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Central Bank Pivot? What it Means for Institutional Clients

David Tulk, Portfolio Manager

Bryan Borzykowski, Host

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Bryan Borzykowski: Hi and welcome to Fidelity Compass. I'm Bryan Borzykowski. Canada's inflation picture appears to be moderating with the latest CPI data coming in at 4.3%, the lowest since August 2021. This comes following the second consecutive rate pause from the Bank of Canada.

Looking ahead, what can we expect to hear from the Fed? How is all of this impacting how portfolio managers are allocating to stocks and bonds and their geographic preferences around the world? Joining me today to discuss all of this and more including a look into his long-term investment approach is Institutional Portfolio Manager David Tulk. David manages a suite of tactical asset allocation strategies for institutional clients. David, thanks for being here.

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David Tulk: It's a pleasure to be here. Nice to see you, Bryan.

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Bryan Borzykowski: Let's start off with the big economic news of the week, that 4.3% annual CPI data. A lot of people might be breathing a sigh of relief. What do you make of this number?

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David Tulk: I'd say that that release is a step in the right direction. Headline inflation has cooled from its recent peak and is expected to cool further for no other reason than the comparisons to each month from the year prior will favour the headline CPI print. I don't think that we are anywhere close to being out of the woods yet because what also was released were a bunch of core measures that still show a fair degree of persistence in underlying inflation. I think this is the bigger challenge facing the Bank of Canada is that getting those core measures back down to a level that they are comfortable with ultimately is going to necessitate, I think, a lot more weakness in the economy and likely a pretty sizeable increase in unemployment as well.

That's really what the Bank of Canada is focusing on. This is something that they've said to us as well, that we're in still the easy part of the disinflationary process coming off of the peak to the levels that we're sitting at today. I think the road ahead for inflation is likely to be a little bit more challenging and that's definitely informing how we look at the outlook for the Bank of Canada's overnight rate.

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Bryan Borzykowski: Well, let's talk about that. They did have two pauses, based on what you're seeing could there be an increase? Some people even think central banks could start cutting rates at some point soon.

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David Tulk: Yeah, absolutely. This is what makes the market. In this particular case we are not in agreement with how the market has priced the Bank of Canada, has priced the Fed as well. The market believes, at least the bond market, that we're going to get this immaculate decline in inflation and that the Bank of Canada and the Fed and other central banks around the world are likely able to start cutting interest rates by the end of the year. I just don't think that that is the most likely scenario unless something really, really goes wrong in the economy. Why that's not the case, in my view, is that that inflation story is still going to be persistent.

Tiff Macklem, the governor of the Bank of Canada, said this quite clearly as well that they're not going to be happy at 3% for inflation. Their target is 2. Yes, they have a symmetric band of + or -1% around that but the midpoint of the target is what they are hoping to achieve. When we look at the inflation dynamics and that stickiness that we anticipate to continue to keep core inflation elevated it just doesn't allow the Bank of Canada whose primary focus at this stage is to get inflation back down to a low uncomfortable level.

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I think I understand why the market would be looking towards cuts. I think something that markets have been conditioned on in recent cycles is that at the first sign of financial market turbulence or at the first sign that some of their policy is beginning to slow the economy, or at least the central bank policy is starting to slow the economy, the pivot emerges where you get that policy response in the form of lower interest rates. That is something that had worked in prior cycles because inflation wasn't really that far away from where policymakers would like it. That's a very different case today. Again, it's that higher and stickier inflation that central banks have to contend with. The market model that has helped you in the last couple of cycles, I just don't think is as applicable to today's environments. I think that will eventually start to influence how the market prices central banks over the balance of the year.

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Bryan Borzykowski: Is there any danger maybe from investors, market watchers, of maybe getting too comfortable with what's going on and saying, okay, well, things are turning the corner, inflation is getting out of control, is there any concern there that people can get too complacent based on maybe some of the better news that they're seeing?

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David Tulk: I think so. I mean, complacency certainly shows up in every phase of the market and through every cycle. I think maybe what we've been conditioned as a result of the pandemic is to recognize that economic events move very quickly. The global economy effectively shut down over a very short period of time and the policy response, as dramatic as it was to support the economy, also happened over a very short period of time. Now as we've worked our way through the hard part of the pandemic and as you've seen policy start to normalize, I think we've seen one of the largest increases in policy rates over a very short period of time as well in history. We're used to seeing these things happen fairly quickly but now when you think of where the themes are starting to assert themselves those are naturally not as short lived.

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Coming back to the theme that economic weakness is necessary to slow the economy down it takes a while for that to happen. You have a corporation that is still likely struggling with labour shortages, so when they think about how they manage their labour force they know that supply is an issue, so that at the first sign of weakness they're maybe

not as inclined to let go a bunch of workers. So, they're going to hold on to those workers into a weakening demand environment longer than they would have otherwise in prior cycles. That just extends the horizon over which this adjustment takes place. I think the market, again, is conditioned into seeing things happen very quickly and right now it is going to take a lot longer because policy inevitably needs that longer time period to work its way through the entire economy. That's just something that we have to try to evolve our thinking in how to look at that.

