Elbows up

David Wolf l Portfolio Manager
David Tulk, CFA l Portfolio Manager
Ilan Kolet l Institutional Portfolio Manager
Bruno Crocco, CFA l Portfolio Manager
Jon Knowles, CFA l Institutional Portfolio Manager

Elbows have gone up in Canada and abroad in response to the dramatic change in the US policy environment. Markets have likewise become irritable. As investors, we must not overreact to the flow of breathless and often contradictory headlines. But it is also important not to underreact – substantial changes to the global political, economic and financial landscape appear to be underway, demanding careful adjustments in our portfolio strategy. Many of the ultimate consequences of the remarkable shift in US policy will only be clear over time. But some of those consequences are already becoming visible, prompting us to adjust our positioning in line with our active asset allocation process.

We would summarize the view as "the market has been priced for maximum US exceptionalism just as the US government is undermining many of the things that made the US exceptional." In that context, we have taken action to reduce our exposure to US equities in favour of international equities and defensive inflation-protected assets.

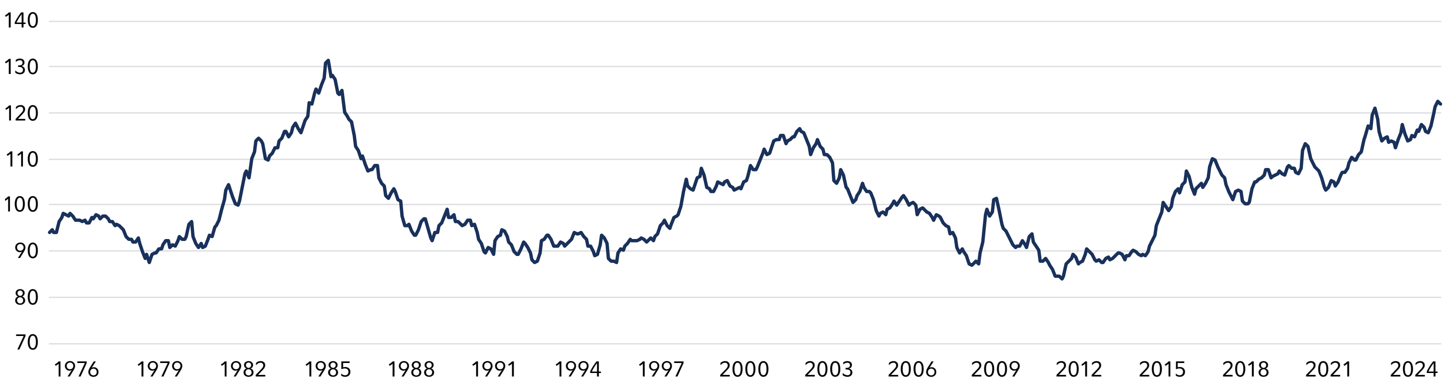
Let us unpack that into two pieces.

Buying international equities

It is clear on just about any metric that US assets are historically expensive relative to assets in other parts of the world. The S&P 500 trades at 22 times earnings compared to the rest of the world (MSCI ACWI ex US) at 14 times earnings, while the broad US dollar is near its strongest level since the mid-1980s (Exhibit 1); putting the two together, the US accounts for over

EXHIBIT 1: Historically Elevated

U.S. Trade-Weighted Real Dollar Index, January 2006 = 100



Source: Bloomberg, Federal Reserve. As of February, 2025

65% of the MSCI ACWI Index, a record high. As above, financial markets have been priced for maximum US exceptionalism. That now looks unsustainable.

