FIDELITY INVESTMENTS
VISION UPDATE:
Accelerating Dreams

Wednesday, October 23rd 2024

Meeting Notes

Contents

Global Asset Allocation Outlook

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Introduction

- Manages $90 billion.
- 30 Lippers, 60 Fund Grade A awards.
- Fidelity Managed Portfolios (FMP) 10 years ago was $2.7 billion AUM → today it's $47 billion.

FMP and asset allocation.

- Manages funds such as Global Growth, Global Balance, Private Investment Pools, Monthly Income Suite.
- 2 key ingredients:
    1. Reach across Fidelity in Canada, US, and internationally to pick managers.
        - Pick managers of different asset classes, geography, style, sectors.
    2. Use rigorous and research based 4 Pillar Framework to lean in or out of asset classes.
- Combine these 2 aspects to add return above the benchmark.
- Has led to meaningful amount of excess returns.
    1. 40% over 10-year period.
    2. Approach might not work every day or month but has led to meaningful excess returns for medium to long term investor.

Views on the investment environment.

- Constructive on markets.
- Remain overweight on equities.
- 4 Pillar Framework to explain the constructive view:
    1. **Pillar 1:** Macro
        - Economy, profits, growth, inflation, policy.
        - U.S economy is good despite concerns about slower growth and unemployment increases.
        - Its capacity is growing fast (productivity and labour growth).
        - The Fed can stimulate the economy as hard as they want without worrying about inflation.
            - Reflects their confidence in economy.
    2. **Pillar 2:** Bottom-Up
        - Insights from underlying and fixed income portfolio managers and analysts.
        - No one can match our breadth of resources.
        - Work with them for 10+ years, trust their insights and process on companies and industries.
    3. **Pillar 3:** Valuation
        - Concern about level of U.S equity valuations → higher than they historically are.
        - Valuations being pulled by the high end of the market (Magnificent 7).
        - Longer term earnings outlook does justify the high levels of valuation.
    4. **Pillar 4:** Sentiment
        - If everyone is on one side of the boat, we want to lean against it.
        - Not seeing extremes in market positioning at this stage.

- 4 pillars are used to remove worry and emotion and be deliberate → still take some reason equity risk.

Rates and implications on the bond market.

- Federal Reserve:
    - Favourable → will try to bring their policy rate down to the neutral level and lead to a shallower rate cutting cycle.
- Bank of Canada:
    - Daunting → challenges faced by Canadian economy is more significant.
    - Productivity story doesn't show up in Canadian economy.
    - Has significant headwinds → how much leverage on household balance sheets.
        - Higher rates and greater rate sensitivity.
    - Will probably have to cut interest rates further into accommodative territory.
- Canadian CPI is 1.6% which is below target.
    - Shelter component → mortgage, rent, construction decreases.
    - 0% at some point next year.
    - Gives room to cut rates further.
- Underweight in bonds:
    - Optimistic outlook → underweight in bonds, funding overweight into equities.
    - Fixed income → underweight in investment grade to fund credit exposures.
- Work with underlying managers for the credit exposures.
    - Opportunities on a security by security basis.
    - More cyclically sensitive allocations within the bond portion.
- Implications:
    - The fed doesn't need to cut as much.
    - Housing and consumer spending has been the driver of growth.
        - More vulnerable due to debt loads.
    - 2023 Canada was in a recession.
    - 3 ways to recover:
        - Foreign rates of growth that are stronger.
        - Higher rates of productivity in Canada.
        - Canada can go on sale.
            - Depreciation of Canadian dollar.
            - Ex. A movie is cheaper to film for the production company shooting it.

Productivity.

- How efficiently are you using your resources in your economy.
- If productivity is strong, growth can be stronger with putting pressure on inflation.
- Good productivity in the U.S at 3%.
    - Due to capital investment → AI, manufacturing, public investment.
    - Change in working arrangements.
        - Instead of 9-5, becoming more flexible has been better for productivity.
        - Better for labour participation.
- Gap in Canadian productivity getting wider:
    - Larger government sector.
    - Concentrated industry, less competition.
    - Haven't invested enough.

        - Intellectual property product (R&D, software) investments are half compared to U.S.
        - Money going to real estate instead of building productive capacity as it's easy to make money.

Thoughts on the rest of the world.

- Underweight Canadian equities.
- Overweight earlier in the year was focused on U.S market.
    - Reflects optimism in terms of earnings, robust economic growth, less rate sensitive economies.
- U.S more expensive but that's not a signal to change our allocation.
- Corporate earnings revised higher in EAFE basket and EM, relative to the U.S
- Supported by bottom-up channel.
- Allocate assets more evenly among U.S, EAFE basket, and EM.
- China has imbalance in housing, other sectors.
    - Enough to inspire rally in equity markets.
    - Lift consumer sentiment.
    - China running a marathon, hurt their knee, and now trying to rush the recovery.

Fund Positioning.

- In the context of Global Balanced, 60/40.
- 66/34 now.
    - Overweight in equities.
- 21% of equities are Canadian.
- Shave it by 4%.
    - Rooting for Canadian implosion - false.
    - Don't own Canadian equities - false.
- Underlying managers incentivized to beat their own benchmark, boosts the performance of the fund.
- Commodities is the best asset class to protect portfolios against inflation.
- Underweight the Canadian dollar.
    - Direction of travel is lower.
    - Funds are less affected, preserve basis points.

Alternatives to diversification.

- Diversification:
    - Inversely correlated → opportunity to diversify by buying both, guaranteed return.
    - This is the principle for the multi asset funds in terms of diversification.
- Choosing capabilities and asset classes that have high returns and low correlations with each other.
- Correlation between stocks and bonds went from negative to positive.
    - Not getting the diversification you expect.
- Using Global Value Long/Short, Long/Short Alternative Fund, and Market Neutral Fund.
- Wants to enhance risk adjusted returns without changing underlying nature of the funds.
    - Allocations with modest but diversified.
- Bring in private real estate vehicle managed by Brookfield into private pools.
    - Enhancement to risk adjusted returns.

- Fresh capital.

Impact of U.S election on process.

- Don't have an edge in politics.
- Getting the impact on markets correct is hard → we don't try to anticipate.
- 2016 election:
  - Markets were limit up in bonds and limit down in stocks.
  - Fear reaction.
  - Good period for stocks.
- Mindful that different outcomes can lead to different policy results.
- Commonalities between parties (motivation to be underweight to Canadian equities):
  - No loyalty fiscal discipline.
  - Not favourable to international trades.

Dividend Investing and Downside Risk Protection

Ramona Persaud, *Portfolio Manager*

Morningstar Ranking and Portfolio Process

- Morningstar recognizes portfolio managers based on performance over time, Ramona is among the top 10 female PMs in the US
- Morningstar dishes rewards based on the performance of the end investor, sometimes this does not correlate well with a funds performance, likely due to volatility.
- Persaud's process emphasizes minimizing volatility to enhance investor trust and match the end investors results more closely with the fund's results

Value and Dividend Investing Approach

- Value investing for Persaud means maximizing returns given constraints, focusing on quality assets at fair valuations, much like finding value in everyday purchases at Costco.
- Her approach blends value and quality, seeking high-quality companies at attractive prices, relying heavily on the strength of Fidelity's research teams.
- She emphasizes optimizing returns per unit of price/valuation, through her engineering background which emphasizes systematic and quantitative thinking.

Fidelity's Strong Research Team

- Fidelity has built a talented research team that excels at identifying the differences between signals (valuable insights) and noise in a growing sea of market information.
- Analysts, such as those in small-cap teams, gather insights globally, meeting with numerous companies and providing valuable data for portfolio managers.
- The research team's ability to filter meaningful information is seen as a crucial advantage in maintaining strong investment decisions amidst market noise.

Engineering Background and Investing Strategy

- Persaud applies her engineering mindset to investing, focusing on reducing friction (volatility and risk) to enhance returns.
- To be a good investor you need a deep level of critical-thinking, intellectual curiosity, and grit.

- She views volatility as both a risk to minimize and as an opportunity to buy high-quality stocks at lower prices during market disruptions.

Noise vs. Signal in Market Analysis

- With the rise of information, the challenge has shifted to separating valuable insights (signals) from overwhelming noise.
- Persaud relies on Fidelity's robust research team to filter out noise and focus on meaningful signals/insights that inform investment decisions.
- An example of the strength of Fidelity's research team is shown by an analyst in our Boston office who met with over 200 companies globally to extract valuable investment insights, demonstrating the team's commitment to finding signals amidst noise.

Market Volatility and Active Management

- At the margins the market is increasingly driven by emotion due to the rise in information noise.
- Volatility provides opportunities for active stock pickers to make strategic decisions.
- Ramona takes a more active investment approach when dispersion is higher, when it's lower, she eases back on her active management.

Earnings and Market Reaction

- Generally view earnings as noise, with more importance placed on long-term market trends.
- Currently, earnings reports show positive surprises, about 80% of the earnings growth has been from the financial sector

Global Strategy and Stock Picking

- Managing global portfolios allows for anti-correlation, offering diversification and a broader range of opportunities.
- Stock picking in various markets, including emerging and established economies, provides exciting opportunities in different sectors.
- The global strategy highlights the value of focusing on diverse markets rather than relying on a concentrated U.S. market.

Consumer Sentiment and Investment

- Consumer confidence is currently at a low, comparable to levels seen in 1980, influenced by inflation and economic uncertainty.
- Despite low sentiment, key economic indicators, such as reduced fuel costs and favorable free cash flow yield in consumer discretionary stocks, suggest positive investment signals.
- Valuation dispersion within consumer sectors points to opportunities, particularly in stocks connected to lower-end consumers.

Thinking Big with Small Caps

Connor Gordon, *Portfolio Manager*

Why should we be looking at small caps and how do you define them?

- Small caps are defined as companies with a market cap between $1 billion and $14 billion.
    - Average in the fund 6,7,8 billion
    - Mid cap in a Canadian context
    - Tend to be bigger profitable durable business that still have a lot of runway to grow

- While small caps might appear risky, they often perform comparably or better than large-cap indices.
- Investors can diversify by gaining exposure to underappreciated global companies.
    - The Mag 7 take up 70% of the S&P 100
    - Investing in a core S&P fund only gives exposure to top 100 companies.
    - Small cap aims to expose investors to everything else
- Small caps offer enhanced returns by providing access to companies under the radar of large institutional investors.
- Inflection points happen to create mispricing, and this fund takes advantage of that.

What is the strategy behind the Global Small Cap Opportunities Fund?

- The fund focuses on identifying 40-50 high-quality, underappreciated ideas globally.
    - Compared to other small cap mandates which have 100 – 200+ holdings
    - Connor believes it is difficult to get the margin of outperformance they do with more that many companies
- The mandate allows for global investments but does not require regional allocation adherence.
    - They look for the best companies by sector not by region
- A sector-based view is used to identify the best companies, regardless of location.
    - Example: Mining - some of the best mining companies are in Sweden, Finland, and Japan
- The fund employs an "inflection point" strategy, targeting companies experiencing positive changes or temporary uncertainty.

How do Connor Gordon and Chris Maludzinski manage the fund together?

- Both portfolio managers bring complementary sector expertise, covering different industries.
- Their styles are 90% similar, but they challenge each other's ideas to identify the best opportunities.
- The strategy focuses on global, high-conviction investments, each manager contributes about 20-25 core ideas and pushes them to the top of the fund.
- The fund's top holdings tend to be 40-50 stocks, ensuring concentrated, high-quality exposure.

What is the process for selecting stocks for the fund?

- The universe starts with 12,000 developed market stocks, narrowed down by excluding companies below $1 billion in market cap or above $14 billion.
- They filter further by avoiding companies lacking transparency (banks), avoiding obsolescence (research in motion, Technology obsolescence risk), and avoiding hyper-macro-sensitive sectors like commodities or interest-rate-dependent businesses.
- The final focus list of around 500 stocks is identified through criteria being profitability, predictability, and durability.
    - Profitability: Focus on companies with high returns on capital and positive free cash flow.
    - Predictability: The ability to confidently project earnings over the next three years.
    - Durability: Resilient businesses with strong balance sheets that can withstand shocks.
- Stocks are then monitored for inflection points, where significant positive change or temporary dislocation presents buying opportunities.

Temporary dislocation: MTU Arrow example:

- There was an issue with an engine they made in partnership with Pratt and Whitney, Arrow was on the hook for a 1-billion-dollar repair charge - leading the stock to go from $220 to $160.
- The team determined that this was a manufacturing issue as opposed to a design issue.
- The normalized earning power of the business had not changed.
- Had the chance to buy the stock at 8 times EBIT when historically it had traded at around 15 times.
- Uncertainty in the moment and the team needed to look out 2 - 3 years and live with that temporary uncertainty.
- The stock has gone from 160 to over 300.

Positive change example: Valvoline:

- Two thirds of the business was motor oil - not growing.
- One third of the company was quick loop oil change a growing retail service that was growing their store count 7 - 8% per year and their sales were growing at some rate.
- Bought the stock at 15 times earnings.
- Valvoline sold the oil aspect of their business and is now a pure play automotive services business with some of the best retail unit economics and the stock is growing at 15 - 20%.
- The moderator mentions Valvoline has grown to the extent it is now an F1 sponsor.

How does the fund manage growth in small caps, and when do they sell stocks?

- The goal is to find small caps on their way to becoming large caps, and the fund does not have a sunset clause requiring immediate selling as companies grow.
- Up to 20% of the portfolio can remain in large caps, allowing continued participation in a company's growth.
- When reinvesting, the focus is on new opportunities in the $2-8 billion range, where the fund historically generates the most alpha.

How does Fidelity's research team support the fund's success?

- Fidelity's extensive research team, with 140 analysts, helps identify potential investment opportunities worldwide.
- The team conducts in-depth research, including on-the-ground visits and meetings with public companies.
    - Connor uses an example of an analyst going to Brussels and meeting every public company
- Analysts regularly provide insights that inform investment decisions, helping the portfolio managers act quickly on opportunities.
- The collaborative structure allows portfolio managers to leverage the expertise of analysts across sectors and regions.

Analyst advantage example: Belron

- Belron is the largest auto glass repair company in the world, own speedy glass in Canada safe flight in the US.
- Analyst returns from Brussels with note "family has sold half of Belron to private equity firm."
    - Positive change - change in management change in governance Conner calls this a trigger that prompted him to look deeper into Belron.
- Connor then leveraged the teams US based auto services analyst to look further, and they discovered that the company is operating at a 5% margin.

    - The analyst believed they should be doing as much as 20%.
- Inflection Point: a "greedy private equity company" just bought half of this company - they believe that the margins could go as high as 20% as well.
- Connor and the team bought this stock in 2020.
- The private equity firm bought it for 3 billion, margins begin marching higher and higher.
- In July of 2021, the private equity company had sold roughly half their stake for 21 billion - 7x in 18 months.
- Connor reiterates the importance of the boots on the ground approach by saying "this is not something you find on the front page."

What effect did senior portfolio managers have on Connors investment style and growth at Fidelity?

- He credits Peter lynch and his book one over Wall Street with teaching him about Fidelity in university.
- Mentions that Andrew marchese gave him enough autonomy to find his own style.
- Try and use ideas and learnings from other PMs.
    - Learned to be ruthless on selling losers and cutting losses to protect his portfolio from Mark Schmehl
    - Learned to withstand short term uncertainty from Hugo Lavallee

How does AI fit into small cap investing?

- Connor refers to AI as the flavor of the day.
    - Looking back on historical performance and previous top 10 market cap stocks outlining the change decade over decade - implying that the largest stocks of will not remain the largest stocks.
    - Promoting exposure to lesser-known small cap stocks
- In 2029 will we be sitting here talking about AI and semiconductors? Conner does not believe so.

Fixed Income Now

Jeff Moore, *Portfolio Manager*
Michael Plage, *Portfolio Manager*

How did the team-based approach evolve in fixed income at Fidelity, especially with Jeff Moore's retirement approaching?

- The team-based approach was developed in 1995, separating from the equity group to focus on fixed income.
- The goal was to avoid a "star system" and create a robust process ensuring long-term consistency.
- The system was designed to ensure smooth transitions and portfolio stability even during leadership changes.
- The emphasis is on process over individual performance, ensuring that benchmarks, volatility, and management objectives are not disrupted.
- Jeff's team is prepared to take over smoothly, continuing the legacy with minimal impact on portfolio performance.

Could you talk about your colleagues (Bryan, Stacy, Michael, etc.) and how they contribute to the team?

- **Stacy**: Quant expert, focusing on portfolio beta and alpha, seamlessly integrates into the team.
- **Bryan**: Structured product analyst, skilled in CLOs, airplane financing, and other structured securities.
- **Michael**: Co-lead on multi-sector strategies, instrumental in the development of tactical bond strategies with Jeff.
- **Celso**: Long-time team member with vast experience, especially in core-plus fixed income strategies.
- The team works collaboratively, ensuring continuity in leadership and investment strategy.

How did the bond market recover after the pandemic and how has fixed income performed recently?

