Fidelity Connects

True North: 2021 Canadian Equity Outlook

Maxime Lemieux, Portfolio Manager

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.

25-year veteran Fidelity portfolio manager Max Lemieux joins us today. For Canadian investors, Max manages Fidelity True North Fund. Today he shares with host Pamela Ritchie his current outlook on investing in Canadian equities, and how he continues to diversify his portfolio for the future.

Max believes that based on where interest rates are, the market is not overvalued. Max also explains that at some point a sense of normalcy will prevail in society, and he thinks that it is hard to see inflation persist in the long term, given current headwinds like demographics.

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[01:35]

Pamela Ritchie: Hello and welcome to Fidelity Connects. I'm Pamela Ritchie. Year to date the S&P/TSX Composite Index is up roughly 5½%. Two-thirds of this index being tied to sectors which many characterize as cyclicals: financials, materials, industrials and energy. Many investors wonder is the relatively strong performance so far a signal to go big on Canada. The bulls believe that it is as the economy will be boosted by the vaccine, pent-up global demand and the narrowing in the output gap. So what is the outlook for the Canadian economy and markets, according to a seasoned investor who runs one of the largest Canadian equity funds with a strong long-term track record?

Max Lemieux joins us today. He is manager of the Fidelity True North Fund. He's here to share his views and updates on his fund and investment thoughts. Max, welcome. Great to see you again.

Max Lemieux: Good morning. Pleasure to be with you this morning.

Pamela Ritchie: I'm going to jump right in here, Max and ask you about the similarities and the differences between what we're seeing in markets right now, and roughly the 2000 period. '99, 2000 period.

Max Lemieux: It's really important to discuss this because it's starting to get really frothy. Last time we spoke it was already getting there, but it's gotten a little bit bigger or a bit more out of control in some sectors. I want people to understand that the overall index, the overall market is not necessarily overvalued based on where long-term interest rate stands and dividend yield, etcetera, but there's certain similarities to '99, 2000. I just want to say briefly, I'll start with what is different and then we'll talk about what's similar. What was different - '99, 2000, we were really near the end of a 10-year economic cycle. It was supposed to end in 1998. There was the long-term capital crash and the Asian flu crisis, and the Fed lowered and reset interest rates at a very low level. Then we had two, three extra years combined with the tech emerging, internet, cell phones, laptop, etc., mobility, so it was kind of a new era in the tech world, and every time there's something new and that speculators or investors, or the small investor, can get more important in the market place, that's when you see those bubbles getting triggered. That's one thing, end of a business cycle whereas today we're really at the beginning. We don't know if there could be a setback in this recovery, but we can assume that we're likely to see a new business cycle as we speak.

The other thing is liquidity. Back in '99, 2000, following the reset in rates in '98, we saw long-term rates starting to increase and increase, and that's what created the crack in the tech bubble and the market in general in 2000, 2001. Basically the telephone companies, if you remember, were buying all this gear to grow the capacity of their internet networks and telecom networks, and sometimes they had to double or triple order some of these gears because there was scarcity from the suppliers — the Nortels of the world, Cisco, etc. What happened, the credit agencies basically realized that the phone companies had too much leverage, so they had to control their free cash flow again and they had to cut back on capex and that's what happened. That was the crack where you saw the house of cards falling apart. It snowballed into other sectors, and then 2001 there was, unfortunately, the sad event in New York City, September 11, but then we saw this new super-cycle in Chinese demand for all the commodities and that was the go-go years between 2002 and 2008 with the housing market. That's very important. Interest rates now are rock bottom whereas in 2000 they were at their peak. Then there was a reset in 2001.

[05:51]

Pamela Ritchie: You circled right back to it. The crack was the fact that they were already two years in on rising interest rates which is [audio cuts out].

Max Lemieux: Exactly. And then of course all the similarities we know. Remember, the small investors today represent about 22% of the volume or the activity in the U.S. stock market. That's exactly where we were in the year 2000. The level of presence of the investors that are under age of 35 years old it's a new high, a new record. When you think about these Robinhood type of accounts where there's no commission to pay, the number of people that buy call options and without necessarily understanding what is a call or a put option, it's like a lottery ticket. People have more free time. There's a lockdown, they're staying home, so hopefully I think what will make this change or put a halt to it will be probably slightly higher rates, we can talk about inflation risk later today, but also people going back to work, people going back to school.

I think that's what's going to happen. It doesn't mean that the broad index will fall apart. If there's an economic recovery and it holds, we should be okay but then it's all about stock picking and making sure that you avoid those more speculative companies that have a risky business model, that don't have a smart management team or that don't have a good balance sheet.

