiscal front. I think the markets would welcome that because essentially the economy was, in retrospect, probably overstimulated during COVID, during the lockdowns and now, of course, we're paying the price through higher inflation and therefore a very restrictive Federal Reserve.

[00:07:45]

Pamela Ritchie: Fascinating. I'm just curious, when you go back hundreds of years, if there's any data in there are how markets are doing in the third year of a presidency after a pandemic, for instance, which only happens every 100 years or so. That's mostly just kind of an outside/offside comment. I'm curious, we hear a lot about the debt ceiling, we hear a lot about commentary one way or the other on what it's going to mean this time. It usually squeaks by, anything different this time?

[00:08:16]

Jurrien Timmer: I think that would be probably the most significant implication if the election turns out the way the experts expect, and I'm certainly not one of them, but if we do get that gridlocked Congress, I think, obviously, some of the fiscal policies that President Biden is proposing now, including business-unfriendly ones like the tax on buybacks – again, not making any political statements here but – that would be obviously welcomed by the market. One risk would be that you would have these debt ceiling shenanigans like we always get when we have a divided government. You could have government shutdowns and all of this nonsense. That becomes a risk.

[00:09:05]

You and I have had this conversation before, these things always kind of come up and they always end up going away. Sane people in Washington, not that everyone is sane there, at the end of the day when the government gets shut down and people can't get their paycheques, it forces them to come to the table. They make some kind of agreement that makes everyone look good and they kick the can down the road. That's what happens every single time. I'm not particularly worried about that maybe becoming like a black swan type of event.

[00:09:43]

Pamela Ritchie: Let's go to the Fed. It's the first time that we get the chance to ask you about last week and certainly about the reaction by markets. At this point, we kind of have parsed through bits and pieces of it but what is the most salient thing for you that came out of the Fed meeting from last week that maybe we haven't thought about yet?

[00:10:07]

Jurrien Timmer: Slide three.

Announcer: The next few slides, "The Fed and the Market" and "Equity Valuation" were tweeted on November 8.

[10:14]

Jurrien Timmer: I think the biggest takeaway is that Powell and the Fed...A very macro way of thinking about the whole story in the markets right now is that the Fed is solving for getting inflation back to 2%. That's the Fed's number one mission. It is willing to sacrifice the economy to get there because it realizes correctly that a short-term cyclical recession is less bad than long-term structural inflation. So that's what the Fed is solving for.

The market is solving for the Fed getting done as soon as possible so that we don't get a recession and we get a soft landing and the markets can sort of find their footing. What those two mandates have in common is inflation because the

Fed is solving for inflation, the market is solving for the Fed to be done, and that means that what happens to inflation going forward is extremely critical. I'm stating the obvious because that's been the case for months now.

[00:11:24]

How quickly the inflation rate will turn down, and it is expected to turn down in the coming months and even weeks. I think the CPI is coming out very shortly and that will inform how long the Fed has to stay up there. That's kind of what I was leading to earlier. You can see that in this chart. The gold line is the actual Fed funds rate which is now at 3 and 7/8ths, the orange line is the expected path of the funds rate expected to go now above 5% and then come back down to about 3 and 5/8ths or so in 2024, 2025. It may not seem like much to see that kink in the curve but I think that's critically important for the markets because the stock market is trading at a valuation that implies that that orange line after the kink is the one that it's solving for.

The market's trading at a 16 multiple and it should be trading at a 14 multiple based on interest rates. This is the formula I've shown in the past. The difference between those two numbers which is two P/E points is basically the difference between where the Fed is going to go in terms of its terminal rate and where it's expected to go after that.

[00:12:45]

That's a long way of saying that the risk to the market is that the Fed has to go beyond 5% like it is now priced in but it has to stay there. It's not that inflation won't be coming down but it needs to come all the way down to 2% for the Fed to really kind of let go of a super tight policy. That was kind of the new thing that came out of the FOMC meeting is Jay Powell saying it's not just that inflation has to come down, which obviously it is and it will, but it has to go all the way down to its target before it's going to let the reins go on this very restrictive policy. I think that's kind of the disconnect right now in the stock market, is that the market expects the Fed to very quickly return to some kind of neutral policy and if it turns out that the Fed is going to stay well above neutral for a long time, just until that inflation rate does come down, then the market may still be kind of wrong-footed here a little bit.

