Fulcrum issues

Emerging inflation pressures and active portfolio positioning in Fidelity's target date strategies

This Mark Twain quote is an apt description of the management approach for Fidelity's target date portfolios. The multi-asset investment strategies combine long-term research and views on participants' needs and strategic allocation and, in certain products, intermediate-term capital-market views designed to generate excess returns. The idea that standing still could lead one to fall behind underscores the importance of reflecting updated research from both a long-term perspective (strategic allocation) and an intermediate-term perspective (active management).

In the long run, we believe that asset prices converge to the expected discounted value of future cash flows,[1] but over shorter-term periods, there can be mispricings. In our active and blend target date strategies, active management provides the flexibility to adjust portfolio positioning as the market environment changes and to take advantage of these deviations. We seek to identify differences between the expectations that are embedded in asset prices relative to our beliefs about what is realistic. We position the portfolios to benefit as fundamental forces persuade other investors to our view.

A cornerstone of our investment process is to identify and debate what we consider to be the "fulcrum issues" affecting capital markets and asset prices. These issues tend to reflect the central issues that investors are struggling to assess and discount. We focus our research on these issues in pursuit of a unique insight. A fulcrum issue today is inflation: whether it will remain low or accelerate, whether any increases are transitory or persistent, and what investors should do. As we move toward the close of the second quarter of 2021, we observe a mending global economy juxtaposed with elevated asset prices, and policy makers conducting an experimental policy that most of us have not seen in our lifetimes. This backdrop prompts a deeper dive into emerging inflation pressures and our active portfolio positioning.

> "To stand still is to fall behind."
>
> Mark Twain

Inflation: Here, there and everywhere – or nowhere?

Scarred by experience, investors and central bankers have been trained to be vigilant about the dangers of inflation. The causes of inflation have been debated for decades, and the dangers it poses to portfolios are demonstrably real. While inflation has been relatively benign since the late 1970s, inflation watchers thought their time had finally

[1] We acknowledge that certain assets (e.g., commodities, alternatives, etc.) have distinct attributes related to cash flows (or lack thereof), market structure, valuation practices and other factors that can affect prices.

come following the response of central banks to the global financial crisis (GFC). The exceptional size of the monetary and fiscal stimulus from governments and central banks around the world raised the spectre of future inflation. While many investors waited in the years following the GFC for inflation to arrive, it has yet to accelerate above relatively low levels.

As is common with markets and investors, the recent past is shaping perceptions about the future. Those who have warned about inflation over the past ten years have been dismissed as quixotic, or as wedded to outdated economic orthodoxies no longer relevant in today's digital age. After decades of low inflation and falling interest rates, a high degree of complacency regarding inflation has taken hold.

One of our investment beliefs is that market participants often extrapolate the recent past far into the future. We think that market participants' views about the potential for inflation are an example of this mistake.

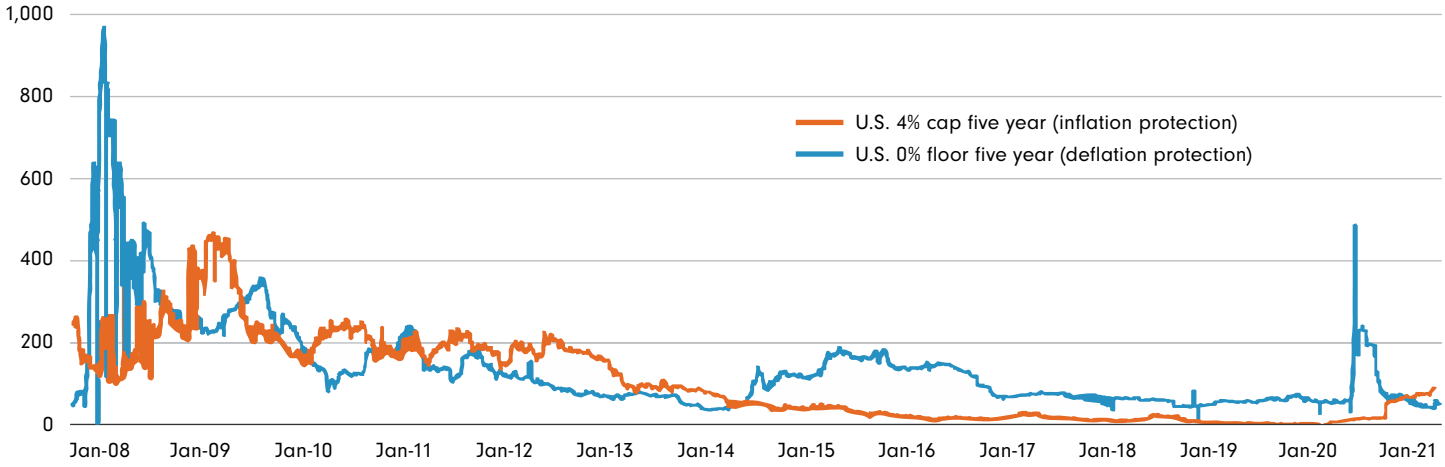
This complacency is evident in several market indicators that suggest persistently higher inflation is unlikely in the foreseeable future. Exhibit 1 highlights the costs of inflation protection and deflation protection in the prices of the Consumer Price Index (CPI) cap and floor. These instruments allow the buyer to insure outcomes above or below the stated rate of inflation. Both series are currently at very low levels, indicating that the volatility of inflation expectations is low. Recent realized inflation measures have had low volatility, and investors appear to be extrapolating this trend into the future.

