Fidelity perspectives

The latest on inflation, interest rates and market volatility

What's happening?

Inflation continues to be the focal point for investors, as readings remain elevated around the world and at levels not seen in decades. Global central banks were initially slow to react, famously referring to the surge in inflation as transitory, and now face the challenge of aggressively combating it with tighter monetary policy, at the same time trying to avoid delivering a hard landing for their respective economies. This difficult task has created ongoing uncertainty among investors as they assess the risks of potential policy errors and attempt to gauge how much further tightening will be necessary to allow for inflation to fall appropriately toward historic norms. The environment is similar globally, with most developed regions facing inflation levels much higher than their respective targets.

COUNTRY/REGION	HEADLINE INFLATION RATE (%)	TARGET INFLATION RATE (%)	CURRENT POLICY RATE (%)
U.S.	8.3	2.0	3.25
Canada	7.0	2.0 (+/- 1.0)	3.25
Eurozone	9.1	< 2.0	1.25
Japan	3.0	2.0	-0.10
U.K.	9.9	2.0	2.25
Australia	6.1	2.0 – 3.0	2.35
New Zealand	7.3	1.0 – 3.0	3.00
Switzerland	3.5	< 2.0	0.50
Norway	6.5	2.0	2.25
Sweden	9.8	2.0	1.75

Source: Bloomberg, as at September 22, 2022.

Although inflation in the U.S. appears to have peaked, progress toward the 2% level targeted by the U.S. Federal Reserve (the Fed) has been largely disappointing. Headline inflation, as measured by the U.S. Consumer Price Index (CPI), slowed by less than expected in August, to only 8.3% on an annual basis, remaining near a four-decade high. Core CPI, which excludes energy and food prices, rose to 6.3%, also topping estimates, and hitting the highest levels since March earlier in the year. The latest numbers also show inflation stubbornly continuing to broaden across categories, only complicating the Fed's efforts.

Following the release of the August report, the Fed delivered a widely expected 75-basis-point (bp) interest rate hike for the third consecutive meeting, lifting the Fed funds rate to the 3.00%–3.25% range and pushing borrowing costs to the highest levels since 2008. Although the meeting delivered the 75 bp rate hike that was expected, market participants were surprised by the Fed's projected policy path, after it signalled a 100 bp uptick in its policy rate to 4.4% by the end of 2022, and an 80 bp uptick in its terminal rate to 4.6% in 2023. The Fed also suggested that no rate cuts are expected until 2024, eliminating any hopes market participants might have had of a more accommodative monetary environment sooner rather than later. Fed Chair Jerome Powell later conveyed a similarly hawkish stance at his press conference, stating that it would be challenging for the economy to reach a soft landing, further deteriorating the already fragile investor confidence. Powell asserted, in no uncertain terms, that the Fed's moves will bring discomfort to households and businesses, but that they are necessary: "We have to get inflation behind us. I wish there were a painless way to do that. There isn't."

