Fidelity Compass

2022 Global Asset Allocation Outlook

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Pamela Ritchie: Hello and welcome to Fidelity Compass. I'm Pamela Ritchie. Today's high inflationary environment demands a different approach to diversification and risk management in multi-asset class funds. As persistently high inflation and underlying supply and demand dynamics continue to pose challenges for institutional investors, many are wondering what steps need to be taken to maximize their returns while managing risk. With monetary policy poised to evolve in the coming months, there could be far-reaching consequences for the market outlook ahead. What might be the right asset allocation approach and where are the investment opportunities throughout this year and beyond? To help us understand some of these questions, we're happy to be joined by portfolio managers David Wolf and David Tulk. Welcome to each of you. Happy New Year.

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David Wolf: Happy New Year, Pamela. Good to see you.

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Pamela Ritchie: Great to have you both joining us here. I'll invite everyone certainly to write in questions, the Q&A is open for that purpose over the next half hour or so. David Wolf, I'll begin with you if you don't mind, to set the table, if you will, the asset allocators challenge at this point of how to look at this inflationary environment and the factors that you clearly have to look even harder at right now.

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David Wolf: Inflation is front of mind for us. I think front of mind for investors more generally and policymakers as well, and understandably so. It's gone in the U.S. from 1% to 7% over the past year. We have long been of the view that inflation was going to be an issue in terms of going up and not coming down and increasingly that seems to be the case. We don't see why that's going to change. You mentioned the supply demand dynamics. Demand has exceeded supply and that's why prices have gone up. That's a pretty basic relationship. We don't really see what's going to change on either side of that. So demand, consumers are in great shape with high savings, rising incomes, wealth effects. Businesses want to invest in higher government spending, certainly isn't coming down. On the supply side, you have supply chain issues, which will take some time to resolve, labour shortages and a more general restructuring of the economy that's related to the pandemic. None of those looks like it's likely to change anytime soon. If demand continues to exceed supply, inflation is going to continue to be not necessarily higher but certainly higher than we've seen for some time.

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What that means for us as asset allocators is a couple of different things. The first, from a strategic asset allocation point of view, the way that we think about it is we're moving to an environment where inflation was low and stable to where inflation is somewhat higher. The question is how much higher, but also more volatile. That means we want to think differently about how we're doing that strategic allocation because not only the perspective returns for the various asset classes, equities, bonds, commodities, alternatives, privates, real assets, et cetera, not only will those returns change but the relationship between the behaviour of those asset classes will also change. Some of the correlations will break, so we're doing a lot of work on that.

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Secondly, from a tactical asset allocation point of view, to your earlier point about rising interest rates and what that means for markets, the thing we're really focused on is markets will eventually, at least in my opinion, have trouble digesting the extent to which policy needs to tighten to regain control of inflation. When that happens is not clear. We've had a little taste of it in the first three weeks of this year, but I think that when we get to the point where central banks decide, listen, we have to take risks with recession, we have to take risks with markets in order to regain price stability, is going to be a very tough time. I think we have some runway yet until we get there and that's really the key call we need to make from a tactical asset allocation point of view.

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Pamela Ritchie: Thank you. David Tulk, there's runway, as David Wolf just mentioned. There are meetings coming up, next week we've got the Bank of Canada meeting, the Bank of England met and moved prior to the end-of-year holiday. We're in this environment, maybe just to add to what David Wolf was saying there, we're firmly here, this is a rate-rising environment in your view and everyone else's?

