Fidelity Connects

Sector Watch

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

We are joined again by Denise Chisholm, sector strategist and market historian here at Fidelity, who is back for another look at sectors and factor investing in today's markets. We're pleased to be featuring Denise on a more regular basis – this podcast was recorded on March 8, 2021.

As vaccines continue to be rolled out across the globe, Denise and host Pamela Ritchie look at what this means for sector and factor investing. Denise focuses on where inflation is taking us, and looks at the yield curve to pinpoint where we are in the business cycle. Based on the yield curve, Denise explains it is becoming more likely a sector rotation away from classically defensive sectors and into economically sensitive could be a dominant trend over the next 12-18 months.

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Pamela Ritchie: This time last year the markets were in descent through the now infamous COVID-19 low points at the end of March last year. Since then they have roared back with, for instance, the S&P 500 being up at the end of last week about 61%. But for the last month or so we have seen relatively high rates of drawdowns, with the tech-heavy NASDAQ almost approaching correction territory. For the moment interest rate expectations are driving all asset classes and sectors and they could continue to do so.

To provide you with some conversational arrows in your quiver on this topic we are joined by sector strategist, market historian, Denise Chisholm. Denise has looked at the reams of data on this topic, how it fits with history and its insights that can help you. Denise Chisholm, great to see you again. Welcome.

Denise Chisholm: Great to see you, Pamela. Thank you.

Pamela Ritchie: And happy International Women's Day.

Denise Chisholm: Absolutely. Happy International Women's Day to you too.

Pamela Ritchie: It is a pleasure to be speaking with you always and especially today. Let's just sort of start off with where actually is inflation potentially taking us right now?

Denise Chisholm: I think there's a lot of angst in terms of whether or not it's different this time. I think the data suggests that it actually is. When you look at terms of CPI, or inflation or inflationary risk, it's very clearly historically driven by income growth meaning that your lower quartiles of income growth have your lowest quartile of next 12 months' odds of an acceleration in inflation. What's important about what we've just seen obviously via stimulus and to some extent through recovery in unemployment and wage growth, so it's been paired. What's unique about this time is that we have spent eight months in the top quartile of that income growth historically, we have not seen that since the late '90s. To the extent that you're saying that, "well, it's been 20 years, we've thrown a lot of things at this, we haven't really seen inflation," this is very different. We haven't seen something like this in quite a long time. I think that there is something different in the market and that relates to different odds of a sustainable inflationary impulse.

[04:09]

Pamela Ritchie: We'll go through ultimately what that means for equities and which areas of the equity market in particular, but let's begin with this delicate balance of what we expect inflation to be, where inflation actually is, and to an extent the low lows it needs to get up off of in order for this all to kind of happen. Can you take us through where we think things are going, where things actually are?

Denise Chisholm: That's exactly the right way to think about it because our low levels of inflation is a key point. We're seeing something now that we haven't seen, we've only seen it a third of the time in the last 20 years, which is inflationary expectations are actually accelerating relative to inflation. It's been a very unique time. We might have seen the CPI hover around 2%, so we say, "well, you know, we don't have inflation or deflation we're just sort of hovering there." But this whole time since really 2010 we've seen inflation expectations come down. What that means is the market's saying, you might have pricing right now, but the next shock that hits you we have a disproportionate impulse towards deflation. Which is a significant risk. So what you've seen in this rare third of the time that inflationary expectations are actually accelerating relative to inflation has been a good thing for the market.

But we don't have to go back in history to the '50s and '60s, we are living this in just the last 20 years and even in the last decade. When you've seen this, and I think that this inflationary expectation impulse is sustainable, you've had 95% odds of a market advance versus 75%, 15% returns in the S&P the next year versus 5% and oh, by the way, it came with 71% odds of a multiple appreciation.

So to the extent that you as an investor are concerned if this inflation is a good thing or a bad thing for the market, recent history suggests that it might be better for the market than you think and that the market might actually expand in terms of multiple expansion pricing out the risk of deflation that was just as corrosive from those levels to the actually inflation risk as well.

[06:30]

Pamela Ritchie: Have we left the risk of deflation? We haven't left it behind us; it's a risk; it could be there, but how far down the road are we now? Did this all begin on November 9th with the announcement of vaccines, or where are we in this saying goodbye to deflation that we think might be possible?

