Fidelity Connects

Canadian Economy and Markets: A Look Ahead

Sri Tella, Portfolio Manager

Pamela Ritchie, Host

Voiceover: Hello and welcome to FidelityConnects, by Fidelity Investments Canada, connecting you to the world of investing and helping you stay ahead.

We are joined today by fixed-income portfolio manager Sri Tella, discussing global trade, government debt levels, and the current investment environment for the bond market.

For Canadian investors, Sri is involved in twelve Fidelity Canada funds, ETFs and private pools, including Fidelity Canadian Bond Fund, Tactical Fixed Income Fund, Monthly Income Fund, and Canadian Balanced Fund.

With host Pamela Ritchie, Sri looks at the impact of low interest rates on Canadian investors. He also touches on provincial borrowing in Canada, Canadian consumers and savers, and the price of oil, noting how global demand is picking up, and that Canada is less reliant on oil then it used to be.

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Pamela Ritchie: Tiff Macklem, governor of the Bank of Canada, had this to say recently: "With a complete recovery still a long way off, monetary policy will need to provide stimulus for a considerable period, and the bank will continue to do its part." Will expectations of rising long term yields, or inflation, here in Canada, mount pressure on Governor Macklem to change his course? Or will the strength of the labour market and CPI data continue to be the major factors driving the direction of monetary policy? To help put all these pieces together and to provide an update on how he's positioned for today's evolving environment, we are joined by Portfolio Manager, Sri Tella. Sri, warm welcome to you. Great to see you again.

Sri Tella: Thanks Pamela. Good to see you too.

Pamela Ritchie: Let's begin with situating Canada within the world a little bit. How does Canada look to foreign investors, fixed-income investors? How does Canada stack up?

Sri Tella: If you look at it on a global basis, Canada, over the last number of years, has been a popular place for foreign investors. Before the pandemic, it had been a good spot in terms of government finances, and as well if you think about going back even as far as the financial crisis, Canada fared very well through that period of time. Now, obviously Canada, the profile has shifted. There's been a lot of debt raised at the federal level in order to deal with the pandemic. I know that's a concern for some people on a go-forward basis. However, that being said, if you look at Canada relative to all the other major developed countries, what it has done isn't out of line with what a lot of other countries have done as well.

So from that standpoint, I think Canada should still see interest from foreign investors, and as well, if you think about where rates are globally, North American rates, Canada, U.S., on a relative basis compared to other developed countries around the world, still look very attractive and that's even after foreign investors look at those yields hedged back to their own local currencies.

[04:08]

Pamela Ritchie: So interesting. Good to get your thoughts on that. I'm just curious, we did that quote from Tiff Macklem in the introduction to welcoming you here today. What does the Bank of Canada, what would they need to see to change course? Would we need to see a Fed move on some level? What would it take to see a change of course for the Bank of Canada?

Sri Tella: I think you will start to already see some of the messaging change over the next little while. Central banks are usually reluctant to make quick shifts to their thinking. They do like to message things to the market over time. I do think the backdrop has changed considerably. Even the last time I was on, I remember being much more cautious on the outlook. But a lot has changed since then. You have vaccine rollouts going fairly well. Granted, Canada is probably a little bit, is behind the U.S. and probably behind where people had initially expected, but it's still much sooner than what we would've thought of a few months ago.

If you think about that, plus the fiscal stimulus that the Canadian government has been providing all along and the renewed fiscal stimulus in the U.S., that bodes well for both Canada and the U.S. over time. If you remember back the Bank of Canada previously had not factored in additional stimulus from the U.S., and they also expected a vaccine rollout to be not till 2022. With that shifting, the Bank of Canada has to shift its focus a little bit.

That being said, the recovery is somewhat uneven. There is still a lot of sectors and areas of the country that have been hit hard, and it's going to take time for that output gap to close in and for us to see sustained inflation and growth over a long period of time. I do think the Bank of Canada will shift its messaging, but in terms of moving rate policy any time soon, I think that's still a long ways off. What they might do is start to message to the market. That will be their first goal is to change the tone of their conversations to sort of prep for what could be coming.

