Respecting the unknowable

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Key Takeaways

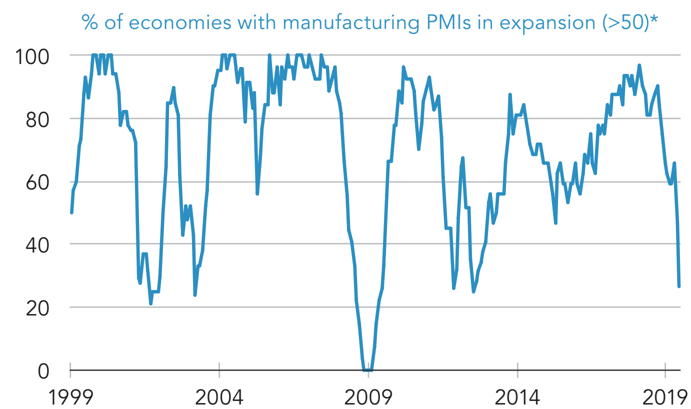
- Global economic outlook pits trade weight against monetary support
- Unusual uncertainty on both sides favours prudent asset allocation approach
- We're focused on risk management & diversification as our stock-pickers engage a target-rich environment

The global economy is currently subject to two main opposing forces – the weight of trade stresses against the support of lower interest rates. Whether these forces net out to recession, rebound or something in-between is subject to unusual uncertainty. As a result, we are keeping our active asset allocation bets small, focusing on risk management and preserving diversification so as to keep our multi asset class funds resilient to a wide range of outcomes.

It is evident that the global economy has weakened (see Exhibit 1). While some of this has to do with the lagged effects of monetary tightening, the more important influence seems to be the intensification of trade frictions, most notably between the U.S. and China. The extent to which these trade issues will weigh further on the global economy looks pretty much unforecastable, given that there are two levels of essentially intractable uncertainty.

First, the outcome of the trade negotiations themselves is highly uncertain, with prospects seemingly shifting with each headline or tweet; everything appears possible from a full resolution to a 'trade iron curtain' falling between the U.S. and China. Second, even if we knew the outcome of the negotiations, the effects on the global economy would be highly uncertain. The world has never seen this degree of trade conflict with this degree of global

EXHIBIT 1: Broad slowdown in global economy



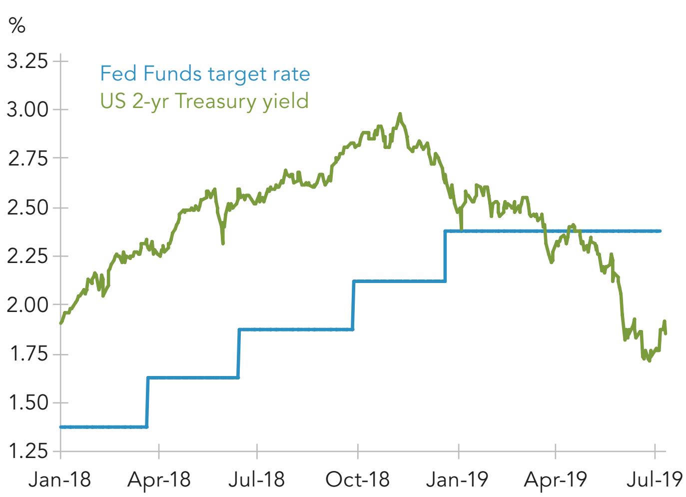
* PMI = Purchasing Managers Index. Latest data point covers 30 countries accounting for roughly 85% of global GDP. Sources: Markit, ISM, Haver Analytics, FMR Co (AART)

supply chain integration; neither we nor anyone else can reliably model the economic effects. So while it is clear that the trade tensions are having a dampening effect on global activity, particularly through the chilling effects of uncertainty on business confidence and investment, little else is clear on this front.

Taking the other side of the trade drag are the central banks, first and foremost in the U.S., where the Fed has signaled its willingness to provide additional stimulus. This is an abrupt shift from just a few months ago, when the tightening cycle appeared set to extend significantly; markets have already done a lot of easing in anticipation of looser Fed policy (see Exhibit 2).

Now, we find it hard to imagine that the Fed of recent decades would consider cutting rates with the unemployment rate near a 50-year low, inflation not far from target and equity and credit markets well-behaved. But the Fed's reaction function may be shifting, as we wrote about a quarter ago – towards an approach that's less tethered to the traditional models and more inclined towards risk management, one that's going to permit

EXHIBIT 2: The Fed's 180



Sources: Federal Reserve, Haver Analytics

or even foster an overheating economy and overshooting inflation, and one that looks to be taking into greater consideration influences beyond the domestic economic data. Only time will tell, but at this stage it doesn't seem unreasonable for markets to be reverting back to 'lower for longer' expectations.

So, in sum, we are faced with an unfamiliar Fed reacting to an unprecedented set of trade risks. The outcome may be not only unknown but in fact unknowable.

As we've written before, we try to be humble regarding our ability to forecast macro developments, an approach that seems particularly warranted in the context of these unusual uncertainties. Instead, we look to take advantage of situations where markets don't share that forecasting humility – when people seem to be sure about something that they can't possibly be so sure about. Such opportunities presented themselves in December, when markets seemed virtually certain that a recession was forthcoming, and again in April, when markets were convinced the trade issue was going away. We will continue to be on the look out for such opportunities ahead.

In the meantime, we are keeping our active asset allocation tilts small. This is consistent with our research team's findings, which suggest that later-cycle periods tend to be less amenable than usual for reliably enhancing performance through big asset allocation tilts. The research also suggests, however, that these periods tend to be particularly favourable for our security selectors to add value. So even as we keep our active allocation risk limited, we are ensuring that our stock-pickers in particular have the scope they need to enhance performance in what we (and they) see as a target-rich environment.

In this context, as asset allocators we are focusing on risk management and providing diversification within our funds. This means not only relying on the diversification inherent in the funds' neutral asset mixes, but also adding out-of-benchmark allocations in asset classes such as gold and emerging market local currency debt – asset classes that exhibit limited correlations to our core holdings while also standing to benefit from the lower levels of interest rates globally.

This doesn't mean that we have no active asset allocation positions on, but it does mean we are concentrating them in areas where we have greatest conviction. One example would be our longstanding overweight to unhedged emerging market equities, funded by an underweight to Canadian equities. Even there, however, our tactical flexibility allows us to calibrate the size of that position to reflect near-term developments.

Those recent developments have, among other things, motivated us to do some hedging of the foreign exchange risk in many of our funds. This is based on the resiliency of the Canadian economy, where growth has rebounded with unexpected strength following the stagnation around the turn of the year (see Exhibit 3).

EXHIBIT 3: Canada's economy surprisingly resilient, for now

Sources: Citigroup, Haver Analytics

The risk is that this improvement will leave the Bank of Canada (BoC) at least temporarily out of sync with generally easier monetary policy in the U.S. and abroad, lending support to the Canadian dollar in particular.

To be clear, our longer-term view here hasn't changed. The imbalances in Canada's economy are as daunting as ever, and slowing global growth amid heightened trade risks is disproportionately bad for a small, open, commodity-producing economy like Canada's. Indeed, BoC analysis in the July *Monetary Policy Report* projected that Canada could be hit twice as hard as the global economy as a whole upon a full-blown trade war, with the Canadian dollar depreciating by roughly 25 per cent in response, underscoring Canada's vulnerabilities in the current environment. We continue to expect the Canadian dollar to depreciate over the medium-term, and will be watching for signs of inappropriate market enthusiasm in the durability of the rebound underway to take the other side.

David Wolf and David Tulk, July 10, 2019

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