Fidelity Connects

Sector to Watch in Global Markets

Denise Chisholm, Managing Director of Quantitative Market Strategy

Pamela Ritchie, Host

Announcer: Hello and welcome to Fidelity Connects, a Fidelity Investments Canada podcast, connecting you to the world of investing and helping you stay ahead.

Director of Quantitative Market Strategy Denise Chisholm is back on the program sharing her insights and thoughts on what factors are driving the markets and what economic indicators she's keeping an eye on.

Denise discusses inflation with host Pamela Ritchie and explains how inflation is still an important topic this year. Denise adds that investors need to be open-minded and that maybe all bad news about inflation is more likely in the rear view for the markets rather than staring us in the face.

So how do investors position themselves this year and what sectors are appealing? Denise explains that for her as much as we think markets are macro driven, she finds relative valuation a much more important predictor of what works within equities and actually equities overall relative to bonds.

She adds parts of the market are deeply overvalued like software and tech, but as an investor you aggregate those things together with areas of the market that are deeply discounted.

She believes the top three sectors are materials and consumer discretionary, financials, and industrials and the bottom three are consumer staples and utilities, real estate, and tech.

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Pamela Ritchie: Hi Denise. How are you?

[00:02:12]

Denise Chisholm: I'm well. How are you, Pamela?

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Pamela Ritchie: I'm very well. I'm very well. It's great to see you. So, this is the question. Is inflation — okay, it is the biggest topic but is it still the biggest topic, actually?

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Denise Chisholm: Yeah. In some ways it's been a continuation. You highlighted the continuation of trend which I think surprises investors sometimes when they look at the year-on-year rate. They say, well, it hasn't really declined yet, so it's just starting to decline. A lot of leading indicators were showing this is just a continuation of that pattern we really saw in 2022. In some ways looking back, 2022 was really a tale of two halves, an annualized inflation rate in the first half of, let's call it, 10 to 15%, wildly higher than the year-on-year growth rate and then a quick moderation in the second half to now we're around, depending on how you look at it and depending on how you measure it, let's call it between 2.5 and 4. That's our run rate going forward. When you think about the problem that inflation can present to either the Fed or the markets, this is really a continued deceleration that we started to see around June that's coming true as we approach 2023. This is very, very different from those investors that want to compare it to the '70s and '80s.

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If you take out shelter, which even the Federal Reserve acknowledged is sort of a backward looking indicator and, ultimately, will true up to the rental deflation that we're actually seeing in the market, all of those CPI equivalents, so everything ex shelter, even if you look at core services, Chairman Powell is specifically concerned about might be correlated to wage growth, all of those are bumping around an annualized run rate of zero. I think as we approach 2023, we have to be open-minded as investors that maybe all that bad news about inflation is more likely in the rear-view mirror for the markets than staring us in the face.

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Pamela Ritchie: Coming back to how the Fed is either sort of pointing things out or, I don't know if admitting is the right word but just coming back to that, you've said before that there are things, goalposts are being moved. Where do you see that? Is that the wages story?

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Denise Chisholm: Yes. They certainly shifted it to wage [indecipherable]. It's really about core services ex shelter. Actually, it was just originally core services which included shelter and then they had to acknowledge the fact that, well, shelter's kind of backward looking. Even the Fed research did a study on that saying, ultimately, we can probably true it up to real rental equivalence in the market and that would lead to markedly lower inflation right now. And then the goalpost is moved to, well, it's core services ex shelter because that, ultimately, if wage growth is sticky then that will, ultimately, be sticky.

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But look, I mean, I think that you have to stay skeptical on the fact that wage growth has decelerated quite a bit and that core services ex shelter component has also decelerated quite a bit, even more so than wages. If you think that wage growth is actually going to cause a bottleneck in that core services inflation, so far, we're not really seeing it. This is so true that, ultimately, the CPI in December came in below Federal Reserve forecast for the full year of 2022. Will they acknowledge it? I don't know. But you can still see those goalposts sort of move until they can't move any more.

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Pamela Ritchie: So, then a cut? How does that sort of narrative fit in these days, the pivot?

