Potential

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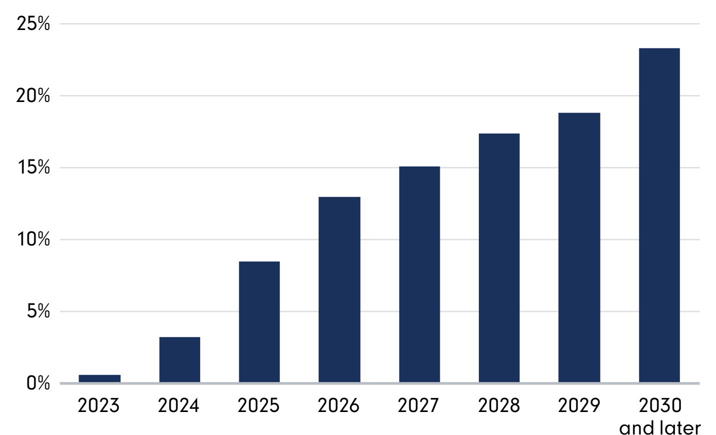
One year ago, we published a piece titled "Three Pillars Holding as Macro Crumbles", explaining why we were not taking a more defensive asset allocation stance despite the ominous economic outlook. As it's turned out, equity markets have rallied since, as those three pillars of our investment process held, and the macro... didn't actually crumble. The economy has seemingly sailed through a historically aggressive tightening campaign by the Fed. From the October 2022 lows, the S&P 500 is up around 20% with the US economy expanding by a consensus-defying 2.5%. Whether these moves are sustainable – whether it's actually recession denied or simply recession deferred – is a key question facing investors.

Like many others, we have been surprised that the US economy has remained resilient in face of 525bps of rate hikes. And while this cycle (like all cycles) will inevitably end in recession at some point, our active positioning has evolved to better acknowledge the possibility that the US economy can execute a soft landing. By contrast, we are not nearly as confident that the Canadian economy can achieve the same outcome. So while we now have a neutral allocation to equities and prefer selected credit sectors to government bonds, we have further reduced our Canadian dollar holdings v US dollar exposure.

A key reason why the US economy has yet to experience a recession, and why the likelihood of a soft landing has increased, is that the economy appears to be far less interest rate sensitive than macro models would have predicted. So what did the models miss? It could be the case that the lag between higher short-term interest rates and its dampening effect on economic activity is now longer than assumed. There are two plausible reasons for this. One, the US consumer had built up a sizable stock of excess savings through the pandemic, reflecting government largesse and deferred expenditures; those savings have been available to offset the effects of higher interest rates (and higher inflation) on consumption. Two, a lot of debt in the US was termed out through the period of ultra-low interest rates, with companies taking the opportunity to borrow at longer maturities and consumers refinancing their mortgages to restore the standard 30-year fixed term (see Exhibit 1). Putting these elements together, a large chunk of the US economy has yet to see its consumption and investment impacted by higher borrowing costs.

EXHIBIT 1: Debt has been termed out



Sources: HY Maturity Wall, ICE Data Services, as of 8/31/23. Chart shows the share of U.S. high yield debt maturing by year.

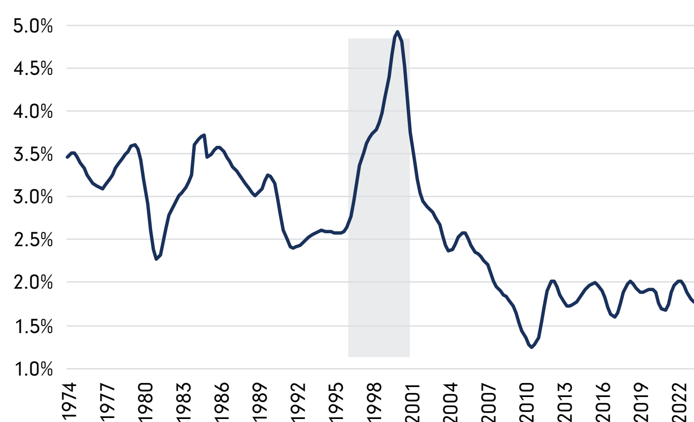
If this were simply a case of longer lags, markets would still be facing a big macro challenge: if it's going to take longer for higher interest rates to slow the economy, and the Fed needs the economy to slow to get inflation down, then the Fed will simply have to hike more. The ultimate end point is the same – recession. It's just a matter of when and how bad.

But there is another, more bullish possibility. If potential GDP growth (the speed limit at which the economy can grow without spurring inflation) is currently higher than the models think, then a recession may not be necessary; so long as growth comes in below that higher potential, excess demand could be trimmed and inflation tamed, pacifying the Fed and validating the more constructive equity market trend of the past year.

Has this happened before? It has. This was the essential story of the mid-to-late 1990s. The Fed raised interest rates aggressively in 1994, leading to the emergence of late-cycle indications and expectations of a recession in 1995–96. But there was no recession. Both the economy and equity markets took off and remained buoyant for several years, in large part because potential GDP accelerated (see Exhibit 2).

EXHIBIT 2: Productivity supported the 1990s soft landing

U.S. Potential GDP Growth (%)



Source: Haver Analytics

Why did the economy's speed limit go up? In a word, productivity. Years earlier, a prominent economist had quipped that "the computer age is everywhere but in the productivity statistics." It finally showed up, enhanced by the emergence of something called the internet. Higher productivity growth meant the economy and thus earnings could grow more quickly without causing inflation and policy tightening in response.

