The Upside

Economies Reopening: Three Things to Watch

Andrew Marchese, Fidelity Canada Chief Investment Officer

Emily Anonuevo, Host

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Emily Anonuevo: Hello, everyone, and welcome to The Upside. I'm Emily Anonuevo. As economies reopen around the world, there's certainly a mix of emotions attached to it. While many are exuberant about getting back to a normal way of life, others are dealing with the emotional aftermath about being locked down for many months. Global markets are experiencing the same sort of mixed emotions. Though some economies like the U.S. are rebounding well, the global recovery in other countries have been uneven as many countries are struggling to contain the pandemic. Then there are the constant storylines about rising inflation and the imminent possibility of a recession that investors are keeping a close eye on. What other key themes should investors be tracking as we progress through the second half of the year? Today, we are pleased to be joined by Andrew Marchese, Chief Investment Officer and portfolio manager at Fidelity Canada. Andrew will share his insights into the markets and what key themes investors should be taking note of at this point in time. As CIO, Andrew leads the team of other portfolio managers, analysts, traders and other investment professionals. Hi, Andrew, great to see you and so happy you can be on the show today.

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Andrew Marchese: Hi, Emily. It's great to be here.

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Emily Anonuevo: Great to have you here. Looking forward to our conversation. I'd like to remind our viewers if they'd like to ask Andrew a live question during the show, go ahead and do so by clicking the Q&A icon you see at the bottom of your screen and submitting your question that way. Andrew, you help manage over $15 billion in assets on behalf of hundreds of thousands, even millions of Canadians and many institutions. You've been managing the Fidelity Canadian Discipline Equity Fund for many years now. Can you just share with our audience your investing principles that have stuck with you through the years and your investing philosophy?

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Andrew Marchese: I think the investment world in the world in general that we're faced with we're inundated with data and information. So, you want to take a lot of noise out of the equation and you want to focus on facts at all times and be very disciplined about your investment approach, almost robotic in it. I think you don't want to succumb to sentiment. You don't want to be swayed from your investment thesis. The only way to do so is really by focusing on the facts, having a plan and adhering to that plan. If you do that consistently over time, you will compound faster than the broader market. You're not going to get every year perfectly correct, but if your goal is long-term active returns above a passive benchmark or a widely accepted benchmark, then I think adhering to those very basic principles go a long way to achieving your goals, your financial goals, your investment goals, and those goals around active returns.

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Emily Anonuevo: Absolutely. Stick to a plan, and like you said, you're not going to get it right every year, and what a year 2020 was and 2021 is shaping up to be. It's been about four or five months, Andrew, since we last spoke and now, we're past the midpoint of the year, end of July. Can you just quickly reorient our audience and investors and explain what the economic story is right now and what's driving the markets and where are we heading?

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Andrew Marchese: I think the economies in general around the globe, with slight variations depending on whether you're speaking of North America, Europe, or Asia, and the countries within each of those continents, respectively, we are transitioning, broadly speaking, from the early stages of an economic recovery towards the mid-cycle. I'm very fond of saying the present never perfectly mimics the past, but it often rhymes with the past. This business cycle and economic cycle is no different. We saw an immense amount of stimulus coming into the system, the financial system globally, from global central banks back in March. The equity markets saw that and responded by pricing in an appreciation in securities based on the fact that global economies and global companies would improve. So, that has played out and as we've seen the macroeconomic data come in, it supports the fact that we are moving towards the mid-cycle.

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That's not unlike any cycle that we've seen in the past, where global central banks step in when there is a contraction in economic activity. This one was induced by the pandemic, as we all know, and then the cycles mature. We see profitability on behalf of corporates improve and grow into the future. Invariably and inevitably, what will eventually happen is global central banks will have to take away that liquidity. That's generally what slows an economy. You never see economic growth abate because cycles just spontaneously mature and kind of age out. They usually end and slow because monetary stimulus, and potentially fiscal stimulus, starts to become restrictive. That's what eventually puts the brakes on the economy. That has worked every cycle for the past 100 plus years. I'm pretty confident that will be the case this time around. We just have to determine what the signposts or the goalposts are, so to speak, on how central banks react to the increase in economic activity and some other measures like inflation or moving towards full employment, usual economic metrics that we monitor as a business cycle matures.