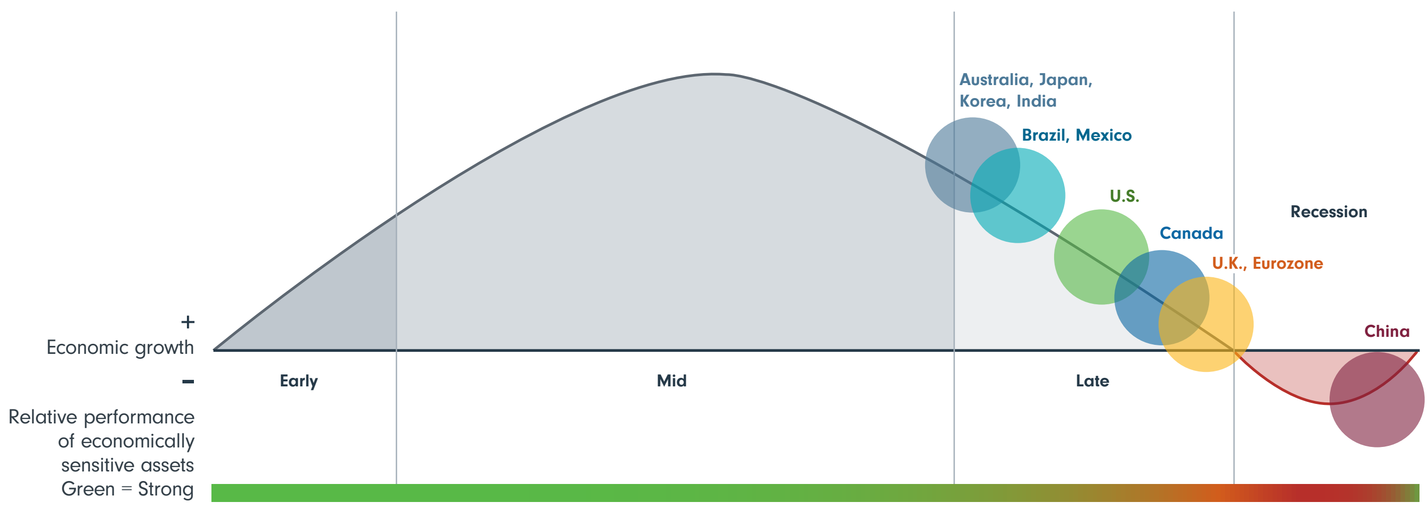
The following are views of various Fidelity portfolio managers and subject-matter experts who have weighed in on the recent volatility.

Chief Investment Officer and Portfolio Manager **Andrew Marchese** notes that the macroeconomic backdrop has been very influential in global markets. Year-to-date, the decline in growth stocks has been entirely due to valuation de-rating as a result of rapidly rising interest rates, secondary to higher-than-expected and persistent inflation and declining liquidity in the financial system.

Equity market performance and leadership has been only slightly atypical due to valuation imbalances within sectors and factors. Rising interest rates in 2022 increase the probability of falling leading economic indicators and negative earnings revisions in 2023, and investors should be mindful of. With that said, Andrew notes that pockets of equities have become more normalized in terms of valuation, contingent on the interest rate outlook. Much like 2021, insight into central bank policy for 2023 will help shape investment outcomes. Andrew also suggests that investors should use indicators such as PMIs, negative earnings revisions and shifts in central bank policy to add risk selectively over the next 18 months even in the face of otherwise worsening economic conditions, based on history.

Andrew continues to believe that a disciplined investment approach is crucial in navigating this uncertain period, and the current environment presents more opportunities for active stock pickers, like our portfolio managers.

