Fidelity Connects

The Global Macro 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.

In today's episode we again feature Director of Global Macro, Jurrien Timmer. Jurrien provides his global macro and markets update, taking a closer look at investors' response to COVID-19 and other factors influencing market expectations and reactions.

Jurrien and host Pamela Ritchie look at how investors may be re-thinking the traditional 60/40 portfolio, as well as discussing the 10-year U.S. Treasury Yield, and how the FED is responding. Jurrien also looks at oil, energy, and other commodities, noting we've been in the 45 – 65 dollar range for oil for a while now, and will likely stay there.

Jurrien also has a few slides so head to @TimmerFidelity on Twitter to follow along.

This podcast was recorded on February 22, 2021.

[01:46]

Pamela Ritchie: Can we begin with where are the bears and the deficit hawks at this point? Where do they live right now?

Jurrien Timmer: We used to have a term for these folks. They were called bond vigilantes. They've been in hibernation for a while, but they're back and they're pushing yields up. The 10-year U.S. yield is pretty much round trip to where it was pre-pandemic, maybe a little bit higher even. What we're seeing, and we talked about this last week, but we have a dramatic improvement in the COVID curve. Number of hospital beds occupied by COVID patients has gone from almost 20% a month ago to now something like 8%, really a shockingly good, in a good way improvement. Some 62 million vaccine shots have been administered in the U.S., obviously globally much more, and so that's all really, really good news. Things are getting better. Economies are going to be able to reopen with precautions and all of that stuff, but at the same time we're about to get another $1.9 trillion or thereabouts of fiscal stimulus from the Biden administration and that could happen as soon as next month. So that puts the total since the pandemic started to over 5 trillion. Remember, that's still the 2020 reconciliation process. The 2021 reconciliation process will start literally the day after this next bill will get passed. That's the Build Better Back or Build Back Better, I can never remember which sequence it is, but that's another 4 trillion of which 2 trillion will be offset by taxes. But still it's a lot of fiscal, and what it all means is that the economy, at least in the U.S., but certainly elsewhere, in the second half will be running pretty hot, and there will be some inflation.

Whether it's cyclical inflation or structural is something we can talk about later, but the stock market reflects this, the commodities markets reflect this, the rotation from growth to value, large to small, this whole reflation is reflected by all asset classes. But until maybe a month ago it was not reflected by the bond side which, with the 10-year yield remaining very comfortably below 1%, and now all of a sudden that's woken up.

[04:18]

Voiceover: So this first chart here is titled "US Bond Market" and was tweeted the afternoon of February 10th

Jurrien Timmer: You can see my very simple bond model. I'm not a quant. I don't play one on TV, but I know how to run a regression in Excel. This chart shows just that the bond yield tends to be a function of two things, nominal GDP and monetary policy, so the forward curve in the money markets. You can see that a year ago we were at the bottom of what I would call the fair value range, which is about ½% to 2% on the 10-year yield, and now we're past the midway part and maybe, I don't know, we're going to go all the way to the top, but I think generally there's a sense that maybe we'll test the top end of the range which would be about 1.9, 2%.

In a way this makes perfect sense because everything else has already reverted back to expecting recovery. The bond market was really the lone handout and here the nuance of what's driving the rise in yields is really super important. Until a week or two ago it was entirely the function of rising inflation expectations, and market participants, the Fed, would all, I think, agree that if interest rates are rising because of rising inflation expectations, but not rising real yields, then that's a pretty benign thing for the markets, for monetary policy. But if real yields are driving a rise in nominal yields, that's a whole different can of worms. It brings us back to the taper tantrum from 2013 where we saw a very sudden move higher in real yields by 150 basis points over six weeks and that was very damaging to the prospects for the economy.

So that, I think, is what the markets are really focused on here. In the last week or so real yields did start to perk up, not by a ton, maybe 20 basis points, which is not the end of the world by any means, but this is why we're seeing now some pressure on the stock market, especially on the big growers and on gold, for instance, and even you could say on Bitcoin, which is moving a little bit lower today. That's really kind of how this whole puzzle fits together.

