Fidelity Connects

The Global Macro View

Jurrien Timmer, Director of Global Macro

Pamela Ritchie, Host

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

Today, we're joined by Director of Global Macro, Jurrien Timmer, who is back for his global macro and markets update.

Jurrien explains to host Pamela Ritchie that the market is having some indigestion as we transition from the valuation to the earnings phase. He also looks at the counter-rotation back to stable growers that we're seeing.

Pamela also asks Jurrien for his thoughts on the potential for stagflation, the recent OPEC infighting, and future rate hikes by the Fed in the US.

Today's podcast was recorded on July 6, 2021 – and per usual, please keep @TimmerFidelity on hand, to follow along with a few charts.

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Pamela Ritchie: America, the biggest economy in the world, celebrated Independence Day this past weekend, making it sort of the unofficial start to summer. The holiday also marks the beginning of the second half for the year and last week's June jobs report may provide some insight into the outlook ahead. U.S. employers added 850,000 jobs and average hourly earnings were up, but unemployment ticked up slightly from the previous month. To help us understand the data and potential policy implications for the Fed as we start into the second half, very happy to be joined by Fidelity's director of Global Macro, Jurrien Timmer. Jurrien, great to see you. Happy 4th of July, belatedly.

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Jurrien Timmer: Happy Canada Day, belatedly.

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Pamela Ritchie: Thank you. Thank you. Great to see you again. A number of things that you have been kind of telegraphing in your discussions with us over the past weeks, and often they've had the word peak in them, seem to be happening. We seem to be in the middle of this. Can you, I guess, remind us what you told us but also put this into perspective. The jobs, we also just saw ISM numbers, a little disappointing. What's happening?

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Jurrien Timmer: By all accounts, the economy, at least in the U.S., is very, very strong. We had the payroll number last Friday. That was finally a solid number after two misses. The manufacturing PMI was just off the charts. The services one was just announced, that was a bit of a miss. But, as we've been talking, the market goes through phases, the cycle goes through phases, and from the lows last year, March, we went into the early-cycle phase which, by definition, tends to be driven by increases in valuation because price bottoms before earnings. So, price goes first, as investors expect, and discount and price in a recovery, and then two to three quarters later, earnings actually follow suit. That first phase is all about P/Es going up, and then the earnings show up for the party, and then the cycle transitions from the early-cycle phase to the mid-cycle phase.

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But often in that transition things can get a little bumpy because that's usually also when the Fed kind of gets into the game and starts signaling that maybe they'll start normalizing policy. And of course, that's exactly what's happening now with the Fed now signaling through its dot plot that maybe late '22 or early '23, it's going to start raising rates a couple of times. We know that when the Fed is doing both QE and has rates very low and it tries to normalize policy, it will do the asset taper first. There hasn't even been any discussion yet. We're thinking maybe the minutes from the June FOMC meeting will reveal something or the Jackson Hole conference in August. We know that the Fed wants to raise rates, not for a while... 2023 is still a year and a half away. But we know that that taper conversation is going to happen beforehand. So, that's going to be probably a 2022 story. So, understandably, the market's having a little bit of indigestion as we transition from the valuation to the earnings phase, and the Fed is kind of doing this dance now and is going to be doing this dance with the market about how much can it lift off policy before upsetting the apple cart and tightening of financial conditions.

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So, in a nutshell, that's where we are and we had the peak reopening a couple of months ago. We've talked about that where the rate of change of kind of improvement peaks out. I mean, things are still improving, but they're improving at a less rapid rate. That peak reopening correlated nicely with a peak in the small- to large-cap rotation. Then we had kind of peak inflation expectations, where the TIPS breakevens peaked out about a month ago and that coincided with the peak in the growth to value rotation. So now we're seeing a counter rotation back into growth, the stable growers, the long-duration equities. The 10-year yield's down to 135 today. I don't think the rotation is over in the bigger picture, but right now, we're seeing that counter rotation and it all kind of fits with that mid-cycle transition.

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Pamela Ritchie: Just to sort of talk about that counter rotation a bit further, there is this question, do you go back to growth? To what extent does that kind of make sense? How much is it short term? How much is it long term? Like, just kinda to add to what you said.