The downside to the US

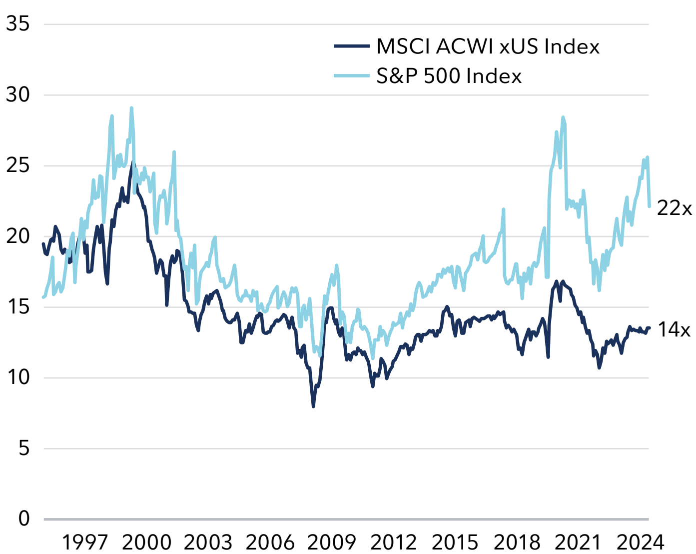
The equity valuation gap has persisted, even widened, for many years (Exhibit 2). These premium prices for US assets have been justified by the superior earnings power of US companies and the dynamism of the economy underpinning it (as discussed in the Q1 paper). That dynamism, in turn, has rested on the longstanding US bedrock of global leadership, strong institutions, predictable governance and the rule of law. It appears that these advantages are being eroded in real time. The optimism of late 2024 that deregulation and renewed animal spirits would turbocharge the US economy has given way to the chilling effect of uncertainty and volatility. It is not clear whether this will cause a recession in 2025, but the scope for the US economy to disappoint has grown dramatically.

The upside to EAFE

Something of the reverse dynamic is happening in other developed markets, particularly Europe. The European economy has been moribund for a long time. And to be clear, US tariffs will not help. But the more important dynamic seems to be the galvanization of the continent in the face of what is happening in the US. That includes an urgent need to provide for the continent's own security, which will require a substantial ramp up in both fiscal spending and collaboration across European countries. This may cause some of the structural issues that have held Europe back to partially dissipate. As an example, Germany's armed forces and general budgetary flexibility have been tightly circumscribed for decades. That has now changed with projected military spending in Germany as well as other European countries projected to increase substantially (Exhibit 3) As a result of all of this, and contrary to the US, the risk to the European economy looks to be to the upside relative to longstanding expectations of stagnation.

EXHIBIT 2: Questioning Prices in the U.S.

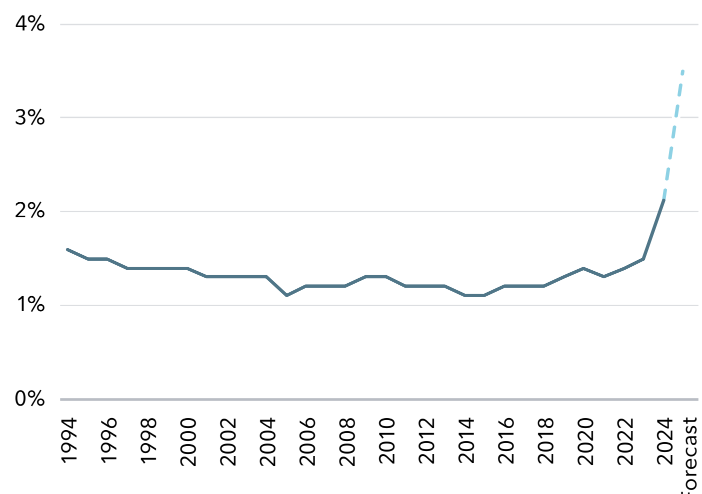
Next twelve-month price-to-earnings ratio



Source: Bloomberg. As of February, 2025.

EXHIBIT 3: Sign of things to come in Europe?

German defence spending as a % of GDP



Source: World Bank, Stockholm International Peace Research Institute, NATO. Data beyond 2023 is estimated by NATO or from recent German proposals.

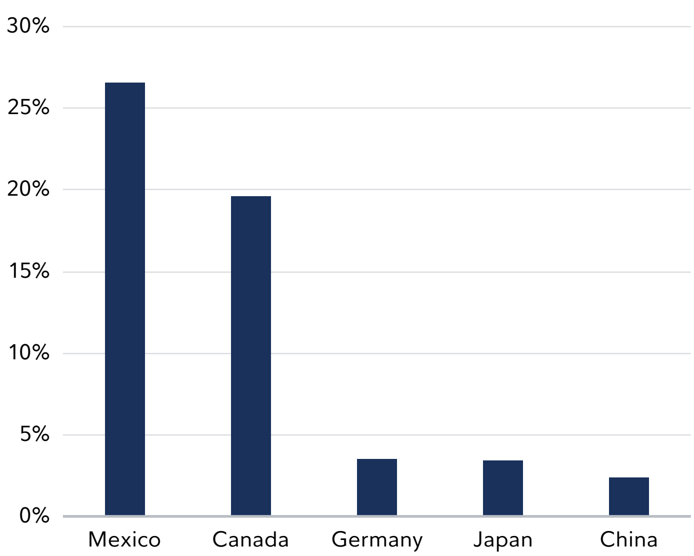
In this analysis, it is also important to remember that the economy is not the stock market, and there will still be great US companies and underperforming international companies. As a result, we will continue to be diversified across those markets. But given the current environment, we believe it appropriate to give our stock pickers in Europe more resources to invest in what we see as a newly target-rich environment.