[06:34]

Pamela Ritchie: That's when we get the magnifying glass out to look through the words of the statements to see where that signalling and forward guidance might be. Let's talk a little bit about different areas of the bond market. I want to talk about the price of oil, which is being impacted today due to OPEC Plus, and there's lots of things swirling around. The fact is we've seen oil go up and that affects Canada. It affects the revenues of Canada. It affects the oil producing provinces. What does a rise in the price of oil globally mean for this country and investment?

Sri Tella: Canada, you can say, is a little bit less reliant on oil than it used to be, but obviously for parts of the country it's a very big deal, especially like provinces like Alberta, Saskatchewan and Newfoundland in particular. I think what you've seen is it's really the economic outlook that's driving this. So you did have OPEC put cuts in place and now they might relax some of the production cuts going forward, but the issue is really more about global demand picking up considerably from where it was. So that's driving not only oil but a broad swath of commodity prices which all of that is beneficial to Canada because of the Canadian economy being so focused on commodities. So it's not just oil, but also other commodities. But for sure, oil prices where they are makes a bigger part of the industry. I mean at current prices most of the industry is very profitable and able to increase cash flow and grow. So that's a positive for the country as a whole, but in particular the regions that have been hardest hit over the last, actually not just year, last number of years because of depressed oil prices.

[08:32]

Pamela Ritchie: We'll come back to some other parts within the bond investment thesis, but I'm curious just to grasp where bonds belong right now? A little bit the case for bonds and actually in this changing environment, if the case has kind of changed. Bring us up to date on where this fits.

Sri Tella: We were speaking earlier about I obviously have a biased viewpoint 'cause I would love to say that everyone should buy bonds and only bonds, but of course, the environment for the bond market is going to be challenged over the next year or so as the pressure is for rates to move higher as the economic growth increases and central banks remove some of the stimulus. That could still be a couple of years out, but the markets obviously already starting to price a lot of that in. So we're going to look at low returns on bonds, but I think it's important to always think about a more diversified portfolio and where bonds play a role, and if you think about a diversifier to your portfolio, but also the thing I would point out is that if historically if you go back 80, 90 years, there's only been a handful of instances where bonds have had negative returns over a full calendar year.

The pace of the move more recently obviously has hit returns on bonds in the short term, but over time some of the yield that you get from bonds offsets the rate move higher, and we are in an environment of low yields, so that is a bit of a headwind that the bond market faces right now. But that being said, if you look at those historical periods of negative bond returns, they're typically followed by a high single-digit return to bonds the following year. Even if you go back to 2013 where we had a similar situation with the taper tantrum, which people are likening the current environment to potentially, we saw negative returns there. We saw 10-year rates move up 110 basis points, but the following year we had, I think it was 8+% returns in the bond market. And then if you go to 2016 through to '18, we saw rates rise, I think it was about 160 basis points over the course of that two-ish year period, and we still had positive returns all through '16, '17 and '18.

I think the key is we're not going to be able to time the market perfectly. We're going to see volatility in bonds, so I think it's important to remain diversified and bonds will still always be a protector of any sort of increased volatility risk-off, and if we see an acceleration in rates, that's not necessarily good for equity markets either which you could argue could face pressures in that scenario. In an actively managed portfolio, there are ways to minimize the impacts of higher rates as well.

[11:51]

Pamela Ritchie: It's fascinating. I want to have you talk a little bit about the health of companies that have been able to, through various stimulus efforts, capitalize themselves, make sure that they have cash. They've been able, in some cases, to refinance at much lower rates. Have we passed what was expected to be a bit of a default cycle? Like most recessions you have the default cycle that comes. Have we skipped over that and, if we have, what does that mean for the quality of companies?

Sri Tella: We've definitely seen the expected default rates in the market come down quite significantly. The key being that the low-rate environment, the opening of the capital markets, and central bank liquidity that's been pumped into the markets, I think, is all supportive of companies being able to maintain liquidly and access the markets. I think the key is that the central banks have made sure that good companies aren't going to fail do to a macro shock to the market. Maybe if a company isn't run well and has its own idiosyncratic issues then there are risks to its business.

