11 Questions for 2024

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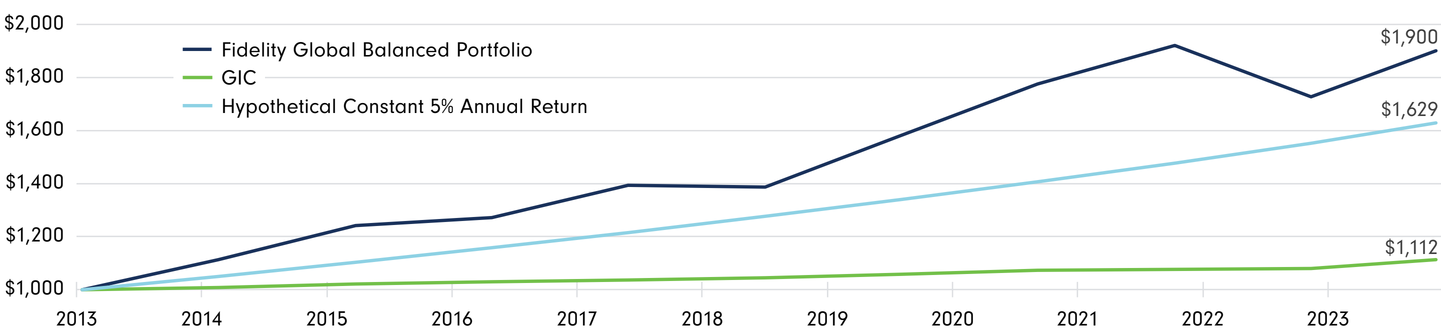
To start 2024 we offer answers to the questions we've been getting most frequently from advisors and investors.

1. *Why would I buy a balanced fund over a GIC?*
2. *What is your highest conviction overweight?*
3. *What is your highest conviction underweight?*
4. *Can the economy stick the (soft) landing?*
5. *Is this the year that bonds come back?*
6. *Where is inflation heading?*
7. *When will the Bank of Canada cut rates?*
8. *Why has Canadian productivity been so poor?*
9. *How big is Canada's housing shortage?*
10. *How are you allocated outside of Canada?*
11. *Will the USD lose its reserve currency status?*

1. Why would I buy a balanced fund over a GIC?

2023 showed that reports of the death of 60/40 were greatly exaggerated. Equities rebounded and, while bonds lagged, that was ok – that's what 'supposed' to happen when stocks rally. Our largest 60/40 fund, the Global Balanced Fidelity Managed Portfolio, returned 12.7% in 2023 (net of Series F fees).

EXHIBIT 1: $1,000 invested ten years ago in the Fidelity Global Balanced Portfolio, a GIC and a hypothetical constant five percent return



Source: Haver Analytics, Fidelity Investments Canada ULC. As at November 30, 2023. Data shown for Series F, net of fees and in Canadian dollars. For illustrative purposes only.

As at November 30, 2023	1-year	3-year	5-year	7-year	10-year
Fidelity Global Balanced Portfolio	7.7	3.0	6.1	6.0	6.8

Source: Fidelity Investments Canada ULC. Performance shows annual compounded returns as at November 30, 2023, Series F, net of fees, in Canadian dollars. Past performance is not a guarantee of future results.

But questions remain regarding 60/40. Beyond their specific merits, there is now a competitive alternative: cash-type instruments, notably Guaranteed Investment Certificates (GIC's), that no longer offer insultingly low interest rates. Many investors are now asking why they should be in a balanced fund when they can finally get a decent return on GIC's. Our perspective, in brief, is as follows.

We have cash-type investments in our opportunity set for our multi asset class funds. And we own some. But we think we can add considerable return in a risk-controlled manner, by taking advantage of the much wider opportunity set of asset classes available to us. We harness that opportunity set to improve both returns and diversification, using our active processes in both tactical asset allocation and security selection.

This approach, in aggregate, has allowed us to deliver considerable risk-adjusted returns (see Exhibit 1). For example, the Global Balanced FMP has returned an annualized 6.8% over the past 10 years (net of Series F fees), well above even the current elevated GIC rates around 5% (which may not stick around for long). And it has done so with a low-to-medium risk profile, improving on the risk-adjusted returns available in Canadian capital markets (see Exhibit 2).

