Fidelity Connects

The Global Marco View

Jurrien Timmer, Director of Global Macro

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.

Joining us again for his regular update is Fidelity's Director of Global Macro, Jurrien Timmer.

Jurrien will update us on the current state of the markets and share his insights into the ever popular reflation trade. Furthermore, Jurrien will dive into what the market is currently pricing in, why bond yields have been on the rise, and what to expect from commodities and emerging markets for the year ahead.

Jurrien explains to host Pamela Ritchie that the outperformance of emerging markets, the rotation of growth to value, and large to small caps - are all a part of the same narrative.

This podcast was recorded on February 16th, 2021, and Jurrien references some charts, so head to @ TimmerFidelity on Twitter to follow along – I'll direct you to the specific tweet.

[01:46]

Pamela Ritchie: Hello and welcome to Fidelity Connects. I'm Pamela Ritchie from a snowy Toronto here today. To help us make sense of the now and what to look for on the horizon, we're joined by Fidelity's director of global macro, Jurrien Timmer. Jurrien, great to see you.

Jurrien Timmer: Good morning and greetings from Boston. I'm back in the cold, although I hear it's not as snowy as it is in Toronto, but it's certainly snowier than in Santa Barbara.

Pamela Ritchie: What is it like there? What's the weather in Boston?

Jurrien Timmer: It's in the 30s, low 40s, rainy, snowy, grey, cold.

Pamela Ritchie: Glad to be inside kind of weather. Very glad to see you back in any case on our screens. Glad to have you here. Let's begin with the virus, maybe with the vaccine, with the solution. First of all, things seem to be going very well on the fight against the virus particularly in the United States.

Jurrien Timmer: There's certainly some good news to report there. I had resisted creating a bunch of COVID charts over the past year because I'm like, I'm not the health care expert, and there are charts that you could see anywhere, but I did create some last week just to highlight how big the improvement is.

Voiceover: This first slide, found @TimmerFidelity on Twitter, is "Covid-19 Cases and Vaccines" tweeted the afternoon of February 16th

[03:14]

Jurrien Timmer: This is an interesting series that I got from Bloomberg. The bars shows the percentage of hospital beds in the U.S. It's also available worldwide, but the U.S. is a pretty good proxy I think. The number of beds occupied in U.S. hospitals by COVID patients and about three weeks ago that was at almost 20%, and as of last week it had fallen to less than 11%. The number of beds occupied by COVID patients has been cut almost in half in less than a month. You can see the blue line is the cumulative number of COVID cases in the U.S., 27½ million, but you see the yellow line, number of vaccine shots given, so that over counts things a little bit because it's the number of shots, not the number of people, but you can see a parabolic rise there to 48 million. I think one out of every eight people is now vaccinated in the U.S., so really a dramatic improvement.

When you think about the narrative in the markets, we have this, then we go to the next slide,

Voiceover: And this is "Covid-19 and the Economy" chart also tweeted the afternoon of February 16th. This will be followed by the same chart but with the pink-purple overlay line showing the change in forward earnings growth estimates, that was tweeted at the same time, but is a different chart,

[04:34]

Jurrien Timmer: You can see this is the Bloomberg Daily Activity Index, this is for the U.S., but it's the same line really for Canada and the rest of the world. You can see we fell off a cliff a year ago, then we recovered, then we had that big third wave surge, and then the economy stalled out. We don't really see much improvement yet, but the idea is that at this point the economy is going to be able to reopen at least for a time, hopefully forever, and that you're going to see some improvement in there. If we go to the next slide, you can see that that improvement is already being discounted by the markets. Of course as we know, markets always discount the future, not always correctly, but they do always discount it. Here you see the purple line is the change in forward earnings growth estimates, and you can see that from the market's perspective, that line is back to where it was pre-COVID. In other words, the markets are expecting that the output gap that was created by the pandemic will be closed by basically the end of the year because this is the next 12 months, so in the next 12 months we're supposedly back to where we started.