Chart 1: Global economic cycle



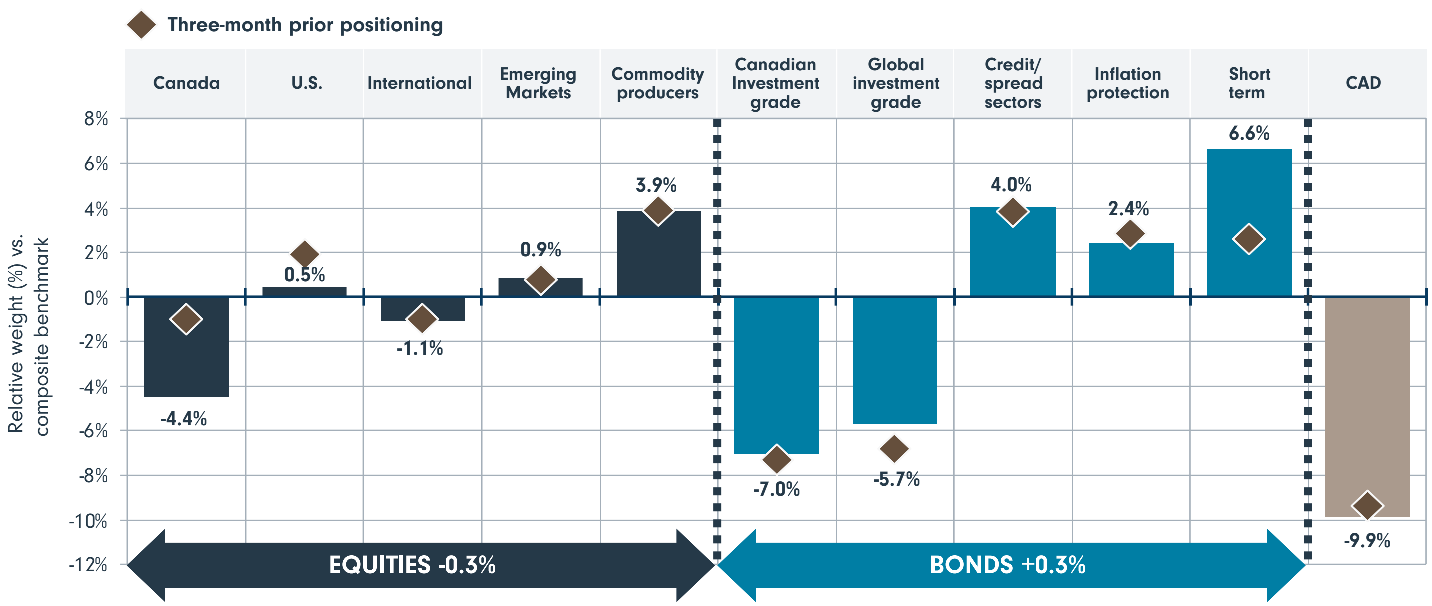
The diagram above is a hypothetical illustration of the business cycle, the pattern of cyclical fluctuations in an economy over a few years that can influence asset returns over an intermediate-term horizon. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one.

Source: Fidelity Investments (AART), as at July 31, 2022.

The Global Asset Allocation portfolio managers, **Geoff Stein**, **David Wolf** and **David Tulk**, note that inflation remains stubbornly elevated. While headline inflation has likely peaked, persistent strength in the housing and service sector components is expected to keep core measures of inflation above central bank targets. Central banks are expected to continue to aggressively tighten policy to bring inflation back under control. While of the damage this action will have on the wider economy and the labour market, the priority of central banks is to ensure that expectations of future inflation remain anchored.

With the investment landscape continuing to evolve, driven by continued monetary policy tightening, the managers believe that the global economy is further into the late cycle, with recession risks rising. Accordingly, in the multi-asset class portfolios they manage for Canadian investors, they have taken a generally defensive posture. They are allocating less than the benchmark to equities and duration, while holding inflation-sensitive assets such as commodities and inflation-protected government debt. Furthermore, they also have materially larger-than-benchmark exposure to the U.S. dollar, to further enhance downside protection by capturing flight-to-safety flows amid broad market weakness. They continue to stress the importance of proper diversification to navigate this volatile period.

Chart 2: Fidelity Global Balanced Portfolio active positioning



Source: Fidelity Investments Canada ULC. As at August 31, 2022. Fidelity Global Balanced Portfolio's blended benchmark consists of 21% S&P/TSX Capped Composite Index, 39% MSCI All Country World ex Canada Index, 23% Bloomberg Global Aggregate Bond Index, 12% FTSE Canada Universe Bond Index and 5% FTSE Canada 91-Day T-Bill Index. Positioning is as at the date noted and is subject to change.

Portfolio Manager **Adam Kramer** notes that with stocks in a bear market, bonds shaping up to post their worst year on record and fears of recession rising along with inflation and interest rates, this may appear a difficult time for investors. However, professional managers who have the flexibility to choose from a wide variety of asset classes are finding opportunities ripe for the picking in beaten-up and beaten-down assets.

