Fidelity Connects

The Global Macro View

Jurrien Timmer, Director of Global Macro

Pamela Ritchie, Host

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

Jurrien Timmer, Director of Global Macro joins us again for his market update. With host Pamela Ritchie, Jurrien unpacks recent market movements, including looking at value vs. growth – noting that the gap between the Russel 1000 Growth Index relative to the Russel 2000 Value Index that we saw throughout last year has now completely closed.

Jurrien also looks at how equity price-to-earnings ratio and inflation have an inverse correlation and how a traditional 60/40 portfolio could be adjusted for inflation changes.

Also, Jurrien references a few charts that can be found on Twitter, so head to @TimmerFidelity to follow along.

Today's podcast was recorded on March 1, 2021.

[01:41]

Pamela Ritchie: We're looking at a broad rally right now. Have we gotten over what last week gave us?

Jurrien Timmer: It looks that way. We are seeing a very broad rally in basically all assets, and bond yields are down from where they were last week. We know last week was about a rise in yields, but unlike recent weeks, because yields have been rising for a while, recently yields rose because of higher inflation expectations which I think market participants and the Fed view as a benign way for rates to rise. It just means investors are expecting better conditions in the economy, so therefore nominal yields should be rising when that happens. Something would be wrong if they didn't.

But last week it was real yields that rose and they rose quite a bit. I think the 10-year real yield's up about 50 basis points in total. Not all of that was last week. As the 10-year nominal yield pushed up to 1.6, obviously we're talking about yields in the U.S. here, there was some sense of okay, we've seen this movie before. We had the taper tantrum back in 2013, and actually we can pull the slide up,

[02:54]

Voiceover: So to follow along here, this is Jurrien's chart titled "US Rates", tweeted on March 2nd in the afternoon.

Jurrien Timmer: Back then the then Fed chairman Ben Bernanke was openly musing about what would happen if they started tapering asset purchases and very quickly, as you see on the left-hand slide here, real yields rose by well over 100 basis points, almost 200 basis points, in a matter of only about four to six weeks. That was quite an adjustment, very, very swift one.

The bond market did not take it well. The stock market took it more in stride because, as we'll talk about in a moment, the leadership in the stock market was much less concentrated from growth stocks which are more sensitive to interest rates than the overall market. This time around, as you can see on the bottom right, real yields rallied about 60 basis points, 50 basis points and it was very quickly felt last week. But then yields are down, and in an important kind of signal from around the world the Royal Bank of Australia all of a sudden, without much announcement or fanfare, increased its long-dated bond purchases, and that gives a hint of where the Fed may be going if real yields keep going up.

When you have so much debt and the economy is still running below capacity, you really cannot afford to have real yields rise and I think the market knows that, the Fed knows that, so it really puts the Fed in the hot seat as we have been talking about in recent weeks.

[04:43]

Pamela Ritchie: So let's go global for a second there. You mentioned Australia. We've got European signalling that probably the ECB is going to have to step in to do something very similar. Does it mean anything for the nuances of currencies as you look at some central banks jumping in to do further buying versus others? Or is kind of coordinated? What should we take from that?

Jurrien Timmer: I don't think it's coordinated, but all countries have the same problem which is that growth is too slow, debt levels are too high, and we have a global pandemic which has shocked the economic system, and even though the economy is recovering pretty quickly from that, economic output remains below potential. If you look at the U.S. unemployment rate, it's about 2 percentage points above what the Fed considers the natural rate of unemployment to be. There is still that gap, both the Treasury, and the Fed and fiscal and monetary authorities around the world will want to close that gap. In the old days before COVID we would talk about competitive devaluation and that with interest rates around the world at or near zero, or even at negative levels, it's really the currency is kind of the last frontier of free market moving assets and that countries would want to see their currency be devalued so that they can essentially get out of debt jail for relatively free.