- Bond yields rose sharply post-pandemic, with 2022 marking the worst bond market performance on record.
- However, this reset of yields was seen as a long-term benefit, offering higher compounding returns.
- Bonds are now yielding 5-7%, providing a sustainable income for investors.
- 2023 and 2024 have shown strong performance in fixed income, with improved liquidity in the bond market.
- Despite volatility, the bond market has recovered well, supported by the Fed's policy shifts.

What's next for the Fed and other central banks?

- The Fed cut rates by 50 basis points in late 2023, with a potential for a few more cuts in 2024.
- Canada and the U.S. are in different positions since Canada is more sensitive to rate changes due to higher household debt.
- U.S. fixed-rate mortgages provide some insulation from rate hikes, unlike Canada's floating-rate mortgages.
- The Fed is focusing on gradual adjustments to avoid spooking the equity markets.
- Long-term projections are still uncertain as both central banks are data-dependent.

Is it too late to invest in fixed income now?

- No, fixed income remains attractive, especially in the U.S. Treasury market.
- Corporate bonds may not offer as much opportunity due to tight spreads, but government bonds remain lucrative.
- Trading duration from the long side can still yield solid returns.
- The rate complex remains at an all-time high, providing ongoing opportunities.
- U.S. Treasuries offer positive real interest rates, making them valuable in portfolios.

Why should Canadian investors consider U.S. fixed income, and what are your views on currency hedging?

- The U.S. market offers greater diversification and yield pick-up over Canadian bonds.
- U.S. Treasuries provide attractive long-term compounding opportunities.
- Currency hedging is recommended to avoid potential losses if the Canadian dollar strengthens.
- Hedging helps mitigate volatility in fixed-income portfolio which offers steady returns.
- Unhedged positions in currency-sensitive strategies could lead to losses that are difficult to offset in fixed income.

What are your thoughts on the potential impacts of the upcoming U.S. elections on markets?

- A sweep by either party is possible but unlikely to significantly impact the markets.
- Governing with a small majority in the House will be challenging and make significant policy changes difficult.
- Market-moving legislation is not expected and the election outcome is not seen as an investable event.
- Inflationary shifts or dramatic policy changes are unlikely to materialize immediately post-election.
- Investors should not reposition portfolios based solely on election outcomes.

Can bonds still provide diversification, despite recent criticisms of the 60/40 portfolio model?

- Bonds offer income, liquidity, and diversification, critical components of portfolio balance.
- Positive stock-bond correlation in 2022 raised concerns, but 2023 showed bonds acting as a hedge against equity volatility.
- The diversification benefit of bonds has returned, evidenced during events like the regional bank crisis in March 2023.
- The 60/40 portfolio model remains relevant, with bonds once again providing a buffer against market downturns.
- Bonds continue to play a vital role in providing portfolio balance during periods of market instability.

Could you explain the different funds the team manages, and their positioning?

- **Fidelity Multi-Sector Bond Fund**: Launched in 2017, it's the most flexible product, allowing up to 70% below investment grade.
  - Uses a 5-step process: macro analysis, sector selection, and asset allocation.
  - Provides flexibility to adapt to the best opportunities in the fixed income market.
  - Offers a good yield per unit of volatility, making it a reasonable diversifier.
- **Fidelity Investment Grade Total Bond Fund and Global Investment Grade Bond ETF**: Limited to 25% below investment grade.
  - Better suited as diversifiers for stock portfolios, assuming negative correlation returns.
  - Less yield than multi-sector but more stable in terms of quality allocation.
- **Fidelity Tactical Credit Portfolio**: Focuses entirely on credit, investing in high-yield bonds and investment-grade corporate bonds.
  - Higher yield but carries more drawdown risk during periods of equity market volatility.
- **Market Valuations and Bond Views**:
  - Stocks and bonds face similar issues with spreads at tight levels, reflecting minimal default risk priced in.
  - U.S. Treasuries offer the best value, providing positive real interest rates.
  - While valuations are high, a shift in market conditions could lead to volatility, but 60/40 portfolios remain attractive.

What is the view on Longer-Dated Bonds (20+ years):

- While the market expects a rise in the long end of the Treasury curve, it's prudent to wait for actual policies from the new administration.
- The yield curve is expected to steepen, offering opportunities in the long-dated segment, but a significant sell-off is not anticipated.

- Short-term caution is advised as the market waits for clarity on policy shifts post-election.

What are some thoughts on high yield investments currently?

- Default rates have been lower than expected, but high yield beta is not as attractive.
- Alpha opportunities remain in well-chosen high yield companies with stable cash flows.
- The focus is on finding strong companies rather than chasing broad market beta.
- High yield remains a selective area with potential for capital gains through diligent stock picking.
- The overall high-yield market is full, but there are pockets of opportunities for skilled investors.

What are your thoughts on floating rates, and why have you reduced your position recently?

- Floating rate notes have been highly profitable, benefiting from higher rates.
- Spreads have fallen quickly, and there's significant liquidity in the market.
- Even weaker companies are getting access to capital, reducing the appeal of floating rates.
- The focus is now on being disciplined, moving into floating rates when there's value and stepping back when opportunities shrink.
- Recent reduction in position reflects the collapse in spreads and the need to wait for more attractive entry points.

Are there any sectors you are avoiding right now?

- Avoiding mortgage-backed securities (MBS) due to tight spreads and limited opportunities.
- MBS are trading at all-time tight levels, limiting potential returns.
- Unlike equity or credit markets, where spreads can continue to grow with earnings, MBS spreads are constrained.
- A spread widening in MBS could wipe out years of returns, making U.S. Treasuries a better option for now.
- The focus is on avoiding areas with high compression risks and seeking opportunities in safer investments like Treasuries.

What are some final thoughts on GICs?

- Strong dislike for GICs, calling them an illiquid form of a highly liquid asset class.
- Emphasizes that investors should at least get an 8-10% return if their money is tied up.
- GICs frustrate Jeff due to their lack of flexibility and low return potential compared to other fixed-income assets.

Michael, you mentioned some of Jeff's analogies. Could you explain one?

- Jeff often says, "A chicken for every pot" or "Leverage will break your heart."
- These sayings reflect his belief in disciplined investing and avoiding unnecessary risk.
- High rates and compounding returns are seen as valuable gifts, and Jeff emphasizes patience in investing.
- Over the years, the team has learned to "speak Jeff" and appreciate his unique approach to market wisdom.

Toronto Vision: A CIO perspective and market outlook

Andrew Marchese, *Chief Investment Officer and Portfolio Manager*

Introduction to Key Investing Tenets and Hypothesis:

- Focus on four tenets of investing but with a new hypothesis related to the global economic cycle, monetary policy, and long-term asset pricing.
- Not focused on short-term stock market moves but longer-term implications for investing post-COVID.
- Suggests we may be in a new era of pricing securities and assets.

Post-COVID Economic Era:

- Central banks have managed the boom-bust cycle better compared to the 80s, 90s, and 2000s.
- Past recessions led to long-term opportunities for growth.
- COVID was a catalyst for unprecedented liquidity and money supply growth by central banks, but it wasn't a traditional economic washout.

Money Supply and Inflation:

- The money supply has grown significantly, starting from the global financial crisis and accelerated post-2020.
- In 2022, there was an expectation to withdraw liquidity, but it only happened for one year before money supply started increasing again.
- Cycles will persist, but their amplitude (growth and contraction) may be muted, impacting investing strategies.

Investing in a Liquidity-Driven World:

- Liquidity and money supply will be the key drivers for valuations.
- Relative earnings growth becomes important, especially in equities.
- Corporations with higher growth relative to peers will gain valuation advantages.
- Money supply levels will influence how asset prices compete for capital.

Implications for Investors:

- Focus on companies with consistent long-term growth.
- Despite cyclical changes, long-term growth and stock-following earnings remain critical.
- Valuations will depend on factors like money supply, risk, and market sentiment.
- News-driven market reactions are faster, making active management more challenging.
- Low-quality stocks may perform cyclically, but fundamentals will still matter long-term.

Winner-Takes-All Market:

- Large-cap industries are increasingly "winner-take-all" unless policy changes disrupt the trend.
- Long-term winners should be held longer in portfolios to capitalize on growth.
- Slower global growth may result in shorter and more compacted economic cycles, affecting equity leadership and asset pricing.

Financial Engineering's Impact:

- Financial engineering, such as ETFs and CTAs, adds complexity to short-term security pricing.
- Investors need to distinguish between durable and non-durable price movements.

Focus on Corporate Profits and Labour Markets:

- Corporate profits are strong, even with slow economic growth.
- Higher unemployment rates may not significantly impact profitability, particularly in North America and globally.

Interest Rates & Oil Prices:

- Bank of Canada cut rates by 50 basis points.
- Potential for lower oil prices, stimulating the economy for both consumers and corporations.
- Lower interest rates and oil prices can boost corporate profits and lower equity risk premiums, benefiting both profits and valuations.

Market Environment:

- Potential similarities to 2016 market dynamics: U.S. election, Federal Reserve rate policy, and global economic influences.
- In 2016, the Fed paused rate hikes due to Chinese economic turmoil, providing liquidity and boosting risk trades.
- Election outcomes should not be the basis for investment decisions due to uncertainty.

Current Market Conditions:

- Key factors: corporate profits, interest rates, liquidity, and valuations.
- Corporate profits are at a solid level, though growth may be peaking.
- Interest rates are moving in a favourable direction, with central banks acting effectively.
- Liquidity is abundant, but may pose long-term risks for future generations.
- Valuation is neutral, with opportunities in specific areas.

Economic Cycle:

- The global economic cycle is still in the late phase, with central banks adjusting policies to prevent recession.
- Current market leadership and trends do not fit neatly into traditional early, mid, or late-cycle patterns.
- The capital cycle is somewhat disconnected from the economic cycle.

Monetary Policy & Interest Rates:

- U.S. monetary policy is still in a restrictive mode, with real interest rates above the natural rate of interest.
- Extended periods of restrictive policy risk leading to a recession.
- Interest rate cuts are likely needed to balance inflation and growth, with estimates of 150-200 basis points required.
- The long-term natural rate of interest has declined, aligning with a lower-growth economic environment.

Stock Market Performance:

- Despite low economic growth, stock market performance has been strong.
- The stock market may be performing better than the overall economy in recent years.

Expectations for the Market

- U.S., Canada, Eurozone, and U.K. are expected to cut rates by 150 to 200 basis points.
- Market expectations are more in line with reality now.

- Factors impacting future rates include credit risk, inflation, and economic data.

Global Economic Growth
- Manufacturing has been contracting globally for about two years.
- Service ISM numbers suggest growth at 1%, but actual growth is better than expected.
- Credit spreads are low, FX markets are stable, and inflation has decreased.
- The Fed has successfully managed inflation, and rate cuts may still be feasible.

Consumer and Corporate Impact of Rate Cuts
- Rate cuts will likely lead to increased consumer spending and lower debt service costs.
- Potential risk: reigniting inflation.
- Current corporate profit backdrop is generally positive despite a mediocre economic environment.

Unemployment and Corporate Profits
- U.S. cyclical unemployment peaked in February 2023, and service employment has flattened.
- The SOME rule indicates a possible recession if unemployment rises 50 basis points.
- Corporate revenues have been revised positively, and profits have remained stable.

Productivity and Earnings Growth
- Increased productivity is driving higher earnings and corporate profitability.
- Earnings forecasts for 2024 remain stable at 12%.
- The stock market has performed well, with the TSX up 33%, NASDAQ up 45%, S&P 500 up 42%, MSCI ACWI up 18.5%, and emerging markets up 11%.

Valuation and Market Performance
- Earnings and valuations are driving market gains, supported by higher productivity and strong earnings.
- Valuation multiples have risen as investors move out on the risk curve due to money supply increases.

Oil Prices and Corporate Spending
- Oil prices have been flat year-to-date, but OPEC's spare capacity could push prices lower, benefiting consumer discretionary and technology stocks.

Liquidity and Money Supply
- Global money supply (M2) remains highly correlated with equity performance.
- Increased liquidity in the market continues to push investors further out on the risk curve, supporting market performance.

Overview of Global Money Supply and Market Impact
- Global money supply is at an all-time high of $107 trillion.
- The impact of money supply on risk asset prices was underestimated.
- Low interest rates, monetary policy, and a benign credit environment stimulate growth.
- There is a correlation between the MSCI AQUI index and global money supply, highlighting the impact of liquidity.
- Liquidity increased during COVID, with a notable lack of resolution from the global financial crisis.

- Even with higher rates, liquidity didn't decrease significantly from April to October 2022.
- Equity valuations are neutral, and stock selection is crucial in the current environment.

Opportunities in Consumer Discretionary Stocks
- Consumer discretionary stocks have not fully participated in the current rally.
- These stocks are facing negative earnings revisions and compressing multiples.
- They may benefit from easier comparisons and potential growth in an upcycle.

Past Recommendations: Utilities and Defensive Stocks
- A year ago, utilities were attractive due to their defensive and offensive nature.
- US utilities capitalized on higher power demands and falling yields.

Preference for US Markets
- The US remains favorable due to its innovative companies, strong payout ratios, and shareholder returns.
- As discount rates fall, dividends and share buybacks become more appealing.

Market Performance and Risk
- Recent gains are driven by benign credit, FX environment, and stimulative monetary policy.
- Investors should avoid chasing trends and be cautious of overbought markets.
- The breadth of participation in the S&P 500 is broad, with 84% of stocks above their 200-day moving average.
- Technical corrections and volatility are expected; long-term outlook remains decent despite short-term fluctuations.

Economic Insights: Small Cap Stocks
- Small-cap stocks indicate a mediocre economy but could improve.
- The Russell 2000 includes many companies that do not make profits, especially in biotech.

Sector Performance and Stock Picking
- Financials performed well due to lower recession fears and interest rate cuts.
- Consumer discretionary stocks have room for improvement despite sector returns of 14%-20%.

Focus on Idiosyncratic Opportunities
- Valuations appear full, making stock picking essential.
- Passive ETFs may not offer the same upside; investors should focus on individual stock opportunities → Focus on stocks with perceived valuation compression, particularly those lacking confidence in earnings projections.

Key Takeaways
1. Valuations and market conditions support risk-taking on a multi-year basis.
2. Focus on relative earnings growth for stock outperformance.
3. Look for stocks with compressed valuations due to low confidence in earnings turnaround.

Lessons Learned

Will Danoff, *Portfolio Manager*

Summary

- Will Danoff, the sole manager of Fidelity Contra Fund, discussed his investment philosophy and the fund's performance. Over 34 years, the fund has outperformed the S&P 500 by nearly 3% annually, managing $300 billion.
- Danoff emphasized the importance of high-quality companies with strong earnings growth.
- He highlighted the role of his team of analysts and the significance of learning from mistakes.
- He stressed the importance of accountability, industry expertise, and the value of owner-operators in companies.
- Danoff emphasizes the importance of aligning investment decisions with personal risk tolerance, suggesting a 30% cash allocation for cautious investors.
- They discuss the potential of various sectors, including telecom and utilities

Fidelity Contra Fund Introduction

- Fidelity Contra Fund has a 34-year history and its status as the largest actively managed fund by a single Portfolio Manager, Will Danoff.
- The fund has $2.5 trillion in assets under management and has consistently outperformed the S&P 500 by nearly 3% per year over the past three decades.

Will Danoff's Investment Philosophy and Team Dynamics

- Will Danoff, discusses his approach to managing funds and emphasizes the importance of working well with analysts.
- Danoff mentions the growth of the fund to over $300 billion and credits the team for their contributions.
- He explains his preference for companies that are doing well and his strategy of paying a premium for high-quality stocks.
- Danoff shares the story behind the yellow smiley face in his office, which represents good news and successful investments.

The Importance of Earnings and Quality in Investments

- Danoff elaborates on his belief that stock prices follow earnings per share (EPS)
- He compares investing to buying high-quality items that last longer, emphasizing the importance of quality over price.
- Danoff highlights the higher average company growth rate of his fund compared to the S&P 500, despite having a slightly higher price-to-earnings (PE) ratio.
- He recounts the impact of COVID-19 on the fund and the office environment, including an incentive for analysts to visit his office with new ideas.

Commitment to Shareholders

- Danoff shares a personal story about a letter from a parent investing in the Contra fund for their child's education, which he keeps on his office door as a reminder of his responsibility.
- He emphasizes the importance of staying true to the fund's mission and the role of accountability in managing money.

Learning from Mistakes and Embracing Innovation

- Danoff talks about the importance of acknowledging mistakes and learning from them, sharing insights from George Vander Heiden and the concept of thesis creep.
- Thesis creep is one of the great traps that ensnare investors, particularly value investors. The company reports some bad news, and rather than recognise the mistake and sell, the investor holds on.
- He discusses the value of having an investment diary or note card to keep oneself honest and avoid drifting from the original investment thesis.
- Danoff highlights the challenges of finding good gold stocks and the importance of companies that went public a few years ago performing well.
- He shares his approach to working with analysts and the importance of understanding a company's strengths and managing expectations.

