Fidelity ETF Podcast

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Announcer: Hello and welcome to the Fidelity ETF Exchange, powered by Fidelity Connects, the Fidelity Investments Canada podcast. FidelityConnects, connecting you to the world of investing, and helping you stay ahead.

In this episode of the Fidelity ETF Exchange, co-hosts Étienne Joncas-Bouchard and Andrei Bruno sit down to recap notable trends and headlines in the Canadian ETF Industry for 2021. With more than $50B in net new assets coming into the ETF industry, 2021 was another record year for the industry. Key topics being discussed today include the return of positive flows for fixed-income ETFs, continued growth for multi-asset ETFs, as well as a conversation on investment factor performance and an outlook for 2022.

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Étienne Joncas-Bouchard : Hello, everyone, and welcome to the Fidelity ETF exchange. I'm your host, Étienne Joncas-Bouchard AKA EJB. And I'm joined today by my co-host Andrei Bruno. Andrei, how are you doing today?

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Andrei Bruno: So I'm pretty, pretty well, my friend. How are things on your end?

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Étienne Joncas-Bouchard: I'm doing very well trying to navigate client meetings with these podcasts, with everything in a very volatile start to the year in markets both on the equity and fixed income side, something that we hadn't seen in a little while with 2021, albeit there's a lot of, you know, headlines out there that we're going to be recapping because this episode, you know, we are going to do a recap of 2021 as well as Q4 and more. And more specifically some of the headlines like inflation, for example, brought in a lot of talk. We're going to touch that.

But all in all, it was a relatively low-vol year, the first time since 2017 we didn't see a drawdown of greater than 10 percent on most broad market indices. I guess before we get into all that nitty gritty comments on all the different moving parts, some key highlights for the ETF industry as a whole. It was a record year. There's no other way to cut it. Last year saw about 53, depending on where you're looking, between 52 and 53 billion in net new assets for the Canadian ETF industry, bringing the total AUM to 323 billion. That is up from 44 billion ten years ago, a compounded annual growth rate of 22%. So quite an extraordinary growth trend that we're seeing still even, you know, 10, 15, 20 years into this endeavor for a lot of asset managers in Canada.

Another interesting stat we're up to 1177 ETFs available on the Canadian marketplace and up to 40 providers now. So quite an astounding landmark year for the Canadian ETF industry with lots of key changes, if you will, from a flow standpoint. So if we look at different categories, equities led the way substantially, with about 30 billion of those 52 billion inflows, which makes a lot of sense given where, how strongly equities outperformed fixed-income markets, for example, which still came in and brought in about 10 billion in net new assets. The two areas I'll mention as well, and then I'll turn to you, Andrei, for some comments on some stuff that you might have noticed. Multi-asset ETFs were up 5.6 billion net new assets last year. That's a 60% increase in AUM. If we look at the crypto space that was born last year, so you know, it already feels like, you know, it's been three to five years since those products came to market, but it was actually at the start of last year. Those brought in close to six billion in net new assets last year, with Fidelity joining the party in October with our Fidelity Advantage Bitcoin ETF and fund.

So that's a really high-level overview, but I'd like to get your thoughts on some of the key trends that you identified from a flow's perspective, before we go into some of the performance. But from a flow's perspective,

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Andrei Bruno: Yeah, sure. So I mean, take a look at, as you mentioned there in fixed income saw just over 10 billion of flows last year. So there was a couple of themes that we saw that emerged there. So we saw flows into the (?) market. Obviously, given the low-yield environment, folks were searching for some yield. Where we also saw flows was kind of in the short-term corporate credit space. Again, that was primarily a low-duration place. As we know, rates moved quite a bit last year and are expected to move some more this year, with both the Fed and the BOC entering the rate-hike cycle. So we continue to see some flows into that space. And then more broadly, we saw flows kind of into the general multisector global solutions as well. And again, it's just a play on giving managers as much flexibility as possible with their mandates, just given how tight credit spreads are and given where interest rates are poised to go. It's just a play of being here, give my manager as much tools as possible so we can find the opportunities where they pop up, kind of clip their alpha where they can, but at the same time being able to kind of avoid the problematic areas of the market as well.

