

## Fidelity Connects

### FMP, the Fed and Inflation

**Ilan Kolet**, Institutional Portfolio Manager

**Pamela Ritchie**, Host

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

Frequent guest Ilan Kolet is back with us again today. Ilan is an Institutional Portfolio Manager on Fidelity's Global Asset Allocation team who manage several funds for Canadian investors, including the Fidelity Managed Portfolio suite of funds.

We caught up with Ilan the week after the U.S. Federal Reserve's Jackson Hole Economic Symposium, and Ilan looks at key takeaways and unpacks what this has meant for the U.S. equity markets, and what may be next for inflation, rates, and possible recession.

A few findings mentioned today include hiring may slow and unemployment drifting higher in the U.S., services prices being largely determined by the labour market and wage growth, and the Fidelity Managed Portfolios continuing to hold Treasury Inflation-Protected Securities (TIPS) as inflation protection.

This podcast was recorded on August 29, 2022, and one quick announcement before we get started. If you're looking for more market insights, mark Thursday September 8th on your calendar. Fidelity's Vivian Hsu, Director of Product Innovation, is hosting a Reddit Ask Me Anything event from 12:00 to 2:30pm EST. All are welcome to stop by and ask their questions about markets and investing. Head to [reddit.com/r/FidelityCanada](https://reddit.com/r/FidelityCanada) to participate.

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**Pamela Ritchie:** Hello and welcome to Fidelity Connects. I'm Pamela Ritchie. Great to see you, Ilan. I bet you did some reading this weekend.

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**Ilan Kolet:** I did. Nice to see you, Pamela. Yeah, nothing like spending a late August weekend catching up on Jackson Hole.

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**Pamela Ritchie:** Your first thoughts. From your perspective, somebody who reads about inflation all the time, what did this mean to you, this symposium?

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**Ilan Kolet:** This symposium is very, very academic except for Chair Powell's speech. His speech, which is, I think, the most important thing for us to discuss today in terms of how it affects positioning and our thinking was very, very short. Our discussion today, Pamela, is probably going to be four or five times longer than Chair Powell's entire speech. It was a very, very short speech. It was forceful, it was direct, it was only about inflation. It didn't really reference a lot of research but he communicated, I think, as clearly and as sternly as possible, economic pain and higher rates are required to bring inflation lower and we should abandon any thought of potential rate cuts in the near term. I think we're seeing the fallout of that certainly since the speech. But it was a very, very direct and effective speech, in my view, and now, the path forward is fairly clear.

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**Pamela Ritchie:** The path forward is fairly clear. What I'm curious, and we're going to get into mostly his speech, as you mentioned, but it's an academic symposium, what were the other parts of this symposium? What were the discussions? There were a lot of big names there. What was that like?

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**Ilan Kolet:** Historically, the Jackson Hole Symposium has been a research-focused conference and the program this year really, again, it brought together sort of the all-stars of monetary policy research from around the world and central bank governors from overseas and a lot of the analysis was on what are the lingering effects from this type shock that we've observed?

For example, there was a session on what's the best way to gauge labour market healing. There was some interesting stuff. Again, for a nerd like me there was some interesting stuff to read and catch up on in terms of it's not just good enough to examine one unemployment rate. You need to look at labour market participation and engagement which is something, Pamela, we've discussed in the past, but really for the focus of the investment community that's joined us today, I think it's absolutely critical what Chair Powell said. Again, if you want the message to come across forcefully, I think they succeeded in doing that. One way they succeeded in doing that is being very ... I don't want to say abrupt but quite terse in the communication. That almost helps to make it make it feel direct when it's a very, very focused conversation that's short and sharp.

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**Pamela Ritchie:** Let's talk about the word "pain" because it was included in there for a reason, it was included in there for people to understand that when all eyes are on inflation there will be some pain inflicted. Let's dig into that a little bit. I think we mostly know what that means. The cost of capital goes up and that disrupts areas like the housing market, like our ability to spend on other things.

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**Ilan Kolet:** So, what did Chair Powell say specifically? Chair Powell said "While higher interest rates, slower growth and softer labour market conditions will bring down inflation they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation but a failure to restore price stability would mean far greater pain."

So what does that mean? What does that really mean? This is something, again, I heard at a conference I attended in May where I had a chance to sit next to John Williams, the head of the New York Fed, where he discussed some of these topics. Pain for households and businesses, for households what that really means is the labour market is likely to soften. The labour market right now is excessively tight.