Could productivity growth be picking up in the current cycle as well? It is certainly plausible. AI holds out the promise of revolutionizing business processes. The transition to clean energy is spurring investment to adapt to current climate risks and mitigate future emissions through renewable resources. And working arrangements have become more efficient as the pandemic blew up the antiquated '9 to 5 in the office' paradigm for many workers. These trends are all consistent with raising the economy's speed limit.

When will we know if potential growth has indeed picked up, permitting a soft landing? Given the nature of the data and the way the models treat them, we probably won't know for years. But we'll get important clues in coming months. If productivity has accelerated, inflation will continue to decline through the fall even as the economy remains resilient. Equity markets will surely cheer. But if this is all simply a matter of longer lags between higher rates and lower growth, with no improvement in potential, inflation will likely start rising again, and the tech-led swell in equity valuations will turn out to have been overly optimistic. The CPI data will thus be as critical as ever ahead.

So as we assess the higher likelihood of a soft landing, what are we doing in terms of our active asset allocation positioning in our multi-asset funds?

First, we have increased our equity allocation to a neutral setting. Just as we respected the relatively constructive outlook from three of our four pillars last year, we do not want to be overly defensive today given the risk that stronger

potential GDP growth could deliver a soft landing. We also want to keep capital with our building block managers across the breadth of regions and styles, who all have experience successfully navigating different market environments.

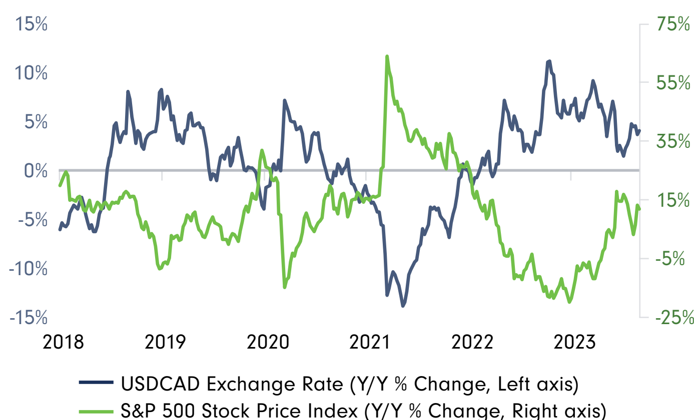
Second, we are continuing to avoid government bonds. As we discussed in our paper six months ago, the combination of the shape of the yield curve, the elevated inflation environment and the uncertain stocks-bonds correlation led us to defy the standard asset allocation 'playbook' of buying bonds in late cycle. That remains the case even with yields having risen further. We believe fixed income duration may continue not to 'work' as usual, whichever of the two scenarios discussed earlier is true. If potential economic growth has indeed picked up, inflation can be tamed, but that would also mean that the neutral interest rate (so-called r-star) is higher – leaving the current stance of monetary policy not particularly tight and giving the Fed no reason to validate the interest rate cuts currently discounted. But if it's simply a matter of lags and recession remains forthcoming, stubborn inflation and further Fed tightening in response to it would make the current 4.5% US 10-year yield no bargain, even if monetary policy needs to eventually reverse course.

Within the fixed income side of our multi-asset funds, we have generally eschewed longer-term government and investment grade corporate bonds in favour of higher-yielding securities – both short-term instruments and credit sectors such as high yield, floating rate, convertibles and emerging market local currency debt.

Finally, one reason we can comfortably remain underweight fixed income duration is that we believe we can more reliably mitigate risk in the currency positioning within our portfolios. More specifically, we have increased our position in the US dollar v the Canadian dollar, which has been a reliable diversifier of equity risk (see Exhibit 3).

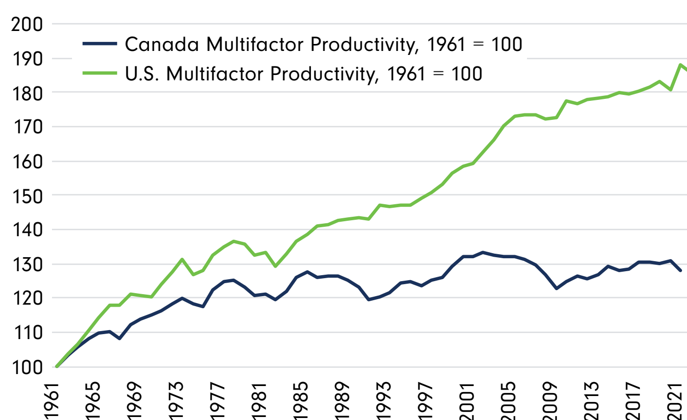
Moreover, this position is also consistent with the emerging likelihood of an upward shift in US potential growth discussed earlier. It seems far less likely that Canada is experiencing the same sort of productivity-driven increase in the economy's speed limit. Measured productivity in Canada has lagged the US badly over the past year (and indeed over the past 50 years – see Exhibit 4). Canada's economic resilience over the past 18 months looks to have had more to do with temporary factors (as discussed in our paper three months ago), as well as immigration, whose boost to economic growth has far less supportive

EXHIBIT 3: The USD has cushioned equity risk



Source: Standard & Poor's, Federal Reserve Board

EXHIBIT 4: Canadian productivity has lagged badly



Source: Bureau of Labor Statistics, Statistics Canada

implications for asset prices than productivity improvements. Those supports already appear to be fading; according to the most recent GDP figures, a recession may recently have begun in Canada. As a result, there is a growing likelihood that growth and policy interest rates can be both cyclically and structurally higher in the US versus in Canada. If so, the Canadian dollar may have a lot further to fall.

David Wolf, David Tulk and Ilan Kolet, September 22, 2023

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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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