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Emily Anonuevo: Excellent. I want to just get into sort of the crux of our discussion, Andrew. I know we wanted to frame this discussion around three main themes investors should watch for as the year continues, to talk about. You just talked about hitting a mid-cycle and keeping a close eye on central banks. As the economies reopen around the world, what's the first theme investors should watch out for and the first theme you'd like to touch upon?

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Andrew Marchese: The first theme I would look out for, it directly affects asset prices of all asset classes; one is speculation. So, let's talk about speculation as a theme. Whenever you see the amount of stimulus come into the system that we saw last year, and by the way, that is unprecedented. We never have seen globally the amount of money injected into a global economy that we saw in 2020. It was higher than the period of time during the global financial crisis back in 2008, 2009 by multiple factors. So, we are dealing with an unprecedented level amount of stimulus. When that stimulus

comes into the system, investors are paid to take on risk. Discount rates have fallen to the floor, and so speculation and risk taking rises. We've seen that in a variety of asset classes, not only within equities and certain categories of equities, we've seen, and it's been well documented through the media, certain pockets of equities that have been built up and valued at previously not seen high multiples, whether it's on price-to-sales or price-to-earnings, etc., etc. So, we've seen that.

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We have seen asset prices in residential real estate and certain pockets really bid up here. Part of that is related to the cost of carry, so to speak, and taking on debt. But it is a form of speculation. We've seen that in other asset classes like art. You look at art auction prices for art, jewellery, trading cards, automobiles, all of this stuff has reached unprecedented highs. So, as a cycle generally matures and central banks pull away the amount of stimulus, and that's going to be a crux in pricing all asset classes going forward, we're going to have to watch how the speculation in certain asset classes, in certain pockets of asset classes, potentially declines. The implication for equities is our belief is that it will transition more, as it always does as you enter the recovery phase, into more of the mid-cycle of the economy, into a market which rewards positive earnings revisions on behalf of corporates, positive earnings surprises, positive cash flow outcomes. Those companies that have negative earnings revisions, negative earnings surprises, misallocation of capital, which results in lower free cash flow, those securities will be punished. That's the way it generally tends to work every cycle. So, we would look for that, speculation maybe to come off a little bit and the markets to become more of a show-me market, where positive fundamentals are rewarded, negative fundamentals are punished.

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I think the second theme we should all focus on in the economy is inflation. It's probably the most topical macroeconomic factor that all investors are talking about today. The common refrain that you hear from central banks is that inflation is transitory. That remains to be seen. As I said, we have an unprecedented amount of stimulus in the system. We are not near full employment anywhere in the world. We would imagine that over the years to come, we will drift towards full employment as the investment cycle and the business cycle matures. That means that if history is any guide, wage pressures should continue to build as supply chains become unlocked, as we get through the pandemic in the coming quarters and years, that may build inflation into the system as well. So, it's one thing to monitor. This amount of stimulus has the potential longer term to continue to build inflation. Now, there's a lot of macroeconomic indicators globally that pose a headwind to inflation, too. So, there's offsetting factors at play. But we're going to have to be very mindful to watch that going forward because that will have an impact on central bank actions. So that would be the economic factor I would be, from a thematic standpoint, paying attention to.

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Lastly, I would say, as always, and I kind of touched upon it in point one with speculation, I would encourage investors really to focus on the fundamentals of companies going forward. I think the pandemic has induced a lot of changes on how businesses function. I think it will induce some changes in consumer and business behaviour that may have positive or negative consequences on revenue and profitability depending on the industry and business you're speaking to. As bottom-up fundamental investors and analysts within Fidelity, that's what we're focused in a lot on. In addition to our day to day, it's any emerging trends on how people consume, or spend money, or how businesses consume and spend money.

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Emily Anonuevo: A lot to digest there. The first theme, the pricing of asset classes, the second, the inflation storyline, and the third, like you said, concentrating on the fundamentals of companies. If we can go back to the second bucket there, Andrew, about inflation… as a new investor, this storyline could cause a lot of commotion, or a lot of emotion and feeling. What should investors be focused on, on the inflation story? Will we understand the bigger picture towards the end of the year? Like you said, they're calling it transitory right now, but when will that inflation story become clearer?