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Denise Chisholm: It's an interesting narrative. I think that, again, like the bearish *[audio cuts out]* evolves as well. Now, obviously, I've been sort of the bullish side and specifically since last June and I think that that's where all of my signals became really interesting. I think that they're still interesting in 2022. But I think the bearish argument has moved. Well, okay, maybe inflation is slow and maybe the Fed could cut but the Fed saying it's not going to cut. The market expects a cut. We can pull out the yield curve or we can say *[audio cuts out]* so if the market doesn't get the cut that it expects, this is going to be a problem. You look back in history and that's just not really the case. It's true that inversion of the curve or expectation of Fed funds cuts does tend to be more often than not true. I think it's about a 60/40 kind of hit rate. But when you look and say, well, what if you were wrong and there was no cut and it was higher, not lower in a year, the market actually has higher odds of an advance.

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So, add/at any inversion it's about 50/50 odds. An inversion is not nearly as negative for the market as you think and incremental returns, average returns, let's call it called 2 to 5 depending on if you're looking at total return. But when you see, okay, you're wrong, there is no cut, there's actually not a hike but interest rates actually go up. You have higher odds of a market advance and into the '70s since 1981 and double digit returns. You can even look and say, well, what if there's a cut but it's not as much of a cut as the market expects? Those odds are 100% odds and double digit returns, meaning that it works the opposite way that investors think. That expectation of cut is really the expectation of recession. As that recession call potentially fades, that's the bullish impetus for the market.

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Pamela Ritchie: That's amazing. So they would cut only because things are too tight going into a recession so if they don't cut, it's because things are okay.

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Denise Chisholm: That's right.

[00:07:35]

Pamela Ritchie: It's very interesting. Let's take the overall investment thesis across the universe a little bit here. This is the case. We've got new inflation numbers out of Canada today. As you say, the U.S. is sort of the case that you've just made there. How do people invest at this point? What's looking good? Where are the sectors to go to?

[00:07:58]

Denise Chisholm: When you think about what the driving factors from an investment perspective are, it's usually not the news staring at you in the face, right? That tends to be more rear-view looking. But what's really fascinating, at least to me, is as much as we think about these markets as macro-driven markets, it's all about the Fed, it's all about inflation – and look, I get a lot of investors who say that to me literally every day – I actually find relative valuation a much more important predictor of what works within equities and, actually, equities overall relative to bonds.

It might actually surprise you that even after a down year in equity markets, that does boost your odds. Usually after a down year in equities you get some sort of snapback but it's not related to what you might think it might be related to, which is how good earnings growth is. Ultimately, you go, okay, we're down a lot but maybe it's priced in some bad news but not all the bad news and if earnings are really bad then that's going to mean that stocks are still bad.

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Actually it doesn't work that way. What is more predicted is that relative valuation starting point and it's not just the absolute valuation of stocks. It's the absolute valuation of stocks relative to bonds. When you look at a 3.5% 10-year, which is where we are right now in the U.S., relative to 17 times forward, you're not like at cheap valuations but you're at advantageous levels in history. Yes, we're a lot more expensive than we were over the last 10 years after the financial crisis when debt deleveraging was the real issue but relative to the rest of history where debt deflation is not an issue, we're still in relatively strong valuation levels. That creates the positive risk-reward for equities in the coming years, that starting point on valuation.

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Yes, there are still some parts of the market that are deeply overvalued. We can point to software, we can point to some aspect of technology, the non-earners, but you have to realize is that as an investor you're aggregating that together with stuff, or areas of the market that are deeply discounted. Homebuilders is actually trading at five times forward earnings. What that means is overall the equity market doesn't look so bad but within the equity market, what actually looks to have the advantage is very, very economically sensitive sectors and not defensive sectors. So I'm going to pick on consumer staples, utilities and to a lesser extent, health care. That is true regardless of the fact that we may approach a recession this year.

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Pamela Ritchie: Really? So, that may not be the thing that sways it one way or the other which is, of course, the reason that people would run for a more defensive portfolio at that point, certainly on the equity side.

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Denise Chisholm: Right. It seems obvious, right? If 2023 is finally going to be the year *[indecipherable]* recession after all those [audio cuts out], all the rate hikes that we've seen, this is the year going to be a contraction. I'm actually a little bit skeptical. I think it's harder to get in a recession than that but let's just give that thesis its due and say, okay. I'm actually doing a presentation on this tomorrow, so let me just sort of talk through it because I'm kind of excited about it because it's interesting when you look at the odds. People say, well, if you knew that a recession is going to happen, we've got eight historically going back to *[1960? audio cuts out]* analyzed and say, okay, consumer staples, utilities and health care actually as an aggregate group do okay even after the recession starts. Yes, that's true.

