Fidelity Connects

David Wolf, Portfolio Manager
Pamela Ritchie, Host

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Voiceover: Hello and welcome to Fidelity Connects - the Fidelity Investments Canada podcast - connecting you to the world of investing and helping you stay ahead.

In today's podcast, we welcome back Portfolio Manager David Wolf, who is part of Fidelity's Global Asset Allocation team. Among many other funds, the Global Asset Allocation team manages the Fidelity Managed Portfolios, which are a suite of risk-targeted investment solutions that use tactical asset allocation to provide a range of income, balanced, growth and retirement-focused portfolios.

Today, David and host Pamela Ritchie will discuss the Federal Government's extraordinary rate of borrowing, and how this may create a challenge for the Canadian economy. David also touches on the growth vs. value rotation, his views on gold and how he and his team is positioning going forward.

This podcast was recorded on December 1st, 2020.

[01:47]

Pamela Ritchie: Deputy Prime Minister and Minister of Finance, Chrystia Freeland stood in the physically distanced House of Commons yesterday and delivered the government's fall economic statement. Up to $25 billion is earmarked for more support to small businesses, workers and childcare. All of that could mean that the federal government closes in on a $400 billion deficit for the year, which possibly, if left unaddressed, going forward, could tip the debt-to-GDP ratio onto a risky path. What do new levels of consumer and government liabilities mean for the markets? How should we think about Canadian equities, bonds and our currency to the broader context of global asset allocation? Today, we are joined by portfolio manager and former advisor to the Bank of Canada, David Wolf. Welcome back, great to see you again.

David Wolf: Great to see you, Pamela, and thank you everybody for joining us this morning.

Pamela Ritchie: Let's go right to it, David, and ask for your views on parsing through some of the political side of things, because there's a lot of that in anything that resembles the federal budget. In Canada, what is the debt position? Is it as non-consequential as the government wants to make it sound like we're not that badly off considering debt of other countries? How do you view this?

David Wolf: It's bad. That's the short answer to a long question and I can give a much longer answer, but the upshot is it's bad. What we saw last night out of the fall economic and fiscal statement — the mini budget that we tend to call it — was just an extraordinary rate of borrowing, a massive deficit, near $400 billion as you mentioned, about 18% of GDP. You haven't seen anything like that since World War II. Then there's a projection for some improvement, but that relies on significant improvement in the economy, and it doesn't account for the kind of additional fiscal spending that might be necessary to fuel that economic recovery.

[03:53]

Pamela Ritchie: So what of [*audio cuts out*] discussion that Canada, for instance, was not at terrible debt levels let's say, five, six, seven years ago, therefore there's room to borrow, which is one argument.

David Wolf: It may come back to the sort of lies, damn lies and statistics old saw. The federal government, the debt number that they show, it started at around 30% of GDP last year — that's a pretty low number — going up to 50% this year because of all the spending and the big deficit. That's still quite manageable. It's lower than what it was 20 years ago, it's the lowest in the G7, that's great — or at least looks great. That is a net debt number, so not a gross debt number, so it doesn't include all of the total borrowing because it nets out assets, some of which can be a little sketchy, shall we say, in terms of their valuation and such. It's only the federal government, so it doesn't include all of the debt piles among the provinces, municipalities… It doesn't include all the borrowing that's been done by households, as you mentioned in your open, by corporates as well. When you take all of the debt together it's not 50%, it actually gets closer to 450% of GDP and that's one of the largest piles. In fact, I think is the largest pile, relative to the size of the economy behind Japan among the developed world. The number that's put out by the federal government sounds good, and not surprisingly so, but high and rising debt is a challenge to the Canadian economy and is a vulnerability that is something that we really have to be quite mindful and careful of going forward.

[05:42]

Pamela Ritchie: How then do you position? Taking this as somewhat a given that this type of debt is what is in the Canadian economy at this point, how do you position for that?

