Fidelity Connects

FMP, the Fed and Midterms

David Tulk, Portfolio Manager

Bryan Borzykowski, Host

[voice-over:]

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

Between the Fed's latest rate move, the U.S. midterms, U.S. CPI print, and continued focus on both earnings and inflation – the economy has definitely been jolted leaving investors to question what is next.

As we venture through this uncertain environment and look ahead to year-end and 2023, today we're joined by a sensible expert here at Fidelity – David Tulk, Portfolio Manager on the Global Asset Allocation team.

David joins host Bryan Borzykowski to reflect on the numerous factors affecting markets right now. This includes action by central banks, with David noting central banks will continue to take stimulus out of the economy and continue to leave financial conditions very tight. David also shares how the market is currently pricing in a 50-basis point rate hike from the Fed in December, and he'll look at factors determining how deep of a recession could be on the horizon.

David also shares a positioning update for the Fidelity Managed Portfolios and other funds managed by the Global Asset Allocation Team. This includes areas of interest, and current overweights and underweights.

Today's podcast was recorded on November 10, 2022.

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Bryan Borzykowski: Hi and welcome to Fidelity Connects. I'm Bryan Borzykowski. David, thanks for joining us.

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David Tulk: It's my pleasure. It's great to be here.

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Bryan Borzykowski: Let's start off with the big news today. CPI came a little bit under what maybe analysts and economists were expecting. What do you make of the numbers?

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David Tulk: We don't want to ever read too much into a single print but yes, the data did come in a little bit softer than the market and analysts had forecast. A bit of a deceleration in headline inflation, part of that was kind of to be expected given some of the year ago price effects falling out of the math. Core also, which is something that we've paid a lot of attention to, that was also a little bit softer than the market had expected. I think we need to ultimately put some of these numbers into context.

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First and foremost, inflation still is well above where central banks want it to be. To suggest that a single print, or even a bend in the curve of inflation, is going to allow central banks to move to the sidelines or even contemplate cutting interest rates, I think that's woefully premature. Far be it for me to rain on the market's parade today in response to the downside surprise, but I think we still have a fair bit of ground to cover in terms of getting inflation back under control. Until that happens, central banks are going to continue to take stimulus out of the economy and continue to leave financial conditions more broadly very tight.

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Bryan Borzykowski: Do you think that there could potentially be more rate hikes in the future then?

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David Tulk: Absolutely. Maybe what we could potentially see is a slower pace of rate increases. The market currently is still pricing in a 50-basis-point rate hike from the Fed in December, so between now and the end of the year. Certainly, I think other central banks around the world will be moving close to lockstep with that move as well. When we think about where policy needs to go in this environment, we're in what I would describe as the nebulous cloud of neutral right now. You think about where an interest rate needs to be to actually slow the economy, we're kind of close to that I'd say, but I think to get inflation truly back to levels that central banks want to see, they need to take those interest rates to a legitimately tight setting.

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To even see real interest rates move positive at this point, they're still not quite there either. From those perspectives, I think we should still brace ourselves for additional rate hikes and a continuation of the hawkish message from central banks, such as we heard just last week from the Fed that the market seems to have glossed over today, but, unfortunately, I think we'll be reminded of the next time the Fed meets or we hear from senior Fed officials.

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Bryan Borzykowski: Great. What about the midterm elections, which always seem to be kind of never ending in some ways, especially in the days after the votes. What are you seeing from that and any thoughts on how that might impact the market?

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David Tulk: At least in terms of the results, obviously, we're still waiting for everything to be finalized, but when it comes to political events like elections, our philosophy generally is to anticipate the policy and tend to ignore the politics itself. Insofar as, if the consensus carries the day and you end up seeing a split Congress at this point, that tends to maybe

diminish some of the policy impulse that we'll get from an alternative where it's all of the House of Congress, the House, the Senate and the president are all leaning in the same direction. Absent that, we should probably just brace ourselves for a little bit more gridlock, at least politically. That can at least diminish the likelihood of getting a lot of additional fiscal stimulus. When we think about where the inflation story is and what central banks are doing, certainly additional fiscal stimulus at this stage might prove to be counterproductive given what central banks themselves are forced into doing these days.

