Voiceover:

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

This episode features Jurrien Timmer, Director of Global Macro, back for his regular global macro and markets update – today's recorded on January 11, 2021.

Jurrien and host Pamela Ritchie discuss the political landscape for the next four years, now with both runoffs in Georgia going to the Democrats. Jurrien believes we can expect further fiscal stimulus and more of the reflationary trade to take place.

Jurrien also explores valuations in the market, and notes that the Russell 2000 Value Index has completely caught up to the S&P500 after lagging for months, and that there is an opportunity for small caps and emerging markets to have run for the next few years.

For more from Jurrien, look him up on LinkedIn, or Twitter @TimmerFidelity

[01:07]

The views and opinions expressed on this podcast are those of the participants and do not necessarily reflect those of Fidelity Investments Canada ULC or its affiliates. This podcast is for informational purposes only, and should not be construed as investment, tax or legal advice. It is not an offer to sell or buy or an endorsement, recommendation or sponsorship of any entity or security cited. Read a fund's prospectus before investing. Funds are not guaranteed. Their values change frequently and past performance may not be repeated. Fees, expenses and commissions are all associated with fund investments.

[01:47]

Pamela Ritchie: Jurrien, great to see you.

Jurrien Timmer: Good morning, Pamela. Nice to see you.

[01:50]

Pamela Ritchie: Good morning to you as well. Jurrien, given what we've just said and what we're seeing and what last week was, is this a hold moment in the markets?

Jurrien Timmer: I think so. Of course, last week was pretty surreal in many ways, but it also brought some actionable pieces of information to the markets and of course I'm referring to the Georgia runoff which both went to the Democrats. So now we have officially a sweep or a blue wave, maybe a blue wavelet because we've already had one senator kind of downplay the notion that after the $920 billion stimulus, or relief I should call it, that's already underway, there should be $2,000 cheques coming right after that. And so that did not meet unanimous approval which goes to show that this is still a political process and just because one party has enough votes to override another one, doesn't mean it's all carte blanche from here.

So, in a way that's good. Markets do like some checks and balances, but the Democrats have the House. They have the Senate. It's 50-50, and with that of course has come more of what we call the reflation trade and that

certainly was the hallmark for last week. The reflation trade means you're going to get lots of fiscal stimulus and assuming that the Fed will not lean into that stimulus by either tapering purchases or raising rates, and we can talk about that a little bit later. Assuming that they will not do that, the economy can run hot for a while. That remaining output gap that we've talked about so many times from 100 to 20 to 70, now it's kind of back to 60 or 50, but eventually back to 100, the hope is that narrowing of the gap will happen sooner and it may even create some inflation. So, you have higher nominal yields, higher inflation expectations through TIPS, break-evens here in the U.S., you have value, cyclicals, small caps, non-U.S. equities all outperforming large-cap growth U.S. equities.

So, last week we saw all of that happen. I mean of course it's been happening for a few months, but then it was put on the backburner because of the runoffs and now that we have the answer to that this has been the playbook. So, this notion of liquidity entering the markets, boosting valuations.

[04:20]

Voiceover:

The chart referred to here was tweeted the morning of January 11th - titled "Liquidity and Valuation" and again that's @TimmerFidelity on Twitter

Jurrien Timmer: Last year when that happened, so in the bottom panel you see here. This is what we call the Liquidity Impulse, the excess growth of money supply growth minus GDP growth. When we had that spike almost a year ago, nine months ago, after the first fiscal relief program, it happened when earnings were plunging, the economy was plunging. So that was purely to boost valuations and therefore stock prices offsetting the decline in earnings. What we're seeing potentially happen now or in the months ahead is if we get another burst of liquidity, it's actually coming at a time when the denominator GDP is growing again and when earnings are rising. So, you can think of it as rather than potentially a bridge over the abyss, this is kind of extra fuel on the fire if you will, and earnings estimates are already being revised higher. We're on the cusp of earnings season. We can talk about that in a bit as well.

And so, this liquidity really could let the economy run hot for a while, and I think both on the Treasury side and on the Fed side that is an outcome that will be welcomed and not try to be offset through tiger policy.