David Wolf: Well, two ways. The first is thinking about Canada relative to other countries. Everybody is doing this debt binge and so you could say "well, we're doing what others are doing, it doesn't really matter". But it does because Canada is both the size of the debt and the rate at which it's getting bigger; i.e. the deficit, the borrowing, is among the largest in the world. That means that the wall, where you hit the wall going on ahead — it may be two years, four years, six years, what have you — is closer for those economies that are more indebted and becoming more indebted. It's one of the reasons why we've been tending to prefer exposure outside of Canada, rather than inside of Canada. There are a number of risks that you and I have talked about many times related to excesses in households and the housing market, etc., but broad debt tends to be a very good leading indicator of economic stress and asset price stress. That's something that we should be quite worried about in Canada. So that's the first thing.

The second thing is, take the world as a whole, and everybody is basically borrowing as much as they can get their hands on, particularly governments. They finally figure it out and this makes it almost the end of an era. So to speak, the governments have finally figured out that if there's no inflation and the central bank is willing to keep rates at zero, you can borrow as much as you want with virtually no consequence. The story of the past 40 years, to a large degree, has been rates going down, governments getting their houses in order — and it's Canada, it's the U.S., it's Germany, it's France, it's Australia, it's basically the entire G20 — and that era is now over because rates are as low as they can go and governments have finally figured out that there's no constraint on their borrowing. But there is a constraint, and that constraint is going to be inflation because this borrowing inevitably is going to be such a real burden that the only way out of it is to let prices rise.

As a long way of getting to your question, the one thing that balanced portfolios like the ones that we run are vulnerable to is inflation because it's not good for bonds, it's not good for stocks and it's not good for the negative correlation between them. What we're doing quite deliberately is shifting, particularly the defensive parts of our portfolio, away from nominal bonds and towards more protected real type assets — TIPS in the U.S., ARBs in Canada, gold, some other asset classes that are quite cheap because nobody's really worried about inflation at this point, but we think it's going to be very important diversification and protection that will be needed… I don't know if it's six months from now or six years from now, but you don't buy insurance just before you need it so it's a good time to get it now.

[09:03]

Pamela Ritchie: One of the things that we also saw in GDP numbers coming out for the third quarter in Canada yesterday, is 40% growth through the third quarter. This is through the summer months. Massive bounce-back, obviously, from an incredibly low negative base that we saw during our initial lockdowns across the country. That accounts for that huge jump. It actually wasn't quite as high as some had expected. But when you see that kind of powering back, and I know it's in the rear-view mirror, does it bring to light the question of "do we need as much stimulus?" If you get the vaccine — I know the vaccine is months away for most people — it sort of brings things into focus; do we need as much as we thought we needed because we might get through this and clearly the economy does bounce back. What do you make of that?

David Wolf: Great question. Couple of thoughts. First, not unlike our conversation with respect to debt, that +40% is pretty misleading. It's accurate, the economy bounced back at a 40% annualized rate in the third quarter of the year. That's wonderful, it's one of the strongest numbers we've ever seen, but it didn't actually get us back to where we were at the end of last year. In fact, you'd still need 25% more growth just to get us back to where we were. It's a little bit like what you heard in the U.S. crowing about record 14 million new jobs. Well you just lost 23 million earlier in the year so you're net behind and it's nothing to crow about. I think the same is true with respect to the economy as a whole and policy makers' reaction to the economy that you talked about. I It's my view that even as we get further economic healing, so to speak, and there are positive signs with respect to a vaccine on the way and markets have certainly been trading like they anticipate or see some light at the end of the tunnel.

But the fact remains that the level of output and the level of unemployment are going to be unacceptable for a long period of time to come, even as things get back to quote/unquote "normal" or whatever the new normal is going to be, and that's going to require ongoing monetary support and fiscal support. To put it another way, you can't be spending — the federal government spent this year on their budget $670 billion and only took in about 270. You can't keep spending $670 billion. In many cases it's to keep folks at home so they don't spread the virus. That's an enormous amount of borrowing, but you can't just stop doing that and assume everybody is going to get a job again and everything is fine. This kind of support, in some form, in some magnitude, I think is going to be needed not just in Canada, but in a lot of countries for quite some time to come.

[11:57]

Pamela Ritchie: The exit strategy is so tricky. It's sort of a paper tantrum type analogy. How do you take the punchbowl away? It's tough once it's already there. I know that you must — given your background and we mentioned some of it in the introduction — go through this with a bit of a fine-toothed comb. It's an excess of

200 pages in the mini budget that we saw yesterday. Is there anything in there that many others didn't pick up on that you kind of tucked away for another moment? Give us some highlights for you.

