A Candid Conversation on Canadian Concerns

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

Key Takeaways

- The global recovery helps the Canadian economy but domestic challenges like housing-related imbalances have intensified
- We retain an underweight to Canadian assets

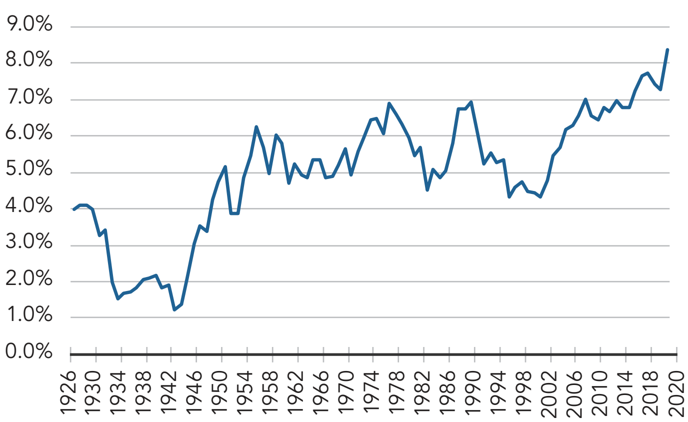
An overweight to unhedged foreign assets is one of the high conviction positions we hold in the multi-asset class funds we manage for Canadian investors. We have maintained this underweight to Canadian assets throughout the market and economic tumult of recent years, including a trade war between the United States and China and a global pandemic. To help understand both the conviction and durability of our investment stance, we answer some of the most frequently asked questions related to our views on the Canadian economy and asset markets.

Even before the global pandemic you had concerns about Canada. Why?

Our concern around the vulnerabilities in the Canadian economy is rooted in imbalances that have built up over time. Too much of the growth of the economy over the past decade has been debt-fueled housing

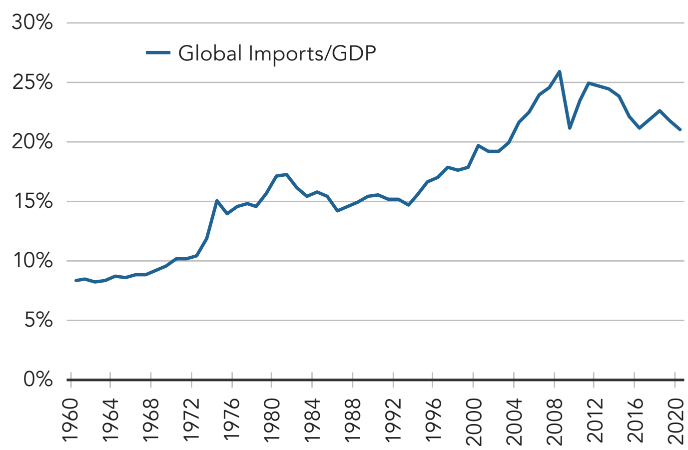
EXHIBIT 1: Cracks in the foundation

Housing Share of Canadian GDP (%)



Source: Statistics Canada

EXHIBIT 2: Canada will struggle with thicker borders



Source: International Monetary Fund (IMF), World Bank, Haver Analytics, Fidelity Investments (AART), as of 12/31/20 and consumer spending activity at the expense of exports and productive business investment. Residential investment now accounts for nearly nine percent of Canadian economic output, the highest share in records dating back nearly one hundred years.

Another concern is the vulnerability a small open market economy like Canada faces to the observed retreat in globalization (see Figure 2). Exports have historically made up a significant share of economic output, and any increase in trade friction would disproportionately affect a country like Canada.

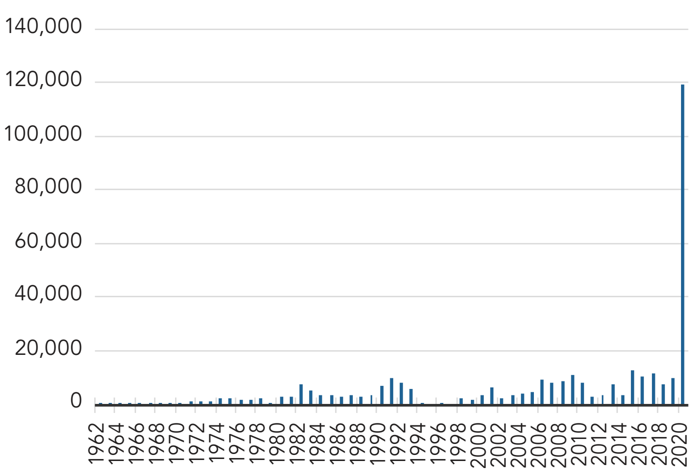
How is Canada's recovery proceeding?