[05:44]

Pamela Ritchie: I mean it's so interesting to think that the valuation side of equities, there could be a baton handoff to earnings than taking it from there. As you say, these bridges have been created. There are more bridges that are going to be built and so on in terms of support, but it might be earnings that takes it to the next leg.

You mentioned inflation running hot. Last year it seemed like the word that no one could – we couldn't trip over ourselves without saying "unprecedented." I wonder this year if the word isn't "inflation" because there's just so many different ways to look at that. Can you just dig in a bit deeper on that for us?

Jurrien Timmer: Yeah, and I've really struggled with this and I think it is the return of inflation – so there's two timeframes, right? There's cyclical inflation. Okay, the economy was kind of down in the dumps and now we have all this policy stimulus and the economy is coming back and you have vaccines. Of course, the vaccines are not coming fast enough. We have new strains of COVID. We have lockdowns.

[06:47]

Voiceover:

So what we're going to look at here is Jurrien's chart on the Bloomberg Daily Activity Indicator, tweeted the morning of January 12th.

Jurrien Timmer: That trajectory of the economy going from 100 to 25 or 20 or 30 back to 70. Markets have been pricing in from 70 to 100, and instead we're going from 70 to 50 and you can see that, these are the Bloomberg high daily activity indicators which are very high frequency indicators of how much people are moving around.

So, every time an economy or a government locks down, you see these numbers go down and they have been going down in recent weeks for the obvious reason that more and more countries are getting into lockdown. Fortunately, the numbers are bouncing here and maybe because of vaccines or what have you. So, the notion is that as the gap is closed and we go from 50 back to 100, it's priced into the stock market, but will it create inflation? Almost everyone I talk to expects to see at least some cyclical inflation as this gap closes. Capex coming back, creating demand for goods. We see it in the commodity indices. But the real question to me is, "Will we have structural inflation?" I think the jury is way still out on that. We can talk about this now or a bit later because it gets a little esoteric.

I've done a deep dive into what Japan has done and Japan has been going down this road for years. The Bank of Japan's balance sheet is 126% of GDP. Whereas the Fed's balance sheet is only like 36%. So, the Bank of Japan has fully monetized the last 100 percentage points of debt to GDP, and the inflation rate is a big fat zero and the currency, the Yen, is completely stable. The narrative that, "Oh my god, we're going to print so much money. We're going to spend all this money we don't have and we're going to destroy the dollar and inflation is going to run hot," it all sounds reasonable to me, and I certainly have my hedges in place via gold, etc. But I think we shouldn't underestimate the deflationary power of demographics which I think is what's happening in Japan, which is where we and you and Europe and China are all going. And so, to me it is far from a slam dunk to assume that we're going to be living in an inflationary world for the foreseeable future.

[09:24]

Pamela Ritchie: There's so many hedges against inflation, if there is inflation, and you've just made a case of why we don't necessarily need to expect it full-on. But there are so many different hedges against inflation. I want to talk about Bitcoin and the drop off the scene and in fact, you're going to do a special on digital cryptocurrencies actually on the 28th of January, so we'll talk around that in a sec. What are the main hedges against inflation or equities, right? That's certainly the other piece.

Jurrien Timmer: Yeah. I'll give you a slight teaser for that, and by the way I did a whole primer deep dive on Bitcoin internally. I went down the rabbit hole, which is the only way you can do it because the learning curve is very steep, and so we will be discussing this soon. But there's also an external version of that paper in the works and that will be distributed as well. The bottom line is that we're living in a 60-40 world, right? And in the old days both the 60 and the 40 would handily beat gold and anything that looks like gold. I'm talking about the old days because back then gold was fixed. We were on a gold standard.

But since 1970 or so when the U.S. went off the gold standard and the rest of the world, so gold has been very competitive with that 40, and especially now where that 40 is sitting at interest rates of near zero and $18 trillion of debt is trading at negative yields. Gold and Bitcoin and other inflation hedges become much more competitive, but

only with the 40 side of the 60-40. I will show in that conversation that equities are a very formidable inflation hedge because not only can companies pass on the price increases, but equities have something that gold could never do and that is compound returns, right? You can never compound Bitcoin, or gold or any kind of precious metal, but the magic of compounding works in equities, plus they are partially an inflation hedge. They're also about growth and everything.