The shift from worries about higher rates to fear of a recession is an example of how the forces that drive markets are always in motion. Because market conditions constantly change, the investments that deliver the highest returns today may not be the ones that do so next month or next year. That means that diversification, research and risk management matter. It's also why strategies that can invest across a wide variety of asset classes may be better positioned to help investors meet their needs for income and to deliver a better balance between risk and return over time.

Chart 3: Changing leadership among asset classes

Best 1-year return   Worst 1-year return

ASSET CLASS	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	YTD 2022
Investment-grade bonds	8.4	10.3	4.1	4.3	2.4	4.3	7.0	5.2	5.9	6.5	7.8	4.2	-2.0	6.0	0.5	2.6	3.5	0.0	8.7	7.5	-1.5	-10.8
Emerging markets debt	9.7	13.7	22.2	11.6	10.3	9.9	6.2	-12.0	29.8	12.2	7.3	17.4	-5.3	7.4	1.2	10.2	10.3	-4.3	15.0	5.3	-1.8	-18.8
Floating rate debt	3.3	2.6	9.8	5.3	5.3	6.9	2.0	-29.3	52.5	10.4	1.5	9.8	5.4	1.8	0.1	10.4	4.3	0.6	8.7	3.5	5.4	-1.1
High-yield bonds	4.5	-0.5	28.0	10.9	2.8	10.8	2.5	-26.1	58.1	15.1	4.4	15.5	7.4	2.5	-4.6	17.5	7.5	-2.3	14.4	6.1	5.3	-11.0
Convertible securities	-4.4	-8.6	27.1	9.6	1.0	12.8	4.5	-35.7	49.1	16.8	-5.2	15.0	24.9	9.4	-3.0	10.4	13.7	0.2	23.2	46.2	6.3	-14.9
Preferred shares	9.8	7.7	9.4	5.1	1.0	8.1	-11.3	-25.2	20.1	13.7	4.1	13.6	-3.7	15.4	7.6	2.3	10.6	-4.3	17.7	6.9	2.2	-11.7
Equities	-11.9	-22.1	28.7	10.9	4.9	15.8	5.5	-37.0	26.5	15.1	2.1	16.0	32.4	13.7	1.4	12.0	21.8	-4.4	31.5	18.4	28.7	-16.1
DISPERSION OF RETURNS	21.7	35.8	24.6	7.3	9.3	11.5	18.3	42.2	52.2	10.3	13.0	13.2	37.7	13.6	12.2	15.2	18.3	5.0	22.8	42.7	30.5	17.7

Source: Fidelity Investments Canada ULC, as at August 31, 2022. Indexes: Investment-grade bonds – Bloomberg U.S. Aggregate Bond Index, emerging markets debt – JPM EMBIG, floating rate debt – S&P/LSTA Performing Loan Index, high-yield bonds – ICE BofA U.S. High Yield Constrained Index, convertible securities – ICE BofA All U.S. Convertibles Index, preferred shares – ICE BofA Fixed Rate Preferred Securities Index, equities – S&P 500 Index. Returns in U.S. dollars.

Adam is focused on areas of the market where excessive worry, fear and pessimism have caused others to sell. The current prices of many assets reflect fears that a recession may be at hand, which has increased their attractiveness in comparison with just a few short months ago. Today, Adam is finding that more risk is being priced in on the credit side than the equity side, and is finding opportunities among investment-grade bonds, high-yield bonds, floating rate debt, fixed-to-floating preferreds and convertibles. Among equities, while he has slashed his allocation in recent months, indicative of his defensive posture, he is finding opportunities among dividend-paying gold miners, pharmaceuticals and dividend-paying oil tankers. His goal is to have a high enough level of current income to dampen the blow in a down market, but participate on the upside with equity-like returns as well, while offering a premium yield and lower volatility than his peer group along the way.

