The Upside

Sector Watch

Denise Chisholm, Director of Quantitative Market Strategy

Pamela Ritchie, Host

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

Today we welcome back Denise Chisholm, who is hopefully a familiar voice to you at this point. Denise is Director of Quantitative Market Strategy and will be presenting another installment of her sector watch, today with a focus on top sectors, trends and themes of 2021, and upcoming in 2022.

In speaking with host Pamela Ritchie, Denise looks at the big inflation story and reflects on the recent announcements from the U.S. Federal Reserve, noting that when you provide consumers with income from government stimulus and wages, what you usually get are higher prices and those higher prices tend to be sticky.

Denise studies historical patterns and historical probability to watch for future trends, and today she dives into what might be ahead for markets and growth in 2022, as well as reflecting on the recent market volatility and spike in the VIX volatility index we saw in late November and into December.

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Pamela Ritchie: Let's go straight to Jay Powell. We saw the head of the Federal Reserve have some interesting testimony, comments, remarks, so on. The market seemed to get a message from him this week.

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Denise Chisholm: That inflation is not transitory?

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Pamela Ritchie: Yes, we're supposed to retire it, he says now.

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Denise Chisholm: Yes. I think history would have shown that that was somewhat inevitable. I think that there are very few other certainties when I study the market that show when you provide consumers with income, both from government stimulus and from wages, what you usually get is higher prices and those higher prices tend to be sticky. Now that said in, I think, his defence, the Fed has a dual mandate. It's not just all about inflation, it is about employment. The problem is how do we think about employment, not just in the unemployment rate but in the level of employment in the overall economy? That, we're still quite a long ways away from full employment to the extent that you measure it like that. Maybe what we're seeing in terms of the way he's thinking about inflation was somewhat inevitable and sort of the retirement of the word transitory, but the employment issue is still a sticking situation and so therefore, it might not lead this retiring of the word necessarily to rate hikes earlier than investors may expect.

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Pamela Ritchie: I read in one of your reports that I think you put out every week and it's interesting ... inflation came in hot and it has been coming in hot. We've been watching CPI come in. We've been seeing inflation come in hotter, hotter. It's just this transitory word and so on. What was kind of the tipping point here that we now think of it as really all pistons are firing here.

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Denise Chisholm: Inflation, I think it's two-fold. One, we certainly saw supply chain disruptions for the first time, at this level, I mean, in some ways ever. But I think what we haven't seen in 20 years, which is wage growth on top of those supply chain disruptions. So you had both. You had an increase in demand and a reduction in supply. Those two things haven't happened together in a very long time, creating this sort of perfect storm for inflation. I rarely look at spot estimates and always look at history and quartiles and now when you look back to 1962, which is usually where I start my historical data sets because that's when we have sector data back to, now you're all of a sudden into all of that top quartile level back to 1962 for inflation. So this perfect storm of events has led us into top quartile of what I would call all of history.

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Pamela Ritchie: You're looking at history, you're analyzing history. Is it showing you that there's sort of a certainty that this is what would happen? We talk a lot about uncertainty, but is this certain?

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Denise Chisholm: That was the most certain thing in the market from an inflationary perspective. When you look, I mean, it's odd sometimes, you always get these contrarian odds when you study history. Well, if I think that higher wages would lead to higher prices, sometimes that's true, sometimes that's not true. In this case, it is very true, especially government stimulus on top of wage growth usually ends up—and by usually, I mean 90 to 100% odds. There's a case or two historically where you don't see an acceleration in inflation, but when you see that top quartile wage growth, you do see a following on of inflation. The question is how persistent it is and whether or not its persistence is disruptive to the economic cycle.

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Pamela Ritchie: Here we have lots of discussions about when exactly lift-off will be, the idea that interest rates, in fact, go up. But there is, it looks like, a shortening of the taper, increasing the taper and getting some of the stimulus that has been pumped in, just lowering it, getting it out of the market ultimately. Markets had a bit of a sucker punch, kind of a one-two punch on Friday. We saw them fall off a cliff, first of all. We did have this variant concern. It was a rush out of the markets but what does that mean typically when we see that kind of rush out of the markets?

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Denise Chisholm: It's an interesting data set to analyze. I don't often get into daily data but you don't often have rare events like you had on Friday. The three events I'll sort of tackle from a historical probability perspective are 1) the spike in VIX by 50%, 2) the decline in crude by 11% and 3) the rotation out of cyclical or economically sensitive sectors by about 150 basis points all in one day. All of those things, not even together, but individually happen less than 1% of the time. These are rare events.