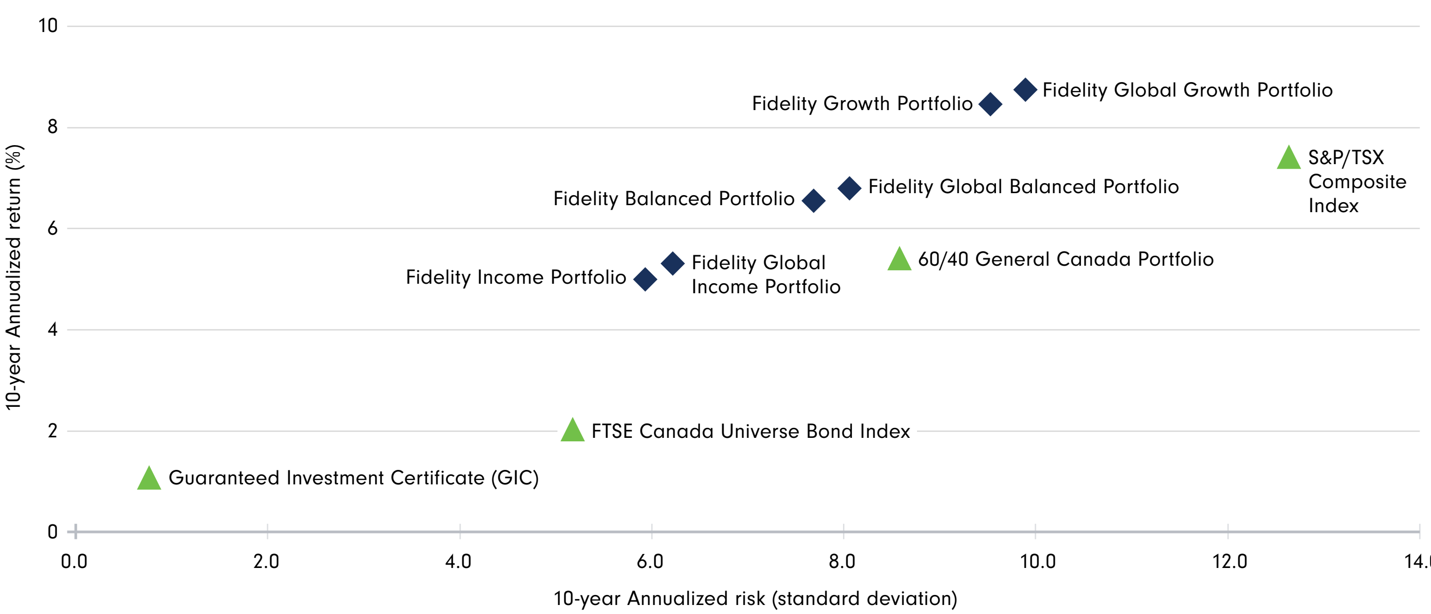
If an investor has a short-term time horizon and zero appetite for risk, GIC's are indeed more attractive than they've been for years. But for those with a longer time horizon and any degree of risk appetite, more can be expected over time.

2. What is your highest conviction overweight?

We are significantly overweight the US dollar against the Canadian dollar in our multi asset class funds. There are two reasons for this.

One, we believe there is considerable scope for the Canadian dollar to depreciate ahead. The economic outlook in Canada is much weaker than in the US, in our view. This primarily reflects Canada's much poorer productivity trend as well as its greater vulnerability to higher interest rates,

EXHIBIT 2: Attractive risk-adjusted returns



Source: Fidelity Investments Canada ULC and Bank of Canada. As at November 30, 2023. Data shown for Series F, net of fees and in Canadian dollars. For illustrative purposes only. General 60/40 Canada portfolio is made up of 60% S&P/TSX Composite Index and 40% FTSE Canada Universe Bond Index. GIC returns are 1yr Guaranteed Investment Certificate returns from Haver Analytics. Refer to standard performance data charts on page 8.