At the end of the day, what the Fed and the Bank of Canada wanted to ensure, and they did it with programs they put in place last year in terms of corporate bond-buying program and other measures, they want to make sure that good companies will survive through a macro shock like we saw over the last year. With rates staying low, a lot of good companies were smart about accessing the markets, shoring up liquidity on their balance sheets, making sure they had cash, and I think that that was important.

When we look for companies to invest in, we were looking for good companies that could make it through for a year or even two years, depending on the sector with depressed revenues, but just making sure they have enough liquidity to get to the other side of this. I think that that's been the key thing that has supported credit markets over the last year.

[14:11]

Pamela Ritchie: On that level it sort of worked and now we're in a new stage. I want to understand what you use the lens of ESG for, if at all. When you look at companies, it's still a little bit in flux exactly what companies will have to live up to on some level to what ESG will mean, but at the moment do you use it as a lens or how is it useful to you, the fact that companies are at least thinking about their ESG scores?

Sri Tella: I think there's two aspects to ESG that are important. One is obviously the more recent phenomenon over the last few years where ESG is becoming a more prominent part of either investment mandates or people's preferences. Canada, the U.S. are behind where Europe might be in terms of ESG issuance in the market place, so I think that's a trend that's important because it's going to be where there's going to be demand for ESG-related investments and green bonds in the marketplace. That could impact valuations as well. I think what's more important to note is ESG factors, whether they're front and centre or not, have always played an important role in the health and outlook of companies.

If you think about when we are looking at analyzing a company, the governance structure, the way independent boards and so on, factors like that have always been important in terms of thinking about the management of a company. Environmental factors, sustainability, if you think about the oil and gas sector as a perfect example, environmental issues, regulation, carbon pricing, all that stuff is really important from a standpoint of a company's health and outlook. Those are all things that we've always thought about.

Now there's a much more formal process because they're front and centre and we're seeing green bond issuance. I think that it's just taken more of a focus and it's more explicitly discussed, as opposed to being factors that we included in our overall analysis. It has impacts for valuations going forward as well in terms of as there's more demand for green bonds and that's going to potentially put valuation differences in the market between non-green and green bonds, and that's something we take into account as well when we're looking at valuations in what we invest in.

[16:50]

Pamela Ritchie: We've seen rates go higher. We've seen actually a pretty big move. How do you look at rate volatility for the rest of this year, or over the medium term? Have we seen the big move or what do you think?

Sri Tella: It's a good question because that's something we debate every day. I think you're going to hear very differing opinions on that. I think my own view is that volatility is going to continue because you're still going to get the market and the central banks, I don't want to say fighting with each other, but the market's going to try to push in one direction, and then the question is whether the central banks have the fire power and follow the right approach in terms of either managing expectations or whether the market sort of pushes the Bank of Canada into actions earlier than they may otherwise want.

I think volatility is going to increase. You have to keep in mind, we've already seen 10-year rates in Canada move up 70 basis points in the last two months. If you go back to that example of 2013 taper tantrum that I talked about, we saw 10-year rates move 110 basis points. A lot of that move, if you draw parallels between those two environments, a lot of that move has already happened. I do think what was surprising over the last couple months is the pace at which the move happened. It was very quick.

Rates going higher shouldn't be a surprise, but how fast it happened, I think it wasn't just market expectations but there was also some positioning issues and technical factors in the market that exacerbated the move, but I do think that we probably see things normalize a little bit over the next little while as we get more direction from the central banks, but I do think we're going to see a lot of headline volatility around economic data, and central bank headlines and even maybe this afternoon when Jerome Powell is speaking.

[19:02]

Pamela Ritchie: All eyes are peeled certainly for that one. With the universe that you set out, that you see at the moment from your perspective, where are the opportunities? Do you like loans? Where do you look for … you're looking largely at provincial debt, you look at certain corporate debt. Where are the pockets of opportunities you can share with investors?

