Three Pillars Holding as Macro Crumbles

David Wolf | Portfolio Manager
David Tulk, CFA | Portfolio Manager
Ilan Kolet | Institutional Portfolio Manager

Key Takeaways

- We are positioned defensively as the macro outlook goes from bad to worse…
- But still-strong corporate fundamentals, less-demanding valuations and negative investor sentiment all provide some offsetting support
- We continue to overweight the US dollar, inflation-sensitive assets and short-term securities

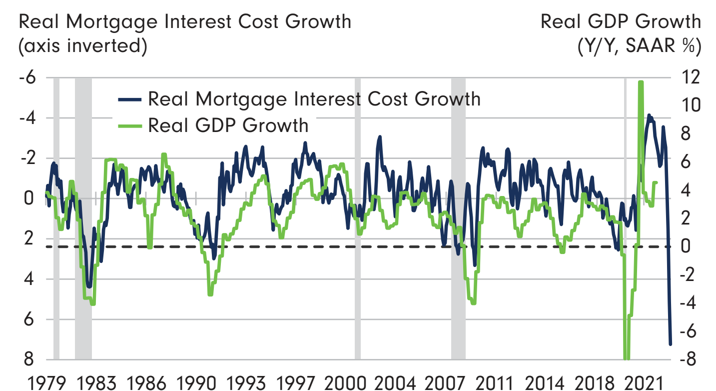
2022 continues to be a tough year for financial markets. Both stocks and bonds have fallen sharply, as central banks aggressively tighten policy aggressively to bring inflation under control. This is a daunting macro environment, and one that's likely to get worse, to an extent that markets are still not fully appreciating. In this context, we acted to reduce our equity exposure during this summer's bear-market rally and are now underweight risk. However, we are not underweight to the limits of our tactical allocation bands. That is because, as challenging as the economic outlook is, macro is just one of the four pillars we use to form our active allocation views. The remaining three pillars in our process – bottom-up, valuation, and sentiment – paint a comparatively less dour picture. To better understand our moderately defensive positioning, it is helpful to review the four pillars and identify the milestones ahead that would motivate a further shift.

Woe is Macro

The primary motivation for our defensive positioning is the maturation of the business cycle as policy interest rates move into increasingly restrictive territory. Central banks are struggling to contain the rapid increase in inflation caused in part by excessively stimulative policy left in place from the COVID-19 pandemic. While we and the market expect headline inflation to moderate in the months ahead, we are less sanguine that core inflation will follow suit. Fearful that expectations of future inflation become unanchored, central banks will be inclined to keep policy tight to ensure inflation returns to target.

This inflation fight is very likely to cause a recession in many economies (Exhibit 1 shows what this could look like in Canada). What is less certain is the depth and

EXHIBIT 1: Ominous



Real mortgage interest cost growth is the three month growth rate of mortgage interest cost deflated by total inflation, lagged nine months.
Source: Statistics Canada, FMR calculations

duration of the downturn. In our view, the market has yet to fully discount the persistence of inflation and the resolve of central banks in dealing with it, which means a weaker economy than is currently priced. This view is the primary motivation for our defensive positioning, including a moderate underweight to equities, a modest underweight to duration, a continued out-of-benchmark allocation to inflation-sensitive assets, and a sizable overweight to the US dollar (USD).

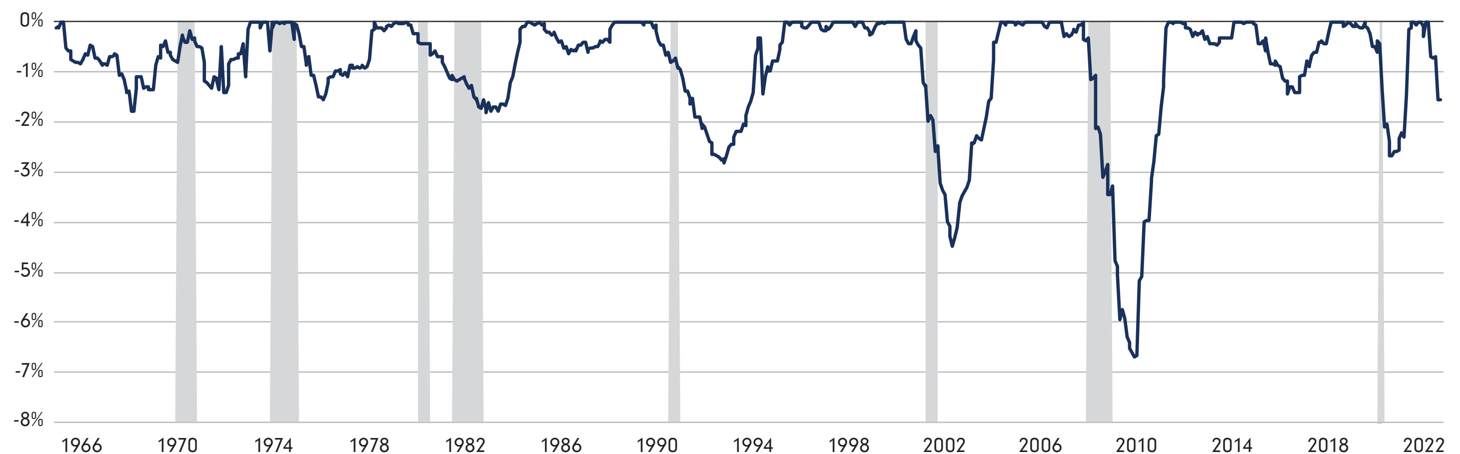
While these themes are common across economies, differences in the details offer opportunities for regional asset allocation tilts. Canada's economy is likely to underperform, reflecting its heightened interest-rate sensitivity, in turn reflecting historically unprecedented levels of household debt and housing activity. Europe is challenged by ongoing geopolitical and energy strains, in addition to tighter policy. By contrast, the United States looks much better positioned to weather higher interest rates, and emerging market economies such as China are turning to policy stimulus. The regional equity market tilts that flow from this macro assessment include a sizable underweight to Canada and the EAFE region against more neutral positions in the United States and emerging markets.