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Bryan Borzykowski: You put out a white paper recently where you outlined your approach to investing. It would be great if maybe you could share some of what you discussed in that white paper, especially your four pillars, which I found pretty interesting. What are those pillars and how does it influence the way you invest?

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David Tulk: Absolutely. I think, certainly, as a preamble to discussing the white paper itself, in these periods of heightened volatility, we as investors need to anchor ourselves. We have a very deliberate process. We don't want to become overwhelmed by market volatility or economic uncertainty. We always come to the pillars to help guide the decisions that we make in the multi-asset class funds. The pillars are macro, bottom-up, valuation, and sentiment. Each of those gives us a different way to look at how the economy is impacting the market. Those will ultimately dictate how we take the tilts away from our benchmark allocations but also decide what type of out of benchmark allocations we bring into the portfolio, either to enhance return or almost more readily, provide additional downside protection or risk management more broadly.

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Bryan Borzykowski: Maybe dig into some of those pillars. What are you finding in each one? Let's start with the macro environment. What's on your radar there?

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David Tulk: Absolutely. Well, let's get the bad news out of the way first. If you look at the macro pillar, certainly in isolation, it's a pretty daunting outlook today. Notwithstanding this morning's deceleration in inflation, I still would come to the conclusion that we have an inflation problem globally. We can put that in the context of a number of different factors, including central banks having less stimulus in the economy longer than what was ultimately necessary after the pandemic. We had a lot of fiscal support as well. We had ongoing supply chain issues, but we also generally had a misreading of the type of shock that the global economy encountered through the pandemic.

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A lot of this was just central banks and policymakers not fully understanding that this was a significant shock to supply. With supply remaining an issue even today, that means that ultimately inflation is likely to still be more persistent than what the market and central bankers currently believe. That inflation story, it's easy to maybe see a little bit of a roll over in inflation but, again, to the earlier comments, to get inflation back to low and stable levels I still think there's a lot of work that needs to be done. That means that central bank policy will need to stay tight and as a result, the macro story is telling us where we're ultimately ending up in a recession.

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We can certainly talk about the timing and the depth of the recession, but this is a comment that we talk about frequently is that central banks, their job, number one, is to bring inflation down. They're not evil, malicious people trying to throw people out of work and cause a recession just for the sake of it. It's, unfortunately, the collateral damage of bringing inflation back to low and stable levels. When we look at the macro lens, as we look out towards economic growth slowing, the pace of hiring, ultimately, slowing as well, it to us as investors suggests that we want to be somewhat defensive in our allocation. I know we'll have a chance to talk about positioning in much greater detail but that pillar alone as a signal to us is to say, well, the business cycle is advancing, recession probabilities are rising, so let's take our portfolio and move it into a defensive level and then the other three pillars inform how defensive we want to be at that point.

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Bryan Borzykowski: On valuations, on that pillar, what are you seeing there?

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David Tulk: Valuations for us, it's not a timing tool by any stretch of the imagination, but valuations will give us a sense of what range in which asset prices can move should there be a shock. One of the things that we're certainly worried about is when markets are at extreme valuations. When there's either a tremendous amount of good news or a tremendous amount of bad news already priced into a market and it's at an extreme level because we know that once a catalyst is realized, those valuations can reverse and sometimes in very dramatic fashion.

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Where we sit today relative to valuations is that we're not as at rich levels as we would have been six months ago, nine months ago. The extent to which we can modulate the degree of defensiveness we have so we don't need to be peak defensive in terms of also being worried about valuations in addition to the macro, we can take much more of what I'd say is a moderately defensive position. We don't use the full range of our tactical tilts in our portfolios, but instead we try to pick something maybe closer to a third to half-way defensive, because the valuation signal in isolation is not as negative as what the macro would give you in its isolation.

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Bryan Borzykowski: Great, and then bottom-up and sentiment, what are your observations on those two pillars?

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David Tulk: In the same vein as valuation they don't send as ominous of an outlook as what the macro would tell us. One of the big advantages that I have as a portfolio manager at Fidelity is access to a lot of company level research. I think about the world primarily as a result of my training as an economist. In terms of the big themes that impact the economy, I think a lot about what central banks are doing and I can also admit to, with a certain amount of humility, that over the last two or three years that hasn't been as reliable of a gauge, largely because we're somewhat in unprecedented times both in terms of wrestling with a pandemic in the modern world but also looking and understanding at what central banks and governments have done. Also, they're well away from their standard textbooks. All of that is to say that the macro lens, it's still helpful, it school grounds our process but it needs to be complemented by something.

