CIO insights: The evolving market landscape

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Are we there yet?

A market's evolution from a valuation story to a profit story

Four pillars of the equity market

Earnings

Interest rates

Liquidity

Valuation

Source: Fidelity Investments Canada ULC.

Executive summary

1

Price movement of risk assets in 2023 will be predominantly governed by corporate profits. Pay attention to **global nominal GDP, global PMIs, housing, wages and employment, and credit spreads**.

2

Focus on leadership, not "the market." **Leadership at this point in the cycle has historically been driven by earnings and balance sheet quality.** Beta and volatility traditionally lead once a new economic cycle is heralded.

3

Valuation is the ultimate "crutch" for adding risk/offence on a single security basis. Use multi-year risk/reward scenarios to govern portfolio turnover and rotation. **Think three to five years, not 12 months**.

4

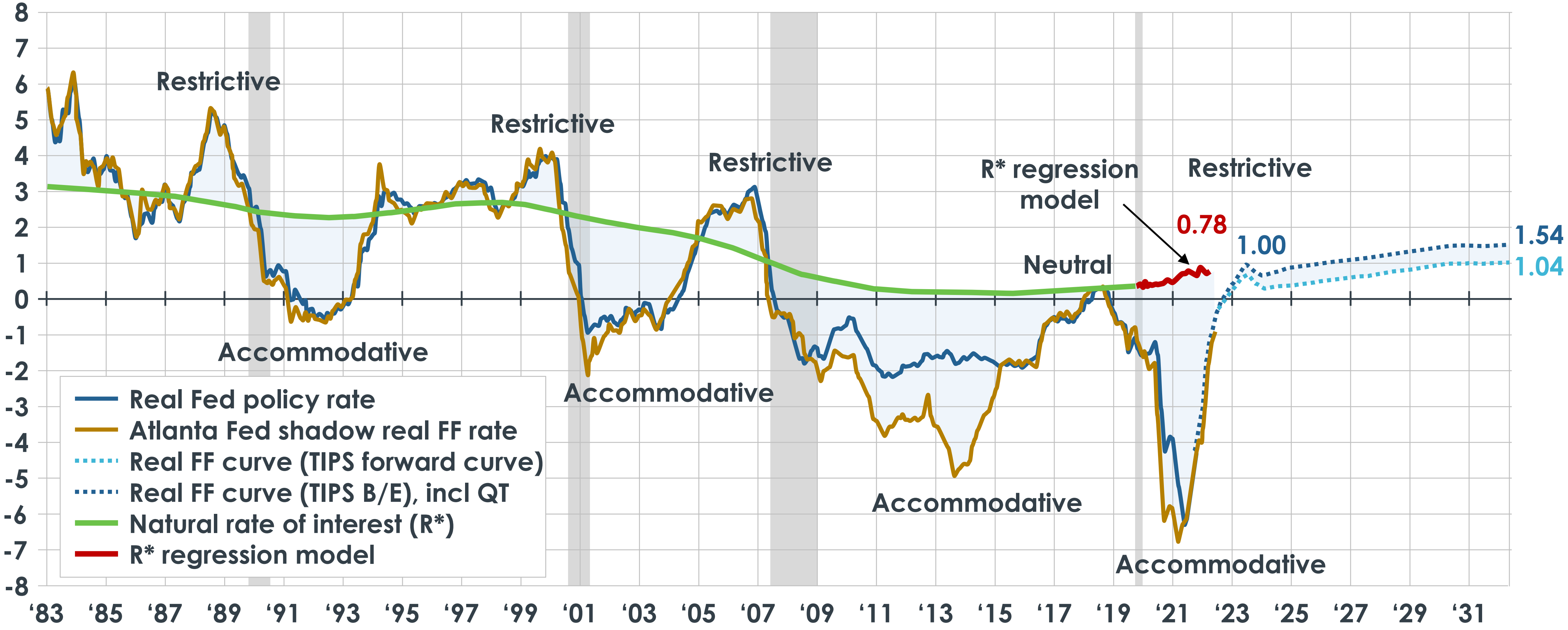
Use PMIs below 50, negative earnings revisions and shifts in central bank policy to **selectively add risk** in preparation for a new investment cycle. **Patience is a virtue**.

Global economic cycle

The diagram above is a hypothetical illustration of the business cycle, the pattern of cyclical fluctuations in an economy over a few years that can influence asset returns over an intermediate-term horizon. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one.
A growth recession is a significant decline in activity relative to a country’s long-term economic potential.
Source: Fidelity Investments (AART), as at March 31, 2023.

Are central banks behind the curve?