Bottom-Up Brighter than the Top-Down

An unparalleled source of information for us is the access that our building block portfolio managers and analysts have to companies. Their 'on the ground' insights are critical in confirming or challenging the macro data. The general message at this point is that companies are not yet seeing significant economic strains in their businesses, significantly owing to the success they've had in passing on price increases, thereby helping to preserve margins (Exhibit 2). Hiring intentions have been pared back in some cases, but demand for labour remains elevated and wage pressures are continuing to grow. Firms also took full advantage of very low interest rates in recent years to term out their debt, reducing the risk of a sharp increase in borrowing costs now that interest rates have risen. Moreover, the well-telegraphed tightening by central banks have allowed firms to develop contingency plans to respond to the inevitable slowing in economic growth.

EXHIBIT 2: Bottom-Up Not as Dismal as the Top-Down

US Equity Profit Margins, Decline from 3-year Peak



Source: Haver Analytics

We expect corporate fundamentals will soften as the wider economy cools. However, a relatively healthy starting point and the absence of the kind of imbalances that have marked the later stages of prior economic cycles does warrant some tempered optimism that the worst-case outcome consistent with a larger equity market underweight can be avoided.

Valuation Looking Less Stretched

The richness that defined almost every asset class during the reopening phase of the recovery from the COVID-19 pandemic has faded as markets have retrenched in a simultaneous fashion. While not a timing tool, valuation metrics provide a measure of vulnerability in the face of a macro or market catalyst. Now that equity markets are closer to historically fair valuations and have priced in a softer outlook, there is less of a valuation-based case to take a larger underweight position (Exhibit 3).

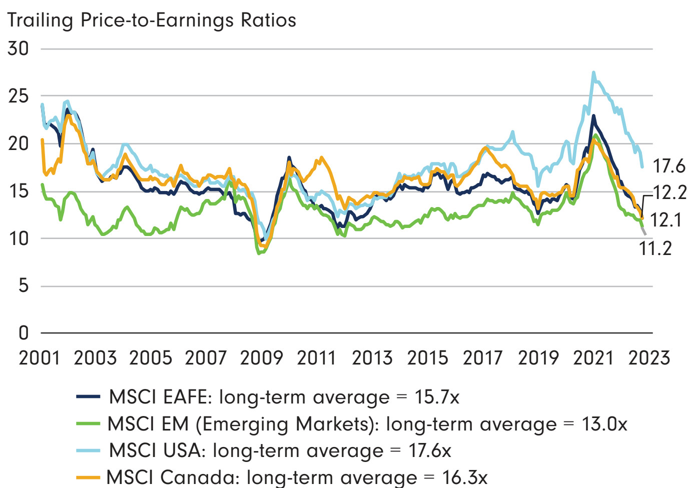
In the bond market, the move higher in interest rates has clearly restored some value. It's not clear how much, however, given our expectation for continued central bank tightening and the risk of a higher secular environment for inflation. As a result, we continue to hold a modest underweight to duration as the expected end of the tightening cycle remains too far over the horizon.

In currency markets, the USD looks rich on a historical basis following its significant appreciation in recent months. It can get richer still, however, owing both to the relatively resilient US economy (prompting the Fed to go where other central banks cannot follow) and the currency's safe-haven status in times of stress. We continue to hold a material overweight to the USD, against both the Canadian dollar and other major currencies.