EXHIBIT 3: Equities and bonds have become positively correlated

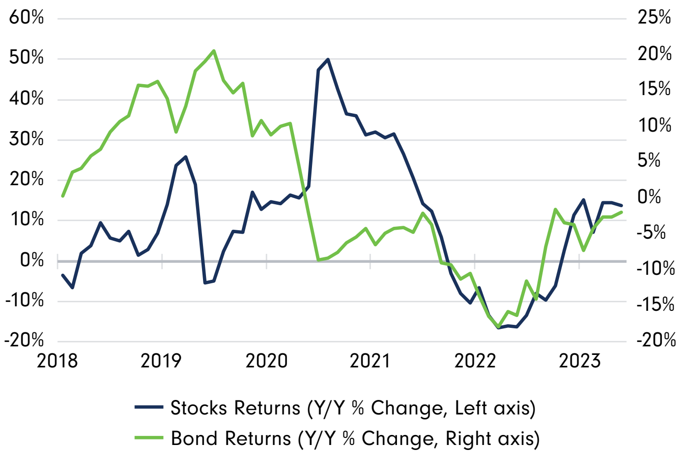
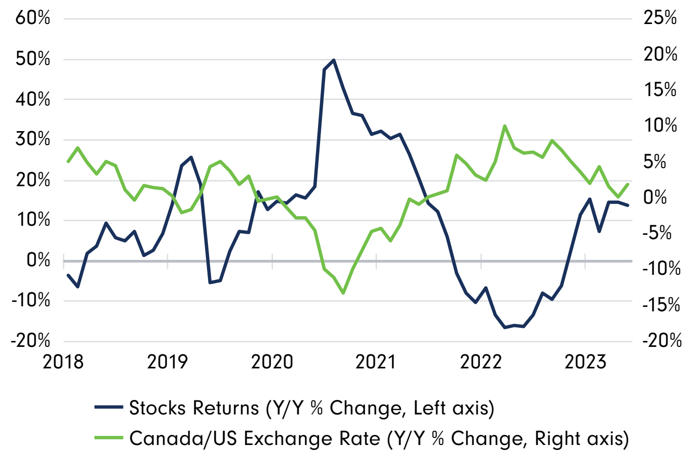


EXHIBIT 4: The USD has cushioned equity risk



Note: Stocks are Standard & Poor's 500 Composite, Bonds are the 10-Yr Treasury Note Constant Maturity Total Return Index. Source: Haver Analytics.

the latter in turn reflecting Canada's much higher household debt and much shorter mortgage terms. That means a higher probability of recession in Canada (we may already be in one) and a greater need for the Bank of Canada to cut rates sooner than the Fed. All of this is going to have to be absorbed by the exchange rate.

Two, even if we had no view on the direction of the Canadian dollar vs the US dollar, we'd want to be overweight the latter in the context of our multi asset class fund structure. That's because the US dollar has been a much more reliable buffer to equity market drawdowns than bonds (see Exhibits 3 and 4). We've been making good use of that property to reduce volatility in the performance of our funds. As asset allocators, it's not common to find positions that we expect can simultaneously enhance return and lower risk, but the US dollar looks like one of those positions right now. And the availability of that currency cushion is comforting to us as we look at adding to equity risk in the funds.

3. What is your highest conviction underweight?

We are significantly underweight Canadian bank stocks in our multi asset class funds, reflecting both our asset allocation positioning and the positioning of our underlying equity managers. We recognize that Canadian banks have long been a cornerstone of many Canadians' investment portfolios, and they've indeed been a great investment for 30 years. But not coincidentally, that's also the period since we last had a credit cycle in Canada. It seems inevitable, in our view, that another credit cycle is coming, given the conjunction of much higher interest rates and historically high debt levels. There are some disconcerting parallels to what happened in Ireland 15 years ago here – an overdone real estate market with masses of debt taken on against it, all of it rationalized by an immigration boom. In the years of recession and house price declines that followed in Ireland, financial stocks fell 99% as the big banks had to be nationalized. To be clear, we don't think that's what going to happen in Canada. But the common refrain that Canadian bank stocks are attractive because they're "cheaper than their historic average valuations" is not compelling; the 'E' in the 'P/E' could be quite wrong if the Canadian consumer retrenches hard. Canadian banks are not cheap enough given the risks, in our view.

4. Can the economy stick the (soft) landing?

The continued resilience of the US economy in the face of higher interest rates and declining inflation has raised the likelihood of a soft landing. As we explored in our last

Thought Leadership piece, stronger productivity growth may have raised the speed limit of the economy, allowing inflation to fall without requiring a recession. Should this narrative prove to be durable, the tailwind that has lifted equities in 2023 will likely continue in the year ahead. On the other hand, if this is all simply a matter of higher interest rates taking longer to bite, the destination will be as previously feared – a recession that will challenge the market's recent exuberance.

