Voiceover: Hello and welcome to FidelityConnects - by Fidelity Investments Canada. Connecting you to the world of investing and helping you stay ahead.

Today, we take a deeper dive into the markets, looking specifically at how certain sectors have been performing, such as Financials, Health Care and Energy, and what factors have caused this.

We are joined today by Sector Strategist, Denise Chisholm. Denise and host Pamela Ritchie look at what typically happens after a recession, as well as historical trends for equity market dislocation and credit spreads being at the tightest levels since the 1980s.

Denise also looks at policy discussions from the Biden administration and notes there is always a risk that stimulus doesn't happen, or to the amount the market has already adjusted to.

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Pamela Ritchie: Beyond the high-level headlines about market action, what are the big-ticket policy items that could shape the markets in a more enduring way over the longer term? What could the impact of various policies look like for different sectors in particular? Joining us now is the award-winning Denise Chisholm. She is market historian and sector strategist at Fidelity. Denise, great to see you, thanks for joining us.

Denise Chisholm: Great to see you, Pamela. Thanks for having me.

Pamela Ritchie: Very glad to have you here. Denise, take us through the history of what we are right on the precipice of, the first year of a presidential cycle.

Denise Chisholm: Unfortunately there is no typical playbook for a first-year presidential cycle and this isn't a typical presidential cycle. I think what you have to do if you're a historian is look at what critical variables there are that make this cycle unique. I think that there are two at least that we can look at quantitatively. The first is high levels of uncertainty and the second is a reflection of that in the VIX. Both show the same trend. We are coming from not only a global pandemic but obviously a global recession where high levels of uncertainty prevailed. As scary as that makes it obviously, we saw the lows in the market in March which now feel like it's some time ago, as scary as that makes it, uncertainty levels and volatility levels remain elevated. So over the next year I think what we're likely to see, if history is a guide, when you come from these high levels of uncertainty and volatility, is a decline and what that typically has meant, which is your highest odds of a market advancement and your highest returns, but with your highest levels of volatility.

I think as much as it sounds like we are going to more certain times, from an investment perspective we may still see 2021 be a very, very rocky road. As optimistic as I am for the equity markets, I think investors need to be prepared for those downdrafts.

[03:42]

Pamela Ritchie: Is there something in the markets that you can look at or measure that there's a decline in uncertainty, or some are saying that because it was a more volatile time with a different president. Some will say, does the decline in uncertainty actually factor into the market? How do you look at that?

Denise Chisholm: And sometimes you can quantify it from an equity market relative to the credit markets. Credit markets are actually great leading indicators that you could see. So when I talk about the equity markets and dislocations, what I'm referring to quantitatively is something I measure called valuation spreads which are any time that there's a crisis investors sell any stocks that they think are risky, and they bid up stocks that they think are safe. The names change every single cycle, the reasons change every single cycle, but the math actually remains the same. That fear factor in the equity market usually creates opportunity. One step further, it creates more opportunity when you compare it to the bond market. The bond market credit spreads are now at some of their tightest levels since 1987, are in the bottom-quartile levels and still declining as GDP is actually reaccelerating, and that's important 'cause it's not typically a contrarian indicator. This is not something you statistically have wanted to bet against. When we think about what we could measure as the decline in uncertainty, we certainly have seen some in the credit markets. We've seen a little in the equity markets, but if history is a guide, there's much further to go as those equity valuation spreads compress relative to what the credit markets are already saying.

[05:24]

Pamela Ritchie: So a bend towards equities at the moment, historically speaking, looks like it should work. I want you to say a bit more on … you mentioned how different it is, and how there isn't a precedent, this is a bit of a change of paradigm. Take us through that in more detail.

Denise Chisholm: History can essentially help you understand what things are similar and recessions are similar. Valuation spreads are similar, but look, it can also help you understand the differences, and what we've seen this cycle or this recession has been very, very different from what we've seen historically. If you look at just transfer payments plus wages, even if you take out contributions and other things, we're growing income at a rate during or after recessions that we've never seen historically.

