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

Director of Global Macro, Jurrien Timmer, is back for his weekly update. Today, Jurrien and host Charles Danis talk about the market's reaction to the latest vaccine and election news. Jurrien also dives into the topics of Q4 2020 earnings reports, fiscal stimulus, inflation and stagflation, the question of "are we in a bubble?" and more.

Jurrien will also be supporting his points with some charts and graphs, so please load up @TimmerFidelity on Twitter to follow along. I'll be directing you to the right tweet.

Today's global macro and markets update from Jurrien was recorded on January 25, 2021.

[01:00]

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[01:41]

Charles Danis: Lots to talk about. Why don't we start with Q4 2020 earnings season? What are you seeing, what are your thoughts?

Jurrien Timmer: Earnings season is now well underway. Sixty-nine companies out of the S&P 500 have reported so far, about 86% have beaten estimates by a whopping 28 percentage points. That's obviously much, much higher than normal, but 69 companies is not quite yet enough to get a full sense and this week will certainly be a busy week for earnings. But it's the same pattern we saw for Q3 last year and Q2.

[02:22]

Voiceover: First up we have two charts, tweeted back to back by Jurrien on January 25th in the afternoon - first is the earnings estimate progression *quarterly* with Q2 2021 in yellow at the top, which will be followed by a similar earnings chart with the calendar year numbers, with 2021 in blue at the top. Again - both tweeted January 25th in the afternoon.

Jurrien Timmer: This chart you've seen many times, of course. It shows the progression of estimates expressed as the expected growth rate going from nine months before earnings season into earnings season, which is that vertical line there towards the right of the chart. What typically happens is that estimates come down towards earnings season because companies generally want to set low expectations so that it's easier to beat them, but during COVID there have been no expectations because there's been no guidance. A lot of these lines, as you can see, have been flatlining and the same is true for the blue line which is the Q4 number.

At the beginning of earnings season the expected growth rate was -9. Right now that has gone up to -4, and that is fairly typical, but the delta is bigger than normal. This is the same pattern as the last two quarters, earnings have come in much better than expected. If we go to the next slide, you can see the same chart but now for the calendar year numbers as opposed to the quarter by quarter number. You can see the red line has been the progression of the estimate for calendar year 2020. At the beginning of 2020 the expectations were for +10% growth. At the worst point in the second quarter it was for a 22% contraction, and right now that has improved to a 14% contraction.

Of course, we still have a lot of earnings season left, so my guess is that by the time that all the data are in for 2020 that that -14 will probably be even better than it currently is. I don't know how much better, maybe -10 or -11, but it just goes to show that the earnings side of the story has been much, much better or much less worse than we all thought it was six months ago, and that's a good sign, and it's certainly a powerful prop for the markets because we know that valuations are pretty full. The forward P/E is around 22, so that's a pretty rich P/E. We know that the discount rate, which is the 10-year Treasury plus the equity risk premium, that is the number that goes into the denominator of the discounted cash flow. That number is pretty low, the 10 year is at 1.1 or so, probably going a little higher. The risk premium is down to about 3%, which is certainly below average. So there's a little pressure on the rate side which undermines the valuation story, so that means that if the market is going to go up, which I think it will, it has to come from even further positive earnings revisions.

[05:35]

Voiceover: So this here is the Earnings and Margins chart from January 26th in the afternoon

Jurrien Timmer: You can see in this chart, the purple line is the expected earnings number, the pink line is the trailing earnings number, so the market is already pricing in a big improvement from 137 to 168, and that's priced into the market right now because it always is. To go up from here we need that 168 to go actually even higher, and what I showed in the last two charts is that that actually is what's happening. That as high as the estimates are, they're not high enough which means that the earnings recovery is actually happening even more than I was expecting. So that is the bullish story, but it needs to come from the earnings because the other parts of the DCF puzzle are already in place, and it's going to be hard to get a lot of improvement on that front.