While our conviction in a US soft landing has increased somewhat, we acknowledge that is very difficult to tell the difference in real time between 'recession deferred' and 'recession denied'. Productivity is notoriously difficult to measure, forcing us to look for its 'shadow' in other economic data. In that context, we are continuing to watch inflation data particularly closely – if CPI continues to come in below expectations, that will be an important clue that productivity has indeed picked up, providing more supply against the current state of elevated demand.

Our equity weightings in our multi asset funds are close to their neutral settings, consistent with the uncertainty regarding the US economy's resilience. But where we do have high conviction is that a soft landing will be much harder to execute in Canada, where the higher productivity argument cannot credibly be made, which in turn informs our underweight to Canadian assets (see Questions 3 and 8).

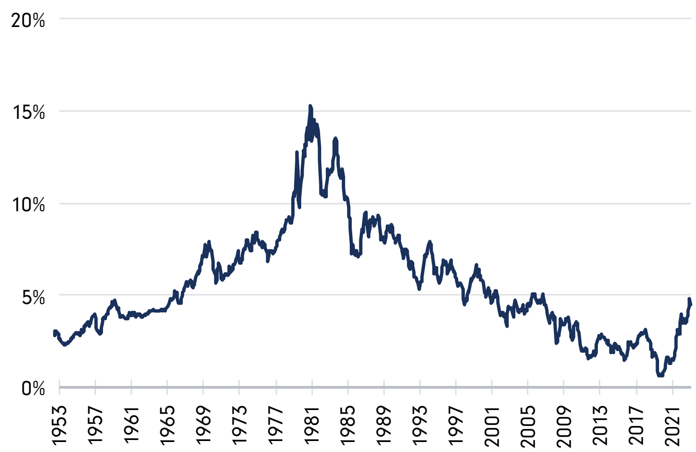
5. Is this the year that bonds come back?

The steady fall in inflation has reinforced the view that most, if not all, of the tightening by central banks is now behind us. And while the timing and size of eventual rate cuts remains an open debate, it is less likely today that the market will be wrongfooted by surprise hikes. Paired with the more attractive level of yields on offer, these factors have improved the outlook for bonds (see Exhibit 5).

As we upgraded our assessment of the bond market, we took steps recently to establish a more neutral position for duration after remaining underweight for most of 2022 and 2023. We remain underweight government and other investment-grade bonds, however, preferring credit sectors such as high yield, floating rate, convertibles, and emerging market local currency debt.

EXHIBIT 5: Bond valuations are better but not compelling

US 10-Year Treasury Yield



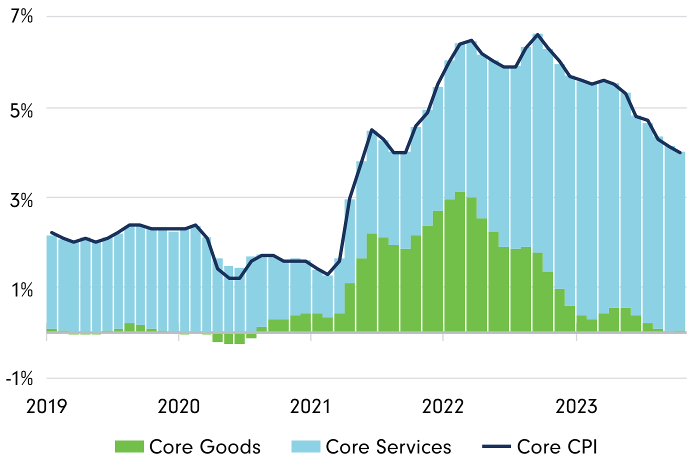
Source: Haver Analytics

Despite a marginally more positive outlook for the bond market, we remain hesitant to establish a larger duration position. As we outlined last quarter, fixed income duration may still not 'work' as it has in prior cycles. If the economy can orchestrate a soft landing, it is likely the case that the neutral policy rate is higher than currently believed, limiting the scope for yields to fall. The same is true if sticky inflation demands that central banks maintain a higher-for-longer stance. Moreover, our ability to use our currency positioning to provide risk management for funds makes us less reliant on the bond market to mitigate the volatility in the equity market.

6. Where is inflation heading?

Inflation in both Canada and the US has slowed significantly from the multi-decade highs we observed last year. This slowing was largely the result of a flattening-out in the price of goods, which account for about one-quarter of the underlying core inflation basket. While it's helpful that goods

EXHIBIT 6: Service inflation has kept core inflation elevated in the U.S.