Over the past several months, prices across asset classes have begun to reflect higher inflation expectations. This trend is evident in increasing breakeven spreads, steepening yield curves, multiples expanding on financial stocks, rallying commodity prices and regional equity returns rewarding reflationary benefactors. Are greater inflation expectations truly on the horizon for the first time in many years, or are the recent increases only temporary? The inverted TIPS curve, shown in Exhibit 2, implies that investors believe inflation will be temporary.

While cyclical expectations have moved higher, we believe that there is greater potential for inflation to be persistent than asset prices suggest. In our view, several of the forces that contributed to the preceding period of benign

EXHIBIT 1: U.S. price of inflation/deflation protection (five year)

>4% caps and <0% floors



Source: Bloomberg data and FMR analysis. Data as at April 30, 2021

inflation have changed course in recent years and have been accelerated by the pandemic. While many factors may contribute to inflation in the years to come, we will explore a few that we consider to be most important: a new framework for U.S. monetary policy, greater tolerance for large fiscal deficits, deglobalization and fundamental forces in the currency markets.

A new framework for monetary policy

Crises have a way of upending the current order, and the GFC was no different. In the GFC's aftermath, the central banking community's long-held inflation-fighting mentality began to erode. Central bankers started to worry more about disinflation. Today, central bankers have expressed comfort with experiencing higher inflation for a period of time before they take action to reverse course. They have moved away from specific inflation targets to "average inflation targeting," widening the tolerance bands for what is defined as an acceptable level of inflation. Central bankers of years past were loath to ever let the genie out of the bottle. Now they confidently assure us that they can, at will, command the escaped genie back into the bottle!

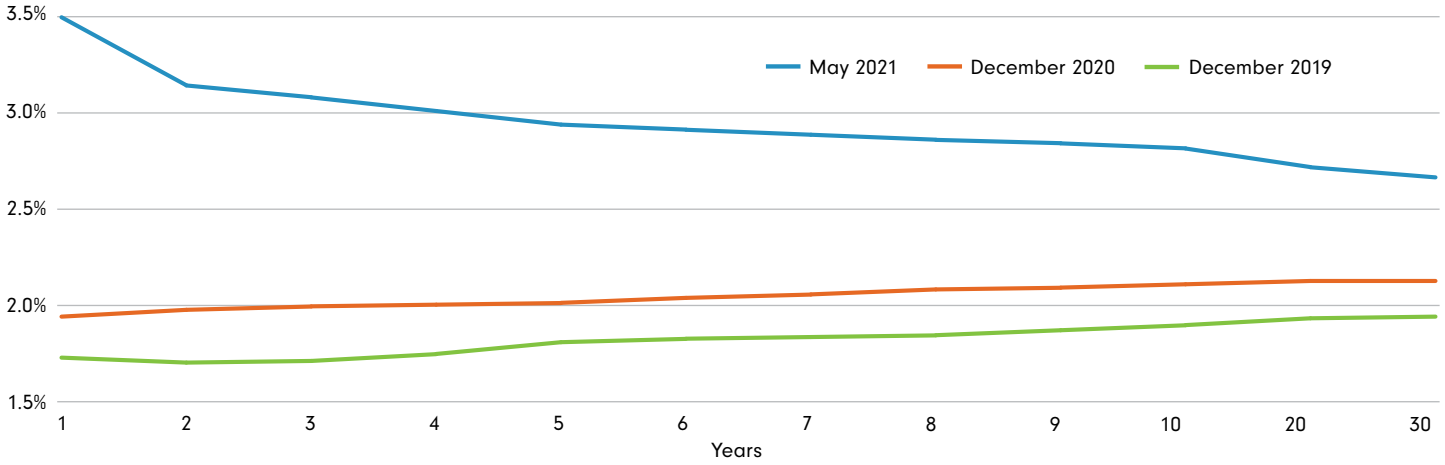
Today's central bankers are also applying a more activist mindset, frequently weighing in on political matters. Beyond lending their voice to political or social issues, the Federal Reserve and the European Central Bank have indicated that policy will be guided in part by social issues. In our view, investors have been struggling to discount the impact of the shift in policy framework and remain complacent about the potential impact this will have on financial assets. We believe we are operating in a new monetary policy regime. While it is unclear what this new approach to central banking will bring, what is clear is that monetary policy is more flexible and open-ended, and the tolerance for higher inflation has risen.

