

## Fidelity ETF Podcast

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**Announcer:** Hello and welcome to the Fidelity ETF Exchange, powered by Fidelity Connects, connecting you to the world of investing and helping you stay ahead.

This is the 20<sup>th</sup> episode of the Fidelity ETF Exchange, and today co-hosts Étienne Joncas Bouchard and Himesh Patel sit down to recap notable trends and headlines in the Canadian ETF Industry from the second quarter of 2021.

With the first six months of the year behind us, the Canadian ETF industry has brought in a record \$30 billion in net new assets (the best first six months ever). Some of the key areas of focus for hosts Etienne & Himesh include the positive uptick in flows for Value and Dividend factor ETFs, the emergence of a new category in crypto currency ETFs, as well as the sizeable gap between inflows to equity vs. fixed income.

Today's podcast was recorded on July 14, 2021.

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**Étienne Joncas Bouchard:** Hello, everyone, and welcome to the Fidelity ETF Exchange. I'm your host Étienne Joncas Bouchard aka E.J.B. Joining me today, as always, is my co-host, Himesh Patel. H.P., how are you doing this morning?

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**Himesh Patel:** Not too bad. How are you?

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**Étienne Joncas Bouchard:** I'm doing very well. Enjoying the beautiful weather. I'm actually finally starting to get over the Montreal Canadiens, losing in the Stanley Cup finals. But, you know, it's all good. I think maybe that's why we took a little break from doing podcasts. I needed to gather myself and get my thoughts together. No, I'm kidding. It's everything's going well right now.

Thank you, everyone, for joining us. I guess our last episode was a little bit of a while ago. It was close to three weeks ago now. And we had the pleasure of hosting Cameron Chamberlain, who is a portfolio strategist at Fidelity. And we took the time to pick his brain on fixed income, the fixed income portion of portfolios, and how we could potentially look at improving them, fixing some of the exposures that we're maybe taking a little bit too much risk on simply by the fact of investing in a lot of indexes that have changed over time. So, we talked about duration risk and basically interest rate risk. How can we balance that with credit exposure and just overall tips and things to look out for when building out the fixed income portion of a portfolio. So if anybody's interested in listening to that episode, it is available on Fidelity. As always. It's also available via Fidelity Connects on your favorite podcast platform. Look for the ETF Exchange.

On to today's episode, H.P. We're actually going to be doing a recap of Q2 of 2021, similar to what we did for the first quarter in which we're going to look at flows. We're going to talk about performance from a stylistic standpoint, from a regional standpoint, asset class standpoint. And then we can talk a little bit about an outlook and what we're seeing in the market and some of the dynamics that might have changed and that might lead us to look at things that maybe were a little bit more out of favour at the beginning of the year.

So, I guess I'll just start it off with just a quick stat. We're up to 30 billion in year-to-date inflows as of the end of June in the ETF, the Canadian ETF industry. That is the highest on record for the first six months of the year—more than 50 percent of that is in equity ETF. So really strong bounce back from that asset class. And in particular, another quick note is that crypto-type ETFs or crypto-themed ETFs have only one billion less in inflows than all of the fixed income space for the for the year so far. So quite astounding, the appetite that was found there. So I guess we're going to kick it off with flows. And what are some of the things that you've seen that stuck out in your mind? Go wherever you'd like to from a stock standpoint region. I'll let you lead the way here and I'll jump in for comments after.

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**Himesh Patel:** I don't think there's any major surprises to what we talked about in Q4 or Q1 of this year. And to piggyback off your comment on the crypto ETFs, I think those have slowed a little bit in Q2. We saw a really quick run out of the gates in Q1 when every one of those crypto ETFs were launched. But like you said, it's only trailing fixed income by one billion, which is a very, very interesting stat, I think, especially for the Canadian investment community. But I guess, like you mentioned, 30 billion in unit eight flows in the Canadian ETF market. Again, another record-breaking year to start the year. We're seeing record-breaking flows in the mutual fund space as well. But I think this is another testament to the Canadian ETF industry and its resilience, more than half of it going into equities. I think an interesting stat is seven billion going into international equities versus only four into U.S.

So, similar to what some of the themes we've been talking about throughout this year is just that move towards international markets and investors diversifying overseas versus just taking that North American exposure. And then I think, again, similar to another theme that we were talking about in the factor space or the style space: value and dividend-oriented ETFs continue to lead from a factor standpoint, 550 million into value ETFs and about 1.2 billion into dividend ETFs. A lot of that actually coming in in the month of June, about 500 million in June just into dividend-oriented ETFs.