Source: Bloomberg

prices in aggregate have stopped going up, services prices – the more persistent part of the inflation basket – have not. And they account for the other three-quarters of the inflation pie.

A tight labour market and elevated wage growth are propping up services price inflation (see Exhibit 6). As long as the labour market remains tight, wage growth will stay strong and inflation will stay higher than central bank targets.

We have long believed that for inflation to continue to fall, we'd need to see a slowing in the demand for labour. So while recent developments on inflation are positive, we're not yet convinced the economy is on a path consistent with a sustainable return to the 2 percent target. This is why we continue to hold positions in asset classes that protect investors against the damaging effects of inflation, such as commodities and inflation-protected debt.

7. When will the Bank of Canada cut rates?

If you're looking for a date, the answer is... 'we don't know'. And neither does the Bank or anyone else. It will depend on the economy.

If you're looking for a condition, the answer is 'when and only when inflation is clearly on course to reach the 2% target'. That is not only a function of the trend in inflation, but the trend in growth — the Bank needs to see the economy soft enough to be confident that slack is being rebuilt and so inflation can continue its downtrend. The market is currently pricing that to happen by the spring. That's a bit sooner than we think is likely, but not completely unreasonable.

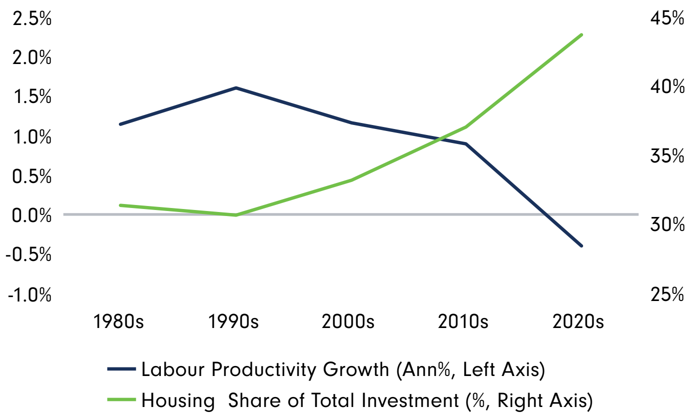
If you're looking for a trade, the answer is 'sooner than the Fed.' As we pointed out earlier, the Canadian consumer is far more sensitive to higher interest rates than the US consumer, owing to its higher debt and shorter mortgage financing terms. The softness in growth required to cut rates is thus likely to emerge sooner in Canada than in the US, prompting the BoC to cut while the Fed stands pat, widening the Canada-US differential in the US dollar's favour.

We note some public discourse expressing skepticism that the BoC can cut rates without the Fed cutting. That is wrong. The BoC moved without the Fed in 1993–4, 1998–9, 2002–3, 2007, 2010 and 2015, with the Canada-US overnight interest rate spread ranging from +225 bps to -250 bps (it's currently -38 bps). In each case, Canadian conditions demanded a different policy response than in the US, which the BoC delivered as per its mandate, recognizing (and often welcoming) the prospective impact on the exchange rate. Expect to see the same again ahead.

8. Why has Canadian productivity been so poor?

Generations of Canadian economists have struggled to answer this question. But one factor that has not been given enough attention, in our view, is the role of Canada's long housing boom. National savings have been increasingly directed towards unproductive housing investment rather than productive capital investment (see Exhibit 7). Some of this owes to high rates of immigration. While newcomers can contribute much to productivity down the road, they need housing right away, a demand many Canadian investors have profited from. So housing is where the resources of the economy have been directed, to the detriment of overall productivity.

EXHIBIT 7: Housing has crowded out productive investment and productivity growth



Source: Haver Analytics

Canada's poor productivity performance has numerous insidious effects. It means that average living standards have already started falling even without a recession, as GDP has failed to keep pace with the rise in population. It means that inflation is harder to tame, because the economy's capacity is not expanding as quickly. And it means that Canadian equities cannot broadly expect to receive the boost from greater efficiency that has already been lifting US equities.

9. How big is Canada's housing shortage?

Our answer here is 'not nearly as big as it's commonly made out to be.'

It is clear both statistically and anecdotally that there is a housing shortage in Canada. The projections appear even more dire. We often hear quoted the headline from the excellent CMHC study that 'Canada needs to build 3.5 million more houses by 2030.'