Portfolio Manager **Mark Schmehl** believes that despite continued volatility in global markets, visibility has improved compared with six months ago, with more clarity regarding central bank actions and the state of the economy. Prices for commodities, especially crude oil, suggest we have likely reached peak levels as we begin to see demand disruptions and improving supply responses. Energy prices, in Mark's opinion, make a key contribution to inflation, which may imply some easing of inflationary pressure. However, it is important to note that this does not necessarily mean inflation will not persist, or that it may not stay higher for longer.

Broadly speaking, Mark believes, most consumers and corporations are in healthy financial condition, with good balance sheets; the exception is lower-income consumers. Although economic conditions may deteriorate, he thinks it is unlikely to be as severe as the global financial crisis of 2008–2009. By and large, company management teams are adapting to the environment, repositioning their businesses and focusing more on profits, which will ultimately drive change across organizations. Focusing on the longer-term picture when evaluating companies is crucial in times like these, as it reduces the chances of acting too quickly without comprehending all the facts.

Against the current backdrop, Mark is spending a lot of time looking at long-term secular growers that he believes have corrected significantly. He is excited about ample opportunities across the sectors, and is focusing on the ones he wants to own when the economy eventually recovers. Over the short term, of course, given the fluidity of the situation, volatility will likely persist. Consequently, Mark plans to make incremental additions to risk, slowly and methodically moving the portfolios to more offensive positions. In his view, markets are forward-looking mechanisms, and often lead actual economic behaviour, so it often pays to become more bullish even as economic conditions worsen.

Portfolio Manager **Will Danoff** believes a number of headwinds have affected stock valuations this year. This period has been one of the most challenging environments to manage money since the Global Financial Crisis, as it has been incredibly macro driven. The Fed, along with most global central banks, is tightening policy in a slowing economy, which is somewhat rare to see. Will does believe that the bulk of the interest rate moves has taken place. That said, he continues to monitor the situation closely, and is trying to focus on how much earnings growth will be affected as we move into 2023.

Overall, Will thinks we are setting up for a better 2023–2024, and that it will provide a better environment for stock selection and overall better performance from the equity markets. Over the past 12 months, he has shifted the portfolio to be a little bit more conservative, tilting away from higher-multiple growth stocks and moving more into the health care and energy spaces. Will continues to work with Fidelity's research department to look for the best ideas for the Fund. During times of volatility, the aim is to upgrade the portfolio and add to high-conviction ideas. Continual upgrading is a key pillar in Will's investment philosophy, and it has served him well for over 30 years.

Portfolio Manager **Dan Dupont** notes that given the current stage of the business cycle and the short-term uncertainty, investors should be aware of the potential for increased risk and added volatility. The macroeconomic backdrop, including economic and monetary situations, continues to be extremely complex and might influence investment outcomes, but Dan reiterates the importance of bottom-up analysis in investing. He continues to monitor currency markets more closely than usual as fiscal deficits and tightening policy contribute to higher volatility globally.

Throughout Dan's experience navigating various market environments, he has always focused on capital preservation, which leads him to lean more into areas of the market that are more likely to outperform in periods of heightened volatility. Dan's portfolios invest in high cash-flow businesses that are better able to navigate increased macroeconomic uncertainty. Dan continues to monitor the developing prospects of a slowdown in global output and orient the portfolios in a manner that is better suited to withstand increased volatility.

Dan continues to find opportunistic short-selling ideas for Fidelity Global Value Long/Short Fund among more cyclical companies that could be adversely affected by a prolonged slowdown in economic activity. Although that is not necessarily his base case scenario, an economic slowdown or recession is becoming an increasingly likely event in his opinion. As such, Dan remains cautious and continues to focus on downside protection across his portfolios.

