Fidelity Connects

Global Equity Opportunities: U.S. versus Europe and Beyond

Patrice Quirion, Portfolio Manager

Pamela Ritchie, Host

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Pamela Ritchie: Hello and welcome to Fidelity Compass. I'm Pamela Ritchie.

Global equity markets are rallying. We've got North American and European markets, we saw earlier, bouncing back following pretty strong earnings reports, and after the Asia Pacific session where markets tracked pretty solid gains after some positive economic data that came out there. Today's advance has marked a bit of a recovery from the string of kind of choppy sessions that we've been seeing.

How is the macro picture impacting our next guest's investing strategy, if at all? And within which regions is he finding some of his best opportunities? Happy to say joining me today to discuss his investment style as he navigates the current market environment is Portfolio Manager, Patrice Quirion. Patrice manages the Global Concentrated Equity Institutional Trust, a go-anywhere strategy that capitalizes on Fidelity's unrivalled global investment resources.

Great to see you, Patrice. How are you?

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Patrice Quirion: Good to be here. Very good.

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Pamela Ritchie: Great to have you join us here. We'll invite everyone to send questions in as we have our conversation today. I wonder if we go sort of immediately to your style which is going to look at what's going on in the world and some of the big headlines, but you often look at it from a very contrarian perspective. Just take us through that.

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Patrice Quirion: I think it's important in any moment but especially moments like we are currently in the market where you see big divergence, big bifurcations to step back a little bit and remind ourself of what are we trying to accomplish. In my case it's always been the same strategy. It starts with trying to find good companies that are dislocated, that are mispriced. Obviously, everybody's looking for ideally a high-quality business at a very attractive price. The question is, "how do you find those?" that becomes really important. My approach is based on a very firm belief that markets tend to be directionally correct but tends to overreact.

The markets are, obviously, tracking fundamentals but there's a big emotional aspect into the markets as well which creates periods in time where momentum gathers a lot of speed. I think we are into one of those periods right now. That creates opportunities when there is areas that are really in favour tends to create areas that are out of favour. By being more patient, longer term focus than most, I find it really interesting when the market has more of these pockets that are out of favour on a relative basis. I spend a lot of my efforts engaged with our global research capabilities to go through these companies where, for whatever reason, this market is less enthused about them for a period of time and go into that out-of-favour grouping of stocks and let's go find some good long-term companies where because of shorter term reasons the valuations are a lot more compelling.

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There's a big contrarian aspect to looking for quality companies in out-of-favour sectors, out-of-favour geographies or in some cases for very company-specific reasons and then just wait for the situation to normalize. A lot of my approach is finding good companies that are inexpensive, that are trading below their intrinsic value on a normalized earnings profile. It often means that I'm more active into either countries that are out of favour, parts of the market that might be cyclical, like when the cyclicals are out of favour.

On the flip side, I tend to spend very little of my time on what everybody talks about, that has a lot of hype, where there's expectations have risen to a high level, and where there's just little opportunities for sentiment to get much better and for expectations to prove too conservative over time.

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Pamela Ritchie: So, that's where you're beginning. That's sort of the fundamental and your profile so how do you layer on the macro because it's been, some will say it's actually normalizing. The macro picture is actually normalizing and that fits in perhaps how?

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Patrice Quirion: Absolutely. I think maybe in the common way where I apply that into a portfolio is looking for not broad cycles but there's a lot of sub-cycles in different parts of the market or different subgroups of companies. A lot of my time is spent looking at those where the market sentiment around that cycle, whatever it might be, over the next six months or year, is overly negative in our opinion. Obviously, those sub-cycles or broad-market cycles are influenced by the macro, but I take it more in terms of not so much is the macro conducive to that subsector today because the market is very focused on that. The market typically doesn't look much past 12 months ahead so the markets will react when those sub-cycles are less favourable.