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Andrew Marchese: It may take some time, Emily. I don't know that you're going to get a clearer picture in one or two quarters. It's an evolving story. I think, as I mentioned, if you simply take the money supply and subtract GDP growth, that would be an equation for excess money supply. And it is… I don't think I'm being hyperbolic here… off the charts. So, that in itself has the potential. Right now, it's manifested itself in asset price inflation, which isn't that concerning to a central bank because it's not manifesting itself in real inflation, at least what they believe to on a sustainable basis. So, we're only going to know that as the months build and build, and then there will be more chatter and discussion in the media amongst investors about is the central bank forced to act quicker than expected, or do we continue in this kind of monetary repression environment we've been living in for an extended period of time? So, I wouldn't expect any quick resolution on that front.

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I will say, though, as I said, as we move towards full employment, the amount of money in the system, there is the potential for this not to be maybe a 10-year event, but certainly more than a couple of quarters. And that's not a prediction. It's just about gauging probabilities. So, I don't think one should dismiss that probability. On the other side of the equation, and I've talked about this in the past, we have a ton of debt still in the system. Generally speaking, globally, we have ageing demographics. Technology spending and use and increases around productivity have been tremendous over time. Generally speaking, in most developed nations, we have more people leaving the workforce than entering the workforce. Those four macroeconomic factors are actually disinflationary. So, they will help combat, from a structural or secular perspective, any cyclical up-swing we do see in inflation.

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So, the biggest, I think, thing to think about over the coming quarters, and potentially coming years, is the central bank reaction to what we are seeing in real time in terms of CPI or core inflation. The fall-on for that is not to predict it. We don't predict such things. You're just trying to basically gauge the probability of something and making sure your portfolio is well balanced and well diversified for a spectrum of outcomes. I think it's not a very wise thing to say this is going to happen with 100% certainty. Nobody has that crystal ball. What you want to do is try to gauge the probabilities of various scenarios, construct your portfolio with your goals in mind, such that you give yourself a great chance to achieve those goals because your portfolio is well diversified along a spectrum of outcomes, including some small percentages for outcomes that may occur at either tail. If you do that, it helps you sleep at night. You make less decisions, which is generally value adding. The more decisions you're forced to make, the worse your investment outcome will be. So, you build your portfolio for the long term with a spectrum of outcomes in mind. Knowing full well that the analysis is to help you gauge the probability, not necessarily with 100% certainty, but the probability of each outcome in that spectrum coming to fruition.

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Emily Anonuevo: One way to tailor that plan is to seek the financial advice of a financial advisor. We talk a lot about the value of advice on this show. Andrew, with your many years of experience, what's the advantage there to seeking out that financial advice and like you said, making your portfolio so well balanced and diversified?

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Andrew Marchese: I think the first advantage is it helps you focus on a goal. I think as an investor, each of your goals, your requirements for your money, your needs, your risks, are all idiosyncratic. They're all personal to you as an individual or your family. I think working with a financial advisor helps really focus on those goals, so you that you're not comparing yourself to the person to the left or the right of you. Your goal should be your goals alone based on the risk you can bear and what you need from your money in the future. I think that's first and foremost. Let's personalize our goals, so we know exactly what we're investing for. You tailor your investment portfolio only to you. I think that first and foremost is important.

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I'm very fond of quoting Eugene Fama and he had a very famous quote, "Your money is like soap. The more you handle it, the less you have of it." So, working with an advisor keeps you focused on that long-term plan. As I mentioned, you tend to make fewer decisions and you should work with your advisor to make fewer decisions and focus on a longer-term horizon. The near term is often fraught with a lot of sentiment and volatility around asset prices that can distort your view or get you distracted from what your long-term goal is. Eventually, if you are correct in your investment thesis and hypotheses, your asset allocation, the securities that you own will gravitate to its long-term expected outcome if you do your analysis correctly. You won't get shaken out in the short term. If you allow sentiment and anything that has developed over the course of 90 days or even a year to somehow change your outlook and it hasn't been because of fundamental reasons, then again, you're handling your money too much. You're more likely to make a poor decision after that. So, you're compounding poor decisions. Even as portfolio managers, we encourage our portfolio managers not to do that. Stick to the plan. Stick to the investment thesis. If the investment thesis hasn't changed, stay the course. So, I think those two things in particular, individualizing your investment goals and investing accordingly and handling your money less are the two advantages that are available to investors about working with an advisor.