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David Tulk: No, it absolutely is. Central banks have telegraphed that in a number of ways thus far. We had already a number of emerging market central banks tighten interest rates last year, which was a theme that seemed to have been glossed over by many in the market because we focus on the Fed and other developed market central banks. But this has been ongoing for a period of time and not only do we face the prospect of higher interest rates but we're also seeing, and have seen, some of the more unorthodox forms of monetary policy or stimulus come back as well. So, contemplating the prospect of a balance sheet reduction at the Fed and other central banks may consider steps like that. You're getting tighter policy in a number of different ways and to David Wolf's point, a lot of that hasn't fully been appreciated by the market. A lot of the volatility that we've seen since the start of the year reflects a revised expectation of saying, okay, we've heard from central banks that their reaction function has changed for a step towards inclusive employment and inclusive growth and that certainly remains the case. But at the same time, they know that they've dumped a ton of stimulus into an economy that arguably doesn't need it. So, that's the transition that we're all trying to navigate today.

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Pamela Ritchie: David Wolf, you mentioned that at some point when this becomes perhaps even more of a reality, certain correlations will break. Take us back to that. What do you mean?

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David Wolf: Specifically, the equity fixed-income correlation that a lot of us have really relied upon for decades, the negative correlation meaning that your bond portfolio hedges your stock portfolio. When you get a drawdown in equities, bonds tend to go up, so you get a mitigation of volatility. That's really been one of the factors behind the success of the kind of 60/40-type portfolios that a lot of folks, both on the institutional side and elsewhere, have gotten to as a basic asset allocation. The problem is that when you have not just higher inflation but more volatile inflation, that historically tends to push the correlation between stocks and bonds from negative to positive, which makes sense because if you get like a growth shock, for example, stronger growth is good for stocks, bad for bonds, you would expect them to go in different directions. Most of what we've seen for three decades is growth shocks with inflation low and stable. When you have an inflation shock, if inflation goes up, that's bad for both stocks and bonds, so you would expect to see that positive correlation.

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We think following along from that, we can't be as reliant on the fixed income, particularly the investment grade and government bond parts of our portfolios, to provide protection, which means we need to be more creative in terms of diversification. We've done that, particularly in our institutional mandates that we're responsible for, moving more into real assets whether that be inflation-protected bonds, real estate, commodities, et cetera. We also have to think about currency because currency positioning is a way that particularly funded out of the Canadian dollar base currency, which as we know is a cyclical currency, there are opportunities to diversify and mitigate volatility in our portfolios from using currency positioning, particularly in more defensive currencies … yen, euro, US dollar, Swiss Franc. I think what it ultimately means if you get that correlation between stocks and bonds going from negative to positive that you have to do some different things in order to properly diversify and protect the portfolios.

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Pamela Ritchie: David Tulk, just going a little bit further into perhaps incorporating along with asset classes, regions as well. You actually mentioned talking about central banks, that other countries around the world have moved earlier, but in terms of having exposure to certain regions versus others, can you take us through how some of that is working at the moment?

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David Tulk: I'll start with Canada and certainly there's a lot to unpack here as we get into various markets around the world. But one of the themes that is unique to a lot of countries through the pandemic is a dramatic increase in levels of debt, both within the private sector and also increasingly within the public sector. One thing that makes Canada's outlook in particular more challenging is that we entered the pandemic with already a very stretched level for private sector debt. That raises a whole host of concerns as we contemplate the risk of a rising interest rate environment where what has really driven Canadian growth, arguably for the last couple of decades, is really housing and consumer-related spending. As interest rates move higher and as the debt burden has increased quite dramatically, I think it doesn't take that much in the way of higher interest rates to really start to cause some pain for Canada's economy. So, all of that is to say, over a medium-term horizon when we look at where we want to invest, Canada has a great deal of concern around it.

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That naturally forces us to look outside of our borders. As we contemplate emerging markets, there are some secular trends that have great appeal that you typically will find stronger potential or underlying rates of growth, generally perhaps more accessible valuations in the current market as well. So, there is an appeal there but certainly, cyclically, there are still some challenges and we can get into the conversation about China in particular or elsewhere in emerging markets but over the longer term, there's an appeal there. As we think about the United States and Europe, I think at the same time is recognizing interest rates are moving higher, we also have to dig a little deeper and figure out where the trend rates of growth lie. You can make an argument that Europe still has a lot of challenges under its surface, so there may be a longer term hesitation with that region and that kind of leaves us with the United States that certainly structurally has a lot going for it but its composition of its market has changed so much towards tech that that almost changes some of the relationships that you think of when you approach the U.S. as an asset allocator. There are a lot of different moving pieces that we consider but I think the view that we have the greatest degree of conviction is concern around Canada with a preference for everything outside of our borders.