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**Pamela Ritchie:** Sorry to interrupt you but on Friday the expectation is for 300,000 jobs in the U.S. to have been created.

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**Ilan Kolet:** Exactly. There are lags to decisions in monetary policy and you would expect to see a slowing in the pace of hiring. But in terms of the pain to households it's in the form of a few things. One, I would expect hiring to slow and perhaps for the unemployment rate to actually drift higher or perhaps not drift any lower. Early indications from, for example, weekly initial unemployment insurance claims already suggest that's happening. The other way to think about pain to households is through housing market and through consumer spending. Different parts of the economy have different sensitivities to interest rates. Generally, the most sensitive parts of the economy to interest rates are the housing market and discretionary consumer spending. Let's think about this for a second. The housing market, when the Fed or the Bank of Canada is in a rate cutting environment, the first switch to flick is the housing market.

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You normally have prospective home buyers on the sidelines waiting for some sort of relief in rates and when monetary policy authorities are dropping rates or cutting rates that's a very cyclically sensitive, rate-sensitive part of the economy, just like consumer spending is. You can imagine the same thing for large durable assets.

If you need to borrow money for a washer dryer or a car, that's very, very rate sensitive. Now let's just flip that on its head. With rates moving higher, I would expect principal homeowners, they'll manage their expenditures and their income such that they always make that principal mortgage payments or rental payment but the frothier parts of the housing market, the more speculative elements, those will certainly come under pressure. For anyone living in Toronto or Vancouver, we're already seeing it.

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Also for discretionary consumer spending, it's maybe one fewer trip to Canada's Wonderland in the summer than you've done in the prior years. Might be a hard sell on my kids but these are the sort of discretionary cuts that you have to make. That's on the household side.

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**Pamela Ritchie:** Let's just go into the services/goods discussion that you and I have had. This was a big change. It was part of the reopening story going back to services. We've seen the line-ups in airports and all the bags that are not being taken and so on. Every other type of service job that has, I think you've told us, has come back; it has recovered; it has reopened and recovered. Now we'll be hit, presumably.

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**Ilan Kolet:** This is going to be very interesting. This is a multifaceted discussion, so it'll just take me a few seconds to set it up. What did we see during the pandemic? We saw consumers who were shut in their house and unable to purchase services, meaning restaurant meals and vacations and travel, kind of switch their discretionary spending towards goods. We've sort of joked that every single Peloton and air fryer has been purchased – those are good complements probably. All of those have been purchased and goods prices shot much higher than their trend-growth line and services came under tremendous pressure. Similarly, the labour market, the parts of the labour market that were really hammered and hurt the most were services jobs because it was just an evaporation of customers and clients.

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But services spending has now fully recovered the lost output, at least in the U.S., and is now back to normal. That exactly speaks to that anecdote of long lines at airports or bad service in restaurants and stuff like that. That's a meaningful dislocation to the economy. That's the real activity.

What that has meant for prices is services prices have pushed higher. When we measure inflation, we often talk about CPI or the Consumer Price Index which includes all sorts of items that households purchase but the more important part of measuring long-term sustained inflation is core inflation which generally excludes food and energy. Seventy-five percent of that underlying core pie are services prices and services prices are determined by the labour market and wage growth and those are very slow moving and that's why I think, and I'm sure we'll get to this, that's why I think it's very pre-emptive for us to raise the "Mission Accomplished" banner on inflation because while the year-ago comparisons have rolled off and perhaps we've begun the slow and steady decline back to a more normal environment, stubbornly high inflation for a long period of time can be just as damaging as an elevated one-time, one-month number, in fact, can be more damaging. That's affected our positioning as well.

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**Pamela Ritchie:** Let's get into that. What's been accomplished is services are back in terms of their levels but what is also slowly being accomplished is they're going further. This has to do with the labour, the wage story. How has that particularly affected your positioning? That has to do with the stickier longer inflation, essentially, sticking around.

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**Ilan Kolet:** Yes, that's right. It's important for us to remember, monetary policy authorities, the Fed, the Bank of Canada, the Bank of England, the ECB, they're not just looking at one number on anything. They're not just looking at one number on the labour market. They're not just looking at one number on inflation.

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**Pamela Ritchie:** The favourite. That's what I keep hearing .

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**Ilan Kolet:** Exactly. That's true and oftentimes we think in comparisons to 12 months ago but again, they're looking at comparisons to 12 months ago, six months ago, three months ago, one month ago. There's just an enormous amount of ways to slice this data. When I look at the details of the data, and I still look at all 354 lines of PCE data when it comes out every month like I did when I was a researcher, it's really clear to us that the services component has pushed higher and is going to remain sort of stubbornly high.

