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

Investors are watching for signals on what President Biden's first 100-days' agenda will look like. Today we will discuss what the outlooks are for the economy, markets, company balance sheets and earnings. To help us navigate these questions we are joined again by Director of Global Macro, Jurrien Timmer.

Jurrien provides his global macro and markets update on a weekly basis – today's recorded on January 18, 2021.

Today Jurrien and host Pamela Ritchie will also look at the fiscal and monetary stimulus causing a weakening of the US dollar, the ongoing growth vs. value discussion, and the outlook for gold.

For more from Jurrien, head to @TimmerFidelity on Twitter

[01:03]

[01:46]

Pamela Ritchie: Jurrien, great to see you. Thank you for joining us on a holiday in the United States. Very kind of you.

Jurrien Timmer: Nice to see you too, Pamela.

Pamela Ritchie: I'm going to jump right in with the macro which fits exactly what you can walk us through here. Janet Yellen who's the Treasury Secretary nominee is going to be speaking tomorrow and addressing the dollar question. It's obviously a huge question for investors, what might she say, what are people lining up to hear? Can you fill us in?

Jurrien Timmer: So, It's going to be very interesting to see how Janet Yellen, what her priorities will be. Obviously, Joe Biden announced a $1.9 trillion additional fiscal plan and now that there is a blue wave, or at least a blue wavelet, that should, at least in part if not entirely, get passed. The dollar has been weakening which I think makes sense because the U.S. has been kind of on the forefront of doing lots of fiscal policy coordinated with monetary policy. I think that will continue. When I speak to my colleagues over in the global asset allocation, that's one of the big questions. We're going to get this fiscal wave now that we have a blue wave. We have a former central banker at the Treasury shortly. Her and Jay Powell at the Fed are kindred spirits if you will. They are not afraid to push buttons that will get things done.

Really, one of the big questions is to what degree, if any, will the Powell Fed lean into the fiscal wave that presumably is coming fairly soon as Joe Biden takes over as president. My sense is that he will not lean into it. He will keep policy very accommodative. He's not going to want to risk a taper tantrum as we called it back in 2013 when the Fed wanted to get out of the QE business, but the market wouldn't let him. My guess is that the Fed will stay very accommodative, they will not raise rates for quite a while, they will not even taper asset purchases.

They really can't do that because, if the fiscal wave is coming, there's going to be lots and lots of issuance coming that needs to be bought by someone. That someone is likely going to be the Fed.

I think that is the more important dynamic. The dollar, Janet Yellen said something kind of cryptic about a dollar regime, but basically that's really all you need to know. Central banks can manipulate interest rates, but currencies are kind of the final frontier, the last frontier of markets that are too big to manipulate. Governments can do interventions but those don't really work very long. The market's so big that it would require tremendous resources to manipulate a currency. But they don't really need to. Everyone wants a weaker currency because everyone has a lot of debt, and we just need a weaker currency when that happens. With the Fed and the Treasury, kind of kindred spirits if you will, starting in a few days, my sense is that the level of coordination, whether it's overt or more intuitive, will continue and that will continue to drive the dollar down, which is very much part of the reflation playbook which includes non-U.S. markets outperforming U.S. markets.

[05:29]

Pamela Ritchie: We'll get into that further. This term though, I'm just sort of curious for investors hearing it 'cause I feel like we're going to hear it a lot. I wrote it down, market-based dollar approach. When we hear that we just sort of look at the chart and don't worry about it, is that essentially … 'cause I think we're going to hear that.