[00:06:32]

Jurrien Timmer: Yeah. And of course, we have the Delta variant to contend with. Certainly, in the UK, that's making a lot of headlines. I think I read that in the U.S., I mean, cases are very low, but the Delta variant is now the predominant strain that's going around. For the vaccinated like I am, and many other people are, I think it's okay. I could get it, but it's not going to make me go to the hospital. But there are still some states in the U.S. where the vaccination rates are like 20,

30%. They're kind of the red states mostly down south. So, there are still pockets of the population that are at risk. I think the Delta variant kind of adds to this indigestion and this counter rotation. I hope we don't get more lockdowns, but it might slow down the reopening at some point if this becomes an issue. So my sense is it's just a counter rotation. It's not a new long-term rotation. But it's hard to tell.

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Ultimately, it comes down to how sticky inflation is going to be. We know that inflation surged to a 5% CPI rate of change. That will be transitory to some degree because of the base effect. But rents are pretty high and you see companies trying to get workers back and having to offer higher wages. We're even hearing stories about companies going back to the office and people just quitting their jobs because they don't want to. So, if between rents and wages, there is some stickiness going on and maybe some parts of the inflation story become more entrenched, then that would bode well for value because value historically has been a better inflation hedge than growth and growth, especially long duration, the big secular growers, are very sensitive to changes in the discount rate, i.e., the 10-year Treasury, which right now is falling. But if that were to change in the years ahead, then those stocks would be at risk because they tend to have higher P/Es.

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Pamela Ritchie: So, I have to say, yesterday, when Americans were enjoying their holidays, when this OPEC story really hit and I could spend an hour talking about the timing because I always find it fascinating. There's some very serious rivalries between Middle East oil producers. It's quite fascinating. That said, I mean, the oil price is seriously something. What do you make of this? Nobody really seems to know what to do with it, actually.

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Jurrien Timmer: Energy stocks were left for dead a few years ago and then it was only a year ago that the oil price was -40. Now, we're at 73. We're down 2% today. But still, WTI is 73. Brent is higher than that. There's a huge shortage. I mean, this is the typical cycle for commodities, right? Like copper, this stuff, you can't just, I mean, you could get the oil out of the ground very rapidly a year ago, or two years ago, when all the shale was going on. But once you turn those wells off, they're not easy to turn back on. So, there are bottlenecks, oil curves and backwardation. As much as we'd like to go to green energy very quickly, there's still a lot of demand for fossil fuels. And so, the energy sector and the financial sector have been kind of the two leaders and, at some point, the supply response will be there.

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There's no question that the oil is there, but it takes a while to get out of the ground. So, the cycle can take a while. The same thing, like I mentioned, copper, there's lots of demand, everyone kind of dusts off these copper mines and by the time they're ramping up production, the cycle has already kind of peaked. There's always this lagging effect. But it goes to the point of maybe, you know, even as lumber prices come down, now oil prices are up and we're going to see that in the CPI, even if we look beyond it, and look at core inflation rather than headline inflation. But, it's yet another indication that maybe inflation will be a little bit more sticky this time.

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Pamela Ritchie: Do we call some of these flashes up and down, and they're in lots of different places in the market, do we call them asset bubbles, or is that going too far?

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Jurrien Timmer: Certainly, that is a very popular narrative. I'll give a little teaser for next week because I'm working on a report that I'll publish this weekend about just kind of deconstructing that narrative. I see this on social media, people throw the bubble word around way, way too casually. Of course, with crypto and the meme stocks, people always like to talk about it, and they'll point out the Fed's balance sheet and the stock market has to be a bubble because of all the money printing that's going on. To me, it's not so linear, but there's a lot of elements to it.

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Voiceover: This first slide is "Nominal Rates and Inflation", last tweeted on June 23rd.

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Jurrien Timmer: Based on where the inflation rate is, or where inflation expectations are, the 10-year Treasury yield is about a percentage point too low, based on the historical correlation. And so, what does that do? Let's say interest rates mean revert back to where they should be in a post-QE era, if there ever is going to be one, what does that do to the valuation for equities, for instance? I'm a big fan of the discounted cash flow model. You plug in your cash flows in the top, your discount rate in the bottom, which is the 10-year Treasury plus the equity risk premium, and a 5% discount rate versus a 4%. That moves the needle quite a bit. That's worth about five P/E points.

