You don't have to go home, but you can't stay here

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Key Takeaways

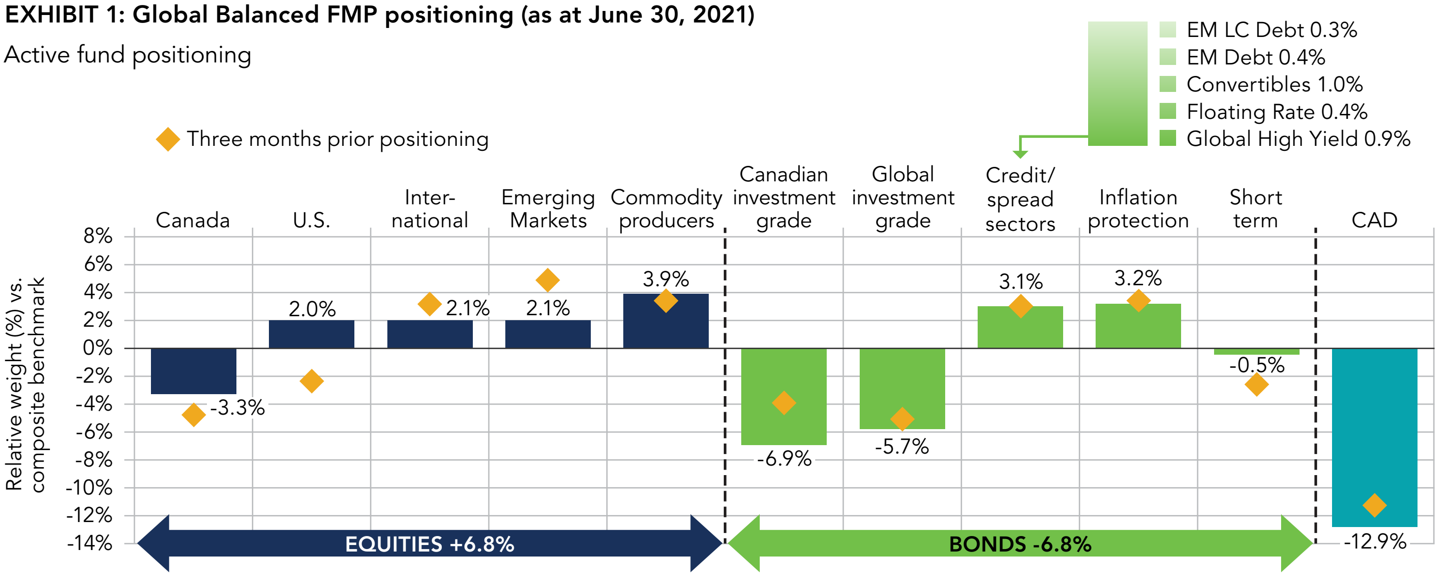
- We are constructive on the macro outlook as COVID-19 vaccination rates increase and economic activity rebounds
- We remain overweight equities but have reduced our emerging market exposure
- We remain underweight Canadian equities

The global economy continues to recover from the COVID-19 shock, and the associated broad investment themes expressed in the positioning of our multi-asset class portfolios remain intact. Over the past few months, vaccination rates have increased, mobility restrictions have been reduced, and economic activity has rebounded. While risks related to virus variants remain, the worst is likely behind us, and we remain constructive on the macro outlook.

In the U.S. and Canada, economic output is now close to pre-COVID levels, but significant dislocations remain in product and labour markets. Monetary and

EXHIBIT 1: Global Balanced FMP positioning (as at June 30, 2021)

Active fund positioning



Source: Fidelity Investments Canada ULC. 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 Barclays 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.

fiscal policies are expected to remain exceptionally accommodative, and while this will support the ongoing healing – in the labour market in particular – it increases our concern that wage and price pressures will persist over the medium term. We are not as convinced as the market or the central banks that the recent surge in inflation is entirely transitory. Accordingly, we expect the current reflationary environment to persist for some time; this is reflected in our active asset allocation positioning, and notably our larger-than-benchmark allocations to risky assets (equities and higher-yielding credit) and to inflation protection (commodities and inflation-linked bonds).

As Exhibit 1 shows, however, we made some adjustments through the second quarter in the regional allocations within our broad equity overweight. Specifically, we reduced our position in emerging markets (EM) equities, with the proceeds primarily going into the U.S., leaving similar-sized overweights across the EM, U.S. and EAFE regions. We remain underweight Canadian equities.