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Pamela Ritchie: David Wolf, anything to add to that?

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David Wolf: With respect to Canada, as David mentioned, we do have those concerns and just maybe to be precise on the sensitivities, if you step back and you say, well, rates may go from 0% to 2%, that can't be a big deal. But actually, because of that huge increase in the stock of, particularly household debt in Canada, that kind of change would put the household debt service ratio, so the obligated payments, from both principle and interest to service the debt among households to a record high. And that is mind boggling but it tells you just how far the level of debt has gone, it outweighs the fact that the level of rates is so much lower than it used to be 20 years ago, 30 years ago, et cetera. We do have those significant concerns.

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Where the rubber meets the road in terms of our positioning, at least from an equity market point of view, is we really have a sort of a bifurcated view in terms of Canadian stocks, which is to say, we want to avoid the domestically oriented sectors of the Canadian market. That's financials first and foremost but a number of other businesses that have really done very well off of the strong Canadian consumer for 30 years that will, we think, have a lot more challenges going forward. The more sort of energy, materials, globally exposed areas of the Canadian market actually look fairly attractive and that has to do with the inflationary environment that we're in globally, as well as a lot of the supply constraints on those resource sectors, we think that the prospects for prices there generally are continuing to be positive. They're also, to my earlier comment, good diversifiers in a more inflationary environment. Our holdings in Canada are really tilting more towards those resource type sectors, avoiding the domestically oriented sectors and looking for opportunities in the more tech and consumer, what have you, areas of the equity market in the U.S. and elsewhere.

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Pamela Ritchie: David Tulk, there's a question rolling in here from one of the institutional investors joining us, expanding on inflation, how do you look at near term inflationary pressures against the backdrop of longer term deflationary forces such as demographics, debt and digitization?

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David Tulk: It's a very interesting dynamic of where the near term turns into the long term. There certainly are a lot of countervailing forces, both towards maybe some degree of disinflation over the longer term, specifically on technology, but there's also maybe even the consideration that the current environment and what we see from inflation may actually contribute to longer than cyclical inflation when we think about what expectations have done. Expectations of future inflation, which are really hard earned on the part of central banks, that was certainly one of the reasons why the 1990s recession in Canada was as painful as it was is that the Bank of Canada kept interest rates at a much higher rate over a longer period of time to bring expectations in line. We certainly saw the same type of dynamic in the United States through the Volcker Fed. That's just one channel where I think the shorter term does link to the longer term.

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If I can return to the longer term for just a moment and think a little bit about demographics. There is that conventional wisdom that demographics are inherently deflationary. I think you could also maybe make an argument to suggest that an ageing demographic can be inflationary in certain ways where you think of peoples' consumer baskets in their end of days tend to be much more expensive if you think about medical services, for instance. Similarly, an ageing demographic puts a lot of pressure on working-age population, so there can be a dynamic where higher wages in the portion of the population that is supporting the older demographic might push higher, which can then contribute to the higher degree of wage-driven inflation over the long term. I do think the jury is still out and there's a lot of fascinating academic research that's unfolding that will get us closer to a resolution. I know there is certainly that give and take but on balance, I think the fear that we have that inflation is more persistent, especially over the horizon, that we consider when we invest that's what's really driving our concerns and our positioning today.

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Pamela Ritchie: David Wolf, just take us through a little bit more on wages, labour. It's undoubtedly great news for a lot of people. It's a question of what ultimately it does to inflation. Do you watch the wage story very, very carefully? Do you watch the margin and wage story very, very carefully? How concerned should we be when we see higher wages?