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The market right now is trading at 22 times forward earnings, or 25 times trailing earnings. If you increase that discount rate by one percentage point, you go from 25 to 20, that's a 20% decline. So, these are meaningful numbers but does that mean it's a bubble? To me, bubbles are very particular things and they require a tremendous belief and a participation. We can talk whether Bitcoin's in a bubble, or was at 65, or whether the bond markets in a bubble. But to me, I can point to the connection of, if the fundamentals change then the valuation changes. But that doesn't necessarily mean it's a bubble.

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And just to kind of take that a little step further, bubbles require excessive sentiment, right? Everyone has drunk the Kool-Aid and it's all in. I challenge you to find me an equity bubble when only 291 billion has entered the markets in 12 years. Now, you can rightfully say, well, maybe the bond market's a bubble because $3.2 trillion have gone in there. I think that's a very fair point. Again, I would not expect to see this if we're talking about an equity asset bubble propped up by the Fed's zero rates or quantitative easing. I'll have a lot of charts next week to kind of show that it's hard to make that connection in my humble opinion.

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Pamela Ritchie: Okay. I'm fascinated to hear how you're going to go through some of the discussion surrounding bubbles and maybe apply different terms for what you're seeing in certain cases. There are a ton of questions coming in about yields, which is not surprising. You sketched out sort of why we're here, what we've seen, and now we're starting to see actually the action. So was it a little bit of a tinderbox situation? We are hearing more on COVID. That is for sure true. Is that what is affecting yields right now?

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Jurrien Timmer: So, we're at 135. We peaked out at 175. We had this very odd kind of flattening trade after the June FOMC meeting. I still don't know whether to call it a bull flattener or a bear flattener because the front end went up, the back end went down. Again, it's part of this counter rotation. The reflation trade that was in play until the June FOMC meeting actually, that meant a bearish steepener, value over growth. You want to own TIPS, short duration, and so, that all is being unwound. I don't think it's a fundamental shift, but it was a very crowded trade because that FOMC meeting really should not have come as a surprise. All the Fed said was, look, the economy is booming, the output gap is disappearing… it's not completely gone but it's narrowing. That spread that I've mentioned in the past between the U3 unemployment rate and full employment has gone from 10 to 1.7. I mean, that is a material narrowing, which you want to see, it's great news, but it doesn't warrant the Fed buying $120 billion worth of assets per month and zero rates.

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When you put it all together real rates were, at least at that point, very sharply negative. The 5-year real rate was at -2%. That's an extremely reflationary policy. It's only warranted when the economy is in a full blown emergency, as it was a year ago. Nobody should have been surprised that the Fed said, hey, look guys, we're going to take the punchbowl away at some point, but yet you had this massive reaction, including a big drop in bond yields. It just shows that everyone was kind of on the same side of the boat. People get complacent because the trade works for a while and now you're seeing kind of the scramble. The S&P today is down, bond yields are down, growth is outperforming value. The dollar has been better bid. That's also a key component of the reflation trade. Again, I see this as a short-term setback and to me, it will be an opportunity to kind of add or reload wherever investors are positioned over the longer term.

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Pamela Ritchie: It's fascinating to watch. It was taken as a full on hawkish meeting by the markets anyway. Another question coming in. This has to do with, again, the money that is in the market due to these extraordinary circumstances and the extraordinary reactions from policy makers and so on, but the question about whether it could ultimately become a version of stagflation. I think we have talked about this before but it's always sort of a concern.

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Jurrien Timmer: Yeah. That is the quadrant of the business cycle. So, if you have four quadrants, you have inflation boom, deflation bust, low inflation, like a disinflation boom like we had in the '50s, where we just had recently, and then stagflation. Increasing inflation and weakening growth. The stagflation is the worst one. All the other ones, you can position yourself pretty well, but stagflation, and of course, the '70s comes to mind, basically nothing worked other than cash and commodities, which is fine. If you position for that quadrant where you have basically cash in commodities and not much else, you'd better be right, because if you don't have stocks or bonds, then you lose the compounding magic, which is what makes stocks and bonds such successful asset classes over the long term. And then, all you have is cash hoping to keep up with inflation because you generally don't get a positive, real return on cash, and commodities, which can do extremely well during different pockets of the economic cycle. But, most of the time, they're just sitting there earning the inflation rate, but they have a volatility like emerging market stocks.