When you add to this the amount of fiscal spending, the Biden administration is working on a $1.9 trillion stimulus plan that could very well be actually passed and enacted by the end of the first quarter, and that's 1.9 trillion. When you add that to the other stimulus or relief packages that has happened over the past 11 months, we're looking at over $5 trillion of fiscal relief, and that's not even counting the next iteration which will be the Build Back Better, I forget what the term is, but that could be another $4 trillion on top of that. That could happen before the end of the year. When you add these things up, you have a narrative of the economy essentially booming in the second half of the year 'cause people are going to have money to spend, the economy presumably will reopen, hopefully herd immunity will have been reached by the middle of the year, and you're going to have an economy that's going to run hot and create some inflation. No matter where you look in the markets you're seeing that narrative come to life, whether it's with rising yields or the value rotation, etc., etc.

[06:59]

Pamela Ritchie: Let's talk about rising yields. You actually have a couple of different reasons why we would see yields rise. As you say, the outlook is looking strong for the second half, why are bond yields rising right now?

Jurrien Timmer: They're rising for now for the right reason. Let me explain that.

Voiceover: To follow along here, look at the "Nominal and Real Rates" chart tweeted the afternoon of February 9th

[07:26]

Jurrien Timmer: From the Fed's perspective, from the market's respective, from the reflationary narrative perspective, the fact that yields are rising is a good sign because that means that things are getting better, right? You don't want yields falling because that means you're in a deflationary shock. Rising yields is part of the reflation trade, but they need to be rising because inflation expectations are rising, not because real yields are rising.

You remember back, this is almost 10 years ago now, but 2013 when we had the famous taper tantrum, that was sparked by a rise in real yields because the Fed was going to taper asset purchases at the time even though the economy was not running hot or inflation was not a threat. The market saw that as a negative signal. Right now, real yields are actually still comfortably negative and even falling if you look at the 5-year real yield, which we can talk about in a second, so real yields are comfortably negative. Inflation expectations, which is the blue line here, are rising, and nominal yields are rising, and that is the right combination of outcomes from the reflationary narrative. My sense is that the Fed is not too concerned about yields rising because they're rising for the right reason as opposed to a very contractionary deflationary reason which would be in real yields.

Really, the big question is, will the Fed at some point try to lean into this by trying to suppress yields, or will it actually take the punch bowl away which is what the Fed normally would do when it sees the economy is going to run hot. I don't think either is likely right now.

Voiceover: Next up is the tweet, "the Fed vs the Market" from the morning of February 10th

[09:16]

Jurrien Timmer: You can see this interesting disconnect between the rise in nominal yields, which is the light blue line, and the flatness of the Fed Funds futures curve, which is essentially a reflection of forward guidance by the Fed, which basically is as flat as a pancake. Normally the 10-year yield would be a reflection of expected interest rates. It would be an expression of the forward curve and that's not happening. It's another way of showing that the rise in yields is entirely the function of rising inflation expectations, not a change in policy. Again, that's a very important distinction to make.

[09:55]

Pamela Ritchie: Let's move now to reflation, to cyclicals and in this point to commodities. Is the global growth story an in-concert story that sees commodities rise? Is that how you look at this?

Jurrien Timmer: Yes. Rallying commodities and the Bloomberg Commodities Index is making new recovery highs as we speak. Again, it's the same trade as rising bond yields, rising inflation expectations, the outperformance of emerging markets and other non-U.S. assets, the rotation from growth to value, large to small, all the same narrative, so this chart here,

Voiceover: Here we have "Liquidity and Valuation" also from the afternoon of February 9th, which will be followed by "Style Rotation and the Earnings Cycle" from the afternoon of the 12th

[10:48]

Jurrien Timmer: the top is the P/E ratio for the S&P 500 and you see how elevated the P/E is, obviously it's a common complaint to point out that the market is very richly priced. Part of that is the consequence of the mismatch between when price bottoms during an early-cycle recovery and when earnings bottom, so we're still in that. Earnings are only now really starting to come up and price bottomed almost a year ago.