The threat to Canada

Our add to non-US equities has not included Canada; we remain underweight our domestic market. Many of the galvanizing dynamics at play in Europe are evident here at home, which we as Canadians on the investment team very much feel. Canada is moving to pursue the right structural things – breaking down interprovincial trade barriers, investing far more in internal infrastructure and our own defence, and seeking alternative trade partners abroad. But these will take time. In the meantime, the prospective hit to Canada from the loss of reliable access to the US market is a hit to our economy an order of magnitude beyond almost any other country's (Exhibit 4). Maybe tariffs get rescinded, maybe the trade war ramps up, no one knows at this point, but the damage to the trading relationship has been done. Moreover, many of the headwinds facing the economy prior to the tariff shock – notably overstretched household balance sheets and moribund business sector productivity – remain in place.

EXHIBIT 4: A Tale of Two Trade Wars

Exports to US as a % of Domestic GDP, 2023



Source: Bloomberg, World Bank. As of December, 2023.

In November, we thought Canada might be like a bad house in a good neighbourhood (from a purely economic point of view) as the US turned inward. Now it seems more like Canada is the house next door to the sketchy park. We are optimistic that good will ultimately come of this, but things are likely to get worse before they get better, and we need to see a greater discount on Canadian assets (including the currency) before we feel comfortable increasing our allocations domestically.

Buying more defensive inflation-protected assets

Part of the proceeds from our sales of US equities have gone into defensive assets, reducing our overall risk posture in the market. This seems prudent given the palpably higher degree and unusual nature of the uncertainty that markets now face. We have specifically targeted defensive inflation-protected assets like gold and TIPS. This is because all roads in this changing world seem to point to towards a more stagflationary environment.

Tariffs are stagflationary

Tariffs are a tax. Like any tax, they make things more expensive, and you get less of them. Any thoughtful analysis of the current tariffs finds that, for the overall economy, the impact is to raise inflation while curtailing GDP growth. The exact magnitude and timing of these effects are uncertain, but their direction is clear. The Bank of Canada (BoC), for example, projects that Canada's GDP would fall by 4 percent over two years, relative to the prior baseline; despite this hit to demand, inflation would be projected to rise slightly. These effects will be smaller for the United States' more closed economy, but still significant. Note that the BoC's analysis uses a model that fully loads the likely second-round effects of tariffs, including fiscal and monetary policy responses as well as moves in financial markets and commodity prices.

Deglobalization is stagflationary

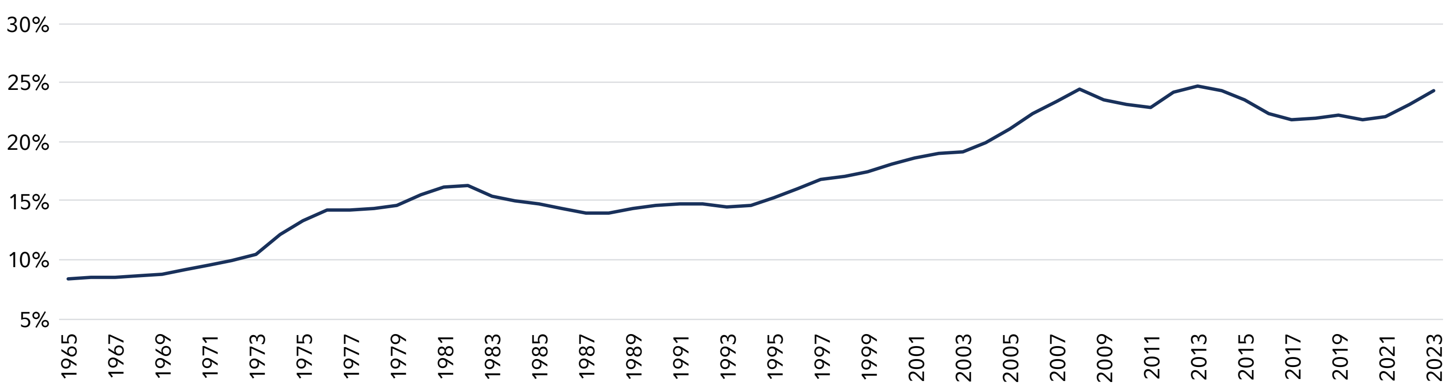
Estimates of the magnitude of the impact of tariffs on growth and inflation may prove to be wrong depending on how long the tariffs are in place, their level, and the responses of markets and policymakers. But it can be set in the context of a more durable trend – deglobalization. Global trade integration has stagnated over the last two decades (Exhibit 5). Trade uncertainty has accelerated post-pandemic as supply chain disruptions made it clear that some efficiency had to be sacrificed for the sake of reliability. Now the decline in globalization seems destined to accelerate further with the US no longer seen as a reliable market to the world. A more fragmented global trading system and thicker economic borders means less specialization, less efficiency, higher costs, lower productivity, and ultimately lower aggregate supply. That lower supply in turn means a lower rate of growth and a higher rate of inflation for a given amount of demand.