Denise Chisholm: Yeah, and I think real rates are the key. When you think about nominal rates, and where we are and what the risks are, can we sustain, say, 3% treasury yield? The answer is actually in recent history what you see is that the change in real rates have actually led the stock market by two years. So over the last, let's call it five to seven years, we've been in this sort of no-go zone since the great financial crisis where interest rates were this cap on growth and to a lesser extent the stock market is its leading indicator of growth, as interest real rates got too high and as real rates got lower, that was the stimulus impulse. I think when investors think about rates, they need to think about real rates 'cause that has been the key driver historically, to the overall stock market recently and even further back.

What's really interesting is if you sort of put the puzzle pieces together and say, okay, we have inflationary risk, inflation expectations are actually rising faster than inflation, and you have an accommodative Fed. So putting that together gets you negative real rates, rising probability of negative real rates for longer. That's unique in history. We don't end up there most of the time, especially when inflation is accelerating. When you have negative real rates and inflation is rising, which is rare, I will not say it's not rare, it only happens about 10% of the time historically, that's actually your highest odds of a market advance.

So again, you can look back in history and say inflation isn't always an unwelcome event and in fact, in this backdrop it may even be the highest probability scenario for the market.

[08:39]

Pamela Ritchie: To what extent do central bankers, Jay Powell being the preeminent because the United States Central Bank sort of is central bank to the world, to what extent can he allow things to run hot? There's been much discussed about this and we have seen … I don't know what you call them in the stock market, there are little bubblings up. I don't know if you call them bubbles or not, but to what extent will he just let that ride?

Denise Chisholm: I think it depends on real rates. If you think about that as the key math, it's not just nominal rates that you say hit a trigger and now Jay Powell actually has to do something about it to talk it back. I think that when you look historically, the real level, and again, taking that chart aside, the real level that has caused consternation historically in the market is about 2% real rates. So when you think about the problems allowing to run it hot, yield rising in advance of inflation, if it's a 3% yield with 1% inflation, that's okay. You can't have anything lower than 1% inflation, that's a problem. I think that you can let it run hot to the extent that you get inflation to sort of offset those rising yields. So it's, again, back to real yields which is the key driver for the economy, for the stock market. I think that that gives him more leeway.

[10:01]

Pamela Ritchie: It's awesome. Let's take all of that information into how you're looking at sectors right now. I'm going to ask this question first because the discussion of where we are in a cycle is important, and it also tends to prescribe how people invest. Where are we in the cycle, and what does that mean to you in terms of the way you look at sectors?

Denise Chisholm: I think that one of the key indicators that we're looking at right now, and I think I just … it's either posted on my LinkedIn this week or it'll be coming up 'cause I just did a weekly on it internally, is the yield curve. If you think about the cycle in terms of the yield curve, what we've seen is sort of sub-par steepening so far. We're just starting to get to that zone of the analogs we've seen in 2001 and 2009 of this rapid steepening part of the yield curve. That is typically the sweet spot for cyclicality in sectors or factors. So when I think about cyclicality and certainly from a sector perspective, it's anything economically sensitive like financials, like energy, like industrials, like equal-weighted consumer discretionary and a rotation away from things that I would call classically defensive like consumer staples, utilities, to a lesser extent real estate — we can talk about that individually — and the big pharmaceutical companies within health care.

That rotation is increasingly likely and increasingly likely to be sustained in this environment. When you look at the income growth we've had, that leads you to higher odds of cyclicality. When you look at the high savings rate, higher odds of cyclicality. The yield curve steepening, higher odds of cyclicality. So all of that is sort of stacked odds showing you that that cyclical rotation that certainly has been in place is likely to be the dominant trend over the next 12 to 18 months.

[11:53]

Pamela Ritchie: Do you like the term early cycle? Is that sufficient?

Denise Chisholm: I don't think so because it is informative, but not sufficient to make investment decisions, in my opinion. I think that there is … when I look at history, it is very clear from an odds perspective what you want to go into the recession with, meaning six months from the prior peak into that recessionary trough, and the six months coming out. Other than that, you know, in some ways we're already out of the recession. Other than those two timeframes you would be shocked at history that shows you sort of 55% odds or 45% odds. Even in a sector like materials when you say how does that work in the year coming out of a recession, it's only has 41% odds. But the sector only has 35% odds. Historically it's not a very good sector. So you could say it has increased odds, but I think you're reaching.

My point when it relates to early cycle is that it's inconsistent as a playbook, and you really have to think not just all I need to know is the economy, but all I need to know is the economy, the intrinsic drivers and the individual sectors themselves. What are the drivers of those, and how does that line up relative to history?