Meeting with Companies and Industry Expertise

- Danoff recounts meetings with various companies, including Franco-Nevada, Brookfield, and GFL, and the insights gained from these interactions.
- For every analyst he meets, he asks them who are the leaders of the industry they are covering.
- Danoff discusses the value of owning the leading player in an industry for scale advantages and the ability to invest in R&D and hire the best people.
- He highlights the importance of having owner-operators in companies, such as GLF, and Fairfax Financials, as they tend to do a better job and are more invested in the success of the company.

Pattern Recognition and Accountability

- Danoff talks about the importance of pattern recognition and the need to keep watching the market and companies.
- He emphasizes the role of Fidelity in seeing every market and company, playing to their strengths, and managing a large amount of money.
- Danoff discusses the challenges of managing a large fund and the importance of accountability and learning from mistakes.
- He shares his approach to meeting with companies and the importance of being respectful and listening in meetings, even if they are short.

Emotional Intelligence and Listening Skills

- Danoff shares his approach to taking notes and re-reading them, emphasizing the importance of listening and learning from every meeting.
- He recounts a story about a meeting with John Chambers of Cisco and the importance of being prepared and ready to probe and double-click on interesting points.
- Danoff discusses the importance of humility and the need to be open to new ideas and perspectives in meetings.

The Role of Owner-Operators and the ‘Best of Breed’

- Danoff highlights the importance of having owner-operators in companies and the benefits they bring to the company's performance.
- He discusses the concept of "best of breed" and the importance of owning the leading player in an industry for scale advantages.
- Danoff shares his approach to managing money and the importance of playing to Fidelity's strengths in various markets and company sizes.
- He emphasizes the need for accountability and the importance of learning from mistakes to improve future performance.

Accountability

- Danoff shares his thoughts on the importance of accountability and the need to hold people accountable for their actions.
- He discusses the challenges of managing a large fund and the importance of staying true to the fund's mission and values.
- Danoff emphasizes the importance of learning from every meeting and the need to be prepared and focused in meetings with companies.

Investment Strategies Amid Geopolitical Tensions

- Danoff emphasizes the importance of understanding personal objectives and risk tolerance, suggesting a 30% cash allocation for worrywarts.
- The conversation touches on the balance between cash and aggressive investments, referencing Vander Heiden's caution on cash levels.

Immigration and Capitalism in North America

- Danoff praises Canada's immigration policies and mentions notable immigrants like Elon Musk and Sundar Pichai.
- The discussion shifts to the success of capitalism in the US, citing examples of entrepreneurs like Steve Jobs, Jeff Bezos, and Wilbur Ross.
- He highlights the resilience and drive of successful individuals who faced challenges early in their careers.

Sector and Industry Investment Preferences

- Danoff outlines his approach to avoiding certain sectors, such as capital-intensive, regulated industries like telecom and utilities.
- Despite avoiding these sectors, Danoff acknowledges opportunities in companies like T-Mobile and data centers.
- In utilities, Danoff owns Cameco and discusses other nuclear energy plays like Brookfield and Constellation Energy.

The Role of AI in Business Efficiency

- Danoff prefers the term "augmented intelligence" to alleviate concerns about AI's potential dangers.
- AI is seen as a tool for handling basic customer service questions and improving productivity, such as generating scenes for movies and reducing the workload of software engineers.

Autonomous Driving and Future Technologies

- The conversation touches on the future of humanoid robots and their demand for GPUs and AI applications.
- Speaker 1 uses the analogy of a poker game to describe the cautious approach to investing in AI, such as to watch the cards, be aware of your opponents' hands, and place bets accordingly. Danoff is waiting for the "killer app" to emerge.
- The discussion includes the potential disruption of industries like search engines by new technologies.

Contra Fund vs. Insights Fund

- Danoff explains the advantages of starting with a fresh piece of paper when creating new funds.

- The larger $15 billion US fund allows for bigger positions in smaller names, while the smaller fund allows for bolder bets.
- He also emphasizes the importance of indexing and the survivor bias in the top positions of the index.

Indexing and Mid-Cap Investments

- Danoff discussed the challenges of indexing and the competitive nature of innovative companies like Microsoft and Google.
- The conversation highlights the importance of watching these companies carefully and finding new winners in the mid and small-cap areas.
- He criticizes the over-indexing trend and the need to focus on smaller, innovative companies.

When do you sell a stock?

- The first reason is deteriorating fundamentals. For example, if government regulations means the oil company has to close down their mines, we should sell that stock.
- The second reason is when a better idea presents itself, leveraging the resources of Fidelity's analysts and management teams.
- It is also important to have meetings with management teams and analysts to identify new investment opportunities.
- The discussion concludes with a focus on the importance of having a good offense in the form of a strong defense in investment strategies.

Diversifying your equity strategy with Global Equity+

Mark Schmehl, *Portfolio Manager*
Dan Dupont, *Portfolio Manager*
Hugo Lavallee, *Portfolio Manager*

Why did you join Fidelity and what was the process of applying?

Dan:

- He really wanted to join Fidelity and had many offers, but he chose Fidelity.
- Firstly, he talked to Maxime Lemieux on McGill campus.
- He tried to impress him by asking if they ever tried to impact the capital deployment of a firm, or if a company had more cash and market cap, would they try to lean on that? And Max said that they didn't know of any profitable company like that, and Dan responded that he knew of one and wrote it at the back of his resume, which led him to interviews.

Mark:

- He was an intern in 1999 during the internet bubble.
- He was assigned Canadian electric utilities and he worked hard covering terrible companies, but he learned a lot.
- He received a Fidelity offer and thought he was smart, so he interviewed at 12 firms, and one fund manager said, "What are you doing here? You should be at Fidelity, where you will learn the most," which convinced him to take the Fidelity offer. He did not regret his decision.

Hugo:

- He wasn’t sure what to do but when Maxime Lemieux came to McGill to tell him about his job at Fidelity, it convinced him that this was the job he wanted.
- He had been rejected by Fidelity twice before, but he worked really hard towards that goal.

- He made a Krispy Kreme report for Fidelity and when he got rejected, he mailed it to 25 fund managers in the US and ended up working for one of them.
- He stayed at the YMCA in New York with 60 other guys and a shared bathroom.
- He ended up at Fidelity by working hard.

What is your opinion on Valuation?

Mark:

- His basic principle is that valuation is the least valuable piece of information you could have on any stock. It is listed on Bloomberg, and we can look it up instantly, He doesn't think it tells us anything, he believes in what is changing and valuation is just there.
- Valuation does matter in extremes to look for very cheap or very expensive company, but it is a salient information point. Valuation makes him do mistakes, so it does not work with his style.

Dan:

- For him, valuation is important. Valuation for the extremes is also very true for him. Buying at the extremes and being patient for things to happen and having the stomach to digest the stress of bad news going out. Positioning in China this year is an example of that. He waits for stock to be really cheap before buying and is quoting that if you jump out of a basement window, it does not hurt that badly. He won't buy some stocks because they are not cheap enough and this is why his fund is concentrated in 30-40 core names.

Hugo:

- He also thinks that valuation matters at extremes. He thinks so much money is lost by waiting for lower valuations. He learned it the hard way with Dollarama but was able to correct that mistake by buying a little higher.

Mark, you are in San Francisco, tell us how it is and what are people excited about for the future?

- He said not to believe the news saying how terrible it is and that it is actually a great place to visit. Things are hoping compared to 3-4 years ago and AI is everywhere with many tiny AI companies that we are not sure if they are real or not. He says AI is not necessarily back, but it is better. It has fundamental value and is being used on a daily basis, like in creating faster power points in minutes instead of days. We are seeing those use cases. People are excited to see technology that will change the world and not pretend like in the last 10 years. It is valuable for him as a growth manager to be there because he is close to it and has first dibs on it by setting up lunch or coffees with these new companies.

Dan, why do you like Tobacco?

- Dan is a value investor. He like the quotes by Albert Edwards from Societe General : "being a value investor is effectively being short crystal meth and long math homework". He thinks "math homework" was undervalued in the last few years and tobacco is part of it. He thinks there is a misperception on tobacco with extremely low valuations and also on the growth prospects. Nicotine pouches are becoming big and there are new products coming in that are less negative on people's health with good volumes. Spirits are cheap also with the fear from Ozempic drugs and other similar drugs and people drinking and smoking less but he thinks it is overdone. It is also less volatile and less cyclical.
- He is looking for good downside protection or a call option if there is volatility. Defense companies are a good example, he was heavily invested in them and when Russia invaded Ukraine, everybody wanted that insurance and buying these stocks to cover geopolitical risk which increased the price by 40% in weeks.

- He may have an “old style” of investing, but he thinks it is still going to pay; staples outperformed technology in the last 50 years and not just in the first 20. He does not try to predict the future, his valuation is what is helping him.

How are you doing year to date and what worked and what did not work?

Mark:

- He harvested the entire AI trade that he got into early which was really profitable.
- He also made big money in crypto related names with big wins and 2 homeruns.
- He does not know what will be the next one, but he is always looking for it.

Dan:

- This year was pretty good for him.
- It paid off a few times, especially with Chinese holdings that had no catalyst and just started doing well.
- Some lower volatility and less cyclical areas did well with rates going down and energy demand going up.
- Inflows in his fund this year were above his expectations.

Hugo:

- It has been a tough 6 months being contrarian.
- The market has a huge dispersion this year and as the real economy slowed, there are fewer and fewer companies doing well.
- There is so much dispersion through sectors; we see this with Canadian banks or industrials.
- There is a lot of market multiple expansion with popular stocks.
- As the economy slows, there are less companies with visibility and that visibility is becoming more expensive.
- It is never perfect, but he thinks that what is cheap is the lack of visibility and he is leaning in the pain with the unpopular stocks.

Global Equity + and the contrast in investment style:

- Different management style and each manager stick to their way.
- There is an approach for everybody, with each style being a third of the fund.
- It is designed to fit with different market cycles with a particular style outperforming depending on the cycle and about having long term results with less volatility.
- The contrasting styles give the opportunity to be automatically rebalanced, helping to prevent the common issue of investors switching funds at the wrong time.
- Together, the portfolio managers won 47 Lipper awards.
- GE+ is the best fund launch for Fidelity with over 3.5 billion dollars in 54-55 weeks.

Important statistics:

- Mark beat 100% of his peers with global innovators.
- Hugo beat 99% of his peers with Canadian Opportunities since he started to manage the fund and 95% of his peers beaten with Greater Canada.

Mark, talk a little bit about developing your style at Fidelity and how Fidelity let you experiment:

- Fidelity lets you fail and fail repeatedly. Being a portfolio manager is a job of experience and the only way to develop experience is to make mistakes. In a lot of firms, they get rid of people making mistakes. He said he made many mistakes as an analyst, but it lets you develop your skills and find the type of manager you are. There is a manager for every style and analysts can follow their footsteps.

Dan:

- He was fairly value at his start and started as an analyst covering staples. He did well because of his style, and then he began covering gold and precious metals, thus having to adapt and learn because they trade on different metrics. He also covered banks during the financial crisis, which was very helpful for him. He then became a diversified manager with a more value-oriented approach. One of the great points in his career was to co-manage with Joel Tillinghast who had one of the best track records which contributed to his learning by forcing him to be at the top of his game. That is when he realized that he was amongst the highest performers, the most motivated people that read every book about investing, and that he had to be on his A game.

Hugo:

- He started in the summer of 2002 and received technology as his first sector. This was formative for him to become a contrarian investor because it was 3 years of negative returns on the NASDAQ and the S&P500. He was going to tech meetings, and nobody was there because nobody cared. There were stocks that went from the bottom of the barrel being overcapitalized to now everybody liking them, and seeing this was formative for Hugo. He recommended Research in Motion which went up 30 times.
- Hugo acknowledges the help from the analyst in the back at the office doing late nights and working hard and the fact that there are a lot of resources at Fidelity.

What is one tool you wish you had from somebody else?

Dan:

- He would like to keep his winners longer. It is something he keeps working on and improving.

Mark:

- He would like to have more patience and it is something he is working on every day. He wants to have the patience to let something happen and not rush from one side to another.
- He improved on it but he is not where he would like. He wants to be like Dan and Hugo and have the ability to stick with his convictions during pain.

Hugo:

- He wishes he would be optimistic like Mark.
- When he lived the pain from the bottom and things started to go well, he struggled to think it would continue to go up, so he wished he would keep his winners longer.

What is something kind somebody at Fidelity did to you?

Hugo:

- He was rejected twice by Fidelity and Maxime Lemieux gave him a chance for a second-round interview. Max talked to his boss and recommended Hugo, which ultimately got him at Fidelity.

Mark:

- In 2003, he was not doing good by longing mining a year too early, and some US portfolio managers said he should be fired and also had a review with the DOR where he was told that his time at Fidelity was done. He went back to his office shattered. He went to his old boss, Bob Haber, and Bob told him to take a breath, that his time is not done and that he believes in his ability. Just to dust off and get back up again. It was a turning point in Mark's career.

Dan:

- Alan Wilkinson sent an email to everybody after doing marketing with him saying a lot of people were asking for his process on more diversified equity fund (he was doing monthly income at that time) and he thinks that helped him to get to manage a Canadian Large cap fund.
- Bob Haber believed in him a gave him early a gold fund to manage which gave Dan some sort of an aura.
- Joel Tillinghast who usually is a quiet type of person but says just a few sentences that are really impactful. He volunteered in a meeting that he was very happy that Dan was a co-manager on NorthStar with him and Dan was touched.

What do you do when you are not doing well?

Hugo:

- He exercises and the important thing is that he does not look at his numbers because he has to believe in the process, it's been successful over the medium and long run, you can not put stress in yourself on things you can't control. He can only control the effort he put in and he is quite happy about the effort he has put in.

Dan:

- He hits the gym and try not to look at the numbers too much to not be stressed out. He does not look at 1 day, 1 week and 1 month performance because it is not really important for him.
- Their boss Andrew Marchese do not come to say that they are doing badly or that they are doing great to not put doubt or encouragement in their strategy. Of course, he is watching, and he trust them for their performance.

Mark:

- In 2022, it was not so great of a year for him. When he doesn't perform well, he exercises and spends a lot of time talking to his wife.
- The thing he try to remember when he is doing badly is the need to be brave. It is hard to be brave and take the risk when you had 1 or 2 years in a row with bad performance, but you have to believe in the process.

Mark, when do you sell a stock?

He sells it when he needs to

- When the fundamentals change
- When the reason he bought it is not correct
- If he finds a better idea

Dan, what are global opportunities right now?

- He is investing more outside of the US because valuations in the US are high. Global stocks are a way to add performance in his funds and he thinks they are a lot of cheap names in Asia and Europe. His process has downside protection first. The UK has been one of his favorite places to invest and Europe is becoming it too.

Mark, anything you would want to tell the audience?

- Canadian Growth Company fund could start to do much better than it has historically and also relative to innovators, because if China is coming back, Canada may be a great place to profit from it.

Dan, what would you like to tell the audience?

- He thinks that global value long/short is in a great place in Global Equity+ because it dampens the volatility and protect then downside. The fund also has a lot of potential upsides.
- He also thinks that Canadian Large Cap has its place because people are more interested in the defensive aspect of it. No matter what the cycle we are in, there is always a place where there are opportunities like with China, utilities or pipelines.
- He is defensively positioned but he can move very quickly.

Hugo and Canadian Opportunities:
- He won't chase utilities, pipelines and REITs because he doesn't think they compound fast over time.
- He thinks that in Canada, we can build great companies and this is what he is looking for in Canadian opportunities.
- There are good things in Canada with energy and commodities exportation.

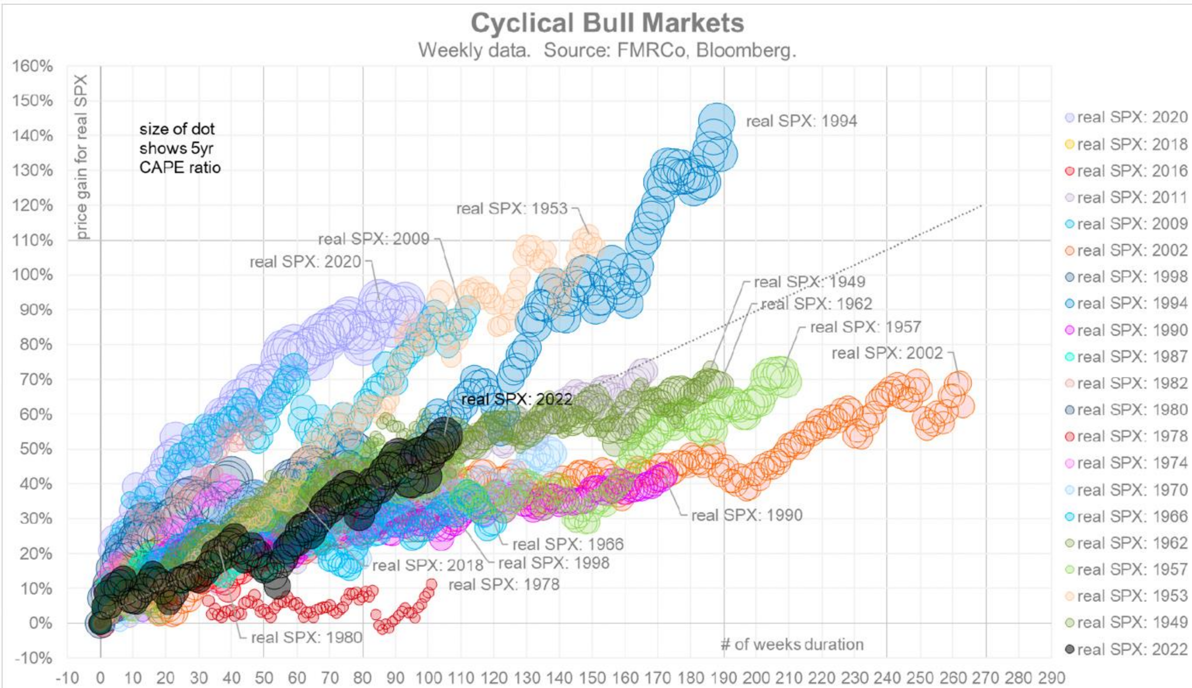
Climate leadership:
- National security, energy security and decarbonation are all intertwined. We saw it with Nuclear. This made the fund perform well.

