Fidelity Connects

Higher for Longer: Bond Market Outlook Amid Persistent Inflation

Sri Tella, Portfolio Manager

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

Portfolio Manager Sri Tella joins us on the program to provide his outlook on the bond market as the year comes to a close and how he's positioning his portfolio heading into 2023.

Sri says overall, the outlook for the bond market is still uncertain for the next 6 to 9 months. He adds there is a lot of volatility right now, so he's taking a more defensive position focusing on good cash flow, and strong, stable businesses.

Sri also discusses the Bank of Canada's upcoming rate announcement and inflation concerns.

He says the pace of rate increase is likely to slow down, but rates will still go higher. The big disconnect going forward is that the market is expecting some sense of pivot through the next year for rates to fall. But he says rates will stay elevated for an extended period of time.

Regarding inflation, Sri says it should temper over the next year. The core and the month over month numbers will remain sticky, but we should see the main headline CPI number come down. The real question is where will it stand in the next 6 to 9 months? Does it get back to 2 percent or stay elevated at the 4 percent range.

This podcast was recorded on December 2, 2022.

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Bryan Borzykowski: Let's start big picture. December 7th is the last rate announcement of the year by the Bank of Canada. What are you looking for? What are some scenarios that you could see maybe playing out on that day?

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Sri Tella: Well, I think the Bank of Canada has done a good job of setting expectations for the market. I think what I'm kind of expecting for the next meeting is, basically, messaging that rate hikes to date have done a lot of what the bank's been looking for in slowing down the economy, helping to temper inflation, but yet there's still a lot of work to be done. It's the same message we're getting out of the Federal Reserve in the U.S. as well. So, the pace of rate increases are likely to slow down, but yet rates will still go higher. I think one of the other things that we'll be focusing on as it comes out is what's the path as we get to these higher rates, how long will we stay there? I think that's where the bigger disconnect is going forward; is that the market is expecting some sense of a pivot through the next year for rates to fall, but the central banks have been pushing back against that and kind of implying that rates will likely stay elevated for an extended period of time. They may not keep rising, but they're likely to stay at a higher level.

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Bryan Borzykowski: I wonder, do you think the Federal Reserve, the Bank of Canada, will they sort of continue on a similar path or does the Bank of Canada do something different from the Federal Reserve as we kind of get into next year?

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Sri Tella: Generally, if you look back over history, the Bank of Canada and the Federal Reserve moved fairly close to one another largely because the economies are very linked. However, there have been periods of time where policy needs to differ and has differed. When you look back to 2015 when oil prices disproportionately impacted Canada, but in the current environment, I think, given the leverage of the Canadian consumer and how much more tied the economy is to housing and how sensitive that housing market is... more sensitive in Canada to higher rates, I think what we're likely to see is that the Bank of Canada doesn't need to raise rates as much as the Federal Reserve.

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You're starting to see that priced into markets where, in Canada, the terminal rate is expected to be maybe another 50 basis points higher, in the low 4s, 4 1/4, whereas in the U.S. it's expected to be closer to 5%. The combination of the Bank of Canada starting slightly earlier in tightening policy, but also the sensitivity of Canadians to the housing market and interest rates more so than in the U.S. will mean that the Bank of Canada is likely not going to need to raise rates as much as the Federal Reserve. But there is a limit to how much they can diverge because there's a lot of other implications.

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Bryan Borzykowski: What happens? If we see that divergence, what does that mean for Canada?

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Sri Tella: I guess the biggest thing we need to think about... one of the reasons ... I guess I'll go back to ... part of the divergence is that with the U.S. raising rates, that automatically has implications on Canada. One of the reasons is Canada doesn't need to be as aggressive. The bigger issue is, I think, is when it starts to impact the currency. If those policy rates diverge by too much, then that potentially has a knock-on effect to weakening the Canadian dollar. A weaker dollar can be good in certain aspects to make our exports more attractive, but, at the same time, when you're looking at inflation and a weaker dollar makes it more expensive for Canadians to buy things that are imported, so that's a feature. The biggest thing is wanting to keep the currency in sort of a tighter range. If there's a big divergence, that's when it starts to cause problems for the Bank of Canada.

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Bryan Borzykowski: Does inflation start to moderate at some point soon? It's Friday, I'm going to make steak tonight, but those things are getting expensive. Where do you see that going in 2023?