Sri Tella: When we look at valuations in various sectors, in credit sectors nothing looks cheap. Everything looks rich on a historical basis. We're back to pre-COVID levels and in some cases even through historical tights of the last number of years. Going forward is really more about a yield story in a fixed-income portfolio because it's hard to see spreads go considerably tighter in any sector. But that being said, as I mentioned earlier, one of the things we're focused on now is because rates are such a big focus is how do we minimize the impact of higher rates to a fixed-income portfolio. Things we like is shorter-dated credit, getting the extra yield, short-dated bonds that have less sensitivity to interest rates, but yet give you a much higher yield in a very low-yield environment. As well, the front end of the yield curve being somewhat anchored because of rate hikes not likely to happen for, according to the central banks, a couple years, but the market's starting to say maybe a year or year and a half from now. That's one area.

Along with short credit, that includes high-yield leveraged loans in funds that can invest in those asset classes, especially leveraged loans are a great spot because they're less sensitive to rate rises because of the floating rate structure on those. That's key. Even a bit of a barbelled strategy where you have that short credit to get your yield, but even maybe having long bonds, which sounds counterintuitive if you think rates are going higher, but if you look at even more recently, we've seen the yield curve steepen out considerably and 30-year yields are actually well above where they were pre-COVID, whereas 10-year rates on that front still potentially have more room to go. If you go back to the 2013 scenario, the yield curve flattens very sharply in that tantrum scenario. We like being a little bit barbelled and that long duration, like I said, while may be counterintuitive, it also does protect you against a risk-off period and an impact to if you get some sort of shock again, and risk assets take a hit it gives you some protection on that front as well.

[22:01]

Pamela Ritchie: A couple questions rolling in here. This is a great question, the Canadian-U.S. dollar, thoughts on that. There's some thoughts that a U.S. dollar might be stronger short term. How do you look at it long term? And I guess Canadian versus U.S., but maybe the Canadian dollar versus other universes as well. How do you look at the currency issue?

Sri Tella: The currency from our standpoint, if you think about it, the strength of the Canadian dollar of late is really more of a U.S. dollar weakness phenomenon. If you compare the Canadian dollar to pretty much every other country, it actually hasn't performed that well. The growth profiles of the two countries, Canada and the U.S., the U.S. is arguably on a trajectory of faster growth than Canada, although Canadian growth numbers did surprise to the upside quite a bit for the fourth quarter.

Pamela Ritchie: Lots of housing.

Sri Tella: Yes, there was lots of housing, which is another topic we can obviously discuss. I think that does argue for some strength of the U.S. dollar, stronger economy and potentially … but at the same time the Fed has indicated it's willing to let the economy run hotter in terms of targeting average inflation, which means theoretically that they could maybe keep rates lower for longer than in Canada. Barring any change from the Bank of Canada in terms of its inflation targeting framework. I'm not a currency expert, but I would say that the key here is that Canadian dollar has been strengthening only more recently because of the U.S. dollar weakness more broadly, and on a relative basis to other countries, it actually hasn't fared as well.

[24:08]

Pamela Ritchie: Questions coming in about seeing a recession on the horizon. Are we prepared for it? Great question, and I might just extend it to what risks keep you up at night? That question. What are the risks that you do scenarios for, that you are concerned could be out there?

Sri Tella: I think in terms of, I guess, a recession, if we think about the probabilities of recession and the way we look at the fundamentals and so on, they're fairly low at this point. The risk is that maybe more from a market-driven shock in that, if the market starts to price in a lot in terms of rate hikes or pushing forward rate hikes, that's kind of where we're spending more of our time right now thinking about, you know, the central banks have indicated that rates aren't going to go up for a while, but the market can tend to overreact at times and as growth comes in stronger, as the economy reopens and people start to hopefully get back to more normal lives, you could see a scenario where the market starts to price in more aggressive hiking path for both the Fed and the Bank of Canada.

If we look historically, obviously last year the recession was an outside shock from the pandemic, but historically recessions get started by Fed hiking cycles. The Fed starts to hike rates and there's a series of hikes and that slows down the economy and that's how we get these cycles.

