New Year, Same Playbook

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

Key Takeaways

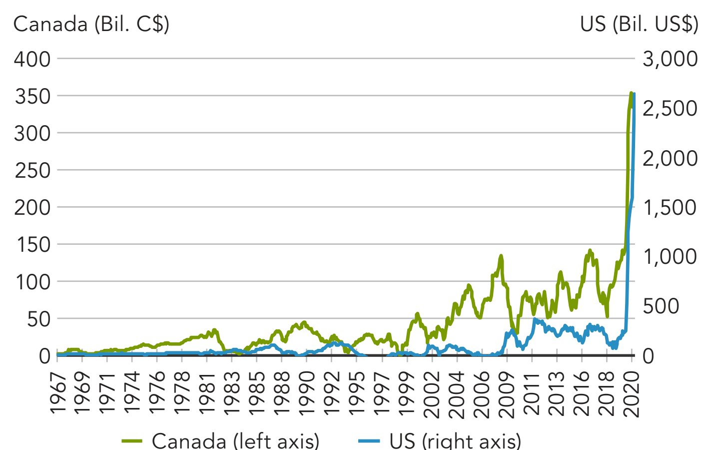
- We retain conviction in our major asset allocation views as we move into 2021
- We remain overweight equities and credit and continue to hold inflation protection and an underweight to Canadian assets
- While some of these themes are shared by the market consensus, we remain confident in our positioning

This year more than ever, the turning of the calendar inspires feelings of renewal and change. But in terms of the positioning of the asset allocation funds we manage for Canadian investors, there is a strong sense of consistency. The views we have held for most of the last year are increasingly coming into focus as the global economy looks ahead to brighter days. There will undoubtably be setbacks and volatility along the way but sometimes when investing, resisting the desire to change is the right decision. So as 2021 dawns, we outline our major views and what they mean for our positioning.

Overweight equities and credit

Expectations for a robust global economic recovery are the primary motivation for our overweight to equities and credit. The distribution of COVID-19 vaccines should allow economies to reopen this year and provide the confidence for households and businesses to unleash pent-up demand created during the pandemic. The desire to resume life as normal is further facilitated by the tremendous stimulus provided by governments and central banks. When combined with the observed reduction in spending, households have been left with considerable excess savings (Exhibit 1). Moreover, the dramatic rebound in financial and real assets has strengthened household balance sheets, enhancing the ability to spend. And as spending rebounds, corporate fundamentals are set to strengthen, likely lifting earnings and providing a further tailwind to equities and credit.

EXHIBIT 1: Government largesse and lack of spending opportunities have resulted in enormous increases in deposits (change from year ago, in billions of local currency)



Sources: Bank of Canada, Federal Reserve Board.
Canada = Currency outside banks and chartered bank deposits (including private sector float).
US = Money Stock (M1).

The conviction we have in our procyclical positioning is reinforced not only by what policymakers have done but importantly by what they are expected (not) to do. Whereas in prior cycles policymakers would look to reduce stimulus as the recovery takes hold, the distinguishing feature of the current cycle is that stimulus is expected to remain in place well into the recovery. Governments have embraced sizable deficits to fund both pandemic relief and ambitious programs of spending well into the future. Meanwhile, central banks are committed to maintaining a low interest rate environment to address the shortfall in economic output and employment relative to their pre-pandemic levels (Exhibit 2) as well as tolerating higher future inflation. In the case of the Federal Reserve in the United States, this desire was codified in the Average Inflation Targeting framework, a new regime for monetary policy that will further cement the Fed's desire to avoid a preemptive tightening of financial conditions.