Greater tolerance for large fiscal deficits

This shift in policy spans both monetary and fiscal authorities in the developed world. Many of the policies implemented since the GFC are unprecedented in terms of their scope and size, with the U.S. leading the charge. U.S. fiscal stimulus reached 4% of GDP after the dotcom experience in 2000, 7% of GDP after the GFC, and 13% of GDP in 2020 in response to the pandemic.

EXHIBIT 2: Inflation expectations: CPI SWAPS

Expected CPI Year-over-Year



Source: Bloomberg Financial LP and Fidelity Investments (AART), as at May 12, 2021.

The U.S. is running a deficit at levels last seen at the end of World War II, as shown in Exhibit 3. In our view, we see the potential for even greater spending in the future. From the trillions of dollars of infrastructure and other spending bills planned by the Biden administration to the eventual reckoning of unfunded liabilities such as Medicare, Social Security and state and local pensions, we believe that investors are underestimating the size and scope of capital outlays that will be required from the federal government in the years ahead. Market participants continue to maintain confidence in the credibility of the U.S. government and policy makers, which we view as an underpriced risk, given the aforementioned backdrop.

Deglobalization

One of the most powerful disinflationary tailwinds during the past two decades has been the inexorable increase in globalization. Examples such as firms outsourcing manufacturing, streamlining global supply chains and China becoming the "workshop of the world" kept a lid on the prices of goods globally. Investors expected globalization to lower companies' costs, but in our view, the effect on inflation has been underestimated. From a simplistic perspective, people trade with each other for cost advantages, which leads to specialization when free trade is allowed. The reversal of this process, which we are observing in recent periods, is inflationary. Exhibit 4 shows a measure of trade openness and the correlation between inflation volatility that has been declining for a number of years.

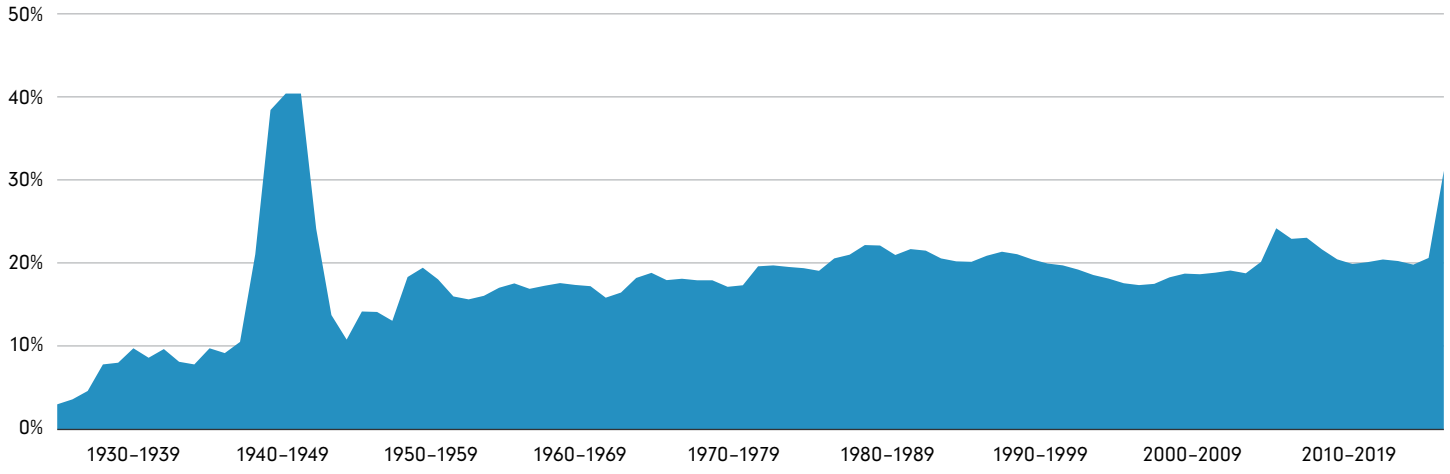
Deglobalization dynamics have historically been accompanied by a deterioration in cooperation among countries. We see this manifest today in the deteriorating relationship between the U.S. and China. As one of the most important factors behind global disinflation for the past three decades, the integrated and mutually beneficial economic and political relationship between China and the west appears to be reversing course, and may turn disinflationary tailwinds into inflationary tailwinds in the years ahead.