[00:13:53]

Actually, if I can just show slide 24. It's just another way of showing that. You can see here the difference between the actual P/E ratio, which is the grey line, and my two little models there based on the 2-year nominal yield and the 10-year real yield, those two models suggest we should be around 14 X and we're at 16 X.

In early January when the stock market peaked, the P/E was 20.5 and it should be at around 14 now but it's at 16. What 16 implies, it implies a real yield of 3/4% instead of 1.5% and it implies a 2-year yield of 3.5 instead of 4.5 which is exactly where they would be ... again, going back to that Fed funds forward curve chart ... after that kink has played out. That, I think, is kind of how I'm wrapping my head around why is the market here when it should be there.

[00:14:57]

Pamela Ritchie: Where can you point us to within the market that may be really ... I mean, we are starting to hear of all kinds of layoffs, we're starting to hear of ... I mean, there's certain tech companies that are off by 70%, which areas of the market are holding that P/E up?

[00:15:16]

Jurrien Timmer: Slide 22.

Announcer: Here, Jurrien refers to two slides "Sector Returns" and "Sector Correlation," both tweeted on November 9.

[15:25]

Jurrien Timmer: We're getting increasing bifurcation now among the 11 sectors in the S&P 500. Energy is clearly the undisputed winner. You see that on the top there. Health care, as a more defensive sector, has done quite well. Utilities had done well but they've come down a little bit as interest rates started to shoot up. Telecom, real estate, all the interest-rate-sensitive stuff, is kind of down. This chart shows the 11 sectors indexed back to the pre-COVID all-time high in February of 2020. It just shows you kind of how they all zigged and zagged over the last couple of years and where they are now. You can see that the spread between winner and loser is becoming increasingly large.

[00:16:16]

If we pull up slide 12, there's another way of kind of showing how sectors are behaving. In this chart, I show the inflation rate on the top and in the bottom I show the 24 industry groups, their 5-year correlation to the CPI. You can see that energy, as we know, is an inflation hedge, it always is pretty much, but you can see that it's correlation to the inflation rate, its relative return, the inflation rate is near 100%. It's a perfect hedge against high inflation.

On the other side you see software and services, retailing, media, sort of the consumer sectors and the tech sectors are perfectly negatively correlated to high inflation. If you think about, okay, at some point inflation is going to come down either the easy way through a soft landing or the hard way because the Fed is creating a recession which will probably help settle down inflation, at some point there's going to be an opportunity here between these two sides. In other words, sell energy and buy the consumer and tech sectors and groups. To me, that becomes the next big trade but we need to see the whites in the eyes of inflation first and so far, we're not quite seeing it.

[00:17:43]

Pamela Ritchie: Fascinating. The question actually that was coming and I was going to ask you was exactly on the oil commodity price side of things, which is a different story to the equities, actually, I might just go ahead and put that to you, sort of the price side of things.

[00:17:58]

Jurrien Timmer: Commodities, obviously, the prices are down and one way of kind of illustrating that is in slide 9.

Announcer: The next slide, "ISM," was tweeted by Jurrien on November 8.

[18:11]

Jurrien Timmer: Obviously, we're looking for signs that inflation is peaking and then we're looking for signs for how quickly it can come down because the faster it comes down, the faster the Fed will be done and the faster we can all kind of go home and enjoy some positive returns. We're looking for early warning signs or early indications.

Here is a good one, actually: the goods producing side of the U.S. economy as measured by the ISM or the PMI, the Purchasing Managers Index, shows that the manufacturing side is already at a point of deflation, actually. We see this in some commodities, we see this in used car prices. Prices in the goods producing side of the economy are coming down.