Why we reduced emerging market equity

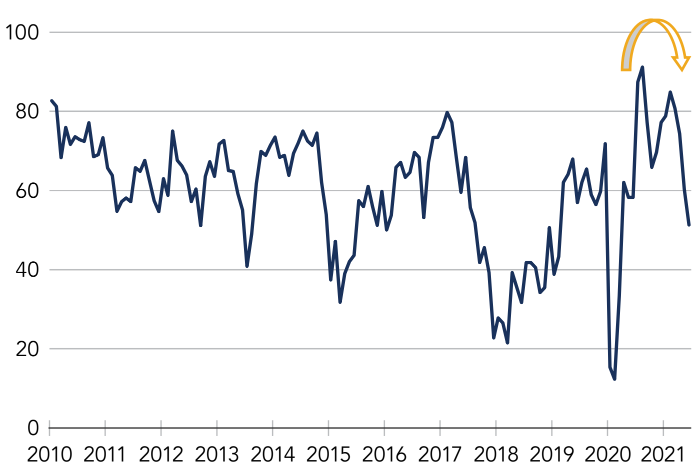
Two primary factors motivated the reduction in our EM equity exposure. The first is tactical. China was "first in, first out" with respect to COVID and its economic impact; China's economy has already passed its reopening and decelerated (Exhibit 2), with policy applying further pressure. By contrast, the boost from reopening is underway in the U.S. and gathering pace in much of Europe and Canada, with policy remaining supportive. Furthermore, the persistence of the pandemic, with the emergence of new COVID variants, poses higher cyclical risks to emerging economies than developed ones, given the generally lower effective vaccination rates and weaker health care systems in EM.

The second factor behind our reduction in EM equity is more structural. EM equities have become a riskier asset class from a Canadian investor's perspective. This is because the broad EM equity market and the Canadian equity market have come to look less and less alike. While obviously in different stages of development, Canada and EM could long be counted on to have similarly-behaving equity markets, outperforming when the global cycle improved, commodity prices rose, and the U.S. dollar weakened. But the correlation between the two markets has generally become lower and less stable in recent years, and plunged in unprecedented fashion in recent months (Exhibit 3).

The biggest driver here has been the increasing dominance of markets such as China and Korea in EM, markets skewed heavily toward technology-related companies. Overall, the share of technology, communications services and consumer discretionary sectors in EM has roughly doubled over the past decade to around 50% of the index;[1] in Canada that share remains below 20%.[2] These sectors tend to have higher rates of growth, but also face a different set of regulatory and other risks (as recent developments in China have

EXHIBIT 2: China past peak growth

AART China industrial activity diffusion index
(6 month moving average)



Source: FMR Co.

shown) than the financials, energy and materials sectors that continue to dominate Canada's market. The less the EM equity market looks like Canada's, the more volatile it can be expected to be relative to the domestic market. That mismatch has become much clearer in recent months; the correlation has actually flipped negative, with Canadian stocks up 18%[3] year-to-date compared with a decline of 2%[4] in EM (in Canadian dollar terms). From a portfolio construction perspective, the additional risk that has emerged in EM equity exposure for Canadian investors would warrant a reduction in exposure, even without any change in projected returns.

Why we didn't bring that money home to Canada

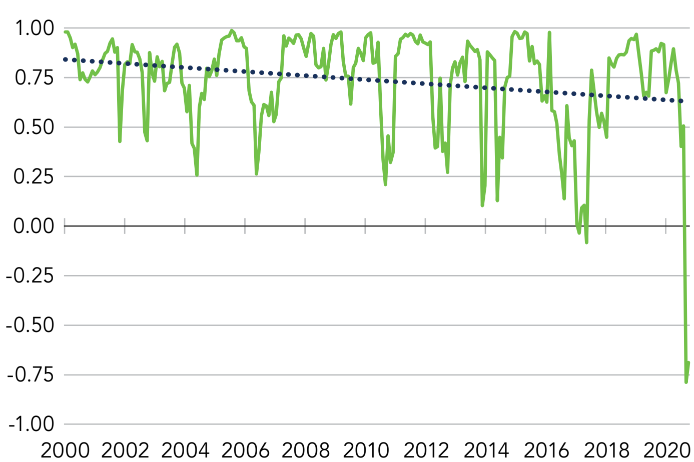
Given our general pro-cyclical positioning and our reduction in EM equities, we might have been expected to bring money back into Canadian equities. We didn't. Here's why.