Canada's economy is recovering. The unemployment rate has fallen to 7.5% from a pandemic peak of 13.7%, though this remains well above the 5.7% pre-covid rate. Further progress from here is likely to be slow in the near-term, with public health measures intended to address the pandemic serving to delay the recovery. But the medium-term outlook is brighter. The increase in government transfers to individuals (see Figure 3) has been an order of magnitude above anything seen in Canada in the last half-century, leaving domestic consumers awash in cash and presumably eager to spend upon a fuller reopening of the economy.

However, those massive fiscal transfers have been funded by an even more massive rise in government borrowing, which has exacerbated a critical vulnerability in Canada. Household and corporate debt levels were badly extended in Canada prior to the pandemic, with public debt joining early last year. The pandemic-related increase in public debt in Canada exceeded all other G-7 countries, with private sector debt pushing higher as well. Our ongoing concern surrounds the sustainability of these debt levels and how they will be ultimately resolved. As we've noted in the past, Canadian debt excesses relative to the US have been a reliable leading indicator of the bilateral Canada-US exchange rate. The deterioration of fiscal balance sheets through the early 1990s severely undercut the value of the Canadian dollar in the years following, a risk we see poised to recur in the not-so-distant future.

EXHIBIT 3: Government transfers to Canadian households

Transfers to households from the government change from year earlier, millions of Canadian dollars



Source: Statistics Canada

EXHIBIT 4: Excessive debt and the Canadian dollar

*Credit to the non-financial sector data, Canada minus U.S.
Source: BIS, Statistics Canada, Federal Reserve, Haver Analytics, FMR Co.

How have Canada's imbalances evolved and how will they be addressed?

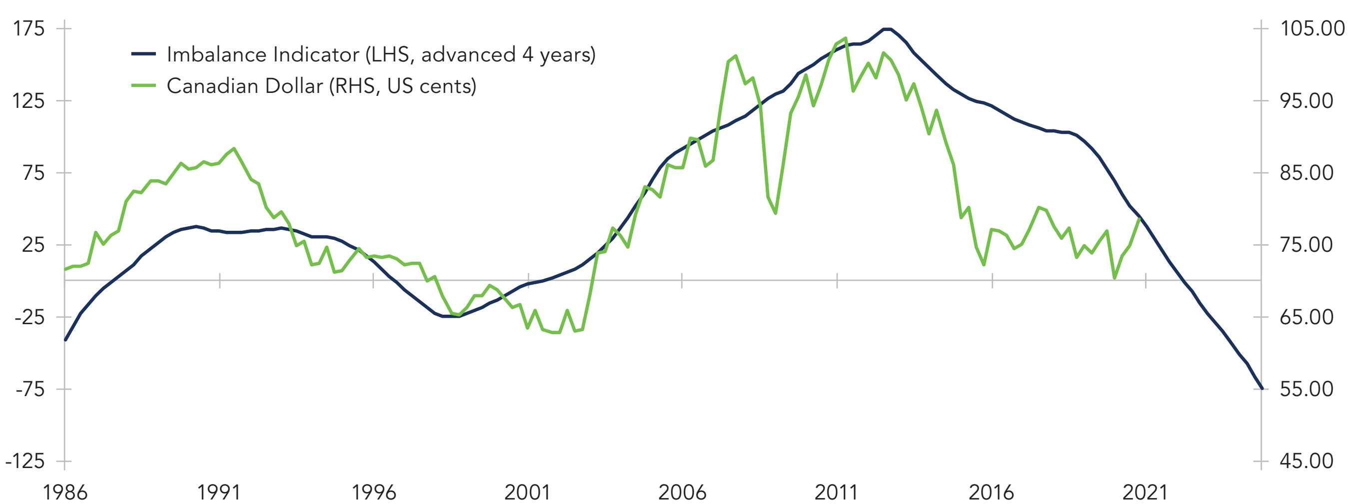
Canada's imbalances have gotten worse through the pandemic. Housing has further taken over the economy, now accounting for more than 40% of all capital spending in Canada. That's only happened in three other developed countries in the past 20 years – Greece, Spain and Ireland, in what turned out to be epic housing bubbles in the mid-2000s. All three countries subsequently suffered deep recessions. All three saw peak-to-trough declines in house prices of more than 35%. In all three, prices today remain well below their peaks, more than a decade after the bubbles burst.

We can't know precisely how the housing-related imbalances in Canada will play out. But here is one possibility. The current froth in the housing market will be compounded later this year by a surge in Canadian consumer spending, as the aforementioned combination of record government transfers and post-pandemic re-opening results in the sort of 'light-switch economy' that is emerging in the US. The resulting rise in inflation will tend to push interest rates higher, with even a small increase in rates putting enormous pressure on an already highly indebted economy. While the Canadian dollar might temporarily benefit from higher rates, as in the early 1990s, ultimately a large depreciation will be needed to improve competitiveness and support exports as domestic demand buckles. Exchange rate adjustment, which was not available to the euro-bound economies mentioned above, is likely to be a critical component in the rebalancing that will eventually be required in Canada.