So, I think that early-cycle trade in that early-cycle rotation is fully underway. It's in full force and I think that will only continue for the next few weeks and months that we come to see. But it's interesting to see what's happening in the fixed-income market with redemptions on the cash alternatives and those high-interest savings ETFs, but still positive flows overall going into other areas of the market. So I think overall it's been a positive year. Again, from the full standpoint, nothing really majorly surprising, but it's just interesting to see how investors have shifted their focus and reallocated the portfolios.

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**Étienne Joncas Bouchard:** Yeah, absolutely. And I think it's somewhat of a ... we tend to see this actually with, it's almost like momentum, right? It's like what's started to do well. You eventually see it trickle into flows. I love your comment on the value and dividend space, because if you look from a factor standpoint, obviously you guys have probably come to know fidelity. That's kind of where our niche is. So we definitely look at it a lot more in the smart beta space, the factor space and really what's performed the best so far year to date is the dividend and then probably second the value factor. Albeit in June, what was really interesting and like you said, that flows actually picked up was that's when performance actually lagged a little bit. So I don't know if this was trying to buy the dip a little bit. And from a stylistic standpoint, like you said, also on the crypto stuff, the number one selling ETF in June was actually the three IQ Bitcoin ETF. So that's still quite interesting as well. So there is a little bit of appetite there. And another comment I can make there, which is

somewhat unfortunate for asset holders. But the flows is actually larger than the current AUM, so there's the amount that was invested in those products is actually more than what's left at the end of the quarter.

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**Himesh Patel:** But crypto assets haven't had their share of performance yet year to date. So it's been a struggle, I think, on that side.

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**Étienne Joncas Bouchard:** Yeah, no, absolutely. Absolutely. And the international thing is also a great point. We've talked a lot about it internally and with clients, with advisors. It's a portion of the book that seems to continually be underweight for obviously the U.S. had dominated from a performance standpoint where you look at S&P 500, the Nasdaq, those indices had done significantly better than, say, the MSCI EAFE from a performance standpoint over the past five years. Whether it was by construction or by design that we're underweighting international markets or simply by the fact that those mandates that we hold, whether it's an ETF or an actively managed fund, likely underperformed, the more growth quality-type exposure we have with the U.S., they are underweight. And then that domestic bias that we have for Canadian equities remains, obviously. But I think that's a positive. That's definitely a positive that there's more appetite for international mandates because there are some interesting products out there. And there's definitely some tailwinds also from a macro standpoint, from a valuation standpoint, the fundamentals are improving over there as well. And so earnings growth is coming back. So, it could be an interesting place to be for the next six months to the end of the year.

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**Himesh Patel:** Yeah, I would say that's a major theme that I'm seeing in client conversations, too, is whether clients pull the trigger on diversifying into the international market or not, I think everybody is watching it very closely. And I think as we start to see those fundamentals coming through in/and the macro tailwinds coming through, for example, the [EFE?/EAFE?] market is trading at 20 times earnings, the U.S. market is trading at about 25, 26 times earnings. But earnings growth is much more positive in the EAFE market versus the US, even though both numbers are pretty astounding, with the U.S. earnings growth expected to be around 30 to 35%, EAFE indexes are actually expected to outearn by about 5 or 10%. So you can get cheaper companies with much better earnings growth. And I think that makes sense from a portfolio construction standpoint. I just think, as we sort of progress through the summer months and pending there's no major market event, I think performance should come through and the flows will follow.

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**Étienne Joncas Bouchard:** Absolutely great point. Definitely a great point. I guess the last comment I'll make on flows is and I had taken a note here to make sure that we somehow incorporated was the ESG Lionsgate, which is doing extremely well on the ETF side. And we've recently at Fidelity here, we've launched a few other mandates. We've added a few mandates in our lineup as well. On the fund side, that's still seems to be a category that's getting a ton of attention. And I don't really see that going away. Like, I feel like every time we're going to be doing these quarterly calls, we're just going to be able to say that, yes, once again, a record quarter for ESG ETF sales.

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**Himesh Patel:** Another couple billion.

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**Étienne Joncas Bouchard:** Exactly. It's like another billion here, another billion there. But definitely we've seen it from a flow standpoint, but we're definitely also hearing it from you advisors, investors. There is a demand for these types of products because I think investors are more and more conscious about the choices that they make in their lives. But now investing is definitely one of those choices. So that's definitely been a bright spot also in the ETF industry. I don't know if you had anything to add there, but I wanted to highlight that that was a good, strong category for Q2 as well.

