

Five Questions and Five Charts

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1. *How have your investment views evolved since the start of the year?*
2. *Where will policy rates eventually settle?*
3. *How is Canada's immigration surge influencing your economic and investment views?*
4. *Is there an update on the recently announced fund enhancements?*
5. *How much Canada should a Canadian investor own?*

1. How have your investment views evolved since the start of the year?

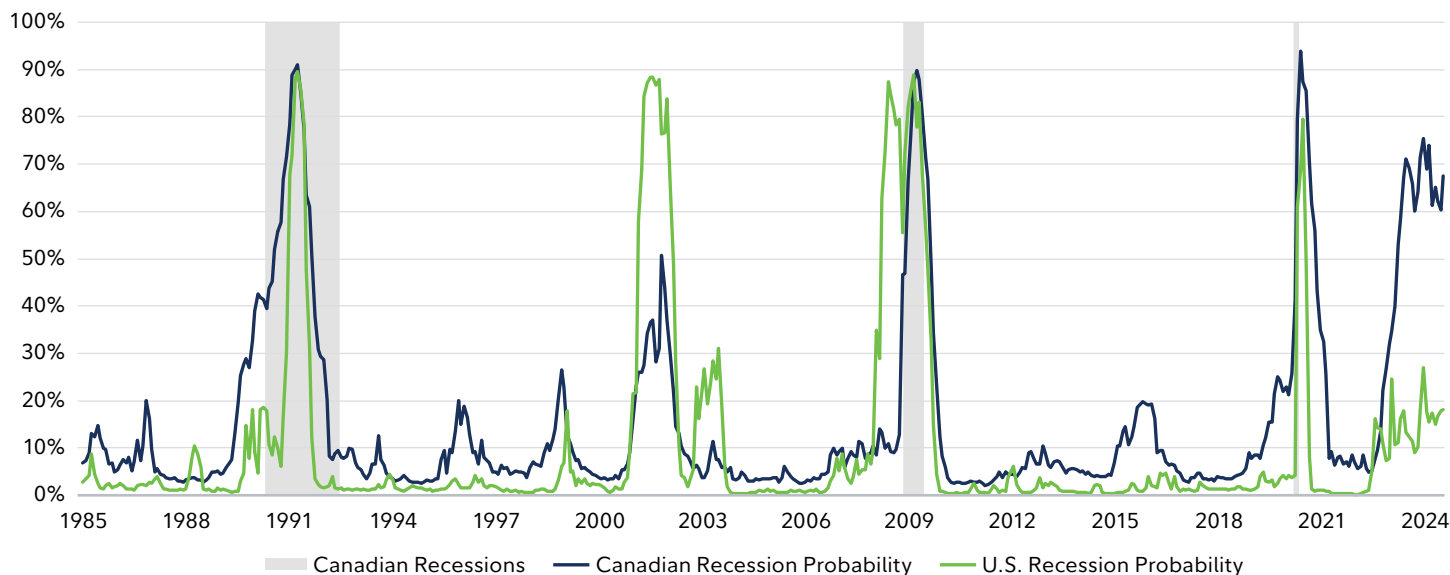
The broad contours of our positioning remain unchanged – a modest overweight to equity beta and a neutral position on duration – but we have trimmed our US equity overweight. While we continue to believe that stronger productivity will help the US economy achieve a soft landing, the relative outperformance of the S&P500 (notably concentrated in the growth portion of the market) has stretched its relative valuation. This raises the possibility that cooling inflation and less restrictive monetary policy causes the rally to broaden within the US and to other regions around the world. As a result, we want a more evenly balanced regional equity allocation.

The proceeds of our US equity trim were directed towards commodities, both as a larger allocation to global commodity producers and a reduction in our

longstanding underweight to Canadian equities. A larger commodity allocation is consistent with an elongated global business cycle reducing recession fears, the potential for more protectionist and reflationary US fiscal policy following the Presidential election later this year, and elevated geopolitical risk. Some of our underlying stock-picking portfolio managers share our more favourable view of commodities based on industry-level supply and demand trends and company-level activity.