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Sri Tella: Just by pure math alone inflation should temper over the next year. If you look a year ago, numbers and how high inflation was, even if we keep at a monthly pace that's consistent and not going down, the year-over-year numbers should naturally drop. We've already started seeing that from a peak of over 8% to just under 7% more recently. We'll continue to get more data in the coming weeks. We should see the headline number come down. That being said, the core in the month-over-month numbers have still been fairly sticky, and so we should see the main headline CPI number come down, but the real question 6 to 9 months from now is, does it get back to 2% which is what the Bank of Canada would love to see, or does it stay elevated in kind of that 3 to 4% range? Obviously, moving to 4% from 8 is a positive, but it's still above what the Bank of Canada would like. That's part of the reason why we could see rates stay somewhat elevated.

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Bryan Borzykowski: Housing. Naturally, everybody is focused on that in Canada. What is the impact that you're seeing on higher rates in the housing market? Housing is such a big part of our economy, so what could the implications be if things slow down?

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Sri Tella: We're already starting to see it show up in the data. Obviously, the biggest has been in housing activity. We've, obviously, seen house prices come down as well, but the biggest move so far has been in resales and sales of housing that have come down sharply because of how much interest rates have gone up and the fact that the sensitivity of borrowers to higher payments and affordability has already been a concern for a number of years in Canada. Higher rates will have an impact on house prices and housing activity, and we've already started to see that. It's likely that we'll see further pressure going forward just given it's more expensive for new home buyers. It's going to be more costly for refinancing your mortgages, and so more money is going to be going into housing.

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What I do think is that, while we'll see housing temper and prices probably come down, my base case is not really a housing crash per se. You have to keep in mind that prices went up as much as 50% in the last couple of years, so even if we see prices come down 10 to 20% over the next little while, there's still a lot of equity built up, so people have value in their houses still. The big knock-on effect to the economy is really more if you're spending more for your mortgage, you're spending more for your steak that you're going to have tonight, that means you're going to have less money to spend on other things. The base case is really it's going to impact discretionary spending because more of your money is going towards essentials. That's where the knock-on effect and the slowdown in the economy will occur.

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Bryan Borzykowski: We already have a question from an advisor, and I was thinking this as well. The question is, is it possible that central banks overshot on the upside with rates and like how they did on the downside during COVID — I mean, maybe that could be up for debate— but have they overshot? That sort of was leading to me a question that we had talked about earlier was just, what is the rate? For the last ten years, a lot of people have gotten used to very low rates. The conversations I have with my friends about their mortgages; they can't believe we're going to 5%. When I bought my first house it was 5% and that was already on its way down. I guess, maybe the central bank did overshoot. What do you think about that and what should the expectation be from people around rates?

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Sri Tella: The easy answer to say is that we won't know whether they overshot until we get 6 to 12 months from now and see what the impact is on the economy. I think part of the perceived overshooting, or the aggressiveness is that they maybe started raising rates a little bit later than they should have. There was a lot of people that viewed inflation as transitory. There's a number of good reasons why people thought that. Now we're starting to realize the things that were missed in terms of persistence of inflation. I think that the overshooting, I guess… yes, in the sense that it will slow down the economy and there will be a hit to growth, but I would say that at this point in time the overshoot is… I wouldn't quite call it overshooting in terms of rates because employment is still strong, and the central banks won't ever come out and say this, but they need unemployment to go up. They need the economy to slow down.

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The Bank of Canada forecasts have very low growth. I don't think they really want to be in the business of forecasting a recession, but they would want to see a mild recession or maybe a couple of quarters of negative growth; that would probably help them on the inflation front. I think the focus is solely on inflation at this point, and there's a lot of cushion in the employment numbers. In fact, we got decent numbers in Canada today; we got another strong print in the U.S. this morning. I think until we start to see that turn down a little bit the central focus is going to be on inflation.

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Turning to your second question about what's the ultimate rate, we have to keep in mind that zero or 1% rates were around for emergency measures. We've been in a low-rate environment for the past 13-14 years since the financial crisis. There have been a number of crises through the period that have resulted in low rates, so unless we feel that we're going to be in a permanent crisis going forward, we are unlikely to see rates be back consistently at such low levels. Now, at the same time we're already starting to see that 4-5% rates, 4% in the overnight and 5% in other fixed-income markets are starting to be restrictive from an economic standpoint. Where's the right level? It's probably somewhere in between. I think the Bank of Canada likes to sort of think of it as, maybe 2.5 to 3.5%. The Federal Reserve has targeted a long run rate of 2.5%. I think those are realistic assumptions. When do we get there? That could still take some time but likely somewhere in that range is probably realistic.