But that headline does not mean what people seem to think it means. It's not that CMHC thinks we're not going to have enough houses for people. It's that CMHC thinks that's how many more houses need to be built to *restore affordability* in the housing market. More specifically, it's the addition to supply that is estimated to be needed to push house prices down enough to restore their affordability of 20 years ago.

In Ontario, for example, that requires a 22 percentage-point decline in the ratio of average housing costs to average incomes, which translates into a 43% decline in house prices between now and 2030. That's roughly triple the drop seen in the early 1990s and nearly double the drop seen in the US housing crash in the late 2000s. CMHC's projections were based on 2021 data; the required drop in house prices is almost certainly larger today, given in particular the adverse effects of much higher interest rates on affordability.

Building enough to crash house prices may or may not be a good thing, depending on one's point of view, but it's clearly a very different thing from the current framing of the debate on housing supply in Canada.

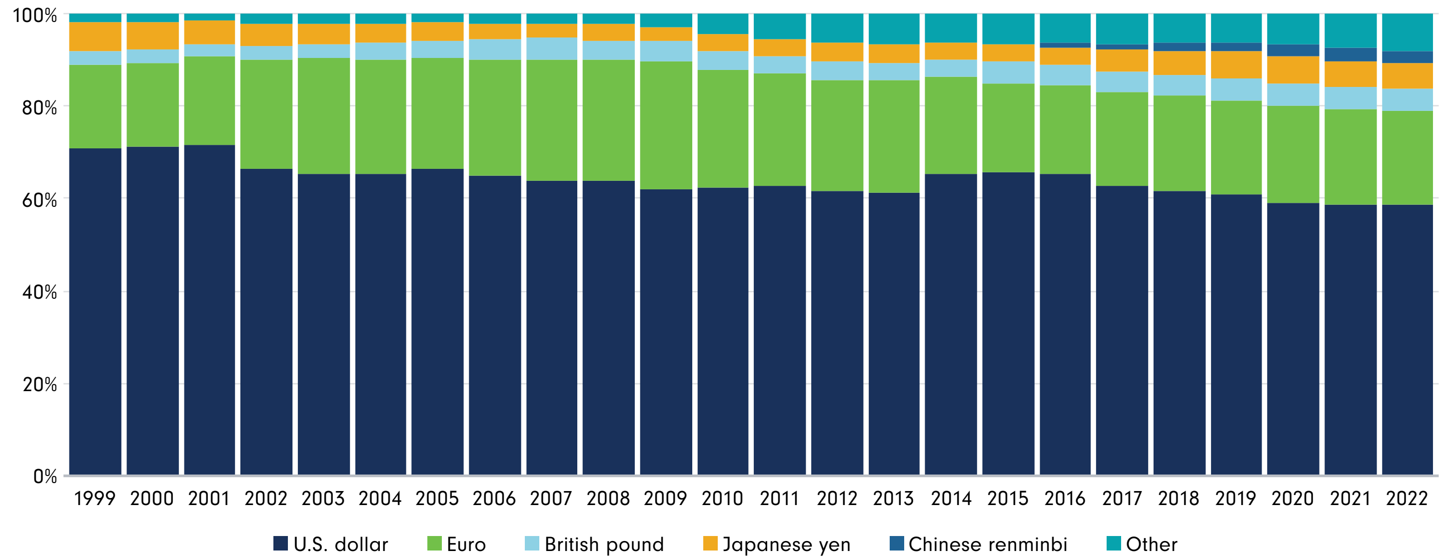
10. How are you allocated outside of Canada?

The underweight to Canadian banks described in Question 3 is reflected in the underweight we have to the wider Canadian equity market. This underweight largely funds modest overweights to the United States, EAFE, and emerging market equities. While all these regions are expected to struggle against the impact of higher interest rates, their respective economic outlooks are still likely to be brighter than that of Canada. As noted in Question 6, we also continue to hold an out of benchmark allocation to commodities as a hedge to the commodity producing part of Canada's economy (recall we are most concerned with the outlook for the domestic portion of the economy).

It is worth noting that while the size of our non-Canadian equity overweight is fairly modest today, our underlying portfolio managers are more active in their respective regions. This reflects our use of equity index futures to tilt the portfolio around the regional equity weights of the benchmark. By adding a short futures contract on a regional equity index, we reduce the exposure of the fund to that region while not disrupting the underlying active managers who are selecting individual securities as part of their portfolio.