[06:40]

Pamela Ritchie: And there's so many great pieces within the puzzle to talk about. I kind of had this image of Jay Powell needing to use a broom to beat back the bond vigilantes. How will he manage that? That is not what he wants to see, is it? He does not want to see something that gets out of control that he then has to act.

Jurrien Timmer: Exactly. That's going to be the next move in this chess game if you can call it that, or the next piece of the puzzle, is to see how the Fed responds to this. If we tee up the next slide

[07:14]

Voiceover: And this one is "The Fed vs the Market" tweeted the morning of February 19th

Jurrien Timmer: This is going to be really interesting to watch. Normally when you have a lot of fiscal spending, and you have an economy that's going to go from having a negative output gap to possibly closing that output gap and maybe even running hot for a while, the Fed would normally lean against that and taper asset purchases and create some forward guidance about when it's going to raise rates again. That's what happened with the taper tantrum, that's what happened during the Trump tax cuts back in 2017, 2018, and that's what normally would happen now. But I don't think that's what we're going to see because the unemployment rate is still about two percentage points above what's called the natural rate of unemployment. It used to be called NAIRU, but now it's called something else. I think both the Treasury and the Fed, even though they probably wouldn't state this explicitly, I think both the Fed and the Treasury are running policy kind of through an ESG type lens where they want to bring everybody back in and that's going to force them to keep policy very, very loose for quite a while.

We have this discrepancy now with the yield going up from ½% to almost 1.4% now. But that dark blue line, which is the Fed Fund's forward curve, remains very, very flat, and generally that curve will be driven by the Fed setting expectations through … remember it's the dot plot and all this other stuff. So the Fed is going to need to keep that curve as flat as can be by promising to not tighten policy and basically by convincing the bond vigilantes to go back to their caves. The question is whether the bond market will listen to that and whether the Fed can just do that through sooth-saying and jaw-boning, or whether the Fed will need to do actually something more concrete like yield curve control or going back to the 1940s analog that we've discussed so many times, doing some sort of interest rate cap where it buys up the bonds if rates go beyond a certain threshold.

We don't have the answers to this yet. I'm sure the Fed will want to do this through words only if possible, but the market will need to listen because if rates rise further, let's say towards 2%, and it is driven by real yields going up instead of inflation expectations going up, it's going to be a problem for the markets, maybe even for the economy. Again, our debt-to-GDP here in the U.S. is under 25% and going higher, much higher, and nobody can afford higher real rates because the way to get out of debt, when you look at debt-to-GDP ratio is to get GDP up, and so the debt stock is fixed when you issue the debt. But GDP is a function of real economic growth and inflation, and real growth is going to be harder to get because of the demographic overhang that we have. So if you're going to get out of debt it has to come from inflation, or if inflation doesn't happen, at least negative real rates. That is the way to inflate your way out in order to keep debt service costs low.

So both the Treasury and the Fed are going to have to make sure that happens otherwise the U.S., or any country, will drown in debt because the debt stock is so high.

[10:48]

Pamela Ritchie: Yes. I mean, the issuance just continues. It's fascinating to look at all this. There's a couple of questions coming in. Let's start with commodities. This particular question is about what we're looking for with copper, with the copper/gold ratio particularly. Can we move into U.S. dollar, gold, copper discussions here?

Jurrien Timmer: The commodity complex is absolutely on fire. We're hearing this in our analyst meetings. The commodity producers are all seeing tons of pricing power, and it makes sense because that's just one part of the narrative that we've been talking about for a few months, this whole reflation narrative. It's part of the rotation from growth to value, from large to small. We've shown charts in the past where we look at the structural backdrop for this rotation and that it's all been one trade. It's been U.S. large-cap growth stocks on one side for the last 11 years and value, commodities, small-caps, non-U.S. stocks all on the other side, and that rotation is happening, and it would make sense for commodities to be part of that. I've shown charts, and maybe next week we'll bring that in, of the commodity super-cycle and how we're exactly at that point in time where not only cyclically there might be a turn, but secularly or structurally there might be a turn. So this is all playing out really nicely if you're a chartist because the charts were telling us this basically 6 months, even 9 or 12 months ago.