So, if you wait long enough, it's really hard to compete with stocks for anything, but on the 40 side of that 60-40 we can talk about TIPS or whatever the Canadian version of TIPS are and you can talk about precious metals, commodities, MLPs. There's all kinds of stuff you can do, but from my perspective from what I've learned doing this study, it's all on the 40 side, not on the 60 side.

[12:07]

Pamela Ritchie: Yeah. Fascinating. In some ways you can almost end the argument there, but there's so many questions coming in here. So, more discussion and questions about the U.S. dollar. There's been a long-term trend. You've been telling us about it. That's backed up a bit. I don't know if there's some short covering. Where is the dollar trend to you still?

Jurrien Timmer: Part of the reflation trade is a weaker dollar and that certainly has been the case for a number of months now, I mean really since last spring when the economy went from lockdown to starting to reopen. A weaker dollar has been part of the story. So, in the last few days dollar is up, gold is down, Bitcoin is down and I think it's all related to bond yields kind of perking up here. So, the 10-year yield in the U.S. is now at 110, 112 or so. So, it rose 20 basis points last week above 1%, which is something that I saw coming because the bond yields should not be below 1% given the state of the world and what's happening. So, 1¼, 1½ I think is perfectly reasonable, but that pressure on yields… so before, TIPS break-evens were going up, so inflation expectations were rising but nominal yields were staying very anchored at low levels at 90 basis points, whatever. And so that allowed real rates to go further negative which of course is very bullish for gold, it's very bearish for the dollar. And so what we're seeing now is that TIPS break-evens are still robust. They're at about 2% for the five-year timeframe but nominally those are catching up, so as a result real yields are becoming slightly less negative at least over the short-term. And that's kind of putting some pressure on not only gold, Bitcoin, but especially gold and the dollar.

So, I think this is a shorter-term phenomenon, but it raises the question which I alluded to earlier and that is if we get a couple of trillion dollars of fiscal stimulus coming…? So far, we've just had fiscal relief and that's already been 4 trillion plus, but if we get several trillion more coming out of the Biden administration for infrastructure, environment, what have you, will the Fed lean into that the way it did in 2016 and 2017? Remember the Fed was normalizing policy back then. It went from QE to QT. It was shrinking its balance sheet. It raised rates nine times I believe to 2¼% and that was in part because it felt it could do so because the economy was strong. But I think there was also a dimension of that, that said the administration back then, the Trump administration, was running large deficits during an expansion which is very unusual. Normally deficit spending should be counter-cyclical not pro-cyclical. And so, there was a sense that the Fed was leaning into those deficits so as to prevent inflation from rising.

Now the question is, if the government is going to do the same thing, it's a little bit more counter-cyclical this time, but will the Fed lean into that by becoming a little bit more hawkish on its forward guidance or reducing bond purchases? My sense is that it will not and maybe it will even start to play around with yield curve control and doubling down on its guidance to keep nominal yields down. And I think at that point when the message

becomes clear, that the Fed is going to allow real rates to go down further by letting inflation expectations rise without tightening policy, at that point I think the dollar, gold, trade really gets another run. But I think we have to wait for some signaling out of the Fed before we get there.

[15:56]

Pamela Ritchie: What about signaling out of Washington through the first half of the year? One of the questions that has come in and I want to kind of pair it with something else. The question is, what key events, indicators are you watching for that could move markets in the first half? And Jurrien, I might add to that, so money for infrastructure in the United States. That could be anything. Some will say they don't have enough of a majority to make a green deal stick. I don't know. Some people will say it'll go to healthcare because we're in the middle of a crisis. Some will say it'll go to roads and bridges. Any thoughts on that front that you can see at this point? And again, just catalysts in the market next six months.

Jurrien Timmer: I'm no political expert but my sense is that Joe Biden is enough of a centrist and you look at who he's put in place for his cabinet, these are all mainstream establishment, centrist Democrats. So, I don't get the sense there is some wild progressive agenda coming in terms of a green new deal for instance on deficit spending.