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Étienne Joncas-Bouchard: Great, and I think there's a lot of good points that you made there with regards to the fixed income space, more particularly, that trade to go lower duration, I think, was really something that was in focus for a lot of advisors and a lot of investors trying to limit some of the interest rate sensitivity coming into early ... it was the early cycle when we started last year. We made our way into the mid-cycle fairly rapidly. That's definitely something that's stood out on that side. If I switch back to equities, if we look from a geographic standpoint, pretty much the same for Canada, U.S. and international. If we pair international global together, it's almost 10 billion for each. So very evenly split, which is quite interesting because over the past five years, I'd say the U.S. was generally the one that was leading in terms of allocations. But as we saw a rotation back to cyclicals and value stocks and equities of that nature, we started to see Canada start to come back more in focus. EM was the worst performing region, if you will. So we didn't see too many flows in that space, necessarily. That could change this year, though.

Those are some of the key highlights from an equity standpoint, at least from a region perspective. Obviously, many of you that listen to this podcast probably know we are biased towards smart beta ETFs or factor-based ETFs on the equity side. And if we look at flows from that perspective, we also saw a similar rotation from growth, momentum, quality towards value and dividend. Two factors that did, you know, meaningfully strong performance relative to their benchmarks last year coming in pretty strong.

So we've pretty much covered flows. Let's start looking it from a performance standpoint, and I think it's, you know, this is obviously a recap that doesn't necessarily just focus on ETFs like we're still trying to talk about various asset classes and whatnot. So Andrei, I know you're specialized more on the fixed income side here in your work as a strategist at Fidelity. Could you give us a bit of insights on to what performed particularly well, maybe in Q4 and then also just 2021 as a whole?

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Andrei Bruno: Yeah, so generally speaking, last year, as we know, duration products took a big hit, obviously plenty of curbs move whether it's Canadian or US curbs. So in terms of what was the best-performing asset classes last year in terms of fixed income, it was led by high yield and leveraged loans and as well as U.S. TIPS.

So as you can imagine in the high-yield and leveraged loan space, primarily what that return was driven by was income-driven returns. So the coupons on the high yield less sensitive to interest rate moves as compared to the investment grade counterpart, leveraged loans or floating rate. So, obviously as rates move higher, leveraged loans start to perform better. So both those areas, the markets did quite well again, just clipping those coupons last year and then TIPS again. As we know, inflation picked up quite a bit last year and continues to remain strong. So they did quite well. Kind of interesting, though, is I think they finished the year up about 3, 3.5% TIPS in terms of, if you if you went back to the Q Q2, Q3 actually topped out at about 7% in terms of what they were turning in 2021.

So that's come off a little bit, primarily a couple of factors at play there. Number one, people just selling the high, obviously asset class rallied quite a bit. Number two, what people need to understand about TIPS is one of the large purchases of TIPS was the US Fed. So now that they're tapering their asset purchases, they'll no longer be buying TIPS. One big buyer in the TIPS market has left the market, so we are seeing those come off a little bit, even though we are still printing a month over month recently, though, the US printed about 7% CPI. So even in spite of that, TIPS are coming off a little bit, so it'll be interesting to see how they perform this year. I don't know if they can perform quite as well as last year, but those are the one, two and three in terms of best performer.

So looking on the other side of the ledger in terms of what were the worst performers, so global aggregate and Canadian aggregate really number one and two biggest losers last year, again, duration play, Canada curve moved quite a bit last year, but just generally globally, most curves moved quite a bit last year. So again, duration just pulling those two particular indices down. US AG was down as well, just over 3% last year as well. But the number three biggest loser was EM as well. I know you alluded to EM not doing so well in the equity space, very similar in the fixed- income market as well. That was primarily led by kind of a Q4 phenomenon there.

In September, obviously, we got the debacle with Evergrande in terms of their default. And there have been tons of other defaults in the high yield space in China, whether it's those property developers or some other higher-risk Chinese names. So we have seen spillover effects into the EM market as a whole, with credit spreads having widened out a little bit there.

So that's kind of a high-level recap of last year. In terms of kind of what we're going to see next year, maybe I'll give you a chance to kind of go through equities in terms of how they performed in 2021 and then we can kind of jump into 2020.

