# Fidelity Connects

## Sector and Factor Outlook

**Denise Chisholm**, Sector Strategist

**Pamela Ritchie**, Host

**Voiceover:** Hello and welcome to FidelityConnects – the Fidelity Investments Canada podcast - connecting you to the world of investing and helping you stay ahead.

Fidelity's market historian and sector strategist, Denise Chisholm, joins us again to look at how the market is reacting to US Fiscal Stimulus, and the vaccine roll out.

Denise also explores what this means for sector and factor investing, with host Pamela Ritchie.

This podcast was recorded on February 9, 2021.



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**Pamela Ritchie:** Just as the great financial crisis is studied and debated in hallowed halls of business schools, the year 2020 will also be etched into our psyches and into the history of capital markets. Last year will be the subject of great analysis and discourse with investible lessons about a whole range of issues. Exogenous shock of a global health crisis followed by macroeconomic shutdowns, the policy response, both monetary and fiscal, and the virus's impacts, seen and unforeseen, that may well reverberate for a long time to come. We're going to dig in today to some of the early lessons, look back at history to compare with analogs going forward into 2021.

We're joined by market historian and sector strategist Denise Chisholm. Denise, great to see you again. How are you?

**Denise Chisholm:** Great to see you. I'm well, Pamela. Thanks for having me.

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**Pamela Ritchie:** Always happy to see you. Always happy that you can join us. I'm sort of surprised in some ways at the market reaction to how big the U.S. fiscal stimulus number seems to be. Did people not hear the 1.9 trillion being talked about for the last several weeks?

**Denise Chisholm:** I think in terms of a driver of recent performance in the stock market, I'm not quite sure the stimulus is it, as you said. It's been hotly debated, and if there's anything we've seen the market do is to discount a trend well in advance. This has been a trend that most have been debating about over the last three to four months. I think what has surprised the market of late has been the precipitous decline of coronavirus cases in the

United States. I think that that might be the bigger driver behind the scenes. I think what's almost more important than that is we don't really have to debate as investors as to whether or not it's going to be 1.9 trillion, or 1.2 trillion or where it will end up. We actually have a lot of historical data on stimulus already that actually has been passed, so we don't have to guess at future stimulus and what it might mean. We can actually look at the past stimulus and look at what it has meant historically.

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**Pamela Ritchie:** In recent history, just to frame us out here, there's been an awful lot of fiscal stimulus, obviously monetary as well, but we're talking about fiscal at this point, added into the system and so whatever comes through in the next month, or is announced in the next week or whatever is going to be on top. Do you want to just take us back recently to what it's on top of?

**Denise Chisholm:** What's really been unique about this recession, it's not only been the most amount of stimulus, but it's actually the quickest stimulus that we've ever seen since 1957. Going, back, that was a time when unemployment benefits were rapidly expanded as well. Looking at all the wages, for all the people that were employed or had been employed, which is, let's call it 90% of the workforce, plus the transfer payments that were actually given to the unemployed. I took out social security contributions, took out taxes and deflated it by the CPI. So it's basically real income growth. Looking back historically to 1961, and you'll see a couple of things. One, it was never higher. Two, the way I think about recessions are really from a stock market perspective, since we're not really buying units of GDP. We're buying stocks as investors. In the 12 months following a recessionary stock market trough, the question becomes, how much stimulus in the form of income was delivered to consumers? It's 15% which is basically eight times prior averages since 1970. We can see obviously it's an order of magnitude. Very, very different and even stepping back, I understand that you can say this is so, so different from history, how can we compare it? I think just the way to think about it as investors is we can quartile it out and say the amount of time that we've spent in this top quartile, whatever the magnitude has been. We have not spent this many months in the top quartile since late 1990. This is fundamentally different than anything we've seen as an investor over really the last 20 years.

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**Pamela Ritchie:** Let's look at that, or you'll tell us how to look at that as savings, as money on the sidelines. We know that there are targeted areas where it's absolutely not savings and it's completely a situation of getting by, of aid essentially. Where does the savings go when we get through this basically?