[06:31]

Charles Danis: The news last week was that vaccination was a little bit slower than anticipated. Dealing with the virus, has the market digested that information, or is it still being pondered?

Jurrien Timmer: That is the question of the day.

[06:50]

Voiceover: Next up is the Bloomberg Daily Activity Indicator - tweeted the morning of January 12th

Jurrien Timmer: The story has been that vaccinations have come out slower than expected at a time when the COVID curve is still raging. I mean, the numbers are just astronomical. But there's some light at the end of the tunnel. In a way, the incoming administration with Joe Biden and the blue wavelet I call it because it's not quite a wave, but it's a wavelet, in some ways his timing of coming in now is very fortuitous, not unlike his former boss, President Obama's timing was a little fortuitous in early '09 when he came in just as the financial crisis was kind of reaching its nadir.

I think in this case we see in the U.S. and elsewhere that COVID cases are coming down now and they've been coming down for, I think for about 12 days in a row, so that obviously is great improvement. The market is always focusing on the rate of change, the delta, not the level. But it's coming down from extremely high levels and that, of course, puts it in a little bit of a different context than improving from a lower level. What we can see here from this chart, the output gap back in the first and second quarter of 2020, the economy just collapsed from 100% to 20, 30, 40% as there were lockdowns that were much stricter than what we're seeing now. Right now we're having lockdowns, but factories are open, construction is happening, things like that. But you can see that in the last few months these numbers are just kind of stalling out, and so I think what will happen here is that the curve is coming down, the Biden administration is now in place. I think there will be a much more concerted centralized effort to rolling out vaccines. It was all a hodge podge of the states can figure it out and I don't think that's really any way to deal with a pandemic.

My feeling is, it's just a hunch, but my feeling is that the news flow is actually going to start getting a lot better in the coming weeks as we now have a really robust way to deal with this at the time that the curve is cresting. In that sense I think Biden will have a little bit of luck on his side that he'll get tailwinds on the news flow. But having said that, if we go to the next slide, that still brings me to the policy bridge. This is an important thing for the markets to look at.

[09:32]

Voiceover: This is the chart Earnings and the Fed, from the morning of January 20th

Jurrien Timmer: In the top panel you see the Fed's balance sheet, in the bottom panel, and I've shown this chart a number of times, you see earnings growth for the next 12 months as well as the New York Fed's weekly Economic Index. And you can see again the economy collapsing and then climbing back, and it's now stalling a bit, but that policy bridge of both fiscal, through fiscal relief, and there's more to come on that from the Biden administration, as well as monetary accommodation, that continues to be in place.

For the markets, yes, the COVID curve is concerning, the lockdowns are concerning. It shows that the economic cycle is stalling out and that can feed its way into earnings estimates, which might actually then end up being too high as opposed to too low, so that's a very important part of the puzzle for the markets this year. But I think the market is rightfully, or correctly, looking past that and pointing to vaccines, even if they're coming out more slowly than expected, that will change as we have this new administration coming in. And the number of vaccines has already increased in the U.S. from 900,000 a day to about 1.1 and my guess is that that's going to be way up from here. And we have the fiscal policy relief, and then the ongoing monetary relief and I think the market looks at those three things and says, you know what, we can look past this and price in a better recovery, maybe in the second half of the year.

[11:10]

Charles Danis: Jurrien, any concern that the Fed may take away, as you like to say, take away the punch bowl in this environment?

Jurrien Timmer: That does become the big issue. We are in a reflation trade, so reflation is that early-cycle recovery, and when that happens you see a rotation from growth to value, which is exactly what we've been seeing from large-caps to small-caps, from U.S. to non-U.S., from developed to emerging, from financial assets to

real assets. All of those things are happening, and part of that playbook is also higher nominal yields and higher inflation expectations, which is also happening. You can see that in this chart right here,

[11:51]

Voiceover: Next here is Nominal and Real Rates, tweeted the afternoon of January 28.