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When you look at historically, recessions at that start, if you knew when they started, the year following you have 63% odds for consumer staples, 50, 50-ish for utilities, which is better than its historical baseline, and a little bit over 58%, I think, for health care. So, you say, okay, well that's still positive for defense, Denise, what do you mean? You shift that by six months and take that point of start from the time the NBER told you that you're in a recession, all that is gone, you're back to 50/50. What has mattered more than those moving goalposts of recession, if you know that can move just by a month and that your timing has to be impeccable to get that defense right, what can move that needle more? I don't want to make that bet. I don't know when it's going to happen.

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What turns out, what has more implications for [indecipherable] performance is how much the stocks have already outperformed. In our case, on average defense outperforms, let's call it 9 to 10% the year prior to a recession. We're well in to 20s, 20 to 25 *[indecipherable]* and our starting point on relative valuation is about 15 to 30% more expensive. Those two things have mattered more than recessions when you look at the gap in the odds of outperformance. That's a fancy sort of statistical way to say it is different this time in the sense that there's so much variability around those recessions, as an investor you would rather use things you know, like what have we already seen in terms of relative performance and what's my starting point in relative valuation, than some sort of guesswork on when this NBER defined recession is going to come.

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Pamela Ritchie: We love it when you practice your presentations for tomorrow on us. It's fabulous. I can't tell you. Also, and this goes right to relative valuation, look at EM, look at Europe. Europe's kind of on fire right now, actually. Is this the same story?

[00:13:14]

Denise Chisholm: Yes. It's a good thing when you see the laggard areas of the overall market have an impulsive advance. That's Europe and, to a lesser extent, EM. You have seen over the last three months some outperformance there and significant outperformance but if you held it for the last five years, call it, you're still significantly in the hole. I think that's likely to continue given that this is all around the dollar, essentially. I think there is a continued trend of dollar depreciation as the Fed doesn't have as much of an inflation problem as many investors think. I think that that's likely to maintain that going forward.

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What's been interesting to look at is that sector valuation or that sector rotation, within Europe specifically, has been solidly consumer discretionary and financials, which are two of my preferred sectors within the U.S. I think you see not only a strong impulsive advance in areas of the market that have lagged, global equities, but you've seen a very strong impulsive rotation into cyclicality. I do think you see it more in Europe and I think a little bit of a lesser extent but similar in emerging markets. I think that that's still to come in the U.S. I think that that pattern is likely a global pattern.

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Now, to the extent that you think that you want to go outside the U.S. to potentially get more alpha, I see Europe at not quite valuation thresholds that make me comfortable as an investor in the sense that what you've often seen happen is value traps. Valuation, yes, the valuation spreads are wide, yes, the gap is extreme but it hasn't historically led to consistent odds of outperformance. This is Europe versus the U.S. You're closer on EM which feels a lot hairier than Europe from an investment thesis story, but EM has actually had much more solid valuation support, to bet on. If you were going to think of, I want to go outside the U.S., where has the strongest statistical valuation support, I would point to emerging markets.

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But that said, I'm not necessarily sure you have to go outside the U.S. to get that strong valuation support but you do have to go down in market cap. I think U.S. mid-caps are really the sweet spot there. We're bottom decile relative price-to-book versus the base, relative trailing and forward P/E versus the base. We're not quite there on free cash flow but we're close,

that valuation support has showed strong odds regardless of the fact that fundamentals in the mid-cap space haven't really been as good as in the large-cap space which means that the stocks are willing to look through it.

When you poured out all the average returns and you say, okay, at these levels what does the overall market tend to do on average, you get double digit returns and mids tend to lead by about 10 to 15%. So, you're talking about a 35% opportunity. It's not to say it's a lock but your average returns from the dislocation signals that we're seeing create a unique opportunity within the U.S. that you don't necessarily have to go outside.

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Pamela Ritchie: So interesting. Coming back to the financials, just to expand on that risk regarding provisions for credit losses if there is, in fact, a recession. We also have big U.S. banks reporting right now. There's some very different reactions to some of those earnings. Are there other factors that you're bullish on within financials, is the question really.

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Denise Chisholm: Yeah. I think we're starting to see idiosyncratic performance around financials, which is probably a good thing relative to some sort of call around inflation or the Fed or what's credit going to do, because generally speaking, all of that news has been fairly well contained. I know that every time that the financials ... it's the beginning of the earnings season and we hear a bunch of banks sort of hypothesize on what the year will bring in terms of, yes, we're banking credit losses because we think that the U.S. consumer is going to be potentially more strained but yet numbers actually come up over the course of those expectations.

