Fidelity Connects

Factor Investing: What's Heating up this Summer?

Bobby Barnes, Head of Quantitative Index Solutions (QIS)

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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.

Today we set our sights on factor investing with Bobby Barnes, Head of Quantitative Index Solutions. Bobby will reflect on which factors could be a fit for you in today's market cycle and see how factor investing can help investors find calm in the chaos.

The energy sector has been a strong performer during 2022's market volatility, but can this run last into the second half of 2022? Also, what's next for consumer discretionary? Bobby shares with host Pamela Ritchie that consumer spending is still strong, but there has been a shift in disposable income.

Among other topics today, Bobby and Pamela also touch on commodities, the automobile industry, metaverse stocks, and how China's reopening could have an effect on inflation globally,

Today's podcast was recorded on June 8, 2022.

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Pamela Ritchie: Hello and welcome to Fidelity Connects. I'm Pamela Ritchie. Bobby, great to see you.

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Bobby Barnes: Great to see you as well. Thanks for having me.

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Pamela Ritchie: Let's talk first, if you don't mind, there's a lot to get through and to get your thoughts on, but the health of the consumer – healthy changed to health? Give us a pulse literally on the consumer.

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Bobby Barnes: The consumer's been fascinating to watch. Your viewers, if they've listened to me before, they've heard me talk about my framework for thinking about the consumer. That is there are three questions or dimensions you need to be mindful of, the share of time, the share of mind and the share of wallet. With the consumer, overall they're still strong, the spending is quite strong but there's been a massive shift in the share of wallet, how they're allocating other disposable dollars. Along with that is also the share of time where we're all at home and there is only so much you could do, and so we allocated time to things like streaming services, but now the world's reopening. We were just talking before the start of this, people are going to graduations that got postponed by 1 to 2 years and the like. That's what we're seeing.

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Just on that share of wallet piece, we just got through Q1 earnings and it was astonishing the impact or the disappointing reports that we saw from pretty large and stable companies like a Target and a Walmart where we went from…

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Pamela Ritchie: The stars fell, literally, watching stars. It was really interesting.

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Bobby Barnes: Yes, that's right. The story is they've got way too much inventory. We all went from buying TVs and sweatpants to going on vacation again. Within the consumer space, the consumer sector has got various components of it. On the retail side, that's where you saw a lot of big blowups. They're overstaffed and their inventories are too high. The other side of that, you have the services where you've got airline companies saying, oh, my gosh, we're earning more revenue per seat than we have in a very long time and our planes are at capacity. That's the punch line: they are strong, spending is still strong but there's been a massive shift here with effectively a reopening trade.

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Pamela Ritchie: It's effectively the reopening trade. How much of this is priced in? It feels like we've been positioning for the reopening for a good two years. Hope springs eternal. We thought we'd be finished with this a couple of years ago. Is it priced in?

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Bobby Barnes: I would say no. I asked myself the question, how did … because it's not just the CEOs of these companies like a Target and a Walmart, the investment community as well kind of extrapolated out these sales and earnings numbers for these same companies. We collectively thought that this was going to be the trend, I guess out into perpetuity, where we would buy far more sweatpants and leggings than we ever have before. I think we collectively got that wrong. One of the things that I'm very sensitive to in my work is forecasting economic activity. Your viewers will recall that my position has been that I expect that to slow for the duration of 2022 and into 2023. You don't yet see that baked in to the earnings estimate numbers yet. I would say that by and large, we're not really pricing in a slowdown per se.

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Pamela Ritchie: That's interesting because that sort of goes … I'm curious whether the positioning ultimately from your perspective is different one way or the other of slowing, because these are the questions nobody seems to be able to really answer right now: whether it's slowing and it means something like a recession or if it's just slowing. Is the positioning ultimately different for either scenario?

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Bobby Barnes: Very good question. It's at the top of mind for everyone these days. The nuance here is that in my work I found that I don't need to parse or disentangle the two that finely between economic slowdown and recession. The prescription or playbook for the types of stocks that you want to be in and via factors is the same. Either one calls for a more of a defensive posture via higher quality companies, those companies that have lower volatility in their sales and thereby earnings and the like. From that standpoint, I don't think you necessarily need to be that precise when disentangling recession versus economic slowdown. I think if you really want to play devil's advocate, the question you need to ask yourself is what could happen to cause an economic acceleration from here that would prescribe for being in riskier, higher beta, pro-cyclical stocks and factors?

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Pamela Ritchie: That's so fascinating. We're going to talk more about that for sure. Back to the idea of inventories, perhaps overstaffed, the wage story, but in which area of the consumer story that's happening. What could happen enter the QT which has already entered – we're in June now – so we know that that's being removed ultimately from the pile of cash. We know the cost of capital is going up. Again, what sort of comes into this story and how are you looking at that right now? Are we taking out essentially easing that's been in the market for over a decade? How should everyone be thinking about how big this is, the QT piece?

