Fidelity Connects

Rising Rates: Financials, Bitcoin and Real Estate

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

On today's episode, we're putting financials, insurance, and real estate in focus with Reetu Kumra, Analyst and Portfolio Manager, and Nicolas Bellemare, Equity Research Analyst.

Inflation and rising rates are the new normal as we've seen Central Banks around the world raising their key interest rates as these heightened inflation levels continue to shock global economies. The U.S. Federal Reserve, the Bank of England, and even Switzerland raised their key interest rates by 75, 25, and 50 basis points, respectively.

Reetu and Nic will unpack what opportunities and risks there are for the Financial sector, and when it comes to housing, how these higher interest rates impact resell volumes and mortgages.

Reetu and Nic discuss how this has been one of the quickest cycles in recent history, as we've seen record monetary easing turning into rapid rate rises in just a few years. Also, with host Pamela Ritchie, they look at commercial real estate, the long-term adoption of bitcoin, innovation in banking, and sharing the advantages of the Fidelity research resources.

This podcast was recorded on June 17, 2022. And one quick note: we recently released a French podcast with Nic and portfolio manager Max Lemieux. This hour-long markets discussion with Charles Danis, VP Regional Sales for Eastern Canada, is available on our DialoguesFidelity French-language podcast channel, if that is of interest to you.

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Pamela Ritchie: Nic, I'll ask you to just kind of start us off with ultimately … I think some people have a bit of whiplash at the end of the week here. Tell us how you're trying to look at this and ultimately whether this all makes sense to you.

[00:02:31]

Nic Bellemare: Reetu and I have been covering financials for about three years. I will tell you, it's been feeling like it's been 10 years. We've gone in that time period from record monetary easing to now what we have, a fast and furious tightening cycle. We had a pretty big deflationary shock with the pandemic and now inflation running near 40-year highs and stocks that went to … pricing in at some point a pretty severe credit cycle recovering quickly and now as we're sitting today, losses in the banking system are near the lows across the past many decades.

While this all seems like a crazy and fast-changing backdrop, I think the key message today is that the process we've developed to invest in financials has been rigorously followed. Some of the key relationships we've identified between leading indicators, the yield curve, inflation, employment, and ultimately the impact on financials profitability, and valuations, those relationships have all helped and followed their course in the sequencing. While it may appear to have been compressed and faster and more extreme, has ultimately unfolded in a lot of the ways that we expect in some of the relationships we uncovered.

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Pamela Ritchie: I find that kind of comforting to hear. I wonder if others feel that as well. Reetu, just picking up on what Nic said towards the end there, it is kind of the speed, the velocity, isn't it, it's just hard to digest.

[00:04:05]

Reetu Kumra: Absolutely. It's really interesting exactly what Nic just said: this might be one of the quickest cycles that we are travelling through in history, definitely recent history, if not history period. While it's only been a few years since we've been focused on the financials, we've really just come full circle here.

[00:04:29]

Pamela Ritchie: Amazing. Nic, take us through ultimately what you want us to know about, let's start with the banks. Let's take a look at how they are traversing this. Rising rates usually is helpful for net interest margins but there are a lot of other stories moving at the same time. How do the banks look?

[00:04:46]

Nic Bellemare: In terms of the banks, this is a very interesting time for stock picking because this is one of the few sectors that can benefit directly from rising interest rates. I was on this program, I think shortly after the Pfizer vaccine was announced, that was back in late 2020, painting a very kind of bullish picture of the going-forward environment for banks. Now, a lot of that move has played out but I still think it's an interesting sector to stock pick into because you have two big normalizations going on at this point.

For the past, I would say, 18 months the banks have been under earning on net interest income due to paydowns of high-spread loans like credit cards and commercial lending and rates that were very low. Now you're seeing that reverse, that's positive for the banks. At the same time, however, they have been over earning on credit. Credit loss has been very low. This is something we have to really stay on top of. Thankfully, we have a global research team. We also work very closely with our high-yield colleagues on the same floor. This is a typical, I think, point in the cycle where it's about stock picking, doing the work on the numbers, and the banks kind of going through that. Those two normalizations is really what you want to key in on in terms of making a call on the banking sector.