[13:11]

Pamela Ritchie: Let's go to financials because it fits the bill of early cycle in many ways. It fits what you've been saying about inflation. What do you see there? What else do we need to know? Let's talk about financials.

Denise Chisholm: I would call it a recovery play. If you want to use the words early cycle, I would use the word recovery but to the extent that they mean the same thing, we'll agree on that part. What's been really mind-numbing for financials investors over the last decade is everything that works up until 2008 whether it was I just want to own it when ROEs are improving, or the sector works when earnings are improving or delinquencies are getting better, that would all give you higher than 50% odds. Even if you got those things right since 2009, it gave you the reverse of what you thought. So what you knew in terms of financials actually didn't work for you over the last decade. The only thing that really worked was actually getting the relative multiple right.

What's been interesting about the relative multiple, when I look at the data on financials the [audio cuts out] is actually, as much as we've been concerned, yield curve is sort of flattening and then negative for a while, that would be a problem for financials earnings, financials earnings were above average almost the entire time. The problem was that multiples compressed and that's what led to the underperformance.

But multiples have been compressing almost linearly related with lower rates every cycle coming out of recession. So if you put the puzzle pieces together that we just did, which is inflation is a higher risk, inflation expectations are likely to rise relative to that, and real rates are likely to stay negative meaning that rates can now rise, not be as much of a problem for the market, we might actually back up that multiple curve in terms of multiple appreciation versus the depreciation that we've actually seen over the last decade.

This is a real problem for investors I think. When outperformance is driven by multiples instead of fundamentals, that's when you get a pain trade. And that's what financials have actually been historically. I think that the risk/reward right now given that backdrop is positive for financials. When I think about recovery plays, I actually think that energy is better positioned. Partly because there's changing correlations, partly because I think that the stacked odds are stronger.

[15:40]

Pamela Ritchie: Let's go there. The stacked odds are stronger. What do you mean by that?

Denise Chisholm: When I look at energy, sort of a unique sector when you think early cycle.

Pamela Ritchie: Sorry, Denise, we're talking about what we might call traditional energy, so we're talking about oil and gas, right?

Denise Chisholm: Yes, I will talk about oil and gas. When you think of the two-digit [GIC?] level or the S&P 500, energy, that would be dominated by the integrated oil company, so old-school energy. I'm not talking about clean energy ironically. When you look at energy historically, it's certainly not an early-cycle play. This is sort of what I'm talking about with that off-school playbook. Energy has been unique this time. I think there's two times when you really get strong odds, and by strong I mean 80% odds of outperformance over the course of the energy data that I looked at.

One is when it's cheap on all levels. It's still not and it wasn't even in 2014, 2015, 2016 because it never got cheap on earnings or free cash flow despite the fact that it was cheap on book. But the second time you wanted to look is actually when demand declines because that's sort of part one of the pain trade. What you usually get in energy stocks historically is a multiple appreciation as you look through that trough despite the fact that earnings are still poor. That's the beginning stages of, I think, what you are seeing in energy. That is sustainable.

But then more importantly energy was in the crosshairs in 2014, 2015, 2016 because they had to spend so much to get energy out of the ground. So capex-to-sales was at the top quartile. It almost doesn't matter what you do in that scenario to change your odds. Even if sales growth accelerates, the market knows that you actually spend more of your capital than you get. They're out of that situation now. On top of that, energy service companies are actually not even in the top quartile, they're all the way in the bottom quartile of capex-to-sales which makes them in the top percentile, their history on free cash flow yield. So if you're thinking in terms of energy, they've never seen the secular headwinds that they have right now. You've also never seen this valuation since the '60s or '70s either.

[17:52]

Pamela Ritchie: That's absolutely fascinating. There's lots of questions about oil and about where it goes from here. One of them, a tack on to that is, this may not be your specific expertise, but the kind of the 'Go Canada' trade. The Canadian oil sands particularly got seriously beaten up. There was a whole stranded assets discussion around it. What does it mean for countries that have large oil industries?

Denise Chisholm: Again, we can sort of debate about the long-term implications, but right now fossil fuels are the way we run global economies. With this demand recovery, we don't have a sustainable [indecipherable] toward energy to drop in. Given what I just said about capex, how restrained it has been in the U.S. given the pandemic, the recession and the culling of excess capital, you're ending up in a scenario where crude is sort of walking down that supply and excess supply on that pinch point chart where it could lead to sustainably higher prices to cull more supply that we right now desperately need in an economic recovery. But to the extent that that is an oil producer like Canada, or even in some place like Brazil, then you have that situation where there might be higher crude to actually call back the production response that you might have lost over the last year.

