## Fidelity Connects

**Sector Watch**

**Denise Chisholm**, Director of Quantitative Market Strategy

**Pamela Ritchie**, Host

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

What's happening with the big topic of inflation? What's on the horizon for energy and other sectors, and how can history guide us for what may come next?

Denise Chisholm, Director of Quantitative Market Strategy, is with us again today to answer these questions and provide her sector and factor perspectives.

Eyes continue to be on both Fed Chair Jerome Powell and President Biden as inflation and gas prices continue to soar in the U.S. Denise believes that rising CPI has been largely driven by the housing market and also that headlines are making the inflation problem seem worse than it truly is, and that the market might be pricing in too many rate hikes. Stay tuned for more.

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



[00:01:42]

**Pamela Ritchie:** Hello and welcome to Fidelity Connects. I'm Pamela Ritchie. Denise, great to see you. How are you?

[00:01:48]

**Denise Chisholm:** Great to be here. I'm well, Pamela.

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**Pamela Ritchie:** I feel like things have actually moved in lightning speed over the course of the last several weeks. I wonder if you can kind of bring us back to batten down the hatches and understand what we're talking about as we move so quickly here.

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**Denise Chisholm:** Yes, I think that that's part of the problem as we think about inflation is how we define the scope of the problem. If you just look at the data, we have massive divergences between all of the indicators in inflation. If we look at the CPI versus the PCE deflator, if we look at the headline versus core on an annual...

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**Pamela Ritchie:** So the PCE deflator, sorry, I'll just ask you to define the term. I think PCI, we know what we're talking about where that's our number that we get out with headline and core and so on, but PCE, why are they different?

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**Denise Chisholm:** The personal consumption expenditure is what they use to deflate personal consumption expenditures in the GDP accounts. They are different both on weighting ... that's the majority of the difference is the weighting of the baskets. The Fed's preferred inflation indicator that they talk about is the PCE deflator which is not the CPI. That's important because most times they're not that different. I mean, if they're different, they're a little different.

We're seeing top quartile, top decile divergences between headline and core and between the CPI and the PCE deflator. Of those four metrics you get to choose in terms of your inflation problem being between on headline CPI, a run rate on an annualized average three month of about 11%, or on the core PCE deflator, a run rate of just under 4%. This is one of the biggest issues in the market is how would you like to think about the problem that the Fed is trying to solve as it relates to inflation? If you're looking at the run rate of the core PCE deflator, it doesn't seem like such a serious problem as opposed to the headline CPI number.

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**Pamela Ritchie:** That's unbelievable, really. I've been listening to Jerome Powell. He talks a lot about the PCE deflator, actually, all the time.

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**Denise Chisholm:** Right. There's a reason for that. I think that history can help in a bunch of different contexts about this. If we know we have a top down file divergence in these indicators and we know that they generally converge together over any given period, which way do they typically converge? The data is fairly clear historically. At least 65 to 70% of the time, headline converges to core and 60 to 70% of the time, what you see is the CPI converge to the PCE deflator. That means that the math on a run-rate basis, we are more likely to converge to the most benign indicator which is right now on an annualized run rate basis just about 4.

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There's another reason why this should be your sort of preferred measure when you think mathematically about inflation, it is because it is the most correlated to real consumption expenditures. It's very interesting and the fact that when you think about why we're concerned about inflation it's because it could potentially be a shock to the U.S. consumer. The way you think about that is essentially a tax, therefore you have less discretionary money to consume other things, so you pull back on your consumption.

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What we really want to think about is the inflation indicator that correlates most strongly to consumption. What you'll find is even real average hourly wage earnings, or the *[indecipherable]* number, or the Atlanta Fed, what you'll find is it's negatively correlated to headline CPI, meaning the higher headline CPI is the more likely real wages are lower and vice versa.

What it usually means is that the consumers actually stem the tide of whatever that headline inflation is *[indecipherable]* inflation by dipping into your savings or dipping into credit or accessing credit.

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The only positive correlation is related to that core PCE deflator, meaning that's how the consumer thinks about that annualized run rate. Again, that's one of our more benign measures. We've talked a lot about all of the headwinds that I see coming and there's specific headwinds specifically in housing which is another reason why the core CPI might converge to the core PCE deflator as well.