I try to spend a lot of time with our research team looking at analogies in the past, trying to think what's the likelihood of the cycle or the sentiment over where that cycle may be in 6 or 12 or 18 months to be on the recovering trend as opposed to be on the continuing deteriorating trend. When I start to feel that there's a lot of that negativity that's been reflected into expectations into stock prices, I'll be willing to step into those areas probably sooner, much sooner than I think most investors are willing to because in general, most market participants have a tendency to wait for confirmation before engaging into those areas of the market. When we get those confirmation that things are starting to pivot, to inflect, the moves can be pretty abrupt, and I want to position the portfolios ahead of that as opposed to chasing on the other side of it.

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Pamela Ritchie: I feel like an interesting example to illustrate we were talking about is sometimes the way that you look at Europe because Europe is one of the places we're going to talk about. We'll go around the world a little bit with you here today but within Europe the banking sector, it's interesting to look at sectors there. I want you to just sort of take us through how you look at Europe as a whole, because it seems like kind of legacy companies, multinational companies, but a lot of kind of legacy companies. How do you weed through it and look at some of the sectors there?

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Patrice Quirion: I'll come back to Europe, but I'd like to maybe spend a minute on how I think about the world.

The reality is different markets are acting in fairly different fashion but typically it is not because the companies, the similar companies are acting in a very different fashion. It's the sector weights of different markets which are very different, typically speaking. If we think of Europe versus the U.S., for instance, Europe will have much less of the tech sector, much less of the biotech sector.

The U.S. composition is very different but if we go in some sectors like either consumer discretionary, consumer staples, industrials, those sectors tend to be made up of multinational companies and if a company is based in Europe or is based in the U.S., typically they will compete globally, at least in the large-cap space that's typically the case. In my portfolios for the past number of years I've been overweight in Europe, less exposed to the U.S. but it was not directly a reflection of economic like macro expectations of the U.S. being maybe, in my opinion, less inclined to beat expectations in Europe on the other side of that. It was really a function of the composition of the market where I've been more nervous on the tech sector and the expectations that are getting baked in at this point. It's been the case as well if we go back late in 2022.

I've been much more favourable onto the typical more macro-sensitive, cyclical sectors either in industrials, either in consumer discretionary. The reality is there's more of that weight into European indices or Japanese indices than there is into the U.S. market fabric. So, that's one of the reason I've been, I guess, relatively overweight the other parts of the world.

The other reason is there are some sectors that are much more domestic by nature, where it's not multinationals. We can think, you mentioned financials and banks as a really good example of that.

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Patrice Quirion: Within Europe, yeah.

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Patrice Quirion: It's really everywhere across the globe where they're typically not multinationals. They are usually like local champions or local markets. I would say the same thing for telcos, for utilities. To me, the interesting part and a decent reason for the overweight in Europe going back a few years was that in my opinion when we do the work around expectations. What's baked into the price of stocks and we were looking at banks specifically, European financials looked really interesting despite the market view which definitely was, and still is to some extent, that those are lower quality financial institutions, less profitable, lower returns. All of that is true on paper.

I think what the market was missing is it's not that the fabric of those markets is so different, it's the fact that Europe had negative interest rates for almost ten years which just really impacted profitability of that sector. As we were seeing inflation coming back, rates starting to show potential to move higher, this is like going back a couple of years, and we were doing the work on what can that mean to that interest margins, to profitability, to return metrics of those financial institutions, you could make a case that those stocks were, in my opinion, dramatically undervalued relative to banks in most other parts of the world. So, this is an example where maybe my approach is more so based directly on the domestic market view as opposed to trying to find within a group of multinationals which one are maybe most interestingly valued.

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Pamela Ritchie: That's really interesting, so within the sectors of Europe. Go further into the financial sector for us, if you would, within Europe because, I mean, there's a lot of different areas and ways you can play that too but are there certain areas of the financials that you prefer?