Sentiment Simply Stinks

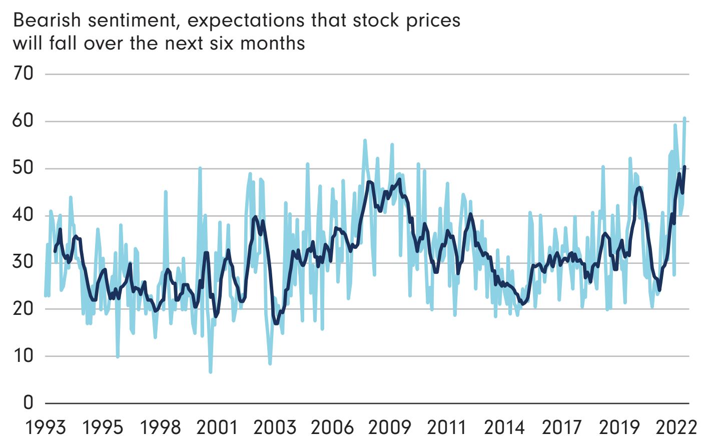
Investor sentiment is an important contrarian input to our process. Sentiment today across a wide range of asset classes is exceptionally poor (Exhibit 4). Investor surveys show extreme levels of bearishness while flows show a clear preference for safe-haven assets. These sorts of extremes in sentiment often produce (sometimes abrupt) reversals. Such reversals are often of the temporary 'bear market rally' variety, though sentiment extremes can also mark

EXHIBIT 3: Equities Have Cheapened



Source: FactSet, FMR. Data as of September 2022

EXHIBIT 4: Sentiment has Become Very Negative



Dark blue line is the 12-month moving average

Source: Bloomberg, American Association of Individual Investors
Data as of September 2022

fundamental market turning points, which we must allow for the possibility of given the damage that the macro environment has already inflicted on both stocks and bonds. The fact that investors are already quite bearish is a factor limiting the size of our own underweight at this point. As in July, if a rebound in sentiment takes markets with it absent a fundamental improvement in the outlook, we expect to take the opportunity to reduce risk further.

Where We Go from Here

The evolution in the four pillars of our framework will continue to inform our asset allocation positioning. The macro pillar is the primary motivation for our defensive positioning at this point, given the view that central banks will have to inflict more damage on the economy to restore inflation to target. Should we see a deterioration in the other pillars of our process – a weakening in corporate fundamentals that is not reflected in earnings forecasts, an unfounded rebound in sentiment and/or a corresponding richening in risky assets – we will reduce risk further.

At the other end of the spectrum, a faster than expected retreat of inflation would likely motivate less defensive positioning. Should the increase inflation prove to have been 'transitory' all along, central banks would finally be able to indulge the long hoped-for 'pivot' towards easier policy, reducing both economic pressure and market angst. We judge this sort of 'immaculate' decline in inflation to be unlikely but certainly not impossible. Valuation is another potential catalyst for us to increase our risk posture. Outside of the US, equity valuations are starting to look cheap; we think they are cheap for good reason, but are arguably at levels that are long-term buys even given a daunting short-term outlook.

As we navigate the economic and market aftermath of the COVID-19 pandemic and face the inevitable and unknowable shocks to come, our active allocation views will always balance the information provided by the four pillars that underpin our investment process. Remaining disciplined in the face of uncertainty is fundamental to our objective of maximizing return while managing risk for our Canadian investors.

David Wolf, David Tulk and Ilan Kolet, November 3, 2022

Follow Fidelity Canada on Twitter @fidelitycanada

Authors

David Wolf | Portfolio Manager

David Wolf is a Portfolio Manager for Fidelity Investments. He is the co–manager of Fidelity Managed Portfolios, Fidelity Canadian Asset Allocation Fund, Fidelity Canadian Balanced Fund, Fidelity Monthly Income Fund, Fidelity U.S. Monthly Income Fund, Fidelity U.S. Monthly Income Currency Neutral Fund, Fidelity Global Monthly Income Fund, Fidelity Dividend Fund, Fidelity Global Dividend Fund, Fidelity Income Allocation Fund, Fidelity Balanced Managed Risk Portfolio, Fidelity Conservative Managed Risk Portfolio, Fidelity American Balanced Fund, Fidelity Conservative Income Fund, Fidelity NorthStar®, Fidelity NorthStar® Balanced Fund, Fidelity Tactical Strategies Fund, Fidelity CanAm Opportunities Class, Fidelity Inflation-Focused Fund, Fidelity Canadian Monthly High Income ETF Fund, Fidelity Global Monthly High Income ETF Fund and Fidelity Tactical Global Dividend ETF Fund. He is also portfolio co manager of Fidelity Conservative Income Private Pool, Fidelity Asset Allocation Private Pool, Fidelity Asset Allocation Currency Neutral Private Pool, Fidelity Balanced Private Pool, Fidelity Balanced Currency Neutral Private Pool, Fidelity Balanced Income Private Pool, Fidelity Balanced Income Currency Neutral Private Pool, Fidelity U.S. Growth and Income Private Pool, Fidelity Global Asset Allocation Private Pool and Fidelity Global Asset Allocation Currency Neutral Private Pool.