[00:06:06]

Pamela Ritchie: Interesting. Reetu, bring us up to date a little bit on how ... we'll dig further back into other parts of banking for sure but the insurers as well have a main story related to interest rates but also, again, some other moving parts within the industry. Give us a broad overview.

[00:06:25]

Reetu Kumra: You're absolutely right. When you think about insurance, there's two areas to really focus on. We have the life insurance companies which are more long-duration businesses, and then you have the P&C companies where they're home, auto, shorter duration businesses. Starting off with the lifecos, there's a few key drivers when thinking about these stocks. One, we have a rising interest rate environment which is extremely positive because as that premium cash flow comes in, they get reinvested into higher rates. On one hand that's extremely positive but on the other hand, a lot of these businesses have asset management businesses that are actually between a quarter and a third of the overall business.

As a result, you have a little bit of a push-pull happening because as we all know the equity markets have been quite volatile and that has negatively impacted AUM. This push-pull, obviously, creates opportunity. On top of that, keeping a close eye on credit should we have any form of an economic slowdown but more importantly, these stocks are down about 16% year-to-date, and so valuation's actually becoming very attractive. Stocks are trading at 1.2 times price-to-book for what would be normalized ROEs of between 13 and 15%, so quite compelling. I echo what Nic has to say and it's actually a really good environment to be a stock picker because there's opportunities everywhere.

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The P&C companies, they're in a very good environment right now because insurance rates are rising across most lines of businesses other than auto. That's a little soft there, so they're able to nicely manage through inflation. On top of that balance sheets are extremely well-suited to be able to deploy capital during volatile environments like this but just the relative fundamentals are seen in the stock prices, so if you look at what P&C stocks have done year-to-date they're actually positive versus the lifecos which are negative.

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Pamela Ritchie: Amazing. There are accounting changes ... it's not a new story, they're sort of in the background to an extent but does it impact the stock-picking equation for you?

[00:08:45]

Reetu Kumra: Absolutely. Absolutely. Whenever, especially in this market, when there's any form of uncertainty, it is an overhang. With this accounting change, although it's just an accounting change, really, there's no economic change per se, but with insurance companies accounting is very important. The life insurance companies are moving into an accounting standard called IFRS 17 and with that overhang and just the unknowns of what that means it has actually limited the outperformance of the sector for sure.

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Pamela Ritchie: I think we should sort of dip in a little bit into the overall story for real estate. Again, we're going to kind of swing back to some of these but I just want to get the overall story for real estate. Nic, when you're looking at real estate, you're looking at the banks, you're sort of looking at it through the mortgage market, more the residential story. Is that fair? How is it looking? There are a lot of headlines for us all to read, what do you think?

[00:09:41]

Nic Bellemare: It is changing. The big story, I think, is just the affordability crunch from ... essentially what we had is, first of all, a big run-up in house prices during the pandemic. Low rates, high savings, spending more time at home, so you've seen a 40, 50% run-up during that period at a national level. Again, some of these factors that were behind the

run-up now are changing. The most important is mortgage rates. At the trough you probably were looking at 5-year fixed mortgage rates in the 1.5%, now you are pushing north of 5%. So that is a very big change. Even when you look at mortgage rates that are renewing today from five years ago, it is a pretty important payment shock. If you do the math of applying these mortgage rates on the higher house price and look at the typical mortgage payment on a new house relative to incomes, it's gone up in a pretty spectacular fashion. You kind of have to look back in Toronto in the late '80s to see something similar to that. Obviously, the early '90s was not a great period for residential real estate. It's something we follow very closely. We have a ton of contacts that are real estate agents, mortgage brokers, real estate lawyers that see day-to-day what is happening, the accidents happening and give us good intel.

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As far as we've seen what you typically see is volumes move ahead of prices in real estate. In May in Toronto we've seen the lowest kind of resale volume in 20 years if we exclude May 2020. Now we're closely watching what will happen in the fall in terms of will listings pick up? One dynamic we have seen is a greater involvement of investors pulling forward some demand. Could that pull forward some supply as well in different environment? That's what we're watching.