[06:15]

Pamela Ritchie: Let's go back to that because we're about to talk about stimulus, more stimulus coming on, but we're already growing income level at the fastest *[audio cuts out]*.

Denise Chisholm: Yes. That's been the big difference this recession versus any other recession essentially. You've seen personal income grow and you've seen credit grow or lending grow, bank lending. That is very rare to happen in recessions. I don't want to say never because I don't have all the data of all the histories, but it is extremely rare in recessions to see something like that. So if I look and I say, let's just take all of the wages and salaries that we see, and this obviously will be differential relative to the unemployment rate, whoever's employed, plus the transfer payments, plus the cheques that people have been given, and we take out all the contributions that you would make, and we take out taxes that you have seen, we're growing that income rate at a rate that's eight times any prior recession that we've seen.

This is a very, very different thing that you can measure. In some ways, and even sustainably, where we've ended up in top-quartile levels we're there for about eight months now. We haven't seen this since the late '90s. So that's the potential paradigm shift. It's open to debate whether or not that that will be effective, but if you look as history is a guide, if I dump all those quartiles of income growth and I say, what happens over the next 12 months to inflation, what you'll see is monotonic increase of inflation acceleration and odds of that inflation acceleration.

I think that this is a regime that investors need to be mindful of. I don't think it's necessarily a bad thing for the equity markets given the low levels of both inflation and interest rates. I think that the market was already pricing in a significant amount of deflation risk, which I think is correct, and that risk might actually be going away over the course of the year as we see this potentially play out.

[08:17]

Pamela Ritchie: So interesting and I want to get right into the sectors and the rotation that we saw in November and what that's meant. But just a final broad question, many think this is early cycle, some don't. What are your thoughts and what sort of comfort levels do we have to get with the messiness of early cycle?

Denise Chisholm: Oh, yeah, it's super messy. And that's sort of the problem with it. It only looks particularly clear in hindsight. In some ways the further you step back the more things like early cycle make sense. Consumer discretionary worked from a market cap-weighted basis, but it didn't work from an equal-weighted basis. In some ways I have two kinds of portfolio managers come to me. Some say, this is classic early cycle 'cause they own things that worked. And others that say, well, none of my early cycle things worked, and that's what you see historically is that early cycle is not consistent. There is not a playbook unless you start to aggregate everything together into either a sector or a factor. We have seen very classic things play out. Like, I said, consumer discretionary on a market cap-weighted basis and the factor of volatility has actually worked quite well from the March low which is typical.

But if I drill down into industries or sort of individual stocks, what you'll see is starting like a 55, 45% hit rate historically. I think investors sort of hearken back to 2009 where literally everything that underperformed into that market low outperformed out the other side. But that's the exception not the rule. That typically doesn't happen in history. I think as we're stair-stepping through this early cycle, which from an economic perspective it is, I think you hit the nail on the head, it is very messy from an investment perspective. And in some ways only makes sense if you stand way back, or if you do it in hindsight.

[10:11]

Pamela Ritchie: That's why we have you to help us through the history of all these things. So Denise, because it has been such a big week, last week too, for U.S. bank earnings, I want to just start with financials. It's been explosive the run their stock prices have seen since the so-called vaccine rotation. Can we begin with that sector and then work our way out through the sectors? The question really for the financials is, is there further to run? They've seen a big run-up.

Denise Chisholm: Financials, the dominant theme here is valuation. We are at, what I measure going back to 1962, rock-bottom valuation prices on earnings. So you're in the bottom percentile. Obviously much, much cheaper on book, but your returns are much lower, so you could argue that those valuation headwinds are justified from that perspective. But really that's been where financials have existed. They've been a tricky sector because a lot of the odds that I look at have really flipped from 2009, from the great financial crisis, and truly changed the makeup of the financial sector. Things that had once worked, like interest rates sort of going down being good, now going up is good. So you've seen these correlations and these historical odds flip. But the dominant theme has been this multiple compression.