Protecting portfolios in this environment

How do we protect portfolios in this environment? We can add to cash, but this is not particularly attractive in a world where central banks are likely to cut interest rates to support growth even as inflation is allowed to run somewhat higher and thus erode purchasing power. We can add to bonds, where the 'stagnation' part of stagflation would tend to help fixed income in driving down yields (and thus driving up prices). But the 'inflation' part of stagflation would surely not help, not only because it tends to push yields up, but also because the associated inflation volatility pushes stock/bond correlations up. As we have discussed many times before, this compromises the protective value of fixed income against equity drawdowns. In years past we have favoured exposure to U.S. dollars when expressing defensive posturing, given the distinct properties the

EXHIBIT 5: Trade Integration has Stagnated

Global imports as a % of GDP, 3-year moving average



Source: World Bank, International Monetary Fund. As of December, 2023.

dollar offers, but with recent changes in policy and shifting sentiment we are less certain these properties will remain. So, instead we have opted to add to our long-standing holdings of inflation protected assets such as TIPS and gold. TIPS did not exist through the stagflationary 1970s, but gold was just about the only asset to go up in real terms through that period and has recently been behaving in similar fashion (Exhibit 6).

EXHIBIT 6: A Reliable Inflation-Hedge

Gold (Inflation-adjusted, January 2025 US Dollars per ounce)

Source: Haver Analytics, FMR calculations. As of January, 2025.

To be clear, as with the equity side of our portfolios, we will remain diversified; we are not abandoning cash or bonds. But the rising risk of a stagflationary environment prompt us to tilt the defensive side of our portfolios further towards inflation protection.

Staying active

The market and underlying fundamental environment have changed quickly and will no doubt change further. In such an environment, our active asset allocation approach is an advantage, allowing us to adjust to conditions while remaining anchored in a disciplined process and a diversified strategic allocation. We will continue to adjust our positioning as the outlook evolves, in line with our overarching mandate to protect and grow our fundholders' assets.

David Wolf, David Tulk, Ilan Kolet, Bruno Crocco and Jon Knowles

March 19, 2025

LinkedIn Follow Fidelity Canada on LinkedIn

Authors

David Wolf l Portfolio Manager

David Wolf is a Portfolio Manager for Fidelity Investments. He is the co–manager of Fidelity Managed Portfolios, Fidelity Global Equity+ Fund, Fidelity Global Equity + Balanced Fund, Fidelity Canadian Asset Allocation Fund, Fidelity Canadian Balanced Fund, Fidelity Monthly Income Fund, Fidelity U.S. Monthly Income Fund, Fidelity Global Monthly Income Fund, Fidelity Global Dividend Fund, Fidelity Income Allocation Fund, Fidelity American Balanced Fund, Fidelity Conservative Income Fund, Fidelity NorthStar®, Fidelity NorthStar® Balanced 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 Balanced Private Pool, Fidelity Balanced Income 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 l 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 Portfolio, Fidelity Global Equity + Balanced Fund, 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 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 U.S. Growth and Income Private Pool and Fidelity U.S. Monthly Income Fund.

Ilan Kolet l 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.

Bruno Crocco, CFA l Portfolio Manager

Bruno Crocco is a Portfolio Manager for Fidelity Investments. He is the co–manager of the Fidelity ClearPath Retirement Portfolios, Fidelity ClearPath Institutional Portfolios and Fidelity ClearPath Index Plus Portfolios.

Jon Knowles, CFA l Institutional Portfolio Manager

Jon Knowles is an Institutional Portfolio Manager for Fidelity Investments. In this role, Mr. Knowles 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.

2454150-v2025317 INM 2440057 03/25