Jurrien Timmer: Shows the TIPS break-evens and the 10 year in the U.S. You can see that real rates, well, you don't see it in the chart, but real rates are negative and they're not getting any more negative, which is why gold is just sitting around doing nothing because gold, to rally from here, I think needs further negative real rates.

This brings in to the picture the Fed. I think that the monetary side here really is critical, and we've talked about this in the past, generally speaking when one lever of policy is loosening, for instance the fiscal side, the other lever, which is the monetary side, will be tightening or vice versa. So following the financial crisis we had the Fed doing QE and zero interest rates, but we also had the Tea Party dominating the landscape after the mid-term elections following Obama's entry into the White House. That caused a wave of fiscal austerity so the Fed was easing in, but the fiscal side was kind of leaning against that.

Then we had the opposite a few years ago when we had the Trump tax cuts. The economy was running pretty hot, we were running deficits, the Fed was concerned about being too accommodative, and so it was normalizing policy into a fiscally very loose period of time. So there's always that balance. In the 1940s, which we've talked about many times, there was not that balance. There was lots of fiscal stimulus because the U.S. was entering World War II, and the Fed basically not only let it happen without leaning into it, but it actually severely loosened policy by essentially monetizing those debts and keeping rates so low that real rates went way, way negative at that time.

[13:58]

Voiceover: Ok – lots of charts today! Now I would like to direct you to The Fed vs the Market, also from the afternoon of January 28.

Jurrien Timmer: I don't know that the Fed would do quite that extreme this time, but as you can see here in this chart, the pink line is the 10-year Treasury, the light blue line is the Fed funds rate and the dark blue line is the Fed funds futures curved. You can see that the Fed is not signalling to the market that it's going to raise rates any time soon, or even reduce its balance sheet. So it is not leaning into this fiscal period, and it's not really listening, if you will, to the rise in the 10 year which has risen at least 50 basis points if not more.

This is really the key thing, especially as everyone plans for the year ahead, that if the Fed does not take the punchbowl away by tapering its QE like it wanted to do back in 2013 and triggering the taper tantrum as we called it back then. If it does not do that then the animal spirits can keep running because at that point even if inflation expectations rise, which they presumably would in this scenario, the Fed would not lean against it and that would allow real rates to actually fall further to further negative levels, and that would be a really positive development for gold, but also for the value and the small-cap and the commodity trade in general.

It's a major assumption that everyone is going to have to make, will the Fed take the punchbowl away or not. My guess is that they will not, that the situation with COVID is precarious enough that they're going to feel comfortable letting this thing run hot, especially after more than 10 years of undershooting its inflation target. So I think they're going to give it all the benefit of the doubt, and they're just going to let it run hot here. That's my guess.

[15:55]

Charles Danis: Thank you Jurrien. We're getting a lot of questions and comments about, are we in a bubble? Quite frankly, if I sum up some of the questions we're getting through the application. Do you have some comments about sentiment, P/E ratios? You're one to talk about cash on the sidelines also, I don't know if you can comment on where we stand these days.

Jurrien Timmer: The last question was a perfect lead up to that because if you take the exact scenario I just described where you have massive fiscal stimulus, you have an economic gap that is closing, and you have the Fed essentially just letting it all happen without offsetting it somehow with tighter monetary policy, that is a recipe that's obviously a perfect storm for speculation in the markets, which is exactly what we're seeing.

[16:44]

Voiceover: This here is the Liquidity and Valuation slide, tweeted the afternoon of January 27.

Jurrien Timmer: Again, normally when you have an economic shock which is shown in the grey bars in the bottom panel, that's essentially the output gap, if you will. Normally what you have is a Keynesian response to that, so the policy bridge, fiscal and monetary, will try to offset that. You see the yellow line which is excess liquidity, so money supply growth minus GDP growth, is the mirror image of the grey bars. So the jaws open and then when things get better and the output gap closes the jaws close, because at that point there isn't the need any more for a policy bridge.