[07:22]

Pamela Ritchie: Let's get into the stock picking in just a minute. You've given a great sense of sentiment and comparisons, but maybe also as a comparison or just generally, when you look out to the innovation that is out there right now, and really to the opportunities right now, I don't know if you're invested in all of it, but is it a broad landscape right now?

Max Lemieux: The technology companies that we see today, first of all some of these names are hybrids. Some of them are clean technology, it's related to the environmental transition that is about to take place, already taking place. But if you see the money that will be spent by the western world on changing the grid, the electricity grid, the type of energies that's going to be more solar, more wind, this is happening at the expense of fossil fuel, and this will have a long duration. I find that in some ways it's very different from '99, 2000 because once you've bought this new cell phone in 2000, you were good for two, three years. This energy transition has a long way to go 'cause those are massive projects. Then the whole digitization architecture that is changing, you'd be surprised. Some of these large Fortune 500 companies, they're not necessarily up-to-date. We're talking to some of our companies that we own. We're talking to our companies on a daily basis, we're working round the clock. Seriously, I'm so proud of our research team, it's been phenomenal. But the reality, the IT firms at some of the companies that we own they told us, some of those large-cap names were not ready for this pandemic and they have to spend the money now, they have no choice. Some companies are already talking about this transition's already part of the past. You have to think about what's the next big thing.

I think there's, as you said, a broad set of subsectors that we can touch on, productivity enhancement from software companies that have a SAS model. There's gears, there's software, there's AI so there's a lot. I think that to top it off, you have a strong foundation. When you think about Google, Facebook, Amazon, these companies now are still growing 15 to 25% a year. Think of Microsoft. They're not necessarily overvalued. Compared to 2000 where you had a lot of companies trading at whatever, 20 times sales, these days you've got a solid foundation of companies that have a very astute business model. Even if we go into a downturn and we've seen it last year, these companies continue to grow earnings. It's really phenomenal what we've seen and what I think we will continue to see, but we have to be shrewd investors and be on the lookout to make sure that we choose the companies that have the best business model.

[10:26]

Pamela Ritchie: What does the Canadian consumer not know that they want and need, but that they want and need, and can afford? I want to kind of get a sense of the Canadian consumer, how you view the health, but also where they want to go. Where does the Canadian consumer want to go? What direction? What's going to delight them?

Max Lemieux: I think in Canada there's a renewal in the marketplace and there's a lot of new IPOs, so I think it's really exciting for the next couple of years. For us, if you think about the past 25 years, the number of listings in the western world have been declining I think to the tune of 40% cumulative. Now we're adding new names. Of course, there's M&A, there are takeovers, but really there's a net positive to find these new names. Maybe they're overvalued in the short term, doesn't mean that we're buying or participating in all these IPOs, but we're in there, we have to analyze them, and there'll be a broader list of names in which we can invest and should help us to generate more alpha in this upcoming cycle.

To come back to the consumer, I think it's super exciting because savings rate … the reality, this crisis has been very dramatic, but it's been a lot more impactful to the service industry and I'm talking about tourism, restaurants, hotels, transportation, but when you think about other type of jobs, a lot of people have just been working from home, or working from their office wherever it is and they've been saving money because we can't travel. I think there's pent-up demand being built and that's why there's room in a diversified portfolio to own stocks that will benefit from the reopening of the economy.

Something to be mindful though is that vaccination rate is not the same everywhere in the world. I think in Canada, unfortunately we're in a tough spot where we're lagging, so I'm not so sure that the expectation for the second half of this year will be met. You have to be careful about what you read from the sales-side research from the street. I think some of these forecasts are maybe a little bit too optimistic on some names or some sectors and therefore, again it's all about stock picking and making sure that, as you know, you've seen what I own in True North over these past 10 years. There are a lot of names that I've owned for the long term and sometimes names that I've held in previous portfolios for 20 years. If you have a good business model sometimes it does not necessarily really matter what happened to your domestic economy, but the reality there is pent-up demand building for all sorts of services.

[13:14]

Pamela Ritchie: Let's lean into that a little bit. I'm noticing, if I flip through a newspaper or ads online, lots of local cruises, so-called. I grew up in the summers going to the St. Lawrence River in Ontario and lots of tours being advertised up and down the St. Lawrence, overnight. Probably you can control it 'cause it's a ship, and maybe you can't control flying off to Italy, but you can control it on a local, but you wonder if because that's what we'll be able to do. Does the inflation, to kind of back into the inflation discussion, does the inflation on some of these things go flying? How do you look at that? Do you take part in it and worry about the inflation?

Max Lemieux: To add to your comment about the pent-up demand for all these services, and vacation and cruises, whatever it might be, maybe you'll get discounts or increases in prices for Virgin tickets to go to the moon. I don't know. The reality, not only that, you've got almost 0% interest rates on these financings to buy a snowmobile, or Sea-doo, or all kind of watercraft or a new car. And it's happening now. For those big-ticket items there was pent-up demand. It's happening now and there might be more. It's possible also that even if you can fly and you've got the vaccine, there could be also a tranche of the population, the more 65+ years old, the people that used to travel a lot because they were retirees, maybe they'll be a little bit more careful.