We have bought back into Canadian equities somewhat primarily to get additional commodity exposure; we remain as concerned as ever on the segments of the market most vulnerable to the domestic economy. The recession probability model developed by our research team suggests Canada spent much of 2023 in recession, due almost entirely to domestic factors stemming from higher interest rates, excessive household leverage, and an absence of a productivity tailwind (Exhibit 1). While these risks continue to loom over the outlook, they have also become more fully recognized by the market, as Canadian asset prices have lagged their global peers this year. Wary that sentiment can become too pessimistic and potentially reverse without improving fundamentals, it is prudent to trim our underweight to Canadian assets, including the CAD.

On the bond side of the portfolio, our views are largely unchanged from the start of the year. A broadly neutral position on duration balances an underweight to investment-grade bonds with out of benchmark

EXHIBIT 1: Higher recession risk in Canada

Source: Fidelity Investments, Asset Allocation Research Team, CD Howe Institute

allocations to a range of more attractive credit sectors including high yield, floating rate, convertibles, and emerging market local currency debt. With a soft-landing increasingly becoming the base-case for the US economy, it is possible that the neutral policy rate is higher than many still believe. This will limit the scope for yields to fall as much as the consensus expects (see next question). Furthermore, the increasing likelihood of more trade barriers and further fiscal expansion following the US election later this year could also stoke inflation and keep interest rates higher than expected.

2. Where will policy rates eventually settle?

Now that central banks have started to cut policy interest rates, the next question is what the easing cycle will look like. Normally rates are cut in the face of economic weakness so that monetary policy becomes accommodative. This is likely to be the case for some economies this time around as well. But for

other economies where inflation has declined amid an otherwise resilient economy, central banks are more likely to only trim policy rates so that the stance of monetary policy is simply less restrictive than it is today. Given our expectation that the United States will be able to achieve a soft landing, the Federal Reserve will likely fall into the latter camp and embark on a shallow rate cutting cycle. The exact amount of monetary easing required is hard to quantify because it depends on the neutral rate of interest which itself is notoriously difficult to estimate. But we think that the neutral rate is higher than the market believes because improved productivity allows for more growth and less inflation without the need for substantial easing from the Fed. The prospect of fewer versus more rate cuts is a factor keeping us hesitant to be overweight duration. With plenty of easing already discounted in a still-inverted yield curve, it is far from clear that longer-term bonds will rally as short rates come down.

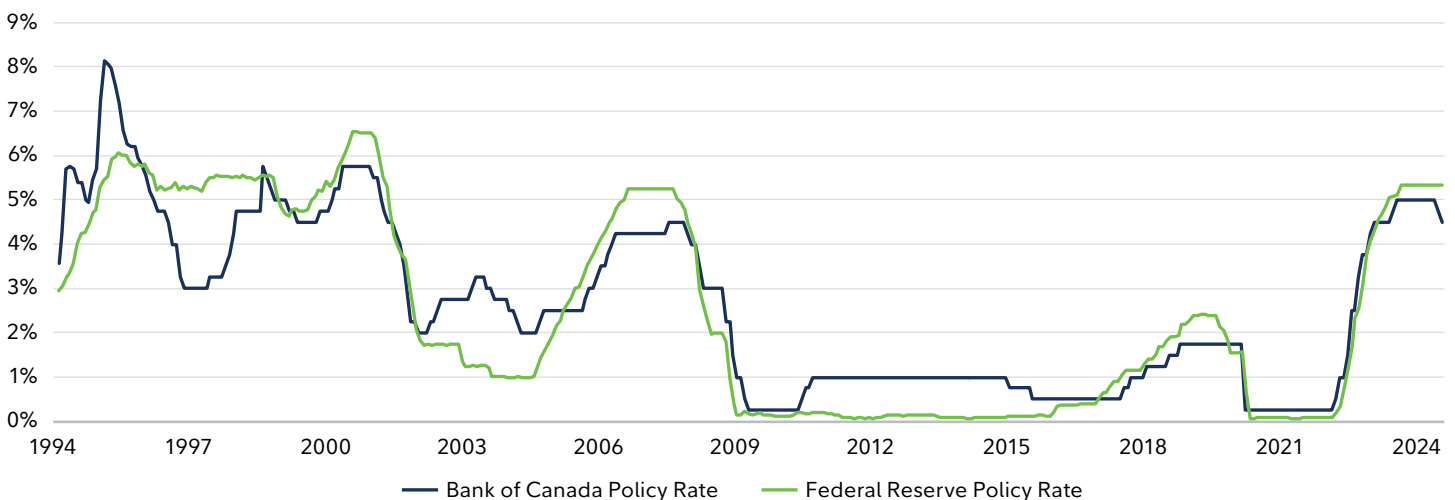
By contrast, the Bank of Canada is expected to deliver a deeper rate cutting cycle to combat a more pronounced economic slowdown. Not only does Canada face significant cyclical headwinds as the shock of higher interest rates ripples through overleveraged household balance sheets, but the economy is not benefitting from the same productivity tailwind supporting the US. This means that the neutral interest rate for Canada is likely much closer to the Bank’s 2.75% estimate, implying more than 175bps of additional cuts should the Bank need to take its policy rate into accommodative territory. However, with term rates already below 3%, even an aggressive easing cycle may not push longer-term bond yields lower. This outcome would pose a conundrum for the Bank of Canada should lower policy rates not also lead to lower 5-year government bond yields (and thus 5-year mortgage rates) that are necessary to reduce the reset risk facing mortgage borrowers.

