Inflation and rising rates: What they mean for investors

Fidelity's Global Asset Allocation team weighs in.

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The market sits on shifting sands as the world emerges from the pandemic. The last six months have proven to be a volatile period, and various factors continue to affect market performance. The Russian-Ukraine war, lockdowns in China, persistent high inflation, tightening monetary policy and the potential for a recession are a few developments that have garnered the attention of investors; these headlines seem to be dictating the movement of the market. It's a difficult environment for investors to navigate, but it is also an environment that showcases the value of active portfolio management. In a recent webcast, Portfolio Managers David Wolf, David Tulk and Ilan Kolet discussed current market conditions and how Fidelity's Global Asset Allocation (GAA) team has been navigating this terrain.

Market performance

While the market prospered under the accommodative monetary and fiscal policies brought on by the COVID-19 pandemic, it now faces a change in regime. With U.S. inflation at a 40-year high[1], the market has begun pricing in potential interest rate hikes from near-zero to 3% by the end of 2022.[2] This has caused the price of stocks to fall globally by around 15%, and for bonds to fall by around 10%, because capital has become more expensive and future cash flows are less valuable.[3]

For many investors, the days of market exuberance are now a distant memory; the major indexes have fallen approximately 10–20% year-to-date, with valuations receding from their pandemic peak.[4] However, David Tulk believes that it is still important to have exposure to risk assets, because "Corporate fundamentals are strong, and there are parts of the market that are objectively cheap." David Wolf adds that "People have gotten way too fearful about the outlook," which presents an opportunity for owning more risk assets, because "Fear is a motivation for seeing through the volatility and appreciating the degree to which asset classes can rebound." These views exemplify the GAA team's four-pillar process of approaching asset allocation through the lens of macro, valuation, bottom-up and sentiment.

The rise in inflation, and specifically in commodity and energy prices, could serve as a tailwind for the Canadian equity market, given its large energy and natural resource sectors. However, David Wolf explains that Canada's economy is sensitive to interest rates due to the "build-up of household leverage and the importance that housing has taken in the economy." Canadian homeowners could face stress if real estate values dip as the Bank of Canada increases interest rates; that would lift mortgage rates, thus reducing demand.

In emerging markets, China seems to present the biggest concern. David Tulk states that "The ongoing zero-COVID policy in China contributes not only to weakness in their own economy but also to the supply chain issues that we see underpinning inflation."

Inflation and interest rates

The Consumer Price Index rose 8.3% in the U.S.[5] and 6.8% in Canada for the month of April, on a year-over-year basis.[6] The rise in inflation is largely driven by a surge in post-pandemic spending. This surge in consumption is the residual effect of the stimulative financial measures put in place during the pandemic, which allowed consumers to withstand a prolonged period of economic inactivity while retaining their savings. As David Tulk puts it, "The inflation problem stems from the actions of policy makers during the pandemic." Ilan Kolet adds that supply chain disruptions and a tight labour market are also contributing factors, and that "Inflation may remain sticky at higher levels than we've enjoyed for the last 20 or 25 years."

1 https://www.cnbc.com/2022/05/11/cpi-april-2022.html
2 https://www.cnbc.com/2022/05/04/fed-raises-rates-by-half-a-percentage-point-the-biggest-hike-in-two-decades-to-fight-inflation.html
3 https://markets.businessinsider.com/news/stocks/stocks-bonds-correction-first-time-50-years-outlook-interest-rate-2022-5
4 https://www.wsj.com/market-data/stocks/us/indexes
5 https://www.bls.gov/cpi/latest-numbers.htm
6 https://www150.statcan.gc.ca/n1/daily-quotidien/220518/dq220518a-eng.htm

In response to the high levels of inflation, central banks, and notably the U.S. Federal Reserve, are now taking that pandemic stimulus away by unwinding quantitative easing and making aggressive interest rate hikes. David Tulk explains that "As financial conditions tighten, it pushes us further along the economic cycle."

While many people recognize that inflation erodes buying power, David Wolf addresses another issue that high inflation creates: "When you have inflation that's more volatile, you tend to have more of a positive correlation between stocks and bonds." Generally, holding bonds along with equities provides a level of diversification, because the two asset classes are negatively correlated under normal conditions; when the price of equities rise, bond prices fall, and vice versa. However, during periods of high inflation, equities and bonds both underperform due to expectations of rising rates and the erosion of real returns. As David Wolf points out,

> Over the last 30 years, you were fine with a 60/40 portfolio. You owned some stocks, you owned some bonds, they hedged each other – and they both generally went up – and everything was fine. In an environment where inflation is higher and persistent, and where growth is harder to come by, you have to think about diversification differently, because a 60/40 or an index is not going to work as well.

The Fidelity solution

The current market environment is one that is unfamiliar for retail investors and professionals alike. However, the combined expertise of Fidelity's Global Asset Allocation (GAA) team can help investors navigate this challenging period with the range of strategies that it offers. David Wolf explains that "The Fidelity Managed Portfolios are core all-weather fund-to-fund solutions" that "use the breadth of our capabilities at Fidelity." The GAA team is able to "go across the breadth of Fidelity and choose the best managers in each individual style, each individual disciplined approach, and then put them together in a very balanced way that has the potential to outperform in any given market." The portfolios combine growth, value, small-cap and large-cap managers in a region-agnostic stack, with the possibility of obtaining alpha from each manager. With the introduction of the new Fidelity Global Equity Portfolio, the GAA team hopes to provide the same capabilities and help steer the ship for investors through these turbulent waters.

For more information, contact your Fidelity representative or visit **fidelity.ca**

Source: Fidelity Investments Canada, as at May 31, 2022.

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