So when I look back, even from 2009, what financials have done well is they actually have grown earnings well. They actually have managed credit well. They have done those things, but it's really been faced with multiple compression. Stepping back from that you see them in a value bucket. This is what has been, I think, investors say is different this time. Cheap stocks, as much as I think people have expected them to work already, and to some extent, you talked about financials working more recently, I think that some investors expected that to happen last March. That doesn't typically happen. Value isn't really correlated to economic growth. That's not the singular driver. It's more profit recoveries, investment spending and capex spending. What you're actually seeing is it's not a recovery play from a profit perspective — and I should put these charts on my LinkedIn — usually when you get to those top two quartiles like you're growing earnings at 7% and accelerating through into that, that's when value works. It's almost like a lag.

This doesn't surprise me that financials were a little bit lagged and now starting to work. If history is a guide, if you sort of step back and think about either value versus growth, or any kind of cyclicality, I think a lot of the inflationary impulse that we just talked about in the stimulus say that this is more of a long live *[tray?trait?]* meaning that if you're thinking that you've already missed the bounce, I think this would argue that we actually might be just getting started with it.

[13:10]

Pamela Ritchie: So interesting. So put on top of that, what you just mentioned there, capex, and maybe even the discussion of infrastructure build from stimulus money, but capex has been a very dry area for a long, long time. Banks, financials, capex, put it all together for us.

Denise Chisholm: This is actually the critical driver behind value versus growth. I think some investors miss that because it gets tied up in either the economy, or even in profits where those correlations are strong. But there has been a secular headwind where technology has really taken share from what I would call real asset *[audio cuts out]* structures and things, and that has been losing share. But from these levels with what we're seeing in the economy with an economic acceleration, and potentially with a policy kicker that I don't necessarily think that you might need to bet on, but we're teed up for a re-acceleration in that relative capex trade. And that has been the driver for value stocks.

I don't know that necessarily it needs to be so binary as value versus growth. When you think of growth as technology, I think technology still looks like a solid risk reward to me. But I think what we're likely to see in 2021 is not the funding come from technology, but the funding come from more defensive sectors continually like consumer staples, utilities, real estate, and to a lesser extent, the pharmaceutical sector of health care where I think that the market is more likely to broaden out. If you think about 2020, and I think even in 2019, the market as much as we could sort of see the distribution among sectors, really the only sector that outperformed was technology, or technology and consumer discretionary. It was a very narrow market from the sector perspective. If history is a guide, I think it's likely to broaden out into these more recovery plays like financials, energy, industrials and equal-weighted consumer discretionary.

[15:18]

Pamela Ritchie: It's really fascinating to go through all these things. Let's talk a little bit about consumers, jobs, there's a question coming in right now just for more explanation on what you said about income growth in the face of unemployment and job-loss numbers that we're seeing, a bit more on that, how you look at that.

Denise Chisholm: When I calculate it, what I'm talking about is any wages and salaries from anybody that is employed, and that will shift through job losses, plus the transfer payments we've been given or that's unemployment insurance, plus the cheques from the government. When I calculate all that up, and I net out any contributions or I net out taxes what you'll see is that that is growing at a rate of about, well, at the peak was 15%, and is now growing at seven. That is about eight times the average growth that we've seen the year following any recessionary period.

If you look at that income growth and you say, okay, do those quartiles matter, is this predictive of anything? Or is it … 'cause I look at a lot of data and you'd be surprised that when you start to say, okay, we think money leads to inflation and maybe that is actually not the case historically 'cause there's other factors that offset it. In this case when you look at that top-quartile income growth relative to history — and again, this is a very different setup relative to any other recession — that has been very correlated and gives you monotonically higher odds through inflation acceleration in that next year.

So this is something that we didn't see in 2009. This is something that we really haven't seen, depending on how you measure it, since either early oughts or the late '90s. So this is very different, and I think investors need to know that this is different relative to 2009, which is sort of our last crisis example. I think that there's been a lot of threat in the market of deflation. Will we end up with low rates forever, essentially? I don't know exactly what's going to happen historically, but what I can say is that the money they've delivered to consumers have the highest chance of now serving a marginal propensity to consume impulse which is likely to lead to pricing power.