[12:20]

Pamela Ritchie: Let me ask a question. Does China need commodities right now? What sparked the last one … many will argue that commodity super-cycles have to have 20 years in between and some say, no, 10 is fine. I don't know where it lands, but certainly demand from China was what drove the last one. Does China need more? How do you view that?

Jurrien Timmer: I think it's less a China story and just more of a supply story. In the last 20, 30 years whenever China opened the floodgates of policy stimulus to build another city or another airport it was all very infrastructure, direct-investment related, so the commodity side would be a direct play on that. As China has evolved and has become more of a mature economy, the incremental policy changes are less about building stuff and more about creating new economies and creating better consumer outcomes, etc. I think it's less of a China story, but it is a global growth story and at the same time supplies have dwindled. We've seen this in energy, obviously energy has its own unique story with Texas, but during COVID energy demand plummeted because nobody was going anywhere anymore, and these fracking wells, once you turn them off they're hard to turn back on. So you do have that supply/demand curve that now has to start up again. Same with copper and other industrial metals.

There is a whole new cycle underway, but for me the question is cyclical versus secular and the same conversation is true about inflation. We know there's going to be cyclical inflation even for no other reason than just the base effect of all the deflationary pressures from the pandemic. We know that inventories have been drawdown because supply chains have been disrupted. So it's a given that inflation is going to happen cyclically, but whether those expectations get entrenched enough to create structural inflation like we saw in the 1970s, it's a whole different story.

We've talked about Japan. Japan has been down this road bigger than the Fed is doing, and they have no inflation there. But again, this is where Fed policy comes in because if the Fed tells the market even if inflation happens we're not going to tighten, which is what they would need to do in order to replicate the 1940s analog where real rates go sharply negative, they do run the risk that those inflation expectations then become so entrenched that people start changing their behaviour and it becomes structural. But that's another conversation for another time.

[15:14]

Pamela Ritchie: But as you say, one that you watch closely to see which type of inflation, which type of durability we're talking about. Just to go back to energy and to oil, you layered on the whole discussion of Texas and the disruptions that are there, the backdrop of basically oil fields that have been switched off and what it takes to get those back online. The difference between oil and other commodities appears to be … or the constraints on the price … appear to be that there is an energy transition coming and therefore oil demand will surge for a period of time, but there might be a cap there. That's sort of one of the discussions. Whereas copper could be used in EVs for the next 100 years. There seems to be … the question is how do you see the oil price proceeding?

Jurrien Timmer: By the way, before I answer that, that speaks to an interesting divergence between gold and silver because silver is used in a lot of these technologies and gold is a little bit, but not as much. The chart for gold looks like hell right now because of the fact that real rates are becoming less negative, but the chart for silver actually looks pretty good because there's a whole other story line there. For energy, we've been in the range of 45 to 65, and I think we'll probably stay there because that incremental demand from emerging markets becoming more mature, and the marginal growth all going to fossil fuels because of transportation, I think that story changes with renewable energy. At the same time you have that supply response that if oil prices go down too far, wells get shut down, but if they go up too far, wells open back up. It doesn't happen for every dollar per barrel but a $20 move will certainly get people motivated to get the financing needed to turn these wells back on.

I doubt we're going to move much beyond that range, and we're kind of on the higher end of the range right now. The Texas story is like a natural disaster story that we've seen everywhere else. They tend to be temporary, so I don't think there will be a lasting move. I think the whole climate aspect of this with renewables, and better batteries and electric vehicles, I think that's obviously a very big structural move.

[17:46]

Pamela Ritchie: Can we talk a little bit about fund flows, savings rates, some thoughts on that? Where money has gone into and maybe some surprises along the way.

Jurrien Timmer: Everyone has been talking about Reddit, and Robinhood and GameStop and all of that stuff. When you look at the actual market performance, it seems that that week where GameStop was happening was kind of a one and done. So markets have returned to normal. It wasn't the start of some systemic contagion where every short position in the world would get shaken out. That didn't happen. The Reddit revolutionaries are still out there and there's hundreds of thousands of them, but they have small positions and those positions have probably gotten smaller since GameStop happened. Remember, for every person that squeezed that GameStop short and made enough money to, whatever, buy a house, there's probably just as many people who bought GameStop at the high with borrowed money and are now down 90%. So there's always two sides of the story. You're just not going to hear about the latter group on Twitter because the people who talk about this are … it's like anything with social media, you're only going to see people's best side on Facebook, or on Twitter or wherever.