Fundamental forces affecting currencies

Lastly, we think it is important to assess many of the long-term trends in the global economy that are likely to weigh on currency markets and the U.S. dollar. There is meaningful

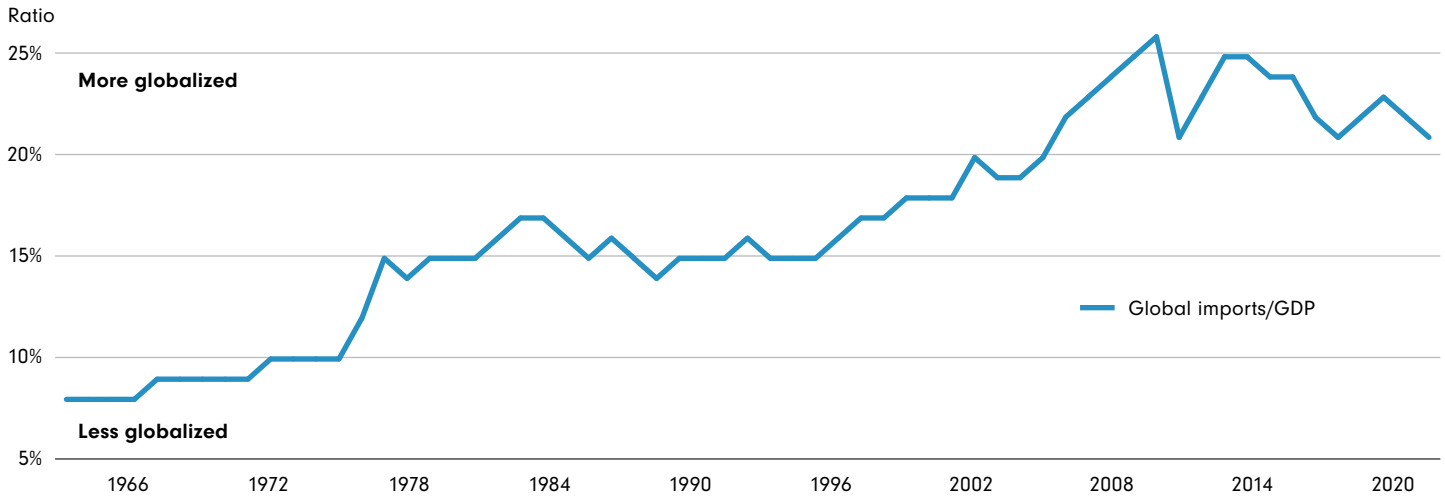
EXHIBIT 3: Largest government outlays as a percentage of GDP since World War II

Mid Price



Source: Bloomberg.

