Fidelity Compass

Quarterly Global Asset Allocation Outlook

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David Tulk, Portfolio Manager

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Pamela Ritchie: Hello and welcome to Fidelity Compass. I'm Pamela Ritchie. It's a time when central banks are grappling with persistently higher inflation. We see geopolitical stresses affecting market mechanics and putting into question economic growth. No wonder, then, that institutional investors may be asking several key questions about the path ahead. Will the disruption in global supply chains and higher energy prices act as a bit of a brake on the world economy? Has the outlook for emerging markets changed? How far will central banks be willing to go in monetary policy normalization? Given the uncertainty that has dampened some market sentiment in recent months, what should institutional investors be thinking about when it comes to managing volatility in the current environment? Very happy to introduce you to, or reintroduce you to, two people who will be joining us in this discussion today, portfolio managers David Tulk and David Wolf. Welcome to each of you. Good to see you.

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David Tulk: Great to be here.

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Pamela Ritchie: Glad to have you joining us here today. I'll begin, David Wolf, with you if you don't mind, asking a bit about the time horizon. We've talked a lot about inflation sticking around a bit, being a bit stickier. You've seen this for some time. Do we actually know how long it might take, do you think, to get this under control?

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David Wolf: Well, it's a great question and arguably the central question that faces us. The short answer is we have to ask the central banks because they're ultimately in charge of how long inflation is going to persist. That's their job. They frankly haven't done a very good job of controlling it and they need to fix that. So if we step back a bit, as you mentioned, we've talked about the likelihood of upside surprises on inflation for quite some time including in these webcasts and other forums. The insight that we had was everybody's focused on demand and demand has been the primary driver of inflation for 40 years. But actually, in this case it's supply, and it's not only supply with respect to the supply chain issues that you mentioned, but also things like pandemic-related restrictions, labour scarcity, commodity scarcity, et cetera. What had happened over time is markets, and the central banks themselves, with the models that they run, because we're so used to dealing with demand shocks, they'd basically taken supply curves out of their models, which in retrospect doesn't seem like a very good idea, obviously.

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But what is meant is they've missed the likelihood that inflation was going to go up and stay up the way it has. Now, they're recognizing their mistake. Markets are also recognizing their mistake that, wow, this inflation is not going away and we really need to do something about it. You've seen the pricing in of some pretty aggressive interest rate hikes, which I think is appropriate. But ultimately, what the question that you're asking in terms of the durability of inflation comes down to is, how hard will it be for central banks to fix their mistake and are they going to be willing to do what they need to do in order to fix it? I think the answers to those questions is really going to shape a lot of what we see in the economy and in markets for the quarters and years to come.

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Pamela Ritchie: David Tulk, are there pain thresholds that we have to think about here? What ultimately can investors tolerate? Give us some sense of what the central bank may have to be grappling with in order to chart this course.

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David Tulk: I think David Wolf outlined that very effectively. Ultimately, central banks have to be comfortable at some point in killing the cycle. They have done a lot, obviously, through the pandemic. You can say with the benefit of hindsight that was understandable in the depths of the alternative being a global depression caused by the pandemic, but as time has gone on, and as we've seen stimulus to the economy, it's very much appropriate now to remove that. Again, they will have to sacrifice a certain amount of economic growth. They will have to sacrifice a certain amount of employment as well. This is an interesting nuance for central banks around the world. A lot of them have either dual mandates, where employment is specifically embedded in what they're trying to accomplish, or they've started to nod in that direction as well. It's not just employment at an aggregate level, there's more of a focus on an inclusive economic recovery. Those very laudable goals, which you can maybe argue shouldn't have been in the basket of monetary policy to begin with, but nevertheless they may be challenged. I think that comes down to if the Bank of Canada and if the Fed and other central banks around the world, if they feel as if the cycle has progressed enough where there is as strong of an employment backdrop as they can hope for, then they can start to take that policy stimulus away. I think as you look at job losses from the pandemic, now having been fully recovered, they're much more comfortable now with taking that next step.

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Pamela Ritchie: David Wolf, how would you look at Canada in this environment and the U.S.? The central banks each have their own stories and paths that they have to chart, but how do you look at each in terms of what they need to deal with?