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Étienne Joncas-Bouchard: Absolutely. That was a very thorough. You set a high level, but that was a pretty thorough. I think you touched pretty much every asset class available in the fixed-income markets, some that I'm sure many of our audience were not even thinking of which is great. And yeah, definitely. I can definitely give a quick summary from a performance standpoint for equities.

I mentioned on the offset emerging markets struggling a little bit, but generally speaking, that's a smaller allocation to most portfolios that we look at for Canadian investors. What was really a driver of returns to me was the rotation to cyclicals, and you saw a lot of those sectors, notably energy, notably financials, real estate, three of the better performing sectors. If you look on a global basis, but especially here in Canada, those are some of the larger sectors obviously at play in our indices relative to other indexes, led to strong Canadian performance. But the reason why to me, it made a lot of sense is not only the fact that it was coming off of a very difficult 2020 and it was just kind of due for a rebound and well-positioned from a value perspective. So it was trading at a large discount relative to its historical value. But fundamentals got a lot better, which was really, I think for me, a key story in 2021 where earnings growth, you know, among most equity, most places in the equity markets was really, really strong. I think the U.S. markets had like 48% or close to that in terms of earnings growth on year over year.

Obviously not expecting so much this year, but it's still in the high single digits, which is fairly positive going into 2022. But when you dig down on those cyclical sectors, you've seen margins improve to levels not seen for close to a decade and energy the highest since 2011 and in the materials sector on a global basis. So looking at the All Country World Index, it hasn't been this high in 20 years, even going back to 2003 or 2007. There's obviously many, many things at play here. Higher commodity prices. But I think it's just a combination of an environment that was favorable to commodity prices. But it was also the fact that a lot of those producers, whether it's in the base metals, precious metals, chemicals to a certain extent, fertilizers and things like that, they hadn't been investing that much money and or not spending too much money and being trying to be nimble over the past years because commodity prices were trending lower. They've just become much more efficient companies for the ones that have survived and gone through this kind of tough phase since 2015, give or take, 2016, I should say, excuse me. So those sectors are looking good.

If we look how that impacts from a factor perspective, obviously value did really well. Dividend stocks also made a very strong comeback. Having to get yield, you had to go in some of those sectors that I mentioned previously. So it kind of correlated very strongly.

What didn't do so well? Not much. There wasn't many places on the market that was down outright for the year as a whole. We started to see more volatility in the growth quality space come, I'd say, Q4 and we've seen that to start this year, obviously, and especially in the non-profitable kind of high-expectations space, right, where we're really betting on the long-term growth of a lot of these names. And we can see it in some of the active ETFs in the space that are very focused on technologies and emerging technologies and things like that.

So, that's one thing that's definitely come into focus, and I think for 2022, it should be a really interesting year with, to me, the number one thing to consider is the way that central banks are going to behave and the tone that they take with markets to say, to indicate how they're going to proceed going forward.

So, you know, with that in mind, from your perspective, what's the down low on what central banks are supposed to, what central banks maybe should be doing or what they're going to end up doing? What's your take on that? And I'll maybe provide a few comments on the impacts that could have from an equity perspective after.

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Andrei Bruno: So I think obviously the transitory inflation narrative kind of fell apart in Q4 of last year. So that was the main kind of narrative. We were hearing it from central banks, both in Canada, U.S. kind of to start 2021 there. But after about 12 months of inflation, It's hard to think that it's transitory.

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Étienne Joncas-Bouchard: We've got to change the word. We got to just change the word to something else, but agreed. Agreed.

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Andrei Bruno: So that kind of fell to the wayside. And the other argument that was being made is that the inflation was a supply-driven inflation. So the argument was that monetary policy typically targets aggregate demand, not aggregate supply. So the argument from central bankers where we can raise rates, but it's going to do nothing to effect kind of the supply chain issue. So now they're kind of getting boxed in a little bit where you're still getting, you're trying to print 7% inflation. And those are high numbers we haven't seen in quite some time, I think since the 80s, I believe, don't quote me on that, but I think early 80s was the last time we got inflation of that size in the United States. So now they're facing a scenario where inflation is still high. Are they going to have to hike faster or are they going to have to hike more? That's the questions that the market's asking right now. And so if you take a look at kind of the rate hike forecast the market is pricing in currently. If you look at the United States, it's a little over four hikes that are being priced in for 2022. And in Canada, a little over seven hikes for 2022. If I was a betting man, I'd bet the end there on the seven.