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David Wolf: Yeah, absolutely. I think there are actually several points to be made on the labour market and on wages. The first is to follow on David's comments on demographics. One of the things that you have with an ageing demographic is you have fewer working-age people relative to the total population and total demand, so naturally you should get some upward pressure on wages. I think that's one of the things that we're seeing in the current environment. Yes, there are effects from the pandemic, there are shifting attitudes towards work, but you also have a lot of service jobs that still need to be done and a lot of folks who don't want to do them or aren't around to do them, at least at prevailing wage rates. So, that's an upward pressure on wages. The labour shortage issue generally, I think, is one that is not going away partly for that demographic issue, but also more generally, you have an economy where labour shortages are very widespread and folks thought that, oh, well, when you end these benefit programs or EI programs in the U.S., Canada and elsewhere, people are going to come back to work. They haven't and it's not clear if and when they will, unless those wages go up. That's one of the reasons we get more concerned about inflation more generally is, it's one thing if oil prices go up 20% or car prices go up because you can't get semis, but if we have ongoing wage inflation of 4 or 5%, it's really hard to get price inflation down to two. So that's again, that more persistent factor.

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The final thing I'll say, and this is very long term with respect to wages and the labour market, we've seen this persistent move to capital taking more of a share of overall income in the economy and labour less and less. You see that in the fact that wages, particularly real wages, have been stagnant, corporate profits have been way up, corporate margins have been very high. I think just based on the way society is evolving and policy is evolving, we could get into a multi-year, even multi-decade trend of that pendulum swinging the other way, that the requirement to address what's happened with income and wealth inequality means that labour is going to be claiming more of the share of national income than it has been over the past 20 or 30 years. That has consequences for all kinds of things. It has consequences for inflation through those higher wages, it also has consequences to the way that we want to think about capital markets and frankly, it gets to an environment where returns on capital are probably not going to be as high over the next 30 years than they have been over the past 30 years. That may not be what we want, obviously, given that we're investors but that's the world I think that we're moving into. It makes it even more important to be, not only good in terms of your investment selection, but careful in terms of your asset allocation because if returns are harder to come by you, certainly don't want to have an asset allocation where it's easy to fritter away because you've got the correlations wrong.

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Pamela Ritchie: Can some of what you've just spoken about on the labour market be solved by ... in Canada ... by immigration suggestion [audio cuts out] is that one piece of policy that could be aimed at that?

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David Wolf: Yeah, it is a piece, but it's only a piece. Frankly, it's not clear that immigration and immigration of various types is sufficient to expand the labour supply enough to really cause a different trajectory for wages. What I'm talking about in terms of that labour capital mix, that's not a Canadian phenomenon, it's not even a North American phenomenon, it's a global phenomenon. It's been moving one way for 30 years and I think given the attention that's being placed on inequality and the policies that are increasingly reacting to it, the pendulum is probably going to be swinging the other way. Exactly how much and how far and when nobody can know. But that's one of the real multi-year, multi-decade trends that we're thinking about in terms of our secular return projections and in turn, how that's informing our strategic asset allocation.

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Pamela Ritchie: David Tulk, related to that from the monetary policy side of it is really the fiscal policy side of it. There's been some proposed, some huge fiscal programs. We know the Build Back Better Act is somewhat in pieces at the moment and there are political reasons for that in the United States and stimulus programs in Canada and so on, but broadly, do you see governments turning off the taps for a bit until inflation settles? Are you able to make such broad statements one way or the other?

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David Tulk: Yeah, that's a good question. I guess the Build Back program needs to be built back better. Generally speaking, I think the type of stimulus that we've seen injected in the economy, some of it can roll off fairly naturally if there was a destined end to a specific program of stimulus targeting a part of the economy that will emerge out of the pandemic in time. But the movements to some of the earlier comments that fiscal policy is going to play a larger role in everyone's life for a much longer horizon, I think that itself is politically a little bit more difficult to touch. It's easy to kind of

get into those type of programs, I think it's much harder to try to extricate yourself from them down the road. That, I think, is the broader political environment that we're looking at. When it comes to these type of themes and decisions that we look at as an investor, we tend to want to play the cards that are dealt to us.