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So, they're not great things to have as structural strategic asset classes. You need to be very specific about what regime you're in. It's not a great thing to have to solve for. I think there are always inflationary pressures and there's always deflationary pressures. If rents end up being sticky and wages go up and we have that political pendulum swing from capital to labour... we have a progressive administration still looking to spend a lot of money on social programs. If that pendulum swings, then inflation could very well be sticky. If that happens while growth is also slowing in this peak reopening, that could be kind of the worst of both worlds. We're not really seeing that in the TIPS breakevens. Those are off their highs. You would think that you would see it there at some point. Again, the Fed's tilt in June, ironically, was seen as a hawkish surprise, as you mentioned, and the market went from pricing in a policy error of the Fed being too dovish to now a policy error of the Fed being too hawkish, which is a little bit of a leap because, again, the Fed's still buying $1 1/2 trillion of assets and rates are well, well below inflation.

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I think that's a little bit of a leap. But everything is always about rate of change, as we have discussed many times. On the inflation side, we can't forget that there are powerful deflationary trends at work as well. Demographics is one we've talked about, technological innovation, globalization, although the world is globalizing a lot less than it used to be, especially now with U.S. versus China. Those tensions kind of spilling over from the Trump administration into the Biden administration. We're probably in some form of deglobalization, so maybe, that disinflation dividend from globalization has run its course.

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Pamela Ritchie: While we're on the topic of globalization, the topic of regulation and the global investment appetite for being global, and EM comes into this, there have been discussions of some IPOs in China, different types of regulatory approaches. We don't need to go into the specifics of it, but I'm kind of curious what you think of the global regulatory story and basically, if that makes investors flock back to what they know, which would be more sort of your U.S.-centric, the implications of it.

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Jurrien Timmer: Certainly, the globalization trend, I wouldn't say it has reversed, but I certainly think that COVID for sure exposed a lot of vulnerabilities in supply chains. Part of the Biden plan is to bring everything back and it was part of the Trump plan as well. I would see maybe the globe kind of segmenting into more regional blocks. The U.S., Canada, Mexico would be one. You get the natural resources up north, the cheap labour down south and you have the consumers in the middle. So, it's not a bad solution. Geopolitically, we saw this just recently in Hong Kong. They shut down one of the tabloid newspapers, the Apple something, and questions about Taiwan and what does that do to the geopolitics.

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So, there are a lot of open questions, but I think it speaks to the broader one of globalization and deglobalization. I think the conclusion for me is that the disinflationary tailwinds of globalization that blew for so long, I think those are pretty much over. We still have demographics, we still have technology, but between that tailwind turning and now the pendulum, I think the pendulum from capital to labour is a very important one. Europe and Japan have tended to be more pro labour. The U.S. has been more rewarding capital holders. We see this in the financial engineering side as well. So, share buybacks are running very strong here. I haven't really heard anything out of the Biden administration about

curtailing those. In Japan, the payout ratio, the share of buybacks and dividends that they comprise of earnings is 50% and Europe, it's about the same. In the US, at the peak, it was 90%. It's down to 70%, but that's kind of a cyclical thing. It's one of the reasons the U.S. has a high P/E versus other parts of the world because shareholders, directly or indirectly, via dividends and buybacks get more of their earnings back than investors in other parts of the world.

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Pamela Ritchie: There's a discussion here about... Fed policy is obviously going to be a massive discussion going forward, but this summer just seems like it's not going to be as relaxing because there's just so many moving parts. Is Jackson Hole where investors, in your mind, look to? Do we look for something in other parts of July for signaling? What's your thought? Maybe the minutes coming out as you [audio cuts out].