David Wolf: The first thing I'll say on that is for anyone out there that has trouble sleeping, get a copy of the 239 page mini budget that came out from Finance Canada last night and I guarantee you will drop off in no time. I made it all the way through, although as I woke up this morning I think I had a page stuck to my head, so maybe I didn't get quite to the appendices, so to speak. But there is always some interesting stuff in there and, particularly given my background as a policy maker, we're not going to rely on what the papers say, or the banks say or anybody else says about what the government is doing. We want to see directly what the government is doing, which is why we, and I, look through with a fine-toothed comb.

One of the interesting elements which didn't, I think, get picked up by many is on page 139 or something. There was a little paragraph saying that the federal government is committing itself to figuring out a tax on foreign owners of residential real estate in Canada. That's new. That's been talked about. It's very tricky in a number of ways. At least property taxes are a provincial jurisdiction not a federal jurisdiction, but we know, and you and I have talked about how foreign capital has been part of the story behind the nosebleed prices that houses have reached in Canada, and particularly in Toronto and Vancouver, which is another sign that the policy makers are recognizing that, addressing that, trying to make housing more affordable to Canadians and it is clearly a vulnerability in terms of the value of houses at this point.

[14:16]

Pamela Ritchie: There was a big piece of that 40% growth in GDP that we saw through the third quarter. There was a big housing boom through parts of sort of spring, summer, all of that chugging through those numbers. Fascinating. It almost feels like the U.S. election was so long ago. It wasn't actually that long ago, but you kind of said that you thought markets would go up pretty much regardless. They have, so any further thoughts as you glance back to a big election for this continent?

David Wolf: I recall that when you and I talked, I think it was two months ago when I was last on the webcast, you said two things. Number one, the only prediction I'm going to make about the election is it's going to be a mess; and that regardless of who wins the market is going to go up because the uncertainty surrounding this election is sufficient that people are keeping cash on the sidelines, and when that uncertainty gets resolved people will dive in. And that is how it's gone. You can't prove the counter factual that if something else had happened the market might have gone down, but we were strongly of the view that the time to get in was before you actually saw that it was time to get in. So we upped our risk profiles and that's been very helpful in terms of engaging the rally that we have seen in contributing to returns in our funds. The market itself has been behaving quite interestingly. Not just strong, but there's been a rotation involved as well from growth to value, and that's particularly helpful for our more value-oriented funds that we run; the multi-asset funds, the monthly incomes, the high income ETFs, etc. It's been fine for the bulk of our funds where we participated in the rally because we try very hard, as you and I have talked about, to make sure that those are really balanced solutions, so whether value wins or growth wins, because we have exposure to both, we win. In terms of the value growth outlook itself, we've seen false dawns in value for years. Growth has outperformed for years and years, and every three, four months or what have you, value starts to work, and energy goes up and banks go up and what have you and it seems as though this is finally value's time to return to prominence, and then it fades.

Whether the 8th time, or the 12th time or whatever time it is is the charm, I don't know, but there are definitely some things going for value in a couple of ways. One, you really need a stronger economy for that, and so the vaccine is a big deal as far as that light at the end of the tunnel. Then the second issue that you have is that valuation spreads, how value is value in a sense, have gotten quite wide. Value is even cheaper than it usually is versus growth. You've got that going for it. But you look at the growth stocks, particularly the leadership in tech, and as you know we have one of the most extensive research operations in the world, and our research analysts say this is not at all like 2000. The biggest names in the S&P, in the U.S. market, etc., the ones that we know — specific names because I'm an asset allocator and not a stock picker — they have great businesses, they have great prospects and the cash flow projections on which the valuations are based are not outrageous. And we have an economy that's increasingly going virtual and high tech and people staying home like you and I and what have you.

All to say, I don't know if this dawn of value is for real, but in the bulk of our funds we want to make sure that we're not exposed to either side overly; which is to say that if value wins we can win, if growth wins we can win because we've got both in the portfolios, and both with managers like Mark Schmehl, Wil Danoff on the growth side, or Joel Tillinghast, Dan Dupont on the value side, who are proven in terms of outperforming in their specific discipline.