Investors may be accustomed to seeing the Bank of Canada and the Federal Reserve move together through time, but there have been episodes in the past

where conditions in the Canadian economy demanded a significantly different policy stance than in the US. One such episode was in 1995–96, when much tighter fiscal policy in Canada (the Paul Martin consolidation) prompted Canadian short rates to move 250 bps below US short rates. We believe we could see the same degree of divergence again, this time given Canada’s much greater sensitivity to past interest rate increases, reflecting higher household debt and shorter mortgage financing terms than in the US. That would represent a widening of another 150–200 bps from here (Exhibit 2). The prospect of significantly more interest rate cuts in Canada versus the US is bearish for the Canadian dollar. And while we continue to be underweight the currency in recognition of the challenges the Canadian economy faces, we are also mindful that the currency market now shares a lot of our pessimism. As outlined in Question 1, we think it is therefore appropriate to trim the size of the underweight to the Canadian dollar until investor sentiment and market positioning data becomes less extreme.

EXHIBIT 2: Bank of Canada can (and is likely to) deviate from the Fed

Policy interest rate %



Source: Bank of Canada, Federal Reserve Board, Haver Analytics

3. How is Canada’s immigration surge influencing your economic and investment views?

First the facts. As Exhibit 3 shows, Canada has experienced a population surge of historic proportions. This has owed predominantly to immigration, which in turn has been skewed towards non-permanent residents (temporary foreign workers, international students and asylum seekers).

The economic theory is that higher immigration leads to higher prosperity – raising the economy’s potential growth rate, compensating for the effects of an aging workforce and injecting dynamism into the system. This is probably true in the long run. But it doesn’t have to be true in the short run. Modern societies struggle to deal with what we’ve called ‘demographic volatility’, which is abrupt and unanticipated changes in population. That is because the supporting infrastructure that modern societies rely on, from housing to transportation to health care to education, is inevitably slow to adjust. Planning and building