Mark, what did you saw in the Shopify meeting?
- He saw the clarity of the vision and what they were trying to do, and the path to get there seemed pretty easy.
- Recently, Mark met several private companies in the AI space and they all sound unbelievable with what they are working on and have amazing things that are coming in the next 12 months, but he can't say much about it.

State of the Market

Jurrien Timmer, Director, *Global Macro*

- The bull market began on October 13, 2022, after the rate-induced bear market of that year.
- The S&P 500 has increased by 68% over the past 24 months.
- Historically, median bull markets show a 90% gain over 30 months, so the current market is in line with previous cycles.
- The bull market is currently in the seventh inning, but there could be more time left.
- Unlike typical bull markets that start with broad participation, this one began narrowly focused on the "Magnificent Seven" stocks.
- Broader participation across more stocks and sectors began in late 2022, making the market healthier as it matures.
- Despite being different from past cycles, this market shows signs of continuing growth.



Cyclical Bull Markets
Weekly data. Source: FMRCo, Bloomberg.
price gain for real SPX
size of dot shows 5yr CAPE ratio
# of weeks duration
real SPX: 1994
real SPX: 1953
real SPX: 2009
real SPX: 2020
real SPX: 1949
real SPX: 1962
real SPX: 1957
real SPX: 2002
real SPX: 2022
real SPX: 1990
real SPX: 1966
real SPX: 2018
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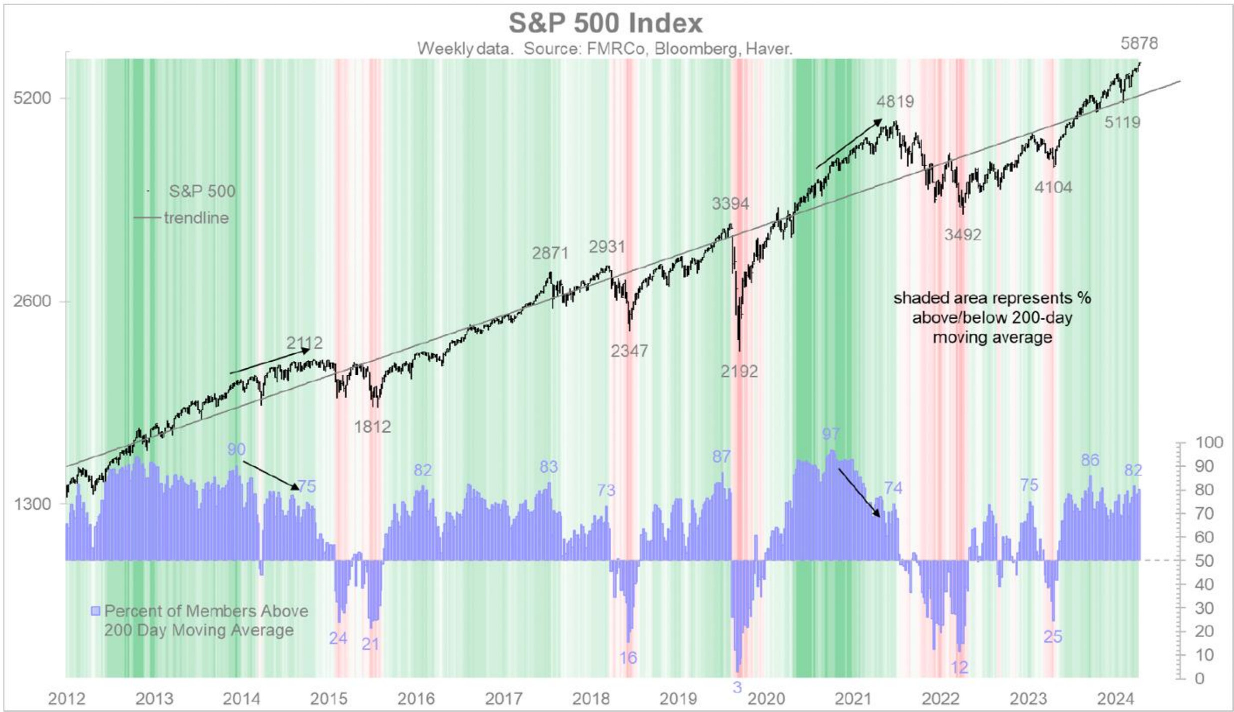
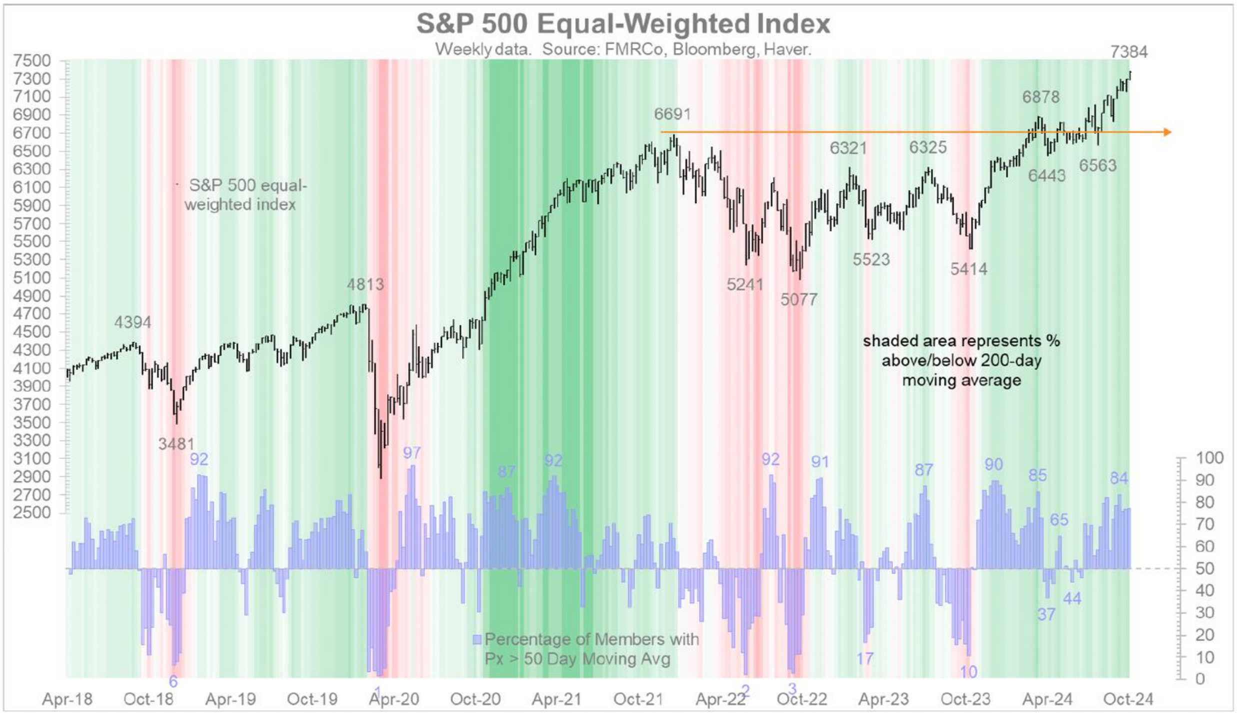
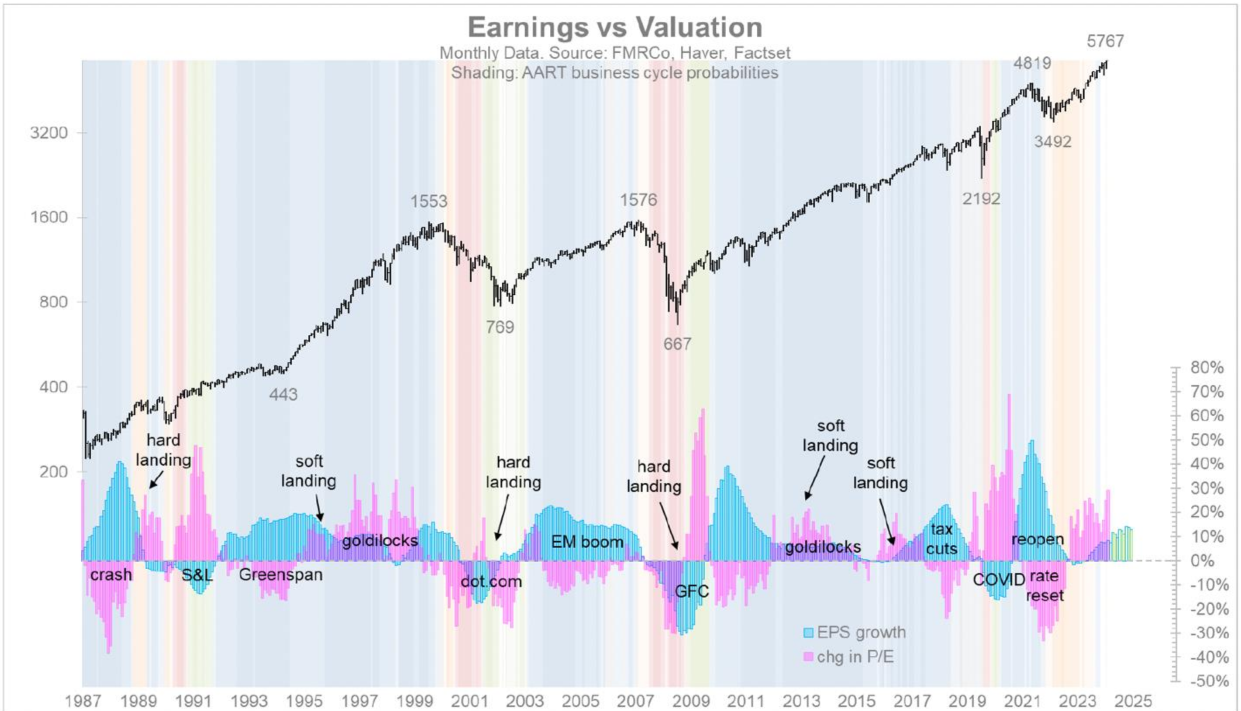
real SPX: 2022



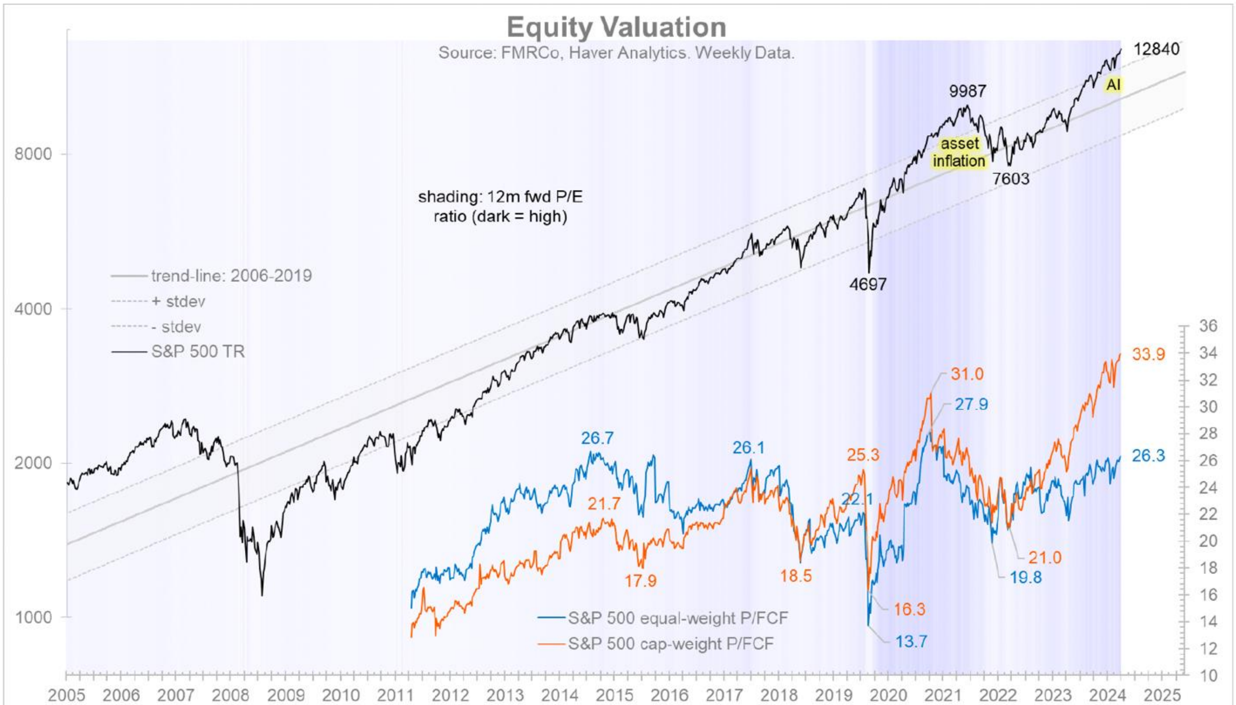
- This chart shows the S&P 500 index, which is capitalization-weighted, meaning larger companies like Apple and Nvidia have a big influence on its movement.
- The market has been dominated by these "Magnificent Seven" mega-cap stocks.
- The S&P 500 is in a long-term rising trend, compounding at about 10% annually, as is typical.
- In 2021, the market temporarily exceeded this trend line when interest rates were kept too low for too long.
- Currently, the S&P 500 is above the trend line again, though not by a significant margin.
- 80% of the stocks in the index are now above their 200-day moving average, indicating they are in long-term uptrends.
- The current market setup, with most stocks in uptrends, contrasts sharply with the late 1990s tech boom when the S&P 500 rose sharply, but the majority of stocks were actually declining.
- Although the broader market has lagged behind the "Magnificent Seven" until recently, many stocks are now going up, just not as quickly as those mega-cap leaders.



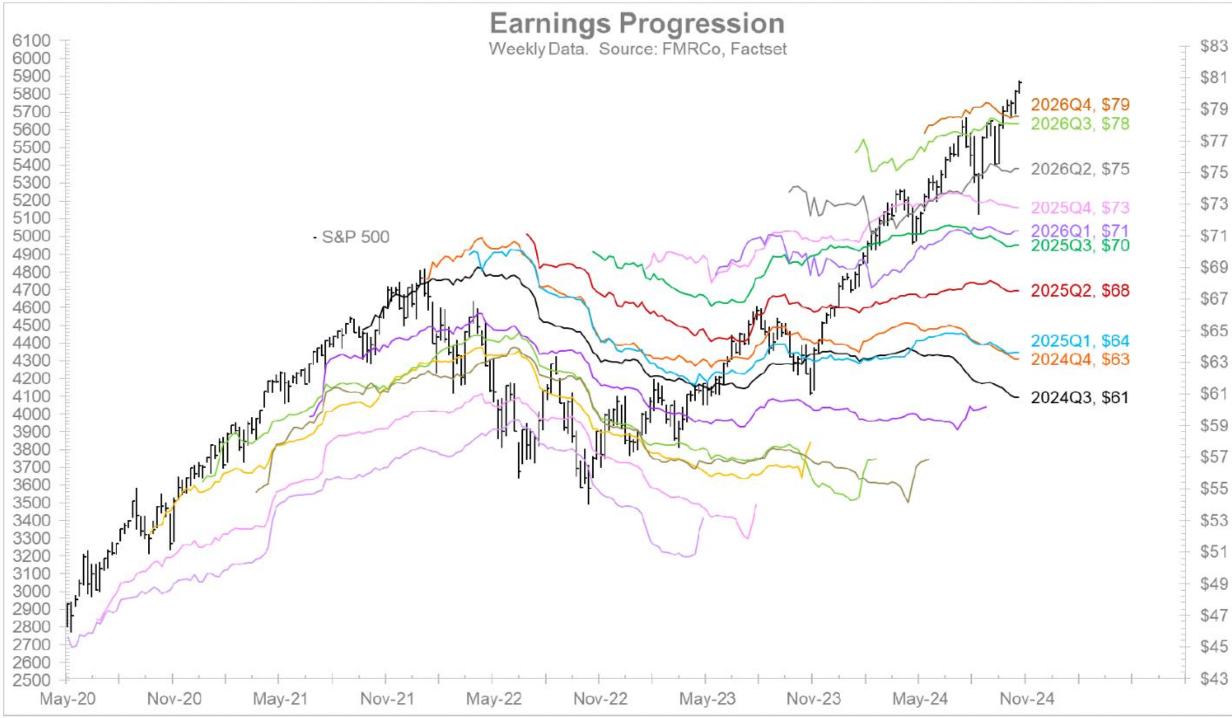
- This chart shows the S&P 500 Equal-Weighted Index, which gives each stock equal weight, unlike the cap-weighted version.
- The index has been making new highs almost weekly, following a consistent pattern of higher highs and higher lows, which is the basic definition of an uptrend.
- The market has broadened in a constructive way, with more stocks participating in the rally, not just the "Magnificent Seven".
- There was a brief period over the summer (around July) when the yen carry trade unwind caused some turbulence, giving a glimpse of how the market could behave negatively if the largest stocks are sold off.
- Currently, the market is in a bullish broadening phase, with more stocks contributing to the upward trend, which is a positive sign for overall market health.