[18:46]

Pamela Ritchie: Fascinating. There's so many questions coming in actually that you're just answering them as you go along. I'll put some of these to you. One I really want to get to though is, President-elect Biden has appointed a Treasury Secretary, that is Janet Yellen, formal chair of the Fed. You know her, tell us a little bit about where you've met her and really your thoughts on what her appointment means?

David Wolf: Janet is wonderful. I think she's a great pick for the Treasury Secretary. I had the privilege to serve on a committee in Basel that she chaired while I was at the Bank of Canada, and got to know her through that and through central bank channels more generally. She is absolutely wonderful. She is a brilliant economist, she was a great head of the Fed and I think she's going to make a great Treasury Secretary. We actually spoke about three weeks ago. We have folks in a lot with our portfolio management group to hear from people directly who we think really have the kind of knowledge and experience that are going to help us in making our investment decisions, and we actually had Janet in to give us a talk, about three weeks ago. It's very interesting. One of the questions I asked her was with respect to fiscal dominance, which is sort of an arcane concept, but it's basically when the central bank can't do anything anymore because they're tapped out and fiscal policy is all that really matters.

Janet is very calm and very nice, but she did get a little bit worked up at that, which was not unintentional on my part I must say, but she was speaking as the former head of the Fed and I wonder if her answer would be the same now that she's going to be the Treasury Secretary. One of the thoughts that comes to mind is only Nixon could go to China, and only someone who used to head the Fed could be the Treasury Secretary that gets the Fed under its wing to really get the kind of cooperation between monetary and fiscal policy that reflates the economy, but also compounds these debt issues and brings the risk of inflation.

[21:03]

Pamela Ritchie: So interesting. Within some of the balanced pieces that you spoke about in your portfolios, the question coming is here the role of gold and what you make of the recent sell-off of gold, where it fits, where it co-relates, where it diversifies… Why do you think it's sold off?

David Wolf: There are two primary reason why gold has sold off. One, it got very crowded. Positioning in gold, whether you look at spec positions, you look at the size of the major ETFs like IAU. Clearly a lot of folks are crowding into gold and it's a trade that had worked very well for a couple of years in some cases when nothing else was working. The other issue that you've had is with this renewed enthusiasm for economic recovery partly coming from the good news on the vaccines, real yields have gone up somewhat and gold tracks real yields extremely closely. That's where you've gotten going from $2,000 to $1,800 or so, it's up some today. We still think gold is an excellent diversifier. I It's not an asset that we expect is going to be giving huge returns over time, although there are periods where obviously it has and will do, but we think it's actually a central part of a portfolio at this stage because it is defensive, but doesn't have the vulnerabilities that bonds have given that neither has any yield. But bond prices can go down in particular if you have a degree of inflation, and bonds could be correlated with stocks in a way that gold is unlikely to be. We still hold a lot of it, we bought more as the price has gone down. As an ex-central banker, if you asked me 10 years ago would you be owning tons of gold, I would've said, "Are you crazy?" I did not believe in, did not understand the role of gold and a central banker will say, "Well, we're off the gold standard so why would you own it?" But when central banks and governments look to be consciously or sub consciously intent on debasing their currencies by borrowing and creating it at unprecedented rates, real assets are useful and gold is a real asset and has been for 5,000 years.

[23:36]

Pamela Ritchie: It goes perfectly to the next question rolling in here, David. This is on currencies, particularly on the Canadian dollar, the U.S. dollar. Your thoughts on those, but it seems like the second part of this question is really what it means for your thoughts on international currencies and equities.

David Wolf: We have had a bias and have pressed that bias, in a sense, away from North America, so from U.S. and Canadian markets towards international markets, so that's EAFE, Europe, Japan, etc., as well as emerging markets — and by the way, that's true on the equity side as well as the debt side. We'll take the U.S. piece first. The U.S. market has done better than any other market for quite some time. If you are getting some degree of a rotation towards value, it's those other markets that have more value in them. The way we're trying to craft the portfolios is — to use a technical word, convexing, which is to say we want to be overweight equities — to be overweight equities in areas that are cheap. If the market goes up we'll participate, and if the market goes down you have a great margin of safety because these stocks in these regions are already cheap. So that's the general strategy that we've taken.