I'll just wrap it up by saying, tying it to the banks, I don't think as long as employment remains strong it's not really a story of big losses on the mortgage books. Real estate is an important sector because it is an early kind of read of where the economic cycle is going. The banks are economically sensitive, so if you see a slowdown there, there are implications down the road for banks but it's not something where you see an immediate kind of credit cycle tied to that.

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Pamela Ritchie: How will a slowing real estate market affect Canadian banks and really the Canadian economy as a whole? You've kind of said there that it's something to watch but anything to add?

[00:12:13]

Nic Bellemare: You're seeing the first thing to slow is more of the flow volumes whether it's resale, transfer costs, mortgage origination. Those are the areas that feel it. Initially the ones that are probably more important to GDP is what's the impact on new construction because that's a big part of the economy and you see that eventually slow down. I would say the main difference with the 1990s backdrop is there was not the same kind of immigration flows. When we compare, for instance, the number of housing completions to population growth it's not in the same place as it was. It's in a better spot in terms of there does not seem to be a big oversupply of building that you have to take multiple years to work through. It doesn't mean there can't be a downturn but it's something to think about when we think about the depth and the duration of a potential downturn.

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Pamela Ritchie: Reetu, tell us a little bit more from the commercial side. Quite an interesting story on the commercial side, where do you broadly see opportunity in commercial real estate?

[00:13:20]

Reetu Kumra: Great question. There's a lot happening and I think it's really a tale of two cities is what we're seeing right now. If you think about the bigger sub-sectors within real estate, well, commercial real estate, you have industrial, multi-family, office and retail. On one hand you have very strong industrial fundamentals and on the other hand you have

fundamentals within retail and office that are a little softer. I can walk through that a little bit. On industrial, what you're seeing is extremely tight supply. Availability across Canada is approximately 1.6% as of Q1 and it's as tight as only 40 basis points in the Kitchener-Waterloo area.

The demand characteristics are very much in place: e-commerce trends, reshoring, the movement from just-in-time inventory to just-in-case inventory just given the supply chain disruptions that we've had over the last couple of years. Those demand trends are very much in place. As a result, when you have such tight supply and demand there's pricing. Rents are moving up across Canada, high teens, as high as 50% in the Kitchener-Waterloo area. It's a really good story there.

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Pamela Ritchie: It's so interesting, maybe we'll come back to this on the residential side a little bit. On the residential side you think of rates moving up, perhaps housing becoming less affordable therefore the rental market on the residential side. I'm just wondering, is there something analogous within the commercial real estate side of things that you see rents kick up?

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Reetu Kumra: Absolutely. There's a number of ways to think about that. As financing rates go up, debt costs go up and what we're seeing right now is actually spreads between financing rates and private cap rates are actually at an all-time narrow period. The last time we actually saw this was prior to probably 2006, 2007 timeframe. They're very narrow. If you look at what the REITs have done year-to-date, it's down about 20%. Basically what the market is implying is that cap rates are going to move higher because that spread is quite narrow. It's interesting because the public markets are suggesting higher cap rates but we haven't necessarily seen that come out in the private cap rates. It will be interesting to see who's right, the public versus the private.

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There's a lot of dynamics just happening even within each subsector. I was saying that industrials very strong. On the other end, you have retail and office that are a little softer. If you look at office, for example, vacancy right now is about 16% across Canada, 11% in the GTA, and you actually have about 8% of inventory coming on in terms of supply, a lot of which is spoken for. It's just an area to watch.

Multi-family is somewhere in the middle. A lot of key drivers are coming back in terms of demand. The under-30 cohort is moving out of their parents' houses again as they go back to work. Immigration has opened up, schools are in-person, and so the demand drivers are very much there. Supply, we are still from an availability standpoint, we're at about 2% but there is a little bit of a regulatory overhang with the multi-family.

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Pamela Ritchie: Nic, what do you want to bring into that discussion on residential? I feel like there's so much in this story of what people are concerned that's coming. I'm just going to go through some of these questions. If you go back to the banks connected to the real estate story, how is it different in the UK, Europe broadly? How does the Canadian market look from this perspective versus others?

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Nic Bellemare: It's a global trend that we're seeing in interest rates. If you compare to the U.S., obviously there's been more of a disconnect between incomes and home prices and that was supported by the lower rate. There's probably some more vulnerability there and that's something we're watching.