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David Wolf: There are clearly some commonalities between the two economies in terms of how this is likely to unfold. In both countries, you've had inflation go up and stay up. In both countries, you've had a very strong economic recovery. And in both cases, it makes sense, as David Tulk just said, to be withdrawing stimulus. I think we're looking at kind of two phases for the economy and for markets. In the early phases, and we'll talk, say, three months, six months, nine months, I think economies will actually be quite resilient to the tightening that we've seen and resilient to some of the increases, for example, in energy prices that folks are really worried about in terms of dampening the consumer and the overall economy. That's because, again, if you go back to the earlier comments about supply, supply has really been constraining

economic activity and growth. As those supply constraints loosen, as those supply chains start to improve, even if it's gradually, even if demand slows a little bit, the economy can still grow. I think the surprise that we're going to get over the next few months is that despite everybody's pronouncements that high oil prices will kill the consumer, tighter monetary policy is going to immediately put us in recession, I actually think the economy could look okay over the next few months.

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The second phase gets more into what we were talking about earlier, which is, how hard is it going to be to get rid of inflation because it's not going away immediately and the economy is still doing okay, is also going to support continued increases in prices. Ultimately, as David Tulk said, you are going to have to kill the cycle and I don't think that's soon, but in the fullness of time, central banks are going to face a very difficult decision, which is to say, to get control of inflation we need to take risks with the economy and we're going to have to take risks with employment. We're going to have to take risks with financial markets. But ultimately, inflation is their job and for all the dual mandates and different goals or whatever, their primary job is controlling inflation. If it requires a recession to do that, then in the fullness of time, that's what they're going to do.

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Pamela Ritchie: David Tulk, everyone runs algorithms to know certain things that could hit one's portfolio one way or the other, and the Fed included, of course, was on this path thinking that certain things were in place and it had to grapple with a few problems. The geopolitical uncertainty that has come from the Russian invasion of Ukraine has really added to this. I just wonder how we put this into the overall ... it's added to the inflation story, it seems, but is there anything else we need to worry about in terms of further inflation unfolding due to the geopolitical state?

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David Tulk: I think maybe one of the consequences of the increase in geopolitical tension, and this is something that actually has been building prior to that as well, is the trend towards deglobalization. If you look at exports around the world, generally as a share of output, they have stopped increasing, which means that the world sort of achieved peak globalization around 2008 and 2009, and we've been moving a little bit in the other direction and arguably that has accelerated, partly maybe as a consequence of geopolitical tensions, probably even more so because of the pandemic and the vulnerability of supply chains that we've been trying to grapple with. When you think about a less globalized world, that is inherently inflationary as the world is less efficient. That, I think, can certainly be a tailwind underlying the inflation story that central banks will need to wrestle with. Unfortunately, there's not a lot that they can really do to respond to those global pressures other than really just look at their domestic inflation profile and respond to that.

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I would also argue that, again, we've seen the composition of inflation move from very cyclical transitory type of elements to more persistent drivers of underlying inflation, which themselves will take a longer period of time to address. The final point I'll make to highlight the challenge the central banks face is that we're increasingly seeing, to some varying degree, but I think on balance, higher expectations of future inflation. We know from the example of the 1970s and 80s, once inflation expectations are entrenched at a higher level, they become very difficult to break and to bring back down to the low and stable level we've enjoyed over recent decades. That can be very pernicious. That, when you think about it from a central banking perspective, requires central banks to display a greater degree of commitment to bring inflation expectations down, so that in a practical setting means that policy may need to be higher for longer than what central banks and what we all currently believe.

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Pamela Ritchie: That's interesting. David Wolf, will you pick up on that to an extent because we all watch WARP and take a look at what's expected, how many hikes and when and how? How do you respond to that if maybe we have to see higher interest rates for longer? The market isn't really pricing that in.

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David Wolf: The market is more and more pricing that in. But let me address that question with the second part of your prior question, which I hadn't gotten to ... my fault ... which is the Canada-U.S. difference. As I mentioned, there are a lot of similarities, but I think one of the key differences, and to the point about what happens with rate hikes and how far and how long, et cetera, is the process of bringing down inflation in our judgement is going to be more painful in Canada than it is in the U.S. That's because of a couple of different things. Number one, the underlying inflation pressure, the demand and supply imbalances actually look worse in Canada than in the U.S. Now, you can't necessarily see that in the inflation data themselves. Inflation is 6% in Canada versus 8% in the U.S., but if you look under the hood and look at where those inflation drivers are coming from ... and some of this is a technical matter of how it's measured ... it actually, in our judgement, will be more difficult to get Canadian inflation down than U.S. inflation down.