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Patrice Quirion: I think the big discrepancy between sort of our best view of what normalized long-term earnings is versus where the stocks were trading was within the banks. There may have been some opportunities within insurers but it was mostly within European banks, and especially in the markets that have more immediate impact or sensitivity to interest rates.

Different banks, given the structure of different mortgage markets mostly, have either sensitivity that comes very quickly or other markets have sensitivities that come further out. In the case of Europe, I've been fairly positive on countries like Ireland and mostly in southern Europe, actually, where most of these financial institutions are more geared to a more rapid increase in earnings when interest rates move higher which was not priced by the market. It's starting to be reflected, those stocks have generally done well. It's, I guess a lower conviction and a smaller position into the portfolios today but there is always a sector somewhere or a country somewhere that is out of favour, where you do the work on what's the normalized earnings potential of a business and compare that to the share prices where you find really interesting opportunities. Maybe it's less on European financials today. Maybe it's more in parts of Asia. We can talk about that later. I'm always trying to move to those areas where there seems to be an important gap where perception is generally negative and that's what creates the mid- to longer term opportunity on normalization.

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Pamela Ritchie: We've seen some really interesting levels being hit in Japan recently. Currency is also a story I wanted to ask you a little bit about, but within Japan, I mean, it's been sort of an extraordinary period of late. You've been there as well.

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Patrice Quirion: Japan is an interesting case where valuations were quite depressed on like an asset value basis, maybe not an earnings basis because there was a lot of work to be done and still a massive amount of work to be done around optimizing the financial profile, the capital structures, the governance on a lot of these companies. Now we're starting to see a more favourable view in Japan. We're starting to see more actions taken to – in some cases – to address, I guess, those lower return on equities or return on invested capital by some companies, some lazy or non-optimized balance sheets, cross holdings. That's creating a fair bit of optimism right now. I would say Japan is probably less into that contrarian bucket for me at the moment.

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Pamela Ritchie: After they hit the levels that they hit yesterday. We saw that.

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Patrice Quirion: There's also an element of flows tend to follow each other. There's some big trends going on. I think one of the major trends of the past year or so is an increasing pessimism towards the Chinese market and for a lot of Asia dedicated funds, or even global funds to some extent, China has been removed in a lot of cases and a lot of that money has found its way into Japan. In a way, I think there's an element of yes, Japan. The corporate sector there is taking some of the right actions that the market wants to see but I think there is more than that to their current strength. I think some of it is tied to flows leaving China going into Japan.

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Pamela Ritchie: Well, what about now just in terms of the flows? Is there a reason for flows to, well, to go to China, not necessarily leave Japan but what do you think on China? It's cheap.

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Patrice Quirion: There's no doubt that valuations are compelling. Sentiment is very negative. That on its own starts to typically get me interested in doing more work. It was Europe a few years ago, it is definitely China at the moment. We've been spending a lot more time on a lot of these companies because there is always a macro view but in relatively concentrated portfolios what I'm interested in is not so much a macro picture. It's much more where is a given company trading versus our best assessment of a normalized earnings power.

There are a lot of these instances where there appears to be a large disconnect between the two in the Chinese market at the moment. It is an overweight position to the portfolio, one that we've been adding to. It's not so much based on a view that I think next month or next quarter things will inflect. I think, generally speaking, it is difficult to have that level of conviction that things will get better tomorrow. I think when the risk-reward starts to skew very positively on a situation where sentiment gets very negative, to me, one signal that I like to look at is when stocks start to react much less or not react at all to incremental news either when...

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Pamela Ritchie: That's interesting, did not react at all even.

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Patrice Quirion: When you get bad news on a company or sector or country and stocks no longer go down it tells you that most of the investor base into that market, into that company, is not there for the next short-term piece of information. It's more there based on a longer term view. Same applies when you get some really frothy or hyped-up parts of the market. When the market stops reacting favourably to good news, this is usually as good as an indicator as there can be on we might be approaching those inflection points. Although it's far from perfect, I think the potential that we are getting there on China is catching my interest.