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Bryan Borzykowski: Let's move into bonds. For the last several years being a bond manager was difficult. Now I feel like you may be having a little more fun as a bond manager. How has the environment shifted for you?

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Sri Tella: It's no surprise that the last year has been a tough one for bonds. As you said in your introduction, it's been the worst year on record. I think we've got our first slide we can put up and show to folks. The returns on fixed income have been … year-to-date we're looking at double-digit negative returns. On the bright side, we're now at yield levels that are much more attractive. If you look back at this chart, I think this is a great chart to show that, generally, fixed income has positive returns. There were very few years of negative returns. In fact, if you look at this, obviously, this is only the first time where we've had back-to-back negative returns. That's really just because of when the rate normalization happened.

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The thing that's exciting now going forward is if you think about... part of the reason we've had such large negative returns is, one, the rapid increase in rates, which is obvious because when rates go up, bond prices go down, but the bigger issue is really where we started from. When you have sub 1% yields, you have no income on fixed income: you're not earning anything. That income in yield is usually what protects you in a volatile environment or when rates go higher. Now we're looking at yields that are 2 to 3% higher, almost double where they were at the beginning of the year.

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If you're looking at sort of the broad fixed income index, now you're actually earning something on your fixed income investments that provide a cushion. When you're earning 1% and rates go up by 100 basis points, you're obviously wiping out more than what you've earned on your bonds. When you're looking at yields of 4 to 5% and you're at a much higher rate level, you can even withstand a further increase in rates and still have positive returns in fixed income.

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I think we've got another slide looking at the spread markets and credit markets. You can see this is as of the end of October. This month we've seen yields come down a little bit and spreads tighten, but, as you can see, really focusing on the bottom numbers, the percentile ranks of where we are in yields and spreads, we are at the cheapest levels or close to the cheapest levels we've been over the last, since the financial crisis, essentially. What this tells me is that there's a lot of yield and income that you can earn. On a longer-term basis, fixed income looks very attractive. Now, there's a lot of volatility and caution to be warranted in the short-term but it's hard to time the markets and given where we are from a historical standpoint and the fact that you're earning some income to protect against volatility, it makes fixed income look a lot more attractive.

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Bryan Borzykowski: How do you know as a manager... you don't want to time the market, but we do know, it's pretty safe to say that the Bank of Canada is probably going to raise rates again, as you've mentioned. How do you sort of approach maybe that near-term buying of bonds if you know that rates are still going to rise a bit? You can get a better yield maybe in a week from now. How do you kind of manage that in your portfolio as to kind of when and where to buy into?

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Sri Tella: I caveat the answer with ... obviously, as a fixed income manager I have to be invested in fixed income regardless of the outlook. But we do have ways of managing around what our outlook is. The other thing we have to keep in mind is where we think rates are going from an overnight basis and what's priced into the markets already. If you look at, for example, the overnight rate being 3 3/4% and then the 2-year north of 4%, obviously, there are rate hikes priced in over the next little while, so we have to look at what we think the Bank of Canada will do versus what's already priced in. If they don't do as much as what's priced in, then there's actually an opportunity for rates to go lower in what we invest in.

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Now, the other side, though, is if we do think rates are going higher, we sort of approach it from a breakeven standpoint, as I mentioned. If we're looking at 1% yields and we think rates are going to go up 100 basis points, you're going to want to be underweight on the duration front, own shorter duration bonds. If you are earning 4% and you think rates are going up 25 basis points, that 4% is going to more than offset what you're going to lose in price terms for the yield coming down. I think that's a real benefit of where we are right now. At the same time, given that we're cautious right now on the near-term outlook, even though bonds look attractive from a longer-term basis, we favour shorter-duration bonds in terms of corporate bonds because they can withstand bigger spread widening. We can adjust on points on the yield curve. What we're trying to do is identify opportunities for specific names or securities that will outperform even in a rising rate environment. The key is when you're investing over a long-time horizon is to minimize the downside when you have these periods of volatility and then maximize the returns when you have positive markets.