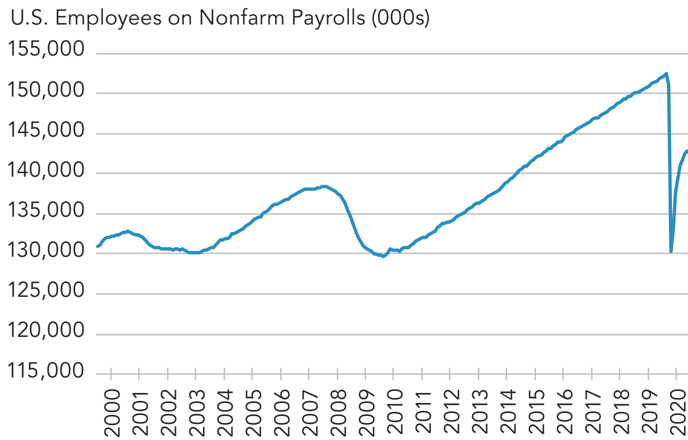
As the prospect of economic recovery has solidified, the stock market's prior laggards – overseas equities, value and smaller-cap – have begun to outperform (Exhibit 3). We believe the scope exists for further catch-up in these segments of the market and have adjusted our equity overweights accordingly.

Protection against future inflation

A rebound in private sector demand, sustained fiscal stimulus, and a tolerant central bank is a potent combination that is expected to lead to higher inflation. Over a cyclical horizon, some patience will be required, as demand-driven inflation will only emerge once the slack in the global economy created by the pandemic is reabsorbed. This process is likely to be accelerated by ongoing dislocations to supply chains and the general trend towards deglobalization that may create a supply-driven increase in consumer prices.

As we discussed in our last *Thought Leadership publication*, the legacy of rising debt burdens is also

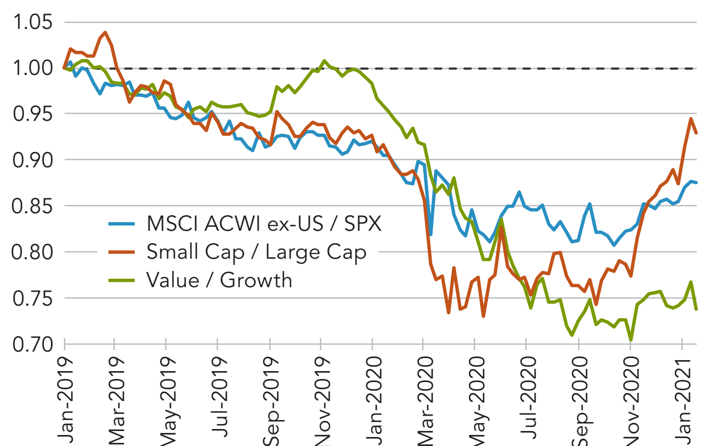
EXHIBIT 2: Even with strong growth, the economy will take a long time to heal fully



Note on Exhibit 2: If the U.S. were to add 200,000 jobs a month, roughly the average monthly gain between 2014 and 2019, it would still take about 4 years just to get back to pre-COVID employment levels.

Source: US Bureau of Labor Statistics.

EXHIBIT 3: Prior laggards have started to outperform (ratios normalized to 1 in January 2019)



Sources: Bloomberg, FMRCo.

a potent catalyst of higher inflation over a longer horizon. Providing protection today against these longer-term risks, especially when we can do so in an inexpensive manner as at present, is a key consideration in how we provide risk management in the funds. We continue to hold out of benchmark allocations to gold and inflation protected government debt.

Canada, currency, and risk management

We also maintain our long-standing underweight to Canadian assets. The outlook for the Canadian economy remains challenged by both private and now increasingly significant public debt burdens. And while an improving global backdrop is a rising tide that will lift Canada's boat, our global perspective as asset allocators allows us to invest in other regions that are not constrained by the structural anchor weighing down the Canadian economy. Emerging markets remain our preferred regional allocation to benefit from the recovery narrative, where an equity overweight is funded by an underweight to Canadian equities. We also hold EM debt in both USD and in local currency.