So, my guess is it'll be things that the other side, at least part of the Republican side can agree on, and so infrastructure is always the no-brainer if you will because every senator and congressman wants new bridges and new roads in their state, right? So very few will say no to infrastructure spending even if it increases the deficit. Whereas if it's on more politically divisive things then you get that. So, the Democrats don't have really that much time until the next midterm election. I hate to even already think about the midterms, but it's a pretty narrow timeframe and they probably get one shot to put through a big, bold plan and I think it will be on things that both sides can to some degree agree on.

So, I don't expect something totally controversial. I do expect it to be big because they want to make a point. And so I think generally it'll be the kind of things that the markets will welcome via the reflation trades, obviously infrastructure. Those are all inflation type of boosting programs, and so I do think that the current rotation towards value, away from growth will stay and we see it. Emerging markets are on fire.

The Russell 2000 value which is small-cap value, that's as far opposite from large-cap growth as you can get.

[18:35]

Voiceover:

So here we have the "Growth vs value" chart, tweeted the afternoon of January 11th

Jurrien Timmer: For months and months, it lagged so far behind and you can see in the chart the yellow line. It has completely caught up to the S&P. I'll tell you, six months ago not many people were expecting that, but yet here we are. So, this is a broad healthy tape.

If the Fed's going to keep financial conditions loose, which I think it will, and again, this is a big call to make because if you think the Fed is going to lean into this then it becomes a much more nuanced trade. It may not be a market where you hold on. But if the Fed is going to let this thing go, then the World War II 1940s playbook really comes into play here.

And we've talked about this many, many times where during the 1940s as the U.S. was preparing to enter World War 2, the Fed kept rates at 1%. It capped long rates and short rates. It increased its balance sheet tenfold, *tenfold*, completely absorbing all of the debt that the U.S. was incurring to pay for the war, and you could argue, that must have ended in disaster and it actually didn't. We did get a big inflation burst in the late 40s and we did get a 30% decline in the S&P, but it came after a very robust rally.

So, assuming that financial conditions are going to stay loose, emerging market certainly is a good play.

[20:04]

Voiceover

Next up from Jurrien's Twitter is the Secular "trends" chart from the afternoon of January 6th

Jurrien Timmer: What's interesting about the backdrop right now, you have this cyclical backdrop of value, small caps, cyclicals, non-U.S. all kind of taking centre stage away from the FANGs or the large-cap growth stocks which are now getting in some corners some bad PR because of what we're seeing happening in the political realm. In addition to the cyclical backdrop, you can see in this chart the secular backdrop, the structural backdrop is very compelling.

So, you see here in the bottom panel the ten-year compound annual growth rate, the CAGRs of stocks to commodities, growth to value, large to small, U.S. to non-U.S. and you can see since 2008 it's all been the same trade. I mean it's been one trade. Large-cap growth versus everything else, and when you look at how far we are away from the last cycle, so there's a clear long-term cycle in place, and how far we've deviated from zeros because these are growth rates, so they centre around the zero trend line. You can see that when you add the structural backdrop to the cyclical backdrop, you have some real opportunity here for this to be a lasting trade that will work not only for a few months but a few years.

[21:26]

Pamela Ritchie: I've got to ask and we're Canadian after all, we have to know about materials. I know there's something to say on there. The commodities have been on fire, certainly particular ones. Maybe you can comment on that. Within the cyclical trade though, we've also seen financials have quite a run which is a large part of a S&P/TSX. How much further do they have to go based on the inflation discussion?

Jurrien Timmer: I think they have some further to go. When I look at our internal notes from our analyst, the commodity space is really hot right now. And there's increasing talk of more capital spending, more capex happening – energy, materials, you name it. Again, in that last chart I showed commodities is part of that same story. So, you could be in for a multiyear trade here and even the financials. Financials of course is a very big part of the value side of the spectrum, and you're getting what we call a bear steepener on the bonds side. So, the Fed is keeping short rates at zero. You look at the Fed fund's forward curve which is the futures markets telling us where it thinks the Fed will be three, four, five years from now. Flat as a pancake. It's at zero as far as the eye can see which is something the Fed has basically confirmed. They're not even thinking of thinking of raising rates.