First, we continue to expect higher returns from EM equities over time, vis-à-vis developed markets generally and Canada in particular. This primarily reflects more favourable demographics and the scope for productivity gains in EM, as well as cheaper starting equity valuations. In addition, EM present a much broader opportunity set for our stock pickers, across sectors and countries, than the smaller and more concentrated Canadian market. Our equity managers have to some degree been able to manage around the recent wobble in China's market, harnessing opportunities elsewhere in EM; no such outlet would exist in Canada.

Second, we continue to believe that Canada's internal imbalances threaten the longer-term performance of the domestic economy, asset prices and the currency. We discussed those concerns in detail in our second-quarter commentary. They have only intensified in the interim. For example, data released since then by the Bank for International Settlements show that Canada borrowed more money last year (relative to the size of the economy) to get through the pandemic than any other G20 country. The size of Canada's debt pile is now closer to Japan's than to that of the U.S. (Exhibit 4).

EXHIBIT 3: Fading correlation between Canada and EM

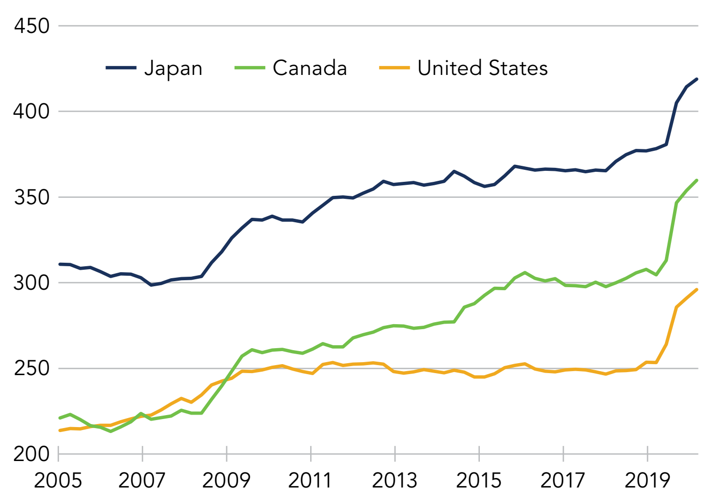
Rolling 6-month correlation of monthly EM and Canadian equity total returns



Source: MSCI/Haver Analytics, FMR Co.

EXHIBIT 4: Turning Japanese

Credit to the Nonfinancial Sector (% of GDP)



Source: Bank of International Settlements / Haver Analytics, FMR Co.

Now, we have long been worried about the risk posed by Canadian imbalances, but a catalyst for their unwinding has remained elusive. Maybe not for much longer. CPI inflation in Canada picked up in the second quarter to 3.4%,[5] its highest rate in a decade. That was with much of the country still locked down. As the demand unleashed by reopening meets ongoing supply-side constraints, inflation will almost certainly climb further. The Bank of Canada projects that inflation will move only marginally higher to near 4% later this year before falling; we believe that the risk is that it will go higher and last longer. The resulting need for higher interest rates would pose a significant challenge to a highly leveraged economy in which the expectation has been that rates only go down and house prices only go up.

While the Canadian dollar may appreciate initially under this scenario as Canada lifts rates sooner than elsewhere, the broader direction of travel for the currency would likely be downwards, not unlike the pattern in the late-1980s to mid-1990s, when rates rose in response to inflation against a backdrop of excess debt. The rise in rates would surely be less pronounced than in that earlier period, but it doesn't have to be nearly as large to have the same effect, with household debt in particular so much higher now.

Conclusion

The global economic recovery has broadened, and while risks remain related to virus and vaccine trends, the reopening of large economies and the associated wave of consumer spending is expected to continue to fuel the recovery in risky assets. This is expected to be fostered by the extension of exceptional fiscal and monetary stimulus, with policy makers seeming unfussed by higher inflation as they continue to support the recovery.

As a result, the positioning in our Canadian multi-asset funds remains pro-cyclical. But in light of the changing composition of global growth, as well as important changes to the makeup of EM equity markets, we have spread our constructive view on equities across non-Canadian markets. By maintaining a balanced global exposure, we are able to bring additional diversification to our portfolios to enhance returns while managing risk for Canadian investors.

David Wolf, David Tulk and Ilan Kolet, August 19, 2021

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Endnotes

[1] Source: MSCI Emerging Markets Index.

[2] Source: S&P/TSX Composite Index.

[3] Source: Bloomberg.

[4] Source: Bloomberg.

[5] Source: Statistics Canada.

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