I think the focus has evolved a bit because I think the world, or at least through the eyes of policy makers, the world needs inflation because when you're debt stock is very high and rising, and in the U.S. we're already at 120% of GDP, and we'll probably be at 130 or 140% in the next couple of years. When you don't have the ability to grow out, and demographically I think that's a high hurdle, then you want to inflate your way out through either currency devaluation or negative real rates. Because the U.S. debt stock is less and less owned by foreign institutions … I mean, there's still a lot of foreign institutions owning it, but because the debt is growing so fast, as a percentage it's becoming less, so then it really comes down to real rates being negative and that's something that the Fed will have to try to engineer because rates are already low in nominal terms. In order to get them negative you need inflation to go up. So inflation I think is what policy makers both fiscal and monetary are really going to be solving for because it's really the only way to get out debt.

From an investor point of view, we can argue whether inflation will be cyclical or structural, whether we think it will happen. Of course, we've talked about the Japanese experience where they've had massive debt monetization and no inflation to show for it. We can talk about that for a long time. But ultimately as investors do you want to be on the same side as policy makers, or do you want to bet against them? If policy makers want inflation, probably better for us as investors to make some moves portfolio-wise to line up with that goal.

[08:05]

Pamela Ritchie: Let's go right there. What are the portfolio adjustments to be, if you want, more in line with what the central banks' policy and moves are? What [audio cuts out]?

Jurrien Timmer: For one, equities — and we've talked about this, we've discussed this during the Bitcoin piece as well, if we're all in some sort of 60/40 world, or some 60/40 paradigm, whether it's 70/30, or 50/50 or 60/40, I would be inclined not to really mess with the 60 part too much, although clearly as this slide shows,

[08:42]

Voiceover: This is "Valuation & Inflation" tweeted March 4th in the morning

Jurrien Timmer: you see an inverse correlation between equity P/Es and inflation. So this is a scatter plot. Inflation is on the horizontal, the P/E is on the vertical, that's the Shiller CAPE P/E, and when inflation is around 2%, which is where it has been for the last decade, you're really in the sweet spot in terms of valuation. Then if inflation goes up a lot or down a lot into deflation, the P/Es come down.

So there is a message here for equity allocation in terms of P/Es potentially coming down if we get inflation, but that doesn't mean that the market goes down because earnings generally are considered in nominal terms. So price can still go up, it's just that that would no longer be a high-valuation market. We can talk a little bit later on about growth versus value and why that's such an important thing right now.

If we get inflation, it does suggest a lasting rotation from growth to value, from stocks to commodities, from large to small, from U.S. to non-U.S. It's interesting, I've had this chart for years and years and it shows the commodity super-cycle, and I posted this chart maybe a year ago saying, "I don't know what the catalyst might be, but it looks like the super-cycle is at a place in time where it should be turning", and guess what, it actually has. It's a good lesson to always be looking at charts and this is why I use charts so much.

Also looking at the 10-year rate of change for growth to value and stocks, and for commodities. It does line up. It's a long way of saying that in a 60/40 portfolio I would be tinkering with the 40 side not the 60, and on the 40 side I think, obviously as the topic suggests, you want to have inflation hedges and that could be TIPS or inflation-protected bonds, it could be commodities, it can be gold, it can be Bitcoin, which is something we just discussed a few weeks ago, and so that's where I would be looking.

Just to take it one step further, you look at the correlation, the five-year correlation between stock, equity returns and changes in real yields, which is how I measure the correlation, and you can see that you have these structural regimes. The current regime that we're in has been in place for about two decades, so when stocks go down bonds go up, so one diversifies against the other.

But it hasn't always been that way. From the '60s until 2000 or so the correlation was upside down meaning that higher yields were associated with falling stock prices which means that you could not hide in long-duration bonds to protect yourself. You had to go in cash or commodities. So now we have TIPS, those didn't exist back then. If there is a change in regime, it definitely means that we need to be thinking about the 40 side of our 60/40 allocation.