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**Pamela Ritchie:** Just going on the PCE deflator of 4 means that we could, if you're looking at it through that lens, be looking at inflation at 4% which is, as you say, incredibly different from looking at it in a different way where headline inflation is looking like it's at 11.

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**Denise Chisholm:** Correct. It's doable for the Fed to hike interest rates to provide a headwind to that 4% to get it into what they are mandated. They're calling the hard line on 2 and we can argue whether that's the right hard line but we have a significant amount of headwinds that have built as inflation has accelerated. I think mathematically you have to appreciate that it doesn't just work one way. CPI, especially headline, can accelerate very rapidly, it can also decelerate very rapidly.

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**Pamela Ritchie:** Which brings you back to is it just a much, much longer transitory discussion? I don't know if that works for semantics one way or the other but there's something in there. Can we go to energy? This is where so much of this discussion was. In fact, when we heard the rate decision last week it was sort of this question of is the Fed chasing the energy price, the oil price, basically?

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**Denise Chisholm:** That is tricky for them to do because that's not certainly something that they can control. In some ways we can walk through the inflation argument being is this the shock that is going to tip us into recession? Meaning inflation is high enough the Fed's going to hike so much that we will get into recession. I think one of the big questions is has the energy shock been enough that we're actually already there? We're on the precipice of a recession because the energy shock has been so significant. Certainly, in terms of nominal prices you can see that. Gasoline hit $5 a barrel for the first time on a national average in some measures anywhere. The problem is, if you recall, the way it usually works from a translation mechanism to shock the U.S. consumer is by thinking about it in relation to income. How much the U.S. consumers spend as a proportion of their income on energy, goods and services? There has been a specific point in history where it has been a shock enough to cause a recession. That tends to be around 6, 6.5%, at least historically. There are different breakpoints for when they pull back on crude oil consumption but the recessionary impact has been much higher levels.

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When you think about gasoline spiking to $5, now we have to think about two very quickly moving pieces. One, gas prices and the other, wages and salaries. They are moving just as aggressively. In fact, the most recent data, June 9th, came out with the Atlanta Fed Wage Tracker, which is sort of like an ECI on a monthly basis, so it follows the same employees, unlike the Average Hourly Wage Index. What you see is that accelerated into June, so it accelerated from 6% growth to year-on-year to 6.5% growth year-on-year.

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**Pamela Ritchie:** *[indecipherable]* absorption is possible of these energy prices even though it's painful.

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**Denise Chisholm:** That's exactly right. If you net those two out, you have some error bands around the regression because they're very quickly moving pieces but we're actually still below 5% of our income in aggregate on energy, goods and services which is about where we were from 2011 to 2018.

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**Pamela Ritchie:** This is the U.S. This is data. It's different in different parts of the world. I won't ask you to compare all the different numbers but, for instance, there's the discussion of whether the U.K. is actually in a recession. I don't know if they have the same situation. Obviously, the energy story in Europe is different. I guess, again, on a relative basis, the U.S. is in a different place, right?

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**Denise Chisholm:** Yes, it is in a different place. The tricky part is when you look at the U.S. and when you look at the data there is clear shifts in terms of how much the U.S. consumer has spent on energy and then clear shifts in terms of when you see consumption change on the back side. You don't see that in Europe overall, meaning it's been a slow march higher that Europe has actually spent more and more of discretionary money on energy, goods and services. There hasn't been this clear historical breaking point in Europe. It's not as quite as tied to that as it has been, at least in the United States.

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**Pamela Ritchie:** Fascinating how that works. What else should we be looking at to look at discrepancies, to look at where we see things converging that really are quite different from some of the headlines discussed in the march towards a recession, if that is even the case?

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**Denise Chisholm:** If you think about dusting off where are we, what are the drivers, if inflation is less a problem, and the 4% PCE deflator is what we should be looking at, then the Fed has to hike less than people potentially expect. Energy hasn't been as much of a shock as many investors expect. I think that the last question to put it all together is, well, what's the market discounting?