[00:18:57]

This chart here shows the level of the ISM index, it's a manufacturing survey, in the horizontal and the prices paid component is in the vertical measured as a deviation from the mean. You can see that black arrow, the blue arrow was the post-financial crisis recovery and the black arrow is the post-COVID lockdown recovery. They tend to go from lower left to upper right back to lower left. The cyclical side of the economy tends to be boom bust. You tend to see inflation, deflation but the point here is that there are no signs of stagflation in the manufacturing part of the economy. Prices are coming down as economic activity is coming down.

[00:19:45]

Pamela Ritchie: I feel like we've been talking around stagflation anyway for a while. There's no *[crosstalk]*.

[00:19:52]

Jurrien Timmer: On the services side, that's where the stickiness is in inflation. It's in rents, owners-equivalent rent which is the largest component of core inflation. We're seeing the inflation on the services side. I don't mean to suggest that all inflation is coming down because of this chart. The manufacturing industry is only a small part of the economy but it's at least a part that is very cyclical and it shows that at least there we're seeing price deflation. We're not seeing it on the services side yet but, again, the Fed's operating with all these very lagging indicators.

If you think about rents, you sign a lease and that's going to be your rent for the next year, presumably. It takes a while for the reaction function of policy to kick in. One of the risks always with the Fed cycle is that the Fed is barrelling down the highway looking in the rear-view mirror because it's looking at lagging indicators. Employment, inflation are both lagging indicators and it creates the risk of a policy error. Certainly, this time around that's no different because the Fed waited too long to raise rates and now it has to do everything all at once and that does create risk.

[00:21:08]

Pamela Ritchie: Can we talk a little bit about growth as in growth of the economy or maybe going in the other direction if we're going to be talking about recession, the role of inflation alongside the expansion story.

[0021:25]

Jurrien Timmer: For instance, let's just take a look at earnings, slide 28.

Announcer: In this next slide, "Earning Estimates," was tweeted on November 11.

[21:35]

Jurrien Timmer: In inflation-adjusted terms, earnings growth is already negative. We're already in a contraction because earnings growth is a couple of per cent and inflation is 8%. Earnings are not really seen in real terms. Earnings tend to be a nominal concept because companies sell into the nominal economy. The nominal effects, the inflationary effects can kind of mask the underlying weakness and that's okay but ultimately the markets sort of see through that and they will just pay less for those earnings because they know what's coming. The earnings growth may be coming from inflation rather than from actually organic underlying growth. It's interesting that the 2023 estimate for earnings in the S&P is falling pretty hard now. It was $247 a share a few months ago; it's down to $231 a share now.

[00:22:37]

The earnings picture, markets are still expecting earnings growth but that expected growth estimate is coming way down. We're clearly not yet in a recession. You look at the unemployment rate, 3.7%; you look at the JOLTS report; 1.9 job openings still for every job seeker. Companies are hiring less. We see that all over the news. We hear that in the earnings report but you don't have the mass layoffs, at least not yet. Hopefully they don't come. I think the needle that the Fed is trying to thread here on the growth side, I think it is hoping that the imbalance of the number of job openings per job seeker can go down to some sort of equilibrium where it's 1-to-1 instead of 2-to-1 without actually even raising the unemployment rate.

[00:23:34]

For the Fed, the ultimate card trick would be to achieve its goal without the unemployment rate going up just because there is so much supply-demand imbalance between how many jobs are open. That stems back to the COVID days where 3 million baby boomers left the labour force, so there's a shortage of labour. I don't think the Fed is trying to get people to lose their jobs but it's trying to have a situation where there are fewer job openings for those people looking for jobs and that that will then equalize the supply-demand imbalance which will then equalize wages and spending and then bring inflation down. I think that is the hat trick that the Fed is trying to achieve here.

[00:24:29]

Pamela Ritchie: You spoke a little bit about what you're seeing in terms of sectors themselves starting to have actual changes. We're not seeing lump trades quite in the same way. Talk a little bit more about sector correlations as well as inflation trends. What have we seen, what might we see going forward as, perhaps, we see inflation going the other way?