[11:59]

Pamela Ritchie: I wanted to just talk to you because you are going completely viral on the internet right now for your Bitcoin report which you've been sharing with us, pieces of it, and then the full thing for the last six weeks, two months. Anyway, the report's online, all you have to do is just type in a very simple search, and you'll see it's everywhere. When did that go out? Like an hour ago?

Jurrien Timmer: I wrote the internal paper in December. Of course, Bitcoin has doubled since that was published internally. Then we had the webcast and then now the external version of that, and it always takes a while to get this done and especially on a brand new topic like Bitcoin, but yeah, we tweeted that paper out this morning and it's going quietly bananas out there.

[12:45]

Pamela Ritchie: Fascinating, absolutely fascinating. Also from weeks ago and probably from the end of last year you talked a lot about things happening beneath the waves, the rotations, and the rotation certainly was from growth to value. It was also a discussion about where inflation fits in the picture, where it's going. We're only March 1st. Have an awful lot of these movements beneath the waves, have we booked them for the year already? Do you find this quick?

Jurrien Timmer: It's happening quickly. But as you say, at the top level of the market, S&P is down 100 points or so from the high, but that's really not a big deal. We went from 3,950 to 3,800, we're back, we're a little bit higher than that,, so not a lot of movement, still well within that typical 10% noisy kind of correction level. But a lot is happening as you indicate.

[13:43]

Voiceover: This chart is titled "Style Rotation" and was tweeted on March 1st in the afternoon. This will be followed by "Growth vs. Value" tweeted back on February 2nd.

Jurrien Timmer: This to me is really a stunning chart because a year ago during COVID when the economy shut, as we know, large-cap growth stocks dominated, the FAANGs, Apple, Google, Amazon. Everyone was working from home, still are to a large degree, they were buying stuff online, and so large growth completely ran away with it even though in the early cycle phase, which really started last March and is still going on, normally you would expect a rotation into value, and cyclicals and small-caps, but that has now happened, but it happened maybe six months later than it normally would happen.

If you look at the line on top, that's the Russell 1000 Growth index relative to the Russell 2000 Value. So really the opposite ends of the dial spectrum. That chart has completely round-tripped back to when COVID was not even happening yet. A really stunning reversal in terms of large growth giving up its leadership. Just to look at it one other way, on the next slide you just see the Russell 2000 Value in the yellow, 1000 Growth in the blue, all indexed to where the S&P 500 was trading in February of last year. So exactly a year ago at the all-time high set back then, and you can see how big that gap was for months, and months, and months and then in the fall it started to close. Last week the Russell 2000 Value actually crossed over the Russell 1000 Growth. So that means that gap has completely disappeared.

This is where the nuance comes in of the taper tantrum, we can call it the taperless tantrum because no one at the Fed is talking about tapering asset purchases. The market today is a different market than where it was in 2013 when we had the original taper tantrum because the market is much growthier today. I'll give you a little back-of-the-envelope math which is, I think, really interesting. If we look at the discounted cash flow model,

[16:09]

Voiceover: This here was tweeted on March 1st in the afternoon, "S&P 500 Earnings Estimates" on the left, and "S&P 500 Fair Value" on the right.

Jurrien Timmer: and let's say we use the consensus earnings estimates and we plug that in, what we get is a fair value in terms of the trailing P/E that investors should be willing to pay for the S&P. That trailing P/E is 25. The forward P/E is more like 22. The trailing P/E is 25 because earnings obviously are rising.

If we then plug in a discount rate instead of 5%, which is what I used for this example, but we go up 200 basis points to 7%, that P/E goes down 9%. So that is the effect of what a taper tantrum would have on the stock market. Interest rates matter. Earnings matter, but also interest rates matter because those make up the denominator of the discounted cash flow model.