But again, as I said, the first step is you're actually seeing as rates move up either on renewals or variable rates, it's actually more of a pressure on discretionary spending. The first thing is not defaulting on a mortgage. It's probably cutting some of the other expenses. You kind of see that slow motion happen. Really it takes a turn in employment to see more of a credit aspect directly tied to the mortgage books.

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Pamela Ritchie: Reetu, I wonder if you can bring us back to a more fulsome discussion on inflation, where you see the rate rises coming in. We're in the middle of this. You mentioned at the beginning that there's a logic to it, it's sort of not uncertain but where should investors think of the financial sector, one of the areas that you're looking at, going from here? The concern is do we go too fast and break something? How do you look at that?

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Reetu Kumra: I think it very much varies by sector. Just looking at the insurance sector, when you look at the life insurance companies, inflation is resulting in higher rates. That's actually a positive for the life insurance companies. When you think about inflation in terms of the P&C companies, there is inflation in their businesses. If you think about car costs, automobile costs as well as material costs, all of that is going up. The key is just to be able to out-earn that on the top line, which they are managing through. What's helping are things like auto trends. Driving patterns have changed, we don't have as much of a rush hour. If there's a snow day, many people will decide to stay home. Those are really high frequency traffic events. And so the P&C companies are managing through the inflation being seen in the system but it's obviously something that is being closely watched.

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Within real estate, it's a little different where the key pinch points are insurance, as I just mentioned (they're getting their top line), insurance, taxes and utilities. It's dependent by sub-sector in terms of if it's a pass-through cost or not. Often what you see is grocery-anchored retail have pass-through cost, office does as well as industrial. The other sub-sectors, they have to really push to pass along those costs. I think the key area to watch is if we were to see any form of a slowdown, can the tenant health actually afford the inflation that's being passed through to them?

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Pamela Ritchie: Nic, why don't we give you this easy question? How many more aggressive rate hikes can the Bank of Canada get away with before kicking off a full-blown recessionary environment? What's your thought? We're obviously going to hear from the Bank of Canada in the weeks to come. There's been lots of signalling there will be aggressive moves.

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Nic Bellemare: Right now they're going aggressive because they're trying to preserve their credibility. So far the economy is holding up, so it opens the door to continue this aggressive path. I think right now the market's kind of pricing a pretty similar peak or terminal value for the rate cycle in the U.S. and Canada, probably around 4% on the policy rate. We just discussed that Canada's built more private debt at a much faster pace than the U.S. over the past 20 years.

That is one reason why the transmission mechanism of monetary policy would probably be faster in Canada. Either it means they can't go there or it means there's more pain on the other side, everything else being the same. That will depend. That's where we're kind of day in, day out talking to people in the housing market, for instance, what's happening on the ground. We just have to go empirically with what we're seeing. The Canadian economy, it does feel more vulnerable to a rate shock, so that's where we're going to see how it does unfolds.

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Pamela Ritchie: It's fascinating. What about other areas within the banks, the loan books, when you look at other sectors? There was a long story, a long worry about the energy companies, what their loan books represented to the banks. A lot of that has changed or at least the narrative around that has changed as we are in an era of more scarcity on some of those fronts. How does some of that look, the loan book?

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Nic Bellemare: That's fair. Clearly, energy is not where the pain is right now. If anything, they're paying down their debt very quickly with this kind of cash flows they have. It's never the same from cycle to cycle. I think the banking system is overall in good shape from all the regulations that have been put in place after the financial crisis. Capital and liquidity levels are good. A lot of the more frothy activity, some of it has taken place more outside the banking system and in non-banks. Some of the more elaborate private lending that you're seeing, partly because of those regulations that have been put in place, has made it capital inefficient for the banks to be involved in the riskier loans. I think that's a positive. Some of the froth has been more kind of maybe the VC high growth areas, not as debt intensive. There's going to be areas that are going to be vulnerable but I would say generally the overall book and strength of the banking systems look decent.

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Not every recession ... obviously, everybody remembers 2008, 2009 ... not every recession is a full-blown banking crisis. To me, the odds are probably that whenever the next downturn or recession comes, maybe more of a traditional recession than one that's really a banking crisis that makes things a lot worse because then banks start to curtail even more aggressively the lending. It just deepens whatever downturn you have.