So, if the short end stays completely anchored at zero very much like it did back during the 40s, although back then it was anchored at one but still, it stayed completely constant for years. Then if the long end of the curve backs up as it's doing now and let's say we go from 1.1% to 1.5, which I don't think is too farfetched, that steep yield curve is very good for financials of course. And of course, then you get the rotation out of growth into value and you buy a

value index, you're going to buy financial. So, the commodities side and the financial side, even though you could argue that those are kind of strange bedfellows, they're both part of the same rotation away from large growth. And again, as I mentioned the structural backdrop suggests that, that trade could have some longevity.

[23:45]

Pamela Ritchie: This question has come in and I'm so curious, based on what you just said, how this fits, so discussions of bubbles, discussions of frothing in the growth side of the story. Does it just sort of have a gentle landing? Is there no bubble bursting? We just have this sort of rotation which on some level is a more gentle eventuality than perhaps anything else?

Jurrien Timmer: Well, that's a good question. There are two markets. I mean you look at Bitcoin, you look at some of the hot names like Tesla and some of these vehicles that are out there and the price action is crazy. Now we have $600 stimulus cheques and you go on Twitter or TikTok, they call them "stimmies." It's like, "How am I going to spend my stimmy? Am I going to buy Tesla or Bitcoin or this or that?"

[24:41]

Pamela Ritchie: Where is the ethics police in all of these conversations? Where are the ethics police?

Jurrien Timmer: Exactly.

Pamela Ritchie: Anyway.

Jurrien Timmer: I know. I know. Be that as it may, but that's one part of the market and there's clearly a lot of froth, a lot of speculation going on and that's not necessarily the high-flying tech names versus value. These people will buy anything that moves and they're buying it only because it moves. So, the market it's a non-denominational thing in terms of which style or sector, but there is definitely an element of speculation and froth there.

But then you look at most regular, traditional investors, older people who have some money saved up who are trying to retire off those savings. I don't think there's any froth or speculation going on among that group. A lot of those people unfortunately sold nine months ago. They're probably not back in and maybe eventually they will.

So, I'm not prepared to say that the market is in some bubble or mania because I don't think it is. I think parts of it are, but they are relatively smaller parts. And you think about interest rates rising, so if the bond yield goes up another 50 basis points, that is going to help financials, but it's going to hurt the large-cap tech names because those are what we call "long duration stories." So, the change in the discount rate that is used for the DCF model, the discounted cash flow model, so the rate that you use to discount future cash flows, when you have those steady long-term growers, changes in the discount rate matter a lot. So, you could see a lot of air coming out of the big tech names in terms of their valuation. They're not going to stop growing earnings, but their valuations could come down. And so, it could get wild in that sense but not on the surface level of the markets. We've talked about this before.

I think 2021 on the surface level, at the index level will be somewhat of a normal year in the same sense that 2020 was normal in terms of where the market ended. But it certainly wasn't normal in terms of getting to that end. I think 2021 could be similar and that rotation from growth to value it can get violent at times. But if your portfolio is in the right place and you're positioned for it, the only thing we can really do as investors is not to overreact to short-term movements.

[27:15]

Pamela Ritchie: How do we react to Bitcoin? Final question.

Jurrien Timmer: Bitcoin for the vast majority of people is a sideshow and the only thing that's going on for those people is FOMO. It's like, "Oh my gosh, someone is making all this money and I'm not part of it." A lot of people who buy it, buy it for that reason. I think the core holders, they're actually called "hoddlers," holding on for dear life, are in Bitcoin because it's almost like a religious belief. They don't believe in the system. They think the Fed is going to print its way into oblivion and they want to have that hedge. It requires somewhat of a leap of faith to go and say, "Something that I can't touch or see or feel is going to be an actual currency or a store of value." And you either believe it or you won't.

We'll talk about that in the future. But it goes up a lot, it goes down a lot, then it goes up a lot, but Bitcoin has been around for 11 years and three times in that 11 years it's gone done 80% to 90% only to then go to new highs. So, you need to have some pretty steely nerves and again, the hoddlers, the hold on for dear life, have enough of a belief that this is the future that they are able to hold on. But for the average momentum chaser those are the people that will get flushed out. Even today it's down 25% in like a day. Those people will get flushed out and then the whales, the large institutions, will come in and they'll swoop that up.