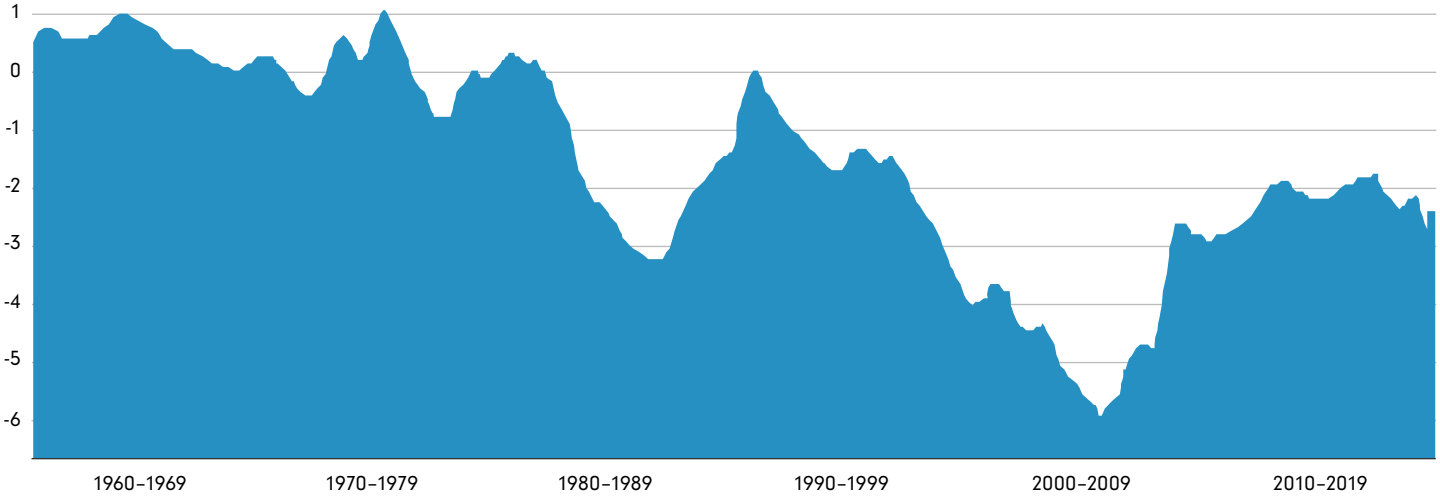
EXHIBIT 4: Trade globalization



Source: International Monetary Fund (IMF), World Bank, Haver Analytics and Fidelity Investments (AART), as at December 31, 2020.

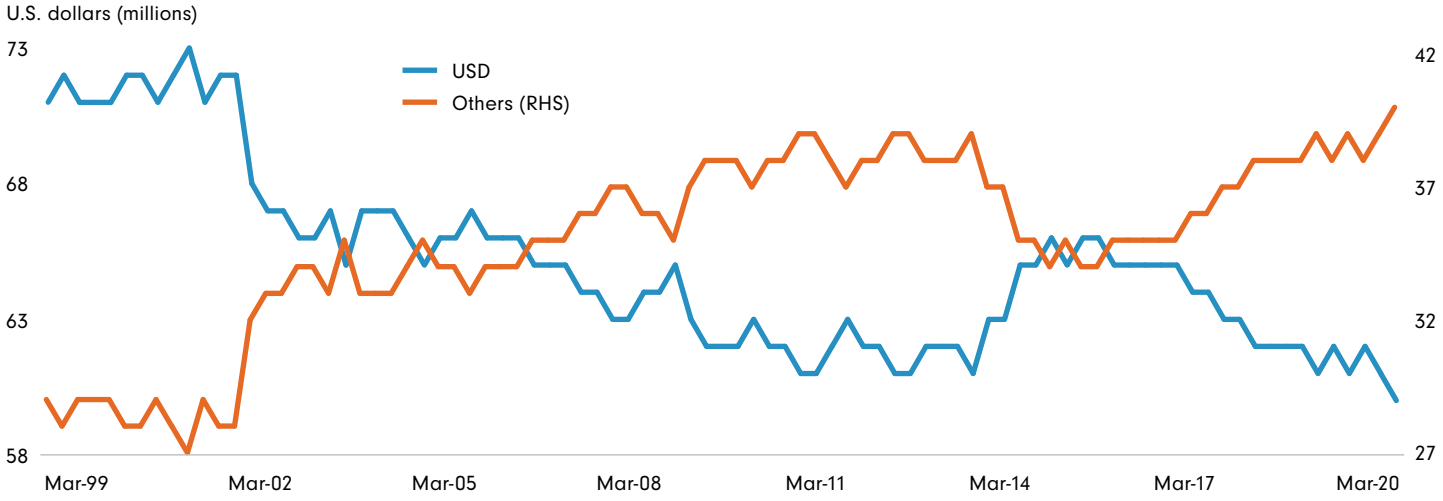
circularity between currency movement and inflation pressure within a country. We believe that currencies tend to move with changes in trade and financial flows. The trade flow is influenced by the relative value and competitiveness of the region. Financial flows have tended to follow the carry or interest rate differentials between countries. These forces – trade and financial flows – tend to manifest themselves in the share of a particular currency in foreign exchange reserves. As China's share of the global economy grows, we expect its currency, the U.S. dollar's most formidable long-term competitor, to play a more prominent role in global foreign exchange markets. Conversely, as the U.S. economy becomes