EXHIBIT 8: Foreign Exchange Reserves

(% share by region)



Source: International Monetary Fund

11. Will the USD lose its reserve currency status?

We think it is unlikely that the US dollar will lose its reserve currency status over the foreseeable horizon. Recall that it wasn't until after World War II that the US dollar eclipsed the British pound as the world's reserve currency, a full century after the US economy eclipsed the UK's in size. And as an extremely liquid and fully convertible currency representing more than half of total foreign exchange reserves, the bar to supplant the US dollar today remains very high (see Exhibit 8).

This is not to say that the US dollar is without fault. The United States faces ballooning levels of government debt and an ageing demographic, both of which will weigh on economic growth over the long term. But just as a currency is the relative price between two countries, many of the challenges that the United States faces are even more acute in other countries. This observation underpins one of our favourite phases: the US dollar is the cleanest dirty shirt out there.

Rooting through the laundry pile of other currencies reaffirms this point. The euro holds together a politically and economic disparate set of countries already scarred by the existential threat posed by the sovereign debt crisis of the 2010s. The Chinese renminbi currently lacks the necessary convertibility and remains subject to the interventions of domestic policy-makers. Other countries, like Canada or Australia, who arguably have more political and economic stability, simply do not have anywhere close to the size or liquidity to serve as a reserve currency. Other 'alternative' currencies like gold or cryptocurrency remain, in the case of the former an impractical historical artifact, or in the case of the latter, an unproven and largely speculative vehicle subject to considerable regulatory risk.

David Wolf, David Tulk and Ilan Kolet, January 8, 2024

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From Exhibit 2

As at November 30, 2023	1-year	3-year	5-year	10-year
Fidelity Income Portfolio	4.7	1.8	4.4	5.0
Fidelity Global Income Portfolio	5.5	1.8	4.4	5.3
Fidelity Balanced Portfolio	6.9	3.6	6.6	6.5
Fidelity Global Balanced Portfolio	7.7	3.0	6.1	6.8
Fidelity Growth Portfolio	8.7	5.9	9.1	8.5
Fidelity Global Growth Portfolio	10.2	5.2	8.5	8.7
60/40 General Canada Portfolio	2.1	3.8	6.1	5.4
S&P/TSX Capped Composite Index	2.3	8.8	9.2	7.4
FTSE Canada Universe Bond Index	1.4	(3.8)	0.9	2.0

Source: Fidelity Investments Canada ULC. Performance shows annual compounded returns as at November 30, 2023, Series F, net of fees, in Canadian dollars. *60/40 General Canada Portfolio consists of 60% S&P/TSX Composite and 40% FTSE Canada Universe Bond Index. The index returns are shown for comparative purposes only. Indexes are unmanaged, and their returns do not include any sales charges or fees, as such costs would lower performance. It is not possible to invest directly in an index

Authors

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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 American Balanced Fund, Fidelity Asset Allocation Private Pool, Fidelity Balanced Income Private Pool, Fidelity Balanced Managed Risk Portfolio, Fidelity Balanced Portfolio, Fidelity Balanced Private Pool, Fidelity Canadian Asset Allocation Fund, Fidelity Canadian Balanced Fund, Fidelity Canadian Monthly High Income ETF Fund, Fidelity Conservative Income Fund, Fidelity Conservative Income Private Pool, Fidelity Conservative Managed Risk Portfolio, Fidelity Dividend Fund, Fidelity Global Asset Allocation Private Pool, Fidelity Global Balanced Portfolio, Fidelity Global Dividend Fund, Fidelity Global Equity Portfolio, Fidelity Global Growth Portfolio, Fidelity Global Growth Private Pool, Fidelity Global Income Portfolio, Fidelity Global Monthly High Income ETF Fund, Fidelity Global Monthly Income Fund, Fidelity Growth Portfolio, Fidelity Income Allocation Fund, Fidelity Income Portfolio, Fidelity Inflation-Focused Fund, Fidelity Monthly Income Fund, Fidelity NorthStar® Balanced Fund, Fidelity Tactical Global Dividend ETF Fund, Fidelity Tactical Strategies Fund, Fidelity U.S. Growth and Income Private Pool and Fidelity U.S. Monthly Income 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.

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