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Jurrien Timmer: I think it will either be the minutes or Jackson Hole. So, there will be a July FOMC, but it's a one day. It's not the one where they update the dots or the summary of economic projections. I would be surprised that anything comes up there. We know it's lurking out there, right? They've already signaled a lift off from the zero lower bound in terms of rates. Well, we don't know this but we presume from history that before they lift rates they will taper the asset purchases. They did that back a few years ago during the last tightening cycle. We all know it's coming, we just don't know exactly what it's going to look like. Will they start reducing or eliminating mortgage-backed securities purchases? The housing market doesn't exactly need it around here, or in Canada for that matter. So, maybe, that's the first one.

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It has to be soon because that would have to be a 2022 story, if the 2023 story is going to be rate hikes. The market knows this, this is part of the indigestion. This dance between the Fed and the market, this is not the first time we've been here; 1994, the market sat around for nine months, made no progress in nine months at two 10% drawdowns within that nine months, which is not really a big deal. That was during the Fed's surprise rate-hiking cycle. That's when Greenspan came out of nowhere in February of '94, started raising rates and ended up raising them 300 basis points. The Fed would be a lot more transparent this time around. Even in 2018, we had that period where the market was kind of sitting around because the Fed was raising rates. It was guiding, kind of bringing it back to normal and then the Fed went a little bit too far. We had that decline in the fourth quarter.

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If you look back long enough, these are all pauses in bull markets, or they were all pauses in bull markets, and it's a time to be able to retool and make sure your portfolios are where you want them to be. If the value to growth trade and the U.S. to non-U.S. trade is a long-term trade, which I suspect it may very well be, then this will be an opportunity to kind of get your house in order, in terms of the portfolio and to get ready for the next phase.

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Pamela Ritchie: So interesting. I'm going to ask you in a minute about Spain versus Italy, but first, before that, just anything else to say on sentiment? You've sort of touched on it a few moments here, but just anything to sort of round out that discussion?

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Voiceover: So, this slide here is "Global Earnings Growth", tweeted on July 7th.

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Jurrien Timmer: So, we do have earnings season starting next week. Unlike the last quarter, expectations are extremely high now. So, last quarter, the growth estimate that was in the market at the time that earnings season began was for about 20% or so, which, of course, is very robust earnings growth, and it was nowhere close enough to where it actually turned out because we ended up with 53% earnings growth. This time around, the market's expecting about 63% earnings growth and my sense is that this particular earnings season, which starts next week, will be more like the traditional one where the effects will be more muted.

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This chart here shows the year-over-year change in forward estimate, so expected earnings around the world. You can see, it's a very similar story no matter where you look. Again, this is kind of the peak reopening. We went from -30% a year ago to now near +50%. Again, I think earnings are robust. They will continue to grow, but that rate of change cannot be sustained, just mathematically. That number is going to come down, just like it did in 2017, 2018. The earnings will grow but at a slower pace than they did. Again, coming off of a +50%, that is a huge, huge number, so it will come down, part of this kind of peak reopening narrative that we were talking about. So, this is part of the sentiment picture, in terms of expecting all this earnings growth.

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And stock flows are at 728 billion cumulative since Covid happened, slightly more than bonds, but slightly less than money markets. So, again, sentiment wise, it really does not send off any alarm bells, as far as I'm concerned. So, again, when I put all the different pieces of the puzzle together, to me, there's not a lot of real big alarm bells going off. I'm less worried about sentiment and more worried about what happens to interest rates, what does that do to the discounted cash flow model at a point where the Fed is going to be lifting off policy and that dance. The Fed does not always pull it off. Sometimes it forces its will onto the markets and then the markets have to kind of react and that could happen at some point in the next 6 to 12 months. But I think the Fed has learned a lot and it has learned to not push the markets too far.

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Pamela Ritchie: Interesting. Fascinating. Italy versus Spain.

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Jurrien Timmer: I don't think Holland was in either of the two countries that you mentioned, so, I don't have a dog in that show. Somewhere I read that some quant AI thing predicted that England would win. So, we'll see.

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Pamela Ritchie: One day, one day. Depends who designed that. Jurrien Timmer, great to see you. We'll look forward to your presentation about demystifying some of the bubbles conversation next week. Thank you for joining us.

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Jurrien Timmer: Great. Nice to see you.

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Pamela Ritchie: Nice to see you, too.

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