**Denise Chisholm:** If you step back, it is a really unique time in history. And I think that you can say when I look at odds, because I do study history, you can always find some sort of counter into a thing. Like, oh, well, I think it would mean X, where really that's either not the case because it's not really a critical driver or there's things that are going to offset it. But what you find is actually the truism that most investors think which is, when you have more money chasing the same amount of goods, you are proportionately more likely to get an acceleration in inflation. This is really something, we haven't really been in the situation in quite some time. I think that if you put together the magnitude of what we've seen and then these nice…they call them monotonic, which is a stair-step probability-based pattern. The higher the quartile of income growth, the more likely you are to get an acceleration in inflation. I think that that's what's most likely to happen as we progress through 2021 with high odds of that inflation acceleration.

I think that what's unique, and I think the lesson from history that investors need to remember, as much as we say, okay, you give more money in terms of income or transfer payments, and we've obviously seen the unemployment rate recover rapidly, more rapid than any other recession either. We're now at 6.3% unemployment in the United States and this is relative to a level that we took five years to get to after the great financial crisis. We haven't seen 6.3% in…Unemployment of 6.3% wasn't recent till 2014, relative to the great financial crisis in 2009.

If you step back from all of that income, where does it disproportionately end up is, yes, it's true, real consumption growth is obviously more elevated, in terms of those quartiles, but really it ends up disproportionately in earnings growth. You not only have higher and higher earnings growth for the income given to the consumer, but higher and higher odds of an acceleration in earnings growth.

If you put the historical story together in terms of what matters, income generates inflation and consumption growth and it disproportionately ends up in earnings because companies have higher and higher margins each cycle. So the big takeaway is what has all this already meant, even relative to what we've seen, or what we will see, is that not only are numbers likely too low but they are likely shockingly too low.

**Pamela Ritchie:** When you say numbers, you mean earnings expectations are too low or shockingly too low. Wow.

**Denise Chisholm:** We're seeing some of that in the current earnings season already. I think it's the most … I think 85% of companies are beating the most since 1995 by an average of 13%. I think that that trend is likely to continue and actually likely to accelerate.

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**Pamela Ritchie:** Let's go back. It's cyclical, so we have to go right in there. We've certainly seen a broadening of the tape, so-called, and we've seen that there is broad acceleration across the market. Bring us to the cyclical story there.

**Denise Chisholm:** It's interesting 'cause I think that there tends to be this investment debate on what I need to own. Is it value or is it growth? Where really I think that a lot of the key themes in the market have been in line with historical expectations and you actually nailed it, Pamela, a broadening out. What we've seen really in 2019 and 2020 was the dominance of technology and to a lesser extent consumer discretionary really holding from a sector leadership perspective. What you typically see post-recessions is four, or five, or even six sectors actually outperform. That broadening out of the market is exactly what we're seeing.

Thematically when you say, okay, what lessons can we learn from history and where do we really want to spend our time as investors focusing on? I get asked a lot, well, what's the playbook for inflation? We haven't really seen it historically. You said that it's very new and it's very different, and it is different every single time. Each sector has about 50% odds, so inflation can take very many different forms from an investment perspective, but the more you stand back from that investment perspective, the more you can see the pattern. If you divide sectors into things that are cyclically or economically sensitive like technology, consumer discretionary, financials, energy, industrials, materials and then look at the more defensive sectors that have been classically defensive like utilities, consumer staples, to a lesser extent health care, like the big pharmaceutical names in health care, and telecom services, the old telecom services, that's defensive. And that's really where you start to see the skew in terms of 2021 leadership is increasingly likely based on what we've seen to be cyclical-led.

I get a lot of questions of well, we've already seen a cyclical rally. It's sort of a junk trade. It's already sort of happened. Is it long in the tooth? I think history would suggest that based on the odds that we have from the past stimulus, again, not even debating on current future stimulus or the current package, is that not only might it not be long in the tooth, this actually might be just getting warmed up.

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**Pamela Ritchie:** It's amazing because as you say, and I'm sure you get all these questions, it has really been pulled forward. There's a lot of questions about how much really across almost every sector has been pulled forward. Where are the sectors where it's been pulled forward more than others? Sketch that out for us. On some actual commodities, classic cyclicals, we've seen huge run-ups.