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**Himesh Patel:** I have nothing really to add. I think we're at the very beginning and early stages of the uptick in ESG ETFs and the demand that we're seeing, I think it'll only continue. It'll be a long-term trend, like you just mentioned. I guess one other thing that we didn't mention on flows was the continuation of flows going into multi-asset ETFs, which was another one of those themes that we identified earlier in the year. But those ETFs just continue to keep growing. And we're seeing on a year-to-date basis about \$4 billion of flows into that category. Which is almost just under half of the assets. So pretty significant growth and lots of demand for those types of ETFs as well.

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**Étienne Joncas Bouchard:** Well, super simple, super simple solutions. It's a way to get broad market exposure, multiple asset classes. Yeah, definitely. And I think that's a very good positive for the health of the ETF industry as a whole. Having multi-asset solutions is good and usually more sticky than a pure equity exposure. Maybe I got my sales cap on right now, but in the sense that it usually means that it's invested for a longer time. And you know how you get the best return, as we found from research in the past, is just staying invested for longer.

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**Himesh Patel:** Exactly. So you're not trading in and out of those passive ETFs and enjoying that lower volatility ride in the multi-asset ETF.

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**Étienne Joncas Bouchard:** Exactly. It's boring, but it works. And yeah. So I think we can maybe move on from flows. We've touched on most of the subjects. I want to move on over to performance and some of the changes in market dynamics that we've seen. And the first one I want to start off with, because it's very tied to the fixed income landscape, which is still in focus is the drop in long-term bond yields. Whereas in Q1, the story was the sharp rally or almost the tantrum that we saw on the long end of the curve where we saw close to a one percent increase on the on the ten year in Canada and the U.S. And now that's reversed back to 50% of that increase is almost come back. So, you know, how is that impacted performance of various ETFs in the Canadian space? How are some of the ways that investors could potentially play this? What are you seeing so far with regards to this change?

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**Himesh Patel:** Yeah, that's a great question. And this exact topic came up earlier today when I was on a client call. When we look back at the bottom of the market in 2020, U.S. 10-year yields were around 50 basis points. It was pretty certain and pretty much conventional wisdom across the market that rates were going to go up at some point in the next 12 to 18 months. And they did. We saw a pretty significant rally in February and March of 2021 of about 140 basis points. Almost like you said, we've chased a lot of that. And I think from a positioning and sector aspect, a lot of fixed-income asset classes still continue to do well in that environment. So obviously longer-term government bonds did well because

rates rallied back down and high-yield bonds and credit and floating rate bonds still continue to do well because of their nature of being less correlated to interest rates versus government bonds.

But I think the bigger question for investors was around inflation and why rates were rising. It all came down to really, in my opinion, inflation expectations and growth expectations for the next 12 to 18 months. We've seen that kind of reverse now just because of the dovish comments from the Fed and some of the data that's coming out on the inflation front.

But I think from a sector perspective, we're at yields that are at all-time lows now across every major fixed-income asset class. And I get the angst from investors that, where do we really allocate to? Where do we really go? And again, one of those reasons why we're seeing flows going primarily into equities vs. fixed income. But I still think and I know you would agree on exactly what we talked about in our last podcast, too, is you need that risk diversification. You need that downside protection for fixed income in your portfolio. And even with yields and rates at all-time lows, it still makes a lot of sense to own these because even if rates continue to rise from here on out, it's a very low probability that we will see another taper tantrum like rise like we saw earlier this year, though it'll probably very slow and gradual. And in that environment, things will just continue to grind. You'll continue to clip your coupons, whether it's on your government bonds or on your non-investment grade bonds or your credit. And that's actually a really good environment for both equities and fixed income.

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**Étienne Joncas Bouchard:** Yeah. Oh, absolutely. I agree with all the comments you just made there. H.P. I think, first of all, like you said, there's no free lunch in fixed income right now. Nothing is cheap. Yields aren't particularly high. If you look at the credit or I guess the spread sectors, if you will. So whether that be in the loan space and the high yield space, investment grade credit, international credit, you name it, we're in the bottom decile, if not in the bottom third percentile-ish at the end of June. So valuations are full. They're priced to perfection.