So we can say to the extent that the market is concerned about something, let's see, historically, how often the market is right in the sense that it will be a knock on market returns on a go-forward basis. So you look over the next 3, 6, 9 and 12 months odds, you have higher-than-average returns with substantially higher odds of a market advance. What you end up with, a situation, is if you wanted to sort of boil it down to historical truism is that the market often overreacts and that usually provides investors an opportunity.

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What I would say specifically on crude oil declines and specifically on the rotation out of cyclicality, that's the real alpha producer. The steeper the decline, almost the higher the probability of the defined trend over the next 12 months. So if there is a historical takeaway to the extent that you're a risk taker and willing to look through what could be a trough for anybody that's willing to look out 3, 6, 9 or 12 months, those are usually sell-offs to lean into from an investment perspective.

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Pamela Ritchie: Interesting. What about the discussion of where growth goes from here? We started off this conversation partly with inflation being hot. It's hot. Will it continue to be hot? This is sort of the transitory discussion which we're supposed to retire but the idea is, are we going to sit at these levels for a long time?

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Denise Chisholm: The funny thing about a lot of second derivatives of variables is that it's very relational to where we've been. Where we're going is very relational to where we've been, once you are up a lot, all of a sudden your odds shift not just to 30%, 50% but in excess of 70% the odds that inflation decelerates. That tells you a couple things. One is that once you reach levels, to some extent, it becomes self-limiting. Two, I will say that we're seeing evidence more and more that supply disruptions are getting solved. The longer these things go out, the more likely it is that inflation is to decelerate. To the extent that that thesis is right and these top quartile levels are in and of themselves self-limiting, we actually might be at peak worry for inflation right now.

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Pamela Ritchie: Meaning we see a deceleration in growth in perhaps the year to come. I mean, we have heard this before. It's just interesting how you're putting the odds around it. Are we coming off the base comparisons at this point? I mean, they should be rolling off at this point, that's one piece of it.

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Denise Chisholm: They should be shifting. That's part of the second derivative effect, right? So you see peak growth, you see peak deflation, that second derivative starts to roll. I will tell you that that second derivative slowing down for GDP is not predictive in any way of the markets but it is predictive for inflation. There is that perception in the market that has been a consistent historical trend that that deceleration might mean that peak worries are over and that's really when you see the yield curve steepen much more.

If there's been one key difference this cycle versus other cycles—and there's actually been a lot of key differences this cycle versus other cycles—it's that our yield curve has really stalled out well before prior sort of steepness levels. I can't remember the exact thresholds but usually what you get is a straight shot to about 200, 250 basis points. We're nowhere near those levels. Part of that is a result of the fact that inflation was accelerating. It's true that the higher level of inflation is, the more steep your yield curve is but the real steepness only occurs after inflation is decelerating.

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Pamela Ritchie: Why is that? That doesn't make sense. Or at least it's ironic.

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Denise Chisholm: It is ironic but it's a worry for the market that inflation is going to call the Fed to act more aggressively and end the cycle. Remember, thinking about the Treasury market being sort of the ultimate guardian of what terminal growth is, if we shorten the cycle, then it doesn't necessarily matter if interest rates are going higher over the next year or two. What matters is that fifth year.

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Pamela Ritchie: What ultimately should investors think about doing in a steepening yield curve environment? What works?

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Denise Chisholm: Steepening yield curve is also fairly clear in history and it does all line up with the additional odds that I'm seeing towards value sectors and cyclicality, meaning economically sensitive sectors like energy and financials, consumer discretionary and then value stocks generally across the board. It's been one good factor from an odds perspective to think about as an investor as well. Now look, there's been a lot of volatility, both around those sectors and around that factor but I do think that this volatility is actually an opportunity.

When you think about investment trends, I mean, we certainly saw, again, the inflation worry, the sort of movement from Jay Powell to be this is no longer transitory. We certainly saw the introduction of a new variant which is causing global growth concerns. We still have all kinds of government issues around government shutdown or potential debt default in the U.S. All of these potentially are wall of worries where you have that volatility you can lean into as an investor as long as you're willing to look out over the next 6 to 12 months.