What this has really meant historically, if you tie it all up, and you want to say stimulus ends up in consumers' pockets, which increases your odds of an inflation acceleration, your highest odds of where that ends up, which is no surprise, is in earnings. And that is with bank earnings to bring it back to that. That's yet another example of why earnings estimates may be too low. If history is a guide, from this money that we have seen be distributed, they may be shockingly too low to the extent that the vaccine rollouts continue and the economy is allowed to reaccelerate.

[18:21]

Pamela Ritchie: *[audio cuts out]* that's your headline, they could be shockingly too low, some of those estimates. That is the explanation to what we often look at as the jobs report, which looks so shocking on the other side, but all these other factors are coming in to it. Let's layer on top some of the policy discussions that the Biden administration has talked about. Taxes, you've mentioned before that with stimulus and taxes sometimes things even out a bit, but where do taxes come in at this point? Personal, corporate, anything, do we know?

Denise Chisholm: Yeah, they do historically net out. Oddly when you look back in history you'd say, oh, taxes have to be bad for either the equity markets or consumer spending, and what you find is exactly the opposite. We've done studies back to 1950 on if you raise personal taxes, corporate taxes, capital gains taxes, what you see is higher-than-average odds and in some cases 100% historic odds of the equity market actually advancing at higher rates than it typically does. The reason, when you dig into that, is because there is typically stimulus offsetting and that's what the equity market sort of discounts is a one-time hit in taxes, but netted out with the stimulus which will recur, typically it does, into the out years.

There's always a risk that that doesn't happen this time, it doesn't happen to the extent that the market thinks it will, and that's certainly a risk. But if history is a guide, taxes aren't necessarily the headwind that you think that they might be. To me, the equity market is acting what I would call rationally from a historic perspective in terms of their … some people have called it the lack of fear of increased taxes. To me, this lines up with what I have seen in history.

[20:04]

Pamela Ritchie: So interesting. It's a big headline. A lot of people look at that. Let's get into some of the other sectors. You actually mentioned the pharma side of health care. Health care has been evergreen to you in the past. I want to go from health care ultimately to energy, but can we begin with health care? Where does it go from here?

Denise Chisholm: At the sector level what's different for me with health care versus, say, utilities or consumer staples, and consumer staples we can debate a little bit 'cause it is cheaper, but health care is actually bottom-quartile valuations on free cash flow, obviously on book and sales, but on free cash flow or on any earnings measures. You don't have that in other defensive sectors, you don't have that in real estate, you certainly don't have that in utilities. You have it in consumer staples, but it has not been predictive, especially in the early stages of recovery. When I say I'm worried about the funding coming from defense, I think that there are parts of health care that act more defensively historically, and I think the risk reward is more neutral to negative in that category. That said, the parts of health care that are not more defensive historically like services, like medical technology, is more geared towards the offence, data, cyclicality, higher odds in this recovery.

So I think it's a little bit of a nuanced view where I think that parts are a little bit more neutral and negative, but parts are still very, very positive, and I would expect that to sort of offset that from the sector level. Much like what I think we'll see in technology where there's going to be differences within the industries. You might not get software to be evergreen, but when I look at hardware and semiconductors they still have bottom-quartile valuation levels to me with higher-than-average returns. So that's sort of the sweet spot that I want to stick to. I think that you're going to see a little bit more sector dispersion in those sectors where you've seen leadership like health care and like technology.

[22:04]

Pamela Ritchie: It's so interesting. It sort of comes into the so-called K-shaped recovery. I don't even know if it's recovery, maybe it's just going forward, but in any case it's an interesting nuance that you provide there. On the energy front, in Canada we heard that one of the executive orders would be that the Keystone XL Pipeline was no longer. It was a sensitive issue, it is a sensitive issue. That said, how does energy … there's obviously ESG movements afoot almost everywhere, how do you look at that? It's kind of a new area, or is it?