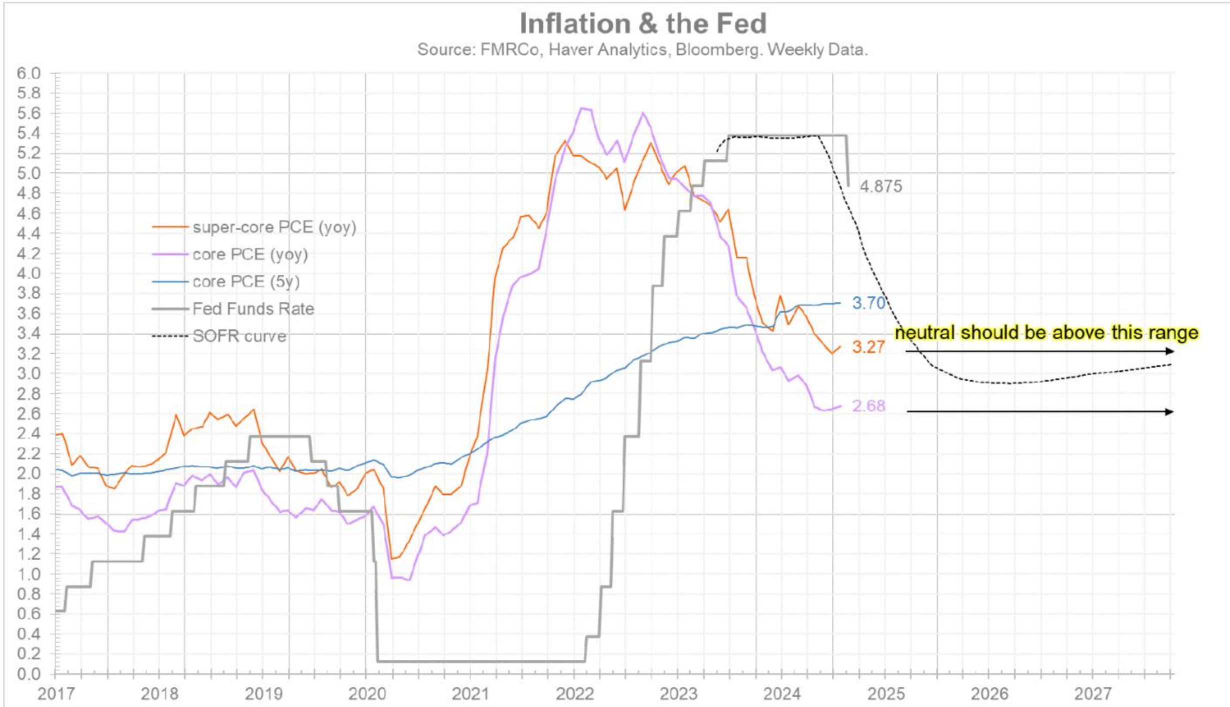
- The total return of a market is made up of three components: dividends, earnings growth, and changes in the price-to-earnings ratio (PE).
- Typically, earnings and PE don't move in the same direction simultaneously; this is shown in the bottom panel with blue bars for earnings and pink bars for PE changes.
- Price tends to anticipate earnings, which is why market timing is difficult. Prices often bottom several quarters before earnings do.
- When earnings and PE move up together, it creates "soft landings" and strong bull markets, as seen during the Greenspan era and after the Shanghai Accord in 2016.
- This cycle is similar to those periods of soft landings, where both earnings and PE are rising simultaneously, explaining the strong market performance recently.
- This pattern is not seen in all markets; for example, emerging markets follow the traditional zigzag pattern of PE and earnings, but markets like India also show simultaneous increases in both metrics, driving strong performance there.



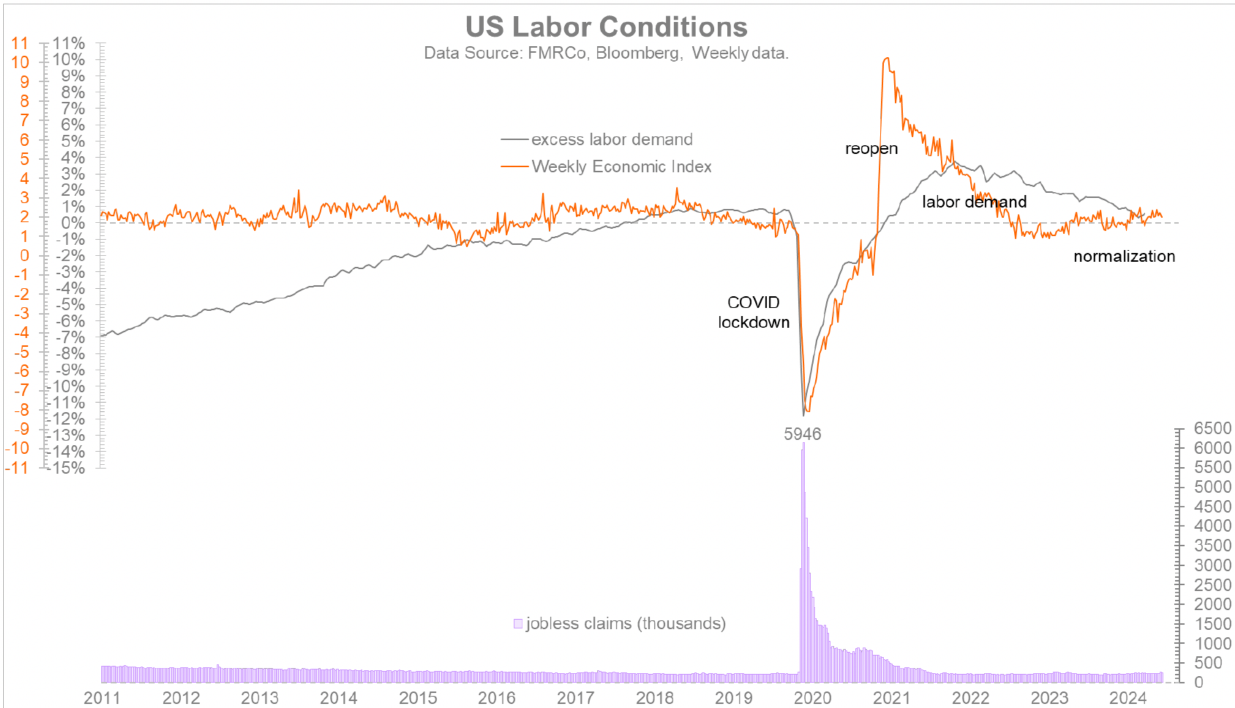
- On a cap-weighted basis, the market is expensive, with a Price to Free Cash Flow (P/FCF) ratio of 34 times earnings, reaching high valuation levels.
- On an equal-weighted basis, the P/FCF is at 26, which, while not cheap, falls within the range of historical norms.
- The average stock is reasonably priced, but the overall market is expensive due to the influence of a few large-cap companies.
- The high valuation of the cap-weighted index is driven by large companies with strong earnings growth, dominating market performance.



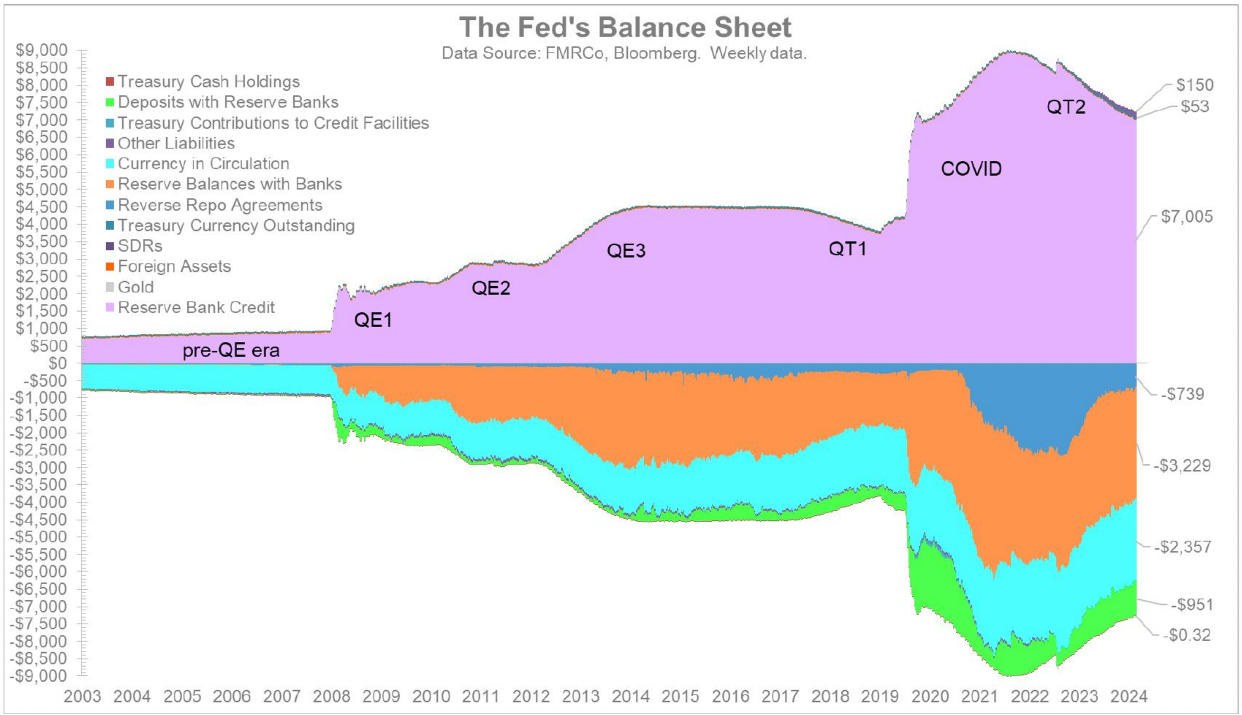
- The chart shows earnings estimates over time, by quarter, with each line representing projections for specific quarters.
- Earnings have been growing steadily since late last year, which has supported the current bull market.
- After the sharp post-pandemic recovery, earnings experienced a modest decline in 2023 before starting to expand again in 2024.
- The earnings growth has been a key driver not just for the U.S. market, but also for global markets.
- Even though future earnings estimates are higher than current quarters, they tend to decrease as the actual reporting quarter, which is normal.
- The overall trend suggests the earnings cycle is maturing, implying that the market is in a later stage of the cycle.



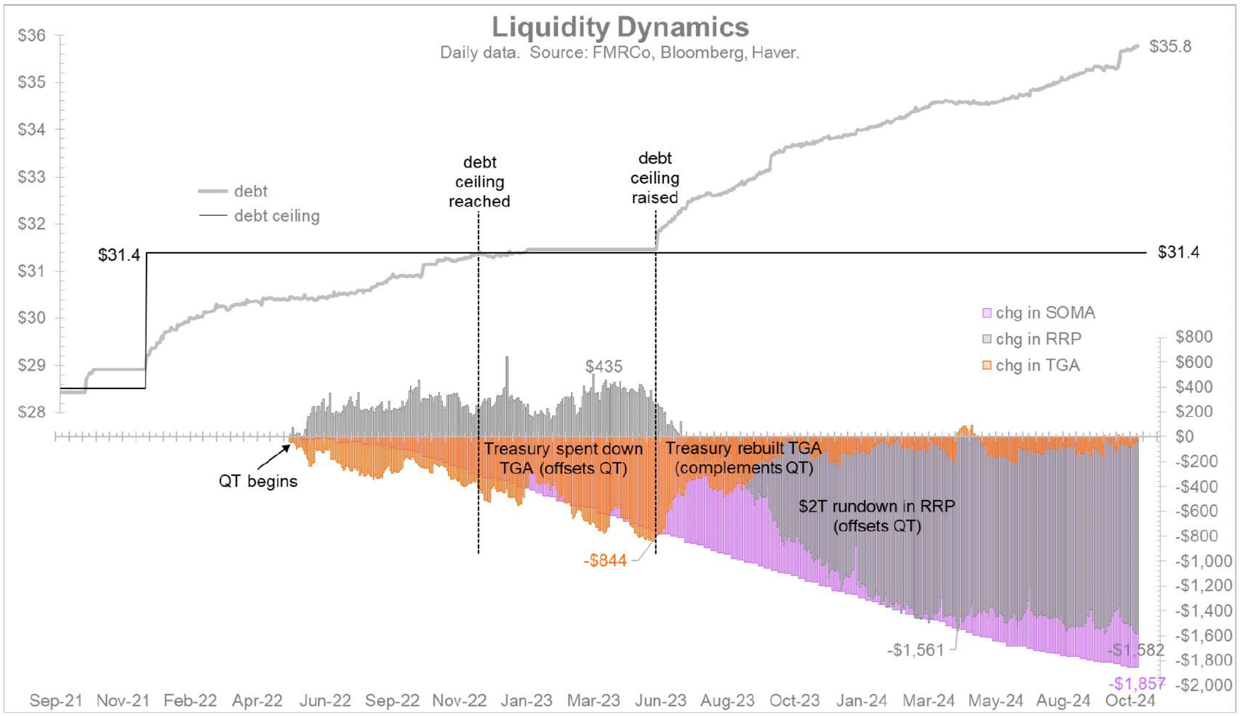
- The Fed has room to cut rates, as shown by the current inflation trends and the neutral rate calculation.
- A neutral rate is typically around 100 basis points above the inflation rate, which is currently in the range of 2.7% to 3.2%, depending on whether core PCE or core CPI is used.
- Adding 100 basis points gives a neutral rate estimate of around 3.5% to 4%.
- The Fed's current rate of 5.375% was well above this neutral range when inflation was higher, but as inflation improves, the Fed can cut rates without being overly restrictive.
- The economy, particularly the labor market, has become more balanced, so aggressive rate hikes are no longer necessary.
- While rate cuts are expected, this is not considered an easing cycle but rather a move from restrictive to more neutral levels.
- More rate cuts could come in the near future, possibly even in November and into next year, bringing rates closer to 4%.
- Globally, other central banks like the Bank of Canada and ECB are in similar positions, with only the Bank of Japan on the opposite side of the rate cycle.