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Pamela Ritchie: Why is peak worry and peak inflation kind of the same thing, or is it the same thing? Maybe I just missed that.

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Denise Chisholm: In this case, it is almost exactly the same thing in the sense that when you look at the sentiment surveys, consumer sentiment or investor sentiment, the number one concern is inflation.

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Pamela Ritchie: It has to be that way. Just from your perspective, did you think that the tapering had to come a bit quicker or that the Fed needed to move faster? You said at the beginning the Fed has dual mandates but it seemed that the markets were a little bit surprised over the testimony that was sort of being discussed over the last couple of days, that this was signalled a little bit more quickly than thought.

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Denise Chisholm: Two things. One, because I study history, I'm always surprised at what the markets are surprised by and consistently surprised.

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Pamela Ritchie: Keeps us humble.

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Denise Chisholm: I will say, when you look at any kind of forecasting whether it be the bond market sort of essentially forecasting inflation or forecasting the Fed or when you look at economic forecasts, they're always wrong almost all the time, invariably. In some ways it doesn't surprise me that the market got it wrong or was surprised by it. The second thing, I try not to focus on what the Fed will do or what actions will take to the extent that I don't think those are a core part of the investment thesis. I actually don't think that the Federal Reserve movement, especially early in the cycle, is a key driver to what I think the stock market will do or for what investors should own. When you look at monetary accommodation...

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Pamela Ritchie: Wait, wait, back up. I feel like that's a real [inaudible]. That's like a red Bloomberg headline, that it's actually not the most important thing.

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Denise Chisholm: It's not the most important, especially early in the cycle. At some point, you can certainly say that Federal Reserve rate hikes at least correlate with an end of cycle but what you see early on when you study history is 12 months before the withdraw of monetary accommodation, we can throw the taper in there, cyclicality works and the stock market has higher odds to go up. And even the 12 months after, the same odds apply as long as your early on in the cycle, meaning that the Fed is more often reacting to the cycle rather than creating it. So as much as it's going to be right at some point, history would suggest that point is far off in the future.

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Pamela Ritchie: The broken clock. What have we learned, Denise? Are there lessons that we're looking at, clearly at this point about when a new variant is found, for instance, over the course of the last couple of years? It was a no-holds-barred sell-off, obviously, the first time around when COVID was discovered globally. We've had several of these scares since. What have we learned about market reaction?

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Denise Chisholm: I mean, in some ways you can go back to the very beginning variant which was the beginning of the coronavirus pandemic. What I would say is that the lesson learned for me is that the markets can go down very quickly but they can regain what they lost very quickly as well.

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Pamela Ritchie: Only with the Fed's stimulus? Only with a monetary and fiscal stimulus like that, though?

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Denise Chisholm: Only with sort of a look through to an end which was ... ultimately the market sort of thrives on peak uncertainty. I'd say, to me, it wasn't just the stimulus, it was the stimulus translation to wage growth. But remember, as much as we want to say that the market ultimately gets it all right, the markets are a discounting mechanism.

What really happened during that sell-off was that valuation spreads got within 75th percentile of being as wide as the great financial crisis. What's really different this time is that they stayed wide and even in the sell-off on Friday, got wider.

So this, what I would call a measure of fear is when investors sell anything that they think is risky, they buy anything that they think is safe and they drive up those valuation spreads, it becomes self-limiting in the sense that the market discounts a lot quickly and that is exactly what happened on Friday as well. We're now back to ... I just checked on forward P/E, the 93rd percentile. We're well into that sort of prior peaks where we say the market is already reflecting a lot of uncertainty.

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Now, what we have this time that we didn't have during the original pandemic is some levels of certainty on the other side. So we have a potential therapeutic that might be launched in December and we also have vaccines that have been used that the manufacturers seem to say that they can pivot within 100 days. All of a sudden now you're adding that level of certainty, of course, that the market likes where that's how you get, as much as we want a time and say that there's bad news coming and that this means that there's more downside, the problem is that might be right on the short term but there might be more upside quicker than you think because there is a certainty on the other side which we didn't have before.

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Pamela Ritchie: That is so fascinating. It's amazing. At this point, what would you point to that we need to be watching? Maybe it's a case of things could react faster than we think, as you say, maybe we get through this period of uncertainty with the new variant and so on faster. Is that really what investors maybe should be looking out for in terms of getting ready or perhaps watching for catalysts?