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Emily Anonuevo: Fantastic insights right there. Andrew, I'd like to get to some live questions that are rolling in. Thank you to our audience for submitting those. The first one here, what are your thoughts on housing and financials, particularly if interest rates rise?

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Andrew Marchese: In Ontario and Canada and other parts around the world, obviously, there's been a real run on real estate, residential real estate. I was talking with some of our asset allocation people just yesterday, there's some statistics that are a little concerning. Somebody threw out the statistic that there have been more in real estate commissions being paid by Canadians than they're spending on food right now, which is kind of… a kind of an eyebrow-raising type of statistic. But then when you compare the situation going on in Canada right now to other parts of the world, say, for example, we have some of our colleagues in the UK and London specifically, and they say, well, if you look at the real

estate and how it evolved here in the UK over years, Canada doesn't look all that disconcerting. There is a lot of debt being borne by Canadians again. We kind of repaired ourselves temporarily through the crisis and with the low cost to carry, low cost to borrow, that has been piled on again. That is one thing to be concerned about, so you have to monitor the pace of central bank tightening going forward and what that potentially does to the cost of carry for many Canadians and mortgages are front and centre in that.

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I've often said, on a cyclical basis, what distorts real estate is unemployment and higher interest rates. So, if you think that unemployment will continue to get better as the economy continues to open up from the pandemic, and you think maybe interest rate hikes are a ways away and certainly material interest rate hikes are a ways away, maybe the real estate boom that we've seen as of late sustains itself for a little longer. But if you look back on 100 plus years of real estate over the course of a cycle, I'm not speaking secularly, but over the course of the cycle, I think personally the two biggest macro factors that cause prices to rise and fall are changes in employment and interest rates. Everything else tends to be noise, in my opinion.

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Emily Anonuevo: A couple of very important economic metrics to watch out for. Another question for you here, Andrew, with economies opening at different rates, as they manage the pandemic, how do you see Canada's import/export and shipping industries being affected?

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Andrew Marchese: It's a good question. Obviously, global supply chains are very intermixed in where value adding services occur. Really, it's never a straight line. Things go back and forth across borders for various value-added parts or services and then end up going to their end destination. I think if you look at... as the question kind of insinuated, the global economy isn't completely synched right now. I think China is a little further ahead than, say the United States, Canada, Western Europe, and then some of the more emerging markets are a little behind that even, but they are kind of recovering. I think generally there is that pattern we see every cycle. In terms of it affecting import/export, I don't think it will be any different than any other cycle. I think what it may be is more industry specific.

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If you look at the global supply chain in semiconductors right now, it's been kind of turned on its head. It may take up to two years to fix that. I think the problems, as it relates to chips making its way into autos has been well documented. That's kind of caused a little bit of kerfuffle in the supply chain for autos. If you look at other industries, there's been bottlenecks, in terms of labour availability, the ability to ship certain things. The cause of the bottleneck varies based on what industry you happen to be speaking of. Those things generally will tend to get resolved and the global economy should move, like it does every cycle, up the curve to plateau at some point in the future. It will then contract knowing full well different countries and continents within that overall mass moving up and then eventually down the curve, will be spread out just a little bit. We see that every cycle. We're more concerned about just going in the details. I mentioned autos, or food, and grocery, and things like that, really going in and understanding the details on how any disruptions in global supply are specific, in particular to that given industry.

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Emily Anonuevo: You talked a lot about a lot of stimulus floating around, a question here about what sectors might attract this stimulus and likely benefit from the expected environment?