Denise Chisholm: In some ways it is. I will hearken back to our discussion that the stock market is always a discounting mechanism, investors need to be mindful of that, what we saw in health care, with health care reform, in 1993, 1994. Now, it didn't come to fruition, and maybe energy as the policy targeted energy companies will, but it didn't come to fruition. At the time, the stocks didn't know that, as legislation was being enacted and talked about, the stocks had bottomed. In some ways that's how I want to think about how energy may be in that context of the mid-90s for health care where, as much as the outcome might not have been the most beneficial run, the certainty premium is actually going to increase as we go forward because it's the uncertainty of the outcome that can sometimes weigh on investors much, much more so.

Energy, in some ways, I would say, when I look at valuation spreads in energy, they're more extreme than I've ever seen in any sector including financials in the great financial crisis, and any sector right now. As much as I think that there are many secular headwinds coming at energy companies *[audio cuts out]* think that that might be reflected when I look at those valuation spreads and when I look at the relative valuations I see, but more importantly when I look at the odds of other cycles.

A couple of key factors that I think I've said before, there's two times when you really want to own energy stocks as an investor. One is when it's bottom-quartile cheap, we never got there on earnings and free cash flow, the second time we want to start looking is when demand declines. I think that that was starting in March, I think we're sort of still at those levels. The acceleration can be questioned, but if history is a guide, what you see is fundamentals continue to deteriorate but the stocks outperform based on multiple expansion. And you've seen that every cycle. Again, we could start to say it's different this time, and maybe the magnitude might be different, but I think directionally those odds line up for me, and more importantly, and I think I have these charts on my LinkedIn if anybody wants to check them out, energy stocks have actually finally stopped overspending relative to their sales base. If you chart capex to sales going back to 1962, this was the problem in 2014, 2015, where capex to sales was at all-time highs.

Said differently, it still costs you a lot of money to get oil out of the ground, so it didn't matter if oil prices were in the 70s versus the 20s, you made the same amount of money because it cost you so much. So you didn't get the premium for it. That was the real problem with capex spending. Now they've been much more restrained and at the two-digit GIT level they're finally out of that top quartile, so sales acceleration can actually increase your odds and more importantly for energy service companies, which is a small subcomponent of the energy index, but I think an important one, you're actually back down to bottom-quartile levels and top-quartile levels on free cash flow yield.

I think energy companies have actually done a lot of the hard work over the last couple of years to end up in a much, much better position than we've seen since 2014, and if you joined that with a lot of these dislocations, I think it's still a positive risk reward.

[25:55]

Pamela Ritchie: It's a fascinating nuance, you just brought to the energy sector generally. It's so interesting to hear that. On much like the materials sector, or maybe all of them, the higher prices sometimes get you to a lower price 'cause you're spending a lot of money when *[audio cuts out]*. Questions coming in about lining up all the sectors that you just talked about as best and worst prospects for the year ahead. This will be our last question.

Denise Chisholm: If you want to either listen in or look online, I think my QSU, quarterly sector update, will be up soon and I have, in that scenario, I always have recommended overweights which are green and recommended underweights which are red. From a risk/reward perspective setup for 2021, I wouldn't put tech first, but since technology is 20% of the market and I get questions on that all the time, I certainly wouldn't put it last. It's a recommended overweight. I think it's still going to potentially outperform over the next 12 months, but I think that there is more opportunity in those sectors that are either more value based, more cyclicality based, more beta trade. My top three, it's going to depend for you for your risk tolerance, would be energy, industrials and equal-weighted consumer discretionary. I do think you bolster that with technology and health care, and then I think you shift away from the defensive sectors. Materials don't screen at that level that great for me. I just don't get strong odds, and I've more leaned into energy from that perspective.

The volatility, I think, is what investors unfortunately are going to need to put up with, and I think that that's going to be true in spades of energy and financials. So it sort of depends on your risk reward. I think industrials might actually be a better sector for people who are a little bit more nuanced and I want the return, but I don't want quite the same amount of risk as energy companies.

[27:55]

Pamela Ritchie: Right. Amazing nuance that you provided for everything. Thank you so much, we'll look for that on LinkedIn as you mentioned in the days to come. Denise Chisholm, thank you very much. Great to see you.

Denise Chisholm: Thanks, great to see you.

[28:09]

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