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Denise Chisholm: I think in some ways the biggest risk in the market is the continued acceleration of inflation at an accelerating rate. I think to some extent, it becomes self-limiting to the extent, even if there's more supply chain disruptions because of the pandemic, there actually might be a softening of demand at the same time, so it's more possible now that it nets each other out. That's sort of one of the biggest risk factors in the market because it's very clear that the market is concerned about both the level and the rate of change of inflation as we approach next year. I think that investors need to always be conscious of the fact that as much as we always think about risk to the downside, there is the increasing scenario that you've seen historically of a melt up.

So I think that we need to think about those in equal fashion in terms of tail events because they both do occur and they occur at odd times. I think investors should always keep that in mind as it relates to inflation, one of the best inflationary hedges is equities themselves. Just remember, for each sort of clip of inflation, your real return is eroding without potentially going out the risk spectrum that equities can provide.

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Pamela Ritchie: Just to get your thoughts on what you were mentioning where perhaps if demand comes down a little bit and supply chains work themselves through a bit more, it may meet in the middle. That's largely on the discussion of goods. What for the services side, the bigger side really, of the economy?

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Denise Chisholm: In the United States, in some ways that's certainly more dependent on the level of government shutdown which we will see as we go forward. But if what we have seen continues to hold, the data suggests that for each variant, mobility is higher and higher. We can certainly say it might be different this time, this variant might be worse but if it's the same historical trend, what we've seen is higher mobility despite the fact that there are coronavirus outbreaks. That's the services sector. That means that while there might be a deceleration, that it might be lower than you expect and come back quicker than you expect.

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Pamela Ritchie: What do option markets at this point tell us? Is there anything that people are particularly, in climbing a wall of worry, is there something that people are hedging in certain ways? Or do you notice anything that might be of interest?

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Denise Chisholm: We certainly saw it in the VIX. You certainly saw it in the skew. What you've seen, I think, consistently in this recovery is that sentiment panics quickly and resets quickly. In some ways, whatever you see, the knowledge base is that it's likely to change going forward. That's why in some ways you're better off buying high levels of VIX and selling low levels of VIX, which we're not at right now but that's essentially your implicit volatility in the options market. Because all of those things reset very quickly, you actually have to, more often than not, especially now, buy fear.

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Pamela Ritchie: Fascinating. When we spoke last time on The Upside, you were talking more about the disruption side of things, disruption funds, opportunities within for looking at growth but in a particular way within the disruption space. How does that work, ultimately, for taking a look at value, basically? How would they work together? Do they work together or are they two separate things? How should investors think about that?

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Denise Chisholm: In some ways, they're two separate things that you can use in a diversified portfolio. Many people think that it's an either/or discussion between value or growth and I don't think that it is. The reason why I don't think it is because when mathematically you look at the top quartile of companies forecasted to grow over the next 12 months and the top quartile of book yield, which means your cheapest sector, they outperform together 75% of the time. So all of these different ways that we talk about value or growth and the indices, Russell 1000 value, Russell 1000 growth, it's an equal split, that's how we sort of create this either/or but when you think about it conceptually as a building block, you don't really need to think about it that way.

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I think investors should be thinking about what's my best building block for growth and what's my best building block for value? I think that the growth one is especially hard to get at, what I would say right now.

First of all, you can't get it from a factor perspective because if you look at past growth, it actually leads to lower odds of future growth, so that's not what you want to invest in. And if you look at forecasted growth, it's more often than not wrong. So factors don't get growth right. We've been bailed out as investors over the last, basically seven years, on equating technology with growth, and it certainly is, it's been the highest growth sector when I look back until 1962.

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So it's certainly there for growth but what I see in the data is that the risk/reward has shifted massively for technology. Even during the pandemic, what you saw is the technology sector even though it outperformed by a significant margin, actually got cheaper back down to the bottom quartile of history. That was a really strong odds just in and of itself. If you go back to the pandemic, you had bottom quartile valuation levels and you had good odds, 70+% odds, the margins were going to expand as we exited recession during those recessionary times. Fast forward to today, those two things have played out. Margins have already expanded to top quartile levels and now we're back to top quartile levels on forward P/E that we have not seen since 2005 in technology.

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Pamela Ritchie: It's so interesting because I think a lot of people did not think it was cheap but you're looking at it from a different perspective. I mean, it didn't seem cheap. It seemed to be the expensive stock and everything else was falling apart and that's where you wanted to be.