Jurrien Timmer: Yeah. I'm not sure what it means but I think it doesn't mean anything. It sounds like a fancy word, but if you're letting market forces determine the currency, that's what always happens. Like I said, you can manipulate a lot of assets, but you can't manipulate the currency. If we end up getting some inflation in the U.S. because we've got this fiscal wave that the Fed presumably, and this is just my own presumption, that the Fed will not fight, they will not tighten into that to offset its potentially inflationary effects. If that's the regime we're going into for the next few years, that will push real rates to further negative levels, because if the Fed's anchoring nominal rates near zero, which I think is what's happening, and inflation expectations go up and somehow they can, through forward guidance, keep nominal rates down, then you will get increasingly negative real rates. And if the U.S. wins that battle, that race to the bottom if you will, because everyone wants that outcome 'cause everyone has too much debt and too slow growth, then the dollar should continue to come down because the dollar ultimately is reflective of interest rate differentials, and with rates everywhere near zero, really the real rate differential becomes what drives it. It also drives gold and Bitcoin and it's part of the … you can weave that into the entire reflation narrative.

[07:16]

Pamela Ritchie: It's like first-year philosophy, just say U.S. dollar, you go, right! It's like saying Plato. Oh, it all fits back. Let's talk a little bit about earnings in a minute, but I just want to sort of, to an extent there's an elephant in the room which is this week of hand-off, the exchange of power, the transition and so on, what do investors need to know if anything? What are you looking for? Are there risks that people need to be overly concerned about? How do you trade this week?

Jurrien Timmer: It's been eerily quiet in Washington which is a nice thing, but also there is still a few hours on the clock, so I think we're all kind of keeping our fingers crossed that there won't be something happening. My guess is other than maybe some last-minute pardons maybe that will be the end of it. If it is a peaceful transition of power, which we all hope and now expect that it will, then it really does not become a market-moving event. What I do think, and this is more of a hunch than something that is scientifically derived, is in the same way that back in 2008 during the financial crisis, or following the financial crisis, we had an election and President Obama was elected and he came into office January 2009. That was right as the financial crisis was bottoming, right as the Fed was really starting to do a lot of QE. So, Obama had these big tailwinds helping him in the first months and years of his administration. I think Biden will get the same thing because we all know that COVID is everywhere, the case count is enormous. I think in the U.S. we're approaching 400,000 deaths now, but everyone is in lockdown so that wave should be cresting at some point because it does go in waves.

At the same time, we have vaccines getting rolled out and then Joe Biden will obviously make this a huge priority and he's going to throw all the resources at this and it will be very meticulously centrally planned which, of course, the vaccine rollout has not been. It's been all just sort of left to the states, so it's been a little chaotic. When all of a sudden you get this centrally focused plan of vaccines, testing, masking and it's much more coordinated at a time when this giant wave of COVID cases probably will start cresting anyway. That combination could create a lot of positive momentum in terms of oh, my god, maybe we're finally getting past this and hopefully in a fairly rapid way. So that could really boost investor sentiment, it would boost sentiment regardless, but certainly investor sentiment, and it should lead to an ongoing rotation to value and small-caps and even commodities, emerging markets, anything that is part of that reflation trade. Because if the economy can reopen faster, fuller and we get to herd immunity faster, then I think that … in some ways that's already priced in, but I think there would be a big confidence boost coming out of it when finally you see every morning headlines and you see the task force, or whatever it's going to be called, doing press briefings to say, okay, we tested so many people, we administered so many vaccines. I think that would be a tremendous boost of confidence because we haven't seen anything like that for months.

[10:59]

Pamela Ritchie: So interesting to see where it all perhaps meets in a different version of a perfect storm perhaps. Lots of questions rolling in here. I just want to get to earnings because it points to growth, it actually points to the virus conversation as well. Obviously companies getting back to [inaudible], what are you expecting? Lots of earnings to come out over the next week or two.

[11:23]

Voiceover:

So to follow along with the chart Jurrien is describing head to @ Timmer Fidelity on Twitter and look for the "Earnings estimate progression" chart, tweeted on January 20th in the morning

Jurrien Timmer: So, earnings season just started, I think 29 companies have reported so that's very small percentage out of the S&P 500. So far 96% of them are beating estimates by about 33 percentage points which is an enormous beat. But that's to be expected because, as you can see, these are the squiggles, the progression of earnings expectations going into earnings season which is that vertical line there. You can see normally the levels trough right at the beginnings of earnings season and then they start to recover. But this has been a pandemic and so the last couple of quarters including this one, there really hasn't been that normal track of earnings estimates coming down and then going up because companies are not giving guidance. So that blue line which is the Q4 number which is now being reported has been basically flatlining for the last nine months or so. And so the line doesn't really mean much, but it does suggest we're going to see a very large bounce because the high-frequency economic indicators have been generally recovering, but these earnings estimates have not and that's just because analysts are not really getting any information from companies that will help them adjust their expectation.