But now let's replace that basket of stocks and earnings with a high-growth long-duration basket, so stocks that have much better earnings growth for much longer. Those are the FAANGs, the big growers as we call them. The fair value for that basket of stocks is 33 times earnings instead of 25. If we then raise the discount rate by 200 basis points, that fair value goes down by 26% instead of 9%. So with the market so much growthier now the market is more levered to low interest rates and is more sensitive to rising rates. Think of it as negative convexity which is a bond term but applied to the stock market because these growth stocks are kind of like long-duration bonds, if you will. The sensitivity of an increase in the discount rate on large-cap, high-growth, long-duration stocks is 26% versus only 9%, and that's why we're starting to see the market have indigestion even though real rates as of last week had only risen 50 or 60 basis points as opposed to a much bigger rise back in 2013 when the market was not nearly as growthy as it is now.

To come back to your question about the rotation and whether it all happens below the surface, if real rates keep rising here, it actually could knock the market down just because those FAANG stocks are such a big part of the market. But that brings the Fed into the mix 'cause the Fed is not going to want to see that happen, and the Fed will either try to jawbone the markets into believing it's going to stay loose forever, or it's going to actually have to put its balance sheet to work and do some form of yield curve control.

[19:01]

Pamela Ritchie: Which a lot of people expect. There's all kinds of people who get out of bed in the morning, have their cup of coffee and just believe that they … smart people with business ambitions, entrepreneurs, people who make money for others, and they just live in the world of very low interest rates and high growth. And low interest rates in theory and in practice create high growth. It's really hard I think for a lot of people who perhaps haven't even seen a world where there's a difference in interest rates to really believe that. What do you see in the market that changes the religion?

Jurrien Timmer: Low rates have been around for a while. We had the 1940s that we've talked about many times. Of course, the 1970s. Nobody wants to go back to the '70s, although fashion is certainly coming back. You've got the paisley shirt here and there was some good music from the '70s, so I don't want to completely blame the '70s for every cultural fail out there. But the '70s was a period during which what probably were thought of as temporary cyclical inflation pressures became entrenched and they became structural. That is the risk … I don't think it's necessarily a high risk because we talked about Japan earlier, we have demographics. The demographic trends around the world are inherently deflationary. But still if the Fed were to engineer a regime of persistent low nominal rates just like we had in the '40s while inflation starts to tick up, thereby creating negative real rates, the risk is that those inflation expectations become entrenched, people start to change their behaviour, and then the genie is out of the bottle and then you can't put it back in.

I don't know what the likelihood of that is, probably it's less than it would have been in the '70s just because the demographics are different, but that is the risk. But again, with debt levels as high as they are, really no one can afford high interest rates, at least not high real rates. And then it becomes a question of where is the natural rate of interest, where is the Fed, how long can they suppress things and what are the unintended consequences and how slippery is that slope? It's not an enviable position for the Fed to be in, and so far the markets are kind of coming back to life on their own, but again, as I said I think what the Royal Bank of Australia did over the weekend is giving the market a taste of where the Fed might have to go.

[21:46]

Pamela Ritchie: Let's get to a number of questions that are coming in. Let's talk a bit about gold. Here's a question coming in, lots of discussion of inflation, we're doing it, we see it everywhere, why is gold plummeting as most people were quite bullish over gold over the recent past? Your thoughts on gold.

Jurrien Timmer: It's a great question. There's a very simple reason and that's because of what we just talked about, which is that last week real rates rose. They have been rising for a number of weeks.

[22:14]

Voiceover: The slide Jurrien references here is "Gold & Real Rates" from February 25th in the afternoon

Jurrien Timmer: This chart shows the price of gold overlaid on the inverse of two different real rates. One is the 10-year real rate, so 10-year yields minus inflation expressed as the TIPS real rate. So this is a market signal not necessarily based on the CPI. The yellow line is the 5-year, and the 5-year as you can tell is much more negative — again, this is on the reverse scale — than the blue, and the reason is that the yellow line is more sensitive to Fed policy because the Fed can kind of set policy up to five years, but not really much longer than that. So this is kind of a tale of two markets.