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Denise Chisholm: Yeah, it depends on how you measure it. I mean, it's always funny when I say that. I usually measure things that are predictive, so what you're talking about, at least you could say it was very expensive on price-to-book and I would say very expensive on relative price-to-book versus its own history. There were a lot of charts out there that would look at it relative price-to-book versus utilities and say it's the exact same as the bubble. The problem with that is, is that you back test relative price-to-book, you quartile it out, you say, does it affect my odds of future outperformance? The answer is no. The answer is no, because margins have been higher every cycle. So of course, price-to-book should be higher. Earnings and free cash flow have not been higher every cycle ... well, they have, but valuations of those levels have not. When you look at price to free cash flow and price to forward P/E, there's where you get your predictive qualities. You want to buy bottom quartile and you want to sell top quartile. That's that monotonic strength.

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Those are the valuation metrics that I actually latch on to, only the predictive ones and everything else you sort of let float away. That's why I think during the pandemic, when you look at those relative forward P/Es, how cheap they were back to the bottom quartile of their history and you look at fundamentals, even margins being the best they've ever been, showed a very, very attractive risk/reward. That was basically true for the last seven years. That is no longer true. Now, we'll see going forward if that was just a correlation to the performance or if it was causal but those are two things that we had on our side that are not only not on our side for technology, but headwinds. If you're looking for that growth bucket, I think that technology might not be it over the next one, three, five years, which means that there's another way to slice the market to get a cohort of companies that could serve as your growth portfolio.

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That's where disruption and innovation, I think, is really unique because what you see is even in the technology sector, they're not all disruptors and innovators. There's actually a big swath of legacy companies. Those legacy companies tend to be cheaper but they also tend to grow slower. To the extent that you're looking for growth, maybe sectors aren't a great way to cut it up. Maybe factors aren't a great way to cut it up. Maybe thematic products with an underlying driver like innovation is a better way to cut it up, that crosses across sectors and factors itself.

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Pamela Ritchie: It's absolutely amazing. Some of the disruptions are actually in those value names. Is that correct?

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Denise Chisholm: Oh, that's definitely true. It's not just growth names across the board. It happens in every sector and across every factor as well. So you actually get a diversification based on that sectors and factors within that thematic basket.

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Pamela Ritchie: To round this out a little bit and ultimately to take a look at inflation.

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Denise Chisholm: That stair-step pattern, that's always stuff that I gravitate towards. When inflation is in the lowest quartile, it's got the lowest odds of deceleration which is, in some ways, this is all intuitive but again, now when you go back to 1962 and you say we finally busted through the threshold of this quartile four, what are our odds that inflation is going to decelerate? 64%. That's the inflation is self-limiting and we need to be conscious of that as investors.

When inflation is accelerating in that highest quartile, when inflation is accelerating, what's the yield curve doing? More often than not that monotonic as well but you stop at 50%. When inflation is accelerating, the Treasury market gives pause. Is this going to call the Fed? Is this going to end the cycle? Is this going to be a problem that we should be aware of? But what you see is, it unleashes the power of the yield curve once inflation starts to decelerate, which show you 75% odds of a steepening of the yield curve. The answer for inflation is, what might happen from here is a deceleration and the answer in the market is, what might that deceleration mean? I think the most important thing it might mean is a re-steepening of the yield curve.

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Pamela Ritchie: And in that environment, value tends to be the benefactor.

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Denise Chisholm: Value and cyclicality. Which part of the yield curve ... I always talk about it like it's one thing but there's actually the short end and the long end and they've been at odds. So the short end, under five years, has actually been steepening. The long end is the portion that's been flattening. Which one of these yield curves is actually more often right and it will show you that the short end actually is. To the extent that the short end is more predictive than the long end, that suggests that over the next 12 months, the yield curve will steepen as well. The odds when the yield curve is steepening or flattening in all of those bottom quartile value metrics like book yield, sales yield or free cash flow yield. That shows you just how much more alpha is produced by value stocks when you see a steepening in the yield curve.

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Pamela Ritchie: Denise, you are such a superstar. Thank you very, very much for joining us, taking us through really how we can get our heads on straight to be taking a look at these markets. Appreciate your time. All the best.

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Denise Chisholm: You too. It's great to be here.

[00:28:16]

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