So, my guess is that earnings season will be strong and that the entire year will be negative. I think at the worst point in the second quarter the expectations were that earnings growth for 2020 would be -20+%. I think we're going to end up at maybe -15 or even -14 or -13 which is obviously negative, but it's a lot less negative than we thought it would be. That's really the key here because when you look at the valuation puzzle, which I do through the discounted cash flow model, there's not really a lot of ways for this market to really advance on its own because the P/E is already high, it's around 22, 23 times expected earnings. The discount rate, so the cost of capital which is the 10-year Treasury plus the equity risk premium, is pretty low and likely going to go higher because the 10-year yield is now at about 1.1%. It's probably going to go to 1¼ maybe 1½, that's my guess because the economy is improving, we might get some inflation, and the implied equity risk premium is only near 3%. Historically it should be closer to 4.

So, you're going to get a little bit of upward pressure on the discount rate side of the DCF and at an already high P/E that means, if the market's going to go up, which I think it will do, it has to come by definition from upward earnings revisions. Remember, the market's already pricing in a return to normal and the earnings expectations that that implies. So, market already has fairly constructive expectations for earnings, but if those expectations are still going to be revised higher, which is what's happened so far, then that's where the fuel is for ongoing price appreciation for stocks. So, in that sense earnings season, even though you look at these flat lines, it's like, well, what does it really matter because we don't really have a good sense of what the expectations are, but it is important because as companies continue to beat estimates that's going to lead to higher inputs into the DCF, which will be the fuel for the market.

So in 2021 market appreciation has to come entirely from earnings at the expense of maybe a higher discount rate. That's the way I'm kind of putting the pieces of the puzzle together.

[15:13]

Pamela Ritchie: And so far, so good. As you say it's only 29 companies, but this is the expectation. I think that goes … a lot of questions coming in and then "likes" on the question regarding is the stock market overvalued? How do you look at this? I think you've answered most of it there. There's some stimulus dollars that are obviously hanging there and then you've got these increased expectations. Anything further to add there?

Jurrien Timmer: The other piece of the mosaic that goes into the valuation puzzle which is the discounted cash flow model, you have earnings and you have interest rates. If interest rates rise, it helps certain parts of the market, so value, financials for instance, value stocks get helped by that because usually when rates rise they're rising for a good reason which is that growth is going up. But it hurts what we call the long-duration stocks. The FANGs, if you will, those were the leaders going into COVID and coming out of it until a few months ago. But it feeds into the idea that you'll see ongoing rotation into value because, if you have a long-duration stock with very good earnings growth but it's a secular growth story, a rise in the interest rates will affect them more because it tends to be stable long-term growth rather than more cyclical growth.

[16:41]

Voiceover:

And here we have Jurrien's "Growth vs value" chart, also from the morning of January 20th

Jurrien Timmer: Small-cap value now fully caught up to the S&P and it's coming, not at the expense of large-cap growth, because large-cap growth is still going up, it's just going up at a far slower pace. There you see Russell 1000 growth on the top, Russell 2000 value on the bottom.

But there's one other dimension that we haven't talked about and that is share buybacks. Share buybacks are important because, when you look at the earnings part of the DCF, so you have earnings and interest rates. Earnings is not the entire story because the amount of earnings that are being paid back to shareholders is also important. Obviously, you want high earnings, but you also want a high payout. So, dividends plus share buybacks in the U.S. has been averaging around 90% which is very high, much higher than anywhere else in the world, which is why the U.S. has commanded a valuation premium. Last year buybacks for months and months were completely flat for obvious reasons because we're in COVID, earnings were falling, so no company is going to start buying back shares when they have no idea what the world's going to look like. In the last few months of the year those buybacks really started to pick up, and we're actually still at around 90% on the payout. That's another thing that when you feed that into the DCF it solves for a pretty good outcome.