How does this outlook influence your positioning?

The central theme that underpins our overall positioning, including our overweight to risk assets generally, is the global robust reopening that is underway. As more of the population becomes vaccinated and restrictions lift, we expect record savings and pent-up demand to fuel a sharp increase in consumer spending globally. The expectation of a cyclical bump higher in growth should help economies that are levered to global growth, notably including Canada and emerging markets (EM).

EXHIBIT 5: Canadian economic imbalance indicator



*Cumulative gap between Canadian consumption and housing investment and net exports and private nonres capex as a share of GDP, scaled.
Source: Statistics Canada.

As we have mentioned, however, we have structural concerns with respect to the Canadian outlook; while a number of emerging economies have their own idiosyncratic issues, owning them as a group provides diversification against the realization of Canada-specific risks. As a result, we are funding an overweight to EM equities with an underweight to Canadian equities.

We have outlined our concerns around the unsustainable trajectory of government and total economy debt in Canada and the risk they are resolved with higher inflation rates. This is one reason we are underweight Canadian bonds and overweight inflation protection within the fixed income components of our portfolios.

Another point worth highlighting is our underweight to the Canadian dollar. We've mentioned that we believe a depreciation is required to rebalance the Canadian economy, but the nuance here is that we also expect a US dollar depreciation. For this reason, we've taken positions that we believe will do well in the event of a Canadian and US dollar depreciation, such as our overweight positions to EM and the overseas developed regions, coupled with underweight positions in Canada and the US.

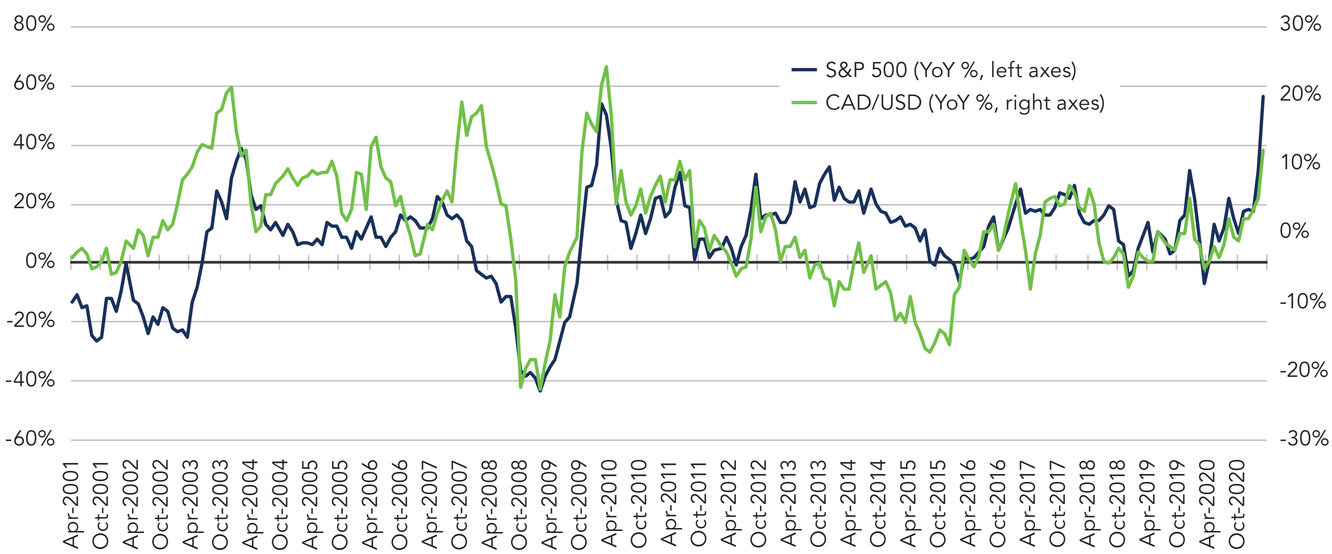
The final point worth mentioning related to our Canadian dollar underweight relates to risk management. The Canadian dollar is a cyclical currency, correlated with movements in equity markets in particular (see Figure 6). So when markets go down, the CAD also tends to go down, as investors shift their holdings in favour of safe-haven currencies. The market upset early last year was a prime example. As global markets fell, the Canadian dollar depreciated sharply. Our underweight to the Canadian dollar cushioned the impact of this decline in the multi-asset class portfolios we manage for Canadian investors.

David Wolf, David Tulk and Ilan Kolet, April 21, 2021

Follow Fidelity Canada on Twitter @fidelitycanada

EXHIBIT 6: The Canadian dollar is a cyclical currency

S&P500 returns and the CAD/USD exchange rate, % change from year earlier



Source: Bloomberg

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 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 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 Conservative Managed Risk Portfolio, Fidelity Conservative Income 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.

530712-v2021414 INM 526947

Fidelity INVESTMENTS