The underweight we hold to Canadian assets also extends to an underweight to the Canadian dollar. This position reflects the view that the currency needs to depreciate to return balance to the economy. Economic activity continues to tilt dangerously towards consumer spending and the housing market at the expense of more productive sectors such as exports and business investment. With the view that the US dollar is also expected to depreciate, we have taken steps to increase our exposure to developed and emerging market currencies that should strengthen against both the CAD and the USD (Exhibit 4).

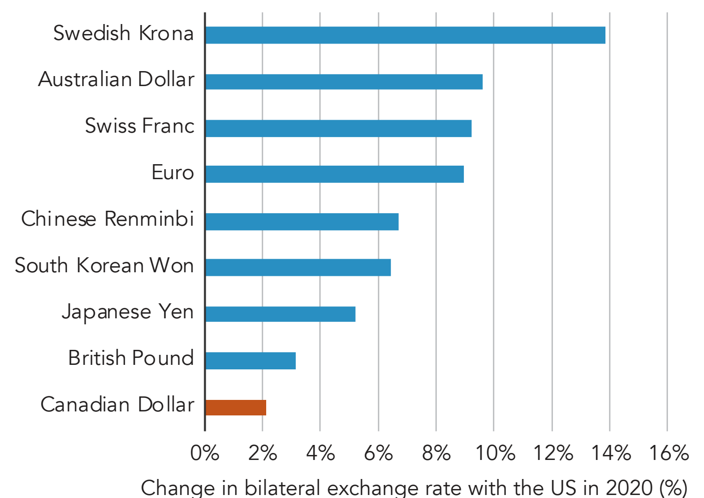
The underweight we hold to the Canadian dollar also plays a risk management role. As was plainly demonstrated in the dark days of the pandemic, when equities and credit are under pressure, global investors flee cyclical currencies like the Canadian dollar in favour of safe-haven alternatives such as the US Dollar, Japanese Yen and Swiss Franc.

To summarize, we are maintaining both positions that are cyclical in nature that are expected to perform well in tandem with the global economy as well as defensive allocation as a hedge against elevated uncertainty and market volatility.

Isn't it all in the price?

You can be forgiven if reading the above gives you a sense of déjà vu. Many of the reopening themes laced with optimism for 2021 are shared by the consensus of economists and professional forecasters. Financial markets have also discounted much of the economic weakness today to look ahead to a more normalized global economy. As a result, measures of valuation of equities and credit look decidedly expensive relative to history.

EXHIBIT 4: The appreciation of the Canadian dollar lagged all other G10 currencies last year



Sources: Bloomberg, FMRCo.

Sharing the consensus expectation amid full valuations is not always a comfortable place to be. The bar for disappointment has moved lower and any unforeseen setback could quickly undermine investor sentiment. It is therefore prudent to ask what could possibly go wrong. Setting aside the unknown unknowns that shroud any outlook, the following risks stand out:

- Negative news concerning the COVID-19 virus or the distribution of vaccines would affect the reopening narrative. It is our judgement, however, that this risk would only delay and not stop the healing in the global economy. Markets would need to adjust to price in a potentially slower recovery over a longer horizon, but the end point of a normalized economy would remain largely unchanged.
- Policymakers prematurely withdrawing stimulus would quickly undermine the wider economic recovery if the private sector was not healthy enough to assume the mantle of growth. Stimulus withdrawal is the hallmark of the maturation of prior economic cycles. However, as noted above, this is a unique cycle and the behaviour and incentive of governments and policymakers has changed to favour more stimulus over a longer horizon.
- The arrival of higher inflation before the global economy has fully healed would test the resolve of policymakers to keep stimulus in place. We would judge this medium-term risk as most likely to upend the global economy and undermine the performance of equities and credit. This is the justification for maintaining a sizable allocation to asset classes that provide inflation protection.