As the question was, the market is fully valued, it's correctly valued, you can put it that way. It really comes, again … and actually, I just did this work over the weekend. There's a baton pass going on, just like it was during the financial crisis, between the fundamentals, and in this case that's the New York Fed's Weekly Economic Index. So, that is a measure of the output gap, this giant cratering as countries went into lockdown during COVID. And if that output gap is not offset by a policy response, we obviously get a very, very bad outcome. That's what we had in the '30s 'cause there wasn't really a policy response until probably 1934 or so.

So, during the financial crisis you had almost the mirror image. Excess liquidity growth, which is the change in money supply growth minus the change in GDP. That's a manifestation of the policy response, both fiscal and monetary. When one zigs the other one zags, and that is sort of the Keynesian response policy response to a shock. You see the same thing here. But this is where it gets interesting because you see that the gap is narrowing. It has narrowed quite a bit actually and things continue to improve and should continue to improve with the vaccines getting rolled out and countries getting closer to herd immunity.

But if on top of that we now have a fiscal wave, because we have a blue wave and the Democrats have a big shopping list of things they want to achieve, whether it's climate change or infrastructure, what have you, and if the Fed — and again, this is the most important, I think, in my opinion, caveat — if the Fed does not take the punch bowl away, right, if the Fed does not lean into that by tightening policy and just lets that fiscal wave come just like it did during the 1940s, which is another example we've talked about many times, then that line can stay up there even as the bars close the gap. That again, could be a very potent cocktail for the markets and for the DCF earnings revisions, ultimately also inflation. But you can see when you have these policy responses it tends to boost P/Es up. I don't think the valuation is going to go any higher and actually it should come down, because now earnings are bottoming and will start supporting price, but it does suggest that we could be in for a prolonged period where valuations are just going to be above normal.

[20:55]

Pamela Ritchie: I don't know if this is fair to put to you, but there are a lot of headlines in Canada today talking about the Keystone XL Pipeline and whether it's … you just mentioned there could be a lot of executive orders as Joe Biden tries to hit the ground running type thing, and this seems to be one of them and it affects Canadians because it's obviously by TransCanada. Any thoughts on what Biden just generally might need to do for sort of his own agenda and the areas that probably he has quick access to? That's the other question.

Jurrien Timmer: I'm no political strategist, but my sense from what I'm reading is that there's only so much you can do in your first term and he really only has two years before the next midterms. He could lose the House or Senate in theory, and oftentimes new presidents will lose one of the two chambers of Congress in the following midterm election. That happened with Bush, with Obama, with Trump. So, I think he's experienced enough to know that he's only going to get so many passes at the goal during this next round and he's going to want to unite, and he's going to want to get bipartisan support, and I think he may be willing to give up a few things in order to get there so that he doesn't have to cram stuff through reconciliation where he only needs 50/50, and then Kamala Harris would be the tie-breaking vote.

I think he's going to try to be more of a healer and try to get some Republicans on board, and in order to do that he needs to aim a little bit lower in terms of what may be part of the Democrat platform. Whether that includes an executive order on the pipeline I don't know, but that is my guess in terms of what will happen. So, I think dealing with COVID is going to be priority one, getting the economy back up. I think even like the tax increases which I know will be coming, even that might be part of maybe next year's legislation instead of this year. I think he's going to just try to get the most urgent things done first, knowing that obviously taxes are a drag, maybe the drag is more than offset by the spending which it should, but I think he's going to pick and choose in a way that may not please the more progressive side of the Democratic party, but you look at his cabinet picks, AOC or Elizabeth Warren, they're not in there, right? So, this is a pretty mainstream establishment cabinet, and I think it tells you where he's going on his first pass. Maybe on further passes he'll go a little bit more. So that's just my guess and that would be a very market-friendly outcome.