The market is down peak-to-trough in the U.S. on the S&P 500, it was, I think, 25%. Now, that in and of itself is an interesting discounting mechanism. If you just look through history and say, I know nothing about what's coming, whether or not a recession is coming or not, what are my odds of the market being up the next year after it's down 20% in any given year? You'll actually see that it's 87% odds of being up and that's through recessions. Even if you look at just sort of a first half experience, when you say, okay, the market's down more than 15% in the first half, what does it do during the second half? You have 100% odds of a market advance in the second half despite the fact that in 1970, which is one of those instances, we actually had a recession.

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**Pamela Ritchie:** So if it's down 15% in the first time, we're down 25.

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**Denise Chisholm:** Exactly. Exactly. There's not a lot of historical instances of even down 15 to 25. I think it's down a lot very quickly. Remember, you rapidly approach the point of it being too late to be bearish at that point, given the fact that we just lived through a pandemic where we discounted a very severe recession in just one month. I think you can see this, not in just historical odds of peak-to-trough contractions in the market but in terms of what the market's discounting, like we talked about in terms of valuation spreads being very wide, the VIX being above 25. So, this is the portion where you can really see consumers or investors really crowd into consumer staples, health care, utilities, the old telecommunication services. I think there's a place for defense in your portfolio, and a lot of this is skewed towards the bid in utilities, but what you're saying/seeing is defensive sectors have rerated by more than 15%, which is historically rare. This has been one of the sharpest reratings in history.

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So defense is now expensive at least on a sector basis. That's because investors get really nervous during times of economic volatility and they think that, well, consumers just don't go out and buy their toothpaste and turn the lights on and go to the doctor and pay their cable bill, but anything cyclical we're going to sort of get rid of and bid down. What happens after defense is expensive like this? You'll see the returns in the market over the next year. If you're willing to extend your time horizon versus those baseline odds, again, 75% of the time the market goes up, delivers you an average return of 9%, if you look at the instances where you had a revaluation of defensive sectors, they've been bid up by 15 to 20% or more in our case, and they're back in that top quartile level. We're well into the top quartile level. What do you have? 100% odds of a market advance over the next 12 months with 22% returns. Now, look, it's 50/50 over the next three months but this is not about bottom picking, but it's about signalling opportunity if you're a longer term investor. By longer term, I only mean a year to sort of think through the fact that the market might be pricing in maybe even already a modest recession.

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**Pamela Ritchie:** We might be in the pricing in of that now.

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**Denise Chisholm:** Correct.

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**Pamela Ritchie:** That's so fascinating because it feels painful but as you say, maybe this is the moment. Let's start at the beginning: what is your outlook for bonds over the next year or so?

[00:14:27]

**Denise Chisholm:** I think bonds are actually interesting here. Technically, I'm an equity market strategist but I actually like the data behind bonds. Again, if you think through what I just laid out from an inflation perspective, I think that inflation is likely to decelerate potentially rapidly at the headline level, potentially not rapidly at the core level. I think that that's, again, the big deviation that you see. I think maybe Fed expectations are too high. The dot plot moved up to 340 basis points by year end. When I look at the run rates in history in terms of your core PCE deflator in these averages, in terms of what the Fed has to do or inflation expectations, you usually see 6, 7, 8, 9 handles from an average perspective, not the 4s where we're in. That 340 basis points might be an expectation that's just far too high which means that maybe the 2-year, maybe the 10-year are in this sort of we've seen the worst of the rise in interest rates and bonds provide an opportunity.

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Even if you look at the double-digit losses that we've seen in bonds over the last year and then two years, the 2-year stack has never been worse in history and I have historical data going back to 1950. If you look at the 1-year stack usually, again, that gives you sort of odds. I think that you could be setting up for the situation where equity markets and bond markets rallied together, which is the exact opposite of what we've seen over the last six months where we've seen fixed income and bond markets essentially underperform or go down by 10, 20%, depending on which index level you're looking at, along with equities where I think that that positive correlation could actually flip to the positive side. I think that the risk-reward behind bonds is actually changing and changing rapidly which provides opportunities.

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**Pamela Ritchie:** That's fascinating. The 60/40 is another discussion but, as you say, they're correlated and positively correlated.

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**Denise Chisholm:** Correct. The correlations aren't as strong as people would suspect. Obviously, we just lived through that. I mean, really, you have to own stocks and bonds over 10 years to really play out those cycles where the negative correlation holds. The negative correlation isn't really strong enough in any one given year to provide this. These go up and these go down all the time, to provide that perfect math behind it. It just doesn't work that way.