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Bobby Barnes: Those are hugely important questions. Unfortunately, what I'm about to say is going to be fairly sobering. There are three things that are headwinds to economic activity right now and I don't think that there's really anything we can do about it. You mentioned the cost of money, the 10-year Treasury is higher now, just above 3%, I think, as of today. That does have the effect of slowing economic activity with about a 12 to 18 month lag. It's been rising since the spring of 2020 now, so we're going to have to pay the piper, as the saying goes, for that increased cost in money.

The other thing that's also a headwind is that the cost of stuff, goods and services, is also higher. And it empirically has the same effect where it leads to slower economic activity via demand destruction over time. The final leg of this is quantitative tightening. In my work, that actually has a more immediate effect. I usually look at it on the other side of it, quantitative easing, and when that has the stimulative effect that we want. The reverse is true as well that coincident with the tightening happening it tends to lead to slowing economic activity.

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To bring this full circle back to your question about the consumer, I mentioned the share of wallet as being a key determinant of how that's going to drive stocks one way or the other. What I didn't say in that moment was that because of the things I've just listed, those three headwinds, the wallet's effectively getting smaller. We're moving liquidity, the inflation, and so that as well is going to lead to slower economic activity. Unfortunately for a lot of consumers as we look forward, maybe into the second half, we won't see the same strength and spending that we've seen thus far year-to-date.

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Pamela Ritchie: With factors you look through the sectors in certain ways, you can slice and dice it in very different ways, very specific types of investments can be made when you apply that. That said, you've got consumer discretionary, I think telecom and the other bottom of the barrel within the S&P. Anyway, these are the areas of the market that have been hit so badly, is that all correct, they've been overcorrected in that direction?

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Bobby Barnes: I don't think they have overcorrected, in fact. One of the things I look at very closely is the most potent predictor of stocks in sectors and factors is earnings revisions. That's kind of my feedback mechanism when I come on to programs like yours and I tell our shareholders these are the sectors I think you should be in or the factors you could be in, I look at the estimate revisions as a confirmation signal because that drives out underperformance. You mentioned consumer discretionary and then within comm services is the interactive media, I think is what it's classified as. That's where you have your Googles and your Facebooks. When you look at the estimate revisions year-to-date for those two sectors and industries, they are the lowest across the entire market by a long shot.

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There are a couple of things driving that. As we mentioned, the shift from goods to services. We all stayed at home, that was great for the streaming services, the streaming movies providers. We're now taking those dollars and allocating them to vacations, so you're getting the negative earnings revisions in that sector, by and large. Same thing with discretionary, we saw a lot of disappointments. Target kind of did back-to-back disappointments with the earnings release, I think, two weeks ago and then the CEO coming back on the financial services news a day or two ago saying, hey, we're going to have to...

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Pamela Ritchie: I was thinking of you when he came on. I was thinking of what you were thinking.

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Bobby Barnes: That's right. Long with an answer to your question, no, I don't think that it's overdone. I think it's likely to continue throughout the rest of the year as, again, that wallet gets smaller for consumers and that's going to drive more likely earnings disappointments and revisions downward.

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Pamela Ritchie: So interesting. We're going to get to some of the obvious discussions. We want your thoughts on energy and where it goes. There's great interest about the consumer, about the idea of consumption, so here's this question, Bobby, to your comments on consumption, are so-called big ticket purchases such as auto parts, is all that part of the reopening trade?

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Bobby Barnes: Interestingly, the latest data for autos, as you mentioned, we're actually seeing some of that roll off already. I was reading a report just yesterday that showed that luxury automobiles are seeing deflation as of a month ago. Many of the other segments, however, within the auto space are still seeing inflation and elevated prices, your mid-size sedans, vans, that kind of thing. That being said, autos, that tends to be a cyclical sector, and so if I'm right about economic activity in general slowing down as we get into the second half, I would expect that to be one of the places where you would see continued rollover.

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Pamela Ritchie: Fascinating. If market volatility is set to continue, can you go through the different factors and perhaps considerations for the second half? I think you've mentioned a number of them. Anything to add to that?

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Bobby Barnes: Yeah, yeah. I would first start by sharing with respect to the earnings revisions, I look at that by factor as a confirmation signal. What I'm seeing is that you're seeing the best revisions in quality and low volatility and there's no surprise there. That was kind of what I've been calling for since the beginning of this year anyway. However, I will share that I'm seeing … and this was a bit of a surprise … I'm seeing good revisions in value, surprisingly. Typically speaking, when you're in a slowing economic environment that's where you typically see the weakness because value stocks, on average, tend to be more pro-cyclical. I continue to watch that one. I'm not quite ready to pound the pavement on that one yet because, as we mentioned, there's an inventory problem, there's an over staffing problem, and many of those companies tend to be cheaper on average. To the extent that that continues to roll over that would be a headwind.