The reason for that is, and we've talked about this in the past, the single most important determinant into the price of a service is the wage that you pay the person doing the service. If you go to the mechanic, it's not the part that gets imported that's expensive, it's the person's time. Looking at things like a U.S. trimmed mean PCE price index which trims off parts of that price index, that's a straight line higher and is sitting at almost 4.5%. That's a lot lower than the normal PCE price index but it still points to a very, very elevated sort of stubbornly high inflation environment.

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To answer your question, Pamela, on how that affects our positioning, we still own asset classes and have overweights to asset classes that protect against unexpected changes to the rate of inflation or elevated inflation. Those are things like oil and gold. So really, no matter how you slice inflation oftentimes the asset classes that do the best job of protecting against elevated inflation rhyme with commodities. They're either commodity producers or the underlying physical commodity or companies or countries that have high exposure or betas to commodities.

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On the right-hand side of this we're looking at the Global Balanced Fund, these are TIPS, fixed income instruments that specifically by construction protect against inflation. The size of these overweights may change and, in fact, you can see for the inflation-protected bonds we've trimmed that slightly but we still have a very high-conviction view on the damaging effects of inflation. For that reason, we have overweights to these asset classes. In fact, in hindsight we would have even had larger overweights to these assets that protect against inflation.

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**Pamela Ritchie:** Is it too late to put that further to work, to be more overweight?

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**Ilan Kolet:** No, not at all. The fund that we were just looking at is a very agile and tactical fund. We can, and do, frequently discuss the output and what we're seeing from our process from our researchers, from the bottom-up stock pickers or credit analysts and we do tweak the overweights and underweights as we see fit. Sometimes, Pamela, that question comes up in the context of that Inflation Focused Fund that we launched at the end of September of last year.

While the headline sticker shock number, we may not surpass that again, we are not just sliding back down to the 2% that we knew and loved for the previous 20 or 25 years. That still implies inflation and the damaging effects of inflation which are particularly damaging for multi-asset class portfolios, is something we want to protect against.

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**Pamela Ritchie:** I want to ask you – so basic and I think everyone knows the answer to it but I sort of want to hear how you take us through it – are we late cycle?

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**Ilan Kolet:** There's a few answers here and I don't want to sound like an economist, so I'll try not to provide every possible answer here.

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**Pamela Ritchie:** You're not an economist.

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**Ilan Kolet:** That's right. Exactly. Good point. Although that's the historical training. We work very closely with our research team, our asset allocation research team based in Boston. That's the team I used to sit on and the woman who sat next to me was actually an expert in running models and developing models that discuss or decide what stage of the business cycle various countries across the world are in. Folks on this call have probably seen a chart with dots representing where various countries are in terms of the business cycle. That research group has Canada and the U.S. in late cycle right now. But there's a diversity of opinions here. You've probably heard from colleagues on my team, David Wolf or David Tulk, mention that it's not impossible that we are actually in a recession right now in Canada and/or the U.S.

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Now, again, the way economic data and recessions work is they're going to tell us in 6 or 12 months, oh, by the way, a year ago you were in a recession. It's always a little odd that way but it's not impossible that once the dust settles on the data we actually see, look, there was a mild recession that happened in 2022, in the second half of 2022. Again, it wasn't a 2008 and it wasn't a COVID recession but it was the type of pullback that we haven't seen in some time but is much more normal than in '08 or a COVID recession. It's a pullback in consumer spending, a pullback in housing activity and retailers running off their inventories. We shouldn't anchor to 2008 which was a 1-in-100-year type of event, or COVID which was like ... I heard former chair, Ben Bernanke, describe it as putting the economy in a medically induced coma. Those are very odd types of downturns.

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**Pamela Ritchie:** Will Canada have to raise rates to keep up with the U.S.? Are there implications for the currency?

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**Ilan Kolet:** One of the things that we highlighted in our last thought leadership paper, which I would recommend everyone to have a peek at and speak to their sales team about getting that, is the difference between Canada and the U.S. in terms of monetary policy normalization. There's a meaningful difference here. Normally, monetary policy cycles in Canada and the U.S. are highly correlated and colinear. Again, both in Canada and the U.S. we have very elevated inflation. We have a tight labour market and we have monetary policy normalization but that's where the similarities end. The U.S. is a resilient, very dynamic, very resilient economy with very flexible labour markets and Canada just isn't that.