[24:54]

Pamela Ritchie: That's the general strategy and it may actually answer this question, but maybe there's something to add. The question, what is your outlook for the next year, for 2021, across asset classes?

David Wolf: It's hard… I seem to say this every year that people should expect lower returns than they have in the past, and fortunately for all of us it always seem to be a year or two away because this year, it started out looking very grim, but stock markets are now positive for the year. I think our flagship Global Balanced Managed Portfolio, Series F is up something around 10% this year. Returns have been quite good. If you stuck with it, if you've been prudent, if you rebalanced as we do through the weakness in the first quarter of the year. I would say just given the world we live in with basically zero interest rates, and given the rally we've seen, return expectations should be subdued for the coming year.

We still think stocks are going to outperform bonds, which is really hard to see them yielding much of anything. We do like real assets, I mentioned, as a diversifier more as a return source. We are preferring as well higher income areas of the fixed income market; that's commercial mortgage-backed securities, that's emerging market local currency debt, it's areas where we have a very strong credit research team so we can avoid the losers, so to speak. And harness areas of the market where you can still get 4, 5, 6 or 7% yields which are obviously not on offer anywhere in domestic markets.

A year ago I would've said shouldn't really expect much out of 2020 and we've had 2020, and yet stuff's still up, so what 2021…

Pamela Ritchie: I was just going to say maybe that's why you got your 14th and 15th Lipper Awards, is that right? Congrats.

David Wolf: That's right. Thank you. Not that we're counting.

[27:07]

Pamela Ritchie: No, not at all. Give us some thoughts — and, of course you do this through the various portfolio managers and where you asset allocate — but in Canada people are always interested in banks, in some of the big sectors that we have here. We have interest rates where they are, banks are reporting, we've seen some success so far in Canada, what's sort of the outlook on the interest rate story, but also maybe some of the other stories on financials? I'll just throw a couple of sectors at you here, but I know you're probably going to say that's not what I do, but I'm curious what you think.

David Wolf: One of the challenges that I think that we have in Canada is we have a very value-skewed market. It's got a lot of financials, it's got a lot of resource companies, and to our earlier conversation, that hasn't been the place to be. Maybe it's getting more the place to be. One of the reasons why the Canadian market has done relatively better in recent [*inaudible*], the strategy that we're taking, as I mentioned, is because of some of the idiosyncratic risks in Canada. If we want those value exposures, we think that we're better off going to parts of Europe, parts of emerging markets than in Canada. The other challenge is ESG, which is something that we've become very focused on as a firm. I think you're going to have Nicole on sometime soon, if you haven't already, to talk about our efforts that way.

If you're looking at ESG from an investment point of view, and you're looking around at different markets around the world, Canada isn't your first stop, particularly given a lot of the intensity in energy sectors that may be improving, but still oil sands are not what ESG investors are going to buy. The more money goes into ESG, the more underperformance you're likely to get out of those sectors. Again, we're not bearish on Canada, but we think there's much better opportunity for return elsewhere.

[29:12]

Pamela Ritchie: Interesting. Just one final thought, just to wrap up our conversation — it's flown by as always. The overweight equities, can you just come back to that, to leave people with a final thought on the positioning.

David Wolf: We are content being overweight equities. We are overweight risk, overweight beta. We're underweight in nominal bonds, in bonds generally, but particularly nominals and then filling that in with some of those real assets as well as higher income assets. There is a big wall of worry out there. It's maybe not quite as high as it was earlier having gotten through the election and with vaccines on the horizon, etc. People are getting bulled up, which also makes us a little bit nervous, but when you have indefinite monetary and fiscal stimulus, which I think is the case, money is pumping in, it's got to go somewhere, it's been going into equities and that's likely to continue and to participate.

Pamela Ritchie: David Wolf, a pleasure to speak with you always. Thank you so much for joining us on Fidelity Connects.

David Wolf: Thank you, Pamela.

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