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Pamela Ritchie: Fascinating. So, it's your biggest overweight right now.

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Patrice Quirion: Europe is still slightly larger in terms of absolute overweight but yes, the weightings in the portfolio into Chinese equities has been on the uptrend over the past months.

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Pamela Ritchie: Give us a bit more of a sense of your positioning elsewhere. Where else are you looking, maybe slightly underweight though. Give us a sense.

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Patrice Quirion: If I can take it from a sector perspective as opposed to a geographic perspective, I would say, in general, I am increasingly cautious on the market. I think there is a lot of optimism based on what is now an accepted fact that we are going to get a soft landing across the U.S. but most economies. I remain somewhat nervous that we may not be in that all-clear-ahead type of scenarios, notably around geopolitics, around the impact it could have on commodity prices, the impact that could have on inflation, and ultimately the reasons the market is more optimistic right now is I think the market is taking for granted that interest rates are going to drift lower from here or from mid-part of this year.

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Pamela Ritchie: So, what is the contrarian then?

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Patrice Quirion: I think when something becomes priced in, accepted, the risk becomes that it does not materialize. If it does not materialize on the inflation front, or even if we get that lower inflation but it doesn't translate into the magnitude of reduction in interest rates, notably in the U.S., that the market is expecting we could be in for a little bit of a reality check on where valuations have moved, especially on the more volatile, more momentum-driven parts of the market.

I think it just creates a risk-reward environment, which is less conducive... In a way we're entering 2024 with high expectations and relatively high valuations on a base case that should get better but it's not a given, which is very different than last year where we were entering the year with low expectations, low valuations on a relatively gloomy scenario but again, which was accepted but not a necessary outcome. We had a different outcome where the economy proved to be more resilient last year...

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Pamela Ritchie: And saw real momentum last year.

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Patrice Quirion: Yeah. I'm just a little bit more nervous. Coming back to the sectors, what does it mean, over the past few years I've been more heavily tilted towards the cyclical sectors where if we go back a few years ago they were seen as very challenged fundamentals, that proved to be a lot more resilient, to have recovered in the bigger way than expected. We've seen a lot of these cyclicals either in industrials or even financials, definitely parts of consumer discretionary just performing extremely well. I think with this scenario that I just described as a likely ... or maybe not a given outcome in the economy but one where the skew seems to be maybe more around disappointment then better than expected I think to...

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Pamela Ritchie: As in it could be higher for longer, interest rates?

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Patrice Quirion: That's one of my fears, or that maybe we get a couple cuts but not as much as the market likes and doesn't necessarily kickstart a new cycle like maybe we would have thought, and also from the fact that the economy never really corrected, especially in the U.S., to the extent that what we were thinking. It almost feels like we're more into... as opposed to having had that slowdown/recession that restarts the economic cycle into an early cycle framework I think we just extended further on to the late cycle.

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Pamela Ritchie: What does that mean about leadership then?

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Patrice Quirion: I think we're seeing leadership into the more risk-on areas of the market at the moment, either cyclicals or technology to a very large extent, although that's a different story driven by AI, we can come back to that. To me, cyclicals are looking less compelling than they did so I've been reducing the weights there. Growth is still, and especially today, I think harder to justify as being overlooked or underpriced or out of favour.

I'm actually gradually drifting towards more defensive stocks into the portfolio which is typically not where I spend a lot of my time. I've been managing the fund for about ten years. I never held a utility until not long ago. I'm increasing the weights in sectors like consumer staples where valuations on a relative basis are as compelling as they've been. Fundamentals are challenged. There's less growth. There's still an element of margins not recovering as fast. I think this is well understood by the market now. I would put health care as another area where we are finding mispriced companies.

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Pamela Ritchie: Globally? I mean, there's some biggies but...