EXHIBIT 5: U.S. current account balance as a percentage of GDP



Source: Bloomberg.

EXHIBIT 6: Currency composition of official foreign exchange reserves



Source: Currency Composition of Official Foreign Exchange Reserves (COFER), International Financial Statistics (IFS).

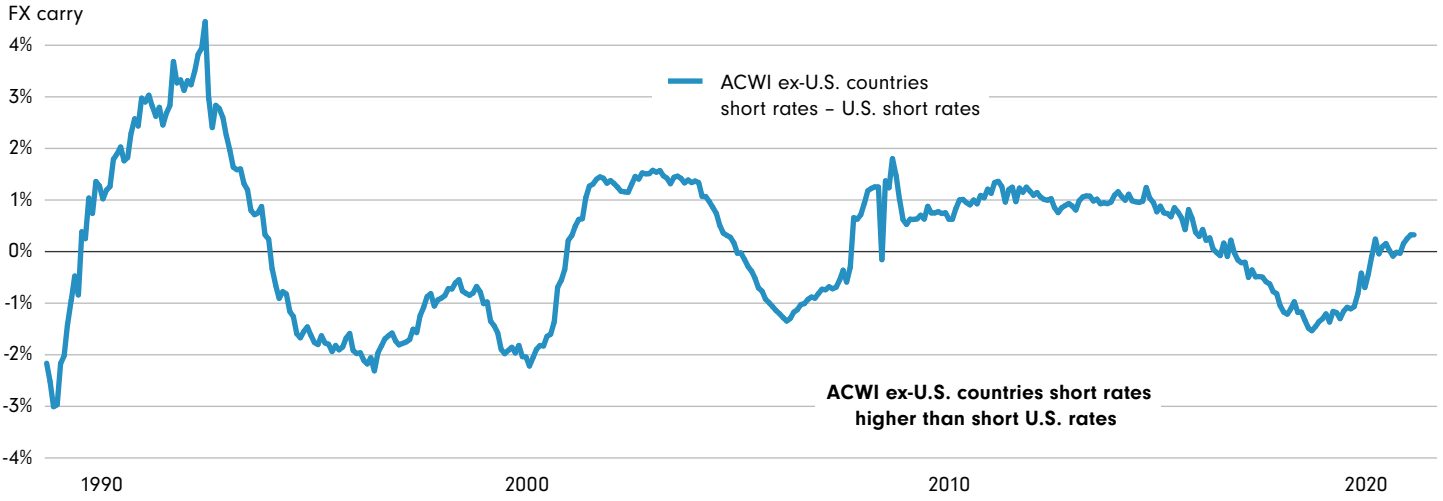
a smaller percentage of global GDP, the U.S. dollar's use as a reserve currency should decline in tandem. Indeed, this has been the case, as illustrated in Exhibit 6.

In addition, we have seen the interest rate differentials and trade momentum all shift in favour of a weakening dollar, as shown in Exhibit 7 below.

Putting it all together: Why we are overweighting commodities

With inflation front of mind, we are focused on managing the opportunities and risks it poses for shareholders in target date portfolios. While cyclical inflation expectations have increased, the absence of durability in those

EXHIBIT 7: Foreign exchange carry: difference in short-term interest rates between U.S. and ACWI ex-U.S. countries