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We can see this in the forward-looking credit markets and one of the real canaries in the coal mine all year has really been credit spreads and I should say the last six months has been really dominant in terms of the uptrend in credit spreads up until last fall and then since fall, the severe downtrend in credit spreads. What you're seeing is that there is a more muted outlook in terms of the coming potential of defaults. I think that that's no surprise given the fact that consumers have really been faced with negative real income growth over the course of the last 18 months and now you're starting to see that accelerate. As inflation comes down real income growth is actually advancing, causing that potential credit event to be less likely from an incremental perspective.

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That's sort of a long-winded way of saying I think we're starting to see some idiosyncratic movement around stocks but the broader picture in terms of credit doesn't seem to be as bad as investors expect and every earnings cycle we see that, as much as it doesn't sound great, numbers actually come up after and I think that you have strong valuation support.

Again, when you go back in history and you say, okay, given the valuation levels that we're at, which are well below what we saw in even the financial crisis in 2008 – and that's on book and earnings so both – what you're seeing is a really solid risk-reward environment unless you think the recession was very severe and by very severe I mean an unemployment rate over the course of the next year ahead of 7.5%. That's certainly not my base case. If that's your base case as an investor then I would say not the sector for you but I think your risk-reward outside of that scenario is pretty solid given the valuation levels that I look at.

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Pamela Ritchie: Fascinating. Let's go to commodities. Let's talk about oil and maybe across the spectrum, I mean, there have been some fascinating headlines around the oil story. That's the commodity itself, not necessarily the equities. How do you look at that?

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Denise Chisholm: I think the commodity doesn't look nearly as bad as the equities are starting to look to me. But I think that the bull case on commodities in general is trying to reopen it. You can make that into a bearish argument or a bullish argument. It's sort of fun to do and then I'll tell you the facts. The bearish argument is, well, a China reopening is going to cause inflation to global markets and that means the Fed's going to do more that's bearish in the market. Or you can say the bullish argument which is China is going to reopen, that's going to be good for commodities, it's going to be good for growth, and that's going to be bullish for the market. So, it's funny, you can go in either direction.

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What I would say is that there are areas in the market where that reopening is priced in and there are areas in the market where it's not. I would say the area in the market where that's already been priced in is crude oil and specifically in the energy stocks themselves. I look at the OECD forecasts, essentially that's an expectation of an increase in demand from China specifically that we've all sort of been waiting for. I think that that's what investors have been waiting and playing for. But when I look in the oil markets, what has been more important than the change in demand is supply and excess capacity. China might not make up for the lack of demand, by the way, in Europe and the U.S. and whether or not that's weather related, we never really had a strong recovery, so it's not just about China. You can't hold all else equal. Demand hasn't recovered very strongly. By the way, we still do have excess capacity because OPEC cut a lot which means that commodity markets know that, well, if you cut a lot, if crude oil actually goes up some of those barrels are going to make their way back onto the market.

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You don't see this at all in the metals and mining space. There's less excess capacity as an issue. You don't have an OPEC in commodities. There's less of an impetus for the China recovery to have been priced in and I think that you've got a really long track record for, specifically, metals and mining ... I'll add copper and gold here because now they look very similar to me, strong valuation support...

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Pamela Ritchie: Sorry to interrupt but do they usually look similar? A lot of people just separate gold out, as you know.

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Denise Chisholm: I think that gold always looks more like commodities than anything else to me when I look through history. Whether people say it's a currency or it's an interest rate play, I say it's a commodity. There's reasons behind that. Sometimes I lump it in with crude which I really shouldn't do because I would lump it in with metals and mining more than crude. Sometimes they're all together. Right now I think that they're dramatically separate. Crude is acting and energy stocks are acting very, very differently. It doesn't always happen but this is the point at which you only get 30% odds for crude oil energy stocks and you get 60 to 70% odds in metals and mining and gold, specifically. If you had to pick a commodity that gold would be related to it would be related to copper.

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There you have, again, that really strong valuation support but unlike energy, you actually have a really strong historical likelihood of looking through what might be a pretty bad year in terms of *[indecipherable]* and margins. Metals and mining, along with energy stocks, are at peak margins. Everybody sort of knows this. From a risk-reward perspective, what does that mean? That means your odds have *[audio cuts out]* a base case of earnings contracting over the course of the next year. Where can you get value, right, value impact your odds of outperformance but where can you get value impacting your odds of outperformance, even if fundamentals slip? That's not at all in energy but it is in metals and mining. I think that if there is a way to play that China reopening trade on the positive side, I see it more likely in the metals and mining space.

