This too shall pass

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Key Takeaways

- We know that an unprecedented shock has been met with an unprecedented policy response
- We think value is emerging in equities, but patience is warranted
- We are positioning the funds for protection in the short-term and outperformance in the long-term

The COVID-19 pandemic is a shock without precedent in modern times. So too is the policy response. Amid this fluid environment, we discuss below what we know, what we think, and what we're doing in the Fidelity multi asset class funds we manage for Canadian investors.

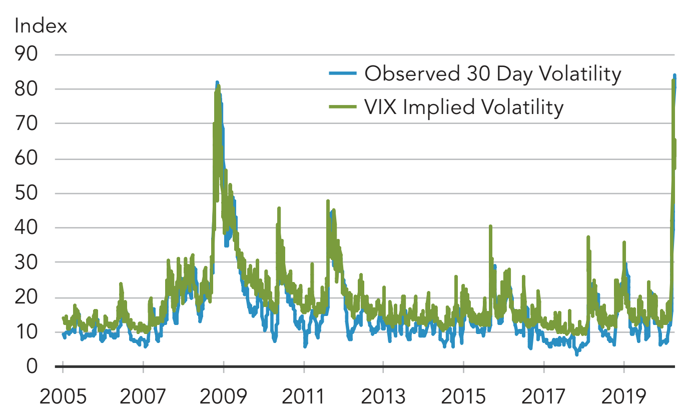
What we know

We know that market volatility has become extreme (see Exhibit 1). The S&P 500 fell 20% in the first quarter despite a late-March bounce; the decline in Canadian equities was larger still, rivalling the worst drops of the past century. The shock has extended to the fixed income markets, where the prices of corporate credit instruments have fallen sharply despite lower policy interest rates and government bond yields.

We know that the chaotic declines in the prices of virtually all assets reflect at least three things. One, the inevitable massive shock to the economy, which the data are only starting to reveal as we write (see Exhibit 2). This will challenge not only the earnings but in some cases the solvency of companies. Two, the uncertainty surrounding just how large and long-lasting that shock will be. And three, the illiquidity of markets, as investors scramble for cash through a door narrowed by regulation and fear.

EXHIBIT 1: Unprecedented swings

Realized and implied volatility in the S&P 500



Sources: Bloomberg, FMR Co.

We also know that the policy response is massive and growing. The fiscal, monetary and regulatory 'bazookas' are all being been fired in a bid to stabilize markets and fill in the economic crater. The actions of the US Federal Reserve have been particularly important, given the central role of US dollar liquidity in the global financial system, with the central bank effectively making an open-ended commitment to inject cash by buying securities in unprecedented scope and size (see Exhibit 3). Other central banks have followed suit, including the Bank of Canada, which has initiated the quantitative easing program it managed to avoid in 2008. Regulators in Canada and elsewhere have eased restrictions on banks to ensure that these liquidity measures allow credit to flow where it's needed. And the fiscal response has arguably been the most breathtaking, as governments pour out cash to families and businesses that have seen their incomes disappear, deficits be damned.