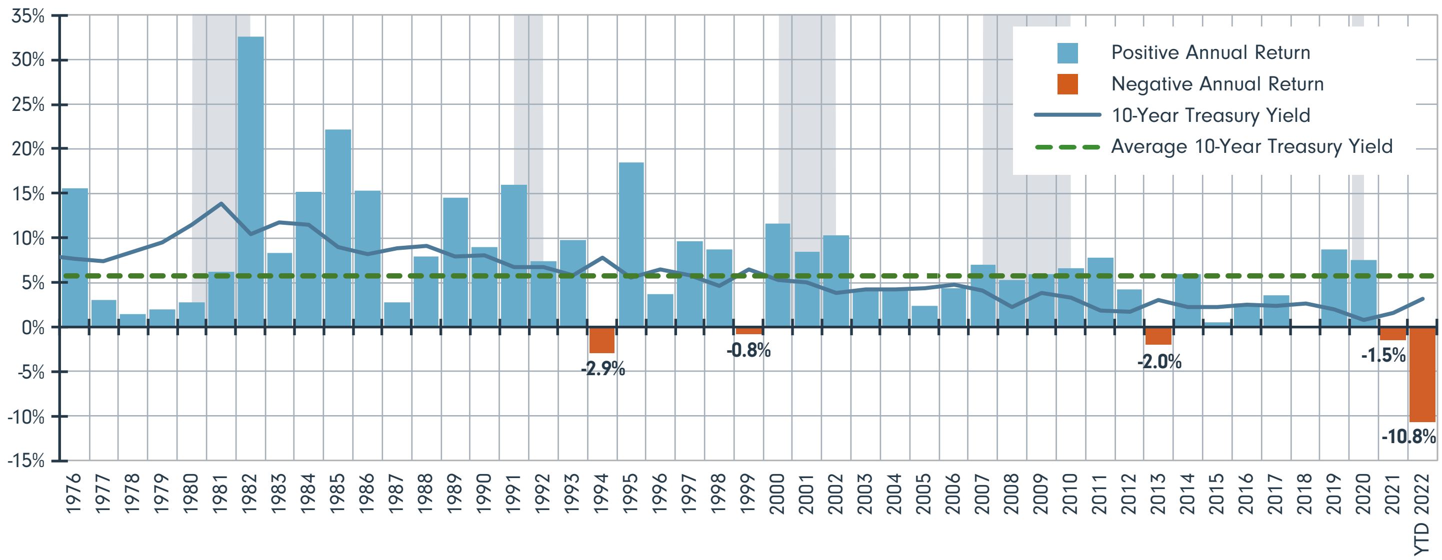
Portfolio Manager **Darren Lekkerkerker** notes that markets continue to be volatile; ongoing concerns about high and persistent inflation, leading to higher interest rates, have increased the likelihood of a recession. Although inflation could be at or near its peak, investor sentiment remains very poor. As a result of that combination, stocks are trading cheaper. Darren acknowledges that trying to predict short-term macro is quite a difficult task, but there is now a good opportunity to add to high-quality stocks on weakness. Darren prefers to focus on high-quality companies, which may be more resilient in an uncertain economic landscape, and which may also be stronger compounders down the road. He notes that quality stocks have continued to hold up better, as they tend to have more stable demand, pricing power, resilient margins and overall better balance sheets. Accordingly, he continues to focus on fundamentals, with a focus on acquiring what he believes to be high-quality stocks on weakness.

Among commodities, Darren notes that weaker global demand is hurting commodity prices in the short term, but he continues to have a positive view of that universe in the mid-term as a number of factors could contribute to an attractive landscape for resources, such as the continued shortage of supply, and the green energy transition, which should benefit demand. In addition, company valuations are cheap, and companies have continued to return a lot of free cash flow to investors through dividends and share buybacks. Among commodities, Darren continues to prefer fertilizer and agriculture stocks: agriculture is a more defensive end market, grain prices remain high, and incentivize demand, and supply shortages exist in fertilizers.