[28:54]

Pamela Ritchie: It'll be interesting to know what you think about the hold on for dear life if they create a floor and what that floor is. Anyway, more to discuss on that because Jurrien, you will join us on the 28th of January and we will dig deep into the future of digital currencies. Really looking forward to that special with you. Thank you for joining us today. Have a great week. Look forward to seeing you next.

Jurrien Timmer: All right. Thanks Pamela. Thanks everyone.

Ending: *[29 :18]*

Voiceover :

Thanks for listening to the FidelityConnects podcast. If you haven't done so already please subscribe to FidelityConnects on your podcast platform of choice - and if you like what you're hearing leave a review or a 5-star rating.

You can visit fidelity.ca for more information on future live webcasts - and don't forget to follow Fidelity Canada on Twitter. Thanks again, see you next time.

[end of podcast]

Commissions, trailing commissions, management fees, brokerage fees and expenses may be associated with investments in mutual funds and ETFs. Please read the mutual fund or ETF's prospectus, which contains detailed investment information, before investing. The indicated rates of return are historical annual compounded total returns for the period indicated including changes in unit value and reinvestment of distributions. The indicated rates of return do not take into account sales, redemption, distribution or option charges or income taxes payable by any unitholder that would have reduced returns. Mutual funds and ETFs are not guaranteed. Their values change frequently, and investors may experience a gain or a loss. Past performance may not be repeated.

If you buy other series of Fidelity funds, the performance will vary largely due to different fees and expenses. Investors who buy Series F pay investment management fees and expenses to Fidelity. Investors will also pay their dealer a fee for financial advice services in addition to the Series F fees charged by Fidelity.

Any reference to a company is for illustrative purposes only. It is not a recommendation to buy or sell, nor is it necessarily an indication of how the portfolio of any Fidelity Fund is invested. The breakdown of fund investments is presented to illustrate the way in which a fund may invest and may not be representative of a fund's current or future investment. A fund's investment may change at any time. Mutual Fund and ETF strategies and current holdings are subject to change.

The statements contained herein are based on information believed to be reliable and are provided for information purposes only. Where such information is based in whole or in part on information provided by third parties, we cannot guarantee that it is accurate, complete or current at all times. It does not provide investment, tax or legal advice, and is not an offer or solicitation to buy. Graphs and charts are used for illustrative purposes only and do not reflect future values or returns on investment of any fund or portfolio. Particular investment strategies should be evaluated according to an investor's investment objectives and tolerance for risk. Fidelity Investments Canada ULC and its affiliates and related entities are not liable for any errors or omissions in the information or for any loss or damage suffered.

From time to time a manager, analyst or other Fidelity employee may express views regarding a particular company, security, and industry or market sector. The views expressed by any such person are the views of only that individual as of the time expressed and do not necessarily represent the views of Fidelity or any other person in the Fidelity organization. Any such views are subject to change at any time, based upon markets and other conditions, and Fidelity disclaims any responsibility to update such views. These views may not be relied on as investment advice and, because investment decisions for a Fidelity Fund are based on numerous factors, may not be relied on as an indication of trading intent on behalf of any Fidelity Fund.

Certain Statements in this commentary may contain forward-looking statements ("FLS") that are predictive in nature and may include words such as "expects", "anticipates", "intends", "plans", "believes", "estimates" and similar forward-looking expressions or negative versions thereof. FLS are based on current expectations and projections about future general economic, political and relevant market factors, such as interest and assuming no changes to applicable tax or other laws or government regulation. Expectations and projections about future events are inherently subject to, among other things, risks and uncertainties, some of which may be unforeseeable and, accordingly, may prove to be incorrect at a future date. FLS are not guarantees of future performance, and actual events could differ materially from those expressed or implied in any FLS. A number of important factors can contribute to these digressions, including, but not limited to, general economic, political and market factors in North America and internationally, interest and foreign exchange rates, global equity and capital markets, business competition and catastrophic events. You should avoid placing any undue reliance on FLS. Further, there is no specific intentional of updating any FLS whether as a result of new information, future events or otherwise.