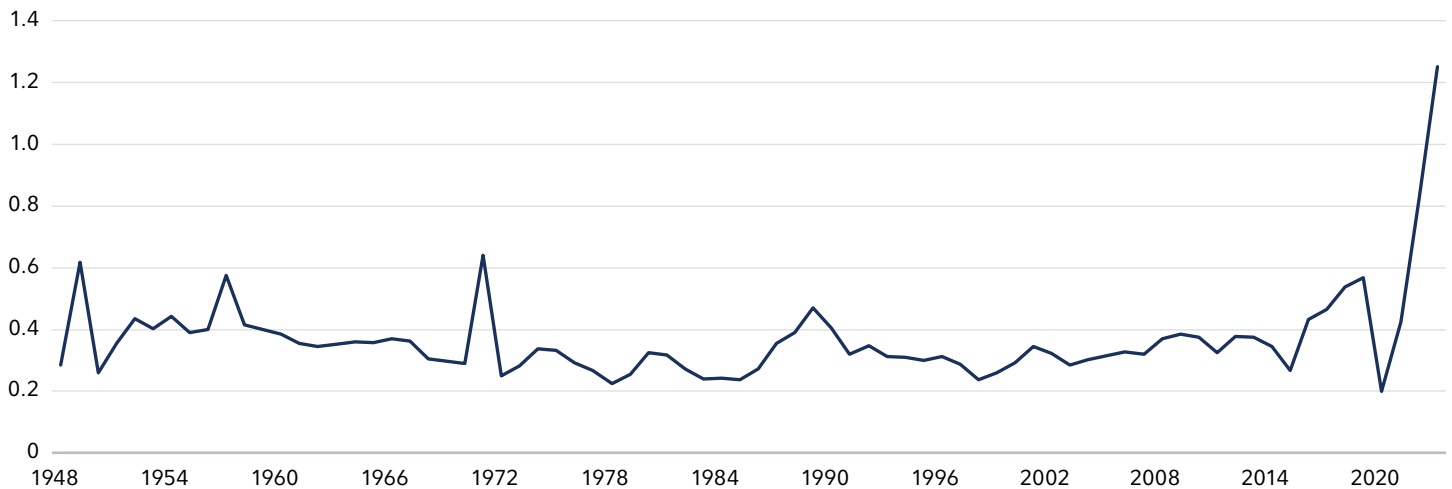
houses, roads, hospitals and schools takes many, many years. So an unexpected surge in population puts immediate pressure on just about everything. And that appears to be what has happened in Canada.

Take potential GDP growth, or in other words, growth in the economy’s capacity. That’s made up of two things – labour force growth (how many workers) and productivity growth (what they’re doing). Other things equal, higher immigration should raise potential growth by directly expanding the labour force. But other things are not equal. It seems clear that the population surge has hurt Canada’s already-poor productivity performance. In addition to the pressure on infrastructure, for example, this has promoted unproductive housing investment over productive business investment. The drag on productivity will be intensified to the extent that immigration is skewed towards lower-skilled workers, or higher-skilled workers unable to be credentialed to make their full contribution.

The result in Canada in recent quarters has been the expected labour force surge, but job growth has been

EXHIBIT 3: Canada’s population surge

Annual change in population (millions)



Source: Statistics Canada

weak and productivity has fallen outright, leading to a higher unemployment rate, sluggish overall economic growth and declining per capita GDP, even as shelter costs keep inflation up.

It’s hard to see a good way out of this, in our view. If immigration keeps up as it has recently, the pressure on the economy and inflation can be expected to endure – getting to the long run can take a long time. If immigration is curbed significantly, as authorities appear to be trying to do, the risk is that the associated flurry of activity now ongoing, particularly in housing, meets with a very different situation when these projects come to fruition years from now.

Many Western countries currently face a similar type of challenge right now, but none to the extent Canada does, in our view, reflecting both the size of the population surge domestically and the degree of housing and debt excesses that preceded it.

These factors contribute importantly to our ongoing concern about the Canadian economy and our