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Étienne Joncas-Bouchard: If! We do not support gambling on this podcast by any means, but I see where you are going here.

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Andrei Bruno: It just seems seven hikes seems a bit aggressive from a Canadian perspective, especially when you consider the amount of kind of leverage in the system in Canada specifically with regards to the consumer. So personal debt to income levels in Canada are about 180%. And so when we say personal debt, we're not even including mortgage debt in that, we're just entering credit card debt, unsecured lines of credit and things of that nature.

So you have to consider, you get seven rates hikes, and that's increasing… If you take a look at mortgages, some people were financing their mortgages at about 2% last year, maybe give or take. You hike rates seven times, that's almost increasing your month-over-month interest expense by a 100%, almost. So it's just I don't think the consumer has the wiggle or the financial wiggle room to absorb seven rate hikes in one year. So it's kind of that notion that I don't think we get seven and I certainly think we are going to get some hikes and don't think it's going to be seven, though.

When you look at the states, they've typically, I mean, if you if you look at last, let's call it 10 years and you look at the central bank, they tended to err on the side of keeping stimulus on versus taking stimulus off. So I think they're certainly going to get some hikes and they're still tapering. Whether or not they may taper quicker. I think that's something they might do is taper to zero a lot faster than they initially anticipated, see how that goes. And then they're going to get their hikes in and they're going to want to see how that goes.

Back to back meeting hikes—I don't know if that's going to happen. I think they're typically, again, they're going to want to hike once, see how the market digests that and see how the consumer digests then and move on from their high level. Again, though, we are going to get rate hikes this year in Canada, the US, obviously some sort of black swan event notwithstanding whether we get some sort of new variant that closes things down. But what we also have to understand, too, is if the supply chain is … folks are thinking that the supply chain bottlenecks are going to start to sort themselves out by 2022 if not by 2023. So if we do see inflation start to come off a little bit, I think it'll take a little bit of pressure off the central banks as well. So maybe we don't get as many hikes as kind of the market is factoring in.

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Étienne Joncas-Bouchard: You almost get the feeling that central banks are taking away the word transitory because they're tired of explaining some of the supply constraints that they're seeing under the hood and just saying, you know what, we're just going to hike rates so everybody can leave us alone. But no, all jokes aside, I think that's a very fair assessment. That especially with being priced in right now seems maybe a little bit aggressive, albeit it's... I think the probability of at least one, if not a couple of rate hikes is pretty close to 100% among everybody in markets. It would take something quite extraordinary to deviate from that. Now it's the scope and the expectations, like, are we going to go above or below those somewhat set expectations by what the central banks have mentioned or just what the market's pricing in?

And obviously it has a direct impact on fixed income. Even actually when we had a meeting with some of our high-yield managers not so long ago, both you and I actually last week, and saying are these higher rates potential risk for either high yield bonds or corporates and saying a lot of these companies are in a better place from a balance sheet standpoint than they were two years ago, and a lot of them took advantage to refinance at these record low rates and spreads.

So it shouldn't cause too many headaches from that perspective, but nonetheless a huge impact to bonds in general, obviously when rates are moving. But from an equity perspective, it's actually quite interesting because this whole change in tone going more hawkish from central banks has really put pressure on the higher priced end of the stock market, which generally speaking was more of the tech consumer discretionary com services side. Those sectors are all mixed up now like you'll find tech companies in com and you'll find tech companies in discretionary. But nonetheless, those are the areas that were trading at a premium relative to the market. And those are taking it on the nose a little bit to start the year.

We actually did a bit of research on our end from a factor perspective to see, are there types of stocks or themes that tend to outperform during these rate hike cycles? And what we found is albeit they tend to be actually more interestrate sensitive, low-volatility stocks did extremely well in the past six rate hike cycles that we've seen in Canada and over the past four rate hikes cycles that we saw in the U.S., both coming out on top from that perspective. And I think a lot of that has to just do with just draw down risk in equities. This environment of ... there's no one consensus necessarily on where central banks are going to be going. It's probably going to create some choppiness and having a focus on companies that are much more stable, so low beta, low standard deviation of their earnings could be a good play coming into this year.