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Bryan Borzykowski: On those opportunities, maybe we can dig into some of that a bit. I guess, government versus corporate, maybe we can start there and then we can talk more about sectors. On those two, what's looking attractive?

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Sri Tella: As we showed on that second slide, credit spreads do look attractive on a longer-term basis, but there's going to be a lot of volatility. We could potentially be heading into a recession. Rate volatility is difficult on corporates and on corporate bonds. That being said, I think you want to be invested in corporate bonds for the longer term because of where valuations are and also given how much rates have come up all of these bonds are trading at discount, so you know you're going to get paid par assuming you're invested in the right names and not worried about a default. That's kind of the key. I think corporate bonds do look attractive, but thinking about government sector, provincial bonds are also a great spot to be right now.

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If you look at provincial finances are much better than expected. They've gotten a big tailwind from nominal growth. Their deficits are falling; in many cases provinces are reporting surpluses. They're not going to need to borrow as much money going forward. Provincial bonds look great on that perspective in, I'd say, in the next year or so. Now, of course, if we're heading into a recession, that's something to watch for if borrowing is going to start picking back up a year from now. In the near term, provincial bonds look good.

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On the corporate side, a couple of areas we like are financials. The Canadian banks have had some technical reasons for spreads widening disproportionately and high-quality bank paper. That's a sector that we like on a longer-term basis. Defensive areas like utilities and infrastructure, airports... those are other spread sectors that look relatively attractive. You also have the benefit... for example, in the airport sector they're still benefiting from the reopening of COVID and traffic increasing. That being said, even sectors that are out of favour like real estate, there's going to be pockets or certain names that are strong performers within those spaces. We're really focusing a lot on individual companies and names that will be outperformers in a tough economic environment.

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Bryan Borzykowski: What would be the characteristics of a strong company that you'd be interested in? Even if you're looking at some of these sectors that may be out of favour, what makes for a good business?

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Sri Tella: Something, obviously, with stable cash flows, relatively low-leverage and high-liquidity. We've proven through history that the real stress case during crisis periods is when you might have a very good company and Lehman was probably a perfect example of this back in the financial crisis— strong, big company, but they just had liquidity issues. They didn't have the money handy to pay the bill that was due the next day even though they were a very large corporation. This is something we spent a lot of time, especially through COVID, was thinking about what companies have appropriate cash on hand, access to capital, even when things get tough. That's kind of the things we focus on; good cash flow, strong, stable businesses that have a steady business operation even through volatile economic times.

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A perfect example in real estate… obviously, people are concerned about real estate but if you look at REITs that have grocery-anchored strip centres, that's kind of their primary asset they invest in. Think about Loblaws, Sobeys, Metro, any of those stores; regardless of the economic environment, people are going to shop. For example, go back to the steak example, you're going to probably go to one of those places to get your steak or at least a lot of people would. Those are businesses that will have stable cash flows even through a tough economic period. So, as long as those companies are operated properly with low leverage and have liquidity; that's an example of a good asset in a bad sector.

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Bryan Borzykowski: Taking all this into consideration, what you just said, how are you positioning your portfolio in today's environment? Are you making any changes or what are you keeping the same?

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Sri Tella: Yes. As I mentioned, we like corporate bonds, so we do continue to have a weighting and allocation, an overweight to the corporate sector as well as provincial bonds for the reasons I mentioned before. Because the outlook is still uncertain over the next 6 to 9 months and we're seeing a lot of volatility in the market, we want to be invested in these sectors because long-term they look attractive. That being said, we're more defensive in our positioning. For example, we've reduced triple-B exposure and moved into single-A and double-A exposure. Part of that is favouring the Canadian banks which are much more stable credits and moving away from lower rated credits with high leverage.

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As I mentioned, if we get into a recessionary period, it's the highly-levered companies that will really start to struggle. Defaults will tick up, but we're not worried about any massive spike in the near-term, but we want to be cognizant of what it means for market valuations. It's keeping an overweight to spread product but being more defensive in the names and sectors that we hold.

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Bryan Borzykowski: A lot changes in a year. At the beginning of this year the 60/40 portfolio was dead. 60/40 is dead, that was the headlines. Now, 60/40 is back. Is it back? Should advisors now be considering adding more bonds into a balanced portfolio than they may have a year ago?