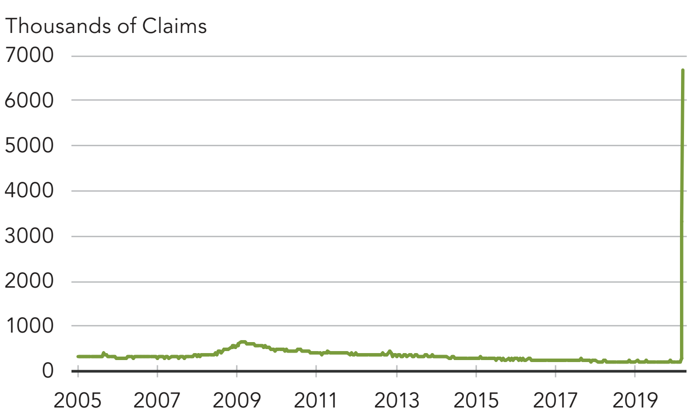
What we think

We think COVID-19 will remain a global issue for an extended period of time. Our research network, encompassing both Fidelity's health care analysts and outside experts, advises us that the virus will likely remain a threat until either an effective treatment or vaccine is produced or 'herd immunity' is reached. That may not happen for many months. Authorities are employing the strategy of 'mitigation', enforcing restrictions and quarantines to 'flatten the curve' so as to not overwhelm the health care system. But there is a tension here: the more the authorities try to diminish the human cost by shutting everything down, the greater the economic cost (which itself takes a clear human toll). The balance that will need to be struck between the two going forward, and thus the aggregate toll taken by the virus, remains uncertain.

We think that the persistence of the virus does not, however, mean the persistence of economic and market declines. Both have taken a big hit. But, as above, economic policy-makers are adopting a 'whatever it takes' approach. We think that this support will ultimately help mitigate the sources of market pressure described above – the hit to the economy, the uncertainty surrounding it and the illiquidity of markets. It will take time and will not be a linear process. But we do expect

EXHIBIT 2: Unprecedented weakness

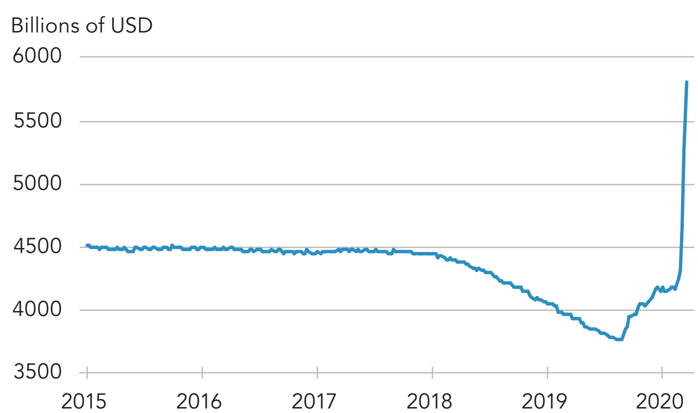
US initial jobless claims



Sources: Bloomberg, FMR Co.

EXHIBIT 3: Whatever it takes

The Federal Reserve's balance sheet



Sources: Bloomberg, FMR Co.

it to show the scaremongering about another 'Great Depression' to have been misplaced.

We also think that the economic, financial and policy turbulence caused by the COVID-19 pandemic and its effects will hasten a number of the longer-term macro issues we've been focused on. Two in particular:

One, we think inflation will eventually be coming. We have long been concerned about the potential erosion of central bank independence. That process may now be unfolding before our eyes. The wartime footing being adopted by policy-makers doesn't allow for peacetime luxuries like fine-tuning financial conditions to hit inflation targets. It may seem silly to fret about inflation when faced with a clear and present deflationary shock. But when the shock passes, we will be left with super-stimulative monetary and fiscal settings that policy-makers will likely be unwilling or unable to take back. We will also likely be left with a further de-globalized world economy that is less efficient and thus more costly. Inflation may well be seen as the path of least resistance in addressing the further ballooning of government debt and impairment of growth created by the crisis and its response.

Two, we think that Canada faces particular challenges here. One, Canada is a small, open, commodity-producing economy upon which global shocks always have disproportionately large effects. Two, Canada's economy came into this crisis with significant imbalances, over-reliant on household spending and debt; recessions are always deeper when there are excesses to be worked off. Three, Canada remains reliant on the energy sector, where the supply/demand dynamics that have driven oil prices to generational lows pose a severe challenge to the industry. Four, Canada's economic growth in recent years has owed entirely to immigration-driven population growth, which has now ceased. And five, Canada's climate is cold and its population is concentrated, which may imply a greater challenge from the virus itself.

What we're doing

First and foremost, we are fulfilling our essential job of being good stewards of the funds in our capacity as fiduciaries. That means focusing on the safety and soundness of our investments, fulfilling our unwavering commitment to daily liquidity, and avoiding selling securities at bad prices that would lead to permanent impairment of the value of the portfolios.