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The last one, momentum. If I rank order, I would actually say that it's quality, low vol and then momentum. Our Fidelity Canada momentum products, they just rebalanced just last month, a few weeks ago, third Friday. When I look at that portfolio, it's actually also taken a very defensive posture. It's overweight health care, staples and the like. As a result of that, those sectors have had better estimate revisions year-to-date, so that would bode well for that factor as we go into the second half as well.

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Pamela Ritchie: Let's go into what is often the elephant in the room which is the whole idea of commodities, generally, and again, obviously energy within that being a bit of a bright star. I might just ask for your overview for the second half and perhaps further out for commodities. Where do we go from here? There are a lot of factors that seem to still be problems, for instance.

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Bobby Barnes: Yes. The commodity one is an interesting one … and admittedly I struggle with it in that there's a difficult needle to thread there where from a fundamental perspective you mentioned energy being a bright star, from a supply demand perspective we've underinvested. I think as it stands today, in the US there are fewer rigs than there were pre-pandemic. As a result, the production is still lower on an absolute basis than it was pre-pandemic.

To the extent that demand remains strong, that's going to be a big tailwind, continued tailwind for energy. Energy has been off the charts year-to-date, not only from a return perspective but again, I go under the hood and look at the estimates and how they're changing and the estimates five months in are 40% higher now than they were only five months ago. It's validating for the performance we're seeing but it's still staggering. That rarely happens.

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Here's the difficult part of it with not only energy but commodities as a whole. At a certain point you get demand destruction and once that happens, you actually don't want to be in energy or commodities more generally. As I look out into the second half of 2022 and into 2023 if we're in a slowing growth environment, that's okay for commodities as long as they didn't fall off a cliff. But if you go into an actual contraction, earnings contraction, that's where you need to be prepared, if you can, to tactically rotate out of those areas.

I don't think we're there right now but I can see a scenario where, because of the three headwinds we mentioned before, cost of money, cost of stuff, goods and services and in quantitative tightening, depending on how severe that stuff plays out you could get to a place where you're in a contractionary environment.

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Pamela Ritchie: You mentioned closer to the beginning of our conversation that in some cases, regardless of exactly where we land, whether it's slowing or whether it's actually more of a recessionary environment, the positioning is the same. You mentioned quality, low vol, and momentum. Is that what you want to tell people in terms of the factor situation for right now? Can you just sort of say what factors tend to do well in a recessionary environment? Is it the same as a slow growth environment?

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Bobby Barnes: Yes, that is correct. The factors that do well in recession are the same as in a slowing growth environment, the ones you just listed: quality, low volatility and momentum. I would take my liberty here by adding to that question, only because I oftentime get this question: what should investors be positioning in if they are fearful about inflation? That's a slightly different mix.

As it turns out factors generally perform very similarly either way in my work but industries and sectors actually perform very differently. The way to think about positioning there is that they're really three silos, you've got commodities where you've got energy and materials, you've got sectors with purchasing power, and that's where you have health care and staples, and then the last silo would be the real assets and infrastructure silo that does well in inflationary environments. There you've got things like REITs and certain industrial companies. If you're trying to think about the scenarios, I've got inflation on one side, I've got economic slowdown/less recession on the other. That's how I would paint the landscape in terms of the various things you can think about for helping inoculate your portfolio from those scenarios.

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Pamela Ritchie: Love that. We started out with the health of the consumer and the pulse and now we've got the inoculations. Tell me about, I'm going to call it geo-economic situation because it is geopolitical and it's ever moving but it's very much an economic story. China has had a wild week in terms of announcements lifting COVID restrictions but there's also sort of a concern about where it goes ultimately. It has been in a recession because it's been locked down. How are the waves from other parts of the world ultimately affecting markets here? I guess I would ask you to round out the international story for investors generally.

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Bobby Barnes: Sure. There's a very interesting narrative there. I've asked the same question in thinking about China. Due to their zero-COVID policy, they were already in an economic contraction or recession. The question in my mind was usually when you're in that scenario, you want to start positioning for the reopening story. You want to go high beta, overweight cyclicals, the whole nine – everything that I told your viewers to do a year and a half ago here in the US. That being said, the question that I ask myself, and I actually just raised this with our analysts on our asset allocation team, is that to what degree can a reopening in China cause, if at all, an economic reacceleration in other parts of the world, say, either Europe or here in North America?

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The very thoughtful guidance that this analyst gave me was that, all things being equal, it's going to add to demand. We just talked a lot about energy, commodities, and so the light switch turning on their economy again will add to that demand. However, the problem with that is that that's also ... given the environment that we're in where CPIs are going up, energy costs are going up ... that additive demand would actually be detrimental to a lot of the things that we're talking about where it would cause inflation to rise higher, not go lower. All things being equal that would cause a continued slowdown to everything that we've discussed thus far.