And the other areas that generally did well in certain cycles that are similar to this in the mid cycle, where value obviously did well as because, albeit that this is causing some volatility to equity markets, the fundamentals, underlying metrics that we can look at from an economic standpoint, whether that's employment, whether that's wage growth, whether that's industrial production, manufacturing production, it's all saying that we're in a relatively healthy environment and a positive one for just equities in general. But I think definitely we're going to see a bit more choppiness than we did last year.

So those are some perspectives from the equity side. It's interesting also when you look at the underlying dynamics of certain of our portfolios. This applies to our ETFs, obviously, in this discussion, but if you look at some of our value ETFs, albeit they outperformed their indices by a substantial margin last year, a lot of them were actually trading at a cheaper valuation. So their price-to-earnings came down as the markets did. Also, we got multiples compression last year, as you know, earnings caught up to the price of appreciations that we had seen in 2020. That's very positive, right? So you're starting the year with technically a cheaper market. At least we got that going for us, right? So, that's quite interesting. I guess, we can maybe, you know, before we wrap it up here, just one thing that you're looking out for other than obviously this rate scenario, if you will, with central banks there. Is there another thing that's top of mind for you going into 2022 that maybe our advisors and investors listening to our podcast would be interested in hearing?

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Andrei Bruno: Yeah, so for me, in 2022, so unfortunately, the fixed-income market, I feel like it's going to be a little bit of the same that we experienced this year. It'll be interesting to see. We've been seeing volatility pick up and rates markets. If we look at kind of interest rate volatility indices, ICE Data have a nice indices that tracks kind of volatility and rates markets. So that has been trending up starting in 2021. So it'll be interesting to keep an eye out for that to see if … and I would predict that it will continue to trend up in 2022.

On your point there, you explained how there's going to be some choppiness in equity markets. I think a lot of that is actually going to stem from kind of the rates markets being choppy themselves, right? So again, you have those certain names that are sensitive to interest rate hikes. So again, when you have people trying to price out these instruments being like, OK, well, we're going to get seven hikes in full now, we're all going to have five or four. So again, I think the volatility in the rates market is going to translate into some volatility into the equity market. So that's something I'll be keeping an eye on.

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Étienne Joncas-Bouchard: Great, great. Absolutely, that's a great point, and I'm lying to myself saying that this is not tied to what central banks are going to be doing, but the way that inflation will mechanically peak and what is really driving that drop in inflation. I think it's going to be really interesting to see and it's going to actually probably dictate a lot of the central bank moves. But just to see, you know, what items come off first, because right now we're still getting numbers that 7% print we saw in the U.S. and what was it today in Canada was 4.8…

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Andrei Bruno: I think it was 4.8.

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Étienne Joncas-Bouchard: Which is a multi, multi-year high. What happen when we go from, if energy prices stay flat and you just get zero there instead of a 40-something percent increase, what happens when you know, maybe used car prices just kind of stabilize because cars, you know, car manufacturers now are getting their chips and they can start producing cars again? Like, I feel like a lot of these items are going to be interesting to see how they develop. So, when will inflation peak is kind of the thing I'm looking out for and what impact that's going to have on markets.

I think right now, we've been, as investors, somewhat addicted to growth over the past five years, and now it almost feels like it's already completely in the rearview mirror. If we see a few undershoots here and there, and if we see maybe a bit less rate hikes than expected, that could be a good inflection point for growth and quality to make a little bounce back sometime this year. I'm not calling for that in the short term by any means, but it could be something that could happen between now and the end of the year, so. Long answer to say that inflation is going to be once again, I think, top of mind for a lot of people.

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Andrei Bruno: Yeah, I'm glad you brought up the used car prices because I think that's kind of a proxy for potentially being able to see that inflection point in inflation because we were on a call with some of our portfolio managers in the fixed-income space, and that's something they were discussing just in terms of how used car prices are kind of approaching new car prices. So I think that's one of the things that will start to turn over when inflation itself is starting to turn over. So it's a good proxy to keep an eye out for on used car prices.

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Étienne Joncas-Bouchard: Absolutely. All right. Well, thank you everyone for joining us. As always, we appreciate the support. And Andrei, thanks again for joining me here and look forward to doing more of these with you in 2022. Thank you, everyone.

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