What we're seeing now on the right-hand side is the output gap is closing … it's stalling a bit because of the lockdowns, etc., but it is closing, you can see a pretty significant closing from about a 10% gap to about a 2% gap. But the yellow line was peaking, but now it's starting to go up again. This is part of the blue wave, the fiscal policy, relief, there's another 1.9 trillion coming after this one, if it gets passed in Congress. The jaws do not seem to be closing. You have an improving economy, you have a lot of people with stimulus cheques, they're called stimmies on TikTok apparently, and that gap is not closing. So, you have all this liquidity flushing the system, people getting stimulus cheques, they're working from home, they don't have a lot of sports to bet on and so you see this in the Robinhood phenomenon and it's pretty incredible to watch. At first it was all the downtrodden stocks like Hertz and the hotel stocks — this was a few quarters ago — then we had Tesla, now we have GameStop, it was the short sellers favourite stock and now these Robinhooders, and you see this on Reddit as well, they're betting against the short sellers and they're winning in a very big way. You see this and clearly there's a speculative fever going on that we rarely ever see. I don't know if this even blows away what we saw in 2000.

But that's only part of the story. That's the bubble story, and you know it always is going to end, and usually when it ends it ends because liquidity is tightening, so that yellow line starts to come down in earnest because the Fed's taken the punch bowl away, or because the fiscal story ends, then it's going to end in tears because that's exactly how bubbles always end. It's because rates all of a sudden start rising and that takes away the liquidity because it's always the liquidity that fuels the bubble in the first place.

Then I look at the other half of the sentiment side.

[19:42]

Voiceover: So now this is Jurrien's Sentiment chart, specifically the bottom left chart on flows, from January 22 in the morning.

Jurrien Timmer: The speculative side, these are the millennials, they have a Robinhood account, they can trade at zero cost and they are just betting on whatever, whatever is moving. But you look at the traditional investor, the people that you guys all have as customers, I don't think there's any kind of bubble there. The top-left slide shows flows into money market funds, and the blue flows out of and then into equity funds in the dark blue and then bond funds in the pink. You can see that, yes, money has come out of the money market and it's gone into stock funds but also more actually in bond funds, but still even a year almost after the pandemic and after the market low, I look at the equity flows here on this chart, these are cumulative flows, and I really do not see a bubble there.

I think it is a tale of two markets where you have the long-term investors who will … maybe a lot of them even got out in March and haven't gotten back in yet, and they've certainly been net sellers since the financial crisis already 11, 12 years ago and so that's one part. That is ultimately where the real money is, where most of the money is. But you have this speculative day-trading phenomenon which is a smaller number, but there are so many of them, there's hundreds of thousands of people like this who are all piling into the same trades, and it's certainly having its effect. I don't want to call it a bubble, but certainly parts of the markets show a lot of froth. And so it is a kind of a dualistic story here.

[21:25]

Charles Danis: The markets within the markets I guess. A lot of interesting comments and questions. If high unemployment and weak economy persists longer than anticipated, could we be looking at stagflation instead of inflation? And what kind of investments should we be thinking about if that's the new norm, if we get into stagflation?

Jurrien Timmer: That is a great question. I think what the market is betting on right now is an inflationary boom or boomlet. In other words, as the economy reopens and the Fed is just letting this thing run hot, everyone will want to go back on a cruise, or go to Disney World or travel. We all feel it. Wouldn't it be great to just go back, get on a plane, go to a resort somewhere? By and large people will have the money to do it. Obviously there are parts of the economy where people are really suffering, and the stimulus cheques in the U.S., some people criticize them because it's a blanket cheque to everyone, but not everyone needs it, and the people who actually do need it are not getting enough of it, and then a lot of the other people who don't need it are getting it, so there's a lot of spending power there. Once that gets unleashed, when we reach herd immunity basically, then you're going to see a little inflationary boom or boomlet. It would be cyclical because once that gets satisfied maybe things go back to normal.