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Patrice Quirion: Yeah. On those sectors I would say all of what I mentioned in terms of sectors tend to apply across the U.S., across Europe, across most of Asia. I would say the other compelling part is, as we talked earlier, China, in general. My case, still paying a lot of attention to being into the higher quality parts of the market. But yes, I think this is a large part of the overweights into the portfolio's combination of China exposure and increasingly defensives and a lot more of company-specific situations as opposed to a broader bet on one part of the market.

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Pamela Ritchie: Just sort of give us a sense of how you're viewing the U.S. I think we can sort of piece it together from some of the things you said but if you're looking at, for instance, staples or other things is that a global story for you? To what extent are you invested in the U.S.?

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Patrice Quirion: It is an underweight but the U.S. is now approaching 70%, or 65 to 70% of the global indices. Even global portfolios or global indices are much less diversified than people tend to think so it is an underweight. Most of the underweight comes from the tech sector which is just simply not my style to be chasing those stocks. Every once in a while, we're given opportunities, we had the opportunity in early 2023 to build a bit of exposure but we've had such a rally here that this is back to a very significant underweight.

In the U.S. it's a combination of some consumer stocks, still a bit of industrials, mostly on later cycle aerospace being an example of parts of the industrial sector or part of the cyclical sector that I think is still interesting. I would put autos in there as well. This is in Europe not in the U.S., but parts of a cyclical sector where we have not seen the type of rerating and optimism than we've seen in other parts of more cyclical sectors. A big part of the U.S. exposure is around health care where I think the U.S. has the majority of the high-quality health care companies being either in medtech in a lot of cases is where I play into the portfolio.

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Pamela Ritchie: And you look at that as defensive, it's sort of evergreen but it leans towards the defensive.

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Patrice Quirion: Yeah, defensive. I think there's still some benefit from health care utilization recovery that's taking place since COVID. It feels like it's a long time ago, but I think there's still an element of elderly people who had not fully gone back to using the health care system or problems that develop over that period of time. Just more defensive and not as overpriced historically stocks into that sector.

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Pamela Ritchie: We could chat for a long time because there's so many good ideas coming out. Just give us a final thought, we've got about a minute, you want to leave with investors.

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Patrice Quirion: I think what's important to remind ourself at a moment like this where the market is extremely narrow, a lot of momentum in some pockets of the markets, I go back to what I started with. I think the market has a tendency to be directionally correct. There's good reasons why those sectors are doing well and why countries like China are not doing well. There are sectors like consumer staples are not doing well.

But the market tends to overreact so the moves tend to be more significant than what the fundamentals would justify. It can keep going on for a while. Momentum works, it builds. But when we get to extremes, and I can't stand here and tell you we are at that extreme, it's really hard to judge are we there, but certainly we're closer to that extreme than not, in my opinion. That means that we are potentially setting the stage for leadership to change in the market. When leadership changes after a lot of crowding in some areas it can be a very abrupt change.

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My strategy is approaching it from a contrarian perspective, when risk-reward really skews on our side, with better than average quality businesses that have the benefit of time, wait for that normalization or shift in leadership in the market, this is where I will try to thrive. I would just recommend most asset allocators, investors, to consider what happens to their portfolios if we get this leadership change based on maybe a broadening of growth across the economy, if we get either positive surprise on China to a large extent or negative surprise on what's been driving the leadership.

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Pamela Ritchie: It's great to have you here, Patrice Quirion. Thank you very much for taking us through your style, process and ultimately how that fits into this moment. All the best.

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Patrice Quirion: Thank you. Pleasure to be here.

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Pamela Ritchie: Thanks to you for joining us here on Compass. Quick note, starting in March, Fidelity Compass webcasts, they're going to be moving from BlueJeans to Zoom events. If you have any questions about that you can certainly reach out to your Fidelity rep about that. Any suggestions on future topics, guests, you can let us know on that. Meanwhile, stay tuned for more Fidelity Compass webcasts in the weeks ahead. I'm Pamela Ritchie.