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Pamela Ritchie: Within what you've just said there, it makes me think sort of the story of inflation comes back because if you do have China demand which, again, nobody seems to really know what that's going to mean, you would assume that inflation comes along with that.

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Denise Chisholm: Not really. It's funny, I mean, inflation doesn't have a lot of relation to growth. I'll say this sort of tongue in cheek, I don't really think that just a recovery actually causes inflation and certainly not inflationary shock, which is where we're coming from. We can *[indecipherable]* it out into at least four baskets that cause inflation. One is supply change, which clearly did. That was a clear impact. You can measure it in supply or delivery times in the ISM if you want to go to that website and you'll see that that's come off a lot. Clearly, M2 or government stimulus, you can see that on an annualized run rate, money supply was growing at 20%, which had never happened historically, now it's negative which also never happened historically.

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That sort of unwound and then you're left with the unemployment rate and the growth rates. I look at them and they just don't relate. We had low unemployment rates right before we entered the pandemic. We didn't have inflation then. So, there's a lot of things that we don't know in terms of how and even when the chairman of the Federal Reserve talks about what causes inflation, I get the theory but when you look in reality, the numbers really don't support it. The low unemployment rate doesn't magically create inflation. It's more excess supply than you think and there's more demand being mismeasured than you think was in that one number. I actually think that China could recover and inflation could still decelerate and that would not surprise me at all.

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Pamela Ritchie: If we go to factors for a second here, the value of low vol. I mean, it still looks choppy, there's still lots of questions about what kind of volatility is ahead. We're in the midst of it, just look at the markets today...

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Denise Chisholm: It's funny, I was actually talking to my boss and he was like, well, you know, there's a lot of academic research on low vol. And he's absolutely right. There's a ton of academic research on low vol if you just sort of basket it up and buy the lowest volatility stocks, stocks don't move a lot, over time they go down less in down markets and they actually go up at a fairly good rate when markets actually go up. So, your risk-reward and your Sharpe ratio really look

off the charts and I think that's largely been true over the last, call it, 20 years. What's happened as that has been mined and exploited, I would say you've left low-vol stocks being expensive. That's sort of why consumer staples is where it is. Investors actually know that they don't move a lot and they use them to be protected and they're bidding them up, gapping out that wide valuations.

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So, low vol looks less egregious than, say, utilities that I just quoted but if you quartile it out going back to the 1990s, you'll say that, no, low vol is ... on earnings and book, I think it's in its top decile and almost in its top quartile on free cash flow and book and it's in its top decile on forward earnings and trailing earnings. You aggregate that all together and say, well, does it matter when it's expensive? Historically, it has. You've led to below 50/50 odds that low vol is going to be leadership, especially true in that market. To me, the risk-reward of, again, that defensive sectors or defensive equities overall from a factor perspective in low vol, all sort of starts to the same thesis which is relative valuation is often more important than whatever news flow comes your way. The starting point of relative valuation does not look to be advantageous.

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Pamela Ritchie: It's fascinating. Can you sum up for us the top ... maybe also you could overlay whether this is sort of a global discussion for you ... but top three sectors and then actually bottom three sectors. You've mentioned them but just sum them up for us.

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Denise Chisholm: Top three are, let's see, I always go back and forth, I'm going to put materials and consumer discretionary together, I don't want to pick one and two, and then financials right after it and then I would say industrials. On the bottom half I always sort of go back and forth as well. I'm going to say consumer staples, utilities and real estate in there because it looks like defensive and looks like a high valuation to me. I think tech is sort of somewhere in the middle. It doesn't look like, I think, a positive risk-reward because your starting point around valuation isn't really that good. But if you wanted to go down the cap spectrum, I wouldn't stop you. I think *[indecipherable]* technology is an area of opportunity. Large-cap, not so much. So, that's within the sector market.

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Within sort of, I would say, the global market, for me, I think that the one defining asset class would be U.S. mid-caps. If you felt like you wanted to play a global trade I would say look at metals and mining. I think that's a good sector and basket of stocks that could give you that potential upside of that reopening play. And if you really wanted to take a flyer and go outside the U.S. with strong valuation support, that would actually be emerging markets.

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Pamela Ritchie: Denise Chisholm, thank you so much for joining us, taking us through your thoughts at this point and unmuddying the waters for us. All the best.

[00:27:55]

Denise Chisholm: Thank you so much, Pamela.

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