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The bottom-up pillar where we can pull in a lot of information from what companies are seeing and what they're doing on a day-by-day basis gives us much more of a real time assessment of how the economy is unfolding and how markets are responding. Again, what that tells us today is that corporations have seen this type of events coming to some extent, at least in terms of higher interest rates and the probability of some of that sort of peak demand around the early reopening phase after the pandemic fading. Corporations are better positioned, to be quite frank. They have taken down some of their debt levels. They used the low interest rate environment earlier on to term out a lot of their debt. They built contingencies into their business plans to anticipate at some point demand would slow down.

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This is not going to stop earnings from slowing just as you would expect the wider economy to cool, but if you think of things that can go bump in the night from a corporate fundamental perspective, I think there's less today than there would have been earlier in past cycles. That signal to us, at least, says that corporate fundamentals are okay. Again, we can modulate how much we want to be underweight risk assets because we're not as worried about the corporate sector as we would have maybe going into something like the 2008, 2009 cycle that revealed a lot of corporate issues on top of what was happening in the wider economy.

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Finally, just to round out on sentiment, sentiment for us is very much of a contrarian indicator. We tend to want to go where people aren't, at least where markets have been taken over by a lot of momentum. One thing we've seen, certainly, recently is that sentiment is very much washed out. There is a lot of pessimism in terms of what investors are saying, at least in terms of how they're investing when we look at fund flows. The fact that there's so much negativity out there just means that things don't have to be good for the market to rally. Just things don't need to be as bad as what they had thought previously.

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Today's a perfect example of that where CPI is still an issue, it's still elevated, it's still very persistent, but because it wasn't as bad as what maybe the market had feared going into it, you see that snapback rally. We've seen a couple of examples of this, at least in these bear market rallies, in terms of equities. Again, knowing that that is something that we need to manage, we want to be at least able to capture a bit of that upside. Insofar as us taking our portfolio to a moderately defensive level as opposed to abjectly or maximally defensive is prudent as a result of that as well.

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Bryan Borzykowski: Let's talk more about your positioning. How has all of this, what we've just talked about, informed where you are putting your dollars?

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David Tulk: Our Global Balanced managed portfolio, this is one of the flagship funds that our team manages. It's also fairly familiar to the advisor and investor community as well and it's something that we bring out on stage every time we have a chance to talk about it. I'll give you the 10,000-foot perspective, at least in terms of stocks versus bonds. If you take out the commodity producer's allocation, which itself is a gold and energy ETF, so a little bit distinct from traditional equities, we are moderately underweight equities. That picks up on that theme of being moderately defensive. Where

we are overweight instead, is really more in the short-term cash type allocation. There are a couple of things going on here but, broadly speaking, given that we anticipate equities to be under pressure as the economy slows and as bonds will continue to struggle as interest rates move higher, we think that an okay place to hide out for now is in those short-term securities.

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That's just one very high level way of positioning ourselves to be moderately defensive. We can also be defensive in terms of our allocation to currency. I know we can dig into this in much more detail as well but the underweight we have to the Canadian dollar, on the other side of that, a lot of that is relative to the U.S. dollar. We're not only overweight the U.S. dollar versus Canada, we're also overweight the U.S. dollar relative to emerging market and G10 currencies as well. That's just another way to pick up on the theme of saying when the economy or when the market is vulnerable, investors do seek the safety of the U.S. dollar, so we want to have that view expressed in the portfolio as well.

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Bryan Borzykowski: There was actually a question about explaining the underweight in Canadian currency. Is there a circumstance where you might reduce that underweight?

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David Tulk: That's a very good question. We're always watching these allocations and we're carrying an investment thesis behind that. The motivation for the underweight, certainly, to the Canadian dollar, part of it is around the macro narrative. A little bit earlier on in the cycle, we had actually trimmed the underweight to the Canadian dollar because we wanted to pick up on the commodity tailwind that was very much a factor over the last year or two. But as we assess that position today, that commodity tailwind can still exist and we still have out of benchmark allocations to commodities but what we're more worried about, at least in the context of Canada, is the impact of higher interest rates slowing the economy. Canada, in contrast to the U.S. or other regions around the world, is much more vulnerable to higher interest rates. If that's the shock that we're managing, our job, at least from a regional equity perspective as well as from a currency perspective, is to shy away from regions where that vulnerability is particularly pronounced.