I think a lot of people bought cottages. I've seen crazy prices around Montreal, eastern townships or Mont-Tremblant. I'm sure it's the same in Toronto in the lakes region, but I think this is ongoing, and I think that people will be less sensitive to what they have to pay. I do agree with you on that. For sure it might bring some inflation, but you have to break down how the CPI is measured. In the U.S., for instance, about a third of the CPI is related to housing, but it's a question that you're being asked. What kind of rent do you think you would get if you were leasing your home? And therefore this is very interesting because, despite the fact that on so many ticket items we might see a price increase, which might be short term, transient, for the next two years, possible, it doesn't mean that it's going to be fully captured in the CPI. In the CPI there'll be the energy price. Oil is back to almost $60 a barrel, so there'll be a point where we'll have year over year positive comparison for the energy pricing.

But the supply chain, think about all the manufacturing disruptions world-wide. This is a big issue. Even Apple has been talking about supply issues, iPads that you cannot get, they're out of stock. But this is ongoing. Car manufacturers seeing it with semiconductors that they cannot get. Transportation cost, through the roof. If you're trying to get stuff out of China to go to Europe or the U.S., there's huge price inflation right now, but this is spot rate, and I think that at some point normal life will prevail and things will normalize again. That's why I have a hard time to think that inflation will persist in a structural manner for the long term. I think that demographics, automation, as long as you don't see huge wage increases, I have a hard time to see long-term sustainable high inflation.

[17:01]

Pamela Ritchie: I want to go back to the questions on energy, on oil and again, maybe there's sort of a transitory message in there, I don't know. It seems to be a new term we're using a lot, this transitory discussion. There are questions rolling in on thoughts on energy, on oil. How do you look at this in the Canadian context? It's a big question mark right now, isn't it?

Max Lemieux: As you know, I was invested and I've remained invested in some of these names, but I'm careful now because the commodity prices have gone up, natural gas has come back a little bit, the weather's been colder than expected, so there's been a bit of money to be made. To tell you the truth though, it's been quite disappointing to look at the performance of the large Canadian energy names vis-à-vis their peers in other areas of the globe. I think that there's still suffering funds that are still exiting the Canadian marketplace for fossil fuel type of investments, and unfortunately I think it has played again some of these names, some in which we are invested.

The reality, if oil stays where it is between $50 to $60, you don't need oil at $80 to print nice quarters with good free cash flow. I think it's a transition though and as I said in the previous show, I don't think these companies will get the same multiples that they've seen in the past. So they might be more profitable, they might generate good cash flow, but unfortunately we have to be realistic about it. But some of these names are up 50% since the bottom and I think that oil, obviously it's all on the Saudis and how OPEC will manage the situation because demand will come back very gradually. I think it's going to come back and remember these companies have not spent a lot over the past 5, 10 years and there could be at some point another spike in fossil fuel. But the question, will that be like tobacco? And people will not pay a big multiple on that.

Pamela Ritchie: Very interesting. Interesting to get some of the nuance in there.

Max Lemieux: One last thing on natural gas. Natural gas though is perceived as part of the transition, the green transition. That's why I think if you have a five-year view, or a ten-year view, I think natural gas gets more interesting, and at some point if you see oil that starts to really decline, these shale producers in the U.S. will stop production and there won't be residual gas part of that production of that well. That might create at some point a very interesting context for the natural gas.

Pamela Ritchie: In Canada, or everywhere?

Max Lemieux: For sure, yeah everywhere.

[19:57]

Pamela Ritchie: Let's move to financials. They're part of the so-called vaccine trade, or rotation or whatever you want to call it but they've done very well. Canadian financials are seen as rock solid. How do you look at them for opportunities at this point?

Max Lemieux: The banks were definitely fortresses compared to 2008, 2009, so I'm very happy to see how they've been able to go through this crisis, but the reality is most governments have decided to take on the risk from this crisis. That's why we've seen all that liquidity being injected that represents for most governments 20 to 25% of their economy. It's massive. It's three times what was injected in '08, '09 during the great financial crisis. But the Canadian banks, they've been really good. Consumers continue to pay their mortgages. I'm a little bit more concerned about commercial real estate, but for most banks it's not a huge exposure on their books, and you're getting a decent dividend yield. To top it off, if you don't have huge losses, the net loss ratio, the NPLs, the provision, sorry, they're back to a reasonable level. It never got close to where it was in '08, '09.