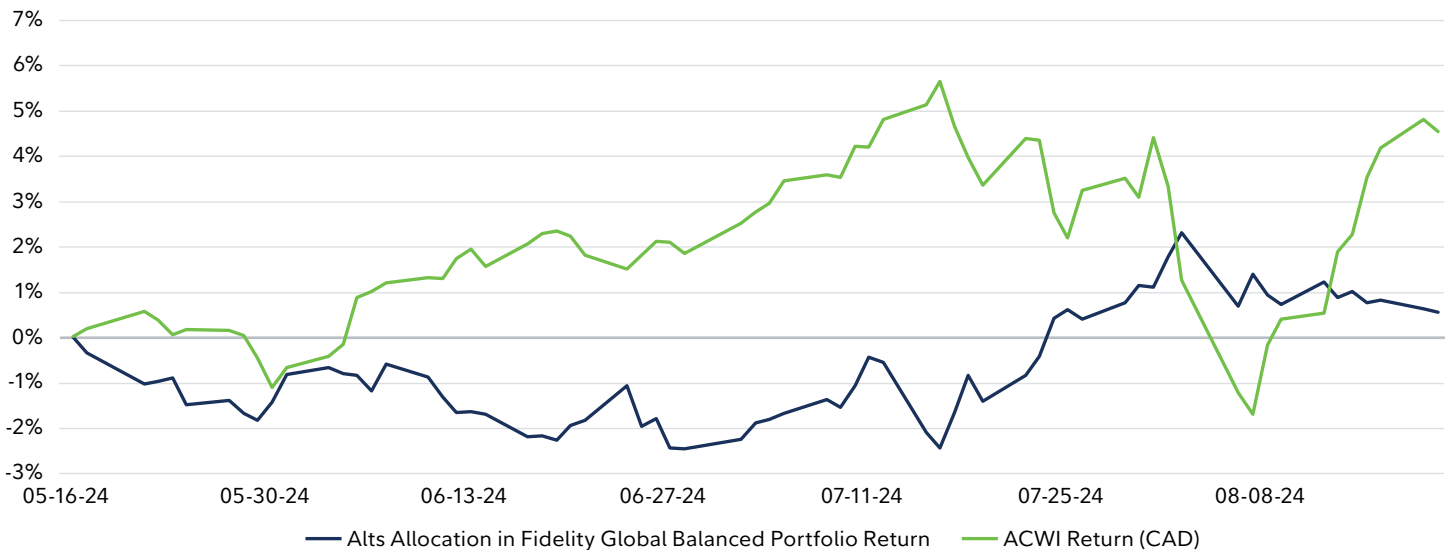
associated underweight to the Canadian dollar and domestically-focused Canadian equities. As discussed previously, we’ve recently reduced the size of those underweights in response to extremes in sentiment and positioning, but we retain high conviction in our longer-term view that the risk/reward tradeoff looks more favourable outside of Canada.

4. Is there an update on the recently announced fund enhancements?

In May we announced the addition of a number of alternative investments in our multi asset class funds. We initiated positions in three liquid alternatives within the Fidelity Managed Portfolios, and we have now funded the Brookfield Canadian Private Real Estate capability in our Private Investment Pools.

Regarding the liquid alternatives investments in the Fidelity Managed Portfolios (FMPs), we have taken positions in the Fidelity Global Value Long/Short Fund, the Fidelity Long/Short Alternative Fund and the Fidelity Market Neutral Alternative Fund. These

EXHIBIT 4: Alts Allocation provided a buffer through equity market weakness



Source: Fidelity Investments

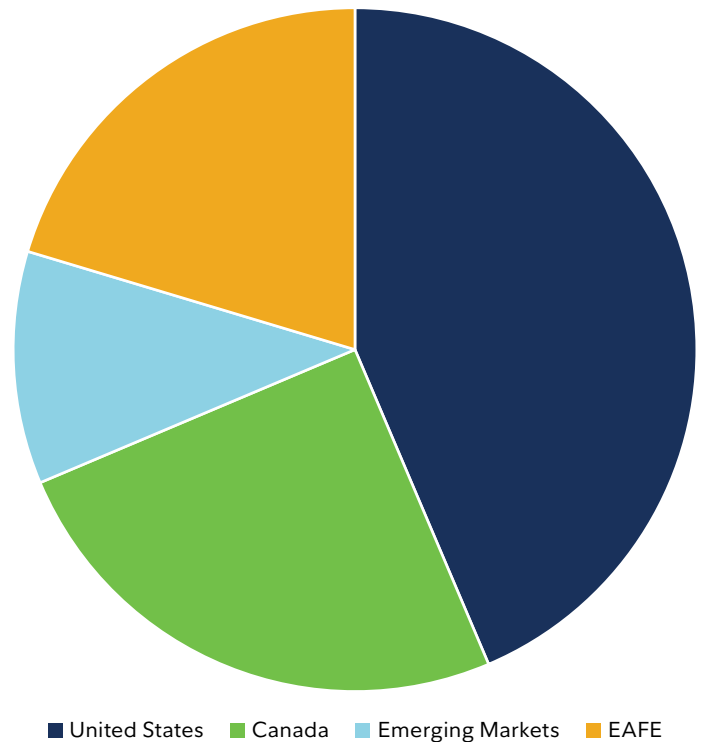
positions collectively now comprise 2–3% of the FMPs’ total allocations, with variation in the specific deployment of capital to the three strategies based on the varying underlying structures across the FMP lineup. As we discussed in May, the goal in introducing these positions is to incrementally improve the risk/return tradeoff in the funds, or in other words, provide investors a better destination with a smoother ride. Early returns are favourable on this front, with the strategies behaving in line with expectations, most notably in providing some ballast through the equity drawdown this summer (see Exhibit 4). We will continue to evaluate the behaviour of these and other liquid alternatives to determine the most appropriate shape and size of these allocations across our funds.