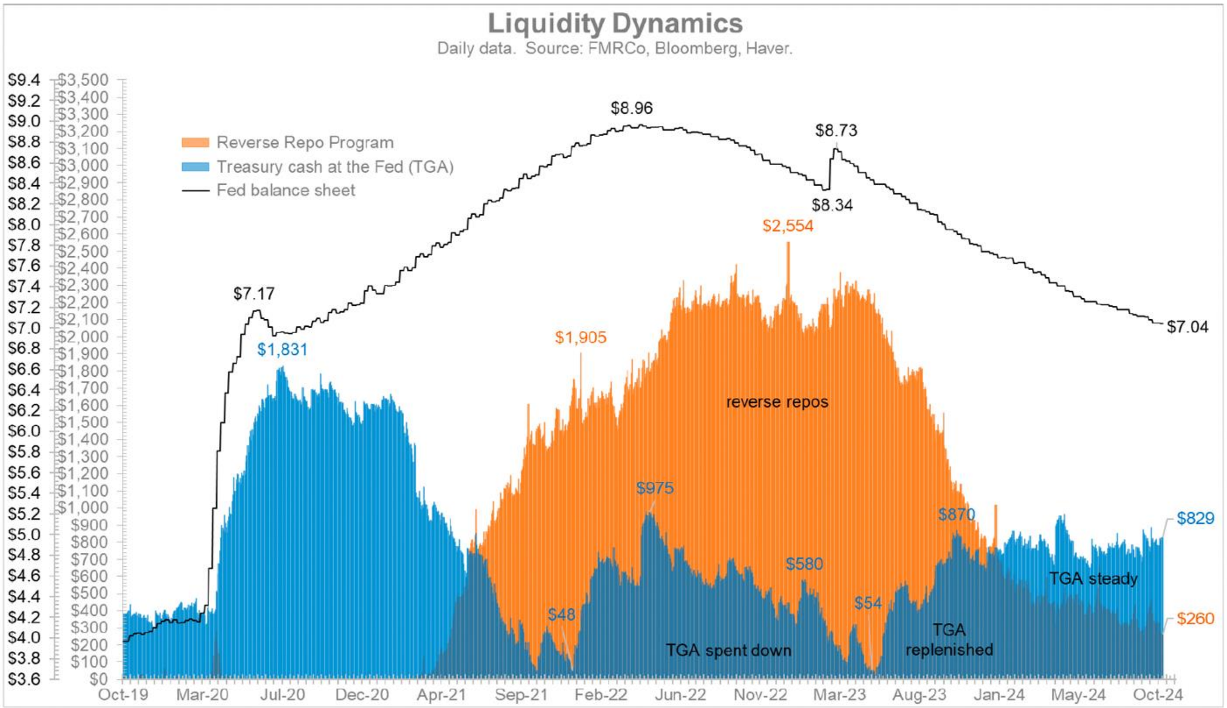
- The central question has been whether a soft landing has been achieved, and so far, the answer is yes, though it remains to be seen if this continues into 2025.
- The Fed has two mandates: prices stability and full employment. While price stability is not yet at the target, inflation has improved significantly compared to a year ago.
- The orange line in the chart shows the Fed's Weekly Economic Index, which tracks economic growth, and the gray line represents the labor supply and demand balance.
- During the COVID lockdown, jobless claims surged, unemployment spiked above 10%, and labor supply greatly exceeded demand.
- As the economy reopened, labor demand increased, but supply lagged due to retirements (mainly baby boomers) and closed bordered restricting migration.
- The imbalance led to excess labor demand, contributing to wage inflation, where there were two job openings for every available worker.
- Now, labor demand and supply have normalized, with the grey line returning to zero, without an increase in jobless claims, indicating a healthy labor market adjustment.
- Unlike previous economic cycles, the current normalization has been driven by labor supply returning, not by demand collapsing or widespread layoffs.
- This dynamic supports the soft landing narrative, with no recession signs from typical triggers like rising jobless claims or an inverted yield-curve, at least for now.



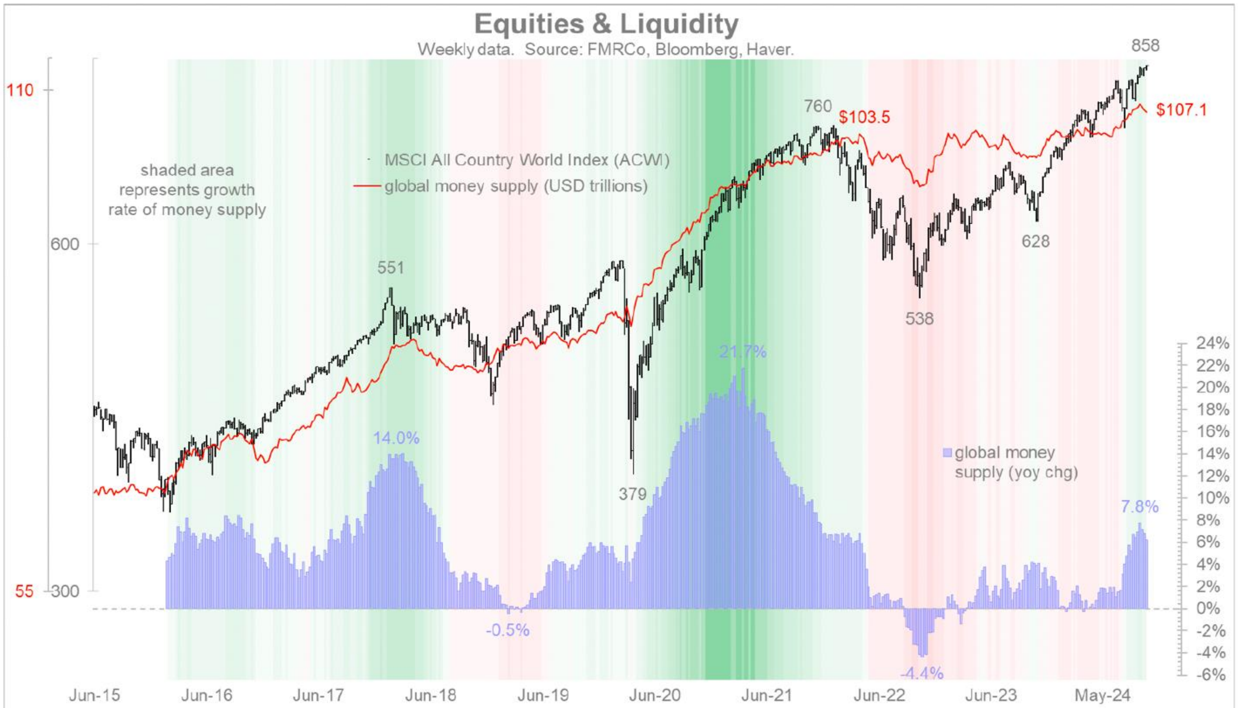
- The chart illustrates the Fed's balance sheet showing the transition from quantitative easing (QE) to quantitative tightening (QT).
- During periods of QE (QE1, QE2, QE3), the Fed expanded its balance sheet, injecting liquidity into the market by purchasing assets.
- In response to the COVID pandemic, the Fed dramatically increased its balance sheet again to support the economy.
- The Fed has since shifted to QT (Quantitative Tightening), reducing its balance sheet by allowing assts to mature without reinvesting the proceeds, which began in QT1 and its continuing into QT2.
- Despite fears that reducing liquidity via QT would lead to market collapse, the markets have held up better than many expected.
- Even while the Fed is now cutting rates, it continues to reduce the balance sheet, signaling that liquidity is not the only driver of market performance.
- The ongoing balance sheet reduction, despite rate cuts, suggests that balance sheet policies and interest rate policies are being managed separately to balance market support and inflation control.



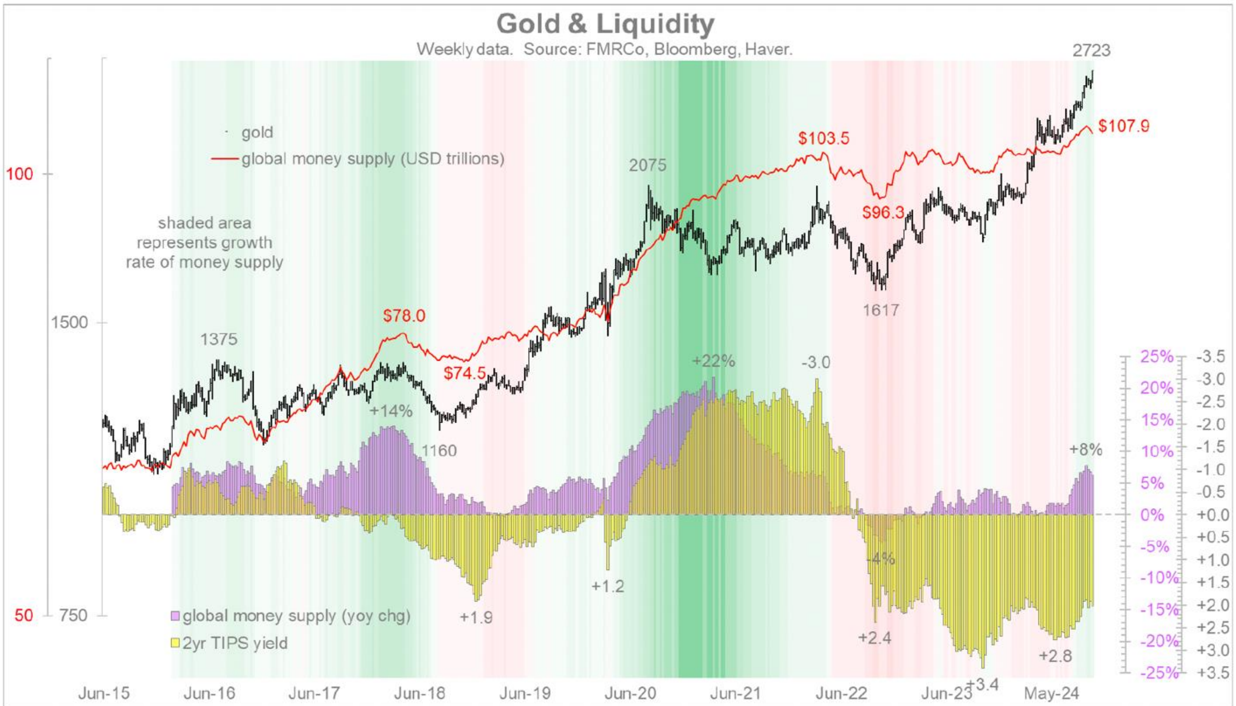
- The purple bars represent the Fed's System Open Market Account (SOMA), which is where the Fed holds securities. This is the part of the balance sheet related to QE.
- Since the start of QT, SOMA has decreased by $1.9 trillion.
- During the debt ceiling crisis, the Treasury spent down its cash balance at the Fed, which acted like a backdoor fiscal QE, offsetting the Fed's balance sheet reduction.
- After the debt ceiling was raised in June, the Treasury started rebuilding its cash balance, which should have been restrictive for liquidity.
- However, reverse repos (shown in gray bars) offset this restriction. Money market funds sold their reverse repos at the Fed to buy T-bills, which injected liquidity back into the system.
- As a result, the $1.9 trillion reduction in the Fed's balance sheet had little impact on markets, as these other mechanisms offset the reduction.
- Bank reserves remain stable, down $1 trillion from the peak but still above pre-COVID levels.
- This balance sheet activity is occurring at a time when policy is shifting from restrictive to neutral, while fiscal policy remains expansive, with a budget deficit of $1.8 trillion (6-7% of GDP) despite the economy operating beyond capacity.



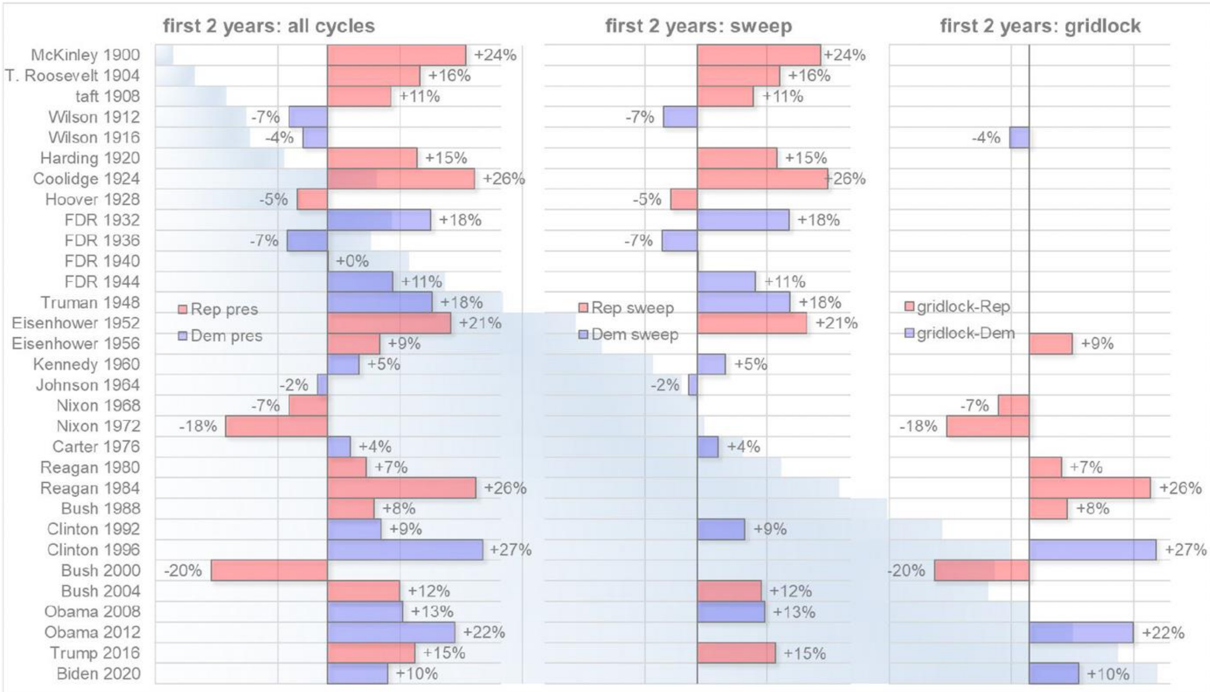
- The reverse repo program (orange) has almost completed a round trip, now down to $260 billion. The expectation is that once this nears zero, the Fed will likely end Quantitative Tightening, having corrected the liquidity conditions.
- The TGA (Treasury General Account), shown in blue, has been replenished and is now within a steady, expected range.
- The potential for another fiscal cliff looms in January, depending on political outcomes. This could trigger another round of drama involving government shutdowns and the Treasury potentially needing to take extraordinary measures due to inability to issue more bonds.
- If the debt ceiling issue arises again, the Treasury has over $800 billion sitting at the Fed in its cash balance. Spending down this amount could act as a form of fiscal stimulus, injecting liquidity back into the system.



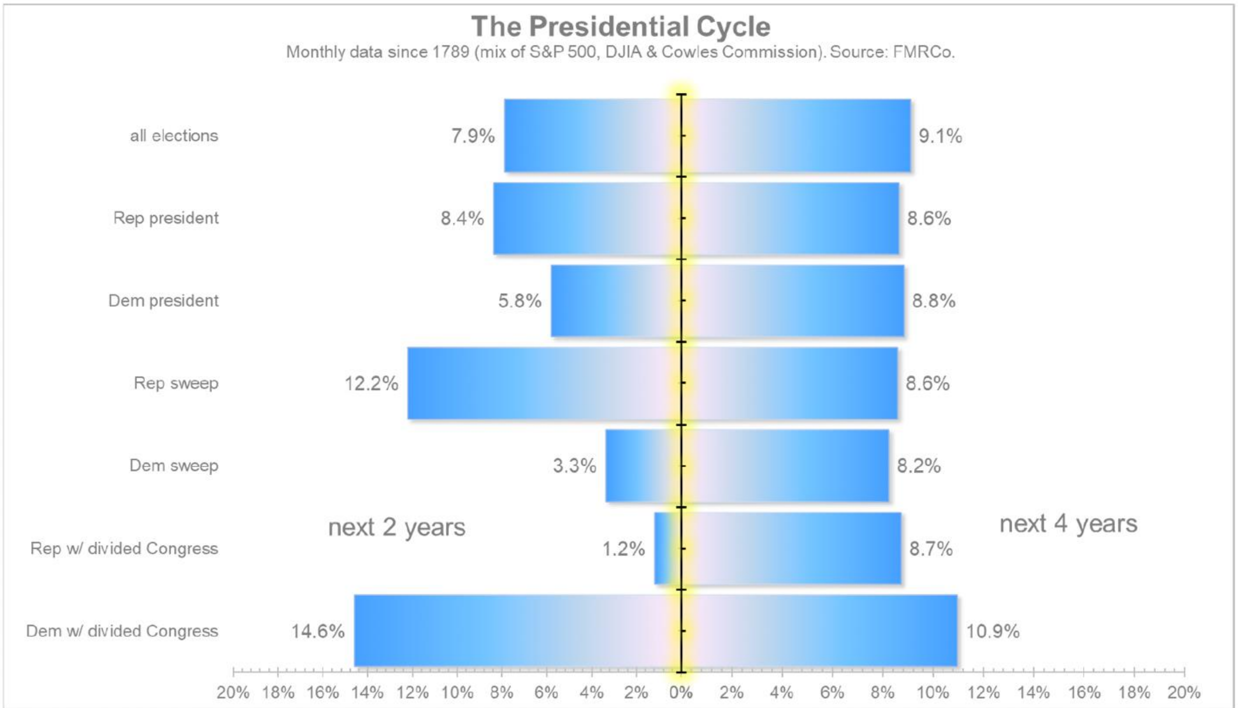
- Global money supply is now at $107 trillion, the highest level ever.
- There was a modest contraction in money supply growth in 2022, coinciding with rate hikes and other restrictive policies.
- The global money supply is now growing again, providing liquidity that supports the stock market.
- Liquidity is crucial for stock markets, as it helps “grease the wheels”, ensuring that markets remain in good shape.
- The connection between money supply, inflation, and bond yields is important to monitor, as rising liquidity could have implications for these factors.
- Regardless of political outcomes (whether Republicans or Democrats win), fiscal stimulus is expected to continue, contributing to the liquidity environment.