Now, the main argument for holding those, like you said, is diversification. And we often forget that fixed income isn't an alpha generator necessarily, or it shouldn't necessarily be an alpha generator in a 60/40 or balanced portfolio. It's there to counterbalance your equity risk because 90% of your risk in a 60/40 will come from your equities. And a lot of the movements that we've seen and we've talked about with advisors is how can I find ways to get more yield? How can I find ways to... Maybe if I can in my barriers from a compliance standpoint or my risk tolerance standpoint for my investors, how can I, you know, reallocate some fixed income to maybe a little bit more on the riskier side of the market like dividend-paying stocks, like prefs and those. And we had a great call with a portfolio manager this morning and just reminded us that fixed income— it's never a bad time to own fixed income. Price movements are temporary. And increases in yields like we saw in Q1 were, for the most part, a buying opportunity. And we've actually seen that become a success somewhat if anybody was at the long end of the curve. Obviously not so great for those that had shortened their duration materially. But overall, I think a very positive quarter for fixed income. We've brought back a lot or I mean, we've made up a lot of the losses that were made in the first quarter, but definitely here on out. It's not the ideal environment, let's say. Where I think from a base case standpoint, it would be pretty fair to say that we're likely going to find ourselves between what point .5 and 1 or 2, say, for example, on the 10 year for the foreseeable future. And that's not necessarily saying one year, two year, three year. I'm saying maybe more like five, ten years. That's a very real possibility. So you still need to own it. You know, the benefits of an active manager are going to show up. Good active managers are going to shine here. It might be a bit tougher on the passive space where there's a little bit more interest rate sensitivity. But nonetheless, that's the stuff I'll add. Do you have anything else to add?

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**Himesh Patel:** No, I was just going to say that's it right there. What you just said is taking that active approach again. Like you said, everything's pretty much priced to perfection, so if you're investing in fixed income now, it's about allocating to areas of the market that will control your risk at the overall portfolio level. So, you want to have that. Protection in those government bonds, you want to have that additional yield in those high yield and spread sectors, and you want to be fully invested because who knows where the market will go? And having that fixed income exposure in your 60/40, for example, will dampen your volatility. And at the same time, if things continue to go positively, if you continue to see equity markets rally, that should still continue to do well, even if you're holding on to your fixed income.

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**Étienne Joncas Bouchard:** Oh, absolutely, and that's the crazy thing is that, like you said, valuations are full, but the reality is the macro backdrop is also great. There's no fundamental reason unless something comes up from either COVID-related or geopolitically related. There's not much that's going to create a very negative impact on either default rates or widespread/why spreads should widen, financial conditions are very easy. I think overall, it's tough to buy, but it likely won't do poorly going forward. But anyway, enough about fixed income. We touched about another subject at the beginning that I absolutely wanted to get to before we wrap this up, which is the growth-to-value rotation that we've seen in Q1 was very strong, started somewhat in November last year. And then in June, we saw really like somewhat of a snapback from large-cap growth tech, some consumer discretionary names. Do you think that was just a quick little bump in the road for a continued period of peer-to-value outperformance? Or do you think what value's had its day already? And you know what time to buy back to the winners of 2017 to 2020.

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**Himesh Patel:** Yeah.

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**Étienne Joncas Bouchard:** Putting you on the spot actually.

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**Himesh Patel:** Another great question because something that comes up quite often, especially in the last couple of weeks because as listeners are probably aware, you and I have been pretty positive on that value, early-cycle orientation trade.

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**Étienne Joncas Bouchard:** We don't have a choice anymore.

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**Himesh Patel:** Yeah, and not to say that we still don't believe in it. I fully have 100% conviction that it will continue to outperform and it'll continue to do well just given the fact that we're not really out of the early second phase yet. I mean, things are still kind of closed. Economic activity is not at full capacity yet. So, I think it was in June, a little bit of sort of a reprieve trade and sort of a catch-up trade for growth and some of these momentum areas of the market, even though actually momentum shifted towards value now.

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**Étienne Joncas Bouchard:** But that's what I was going to say. I was going to say that was one of the interesting developments that I had, is that and it's almost like a quant indicative of moving from the early to mid-cycle is that momentum no longer looks like quality and growth. It looks like value and dividend. You now have overweights in, for example, Fidelity's, momentum factor indices and ETFs. You have overweights to financials. You have overweights to materials, to real estate, for example, to sectors that had struggled obviously last year, but benefited from a very strong reflation narrative at the beginning of the year and now find themselves in this momentum factor. And I could say the same for iShares or any other ETF provider dependent. It's almost irrelevant how the index is, what the methodology is. This was a massive turnover quarter for momentum strategies

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**Himesh Patel:** ...Going into sectors that typically are in momentum, I think.

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**Étienne Joncas Bouchard:** Well, we forgot that they could be momentum.

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**Himesh Patel:** Exactly. Well, yeah, we all forgot about that, I think. And the interesting stat was, I think in a broad market, passive U.S. momentum ETF, it went from, in the rebalancing in June, it went from, I think, 30% overweight to tech now to a 30% overweight to financials. So it essentially reversed its factor during that single rebalanced period. So like you said, lots, lots of turnover and I think probably one of the highest turnover periods for momentum type of ETF.