[19:26]

Pamela Ritchie: It's astonishing. Some of the things that you've been pointing out, they do kind of reprogram the mind a little bit. I feel like we need to kind of swing back. Talk about the correlation between what you're seeing in energy right now and inflation, the two of them together which you mentioned off the top, and oil doesn't always fit with it in a perfect way, but right now it's different. Can you just talk about if we see rising inflation and we see rising oil prices, how long can that last or how long can they work together?

Denise Chisholm: They are very different things historically. It's so funny because I think that when we think about the impulse and the odds historically say inflation, ah, I always think energy, but they're very two different things. Energy beats to its own drum historically, both the stocks and the crude price itself. So oil prices are really truly a function of supply and demand, and that may or may not relate to the rest of the economy and the inflationary impulse in it. I think that this time they are correlated, but there is no causation between them. I think that that's point one.

When I think about point two, how long can it rise? You'd be surprised. The key driver to a sustainable decline in demand, and I don't mean recessionary demand, but crude oil crimping its own demand, is when you reach about 5% of personal consumption expenditures. So when consumers are spending sustainably over that 5% threshold they go, no mas. I'm going to drive less; I'm going to do something; I'm going to do something less so I have more cash to spend in other areas. We are very far from that right now. We are in the twos.

When you think about the sustainability of higher prices, don't really think about it as a nominal price tag, $3 gas is going to be a problem for the consumer. It's not, it's relative to their income. We just talked about income being in the top decile or quartile for eight months, which is the longest it's been since the '90s. Think about that income quotient and what it could support in terms of a gasoline price. Very different this time.

[21:38]

Pamela Ritchie: That is absolutely fascinating, and the fact that we are still reopening and probably will be for some time, to see where all of that goes. Lots of questions in here. Let's start with the dollar because it has to do with everything, of course. We have seen a strengthened U.S. dollar. I don't know if that trips up some of the things that were in the midst of rotation, oil being one, perhaps materials, anything cyclical. How do you look at the U.S. dollar's strength right now?

Denise Chisholm: I look at the U.S. dollar strength as perfectly logical. When you think about the biggest pushback I got when I actually presented on dollar appreciation was twin deficits. Nobody is going to want to own the dollar. I think that that's not the right driver historically. First of all, you already saw in trade-weighted dollar peak-to-trough contraction of 12%. That in and of itself usually happens only 10% of the time and leads to 80% odds of some sort of snapback. But regardless of that, if you think about debt and deficits as being the driver, you get the opposite odds that you would think. Meaning that when debt goes up your currency, and I don't mean just the U.S., but this is true in Europe as well, actually tends to strengthen not weaken.

It's been this interesting corollary. The key drivers historically have been relative growth and relative interest rates, and those two drivers are swinging back hard in terms of favourability for the U.S. I think we might have already seen the depreciation. The critical drivers are now in favour of the dollar. Now what I would say is what it means on a go-forward perspective is not much if it's just modest appreciation, which is what I expect it will be. The dollar actually only matters to sector allocation at very big extremes like 10% appreciation over the course of six months. You'd be surprised in terms of energy, only those extremes matter. Sales acceleration or deceleration can offset dollar strengthening or weakening.

So the dollar is not really the key driver of energy prices to the extent that it's not extreme moves. I think it's very likely that you end up in a scenario over the next 12 months where we see dollar strengthening and investors are scratching their head and saying, "how did energy stocks outperform?" I think history could give you that guide.

[24:01]

Pamela Ritchie: That is fascinating. You segmented out a little bit. You were looking at classically defensive areas. You talked a bit about pharma and some others, but real estate you say sort of has its own story. We actually spoke to Steve Buller last week and got some of his thoughts on the global real estate picture. Just tie it all together for us within our discussion here. Where does real estate fit?

Denise Chisholm: I think that real estate, when you look historically, it acts like a cyclical. I would not call it a classically defensive sector. When I think classically defensive sectors, you can literally equal weight consumer staples, utilities and health care and the old telecommunications services sector. Those sectors equal-weighted together will give you 100% historic odds of outperformance in either a down market or a recession. That's your classic defensive. Can't get it wrong. Real estate is 50/50, and in fact, if I had to pick another defensive sector, it wouldn't even be real estate. Historically speaking it would be energy. So real estate isn't classically defensive, but it's also not classically cyclical either.