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**Pamela Ritchie:** Honestly, you're so fascinating. I love the way that you look at things from a very different angle, a different lens for us. Thoughts on commodities. We talked about energy, talked about where you see, ultimately, ability of the consumer to absorb. Broadly, on commodities, we have lots of discussions about what Doctor Copper is doing with its PhD and so on, what do you think broadly for commodities from here?

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**Denise Chisholm:** I think copper is not as, again, predictive as most think and sometimes it's actually a contraindicator to the global economy. I think what specifically energy, and less so the materials base, really have going for it is something very different this time. It's pretty rare. You see a dislocation of in some ways valuation, relative valuation versus any time in history. If the narrative is, so crude is going to kill the economy or commodities are going to kill the economy, and we have to put that playbook in play and say, okay, well, what happens then, usually they typically underperform. Most of the time when you see underperformance on that back side, after the economy slows aggressively, is on top of relative valuation being well into the top quartile. This is, again, specifically for energy. This is something very, very different this time. People have massively underestimated the earnings potential in energy companies, leaving them not only in the bottom decile or 5%, they've never been cheaper on a P/E perspective.

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If you look at that historically, that matters because if you quartile out all the relative valuations going back to 1962, you'll see that the top quartile, doesn't really matter what crude does. Crude can go up but the stocks usually underperform because relative valuation has hit a threshold. That works so on the opposite side as well. When you're in that bottom decile of relative valuation, crude is much less predictive than you think. Even if crude goes down, you're still in this 60% of the time, so more than half the time, the stocks actually outperform because they have that relative valuation support. I think that's key. We might certainly see commodities peak out or flatten out or trade flat-ish over the next year but I think that there's still opportunity from an equity rotation perspective to own them in your portfolio.

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**Pamela Ritchie:** I think you've gone through is a recession a foregone conclusion at this point and made the case that it isn't. Is there anything just to add there? The question goes on to say, will this signal the end of a cyclical bull market? Just your thought broadening it out a bit.

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**Denise Chisholm:** I would say that I don't know. To me, when I think about cycle-ending characteristics in the sense of the data, I think it takes higher crude prices to actually get there. You're right, my base case is we muddle through. Even if you look at the Fed raising interest rates, when you look at all those verticals in terms of in any given year when they've raised between 3 and 350 basis points in any given year, you have 80% odds of positive GDP growth that year and 60% odds of positive GDP growth in the year following. A recession still isn't the base case what I'm seeing in the market historically. There's always the it could be different this time, sure, but I'm just saying what if it's not, that's still not your base case. You need something additional.

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That said, even if that's wrong, you get back to the what's the market discounting and there's a whole lot of signals on that side that, again, sort of point to the it's looking a little, depending on your time horizon, a little late to be bearish. Certainly, everybody has followed the fact that inflation headlines have been bad enough that consumer sentiment has never been lower. Never. Never.

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**Pamela Ritchie:** Very grim. Grim, grim.

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**Denise Chisholm:** Not even in 2009. I remember those very grim days. It's an interesting contraindicator in the sense, what you'll see is usually it's monotonically correlated to how much you'd like to buy into the market on the other side of that, meaning that the more bearish sentiment gets, the more likely the market has been to have gone down, the more likely the market is to go up, again, with 100% odds, 22% average returns over the course of the next year. Again, this isn't a short-term indicator. It doesn't mean it can't go down in the next quarter but you're setting up a whole lot of data that says to me mathematically, there's more opportunity in the coming year than not.

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**Pamela Ritchie:** Take us back to the dynamic of if things tip further down and fast what you catch after the bottom bottoms, essentially, how quickly that happens.