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**Étienne Joncas Bouchard:** But again, it's really interesting to see.

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**Himesh Patel:** Yeah. And again, just going back to our views on the quality, growth versus value, trade or performance, I think it was a little bit of a catch-up. I think as we continue to look out for the next six to 12 months, a shorter-term time period, again, things aren't fully reopened yet. So, as we continue to see pickup in economic activity, maybe inflation comes down a little bit and we start to see some downside surprises. Those cyclical areas of the market will still continue to do well, I think, and they're still relatively cheap compared to quality and growth.

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**Étienne Joncas Bouchard:** That's exactly what I was going to bring up, because I think the whole top-down thesis will slowly, eventually unravel. We're in the sense that that will be priced in. What is very hard to see unraveling right now is the earnings momentum that we're seeing in a lot of those cyclical sectors that are still very cheap on a relative basis.

I had pulled the MSCI World sectors from a valuation standpoint. So, the four cheapest sectors are financials, materials, energy, utilities. Those are four sectors that are generally overweight in value strategies right now, not necessarily all of them, but the majority of them. And then if you look at an earnings growth standpoint, the four sectors that are



expected to have the highest earnings growth are energy, real estate, materials, and industrials. Once again, cyclicals that are relatively cheap, so as long as that continues, and it's impossible to say how persistent that will be, as long as we get quarter after quarter of strong earnings growth... It's almost like value is somewhat turned into growth. We said momentum turn into value, but the cheap sectors are actually putting out some amazing numbers.

And what's interesting is we talked about that rotation momentum to value. But another one that I'm going to be watching out for come August is the way that we're going to rebalance in high-quality factors. Because if we go back to 2002 to 2007, for the large majority of that period in which cyclicals did extremely well, it was obviously a very strong commodity cycle hike. The high-quality factor was overweight materials, overweight energy and overweight some of those more cyclical sectors also like industrials and financials. Now will this be, once again like we said, persistent? But I think a lot of high-quality factors will start to slowly add more cyclicals into it, whereas previously it was filled with consumer discretionary, which arguably can be obviously cyclical. But you also had tech, you had health care, you had staples to a certain extent in some regions. So, I think that will maybe look a bit different come the end of Q3. But anyways it was something I wanted to point out there.

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**Himesh Patel:** Yeah. And like you just said, quality has been tilted towards growth recently. So it'll be interesting to see exactly how it'll rotate and turn over. Perhaps it goes into quality value. But again, I think the market mantra is stocks follow earnings.

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**Étienne Joncas Bouchard:** Exactly.

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**Himesh Patel:** Earnings growth is more positive on the cyclical areas in the sectors of the market versus those that are more growth-oriented, even though both are still on an absolute basis positive. So it's still a net positive overall. But if you're looking to allocate and figuring out which areas of the market might do better versus others, I think you've got to follow where the fundamentals are shining through.

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**Étienne Joncas Bouchard:** Perfect, H.P., we're getting close to time. I'll put you quickly on the spot. We don't necessarily have time for a full outlook, but if there's one thing that you'd say look out for in the next quarter. Is there anything that sticks out in your mind that maybe investors should keep their eye on to that will likely drive the market? Is there something in your mind?

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**Himesh Patel:** I don't think there's a big catalyst. I just think, as we move into the fall of 2021, it's sort of a Goldilocks environment right now where nothing's too hot and nothing's too cold. But there is some of those market-moving days like we're reporting on today where we got that dovish speak from the Fed and things are kind of risk-on right now with growth outperforming on the day. But I don't think there's one thing I can point to. I just think there's going to be lots of things that are just going to come out like new inflation data, new economic GDP data that might move the markets on a short-term intraday basis. But we're kind of in this Goldilocks environment where if earnings continue to come through and the fundamentals speak for themselves, I think you'll be rewarded over the long term.



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**Étienne Joncas Bouchard:** Yeah, the market is just going to tread on. There's no... I'd agree with that. I think keeping an eye out for any sizable undershoot for either an inflation data point, either a retail sales data point, anything that would somewhat give doubt in the mind of investors of this early-cycle recovery and the pace and the velocity of it. I'd say if we see like a really big undershoot on one of those, that'll move markets quite a bit. But then once again, what do I know? That's just a guess there. Thank you H.P. for joining me. Thank you, everyone, for listening in. We'll leave it at that. Thanks for joining us.

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