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The second aspect of that is the Canadian economy is significantly more leveraged, both outright and with respect to interest rates, than the U.S. Think what's happened the last 15 years, American consumers have generally got their balance sheets into better shape. You've had broad-based economic growth. You have a consumer that's really pretty well positioned to deal with higher rates. That's not true in Canada. We've had, obviously, a huge extension of the housing boom, a big increase in leverage, housing and consumer spending generally has dominated as far as economic growth is concerned. The vulnerability that the Canadian economy has through tighter monetary policy and to higher rates is considerably higher than the vulnerability in the U.S. Right now, the market is pricing the Fed to go up to about 3% by the end of next year. We think that will probably be tolerable for the U.S. economy and consumer. The market is pricing the Bank of Canada to get to about 3% at the end of next year. That's a lot less likely to be tolerable for Canada.

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Pamela Ritchie: The fiscal story, perhaps, David Tulk, on a couple of these. We're going to hear more about spending over the course of the next while, what implications, I guess, just to add to what we can tolerate. I mean, the fiscal story, can we grow out of the debt that is sitting there right now? What's your comment on that? This is a Canadian question.

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David Tulk: This is a challenge and this is something that Canada will face acutely, but lots of other regions around the world will face as well. When you look at really the history of high levels of debt and indebtedness, basically the only way to really come out of it on a sustainable basis is to rely on inflation. Historically, you can try to grow yourself out of it, but that's proven to be very difficult when you look at historical examples. You can try to develop some theme of austerity but, again, that doesn't seem to be the flavour of the day in the Canadian economy in particular. If you have maybe some of your debt that's denominated in foreign currencies, you can maybe rely on a depreciating exchange rate, so I think that's certainly something that we would anticipate in time from Canada. So really, the path of least resistance is to let inflation erode the real value of that debt. I [audio cuts out] the politicians later on this week, but if there is a slight silver lining [audio cuts out] through the lens of dealing with [audio cuts out] when it comes to inflation, that could very well be the case.

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As for the more immediate priorities of the government and the spending patterns we might see announced later on this week, again, I think the focus very much is maybe on actually contributing to even more inflation, just thinking of additional stimulus that is pushed into the economy. This actually just brings me to another quick point that I wanted to make. When we think about something that David Wolf said earlier about higher commodity prices and the risk of that slowing the economy, one thing that we have certainly seen is a tremendous amount of fiscal support. So household balance sheets, income statements are better positioned now than they would have been previously. So, there's at least some offset to that [indecipherable] economic growth.

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Pamela Ritchie: David Wolf, I wonder how this all leads ultimately to an overview of positioning. We included in the introduction a discussion of emerging markets, some of the ... what this environment means for the emerging markets, a discussion of that, but broadly to positioning, what ultimately do we need to keep in mind walking forward here?

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David Wolf: Whenever we think about our portfolios and asset allocation strategy generally, there are a number of different dimensions that we think about, the kind of equity beta that we're running, the kind of duration that we're running, the kind of regional splits of asset allocation, the sorts of credit exposures, currency exposures, et cetera. A couple that I'll mention specifically, so number one, we are tending towards continuing to have an overweight to equity. The reason for that goes back to my comments earlier, which is, I think it's going to be pretty stress-free or relatively stress-free these first few months of tightening. The market's already suggesting this to some degree. If you said to me three months ago, the market's going to be pricing 150 basis points, more Fed tightening, what do you think equities are going to do? I would have said down and from that point, they're not. They're down for the year, but they're actually up 9, 10% from the lows that we saw immediately following the Russian invasion. The market, I think, is sensing the fact that, yeah, growth will be okay for a while, inflation will, at least in a measured way, start coming down and I think that gives you some runway for equities. So we're retaining that positioning.

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I think further out, though, and one of the ways that we're going to be trying to approach the cycle is to say, we're going to take opportunities of equity rallies to reduce our positioning in our risk profile. The reason is, as I mentioned, it may seem pretty stress-free at the outset, but in the fullness of time, to really get inflation back to target and regain that control, we're likely to need a recession and the central banks will probably have to put us in one, however, reluctant they may be to do that. That's obviously an environment where we want to have a much lower equity risk profile. We're underweight now, but we expect to be evolving that as the cycle goes along to a more defensive position and that's consistent with the history. When you look back at it, it sort of is a stylized way of putting it. It's not really the first hikes you're supposed to worry about as an investor, it's the last hike. So we've just seen the first hikes, it still will be some time before we get those last hikes.