We are rebalancing opportunistically, shifting into risky assets at a measured pace as bond market liquidity becomes available and the equity market searches for a bottom. Our rebalancing approach is an element of our broader active asset allocation process, informed by our dedicated asset allocation research as well as our collaboration with the managers of our equity and fixed income building blocks. Those inputs suggest only a gradual shift back into risky assets. The goal is to steadily accumulate cheap assets that will lead to outperformance in the funds over the longer-term horizon on which we remain focused.

We are, to be sure, seeing value emerge in equities. From a bottom-up perspective, our managers are seeing better opportunities to buy good businesses at cheap prices, including some of our long-skeptical managers who are now fully invested. From a top-down perspective, the equity risk premium that can be collected – the relative cheapness of equities – is now back up at generational highs (see Exhibit 4). However, the stock market lows may not yet be in. The downgrades to forecasts by economists and equity analysts look woefully inadequate thus far. The uncertainty surrounding those estimates and the broader outlook cannot be expected to fade soon. And we are not going to fund equity purchases by selling bonds into distressed markets at the adverse prices our fixed income colleagues tell us they would fetch.

We are also adjusting the profile of our portfolio allocations as we make the shift back into equities. As noted above, we think higher and more volatile inflation is a plausible long-term outcome here, one that markets have clearly not priced in. Among other things, this would mean a move to appreciably negative real interest rates (given the likelihood of financial repression manifested in effective caps on nominal rates) and a less-negative correlation between stocks and bonds (given that inflation shocks, unlike growth shocks, tend to affect both asset classes in the same direction). As a result, we are further tilting the defensive elements of our portfolios away from nominal bonds towards inflation-protected bonds and gold.

We are furthermore increasing our diversification from Canadian into global assets. As above, we are concerned about the particular challenges Canada faces in this environment. But more broadly, it remains the case that going global offers greater market breadth and depth as well as a wider set of opportunities, with unhedged exposure bringing the added benefit of reducing volatility through counter-cyclical currency exposure. In fact, it is hard to imagine a better demonstration than the current episode of the value of diversification into global assets specifically and across asset classes more broadly. We have not been able to avoid drawdowns in our funds as virtually all asset prices have fallen. But the drawdown since the end of January in our Global Balanced FMP (net of Series F fees) was 11%, a 23% smaller decline than a generic Canadian 60/40 index portfolio and 52% less than the drawdown in the S&P/TSX Composite. Looking over a longer period, since we moved to active asset allocation in late 2013, investors have earned a total return of 49% in the Global Balanced FMP even with recent losses incurred through the end of March – roughly double the return on the generic Canadian 60/40 portfolio (see Exhibit 5).

Let us conclude with another thing we know: this too shall pass. Our unwavering focus in the meantime is to protect the portfolios as the crisis plays out while positioning them for outperformance when this does, indeed, pass.

David Wolf and David Tulk, April 7, 2020

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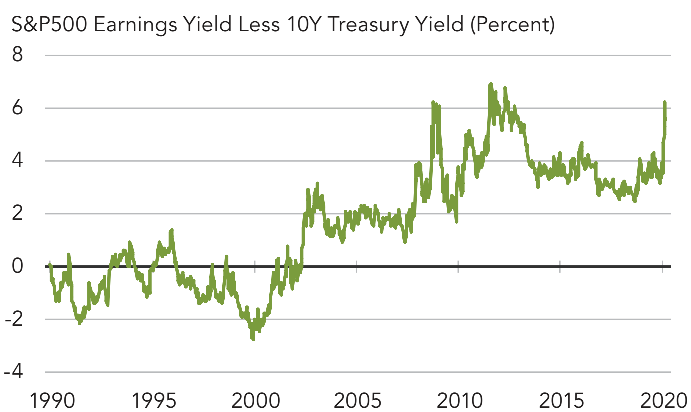
EXHIBIT 4: Elevated compensation for bearing equity risk