So if the economy normalizes itself, I think we're in good shape to have decent returns. It might not be as exciting as what we've seen some names in the industrials, or technology or even some of these consumer good type companies, but you could get decent returns. Now that you've got also the yield curve that is steepening a little bit, so that's going to be helpful also, especially for the Canadian banks that also have a presence in the U.S. because the steepening has been a little bit more interesting in the U.S. than in Canada. Normally, and we start to see this since the election in the U.S. and the announcement of the vaccines, since it's really going to lead us towards a normalization. I think that the financials also have recovered quite nicely and also on the back of long-term rates going up a little bit, so that's quite helpful.

[22:12]

Pamela Ritchie: I just want to talk a little bit about the approach to Canadian investors. A lot of investors look at perhaps the Canadian markets and go at it from their own perspectives and so on. You've had this track record that's been so good through all these different periods that you're bringing up as comparisons and so on. Just a thought for Canadian investors going forward, how do you sum up … we're not finished yet, we have more questions, but how do you look at this moment for Canadian investors?

Max Lemieux: It's a bit of euphoria because at a social level everybody's eager to go back out in the world and meet friends, family, relatives. We've been deprived from having a normal life for so long, and also people open up their statements, they look at them and wow, they're more wealthy than just before COVID arrived. I think it's exhilarating, and then you see a lot of these small-cap names or technology names that are reaching new high day after day, and sometimes you're scratching your head. What do I do here? That's what we reassess everything we own on a daily basis. Our research team has done such a phenomenal job being on top of things, and we keep calling companies every day. We're working almost seven days a week and trust me, we read research and I see research that pops up in my mailbox at 11:00 p.m. sometimes. We're really working hard and making sure that we own the best names and the companies that have really a durable business model that will continue.

The green transition is big. It's also about electrification, a lot of new names, names that will go public also in the next 12, 18 months. I talked about all these new IPOs in Canada which it is very different from what we saw in the past 15 years. We saw a lot of mining or junk names that went public in '05 till '08 and then 2012 till 2018, but really now, to me, it's a bit like a renaissance. It really reminds me of '99, 2000 when you have all these new names, but the greatest thing out of this is that these new names have, most of them, very interesting and more resilient business models. Maybe they're overvalued right now when they go public, but I know that over the next 12, 24, 36 months they'll be very interesting names to buy at some point if it's not already in the portfolio. It really broadens the number of stocks that we'll be able to pick from and I think for the Canadian investors, for the Canadian marketplace, to me I find that very exciting. I've always been underweight natural resources over my whole tenure as a diversified fund manager and to me to see these new names that are not necessarily related to resources, I find that really exciting.

[25:19]

Pamela Ritchie: To ask you on resources then, how do you look at the industrials as a sector, there's a lot within that, taking part in the so-called green transition and as you say, maybe some valuations are higher now, but as a longer-term picture, how do you look at that sector and its involvement and its transitions that are going on?

Max Lemieux: There's a whole supply chain and you could be a car manufacturer, or a truck manufacturer or you could be also in different parts of the supply chain. It could be at the service level, it could be also the rare earth material. I've not owned lithium stocks this time around. I kind of missed it, some of these names have tripled or quadrupled since spring last year. I own, and I still own, other types of rare earth material or other types of materials that could be included in batteries, and sometimes they're overvalued in the short term. If you take a five-year view and you believe in EV's penetration out there, it's going to happen. Therefore if they're reasonable over three, five years in terms of valuation and can make a case out of it, and you believe in the management team, they've got a good balance sheet, well therefore, sometimes you have to stomach the short-term valuation that could be a bit excessive, but you know that on a five-year view you'll be rewarded and very handsomely sometimes.

You have to separate what is the noise, what are the fake companies or the companies that basically will not really make it, and sometimes we don't have an answer today. You see this as it evolves quarter after quarter when we're calling companies, when we watch the competition, we might change our mindset on company X, Y, Z. There are plenty of different ways to play it. There's also the energy manufacturers if you want. When you look at the public utilities, I can think of Hydro One, Fortis, etc., those were great names to own during the crisis and they've really helped me to protect the shareholders' money in True North, in the fund, but the reality, you have to own the renewable utilities or companies, the IPPs and independent producers and those are the ones that went up quite a bit because this transition is going to last 10 to 20 years. The reality is the penetration of solar energy and wind energy is just going to continue to grow at a very fast pace for the next 10, 15 years. So when you see the governments are deploying the money, and I think it's a huge generational shift and we're not going backwards. I think that sometimes it could be overvalued in the short term, but if you take a long-term view and choose the best operators, I think there'll be very interesting situations in that space.

[28:20]

Pamela Ritchie: We're going to leave it there. That's fabulous. So interesting to get your thoughts on that. Max Lemieux, thank you for joining us today and we'll see you again soon.

Max Lemieux: Take care.

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