The other part of it is the policy response. If you look at the bottom panel, you see the output gap in the grey, and you see the excess liquidity, so money supply growth minus GDP growth, in the yellow. Normally the jaws kind of open during a shock because the policy response is trying to build a bridge to the other side of whatever the crisis is. On the left hand of the chart you see the financial crisis, on the right hand is the pandemic, and as things get better, as that output gap closes, the jaws close because at that point the policy response is no longer needed. This is the narrative of the Fed typically taking the punch bowl away as ongoing accommodation is no longer needed.

But that's not what's happening now. Not only is the Fed not about to take the punch bowl away anytime soon, maybe it's even spiking it further, but on top of that we're getting even more fiscal stimulus, another 1.9 trillion or something approaching that number, possibly in the next month. So that ongoing gap, I think bodes very well for the reflation and potentially inflation trade. If we go to the next slide you can see that same bottom panel, but then on the top you see the year-over-year change in the excess return between growth and value, and large-caps and small-caps. You see that small-caps have been on fire now for a number of months. That's the dark blue line, and value to growth is still lagging behind, but they're all moving in that same direction.

What I don't show here on this chart is emerging markets. Again, very, very strong tape there. The excess return, the year-over-year excess return running at 12 percentage points, the EM is outperforming the S&P by 12 percentage points on a year-over-year basis. Again, all part of the same narrative, and I think it has some legs.

As we talked about the dollar, the dollar is very much part of that. The dollar does need to weaken for this to happen, but this is an all systems go type of market. The earnings growth side, that is a global thing. Emerging markets earnings are recovering faster than almost any other region in the world. So it remains a very bullish story.

[13:47]

Pamela Ritchie: Let's talk a bit about oil. Oil's been hitting at 60, sitting at 60. People didn't think this possible, certainly not back in April. We watched the ETF just tank and go into negative territory, but here it is. What do you make of that price level, the sustainability of it? You can bring in the Texas situation right now. It's part of a story. How do you see oil being sustained at these levels?

Jurrien Timmer: If you want to get technical about it, oil went from -40 last May, it was there for a few seconds, to +60. That's $100 per barrel move. It's pretty amazing. Obviously, there's a story right now. Millions of people out of power in Texas, this big freeze and the snow, it's probably the same storm that you guys got in Toronto maybe, I'm not sure. So there is obviously a short-term catalyst for that. Oil production is now 2 million barrels a day less than it normally is because, obviously, Texas is a hub for oil production. That will be resolved, things will get normal although all the people that were complaining about folks leaving California to go to Texas, maybe they'll have second thoughts now seeing that Texas is in a deep freeze.

It's not just oil. It's the grains, really all parts of the commodity spectrum with the exception of precious metals right now, although I think that's temporary, are basically on fire. Commodities is a tough asset class 'cause when you rank it on the efficient frontier over a 50-year time span, it doesn't rank very well because it has lots of volatility. There are no gains to compound like you do in equities. So it works from time to time, but for short periods of time, and you need to be very tactical because it's kind of an active allocation, not a strategic one. But right now is exactly the moment in time where it's working, and I do think it will continue to work. The big question is, will we actually get the inflation that the market is now starting to price in? The Fed has not seen its inflation target met in over 10 years. We have kind of a running joke in our shop saying that, if the current set of conditions, the COVID curve falling, more fiscal, ongoing Fed accommodation, a reopening of the economy, people sitting flush with stimulus cheques, if that doesn't create inflation, then maybe nothing ever will. So we'll see if that actually becomes a story in the second half of the year. My guess is that it will, but it'll be a cyclical story and maybe not a structural story. But that chapter remains, it has not been written yet.

[16:48]

Pamela Ritchie: I want to ask you about the significance of what's going on in Texas right now, apart from the fact that it's obviously a dreadful situation for those who are freezing. It is not a joke not having your heating and not being able to deal with it. From an investment perspective, what is the significance of this right now? There's a discussion that wind had been part of what's input into the grid. Is it a failure of, or fragility of new types of energy that we need to look at? Is there a transition story? Does the price of oil just go up from here? What do you look for in terms of significance?

