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FidelityConnects: The Global Macro View

Comments from Jurrien Timmer, Director of Global Macro

Earnings season has begun, where do you begin the week looking at?

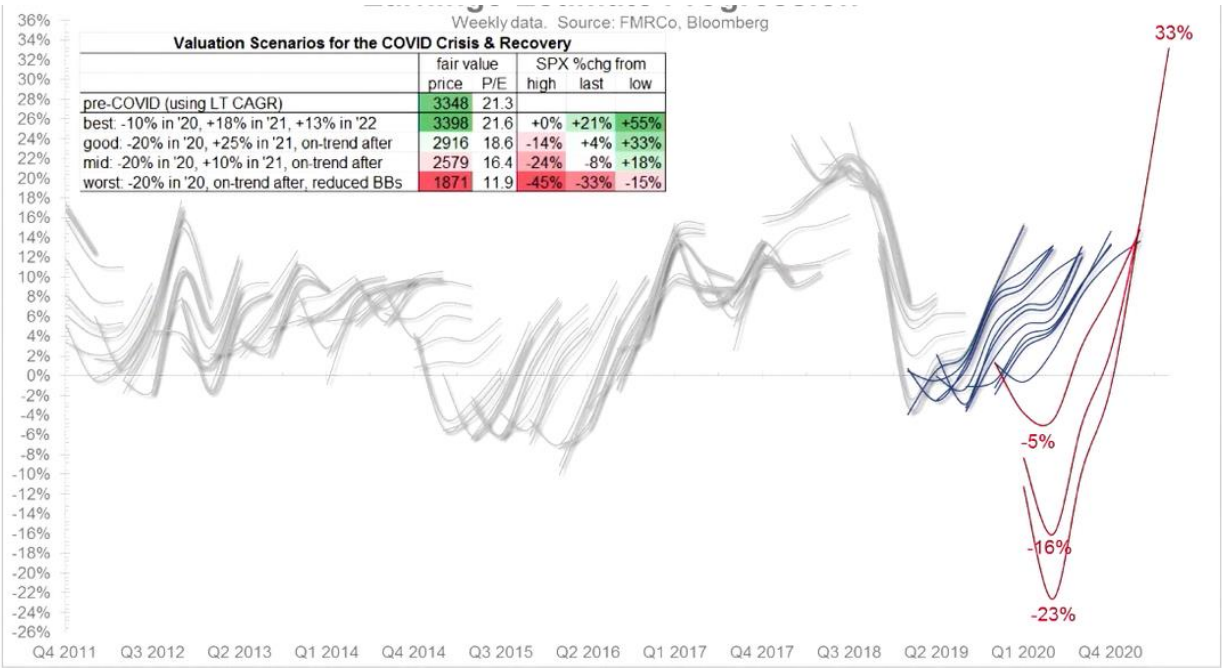
- I look at 1) where are we going and 2) what's priced in.
- The price discovery process has been difficult and volatile. Market was down 35% which was pricing in a worst-case scenario. Now we're only down 17% from the highs, up 28% from the lows. The worst-case scenario is on the back burner and we're seeing a "U" shaped market priced in.
- Don't fight the Fed continues to be true. The government stepped in with a highly coordinated fiscal and monetary response. The Fed is now buying the fallen angels: high yield bonds that used to be Investment Grade at $2.3 Trillion.

What do you use through Earnings season and incorporate into your model?

- Earnings season is different this time due to 1) numbers are more dramatic 2) earnings season is no longer the expected perfectly choreographed dance, starting predictably low then beating their estimate.
- Earnings numbers come down to the recovery path, which we don't know when will happen and what the economy will look like. The guidance function of earnings won't be there to the degree that we're used to.
- If a company has terrible earnings but the stock price doesn't go down on the bad news then all of the bad news is priced in. I'm looking at stock price and it's fundamentals now!

How long will the prolonged recovery impact pricing?

- I use the Discounted Cash Flow Model. This is where the price is moving higher while the fundamentals are moving lower. It becomes confusing to make sense of the price action. The market is always pricing in future scenarios.



- We have had unheard of numbers where it gets worse in the 2nd and 3rd quarter. But we know that a recovery is coming, the question is what is the the shape of the recovery?
- In this table we have the 4 options:
    - 1) The Check Mark: Best case is a sharp plunge with a sharp recovery of about 20% upside, value is 3400
    - 2) More reasonable is a "V", earnings come back strong but don't completely erase the decline we just saw. Fair market value is 2900.
    - 3) "U": 2600 is fair value. Market is pricing in the middle of the road scenario.
    - 4) "L" means the shock but doesn't erase the decline. If the financial engineering era of share buy backs is over then there's an S&P below 2000. The economy falls and the comeback doesn't offset the declines.

High Yield & the Feds Moves: are the concerns there over?

- Our High Yield team is very busy and now is a **very good time to be an active manager!** It's harder to differentiate between good companies at cheap prices and companies that are bad. On the High Yield investment credit side this is being seen.
- Fed is making sure that companies can refinance the debt by buying almost everything. The Fed is now buying corporate bonds, treasuries, HY, and mortgages.
- Part of it is plumbing; the Fed wants to keep this credit cycle going as the health crisis isn't usually the cause of the credit crunch.
- The Fed is trying to avoid any collateral damage that is unnecessary. There are issues down the road but that's not a concern for now.