When I think of it in terms of a risk/reward, I don't think of it as I don't want to own defensive, so I don't want to own real estate. I think that during cyclical rotations not all cyclicals work, oddly. During defensive rotations it's very univariate. Consumer staples and utilities tend to work together when they work, especially in economic environments that are similar. Cyclicality is when you get a cyclical rotation, only half the cyclical sectors actually work, and I think that real estate might be a cyclical sector, but it's risk/reward remains well lower versus energy, industrials, equal-weighted consumer discretionary and then to a lesser extent financials. So I think that the risk/reward is very, very different versus the other more classically, I would say, economically sensitive sectors.

[25:54]

Pamela Ritchie: We could go on for a lot longer than the time we actually have allotted here. I want to ask you quickly to comment on gold. There's a couple of questions coming in on that, but then I want to have a bit of time to ask a couple of other questions. Do you have some quick comments on gold? It's fallen out of bed. Lots of people do invest in it, and they're kind of scratching their heads a little bit about when it has a time again, if at all.

Denise Chisholm: Gold always makes me a little nervous from a historical perspective 'cause it has these changing correlations. Sometimes it's an inflationary hedge, sometimes it's a deflationary hedge, sometimes it's related to real rates, sometimes it's not. What it is usually related to is the materials sector. That's been the correlation that has sustained the length of time. I think that when you think about the economy and where we are in terms of an acceleration, and when you think of where we are in the yield curve and that usually denotes higher commodity prices, I think gold still might be a positive risk/reward. That said, I'm not sure it is the ultimate store-of-value when we think about how investors view it. I think we need to be careful in terms of rethinking that store-of-value, especially if the dollar is actually in a sustainably strengthening trend.

[27:10]

Pamela Ritchie: I'm going to go for it here. We're going to have two more questions here 'cause there's so many, and many of them are comments about how amazing you are, just so you know. But here's one quick one. On the tech sector, how bearish, is there nuance within the subsectors of tech? We tend to just watch the Nasdaq and the direction it's going, but what are your thoughts?

Denise Chisholm: I think that what we're seeing in terms of right now over the last two weeks, I think the [indecipherable] did have a correction. I think peak-to-trough it was 10%. That was a stock thing, not a sector thing. I think people think that the two-digit [GIC?] level or the S&P 500 information technology sector is the same thing as momentum. It's not. High-momentum stocks are often tech, but that's not all of that sector. I think the risk/reward at the sector level is still positive. I think that there's better things to own in the market from the way I look at it in terms of energy, industrials, equal-weighted consumer discretionary and to a lesser extent financials, but I think that the risk/reward for tech is not negative either. We're at median levels on terms of valuation relative to its history going back to 1962, so I don't think that valuation is a headwind, and margins are actually re-expanding as you would expect it to do in an economic recovery and that's been the critical driver regardless of valuation.

I think the risk/reward is still positive. I don't think that the downdraft at the sector level is going to be that significant, or it could be more short-lived than we think. That said, I think that there's opportunity elsewhere, so we see the market broadening which is exactly what you want as an investor and exactly what we haven't seen over the last two years.

[28:43]

Pamela Ritchie: Everyone watching right now probably knows a little girl or a young woman who will grow into a woman in the world, perhaps in the workplace, and I would say many of them could do far worse than following some of your roles and clearly influence at Fidelity and peoples' lives. I'm wondering who was a mentor to you. How did you get this way? Have you worked with great women over the years on this International Women's Day that affected you and the way you have looked at your career?

Denise Chisholm: Mentors are incredibly important in any career, maybe more in our career, but I don't know if that's just the only career I know. I think what's clear about mentorships is that they see something in you that maybe you don't see in yourself, or haven't learned it in yourself. My one female boss at Fidelity was amazing in the sense that … look, you've all heard me, you know I have sort of a unique role and a unique experience in the financial markets. I am not a classic analyst at Fidelity, that's a fundamental analyst that picks stocks and writes up companies to our individual portfolio managers. But she promoted me and gave me the title 'analyst', and she sent me flowers, and in those flowers she wrote a card that said, "Congratulations to our newest analyst." I still carry that card with me in my wallet to this day. Whenever I'm feeling do I belong, does this make sense, is this the right process, I pull that card out and I read it, and that's how I go on.

[30:28]

Pamela Ritchie: Well, you inspire me. Thank you for joining us today to inspire others about how to think about this market, and we'll see you again soon. Denise Chisholm, thank you for joining us.

Denise Chisholm: Thanks so much Pamela.

Ending: *[30:43]*

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