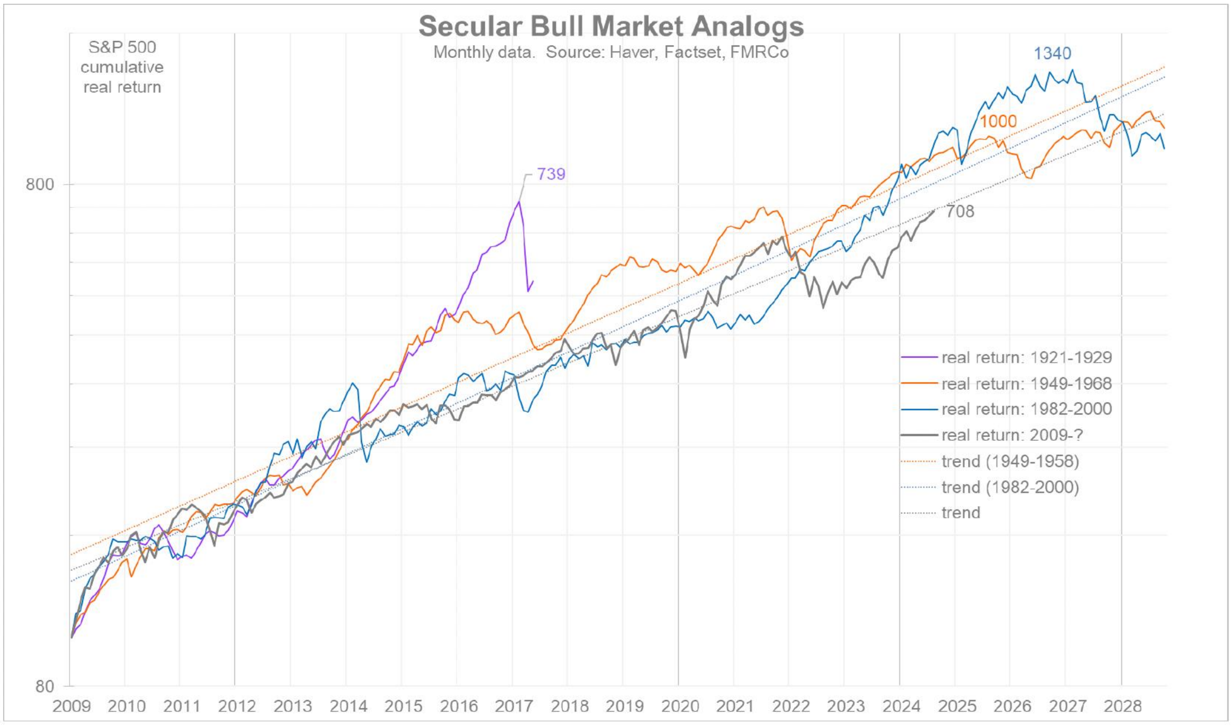
- Gold prices are rising, currently at $2,723, in response to shifts in liquidity and real rates.
- The purple bars show the rate of change in global money supply, which is growing again after a period of contraction.
- Real rates (in yellow, on a reverse scale) have become less positive, creating a favorable environment for gold.
- This combination of increased liquidity and declining real rates is driving the movement in gold, as it signals that another wave of liquidity may be on the way.
- Gold typically responds positively to these factors, which us why it's "on the move" now.
- There is a rough correlation between bitcoin and gold.



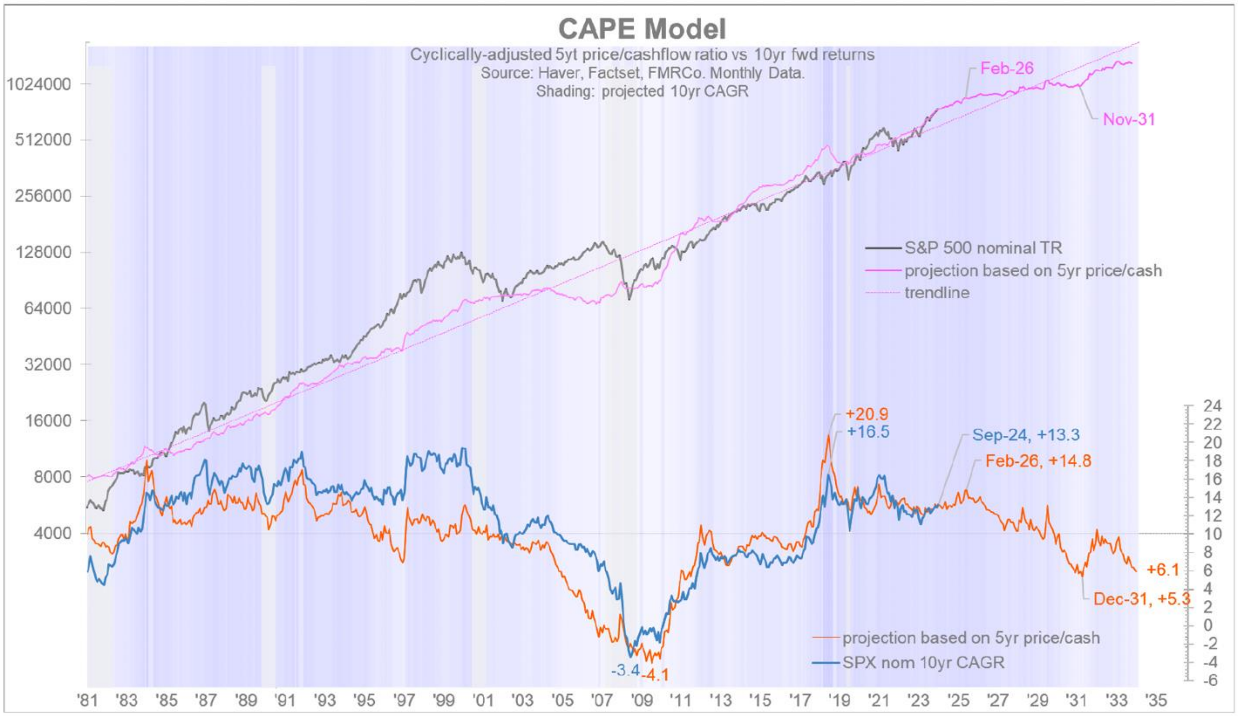
- The upcoming election has two main perceived outcomes:
  - A Republican sweep: Trump wins, Republicans control both the House and the Senate. This could lead to fiscal expansion, extended tax cuts, deregulation, tariffs, and onshoring industrial policy.
  - Democrats win the White House (Kamala Harris as president) with a Republican-controlled Senate and potentially a divided House. This scenario would also be favorable for markets.
- The chart highlights historical market performance under different political alignments during the first two years of a presidency, comparing:
  - All cycles
  - Political sweeps (either party controls both the executive and legislative branches)
  - Gridlock (divided government)
- Historically, Republican and Democratic sweeps have shown strong market returns. For example, Republican sweeps under Eisenhower and Reagan saw +21% and 26% market returns, respectively.
- Gridlock can also yield favorable outcomes, particularly under Democratic presidents with Republican Congresses, like under Clinton (+27%) and Reagan (+26%).
- These two scenarios-Republican sweep or Democratic White House with divided Congress-are historically among the best setups for markets, as seen in the chart.



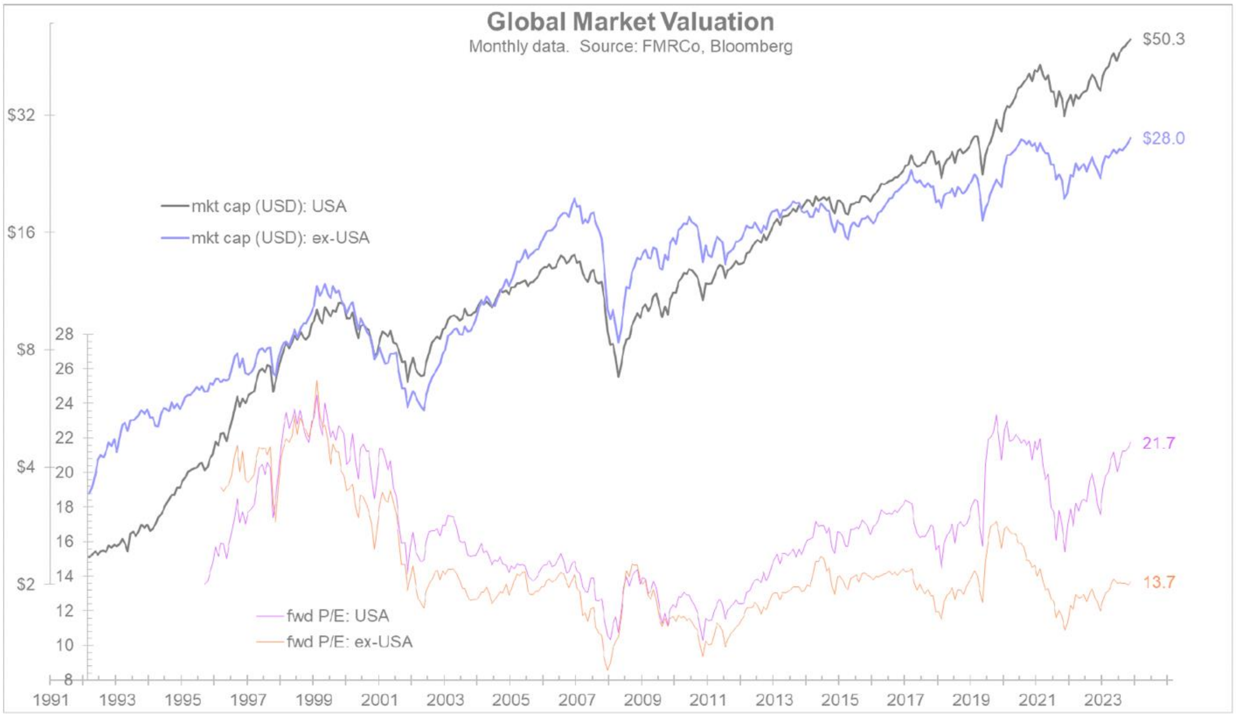
- The chart present market returns based on presidential cycles going back to 1789.
- The next two years after elections typically show the best outcomes, particularly under Republican or Democratic sweeps.
- A Republican sweep yields an average return of 12.2% over two years, while a Democratic sweep returns 3.3%.
- The worst potential two-year outcome is a Republican president with a gridlock Senate, where no significant legislation occurs. This scenario often results in negative market returns due to political inaction, as seen in previous cases like Bush in 2008.
- Over four years, market returns tend to even out regardless of the political alignment, demonstrating that long-term investors should not be overly concerned about short-term political outcomes.
- The US stock market ($50 trillion) and global economy ($105 trillion) are massive and hard to shift significantly, implying that while policies matter, markets are ultimately bigger than any politician or policy.
- Historically, midterm elections act as a course correction, often counterbalancing the results of the presidential election.
- Despite the political drama that elections bring, markets tend to remain resilient in the long run.



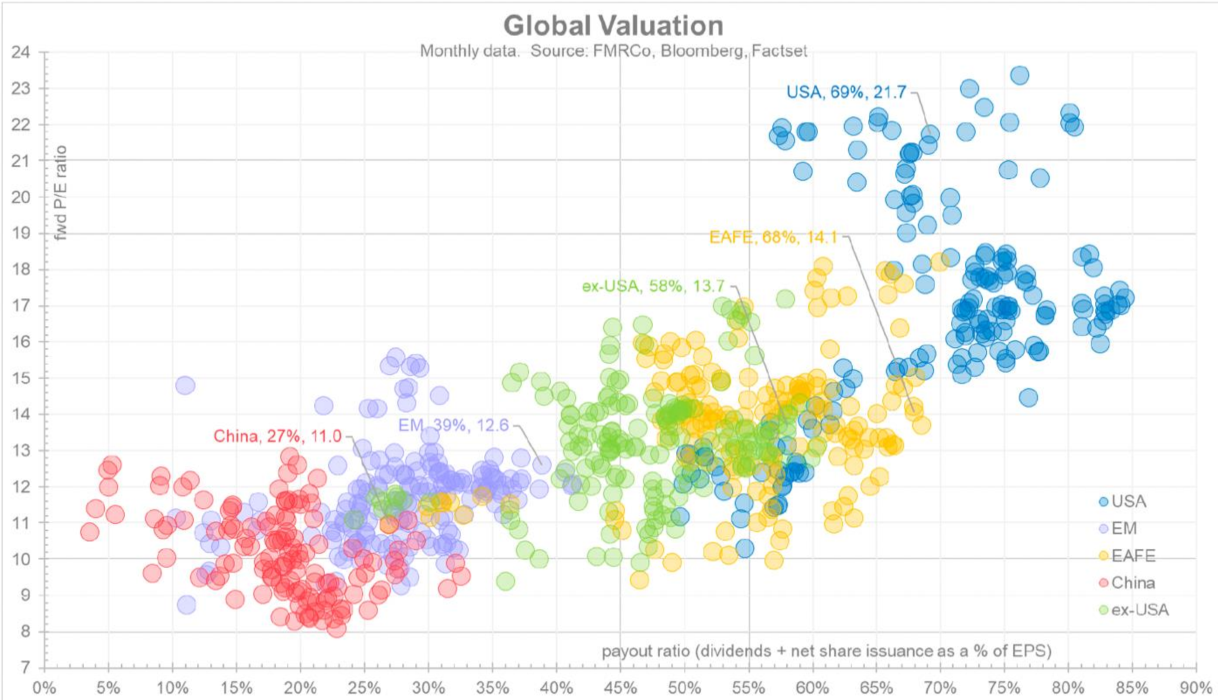
- The chart compares different secular bull markets throughout history, which are long-term, structural super cycles of strong market performance.
- Historical secular bull markets occurred in the 1920s, 1949-1968, and 1982-2000, with robust long-term returns.
- The current secular bull market began in 2009, following the global financial crisis, and continues today.
- Secular bull markets typically last longer than cyclical ones, spanning multiple smaller cycles, and we're likely in the later stages of the current long-term bull market based on historical patterns.



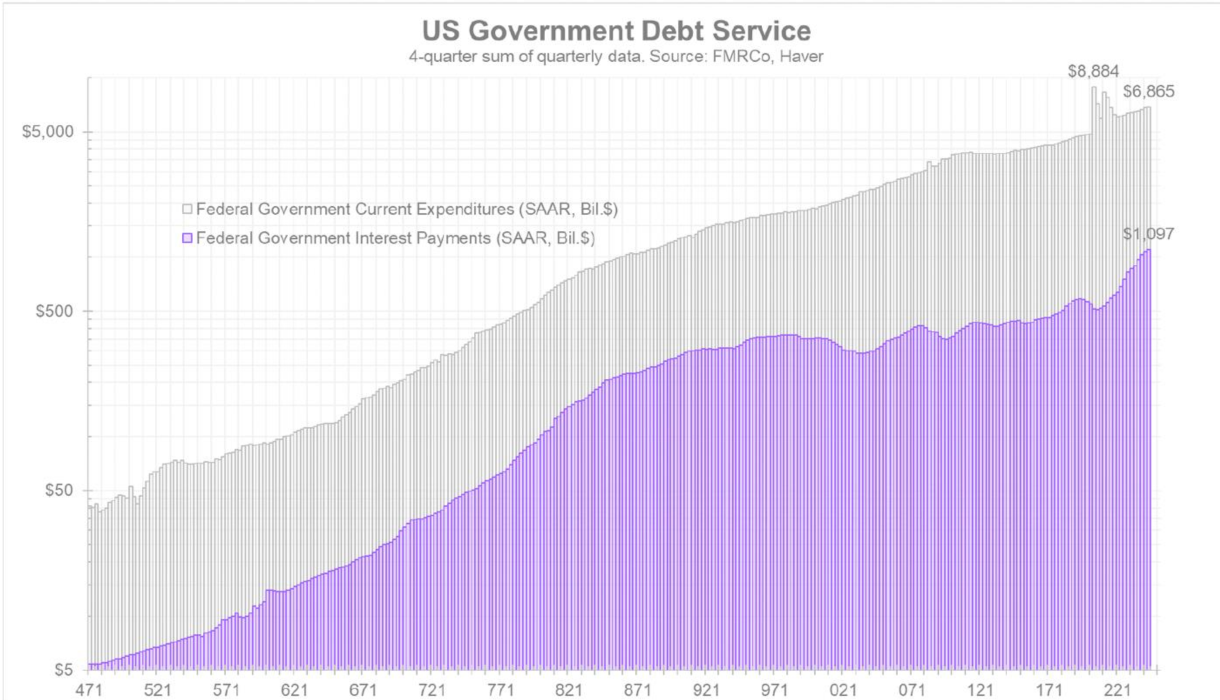
- The CAPE model (cyclically adjusted price-to-earnings ratio) is used to predict long-term market returns based on past valuations, specifically focusing on the five-year price-to-total-cash ratio (including dividends and buybacks).
- The current CAPE ratio suggests that past valuations can predict 10-year returns, meaning higher P/E ratios today lead to lower expected returns over the next decade, and vice versa.
- Historically, the model bottomed in 2009 after the financial crisis and peaked in 2021.
- The current positioning on the chart aligns with what the model predicted, suggesting that the rate of change in returns will likely peak in the next couple of years and then begin to decline.
- This doesn't necessarily imply a bear market, but rather that the rate of return will be lower in the coming decade compared to the last 10 years.
- The expected lower return environment is likely to be influenced by inflation and interest rates, leading to a more moderate return profile compared to recent history.