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Pamela Ritchie: Does it make a difference when we have a lot of expectations? It looks like some Fed signaling, depending on how you interpret things, that the hikes are going to come quite quickly and faster. How does that impact one way or the other when the pain comes earlier or later, I guess?

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David Tulk: There's an adage in central banking that central banks traditionally take the escalator up and the elevator down, but that might get flipped on its head at this point with the elevator on their way up when you look at how the market has priced several 50-basis point rate increases in a row. That is telling, certainly, that there is the recognition among central banks now that they are woefully behind the curve and need to do a certain amount of tightening, arguably more tightening than they had previously envisioned. The interesting thing and again, this kind of hinges into what David Wolf talked about with respect to the first versus the last rate hike, given where policy sits today, it's exceptionally stimulative. If you are able to move 50 basis points at a time maybe several meetings in a row, you're now only approaching the bottom of a range that might be considered to be neutral or even further from something that's outright contractionary.

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It's relatively easy to take these larger steps given that the prevailing level of stimulus in the economy more generally is still accommodative. I think central banks would be very loath to finish a rate hiking cycle or be above neutral and then take 50-basis point rate hikes at that point. I can imagine that strategy of saying, okay, we are behind the curve, we need to do a little bit of catching up and as we get closer to that threshold at which economies are vulnerable, then that's where the policy environment will become much more difficult and that's also an environment where financial markets are likely to be more sensitive. Tying it back to Canada, given the vulnerability that exists in our economy with respect to leverage, it's likely to bite first and more aggressively in Canada than perhaps in other economies around the world.

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David Wolf: Maybe if I could just follow on that because I think there's an important link to one of the topics that is really been front and centre in markets of late, is the yield curve. As David was talking about, you have a situation where markets are expecting the short-term interest rate to be much higher in a couple of years than it is right now. That's why the 2s 10s curve is as flat as it is or even close to inverted. That's not the case now and, actually, the yield curve that tends to be most predictive with respect to forthcoming recession or economic pressure, what have you, is the 3-month to 10-year yield curve, which doesn't reflect expectations of policy two years from now, it reflects where policy is today. As David mentioned, where policy is today is very stimulative. Long-term interest rates are much higher than short-term interest rates. They won't be in a year or two the way that the market is positioned, and that makes sense. But there's a lot of wood to chop to get from here to there so, again, it feeds into this two-phase type of approach, which is the initial phases of tightening are probably not going to be terribly damaging as we expect and as the curve seems to say. But further out, you are going to get to neutral, maybe beyond with respect to policy, you do have economies that are very sensitive to interest rates because of high debt, particularly in Canada, and that's going to be a much more challenging environment. So again, being risk-on at this point makes sense, using opportunities of rallies to trim that back, we think also makes sense.

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Pamela Ritchie: David Tulk, the other forms of Fed tightening and, ultimately, its role in the bond markets of buying up bonds, that also is going to change. We've got some signalling that that's going to happen. Does it matter that markets have responded to that yet or not? What are your thoughts?

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David Tulk: It's certainly a risk that if the Fed does not communicate that message effectively to markets, at least their intentions with respect to the size of their balance sheet, that can certainly bring in additional volatility. It also highlights just exactly how far off the conventional pages central banking has taken us in the last couple of cycles. Bringing balance sheets back down, selling securities back into the market, that can be very challenging. You mentioned in the opening that there's a lot of technical aspects to central banking involving themselves in financial markets. You can think of how much the central banks own of nominal government bond markets, so they can certainly encounter issues of liquidity or challenge with market functioning should they sell too aggressively into a market. They're definitely aware of these issues, which probably leads them to err on the side of caution and rely on more conventional tools to tighten policy relative to very large-scale asset sales are back into the market. I think there's also probably a strong motivation for central banks just to hold a lot of these securities to maturity and just refund the proceeds back to Treasuries around the world given some of the debt profile that exists among governments. That's the likely course of action but again, we are in these unprecedented times and probably one strong conclusion is that you need to sort of expect the unexpected and we need to be very sensitive to communications on this front and on this topic in particular.