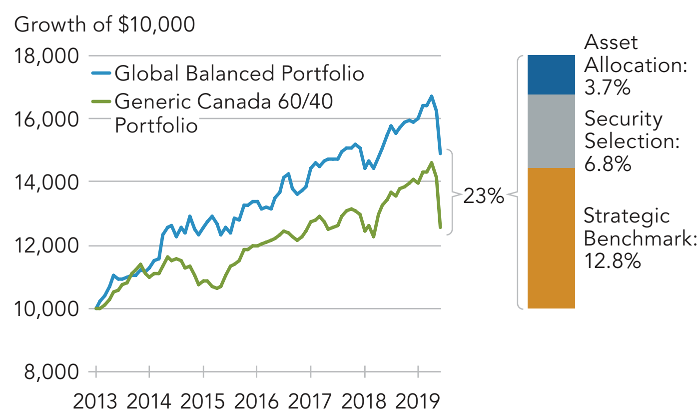
The equity risk premium



Sources: Bloomberg, FMR Co.

EXHIBIT 5: The value of diversification and active management

Portfolio returns (FMP60G v generic Canada 60/40 chart)



Source: Fidelity Investments Canada. For illustrative purposes only. For full disclosure, refer to page 5.

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David Wolf is a portfolio manager for Fidelity Investments. He is the co–manager of Fidelity Managed Portfolios, Fidelity Canadian Asset Allocation Fund, Fidelity Canadian Balanced Fund, Fidelity Monthly Income Fund, Fidelity U.S. Monthly Income Fund, Fidelity U.S. Monthly Income Currency Neutral Fund, Fidelity Global Monthly Income Fund, Fidelity Dividend Fund, Fidelity Global Dividend Fund, Fidelity Income Allocation Fund, Fidelity Balanced Managed Risk Portfolio and Fidelity Conservative Managed Risk Portfolio. He is also portfolio co–manager of Fidelity Conservative Income Private Pool, Fidelity Asset Allocation Private Pool, Fidelity Asset Allocation Currency Neutral Private Pool, Fidelity Balanced Private Pool, Fidelity Balanced Currency Neutral Private Pool, Fidelity Balanced Income Private Pool, Fidelity Balanced Income Currency Neutral Private Pool and Fidelity U.S. Growth and Income Private Pool.

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Exhibit 5 Source: Fidelity Investments Canada ULC. For illustrative purposes only. For Canadian investors that have zero global exposure, the example highlights the advantage of global diversification. A general Canadian balanced portfolio of stocks and bonds is compared with Fidelity Global Balanced Portfolio, which includes global asset classes to diversify the portfolio. Performance shows cumulative returns as at March 31, 2020 (Series F), net of fees, in Canadian dollars. Value added shown at right comprises three elements: 1. The strategic benchmark, which reflects the neutral asset mix of the Global Balanced Portfolio; the value added is shown net of series F fees for the Fund, since this would be the expected excess return of the Fund over the general 60/40 Canada portfolio absent active management 2. security selection, which reflects the contribution of active equity and fixed income management of the underlying Funds to the overall Global Balanced Portfolio return, and 3. Asset Allocation, which reflects the tactical tilting of the Fund's asset class exposures over time relative to its neutral mix. Fidelity Global Balanced Portfolio's strategic benchmark consists of 21% S&P/TSX Capped Composite Index, 39% MSCI All Country World ex Canada Index, 23% Bloomberg Barclays Global Aggregate Bond Index, 12% FTSE Canada Universe Bond Index and 5% FTSE Canada 91-Day T-Bill Index. The Fidelity Managed Portfolios changed from a static asset allocation approach to a tactical asset allocation strategy with +/- 15% bands in October 2013. General 60/40 Canada portfolio is made up of 60% S&P/TSX Composite Index and 40% FTSE Canada Universe Bond Index. The rate of return shown is used to illustrate the effects of the compound growth rate and is not intended to reflect future values of the fund or returns on investment in any fund.

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