[23:53]

Pamela Ritchie: The next question is to do with China, and again, it's hard to know exactly how a Biden administration will approach that. We have maybe some hints generally. The question here is more about supply chains and the idea that there may be different, a bifurcated supply chain situation going forward. What are your thoughts on that and really the implications of a change-up to supply chains, some of which has happened but ongoing?

Jurrien Timmer: If it's supply chains at the corporate level, that's ultimately a decision that companies need to make, and I think there's already been a redistribution going on of supply chains, not necessarily back to the U.S. or North America, but from China to other countries just because the cost of labour has become much more expensive in China. The whole point was to bring living standards up and over the last 20 years that's exactly what's done. So that labour arbitrage ends up going to Vietnam, or Philippines or other countries. So that's an ongoing process. But if Biden takes a hard line against China, and either creates incentives for companies to redistribute their supply chains, or penalizes them if they don't, that would be a different story, but I don't know that that's high enough on the radar screen. I think when it comes to things that deal with national security, which of course COVID, supply chains of PPE and things like that, I think that that's a different story. That would be a centrally mandated story, and I think that would happen under any circumstances because I think everyone got a wakeup call that you're extremely vulnerable in this kind of situation.

If supply chains get brought back to the U.S. in sort of an America first, which sounds more Trumpian than Biden, but if that were to happen I don't think it would be the panacea that politicians like to think because those jobs would all be taken over by robots basically. No one's going to build a brand-new plant here and have people operate the machinery, it's basically going to be robots. So, who knows how that's going to play out? But I will say that I think the tensions will dissipate between the U.S. and China, but they won't go away because the China policy, or the stance against China, is not a Republican or Democrat type thing. I think it goes across the aisle in Washington that politicians recognize that maybe China has been getting a free ride for too long.

[26:43]

Pamela Ritchie: We'll end on a favourite topic. Only got a couple of minutes here, but gold. It's gotten beaten up, we have the dollar sort of doing a few different changes and now we have the Bitcoin story. Put this all together for us in a nice bow on the gold front, how you see this working out.

Jurrien Timmer: Gold has been in a holding pattern, it's like 1840 or something like that now. It's been going sideways basically. It's what us technicians would call a bullish wedge. I do think it will ultimately break out and make new highs, but what we need is we need to see more negative real rates. That has really been the main driver and so to see more negative real rates we need two things, we need inflation to come up which many people expect, at least cyclically, maybe not structurally, and we've talked about what's happened in Japan. But if cyclically inflation comes up, and the Fed somehow keeps bond yields low, so if bond yields do not follow inflation higher, then real rates, they're already negative, but they would become more negative. And so you do need that 1940s style fiscal monetary cocktail where the fiscal wave is coming, it produces growth and inflation, but the Fed kind of stays purposely behind the curve. I think that's what happened in the '40s, my gut is that that's going to happen here, now. If that happens gold will run, Bitcoin will run even more. Bitcoin is also being helped by why would I buy stodgy old gold when I can buy brand-new digital gold? We can talk for hours about that and actually we are going to be talking about that next Thursday.

But essentially gold is waiting for that outcome to be declared. So, if we start seeing inflation perk up, and the Fed either does yield curve control and manipulates long rates down towards 1% or lower, which is what it did during World War II, then that will be a very bullish outcome. But if the Fed just lets rates rise and takes a complete market approach, then rates and inflation would just go up together and then real rates would kind of stay where they are, and that would be less reflationary and not as favourable for gold. So that's kind of how I see it.

[29:05]

Pamela Ritchie: That sort of down the road discussion. Jurrien Timmer, we're so grateful that you joined us today. It's a U.S. holiday and you've joined us anyway and we appreciate you framing out this historic week that's ahead. So, thank you for joining us.

Jurrien Timmer: Thank you/Thanks Pamela.

Ending: *[29:19]*

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