U.S. monetary policy

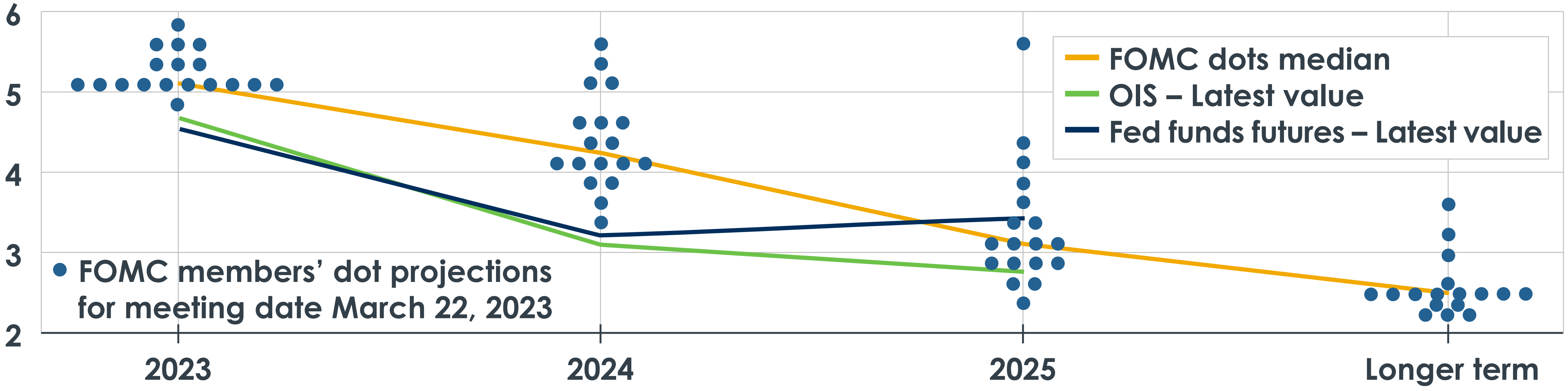


Source: FMRCo and Haver. Data as at April 19, 2023. Monthly data.

Market implied policy rates

Country/region	Policy rate		Implied policy rate			
	Apr 18, 2022	Apr 18, 2023	6-month	1-year	2-year	3-year
U.S.	0.29%	4.80%	4.96%	4.13%	3.13%	2.97%
Canada	0.93%	4.50%	4.54%	4.09%	3.16%	2.66%
Eurozone	-0.59%	2.90%	3.81%	3.49%	2.95%	2.74%
China	1.90%	2.25%	2.12%	2.26%	2.54%	2.75%

Implied Fed funds target rate



Source: Bloomberg, as at April 18, 2023.

Earnings

	Q1’23	Q2’23	Q3’23	Q4’23	CY2024
EPS estimate	$51.02	$54.39	$56.66	$57.96	$241.05
EPS YoY growth rate	-5.7%	6.6%	4.2%	2.3%	10.0%

- Historically, GDP and EPS bottom 18–24 months after a peak in bond yields
- To date, negative EPS revisions have been primarily a function of cost inflation. Aggregate demand for goods and services, which is a proxy for revenue, has been resilient

➡ This is consistent with past economic cycles

- The fate of aggregate demand will be the primary driver for unemployment and a lagging signal to central banks that monetary tightening has been sufficient

Source: Bloomberg consensus earnings per share estimates. As at April 18, 2023.

Valuation

1

S&P 500 ~18.5x NTM EPS represents a modest premium historically.

2

Nominal yields meaningfully above long-term inflation expectations:

- positive real rates
- implications for fixed income and gold

3

Focus on leadership, not market levels:

- note premium (and potentially widening premium) of defensive versus offensive or late-cycle versus early-cycle stocks
- balance sheet and business quality factors leading the market

Source: Bloomberg, as at April 14, 2023.

Valuation (cont'd)

Best-performing factors for the S&P 1500, year-to-date

Factor	Return	Factor	Return
Current ratio	9.5%	Long-term ROIC	6.7%
Equity to assets	8.9%	Sales growth	6.2%
Long-term ROA	8.9%	Large-cap growth	5.6%
Interest coverage	7.4%	Small-cap value	-3.6%

Source: Bloomberg, as at March 31, 2023. The S&P 1500 is the S&P Composite 1500 Index, which covers approximately 90% of the market capitalization of U.S. stocks.

Recap

1. 2023 will require **discipline, patience and rigour** around profit forecasts and upside/downside scenarios.

2. Equity markets have priced in most of the change in central bank policy or change in liquidity, but have not yet fully priced in earnings compression.

3. Market levels may obscure transition of leadership during the course of 2023.
   → **Focus on leadership and opportunities**, not "the market."

4. **Price moves before earnings**:
   → Understand when the worst fundamentally has been discounted.
   → Don't be paralyzed by fear or analysis.

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