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Canada certainly is at the top of the list. The macro story is saying, well, if Canada's going to underperform other regions from a growth perspective, that's a motivator for being underweight the Canadian dollar. Similarly, I don't think the Bank of Canada can match the Federal Reserve in lockstep in terms of taking interest rates higher, especially as you get to that neutral level and beyond. If you think about it from a currency differential perspective, that would also tend to favour the U.S. dollar relative to the Canadian dollar, so that's another motivation to be underweight the Canadian dollar. Third and finally, as I touched on this earlier, when the market's under a lot of pressure and both stocks are weakening and maybe bonds are weakening, that's traditionally a market where you'll see the Canadian dollar weaken as well.

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To provide that level of risk management into the portfolio through the currency lens is something that we would also use and reflect in terms of the underweight to the Canadian dollar. If anything were to change, certainly on that front, I know the question is about reducing the underweight, if we were to be much more advanced in that macro narrative when it comes to Canada, that might cause us to reconsider. Certainly, the commodity story is also something we're watching

very carefully. If you think about the type of themes that I outlined that motivate the underweight, I think we'd be hard pressed to become outwardly optimistic and overweight the Canadian dollar, just given the challenges that we think Canada will face for quite some time.

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Bryan Borzykowski: You have an overweight a bit to emerging markets, which I thought was interesting. Why are there opportunities there?

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David Tulk: Basically, this comes back to the four pillars. When we think a little bit about the macro pillar, again, I talked about it globally in terms of the challenges that we face, but when we look at individual regions, there has been a little bit of a difference opening up between emerging markets and more developed markets. When we think about policy tightening, that's something certainly developed market central banks are continuing to do, but there's a little bit of policy easing on the margin taking place within emerging markets. If you want to think about it through the business cycle lens, you can make a case to say that the emerging market economies are a little bit more advanced through the business cycle, so there might be some scope for relative outperformance there.

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Obviously, we need to temper that because there's only so far that emerging markets can disconnect from what's happening in developed market economies, but if we want to play a little bit of offense from the cycle perspective, that can take place in emerging markets. Similarly, from a valuation perspective, emerging markets continue to be much cheaper than developed markets. There's a valuation argument for an allocation there as well. From a sentiment perspective, everybody and their brother are really against emerging markets now, even relative to other asset classes or geographies. The sense that, again, sentiment as a contrarian indicator does give us that motivation to say, well, this does maybe deserve a small position. It is a way for us, again, to play up the regional equity story and have a little bit of offense in addition to a lot of the defense that I've described thus far.

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Bryan Borzykowski: Finally, on positioning, I see that you also have an allocation to spread sectors. What's your thinking behind that?

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David Tulk: Absolutely. When we think about the bond side of the portfolio, generally, you can see that we are underweight investment grade, so we're modestly underweight duration. That's a reflection, certainly, of where we see interest rates moving more generally. But at the same time, we want to be able to find more ways to diversify the fixed-income landscape especially within these portfolios and especially because bonds have had such a terrible year thus far. To have selective allocations into credit are something that we're doing to achieve that goal. I should be very clear that all of these allocations are being done with active managers. This, again, leverages Fidelity's research platform to bring in really strong, idiosyncratic securities into the portfolio.

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Having allocations into high yield that are carefully managed, I think can still provide some upside. Jeff Moore has talked about this in the past as well, he would identify the spread cushion as being sufficient to maybe offset any type of capital loss that the securities could potentially face. That's the motivation for that allocation. We still have a floating-rate note allocation, so that picks up on the move higher in interest rates. On top of that as well, the allocations into emerging market debt give us a really good yield pick-up, again, actively managed and allows some offense to be expressed across the portfolio as well.

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Bryan Borzykowski: A question that just came in is around how much energy prices are contributing to inflation. Could it spike this winter and maybe come down in the spring?