Jurrien Timmer: I don't think beyond, obviously, the short-term impact on the economy, and certainly on people who are in their homes and it's 45 degrees inside. Not taking away from that, but this would be your typical natural disaster playbook. There's a tornado somewhere or an earthquake, but they tend to be short term. As long as one of these occurrences does not have a lasting systemic impact on the economy, which presumably this would not. Maybe by next week we're back to 70 degrees over there. I don't know what the weather forecast is. I would think that the market would look past this. Yes, there's a short-term shortage in oil production that boosts the price of oil. It's probably going to change. The difference between West Texas and other sources of oil, there's a lot of really technical things going on in the energy market, but ultimately I don't think it will really have a lasting impact on the economy.

[18:27]

Pamela Ritchie: That's great to hear. Sometimes things are noisy and you wonder which angle they're going to look at this from. I want to go back to something I feel like we haven't spoken about in a while which is share buybacks, and what is being seen for investors on that front and how it fits into the valuation story.

Voiceover: This chart here is from the morning of February 12th - "Announced Share Buybacks"

[18:51]

Jurrien Timmer: This is a big component of the valuation story. We've talked about this many, many times. We know that the earnings picture is panning out. Fourth quarter earnings season, a big success just like the second and third quarters were. We started at a -9% earnings growth estimate at the beginning of earnings season. We're now at +5%, so that's a 1,600 basis point turnaround, very similar to previous quarters. The earnings story is right there, it's an important part of the puzzle because valuations are rich, interest rates are rising, the equity risk premium is already very low at 3% right now, so you need positive earnings revisions to help paint a bullish story for the market, otherwise the other pieces of the puzzle are not going to work in your favour. Fortunately, as high as earnings estimates already are for 2021 and 2022, they are being increased as we speak because companies are guiding higher and analysts are upgrading the earnings revisions. So that's a very important part of the bullish narrative. The other one is what you see here in this chart. This is the year-to-date progression of announced share buybacks. The black line is 2021, only five weeks of data, but it's running at a good clip. It's what we want to see.

Remember, for the valuation piece of the puzzle what the market cares about or what investors care about is earnings growth, they care about the discount rate, which is the sum of the 10-year treasury and the equity risk premium. So earnings growth is strong, but the discount rate is rising. Then you have to look at what we call the payout ratio, which is the share of earnings being returned directly via dividends or indirectly via buybacks to shareholders. So the buybacks are an important piece of that puzzle. For the U.S., the payout ratio has been running at around 90%, which is much higher than anywhere else in the world because the U.S. has this buyback, this shareholder-friendly culture which Europe and Japan have less so, so there they have to rely on dividends, here it's dividends and buybacks. So the good part of the story is that buybacks are running at a good enough clip to be able to maintain that 90% payout ratio which means that valuations, even though they're very high, can probably be sustained at these levels.

[21:28]

Pamela Ritchie: Quick question here. Global versus U.S. Based on what you just said about share buybacks, your U.S. dollar thesis, how do you look at that?

Jurrien Timmer: Global versus U.S., there's a valuation gap and there has been for a long time. That valuation gap has to do with the S&P 500 being more of a new economy index with tech stocks, etc., and Europe and Japan more old economy. More banks, more value. There is that gap and that will likely remain in place, and the buybacks are part of that. But there's the cyclical recovery story and then there's the dollar story. So the cyclical recovery story feeds into the value-to-rotation which then favours Europe and Japan as well as EM, and the weaker dollar story obviously creates currency translation effects. I do think Europe and Japan, I would lump them in with EM from that perspective, but the EM chart looks just super, super compelling. But you could be just ex-U.S. at a broader level and probably get a good outcome the same way.

[22:39]

Pamela Ritchie: Such a pleasure to speak with you. Welcome back to Boston. We'll see you again next week. Thank you, Jurrien Timmer.

Jurrien Timmer: Thanks Pamela.

Pamela Ritchie: All the best.

Ending: [22:49]

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