We have also begun deploying capital to the new Brookfield Canadian Private Real Estate capability in our Balanced Private Pool, Asset Allocation Private Pool, Balanced Income Private Pool and Conservative Income Private Pool. Fidelity Canada announced the strategic agreement with Brookfield to make these investments last summer, but as we said at the time, we intended to be deliberate in deploying capital – recognizing the headwinds in the commercial real estate sector and harnessing the advantage of having a new vehicle unencumbered by legacy assets. In other words, we were able to wait for the right assets at the right prices. The market appears to now be finally thawing somewhat, as prices adjust and interest rates start to come down. As a result, our Brookfield partners are now seeing greater opportunities in the market and have begun putting capital to work. As of the end of July, we had taken a 1% position in direct real estate in the Private Pools mentioned above, and have greater visibility into the further deployment of capital on our way to our previously-announced 5% intended target allocation.

5. How much Canada should a Canadian investor own?

This is a portfolio structure question we get a lot, and we are sympathetic to the desire to invest in the US and beyond. After all, Canada is only about 3% of the global market, which in turn is very dependent on specific Canadian sensitivities like commodity prices and the domestic consumer. Holding foreign securities allows a Canadian investor to diversify away these exposures and better manage risk in a balanced portfolio. This is not to say holding foreign securities is without risk, so the ‘right’ amount of Canada to hold will depend largely on the risk tolerance of the investor.

EXHIBIT 5: Going global: country exposure in the Fidelity Global Balanced Portfolio (%)



Source: Fidelity Canada

An investor with a larger allocation to equities should hold more foreign content than an investor with a portfolio allocated to bonds. The reason for this is that the Canadian dollar tends to be correlated with the equity market risk that dominates the total risk of the portfolio. By holding equities or bonds denominated in currencies like the US dollar that tend to be negatively correlated to equity market risk, the total volatility of a Canadian investor's portfolio will tend to decrease. This is true to a point, beyond which adding more foreign content will start adding to overall risk in the portfolio as currency volatility starts to dominate.

Let's consider the example of a Canadian investor invested in a 60/40 portfolio who has access to a full suite of foreign asset classes on an unhedged basis. Our research would suggest that the 'optimal' range of Canadian exposure falls between 20–40%. In other words, such an investor 'should' have 60–80% of their exposure outside of Canada. Some home bias is warranted – that number is more than 3% – but allocating to foreign equities and bonds is also important for an investor seeking to maximize risk-adjusted returns over the long term.

Our research on determining the 'optimal' foreign exposure for a portfolio underpins the strategic benchmark design of funds we manage for Canadian investors. It is no coincidence that the Canadian exposure in the Global versions of our Fidelity Managed Portfolios (FMPs) all fall within the 20–40% range cited above (Exhibit 5). Of course, for Canadian investors less comfortable holding a larger foreign allocation, there are versions of the FMPs, as well as a number of other funds in our lineup, with larger allocations to Canada. Finally, it should be noted that the 'right' amount of Canada in a Canadian investor's portfolio will depend not only on an investor's risk tolerance and portfolio holdings, but also the cyclical outlook for Canada versus other markets. As we noted in Question 1, we remain very concerned about the domestic outlook for Canada's economy but are more optimistic on the largely global factors that could boost commodity prices. Balancing these crosscurrents leave us still notably underweight Canadian assets but at a smaller magnitude than in the past.

David Wolf, David Tulk and Ilan Kolet, August 22, 2024

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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.

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