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Pamela Ritchie: David Wolf, I wanted to ask you a little bit more about EM. We touched on it, but just as we mentioned it off the top, a lot of the emerging markets obviously did not have the monetary policy situations and responses. I'm just curious how different they are, how sensitive they look to the inflation story and whether you still find opportunity, generally speaking? How do you look at emerging markets right now?

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David Wolf: We have positions in EM. We're actually in aggregate in terms of asset allocation, slightly overweight EM. There are a few reasons for that. One, we think it's a good diversifier within equities and a better diversifier than it used to be in the spirit of, as David Tulk mentioned, deglobalization. As regions kind of unhook from one another, you're going to get more idiosyncratic performance in different markets, and so you're going to get more diversification being in EM versus in the U.S. versus in EAFE, versus in Canada. The other thing that we're seeing that we like is an improvement in the policy stance in China and just the fact that EM is cheap. A lot of that is in China but not only China, and one of the core pillars of the way we do asset allocation is valuation and particularly relative valuation, and the relative valuation of EM equity is considerably cheaper versus, say, a U.S. or a Canada or an AEFE than it generally has been historically.

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There are some concerns that we have in terms of EM investment right now. The first is, if you think about the commodity shock that happened before the Russian invasion and then since then with the rise in oil and food prices, that's the kind of shock that a lot of these emerging markets, notably China and India, are disproportionately sensitive to. So that's going to be something that's very difficult for those economies to deal with. We also have regulatory risk in a number of places, not least China, and some different policy choices that are being made with respect to dealing with COVID and the most recent waves. There are a lot of uncertainties, there always are in EM and elsewhere, but there are a lot of reasons why we don't think it makes sense to have a really high-conviction, high-leverage type of trade in EM. But because of the cheapness, the diversification and the right direction of policy, it is a place where we want and have exposure.

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Pamela Ritchie: Really interesting. David Tulk, anything to add to the global picture right now? Again, we're focusing in on central banks, that's really the course of this conversation, but the Fed tends to be the global central bank, too.

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David Tulk: Actually, just before I pull the lens out a little bit, I wanted to add a quick point to what David Wolf just said with respect to emerging markets and this reveals part of our process. When we seek exposure into a region like emerging markets where there are arguably more opaque economies relative to developed markets and there is more opportunity for securities selection on a name-by-name basis, we use active managers. This is something that Fidelity certainly has a strong capability in, in terms of the analysts we have around the world that can allow our building block managers in emerging market equities and in emerging market debt to look at very specific examples of idiosyncratic stories or themes around companies as opposed to necessarily making as much of a macro call. We certainly decide how much of an overall allocation we want to make and then we really rely on their expertise to do a very strong case of security selection under there. That's just a little bit of an observation as to our process.

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But more generally, when we think of the global economy and again, it was mentioned earlier in the call, but the direction of travel for us is to be generally more defensive through time. And that's the recognition, certainly, that we are going to face a market of higher interest rates and there is going to be certainly some pressure on equity valuations as those interest rates move higher. Within that we have those concerns around Canada, that certainly high-conviction view we have, it's ... and this is an interesting sort of nuance to the story because as David Wolf described, there are two stages to monetary tightening, that also sort of applies to our view on Canada where that you can see over the shorter term as long as the commodity story and global inflation is really the dominant narrative, Canada might do okay in that environment and only later when those interest rates reach those more critical thresholds, that's where the Canadian story becomes that much more challenging.

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We have reduced the underweight we have to Canadian assets. We still are underweight, that reflects the medium-term concerns and we never really are sure of when the short term turns into the medium term, but in reflection of that shorter term narrative of higher energy prices of the commodity cycle, we've trimmed that underweight tactically somewhat so, hopefully, that gives you a little bit of a nuance or perspective into some of the more regional equity calls that we've been making as of late.

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Pamela Ritchie: It really does. We've come exactly to time right there. David Wolf and David Tulk, I want to thank you very much for heading up this conversation and joining us in this forum today.

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David Tulk: You're very welcome.

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David Wolf: Thank you.

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Pamela Ritchie: Great to see you both. That's David Wolf and David Tulk joining us today. Thank you for tuning in, so glad that you could. Always feel free to send suggestions for future topics or guests, for instance, that you'd like to see on the show, on Fidelity Compass. We're always happy to have ideas shared with us. In the meantime, do stay tuned for more Fidelity Compass webcasts in the weeks and the months ahead. I'm Pamela Ritchie.

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