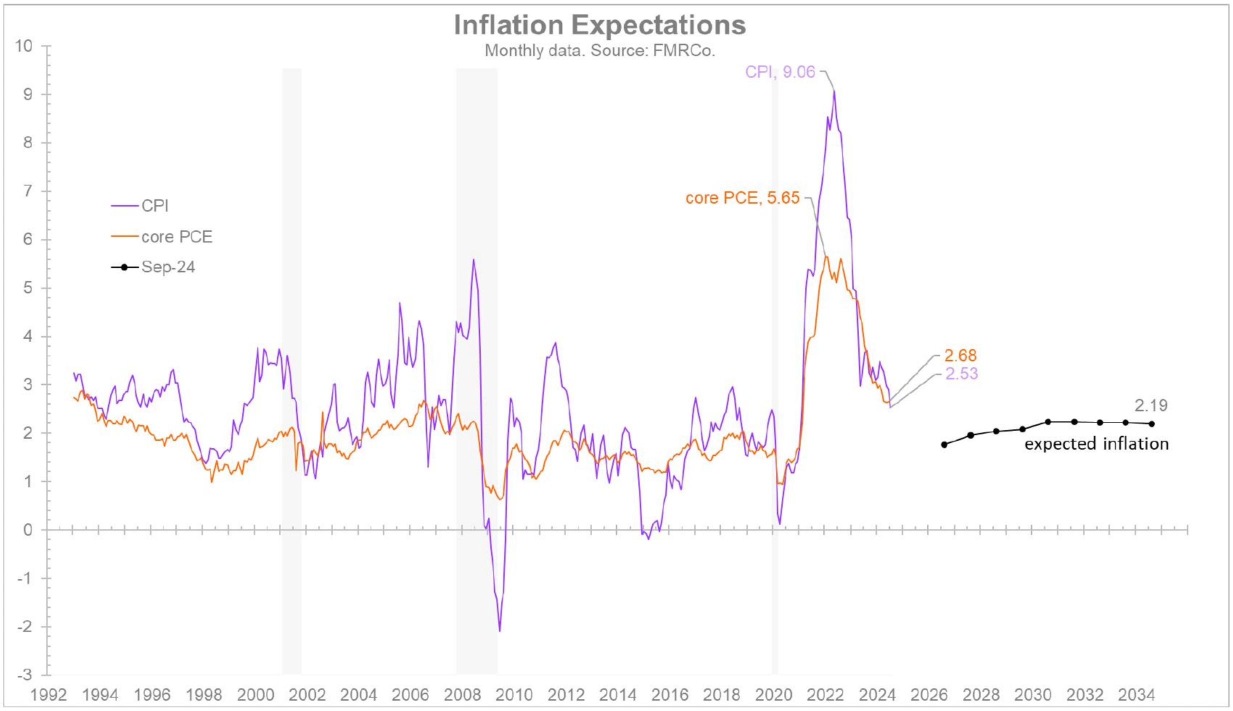
- The global market has a total capitalization of $80 trillion, with $50 trillion from the US and $28 trillion from non-US markets.
- The US market is trading at a forward P/E ratio of 21.7, making it more expensive compared to the rest of the world, which trades at a P/E of 13.7.
- While the US market has been dominant, especially with its large mega-cap growth stocks, the valuation gap between the US and non-US markets raises the question of mean reversion versus trend following.
- There's a temptation to underweight the US and overweight international markets due to this valuation disparity, but the dominance of US earnings growth explains its outperformance.
- For non-US markets to outperform, their earnings growth needs to surpass that of the US, especially as China's stimulus could provide some appealing opportunities in international markets.



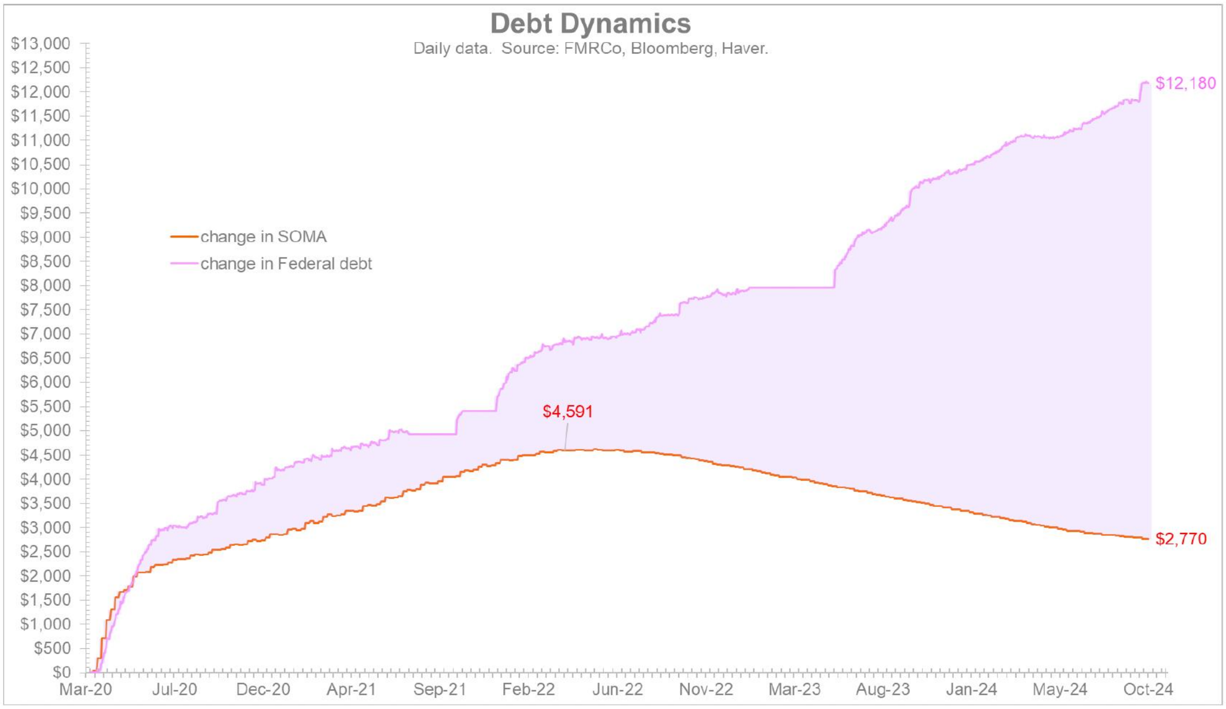
- China's Share Buybacks:
    - The Chinese government is facilitating companies' ability to buy back shares, which is considered a stimulatory action.
    - This is aimed at boosting market sentiment, but it will only be effective long-term if earnings also increase. Otherwise, it's a temporary trade opportunity.
- PE Expansion in China:
    - The PE ratio of the MSCI China index increased from 9 to 11, with past rally expansions going as high as 5 points.
    - This suggests short-term gains may continue, but without sustained earnings growth, it remains a shorter-term trade.
- Valuations Relative to the U.S.:
    - The U.S. market is trading at a 59% premium to the rest of the world.
    - Valuations outside the U.S. are more attractive, but the earnings need to grow significantly for these markets to outperform the U.S.
- Global Earnings Growth:
    - While global earnings are growing, they haven't outpaced the U.S., which remains dominant because of its mega-cap tech companies (Mag Seven).
    - A critical question remains about what happens if the U.S. tech giants slow down: will non-U.S. markets outperform simply by declining less sharply?
- Uncertainty About Global Leadership:
    - The leadership role of U.S. mega-caps raises ongoing questions about the sustainability of global market outperformance relative to the U.S.
    - The debate over U.S. vs. non-U.S. markets will likely continue into next year.



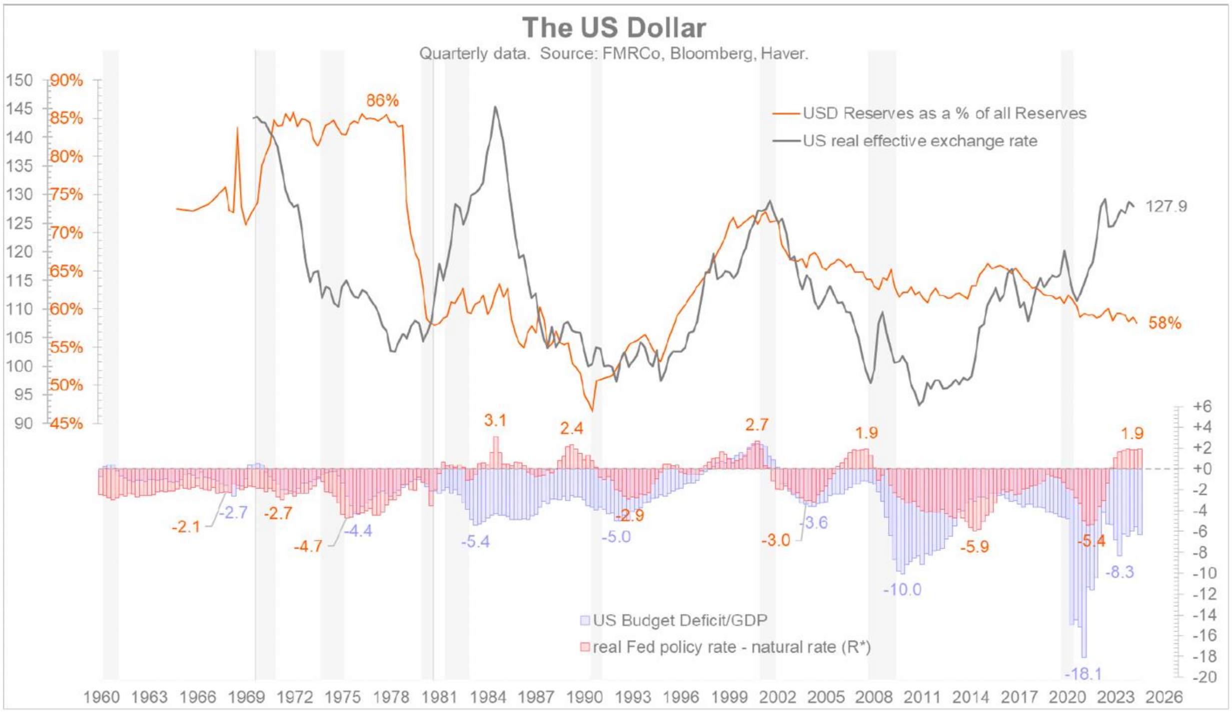
- Fiscal dominance refers to a situation where fiscal policy (government spending and debt) takes priority over monetary policy, and central banks (like the Fed) take a back seat to government actions.
- The US government currently spends $1.1 trillion on debt servicing (interest on national debt), and this amount is projected to rise as deficits grow.
- The US deficit is 6-7% of GDP, even though the economy is running above potential, meaning the government is borrowing heavily even in good times. This raises questions about sustainability.
- Historically, we've seen fiscal dominance in places like Japan, where the central bank supports the government by buying bonds to fund deficits, leading to consequences like currency devaluation (as seen with the yen).
- In the US, this could mean the Federal Reserve is pressured to keep interest rates lower or adopt more accommodative policies to help manage government debt.
- There's an ongoing debate about whether inflation will return to the 2% target or if 3% will become the new norm, given the high levels of government borrowing and spending.



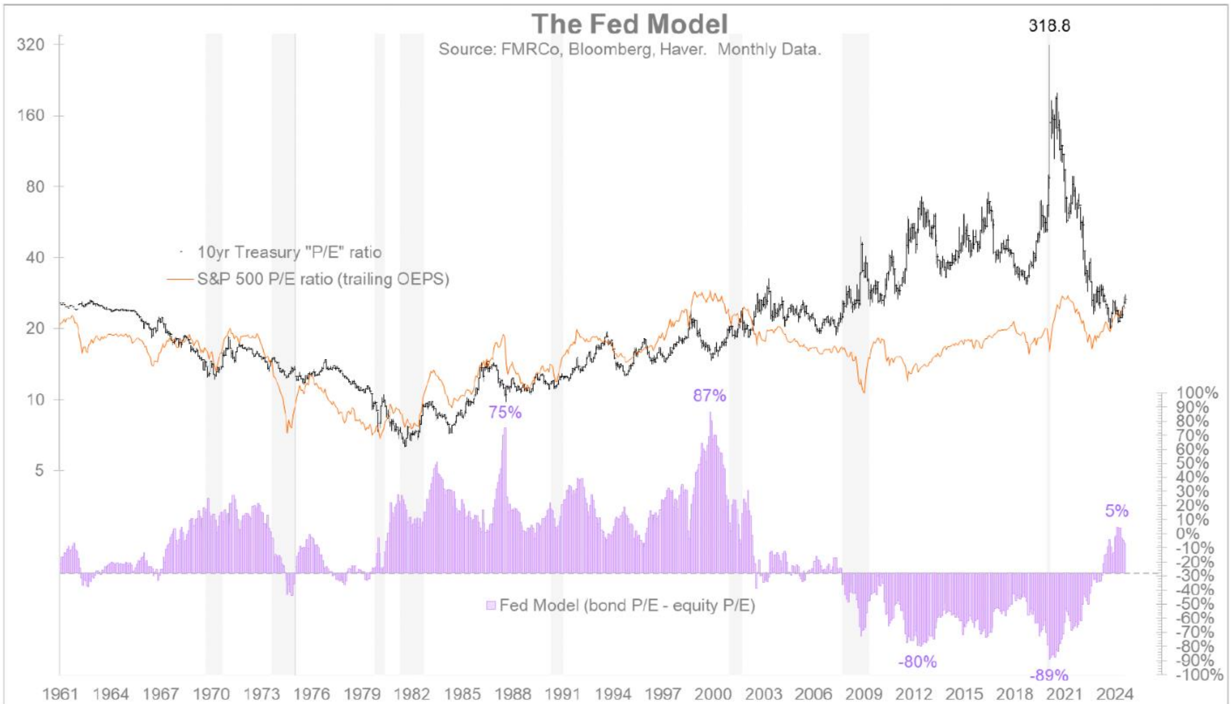
- The market is currently pricing inflation at around 2% for the foreseeable future, based on the TIPS market (Treasury Inflation-Protected Securities).
- Inflation has been moving in the right direction, with recent drops in CPI (9.06%) and core PCE (5.65%), now at 2.68% and 2.53%, respectively.
- There is a possibility that "3 is the new 2", meaning inflation may stabilize around 3% rather than the previous target of 2%, especially considering the era of fiscal expansion.
- Even if inflation is slightly higher at 3%, this isn't a significant issue for the stock market. Historically, the sweet spot for price-to-earnings (PE) ratios occurs with inflation between 0% and 4%.
- Fiscal dominance (where fiscal policy leads and the Fed becomes more subordinate) is something to consider for the future, although it's not currently the case in the US.
- The mention of assets potentially not being priced correctly highlights the market's challenge in adjusting to inflationary shifts, with some potential mispricing risks.



- The chart shows the change in federal debt since COVID alongside the Fed's balance sheet (SOMA - System Open Market Account).
- The federal debt has increased to $12,180 billion, while the Fed's balance sheet has decreased to $2,770 billion after reaching a peak of $4,591 billion.
- Central banks are no longer buying this debt, which raises concerns about who will absorb the new supply.
- If central banks don't return to buy, there could be an increase in the term premium (the risk premium for bonds), especially for 10-year Treasury yields.
- For the past decade, the term premium has been negative due to central bank intervention, but now it's at zero, despite the large deficits and rising rates.
- There's a question of whether bond investors (the "bond vigilantes") will start demanding a risk premium in this new fiscal environment, especially under possible fiscal dominance.



- The US dollar has remained strong, despite its declining share of global reserves (down to 58%).
- This strength is due to tight monetary policy (higher interest rates) combined with loose fiscal policy, which has attracted capital to the US.
- The US economy is growing faster than other regions, which also supports the dollar.
- There is a potential risk: if fiscal dominance occurs (where fiscal policy overtakes monetary policy), the Fed could become subordinated, leading to possible weakening of the dollar.
- The real Fed policy rate has remained positive, even as the US budget deficit as a percentage of GDP has increased significantly (especially during the pandemic).
- A key question for the future is how well the US can grow out of its debt compared to other countries, which could ultimately determine the dollar's strength.
- The idea of the "cleanest dirty shirt": while many countries are in debt, the US is still seen as having a better chance of managing its debt and maintaining a strong currency.



- Interest rates are playing a similar role as they did in the 60s, 70s, and 80s—when they rise significantly, it leads to market corrections or bear markets.
- The PE ratio of the stock market used to move in tandem with the PE ratio of the bond market (inverse of bond yield) during that period.
- During the era of QE and zero interest rates, this correlation broke, and falling rates led to concerns about deflation rather than inflation.
- Since the rate reset in 2022, the old pattern has returned, with rising bond yields causing wobbles in the stock market.
- Rising bond yields have caused market disturbances in 2022, late 2023, and are doing so now, signaling potential short-term corrections.
- Interestingly, rising bond yields correlate with the odds of Trump winning in the prediction markets, as the market sees higher yields as an indicator of fiscal expansion and fewer rate cuts from the Fed.
- A stronger dollar is also linked to rising yields, as it implies tighter financial conditions and less immediate support from the Fed.
- While cyclically and secularly things look stable, rising yields are a key factor to watch in the coming years.