A final check in being comfortable with sharing the consensus expectation is to evaluate investor sentiment. Extremes in measures of optimism or pessimism often give contrarian signals for the direction of financial markets. Given the expectation for strong growth and market returns, we are closely monitoring signs of extreme optimism. Measured across a wide range of indicators, sentiment is tilted positively but not overly so. Moreover, there appears to be some gap between cup and lip – investors may share our views but are not (yet) positioned accordingly. As a result, we remain comfortable with our current cyclical positioning while maintaining elements of defensiveness to protect against risks over a longer horizon.

David Wolf, David Tulk and Ilan Kolet, February 4, 2021

Follow Fidelity Canada on Twitter @fidelitycanada

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.

Commissions, trailing commissions, management fees, brokerage fees and expenses may be associated with investments in mutual funds and ETFs. Please read the mutual fund or ETF's prospectus, which contains detailed investment information, before investing. The indicated rates of return are historical annual compounded total returns for the period indicated including changes in unit value and reinvestment of distributions. The indicated rates of return do not take into account sales, redemption, distribution or option charges or income taxes payable by any unitholder that would have reduced returns. Mutual funds and ETFs are not guaranteed. Their values change frequently, and investors may experience a gain or a loss. Past performance may not be repeated.

From time to time a manager, analyst or other Fidelity employee may express views regarding a particular company, security, and industry or market sector. The views expressed by any such person are the views of only that individual as of the time expressed and do not necessarily represent the views of Fidelity or any other person in the Fidelity organization. Any such views are subject to change at any time, based upon markets and other conditions, and Fidelity disclaims any responsibility to update such views. These views may not be relied on as investment advice and, because investment decisions for a Fidelity Fund are based on numerous factors, may not be relied on as an indication of trading intent on behalf of any Fidelity Fund.

Certain Statements in this commentary may contain forward-looking statements ("FLS") that are predictive in nature and may include words such as "expects", "anticipates", "intends", "plans", "believes", "estimates" and similar forward-looking expressions or negative versions thereof. FLS are based on current expectations and projections about future general economic, political and relevant market factors, such as interest and assuming no changes to applicable tax or other laws or government regulation. Expectations and projections about future events are inherently subject to, among other things, risks and uncertainties, some of which may be unforeseeable and, accordingly, may prove to be incorrect at a future date. FLS are not guarantees of future performance, and actual events could differ materially from those expressed or implied in any FLS. A number of important factors can contribute to these digressions, including, but not limited to, general economic, political and market factors in North America and internationally, interest and foreign exchange rates, global equity and capital markets, business competition and catastrophic events. You should avoid placing any undue reliance on FLS. Further, there is no specific intentional of updating any FLS whether as a result of new information, future events or otherwise.

"Fidelity Investments" and/or "Fidelity" refers collectively to: i) FMR LLC, a US company, and certain subsidiaries, including Fidelity Management & Research Company (FMR Co.) and Fidelity Management & Research (Canada) ULC ("FMR-Canada") – which carries on business in British Columbia as FMR Investments Canada ULC; and ii) Fidelity Investments Canada ULC ("FIC") and its affiliates. Fidelity Management & Research (Canada) ULC ("FMRCanada") commenced business in Ontario on February 1, 2018. FMRCanada is registered as a portfolio manager with the Ontario Securities Commission ("OSC") and as a portfolio manager with the other Canadian securities commissions. The scope of FMR-Canada's business is currently limited to offering the Global Asset Allocation ("GAA") strategies through a discrete portfolio management team at FMR-Canada. The GAA strategies are offered by FMR-Canada on a sub-advised basis to accounts advised by Fidelity Investments Canada ULC ("FIC"), with FMR-Canada acting as either direct sub-adviser to FIC or as sub-sub-adviser through non-Canadian Fidelity advisers, including (and principally) US SEC-registered investment advisers, such as FMR Co., Inc. ("FMRCo"). FMR-Canada does not offer these strategies directly to investors in Canada. FMR-Canada has also registered "Fidelity Investments" as a trade name in Canada.

© 2021 Fidelity Investments Canada ULC. All rights reserved.

471467-v2021125 INM 471223