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Andrew Marchese: I think the stimulus is really about pricing of assets, as is the discount rate. If you think about the three pillars, if you will, of a stock market, their profitability and their discount rate. Profitability is future profits. That's what we pay for. We attach a multiple to it. The discount rate is effectively interest rates, 10-year bond yields. The lower, the more we'll pay for something. The higher, the less we'll pay for something. The market will kind of predict where interest rates are going based on inflation. As we know, historically, inflations constrict or contract P/E multiples or price-to-sale multiples. The stimulus gets into the argument about what I made earlier, where you start speculating more. That to me is very dangerous. So that, I think, when it starts coming out of the system, one has to examine their portfolio to understand how much of the future success of a given asset, or business, or whatever it is you own, or what we're speaking of, is priced in. If the market has discounted much of the future, then needless to say, I think, your risks are to the downside. The likelihood of a longer-term prognostication coming to fruition, particularly when it's fully priced in, the risk of that actually coming to fruition becomes quite high because the odds of you achieving it are probably pretty low. So, I think that's what all this excess money in the system does, it spawns risk taking.

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I don't think it's a business or an industry per se, I think it's an asset pricing phenomenon. I think the hardest part for investors right now is to understand what kind of success and profitability of a business or a certain asset class, is being priced in. The current system has distorted the pricing mechanism, if you will, of certain asset classes. It's our job to really ferret out how much success in the future has been priced in and then to properly gauge, as I said, it's a probability analysis of how much risk is there of this not coming to fruition. And if it doesn't come to fruition, how much could the asset class or the business be priced down? So, stimulus doesn't really tell you about where the next 90 days are going or whatnot. It basically tells you when this ends, we have to have an assessment as investors of what is the magnitude down if I've overpaid for a certain asset class or a business and it won't predict the timing either. But you just have to know that if you've paid it for way too much success, at some point you run the risk of actually having that security rerated or derated downwards. In some cases, the fall could be precipitous. So, we need to avoid those situations as all investors.

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Emily Anonuevo: Andrew, as I mentioned off the top of the show, as CIO, you work with a lot of investment professionals, other PMs and analysts. If you could just talk about the advantage Fidelity Canada has. We have a solid advantage over other financial service firms to adjust and adapt to many changes and just the depth and breadth of our team. You've been here for many years; can you expand on that?

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Andrew Marchese: I think you hit the nail on the head there with the last statement. I think the depth and breadth of our team is extremely strong and that hasn't occurred by accident. We've been very methodical and well thought out in terms of how to build this team and construct the team and the number of resources we need in each of the asset classes, fixed income, equities, multi asset, systematic, etc. That will continue going into the future. So, I think the vast global resources that we have in a variety of different asset classes is a key success factor and a key advantage in our competitive backdrop.

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I think number two, and it builds on the first point, is the depth and breadth of product that we offer. We don't adhere to one style. I personally don't believe that one style always beats the market. I believe in a diversification around asset classes, styles of investing, factor-based investing, and I think to offer each individual investor the best chance to achieve their personal financial goals with the backdrop of an adequate and proper amount of risk in their portfolio, you need to have that diversification and breadth of product offerings. I think we do that and I think we'll continue to do that as the financial backdrop changes in the future. I think those are the two things that we're really focused on, having ample resources, high-quality resources and continued evolution and innovation around product breadth and offering that so that we can offer our clients the best chance to achieve that return risk construct for each of their portfolios.

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Emily Anonuevo: Andrew, I want to thank you so much for joining me on the show today. I always learn so much from you whenever we check in with you about your investment process, your investment philosophy and I always come away with some good quotes as well. So, I thank you for your time and I'm sure the investors on the line appreciate your time as well. So, thank you.

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Andrew Marchese: Thank you, Emily. It was a pleasure to do this.

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Emily Anonuevo: Now, we have a fantastic line-up of shows coming up for you. We just launched a new segment of The Upside, Focus on Investing in your Wellness. So, join host Jessie Sarafian on Monday, July 19th, for her second instalment of The Upside. She'll have a yoga demonstration on easing neck and shoulder tension. So, that's Monday, at 12:30 p.m.

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Then on Wednesday, investment director Tom Stevenson will join us live from London, England, as he shares his thoughts on the global markets and latest macro trends through a European lens. So just head to fidelity.ca under investor education to register for those webcasts. We also have The Upside on our YouTube channel. Just search Fidelity Canada, click and subscribe. Thank you so much for watching and I'll see you next time on The Upside.

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