If we start to look at an acceleration of the removal of monetary stimulus, then that's something to watch out for in terms of what that means for the markets and the economic recovery. But that's also why we feel that the central banks will be very cautious in removing that stimulus, and they're going to do a very good job of trying to talk the market back if there's any extreme moves in the marketplace, because the economy is still very vulnerable to higher rates, and so that could quickly derail the recovery.

[26:27]

Pamela Ritchie: As you say, the vulnerabilities are there. What about the strength, or maybe vulnerabilities, of the consumer, the Canadian consumer? I also want to try and squeeze in a question about provincial debt in different circumstances. First of all, what's your take on Canadian savers, health of the consumer?

Sri Tella: This is where it gets interesting because the numbers will tell you that consumers are in great shape, that savings rate has gone up significantly because people aren't able to spend money on a lot of things that they normally would spend on. People probably consumed goods more and more than they historically would have because that's really all they are able to spend their money on because they can't go out to eat. They can't go to movie theatres and do all the stuff people love to do.

That being said, there's a big discrepancy and the averages are not necessarily indicative of the broader situation because you're seeing a lot more inequality in terms of, there's a lot of variability in terms of people that have been impacted and not impacted, and obviously I think the numbers skew to middle and high-income type earners and savers. That's where a lot of the savings is and so those numbers get skewed higher.

You also have the aspect of debt deferral that we've seen over the last year, which has also improved household balance sheets and metrics. It's lowered default and insolvencies because people haven't had any payments due on some of their debt. So I think it's hard to draw a big true generalization. I do think the consumer, as things reopen, we do expect there's going to be pent-up demand in spending, and that's going to show up in the numbers. The question is will it be sustained? That's where we're sort of trying to do a lot more work now is thinking about … we've started to talk about inflation, inflation is going to pick up because last year prices were quite depressed, and so just from base effects from one year to the next we're going to see inflation temporarily pick up and you'll likely see the same with spending. As people start to be able to leave their houses and go out and do more things, consumers are going to spend more.

As we said, a lot of people do have savings built up and they're going to want to do things. They're going to want to travel. They'll want to go out to restaurants. They're going to want to do a lot more of that. So that's going to pick up. But the key will be in the next three to six months is, will that be sustainable, or will it just be a quick out of the gate, things are going to improve and then we kinda of go back to normal and flat line again? That's where there's diverging viewpoints and that's also where you may see the market get ahead of itself in looking at near-term numbers and not necessarily think about whether this is sustainable longer term.

Pamela Ritchie: Becomes sort of a cyclical versus structural story for the savers and how they look at it and inflation as well. Can I ask you in 30 seconds to just give us a little bit of a taste of the provincial … their debt loads, the deficits they're trying to grapple with. It's obviously an extraordinary time. You've mentioned the oil producers and the impact, but what about the other provinces?

Sri Tella: Broadly, optically provincial borrowing has gone up significantly for COVID-related spending, and the hit to revenues and their budget deficits have increased, but as things have improved in the economy, you're starting to see some of those numbers get revised to a much better spot. If you look at the borrowing profile of the provinces or expected borrowing profile over the next couple of years, it's actually stable to improving. The key is really to think about the bulk of the spending's been done at the federal level. It hasn't been done at the provincial level. The federal government has been spending to support the provinces and even municipalities. While there's going to be a lot of debt issued out of the provinces and their numbers aren't going to look as good as they did a couple years ago, I think there's no need to be overly concerned about provincial debt levels currently. It's really more about the federal sort of spending and how that's going to look a few years from now as things start to improve in the economy.

[31:05]

Pamela Ritchie: Sri Tella, it's always a pleasure to speak with you. Thank you for joining us on Fidelity Connects.

Sri Tella: Thanks for having me.

Pamela Ritchie: Sri Tella joining us today to talk about the fixed-income market particularly as it has to do with Canada. Thanks for joining us. I'm Pamela Ritchie.

Ending: *[31:23]*

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