**Denise Chisholm:** After huge declines. I always look at it slightly differently in terms of what's been pulled forward. I think people react to price more than anything else. We're 70+% off the bottom, maybe 80 by this point. I've stopped counting. In that you're saying a lot has been pulled forward. I understand sort of the investor mindset around that, but I think people need to understand how typical that is seen in a recession. You more often pull forward all of the performance, because essentially the stock market discounts future cash flows. I think the question becomes then, what are the future cash flows after what they've discounted? Even what we've seen this time, and I have a couple slides on LinkedIn in my past that you can go back to and look at how really this has been what we've seen historically. In terms of the recession of 1982, we actually spent…we contracted 2%, were flat for two quarters, and by the end of that flat-for-two-quarters, there was no recovery and stocks were back to all-time highs. This is seen often in recessions. This is not atypical in terms of the overall stock market.

The other thing that I'll say that's really unique in the equity market is—again, we can talk about valuation and I'm sure that will come up as a question—but I find it not predictive as much as valuation spreads. That diffusion or that difference is really a measure of fear in the stock market and you see it wide in recessions. What that is is a function of investors selling anything they think is risky and buying anything they think is safe, like utilities, and then that gap widens up. The names change each cycle, but that spread stays as a historical trend. What's been unique about this cycle, ironically in the face of all that stimulus, is valuation spreads have remained wide. So there is excess fear within equities, especially relative to credit, which tends to be a better leading indicator. As much as it seems we have pulled forward a lot of it, the indicators that I'm looking at that have been high probability indicators in prior cycles are still flashing the green lights.

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**Pamela Ritchie:** Let's hit the valuation spread, you kind of did there, but is there anything else to say on that? Because it's true, when people wake up each morning and you take a look at what's going on with headlines, it looks like fundamentals for some people have been completely decoupled from the situation. Just go back into detail why you see that differently.

**Denise Chisholm:** I'll give you three reasons why I see it differently. First of all, when we talk about valuation, we need to think about it in the framework of earnings cycle that evaporated. The entirety of the market is acting like a cyclical in the sense that you want to buy it when it's expensive, because earnings are at trough. That's sort of the way you want to buy material stocks, copper stocks, a lot of stocks. And that' why, from that perspective, valuation, I think you need to put it in a different bucket. We saw this in 2009 as well. When stocks got down to 10 times earnings people were like, oh, well, stocks finally got cheap. Then they went down another 30%. The P/E went up to 15. That was the time you bought it. Give some sort of credit to the fact that valuation is really not in a normalized fashion in any way, shape or form.

The second thing that I'd say, and again I'll make three points, but the second thing that I'd say is if you just look back all the way to 1962, quartile out the valuation of the stock market and look at it: what are my odds of stock market advance over the next one, three or five years? You'll see that regardless of the starting valuation, it's about 75% in each bucket. I gave you some information—it's informative—to tell you what the valuation of the stock market is, but it's not predictive. What is much more predictive historically for stocks is the equity risk premium. I'm sort of quasi going to use an equity risk premium in terms of equity to bond valuation, so the equity earnings yield minus the long-term Treasury, so the 10-year yield. But you can use it in terms of any differential. Going back what you'll see is that actually disproportionately changes your odds and that's what investors sort of know to be true which is, when bond yields are low, it forces you out the risk spectrum. That's why you progress towards equities. We're still there. We're still in the top quartile of equity risk premium. Stocks are still disproportionately cheap relative to treasuries, and I think that that's important.

And then the third and final point that I think is important: when people hear inflation they think multiple compression. And while that has been true historically, where you're more likely to see multiple compression, when inflation actually accelerates, like essentially I'm calling for, what investors need to know is those odds changed since 2005. We've gone from a situation where multiples used to compress when inflation accelerated to now where multiples actually appreciate when inflation accelerates. The reason is not that it's so different. The reason is once you get to a low level of inflation, the market starts pricing in the risk of deflation. I think based on the stimulus, and we can have debates about: Is it reflation? Is it sustainable inflation? Is it inflation that's just transitory? What I think it is is taking away the deflation risk over the next one, three, and potentially five years. That's the driver to the market. As much as we might see some multiple compression based on the fact that we were in an earnings trough, I'm not sure that this multiple compression is actually sustainable. So based on the odds that I look at, you could end up in a situation where stocks are more expensive for longer, based on the historic odds with markedly higher earnings growth which again together presents a positive risk-reward backdrop for the overall market.