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David Tulk: Certainly. When we think about inflation and the influence of energy prices, it's always going to be on a year-ago measure. When we think about year ago prices, we have seen commodity prices come down to some extent, but certainly anything on the geopolitical front could send commodity prices higher. I know it's virtually impossible to try to forecast anything on the geopolitical front. We're thinking of it more in terms of the impact on the wider economy. Because that inflation story certainly is something that we think will prove to be persistent, I think you still want to have allocations to commodities and especially just in appreciation of the geopolitical risks. We could certainly see, I don't want to ... forecasting the economy is hard enough, I don't want to try forecasting the weather, but certainly when you think about the dynamic around energy prices, that could be very much driven both by geopolitics and weather generally. That's certainly possible as a trajectory but from our perspective, having those allocations play into the wider themes as much as anything else.

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Bryan Borzykowski: Earlier you were talking about a recession, I'm just wondering, how deep do you think this could be and are there any signs that you're watching out for advisors could look for to say, hey, maybe things are getting a bit better?

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David Tulk: As the standard economist answer, the answer to the how deep of a recession is that it depends. It certainly depends on inflation and what will transpire from here. It depends on the conviction that central banks have in terms of keeping interest rates elevated. We, again, think inflation will be more persistent and we think that central banks will stay tighter than the market expects. That doesn't particularly bode well for the outlook for growth. Where I think it really depends is on individual regions. This comes back to a theme that we talked about earlier in terms of how interest-rate sensitive different geographies or different countries are. That really informs the regional equity allocations we have. We talked about Canada as being very interest-rate sensitive and, as a result, that's the high-conviction underweight we have. But if you think about the U.S. economy, the U.S. economy is much less interest-rate sensitive. All things equal for higher interest rates, we could see a more mild recession in the U.S. and that's the motivator for a larger allocation on a geographic basis into the U.S. versus some of these other regions.

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Similarly, across Europe and the Far East, again, this is an area that will see higher interest rates and still has issues with sovereign and private sector debt, so that's the motivator for being underweight in the international bucket. Finally, emerging markets, they're already in a recession and, if anything, if you get policy stimulus and any type of improvement on the inflation front or on the growth front, that's one region that can stand to benefit and that hinges into our comments on emerging markets earlier.

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Bryan Borzykowski: Are there any circumstances, just moving back to bonds for a minute, are there any circumstances where you would bring investment-grade bonds to the benchmark in the Global Balanced portfolio?

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David Tulk: I think in terms of bringing it fully back, we all generally want to have spread sector exposure. That's true of any market. Again, having actively managed portfolio allocations there is something that is really important with that allocation. I don't think we'd ever want to get rid of credit entirely as those plus sectors. That will limit the extent to which we will bring investment grade back to benchmark. Within the bond story, and this is a really interesting story that, at some point, you're going to want to start nibbling away at investment grade as central banks get closer to completing their rate hiking cycle. I don't think we're quite there yet but nibbling away at some of the long-duration Treasury exposures, that, at some point I think will be an allocation that we'll try to increase. Again, I don't think we're quite there yet, so we want to be somewhat prudent in how that part of the portfolio is handled.

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Bryan Borzykowski: We've just got a couple of minutes left and maybe kind of a final thought here. I think investors, probably advisors, too, it's very confusing in a lot of ways what's going on now. You see job increases happening. Canada added 108,000 jobs not long ago, couple of weeks ago they announced that. Then we see CPI coming down a bit but you're talking about a recession. How do you make sense of it all? What's your advice for investors on how to deal with kind of all of the news and what to do with their portfolios?

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David Tulk: The advice that I give myself more than anyone else is really sticking to the four pillars of our process. That roots us in economic fundamentals, it roots us in all of the information that we have available to us from across the firm, it roots us in how things are priced and how investors are feeling. I think the advice that I can give to the world more generally is to really stay diversified. That's a core philosophy for us, is definitely having the degree of diversification both across geographies, across different asset classes because you know the world will remain uncertain, that's definitely a truth there. To have different exposures that you can use to provide offense and others to provide defense and then using a well-articulated process to allocate across the two and staying invested in the market, I think, ultimately, is the key to success that we bring to our portfolios every day.

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Bryan Borzykowski: Great. David, I will leave it there. Thank you so much for joining us and sharing your thoughts on everything that's going on.

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David Tulk: You're very welcome. Thank you.

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