[00:24:54]

Jurrien Timmer: As I showed in the earlier chart with the correlation, I think the biggest opportunity if inflation does go away and interest rates can start coming down – and I do still think that the bond market looks very attractive here. We can get over 4% across the entire term structure. The long-duration stocks like the secular growers, including the big tech companies which had some notable blow-ups in the last earnings season, those stocks require low interest rates because they have a very long duration, so you are discounting a longer series of cash flows with that cost of capital than you might, for instance, the energy sector or the industrial sector which has a shorter, more cyclical runway.

[00:25:51]

The FAANGS and health care and other growth areas tend to have a much longer runway, so they are more sensitive to rates going up or down in terms of what people are willing to pay for their earnings. I think, especially as these big tech names have really come down a lot this year, that, I think, is where the opportunity would be going forward but we need to get from here to there first. We don't know how smooth or jagged that path will be. Certainly, this week's CPI report will hopefully give us more of a sense. I think that's actually a more important news event than the midterm election.

[00:26:35]

Pamela Ritchie: Interesting. It's a busy week, it's quite a week. I'll get just maybe one or two questions in if we can. If the Fed rate stays historically high for years can we expect a small bond market rally?

[00:26:50]

Jurrien Timmer: The longer the Fed would stay ... let's bring back slide 3.

Announcer: And these last two slides, "The Fed and the Market" and "The Yield Curve," were tweeted on November 8.

[27:02]

Jurrien Timmer: There's this notion of what is the neutral rate. The neutral rate's probably between 3 and 4%. The Fed is going to go to above 5 and at some point it will go back to 3 to 4% because that's kind of the equilibrium over the very long term. The longer the Fed stays above that line, obviously, the greater the risk will become that we do get a recession. We see that in the yield curve which is very inverted. We see that in many other indicators as well. The risk is that we get a recession sometime next year. Even if we know that with absolute certainty, it still doesn't really inform us about the stock market because we don't know if it's going to be a long recession or a short one, deep or shallow, when it starts, how much of that is already priced in. It's not a linear thing where you know a recession is coming, so you're going to sell now. For the bond market, obviously, the yield curve inversion, which I have in here somewhere.

[00:28:11]

Pamela Ritchie: It's after the PMIs.

[00:28:14]

Jurrien Timmer: Page 11. The yield curve inversion tells you that the further the Fed is going to push things, the better bid, the long end of the yield curve is going to be relative to the front end. I think the opportunity for bond investors is there no matter what. It's just a question of where on the curve you want to be. Certainly, long duration, I think, makes a lot of sense. The 30-year is at 4.5% but even a 2-year yield at 4.7 is pretty attractive because even if the Fed stays up there longer then you just roll that 4.7 into 5% two years from now, or whatever it's going to be. Either way, I think the bond side offers some value.

[00:28:57]

This is kind of the takeaway I've been ending my talks with in recent weeks being in front of audiences, including your audiences, is that the 60/40 paradigm worked beautifully for many, many decades until this year. This year neither the 60 nor the 40 has worked. I have some good conviction that at least one of them is going to work from here going forward, either the equity side, the 60, or the bond side, the 40. Unfortunately, I don't know which one it's going to be, so therefore I want to have a little bit of both or a little bit of each because I think one of them is going to start working and one is better than none. At least it's a marginal improvement in that sense.

[00:29:45]

Pamela Ritchie: Well, let's leave it on that note. It's a perfect note to end it on. Very glad to see you set us up for a very important week in the markets and, obviously, across the political spectrum. Jurrien Timmer, thank you for joining us today.

[00:29:57]

Jurrien Timmer: Thank you. I'll see you in Boston next week, or I'll see you from Boston next week.

Announcer: Thanks for listening to the Fidelity Next 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 more information on future live webcasts. And don't forget to follow Fidelity Canada on Twitter and LinkedIn.

Thanks again and see you next time.