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**Pamela Ritchie:** You're taking away some of the risk that it's sort of a Japanese situation, or the deflation settles in and stays. It removes that for a period of time. It's so fascinating. I have to get to these questions. There's so many great questions coming in. Let's bring in the dollar. The dollar kind of fits with how we started with, is there too much inflation? Were people shocked? We saw the dollar strengthen. Maybe that has more to do with the virus though? How do you look at the U.S. dollar changing?

**Denise Chisholm:** The way I look at the dollar is in some ways the big concern has been the twin deficits. That's been the focus. That has been the driver if you want a market narrative. The problem is now that we've already seen massive depreciation in the dollar and by massive, I mean an event that only happens less than 10% of the time. Peak-to-trough, trade-weighted dollar has now declined 12% or so. Even when I look at that in history, what you usually have is a modest appreciation just in that see-saw currency pattern. But if you want to say, "No, it's so unique. It's different this time. Denise, you don't get it," what I'd say to investors is I think that when we step back from the framework of what are the critical drivers to currency, it's usually not debt or deficits. It's actually more likely to be relative GDP growth or relative interest rates.

Ironically what you find, especially we saw this in the European financial crisis in 2010, 2011, 2012, what you see is companies that marginally add debt are also more likely to grow faster. Those that grow faster, actually, that's the critical driver for currency strength. In 2021, given what we're seeing in the U.S. in terms of stimulus, what we just talked about in terms of earnings growth and GDP, contrasting that with what we're seeing in Europe currently means relative growth and likely relative rates are going to shift back in favour of the dollar. I think there will likely be a modest appreciation in 2021 versus continued depreciation. So whatever sort of existential risk we want to debate for the dollar, I think it's got a fair reprieve for at least a year, if not more.

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**Pamela Ritchie:** What does that do to cyclicals? What does that do to commodities? Let's start there.

**Denise Chisholm:** It matters. The dollar does matter. I think that investors always say, tell me what the dollar does and then I'll tell you what sectors to own. Boy, I cannot make a portfolio that way when I look back in history. It's a piece of the puzzle, but it's not the piece unless it's extreme on both ends. When you look at energy historically, energy has a real problem offsetting massive currency strength, and by massive currency strength I mean anything over 7% appreciation for the dollar. It has a really easy time despite poor sales growth at doing well when the dollar depreciates by more than 10%. I don't think we're going to see either of those buckets. I think we're going to be in this muddy middle where what's most important for energy stocks is actually an acceleration in sales, which is highly likely in 2021. It would not surprise me in the least, studying history, if the dollar modestly appreciates and energy still outperforms in 2021.

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**Pamela Ritchie:** Really fascinating. There's a question here on demographics, and then after that I might ask you to sort of sector out the sectors for us. First of all, let's go to this demographics question. Denise, what do demographics tell you for both the bond market and stock market over the next decade? So, we're looking 10 years out.

**Denise Chisholm:** Lower for longer in all methodologies. I think that that is our secular headwind for sustainable inflation from an out of control perspective. We've got headwinds that didn't exist in prior decades, so there is a deflationary trend, not only globalization, but the demographic trend that you talked about. That's lower bond yields, lower inflation, lower rates over all is sort of the critical driver. I think these headwinds, the demographic, and globalization have really led to disinflation since, let's call it, the '80s. Now we still have those headwinds but likely offset narrowly by stimulus. We've never seen developed economies deliver this kind of stimulus. We never saw it because we never had these kind of headwinds either. Japan never delivered this level of stimulus from these levels of company profitability either. I think that that trend is persistent, and I think that that is the deflationary corrosiveness to the market that once you get down around 2% inflation with those demographic trends the market starts to price in deflation risk. To the extent that you can parse out the risk rewards, I think those trends likely persist, but they are offset by stimulus and what we've seen in economic growth for a period of, let's call it, three to five years.