In a very tight labour market, for example, you have people job jumping very, very quickly. In a downturn, the adjustment, if the necessary adjustment in the economy is X million jobs have to go away, that happens quite quickly. It's not normally a prolonged process. But the real difference in our thinking between Canada and the U.S. right now is aggressive monetary policy normalization in the face of elevated inflation is going to have very, very different knock-on effects in Canada versus the U.S. I think the U.S. can probably withstand the rate normalization.

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There will be some pain, as Chair Powell mentioned, but in our view the pain is going to be magnified or amplified in Canada. That's because of something we've discussed several times, extraordinarily elevated debt levels, a huge mountain of debt with very rapidly changing borrowing costs. That does present sort of a Canada specific problem whereas U.S. households repaired their balance sheets following the financial crisis. Canadian balance sheets just kept churning higher. Now we're in a situation where the monthly carrying cost of those debt loads is going to become quite a bit more painful.

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**Pamela Ritchie:** Let's go a little bit, if you don't mind, with some of the time that we have left to looking out to for how long do rate rises have to go on for. We've had this sort of front-loaded discussion, discussion whether the September rate rise will be another 75 basis, what will it be, how much and so on but ultimately, it's really a question, it seems, of when they can suddenly start cutting. That's what the market and the pivot discussion was trying to price in, trying to figure out when that was all going to happen. How different does the landscape to you look after Jerome Powell's speech on Friday?

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**Ilan Kolet:** I should be really, really blunt here. Any potential rate cuts are likely a long ways off.

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**Pamela Ritchie:** A long way like January?

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**Ilan Kolet:** Oh, no further than that, in my view. We don't specifically forecast meeting by meeting rate decisions but let me set up why I think anyone sort of clinging to the rate cut raft is probably in for some trouble.

What will govern the path of monetary policy is the path of inflation and the broader damage and the depth of that damage on the greater macro economy. Right now, the macro economy looks like, in the U.S. and in Canada perhaps, it looks like it is basically digesting those rate hikes. Again, in my view, we're still in the normalization phase. We're not really even in the intentionally restrictive phase of the rate hiking cycle. There's quite a bit more to do, I think, and what the Fed is going to need to see, and we'll see this evolve in their language and I'm sure we'll have discussions as that language evolves, or I'd love to have discussions as that language evolves, you won't really see it in the actual rate decisions but you'll see the language change in between meetings.

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Imagine a case where we get five more months of slowing monthly inflation prints with a slight drift higher in the unemployment rate, then you could imagine the language from the Fed or the Bank of Canada begin to evolve in such a way that it doesn't sound as forceful or as aggressive as what was delivered by Chair Powell last week. That was a stern sort of talking to, in my opinion, and that is exactly the right tone to take when inflation is very far from where it needs to be.

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**Pamela Ritchie:** I want to really ask you this question about belief. You'll see all kinds of headlines, the central banks of the world have to get the trust back and do we believe and well, there's a mid-term election coming up in November and so by then the Fed won't be able to go tough. Go to that question of belief. He sounded pretty believable on Friday but that's more for you to answer than me. I'm curious, should markets believe what he's saying and will something like a mid-term election throw him off course if he sees inflation?

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**Ilan Kolet:** I would say quite the opposite. I jotted down one line from Chair Powell's speech where he says, "Restoring price stability will likely require maintaining a restrictive policy stance for some time. The historical record cautions strongly against prematurely loosening policy."

I don't know how much more clear he can be to say, let's move away from this sort of delusionally optimistic view that we're suddenly going to get rate cuts or a pause in the rate hiking cycle if inflation has one more month that's in line with the Fed. That's just not convincing. We're far away from that. These are views that are specifically expressed in the portfolios that we manage for Canadian investors. That speaks to, number one, why we continue to hold inflation protection but two, our general overweights and underweights are very, very muted. For example, in equities outside of our commodities overweight we're roughly neutral equities to our strategic benchmark. So again, we're managing these portfolios for the long term and we do take monetary policy and all policy very seriously but that's why we have the muted bet sizes that we do in these portfolios.

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**Pamela Ritchie:** Absolutely fascinating to get your thoughts. Ilan Kolet, thank you so much for joining us today and taking us through how the positioning works and ultimately how you interpret the remarks over the weekend. All the best.

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**Ilan Kolet:** Thanks, Pamela.

[00:25:53]

**Pamela Ritchie:** Thanks for joining. I'm Pamela Ritchie.

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