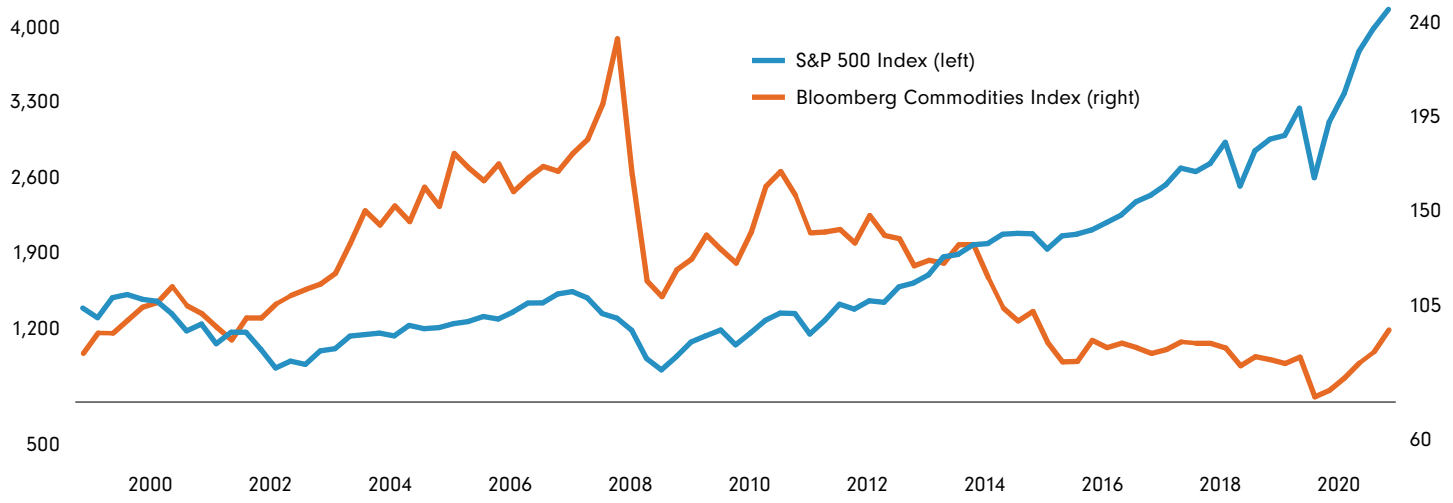


Source: Bloomberg.

expectations suggests we should be patient and prepare by helping to build protection. Historically, commodities have provided positive returns during periods in which there were surprises in inflation expectations. We believe that there are multiple reasons to overweight commodities in a multi-asset portfolio:

- Commodities, especially oil, have been a source of deflation in recent years, a trend that we view as likely to reverse. For example, shale oil companies invested a cumulative amount of nearly $800 billion in capital expenditures over the last decade, which generated little free cash but was highly deflationary. This is slated to reverse as investors become reluctant to fund further investment.
- Supply and demand for many commodities are well balanced; producers have restrained capital expenditures for several years and are seeing new demand from green initiatives. Many commodity markets are now in deficit, as measured by stocks-to-use ratios, and exhibit positive carry. Instead of investing significant sums of money in projects, mining executives are increasingly focused on return of capital. While in theory higher prices will provide an incentive to invest, in many cases it can take years to bring on new supply.
- Commodities offer a way to lean against the optimism embedded in financial assets after several years of equities outperforming commodities, as illustrated in Exhibit 8. Relative to long-duration assets trading at higher multiples (e.g., U.S. technology stocks), commodities tend to have less sensitivity to the prevailing interest rate backdrop. With U.S. equities embedding higher valuations, due in part to strong fundamentals leading up to and during the pandemic, commodities are a way to diversify, especially if rising inflation were to reduce valuation multiples.
- In the scenario that fiscal largesse and easy monetary policy in the U.S. are sufficient to put downward pressure on the dollar, commodities should provide ballast to portfolio performance. As commodities are priced in dollars, weakness in the U.S. dollar typically strengthens the purchasing abilities of commodity consumers in foreign currencies.

EXHIBIT 8: Record equities outperformance vs. commodities



Source: Bloomberg.

For these reasons, we believe commodities offer a favourable range of potential future outcomes, especially in an environment where many asset classes are "expensive" relative to our view of fair value. While we acknowledge the risks to this thesis, such as the deflationary forces of technology or the slack in the economy, we believe that there are reasons that suggest the regime is changing. We believe it is important to reflect the probability of this scenario. If our outlook is realized, we will continue to maintain discipline in our investment process, make adjustments to positioning as needed and follow the spirit of Mark Twain's quote: standing still is falling behind.

Written by: Fidelity's Target Date Investment Team

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