You can see that the price of gold is trading perfectly in line with that blue line. So that blue line peaked back in July of last year, but it had a secondary peak in December when gold was at 1953 and the real yield was at -1.06. That real yield has risen to -0.6 and that has knocked the price of gold down further. So I'm still bullish on gold. I'm bullish on Bitcoin over the long term, and we can talk about Bitcoin if you want, but over the near term…

[23:36]

Pamela Ritchie: There's a question on that, will Bitcoin growth rotate to gold? That's sort of that connection.

Jurrien Timmer: I think it may very well do exactly that because the Bitcoin move has gone up a lot, but for gold to start working again the Fed needs to indicate that it's willing to supress nominals. We already know, or it's kind of a market given that inflation will at least make a cyclical appearance, so if the Fed puts its money where its mouth is and says, "You know what, we are going to keep nominals down no matter what," I think at that point gold would spring back to life.

Bitcoin, I think this is kind of interesting. Looking at the price of gold back during the '70s. During the '70s when the U.S. went off the Bretton Woods Agreement, gold was finally free to move because it was always fixed at $35 before then. So gold became a discoverable asset, if you will, just like Bitcoin is now, and gold had these two big up moves and if you overlay Bitcoin, it looks pretty much like a very similar discovery process. But even then, even though the gold line suggests that Bitcoin should be much higher in a few years, we are kind of running faster than the analog, and we're running faster than the stock-to-flow.

So my sense is that Bitcoin is moving today, but a lot of this move I think is kind of overdone in the near term. That doesn't mean Bitcoin is going to go down a lot, but my guess is that it's going to be kind of in a range here for a while because the analog suggests that it's a little bit gone too much, too fast. But Bitcoin, and gold, and commodities and TIPS I think will all be viable inflation hedges either for real inflation or monetary inflation, and it's really just a matter of price location. So I'd rather buy Bitcoin at 30 than at 40. I don't know if we'll get to 30, that's not a prediction at all, and I'd rather buy gold at 1600 than at 1900. But it becomes more of a tradable asset here, but definitely a strategic allocation to both is, in my mind, a good idea here.

[25:51]

Pamela Ritchie: Let's see if we can get in a couple of quick questions here. The rally in copper, is that overdone? Your discussion on gold, I wonder if that ratio with copper and gold is [audio cuts out].

Jurrien Timmer: I don't know that I have the slide, but it's probably a little bit overdone. The copper/gold ratio is really skyrocketing and actually suggests that the 10-year yield should be at 2½. I don't think that's going to happen, but I do think yields could go eventually to 2%, which is the top part of my fair value model. But commodities across the board, whether it's oil, grains, industrial metals, precious metals, they all look equally good. Oftentimes when one's moving the other is moving … when one is zigging the other one is zagging, but other than gold it's been a fairly uniform move here.

[26:42]

Pamela Ritchie: And last quick question, I think we've sort of answered part of this when we talked about value versus growth, but when you're looking at a portfolio and you're in the equity side of it, the 60%, is it good to have a good balance between value and growth? [audio cuts out]

Jurrien Timmer: Again, I don't want to bet against the big growers because they generate a ton of free cash flow. You're paying for it, obviously there's no free lunch, but I do think that that is probably a sustainable business model. I don't want to necessarily bet against something that has worked so well for the last 10, 11, 12 years. But clearly cyclically there's a rotation going on and it's happening pretty fiercely now, and the potential is that that cyclical rotation is also a secular rotation. So for me, the barbell way of having my cake and eating it too is to not be short U.S. large-cap growth, but to also own non-U.S. stocks, whether it's emerging markets or Europe or Japan or EAFE in general. In that way I've got both growth and value and I'm short the dollar at the same time which to me is kind of the ideal portfolio.

[27:57]

Pamela Ritchie: Fantastic. Great to speak with you, Jurrien. Have a great week and we'll see you again soon.

Jurrien Timmer: Thank you very much.

Pamela Ritchie: Jurrien Timmer joining us.

Ending: [28:06]

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