How do you get out of these new programs?

- I'm not too worried about it; this is simply a bridge to the other side.
- In 2008, the Fed offered similar programs and the companies got out and some even shrunk their balance sheets. Once the crisis passes the bonds can mature or be sold.
- Debt to GDP will be 130% - the worry is about what does the dollar do? Gold prices are up, does this imply inflation? There are long term pressures that the Fed will have to naturally resolve themselves.

Comment on the Percentage of Machine Buying going on in the S&P?

- It was a factor a couple weeks ago and was an issue in Q4 2018. High frequency and algorithms along with liquidity drying up which emphasized the decline, but they can also emphasize the recovery. Ultimately, they don't change the game.
- We are seeing days of 5-10% which is due to high frequency trading. It requires a strong stomach to be able to withstand the exaggerated moves and not panic.
- This provides opportunities for our active managers when the programs hit the market, and everything is dislocated. Ultimately fundamentals will win.

Will risk assets and equities be able to move on their own or will the Fed always have a say? Can there be separation again?

- Only at these inflection points is everything comingled. The DCF has earnings in the numerator and cost of capital in the denominator therefore cost is determined by interest rates (Fed) and inflation.

- Right now, everything is macro which requires a policy response. The market is in lock step with these variables. Once the policy relief and Fed fades away, then earnings and interest rates will drive stock prices.

Give us general thoughts on each of the main global fixed income markets.

- The 10 year yield is 0.75% right in line with the copper-gold ratio which is roughly the right ratio.
- Against the lower level the inflation break evens are rising! The 5 year TIPS are at 1.7% which is higher. Real yield is falling dramatically and is wow at negative levels. There's a sharpe divergence from when all three would move together.
- Tells you that the market is looking ahead to where it's a bigger part of the treasury market. As the treasury issues more debt (which must be done) it would have to rise its interest rates. If the Fed doesn't and engages in yield curve control to cap rates (previously happened in the 2nd world war) keeping nominal rates low then inflation could go up and real rates fall over a multi-year time frame).
- The Treasury market is pricing this in now already.

With the Fed being a bigger player are there echoes of Japan?

- The risk is that we are going to end up looking like Japan, where fiscal is large player in economy, and the BoJ is a large player in bond market.
- The Economy grows slowly there and it doesn't take much to go into small recessions! Slower growth, ex. 2%, means your closer to a recession compared to larger growth.
- The price we pay for the Fed removing the worst-case scenarios is less upside down the road. With out demographics I can see us being more like Japan in the future.
- There's a battle between capital and labour. The US has a stock market that has always been more focused on the capital side and being shareholder friendly. In Europe companies are run with employee interest and the labour side.
- Will the corona crisis start a gradual regime shift where labour starts to win over capital? Where less emphasis on shareholder return and a focus on employees, which is the cultural part of it.
- The US would lose the P/E premium is has earned over other companies, and it's an opportunity to invest outside of the US vs. inside the US. Its an actionable thing for investors.

Presidential Election and Shifting Politics

- The focus has shifted because of two things:
  1) Bernie is out which removes the most binary outcomes; an more extreme shift from a right wing populist to left wing. There's a choice between what we haven't gotten familiar with and adapted to vs. what we would call a globalist.
  2) Elections matter with all else being equal. But if you wait long enough after an election the market will do its thing regardless of what's going on in the office. More importantly than who gets elected, will be the shape of the economy.
- It depends on how the president re-opens the economy. The election is a referendum on how Trump is handling this.

Real estate - REITs - what would be your opinion on these markets and continuing downside risk?

- It comes down to valuation now. There was a big shock to owners of real estate. It was both mom and pop shops along with large chains and restaurants being unable to afford rent. No one priced in this possibility.
- Ultimately, it comes back to how quickly the economy can re-open and tenants can pay rent (includes REITS).
- It's in everyone's best interest to bridge this gap and provide relief, offer paychecks and small business loans knowing it's a temporary shock.
- Demographic trends of an aging workforce mean demand or stable cash flows isn't going away. With REITs it's just about getting over the hump and how well will investors be compensated to take the short-term risk.

Retesting the lows? Have we seen the bottom?

- We're starting a trading range between 2500-2900, which is "V" shape vs. "U" shape.
- We won't have a full re-test. Now that the markets have exceeded expectations the sell side of Wall Street are saying the bottom is in.
- The low on March 23rd was the momentum low or internal bottom. This is easily identified. Now we've built the range.
- We could get a re-test or not, we could get a higher low but the government has removed the worst case scenario. If we break into new highs next year then it would be a successful retest of the lows.
- We've priced in a lot of good news and will tread water in this space for a while. We can rebalance around dips but that's the most dramatic we'll experience. It will be a bit of boring moving forward.

What fiscal monetary tools are left for future waves of COVID-19?

- More of the same which we suspect would be enough. There may be a 2nd or 3rd wave which should be smaller than the first. The second wave would require just the region to lock down, not the entire economy at once.
- Fed has said that it has infinite fire power, can expand their balance sheet (4-6T in months, could be at 10T in the future) and the fiscal side is more of the same.
- We have more hope everyday for treatment strategies and treatment plans. With Apple and Google processes, we are working hard to get back! Human ingenuity will come through.