David Tulk, CFA | Portfolio Manager

David Tulk is a Portfolio Manager for Fidelity Investments. He is the co-manager of Fidelity Managed Portfolios, Fidelity Balanced Managed Risk Portfolio, Fidelity Tactical Strategies Fund, Fidelity Conservative Managed Risk Portfolio, Fidelity Conservative Income Fund, Fidelity Inflation-Focused Fund, Fidelity Conservative Income Private Pool, Fidelity Canadian Monthly High Income ETF Fund and Fidelity Global Monthly High Income ETF Fund.

Ilan Kolet | Institutional Portfolio Manager

Ilan Kolet is an Institutional Portfolio Manager for Fidelity Investments. In this role, Mr. Kolet serves as a member of the investment management team, maintaining a deep knowledge of portfolio philosophy, process and construction. He assists portfolio managers and their CIOs in ensuring portfolios are managed in accordance with client expectations.

Commissions, trailing commissions, management fees, brokerage fees and expenses may be associated with investments in mutual funds and ETFs. Please read the mutual fund or ETF's prospectus, which contains detailed investment information, before investing. The indicated rates of return are historical annual compounded total returns for the period indicated including changes in unit value and reinvestment of distributions. The indicated rates of return do not take into account sales, redemption, distribution or option charges or income taxes payable by any unitholder that would have reduced returns. Mutual funds and ETFs are not guaranteed. Their values change frequently, and investors may experience a gain or a loss. Past performance may not be repeated.

From time to time a manager, analyst or other Fidelity employee may express views regarding a particular company, security, and industry or market sector. The views expressed by any such person are the views of only that individual as of the time expressed and do not necessarily represent the views of Fidelity or any other person in the Fidelity organization. Any such views are subject to change at any time, based upon markets and other conditions, and Fidelity disclaims any responsibility to update such views. These views may not be relied on as investment advice and, because investment decisions for a Fidelity Fund are based on numerous factors, may not be relied on as an indication of trading intent on behalf of any Fidelity Fund.

Certain statements in this commentary may contain forward-looking statements ("FLS") that are predictive in nature and may include words such as "expects", "anticipates", "intends", "plans", "believes", "estimates" and similar forward-looking expressions or negative versions thereof. FLS are based on current expectations and projections about future general economic, political and relevant market factors, such as interest and assuming no changes to applicable tax or other laws or government regulation. Expectations and projections about future events are inherently subject to, among other things, risks and uncertainties, some of which may be unforeseeable and, accordingly, may prove to be incorrect at a future date. FLS are not guarantees of future performance, and actual events could differ materially from those expressed or implied in any FLS. A number of important factors can contribute to these digressions, including, but not limited to, general economic, political and market factors in North America and internationally, interest and foreign exchange rates, global equity and capital markets, business competition and catastrophic events. You should avoid placing any undue reliance on FLS. Further, there is no specific intentional of updating any FLS whether as a result of new information, future events or otherwise.

"Fidelity Investments" and/or "Fidelity" refers collectively to: i) FMR LLC, a US company, and certain subsidiaries, including Fidelity Management & Research Company (FMR Co.) and Fidelity Management & Research (Canada) ULC ("FMR-Canada") – which carries on business in British Columbia as FMR Investments Canada ULC; and ii) Fidelity Investments Canada ULC ("FIC") and its affiliates. Fidelity Management & Research (Canada) ULC ("FMRCanada") commenced business in Ontario on February 1, 2018. FMRCanada is registered as a portfolio manager with the Ontario Securities Commission ("OSC") and as a portfolio manager with the other Canadian securities commissions. The scope of FMR-Canada's business is currently limited to offering the Global Asset Allocation ("GAA") strategies through a discrete portfolio management team at FMR-Canada. The GAA strategies are offered by FMR-Canada on a sub-advised basis to accounts advised by Fidelity Investments Canada ULC ("FIC"), with FMR-Canada acting as either direct sub-adviser to FIC or as sub-sub-adviser through non-Canadian Fidelity advisers, including (and principally) US SEC-registered investment advisers, such as FMR Co., Inc. ("FMRCo"). FMR-Canada does not offer these strategies directly to investors in Canada. FMR-Canada has also registered "Fidelity Investments" as a trade name in Canada.

© 2022 Fidelity Investments Canada ULC. All rights reserved.

1060165-v20221027 INM 1048707 10/22