[00:24:06]

Pamela Ritchie: Reetu, I'll come to you just for a bit of an update on Bitcoin. It's been an extraordinary time, obviously, for Bitcoin. Some of your thoughts on the moves. It's been a case of people selling pretty much everything on certain days this week anyway. How do you take a lens and look at Bitcoin at this point?

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Reetu Kumra: Great question. Of course, we've seen a lot of volatility in Bitcoin. I think the way to think about it is what's happening in the short term where everything is all about the macro-backdrop, monetary policy and just what's happening in the long term in terms of the broader adoption story that's happening.

Starting off with what we're seeing short term, I think monetary policy is driving everything right now. What we're seeing is liquidity is being taken out of the system. It's driving rates higher, real rates higher. It's putting pressure on asset prices, particularly what is considered a risk asset and, of course, Bitcoin falls into that category in the near term. Bitcoin is being impacted along with other risk assets.

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There's also additional stuff happening in the crypto ecosystem that's further exacerbating this. About a month ago, we saw the unravelling of Terra Luna and then just this week there's a borrow-lend platform called Celsius, they basically announced that they would have to restructure. They halted withdrawals and then there's speculation that they'll have to restructure. So, that further exacerbated things. There's just a lot of volatility happening in the space. Taking a step back, there is that broader adoption story happening longer term. If you think back to the COVID crisis, Bitcoin, the adoption story accelerated during that time. Think back to the onset of the unfortunate circumstances of what's happening in the Ukraine and Russia. There's a huge adoption story happening at that time where Bitcoin is really a lifeline for a lot of people who are trying to store their wealth and flee at the same time while local currencies were collapsing, not to mention donations that were being sent.

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While this adoption story is happening, I think what's front and centre right now is what's happening with the macro environment. Things to look out for just given the unravelling of a few crypto ecosystem specific events that I had talked about earlier, regulation is going to come out of this. With every good downturn there's always regulation that comes out. I actually think that that will be a very big positive for Bitcoin and the rest of the crypto ecosystem because that is the one big hurdle that's preventing massive institutional adoption.

There's also other things to be thoughtful of. There's a lot of financial innovation happening in terms of Bitcoin becoming any form of the medium of exchange where there is a layer-2 network being worked on called a lightning network where it will accelerate the scale of what Bitcoin can offer in terms of a medium of exchange. We're still early on in that process but these are things that are happening in the background.

[00:27:14]

Pamela Ritchie: Nic, I might just end with you on banks, innovation, disruption, the old story of Silicon Valley coming for the banks type thing. The banks have sped up massive amounts of innovation. Any thoughts to share on that front, about when someone should buy a house in Toronto? You can either give that answer or give a broad one, but I would like to know what you think about the banks on the innovation front.

[00:27:40]

Nic Bellemare: It's interesting. In a nutshell, I think the attitude has changed in the last ... with the change in the rate environment and the funding environment for start-ups. I think some of these pure fintech were more boldly going head to head with banks. I think there's a realization that both sides bring something to the table.

Fintechs, just through the nature of maybe smaller teams, the people they hire, the fact that they don't have as much of a reputational regulatory risk, they can be faster at innovating and developing new user interface and products that are easy to use and embed in daily life. I think they realize now the challenge is the funding side. It was when money was plentiful and free. Some [indecipherable]

propositions are changing now and the banks have a lot of funding with deposits. The banks also have a good reputation and brand-end distribution as well because they're already connected to so many people, some of these fintechs...

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Pamela Ritchie: We'll have to leave it there. Sorry, we've come to time. I asked you a big question at the end. Just quickly, is there a specific date, time, down to the second when should someone buy a house in Toronto?

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Nic Bellemare: It comes down to personal circumstances. If you're not in a rush, into the fall or maybe taking the pulse of where we are at that time.

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Pamela Ritchie: Got it. Thanks so much, Reetu and Nic. I've asked a lot of different questions there but you took us on a tour through the financial sector. I really appreciate your time. Thank you.

[00:29:13]

Reetu Kumra: Thank you for having us.

[00:29:14]

Nic Bellemare: Thank you.

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