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**Denise Chisholm:** Yes, that's a great question. It's really important to remember as an equity market investor, the equity market V bottoms. It doesn't base, meaning that even in 2009, let's go back to the anecdote and then we can sort of talk through the math behind it. In February 2009, there were a lot of these indicators that were signifying bottoms. Valuation spreads were very wide. Credit spreads were already sort of coming in, a lot of indicators signalling very bullish things over the next 6 to 9 to 12 months. Over the course of that next 35 days, the market fell another 17%. If you had closed your eyes and never looked at that 17% and just based it on your bullish signals, by April, again, this was February, by

April you would have been in the money. That 17% not only came back but you increased it enough to be up 5% from that February timeframe. That shows you look how quick ... Sure, can it go down more? Absolutely. The market has gone down more but that mathematically, that V bottom, is the portion that you get back the quickest. That's why people say, don't time the market – unless you have a really strong price indicator that I personally don't have. I usually extend my time horizon to potentially be able to look through bottoms when I see opportunities.

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**Pamela Ritchie:** So, let's just see changes on favoured or least favoured sectors. Lots of discussion about stock picking at this moment and that certain things can be quite different within the sector. How do you answer that question?

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**Denise Chisholm:** That's a great question because I do think that the more tumult and volatility that I see in the market, the more probability is there for me to rerank the sectors. You've heard me talk about energy, obviously, is what I liked in terms of leadership. Then I reranked it to financials over energy and I think that what we're setting up for is the potential for consumer discretionary to be leadership off the low.

When I look at that consumer sentiment indicator, that's 100% historical odds of consumer discretionary outperforming. When I look at of all the sectors which is the sector that has the widest valuation spreads, which is an expression of fear in the consumer discretionary sector? Granted, that's been where the earnings misses have been. I think that that is setting up for the potential opportunity from a mean reversion perspective that I haven't really seen from a leadership perspective in quite some time. I think the technology sector has more to go in terms of relative valuation compression but there might be opportunities, typically within semiconductors. I think I'm most interested in that piece. I think it can be a blended approach with all of the fall out in the market. I think energy is still going to be a positive risk-reward but I think it's looking more likely that the leadership is going to shift.

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**Pamela Ritchie:** Fascinating. As you see some of these rallies in certain days this week even, the tech names and so on, is it a time to actually take a look at maybe looking at other sectors?

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**Denise Chisholm:** Yeah. Whenever you see turmoil like this you always have to sort of dust off the thesis. I think overall for the technology sector we're really not there yet on valuations. I think that there's still some headwinds for the technology sector from a leadership or overweight perspective. I think that there's opportunities within health care. I think that that's the one defensive sector that I think is going to be very sticky because it has relative valuation, it has strong margins and it has strong relative earnings growth. I think that that's an area that could be leadership coming out of whatever our low is.

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**Pamela Ritchie:** The PCE indicator, the measurement that you've been discussing, is it used in other countries or just in the U.S.?

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**Denise Chisholm:** I think that that's just in the U.S. We're the only ones that I know that have a differentiated price basket in terms of the CPI and the PCE deflator. I think that that's what Social Security is tied to from a pricing basket. The basket is different in the sense that CPI, 40% of the CPI is housing and only 20% of the PCE deflator is housing, so that's a big difference and that's certainly a big difference that you've seen this cycle. I do think that that's one of the reasons why we're likely to converge the CPI to the more benign PCE deflator as housing inflation decelerates over the next even three months. I think when you've seen this rise in mortgage rates, it's 150, 175 basis points over the last year, when you look at that since 1975, that's top decile. When you look out after that top decile move in mortgage rates over the next 3, 6, 9 and 12 months, 0% odds of an acceleration in housing appreciation. It's very likely, 100% historic odds, that house prices are going to decelerate. It's just a matter of what they decelerate to which, again, leads to that convergence trade between the CPI and the PCE deflator.

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**Pamela Ritchie:** Quick thoughts on, you can make this short, on crypto as an indicator, or is it an indicator, or is it its own story?

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**Denise Chisholm:** I think it's its own story. It's emerging technology and it certainly acted like that, it certainly traded like that. It's always tough to pick bottoms in, let's just call it concept capital, because there's no valuation. I don't know if there's an opportunity in crypto right now. I don't think that the correlations to the market are necessarily going to hold. I think if there is one correlation that has held, it's really been in that emerging technology vertical. To the extent that there starts to be opportunities within that vertical, I think that might bode well for crypto over the next year.

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**Pamela Ritchie:** Really fascinating. Denise Chisholm, thank you so much for joining us. We are all the better for it every time we speak with you. Have a great rest of your week.

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**Denise Chisholm:** Thank you. It's always great to be here.

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