Portfolio Managers **Jeff Moore** and **Michael Plage** acknowledge that investing is daunting during times of heightened investment fog and on the heels of large drawdowns. Indeed, the fixed income market has been particularly challenging to navigate this year, with 2022 being well on its way to conclude as the worst calendar year on record for bonds by a landslide.

Chart 4: Bond returns vs. interest rates

1976 – YTD 2022



Source: Barclays and Bloomberg, as at August 31, 2022. Note: Bond returns are based on Bloomberg Barclays U.S. Aggregate Bond Index. Shaded gray bars represent periods in which the U.S. was in a recession.

Driven primarily by interest rates moving sharply higher from historically low levels, U.S. investment-grade bonds, as represented by the Bloomberg U.S. Aggregate Bond Index, are down nearly 11% year-to-date (as at August 31, 2022). Notably, 2022 is shaping up to be just the fifth negative year on record for the index, and the first instance of back-to-back negative years, after posting a -1.5% decline in 2021.

That's all the bad news. The good news is that yields on U.S. Treasuries, investment-grade credit, high-yield corporate bonds and global debt now match, and in many cases exceed, the best levels any time in the past ten years or more. Higher market yields portend a bond investment return frontier pushing upward, which improves the prospects for compounding, total returns and diversification. The bond market is now poised for positive returns even in a great many adverse stress scenarios.

For now, the managers' take remains to hold off on bold asset allocation moves in terms of duration and risk sectors. Inflation needs to trend lower, and quickly, to track market expectations; otherwise, the Fed will lose its credibility, and market expectations need to shift. Until the managers see clear evidence that inflation is approaching the Fed's target, and the end of the hiking cycle is in sight, they will remain cautious.

What's happening with cryptocurrencies?

Portfolio Manager of Fidelity Advantage Bitcoin ETF and ETF Fund and Fidelity Advantage Ether ETF and ETF Fund, **Reetu Kumra**, shares her latest thoughts.

Bitcon (BTC) and Ether (ETH) have been quite volatile lately, given the ongoing macro uncertainty, which remains front and centre. BTC and ETH continue to be viewed as risk assets, and as central banks continue to engage in quantitative tightening in order to slow inflation, real rates continue to move higher and asset prices continue to fall. More recently, Fed Chair Powell cautioned the market against prematurely lowering rates and prioritizing price stability over employment.

Within the crypto ecosystem specifically, a number of events since May have exacerbated negative sentiment, including bankruptcies, such as the collapse of Terra Luna, which triggered bankruptcies across the space, including Celsius and Three Arrows Capital. This drove increased regulatory scrutiny – and focus that is quite needed as the industry matures.

On a more positive note, in mid-September, ETH experienced one of the largest events in crypto ecosystem history, "the Merge." This allowed the Ethereum network to move from a proof-of-work to a proof-of-stake consensus mechanism. As a result of moving to proof of stake, there are a number of advantages, including increased security, lower energy usage, to the tune of about 99.8% (a common criticism of BTC), Ether is now yield-bearing, and the merge is a gateway to a long-term improvement in scalability and lower fees and fee volatility, which should help drive increased activity. Perhaps the most important benefit of the merge was that the ETH inflation rate dropped from about 4% to about 0.2%, a level even lower than that of BTC.

Despite the short-term market events, there is a broader longer-term adoption story. Progress continues on the Lightning network for BTC and DeFi, NFTs, gaming and soulbound tokens within ETH. As innovation continues in the space and regulatory clarity emerges, longer-term institutional and retail adoption could create a tailwind for the crypto ecosystem. If investors believe in bitcoin and ether fundamentally, the macro-induced sell-off could provide a compelling opportunity for a long-term position.

To close...

Despite market volatility, investors should not lose sight of their long-term investment goals. Diversification and professional management can help manage short-term risks while pursuing long-term investment goals. For more information, please visit fidelity.ca or contact your Fidelity team.

FIC-1027973 09/22 1029149-v2022930