I think that part is kind of done here, but there's a whole other side. That is just investors who are watching this episode right now who are saving for retirement by buying funds, or ETFs or individual securities or they are intermediaries, fiduciaries who are doing it for their clients. From that perspective, I don't really see any signs of a bubble. If we look up the chart

[19:40]

Voiceover: And this chart here was tweeted the afternoon of February 24th, titled "Fund Flows"

Jurrien Timmer: You can see that mountain of cash last year, that's the top line, those are assets in money market fund, mutual funds in the U.S. About $1.1 trillion was added to money market mutual funds in March of last year. So that was the mountain, the wall of cash that we've talked about so many times. That wall has been coming down, but it hasn't, as you can see in the bottom panel, which is the difference just from last February, the wall hasn't completely come down. It's still about half there, so people have not withdrawn all of the cash that they put in, and on top of that when you look at the yellow and the blue line where those proceeds have gone, they've actually gone more into bond funds than into equity funds.

So to me that is not the sign of some speculative frenzy where people are just buying stocks in a rampant way; they're actually buying more bonds. If we can take this one step more, if we measure the cumulative flow since the financial crisis, because that was a very big change in terms of sentiment, people not trusting equities, people buying bonds because that was the beginning of the QE era, and so investors were basically paid to buy bonds because they knew the Fed was going to buy them as well. When you look at the whole cumulative arc of bond flows and equity flows, we're basically at a net kind of almost zero cumulative flow from 11 years ago. 133 billion has gone into equity funds since March of 2009, and $3 trillion has gone into bond funds. So if you want to point at a bubble, look at the bond market not the stock market.

So when I look at the totality of sentiment the Reddit crowd is a portion of that, but where the real money is being moved I don't see any sign of a bubble, and so I think therefore the bull market is sustainable. If we get some inflation, generally speaking P/E ratios are inversely correlated to the inflation rate, so if we get a lot of inflation and its structural, P/Es will come down and that will be a headwind to the stock market. But inflation would have to go up a lot for a long time for that to happen because, in the 2 to 4% inflation area that's the sweet spot for the stock market, and then if inflation goes up or if it goes into deflation, the P/Es come down. So inflation would have to go well north of 4% for the market, I think, to be vulnerable here. But again, we go back to the real rate story, the real rate story is really the linchpin here.

[22:40]

Pamela Ritchie: And with that in mind, two questions, both of these coming in from investors. One, does 60/40 need to be rethought anymore from what you're saying, and also is this the time to take a look at TIPS or the Canadian version of that which is Real [audio cuts out]?

Jurrien Timmer: I think 60/40 is good unless what I just described happens, which is that inflation would become structural and it would go well north of comfort levels. In that scenario we kind of go back to the '60s and '70s where the correlation between stocks and bonds was the opposite of where it has been over the past 20 years, and in that scenario bonds no longer offer diversification against stocks. Then you have to look at other asset classes, gold, Bitcoin is one of them, TIPS, commodities, credit. It's a little premature to make that leap that we're going to go there, but that certainly would be an important thing to watch. As far as TIPS, I think actually, if nominal yields rise further from here and they go towards 2%, that upper band, I would be more inclined to buy nominal bonds than TIPS. Remember, TIPS break-evens have already gone up a lot. That doesn't mean they can't go up more, they may very well do that, and I think TIPS are an essential diversifier in a 60/40 portfolio from the 40 part of course. But I would be more interested in actually buying nominal duration if yields keep pushing higher because at some point the Fed's going to have to lean into that.

[24:19]

Pamela Ritchie: So interesting to watch the flags on that. There is more to discuss, but we will leave it there for today. Jurrien Timmer, thank you very, very much. We'll see you again next week.

Jurrien Timmer: Thank you.

Pamela Ritchie: Thank you, Jurrien Timmer for joining us.

Ending: [24:35]

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