The stagflation question is an interesting one because we do have an economy that is limited by demographics in terms of how much it can grow, and if the Fed makes a policy mistake basically like it did in the '70s, you could have a stagflationary scenario. It's a hard thing to gain because there are so few examples of stagflation in history. It really was the '70s and that was about it. You don't have a strong sample size to bet on, but we can see what worked in the '70s and it was cash, it was real assets, it was certainly not bonds. In the '70s gold and cash worked, stocks, they worked okay, but they didn't beat inflation, and bonds were basically the worst. So when you think about a 60/40, it's really the 40 in the 60/40 that you have to think about in a stagflation environment. Stocks would not do great because in stagflation the P/E is going to come down and the P/Es are high right now, so you do have a pretty big headwind there. You would get that as the discount rate presumably would go up. So it's not a great story for stocks at all, but in these periods where things get really frustrating, which a stagflationary period is, if you can at least keep up with inflation, knowing that it's not going to last forever, there are worse outcomes.

But what I would say, you would play on the 40 side of the 60/40 and you would replace some of the bonds with TIPS, for instance, inflation protected securities, you would replace some of it with cash, gold, maybe Bitcoin if you believe that that's a digital version of gold, not everyone does, so you have to cross that Rubicon on your own to decide whether that's a legitimate asset class, but if it is then it could be Bitcoin and other digital currencies as well. But that's how I would think about stagflation. It's you take part of that 40 and you put it in stuff that doesn't get hurt when rates rise. But again, very small sample size, really hard thing to gain for.

[25:05]

Charles Danis: Questions around policy again based out of the United States, almost a doubling of the minimum wage, its impact, anti-trust laws for huge tech companies, any thoughts on those two?

Jurrien Timmer: I don't know if there will be aggressive legislation against the big tech companies, or whether it will just be through tax policy because corporate taxes presumably are going to go up. For these big growers that's only part of the story. If the tax rate goes from 21 and 28, and Amazon doesn't really pay taxes to begin with, then that tax policy will have no teeth. The real issue with these companies is that they are, I don't want to say sheltering, but they are getting their income from all over the world, so they're keeping that income away from the U.S. taxing authorities, from the IRS. If they fix that, if they close that loophole so that no matter what you're going to pay at least 10 or 15% no matter where the income is hiding, that I think will have a meaningful impact on profit margins for these big growers. Remember, the rotation is already happening, it's already going from growth to value, from large to small, so the big tech companies … I don't want to shore them, I don't want to bet against them because they are very powerful free cash flow generators, and I don't want to fall on my sword by betting against that machine that has worked for so long, for over 10 years. But on the other hand the rotation is happening and the structural backdrop is very ripe for this rotation to really have some teeth, or to have some longevity, because it's been a one-way street for the last 10 years.

A regulatory or tax risk would be icing on the cake for that rotation. Think of it this way, if rates rise and you have these long-duration stocks that have long, long run rates of solid earnings growth, which is what these companies all have, when you change the discount rate and the discounted cash flow model, the DCF, that has an outsized influence on the net value of those stocks. So there are a number of reasons why you could say the heyday for the growth stocks are over and value is going to just dominate, and the regulatory risk can be part of that. But again, I'm hesitant to go too far against the growth side, so that's why for me an all-weather portfolio has been don't short the growth side but play the value side and the weak dollar side by essentially going out of the U.S. into emerging markets. It's kind of a barbell approach.

[27:59]

Charles Danis: I was going to ask if you had any last words of wisdom but that just about covers it as far as what to look for in rebalancing these days and it's RSP season in Canada, so people are looking for new contributions and rebalancing, so thank you very much for those last thoughts. Again, thanks for joining us today.

Jurrien Timmer: Great, Thank you.

Charles Danis: Until next time, bye for now.

End of podcast: *[28:19]*

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