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Sri Tella: I would say that definitely that would be the case. Of course, I'm biased being a fixed income manager but if you go back to the start of the year, it's hard to make the case when bonds are yielding 1-1.5% for them to compete with any other asset class. But when you're looking at 4.5 - 5% and in an environment where we could be facing some growth headwinds, that makes fixed income a much more attractive opportunity. The other thing is, if you look at yields on fixed income from the beginning of the year versus now, they compete more with other asset classes. The dividend yields on equities and even people move to private assets and that's still alternatives are a big draw.

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Alternatives have a place in a portfolio as well, but the sectors and the areas they invest in are going to be challenged with a much higher-rate environment. It kind of shows you the role that bonds have in an overall portfolio. At 1%, like I said, it was hard to argue that there's a hedge in there for risk aversion because there's not much for bonds to rally when they're at those levels. Now that we've moved to much more attractive pricing levels, they clearly are back to playing the role that they do in a diversified portfolio.

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Bryan Borzykowski: We talk a lot about Canadian bonds, but what sort of room does maybe international bonds, U.S. bonds, have in that diversification? Is it enough to stick with the Canadian market or do advisors need to look elsewhere to complement their Canadian allocation [inaudible]?

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Sri Tella: Just to be fair, I focus predominantly on the Canadian markets. That being said, I think a diversified portfolio makes sense. If you look at Canada and, let's say, North America as being a more stable market right now … obviously, Europe has a lot of issues with the impact of Russia and Ukraine, and energy prices and inflation there. Once you move outside, into sort of more emerging markets you're introducing a lot more volatility. There's spots you want to pick and choose, but Canada has been a good place in terms of the ability and growth. It's still leading the G7 in growth and the prospects for Canada going forward are strong. Within the Canadian market, you actually have opportunities of foreign issuers that have been tapping the Canadian market and so there are definitely some good opportunities within Canada. Always, diversification across geographies is a good thing, but for Canadian investors who want to sort of stay invested in the domestic market, I think Canadian fixed income is as attractive as any of the other markets.

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Bryan Borzykowski: We're almost done, but I'm just wondering about currency. The Canadian dollar has been down compared to the U.S. dollar. You were talking about the interest rate differential potentially in the future between U.S. and Canada. What is the impact that lower dollar might be having on what you're doing just maybe generally, and do you have any sort of thoughts on how that could play out over the next year?

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Sri Tella: I guess looking at it a couple of ways, the weaker currency has actually been a bit of a boost to some of the finances of some of the headline areas of Canada. If you think about the fact the energy producing provinces and energy companies that are selling commodities in U.S. dollars, but now earning more Canadian dollars as a result of that, that's been a boost from that perspective. It's made things more competitive internationally. Now, the issue is if you have growth slowing down across the board then that's going to have an impact on exports and maybe that has less of a benefit to Canada.

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The flip side of it is weaker currency makes it more expensive for Canadians to buy things that are coming from abroad. Given that the focus on inflation is front and centre right now, that's going to be a headwind in terms of making it more difficult for the Bank of Canada to control inflation. I think that's an element of where I think that the Bank of Canada is going to have to be cognizant about that differential and the weakening in the Canadian dollar. That's kind of the extent of where I would look at it. I'm not a currency expert, but I think the Bank of Canada likes it to stay in that range where we're competitive, but not to the point where it's so weak that it's impacting us from foreign investment and inflows.

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Bryan Borzykowski: Just to wrap it up, any last thoughts on the bond market, the future of 2023? What would be your parting words of advice for the advisors listening in?

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Sri Tella: Kind of the theme of the whole conversation has been fixed income is a much more attractive place to be. There's, obviously, a lot of caution and volatility in the markets broadly, not just in fixed income but across the board. Fixed income is back to sort of having its attributes of playing a role in a diversified portfolio. The outlook for fixed income going forward, given where yields and rates are, are very attractive on a long-term basis. I'll just go back to the other point that I made earlier; it's really difficult to time the market. When you have historical valuations that look this attractive, I think it makes sense to start getting back into fixed income and adding but keeping some dry powder to add as we get more volatility or any sort of turbulence in the markets. We're starting to see that broadly, in terms of flows, especially from institutional clients that are starting to reallocate to fixed income given how much valuations have improved.

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Bryan Borzykowski: Great, we will leave it there. Thank you so much for this. That was very insightful and looking forward to chatting with you again soon.

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Sri Tella: Thank you for having me.

Ending: [00:31:51]

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