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It's difficult, obviously, to opine on the future of policy, but what we try to do is we try to take a step back and say, okay, well, what are the real implications for the market or the economy? Again, you can think of various fiscal policies maybe targeting individual industries and that's something that the security selectors we used as building blocks have a great read on. We take away the notion that debt as a theme that you've touched on a few times over the last half an hour, that is something that is not going away. Hinging that back into the inflation story, one of the ways that an economy can try to come out from underneath a significant debt burden is to inflate your way out of it. You're borrowing a lot of money, you're paying back people in diminished dollars. If you have a lot of foreign obligations, you can use currency debasement to try to pay those folks back in diminished dollars. That again contributes to the secular theme of inflation that we've been very worried about. That debt burden can only be exacerbated by the willingness of governments and the desire to continue to run large programs of support into the wider economy.

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Pamela Ritchie: Both of you have worked at the Bank of Canada. David Wolf, I'll put this to you, this is coming in from someone, can you give us a little bit of perspective on just the mindset of the Bank of Canada, whatever kind of insight you would have from years ago being employed there? What are they grappling with? It looks like they have a lot of hikes ahead of them.

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David Wolf: Having been in the room in 37 rounds of interest rate deliberations at the bank, I can tell you that there will be and in fact, they're probably meeting as we speak in advance of the rate decision next week. I think there's a lot of angst. Frankly, I think whether it be the Bank of Canada, the Fed or others, they recognize that they've ... I guess I'll use the technical economic term ... messed up, which is to say that inflation has swelled far more than they would have expected. It looks to be more durable than they expected and policy has been too loose for too long. So, they need to regain control of inflation but they know that having missed out on the opportunity to ease slowly and gradually and sooner, they're worried about the risk that they have some catch-up to do. How they balance that is really a very challenging thing.

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The market right now is pricing in more than likely a rate increase next week and close to rate increases of a quarter point at each of the eight meetings this year. I don't think that's unfair. I think it's reasonable to expect that they're going to move fairly gradually but persistently. The key challenges as both David and I talked about before, is it won't take a lot of tightening in Canada to really pose a threat to economic growth given how leveraged the economy is generally and the consumer is in particular. I think expectations for tightening are reasonable. I think there still is an underestimate of the consequences of that tightening in Canada in particular.

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Pamela Ritchie: Final thought, just curious where energy fits into this overall story. David Tulk, we're hearing about it non-stop. Europe is actually seriously grappling with it. It's a real problem. It's part of the inflation story. I know it's not core, but does it have the power to interrupt things overall or how do you look at it from your perspective?

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David Tulk: We generally are of the view that the cure to high energy prices typically is high energy prices. So, there's that risk of demand destruction if we see WTI reliably above $100 a barrel. But again, in the context of what we've approached from an investment perspective, David mentioned how we view the energy part in Canada as part of the bigger story when it comes to the outlook for Canada's economy and the inflation story more generally, and we can think of energy also as a function of demand and supply. As the global economy reopens, certainly there's demand and supply remains constrained from a number of different factors including geopolitics and directed capital that might not go towards investing in parts of those businesses. It's a combination that I think does leave us with higher energy prices and that can certainly be something that presents a risk to the global economy. But again, I would put it in the context of thinking also about how central banks respond. You tend to look through relative price shocks like energy. Again, they've got a lot on the inflation plate they need to deal with, so energy only complicates that analysis.

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Pamela Ritchie: Great to have each of you share your time with us here today. I'd like to compliment you on the outfits that you chose for today. We clearly all have very good taste. We'll see you again next time.

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David Tulk: Thank you.

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David Wolf: Thanks, Pamela.

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Pamela Ritchie: Thanks for joining. I'm Pamela Ritchie.

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