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That's how I think about China. The stocks are popping right now as they typically do when you turn the light switch back on but I think if you're going to hold this portfolio for the second half of this year and out into 2023, after this initial pop you might get a weakness due to just general global slowing of economic activity. Same thing with Europe. The war in Ukraine is still ongoing. The thing is, Europe had problems pre-pandemic with Brexit and getting that sorted out, economic activity, even if you rewind the clock all the way back to the global financial crisis they never really came out of that in a robust way like we did here in North America. Now with COVID, best case, if you resolve COVID and resolve the Ukraine war, they just go back to kind of the same issues they had before. I don't see an opportunity for economic reacceleration there either. I think they're kind of more like the U.S. where they're kind of likely to continue to slow through the duration of 2022 and into 2023.

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Pamela Ritchie: Very, very interesting. Given what you've said and kind of laid out for us and you've given some of the factors that will work, as we say, kind of in either eventuality in terms of a slowing/recessionary environment. With all that, how do you sort of do the asset allocation in your mind? What might investors want to consider? They need to be defensive, it sounds like in some way, but don't want to miss out entirely. How do you come to this?

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Bobby Barnes: There are a couple of dimensions to the asset allocation. Within stocks, you consider North America versus Europe developed international and then emerging markets. Across those three within your equity part of your portfolio, defensive basically equates to being developed first and foremost. So you would underweight, say, emerging markets and China and the like and overweight, say, the U.S. or Europe. Even within those two the US actually has a more defensive profile than Europe does. Defensive either by volatility or if you want to go with the quality lens, which is typically my preference when making these evaluations, the return on equity in the US is higher as a system, as a market, than it is in developed international. That's why it makes sense to overweight the U.S. versus those other areas.

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Obviously, that's just one part of a multi-asset portfolio. There's also the consideration of equities versus fixed income. It is the case, actually a rare case, where year-to-date we haven't seen the diversification benefits that you typically get by holdings, your 60/40 portfolio, where kind of both fixed income and equities have gone down year-to-date. That being said, I don't think that that's a dynamic that will be persistent and pervasive. I think we will get to the point, back to the more natural relationship between the two where they typically have a negative correlation. So when stocks are down, Treasuries are rallying.

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Pamela Ritchie: I was going to ask you how different is having an allocation to fixed income now than it was six months ago? I guess that's the answer.

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Bobby Barnes: That's right. We still have some rate hikes ahead of us. If you do the bond math, all things being equal, that usually causes the price to go down and yield to go up. That being said, it typically does offer some good diversification benefit and that's kind of the benefit of when you've got an all-in-one 60/40 solution like we do in Canada, it kind of does the work for you and it saves you from yourself, is the way to think about it.

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Pamela Ritchie: But it includes growth, right? How would you sort of slice and dice within the thematic discussion, the place or the role or the case for growth?

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Bobby Barnes: Thematics in general, these are emergent themes. We call them disruptive. They've got high growth potential way out into the future. As a result of that ... and I remember this is a discussion that you and I have had before ... when thinking about growth I bifurcate it. There's aspirational growth out into the future and then there's kind of quality growth. The way that I think about thematics right now because that's kind of ... by and large it's more so the aspirational growth ... most of that is fairly low quality.

One way to define or to see that is if I take the Russell 1000, only about 17% of the Russell 1000 companies are unprofitable. The average thematic, however, things like clean energy, digital health, that kind of thing, they usually double that. You've got 30% of the portfolio that's unprofitable.

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That being said, within the thematic space my favourite one, given where we are in the economic cycle right now, would be metaverse where it's got ... the constituents of the metaverse... kind of a similar proportion of them are unprofitable as the Russell 1000, so it's about, call it, 15 to 17%. The reason that I gravitate towards that one for now if you want to play growth is that again, you're not taking on twice the amount of exposure to unprofitable companies. A lot of these companies are very well-established. Facebook, who's changing their name to Meta imminently, that's a very large, very profitable company and that's one expression of the metaverse. You don't have as much sensitivity to declining economic activity if you go with, say, a metaverse thematic as opposed to something like clean energy, telemedicine, all the ones that I listed before.

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Pamela Ritchie: Wow. That's the way to end off. So the metaverse within the thematic discussion could be your favourite at the moment?

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Bobby Barnes: Yeah, that's right.

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Pamela Ritchie: Bobby Barnes, so glad to speak with you. Thank you very, very much for joining us here today.

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Bobby Barnes: Yes, thanks for having me, as always.

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Pamela Ritchie: Thanks for joining us. I'm Pamela Ritchie.

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