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**Pamela Ritchie:** Oh, my gosh. There's so many macro tangents I want to take out of there, but let's focus right back in on the sectors. Fascinating! If we have a version, we started talking a little bit of this broadening of the tape, all boats rise in this environment, however you want to look at it, where do we go from here? Knowing everything that you've just said, which sectors pull ahead, or to lesser extent?

**Denise Chisholm:** The best risk rewards, in my opinion, you can actually find it on my quarterly sector update that I actually do for clients — fidelity.com/qsu. It's got a sector strategist column that is green if it's a recommended overweight. It's red if it's a recommended underweight. The clear takeaway is to lean into cyclicality where the best risk rewards that I see are energy, industrials and equal-weighted discretionary. They're all recovery plays that all have strong historic odds at both market troughs and their own earnings troughs. What you've seen is energy has never really reached valuation levels that were compelling, and now what we've seen as a critical driver of demand declines. Demand declines are something that you really want to be interested in and start looking as an investor because it gives you 80% odds. While you get the performance from energy, it's not really from the earnings. It's usually from multiple appreciation as the stocks start to look through improving fundamentals.

As much as you can say this is going to be much different this time because of electric vehicles, or because fossil fuels are dinosaur, I think that a lot of that is reflected in the stocks given that a) valuation spreads are the most extreme of any sector I've ever seen since 1990, and two) we're finally out of that free cash flow depletion levels that we saw in 2014, 2015 where capex-to-sales was at all-time highs, so they had to spend so much money getting oil out of the ground. Energy service companies are now the cheapest they've been on relative free cash flow since the 1980s. A lot of that is reflected in the stocks already, and I think that that's why energy for people who are buckled up for a little bit more volatility, I think is a really positive risk reward and industrials sort of look like the same play in some ways with a better secular uptrend at the sector level.

But that doesn't mean that you need to fund that with technology stocks, and I think that that's the pushback. The question that I get a lot: does this have to be a rotation from growth to value? I think that if you stand back, unless you can only buy growth or value, and that's the only thing you can buy as an investor, and if you told me I had to pick one, I'd pick value 'cause I think that there's a disproportion amount of return there, but you don't need to pick one. I think technology as a sector is still a positive risk reward. We're only at median levels on valuation. With all-time high in fundamentals, what usually happens when we come out of recessions is that we defence consumer staples, utilities, telecom, and to a lesser extent health care start to underperform to fund the cyclicality joined with leadership like technology.

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**Pamela Ritchie:** Final point to make on just what we used to think of as defensive that is maybe not fitting as easily into the bucket. I'm thinking of the FANGs which became defensive. They're high-growth stocks in a lot of cases. Is there just a final word to say on how things have changed, if they have?

**Denise Chisholm:** In some ways things haven't changed. I only call defensive things that have been consistently defensive in history. I don't even include real estate historically in that bucket, although I think the risk reward for real estate right now is negative for lots of other reasons. I don't need to make them defensive. They might be a cyclical that actually doesn't look as good from a risk-reward perspective as well. I think that there are always … 2009 was really the exception, not the rule. There are always groups of stocks that can grow through a recession. This time it happened to be some of the largest stocks in the market. There are always stocks that can act defensive through a recession and act as secular leadership. As much as we expected a rotation into the bottom. In 2009 we saw it, 90% of sectors that outperformed into the low then underperformed out of the low and vice versa. You had to flip it on that low. That's not typical. Actually what you see is there are sectors, even at the two-digit kick level, that outperformed the six months before a recession hits, the six months into that recessionary stock market trough and the 6 to 12 months after. So, there is usually secular leadership during recessions and I think technology—and let's call it FANG—has the potential to be in that secular leadership bucket.

**Pamela Ritchie:** Fascinating to get the subtleties sketched out for us with all your amazing research. Denise Chisholm, thank you very much for joining us. We'll see you again soon.

**Denise Chisholm:** Thanks for having me.

**Pamela Ritchie:** All the best. That's Denise Chisholm joining us.

*Ending: [28:42]*

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