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Bryan Borzykowski: Speaking of things that happen quickly, the banking crisis that everybody was talking about not too long ago, not many people are talking about it anymore. It came on quick. It seemed to disappear. I guess the issue with that was partly the rapid increase in rising rates put pressure on a certain sector of the economy, a certain industry. Where are we with the banking crisis, the regional banking crisis here and are there other potential cracks or issues in the market that maybe you're looking at that could have come as a result of this rapid rate rise?

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David Tulk: Before we get to what shoe might be next to drop, I think it's an important point that you referenced about how this banking crisis sort of seemed to have arrived and disappeared very quickly. I think it also might be what is driving market expectations in looking for interest rate cuts. What we saw through the banking crisis, you're right, is that a secular or very sharp increase in interest rates revealed some low hanging fruit in terms of segments of the economy that were not only very rate sensitive but maybe had some idiosyncratic vulnerabilities as well. Part of that credit tightening that you saw that really impacted regional banks in the U.S., part of that is very desired on the part of central banks because what are central banks trying to do? They're trying to slow the economy down. How do they do that? They raise interest rates to raise the cost of capital so banks are less likely to lend into the economy.

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That transmission mechanism is exactly what central banks want to have happen but obviously they don't want to cause systemic risk in the banking system because that causes confidence in the banking system to disappear, you get bank runs, you get a bunch of other really nasty things. The Fed in this case had to try to calibrate their policy response so they can segment their tools to say that, look, we need to still tighten credit, we need to slow the economy down. That's what monetary policy is supposed to do but we also want to be able to make sure the financial system is safe and trusted. That's why they have those liquidity facilities that they were able to bring back into vogue. The common way of saying that is that the Fed proved that they can walk and chew gum at the same time. So, that's why that particular part of the economy is sort of back to operating normally, at least from the perspective of a macro investor.

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Coming back to your question, I think it also deserves close scrutiny that the wider theme of credit tightening and the wider theme of different parts of the economy being vulnerable to higher interest rates deserves a lot of scrutiny. I don't know exactly what the next shoe that could drop. It could be something in real estate, it could be something in venture capital. I think this is one of those things that people only really know with the benefit of hindsight. But I know that there are vulnerabilities. When we think about how we want to position our portfolios in this type of environment, it's the bigger theme of tighter policy and higher interest rates is what we want to key off of. That's something that does keep us thinking that we want to still be somewhat defensive despite what we've seen certainly in equity markets in recent months.

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Bryan Borzykowski: I want to ask about the positioning in one second but just maybe to wrap up kind of the economic discussion here, if inflation is sort of going to be choppy, it's not going to go down to maybe where people would like it to, what will it take, do you think, for some of those core inflationary numbers to finally fall? Does that require another rate increase by the Bank of Canada at some point? What are you going to look at to say, hey, maybe we actually are past this point of high inflation.

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David Tulk: The bank told us very specifically that they are in data dependent mode. When Tiff Macklem spoke this week on the heels of the inflation report I think he did try his best to push back against market pricing and try to make sure that there was at least some probability of an interest rate hike still on the table. That makes a certain amount of sense in any environment because a central bank doesn't want to entirely just cut off one of their options. They want to retain as much flexibility when setting policy as possible. The bank wants us to keep the door open and really let the data drive our expectation and ultimately the central bank's decision. That's the first point to make.

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I think the second point to make as well is that we're in that level of policy generally that is broadly construed as being neutral to somewhat restrictive. That sounds like a science where you can quantify that to the single basis point but in actual fact it's one of the squishier things about monetary policy. Central banks think they've calibrated it correctly but again, we've gone through this pretty massive change in the way the economy has been operating through the pandemic and as we've come out of the pandemic. Who really knows how rate sensitive different parts of the economy are?

That's where the bank itself is trying to fumble around and calibrate policy correctly. They think that they are somewhat restrictive but ultimately they're going to take their cue from the economic data. That's certainly a major part of how the Bank of Canada is likely to operate. I know that's not giving people a lot of clarity and that's probably intentional to some degree because nobody really knows with a high degree of certainty.

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I will also make the point that as part of that transmission mechanism, I think what's needed is time. This is where, again, coming back to some of our earlier conversations where we think about the way an interest rate moves through an economy where there are certainly some segments that move faster, so anything that's very rate sensitive would certainly move faster. But also, you know, you need to get that critical mass of industry or of the economy more broadly to start feeling the effects of tighter policy.

Where it ultimately has to go to bring inflation back down, and this goes back to how the CPI basket is constructed, it's services and a lot of services can be tied to the labour market and wages. The very clear indication of the labour market displaying weakness, that'll give central banks a great deal more comfort at least insofar as knowing that that's likely to have a more durable and lasting impact on slowing inflation.

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Bryan Borzykowski: Great. Let's talk about how this is impacting the way that you're investing all of this, where you're finding opportunities. I know we have a slide that maybe we can just bring up to get this part started. Just to clarify, you're a portfolio manager not an institutional portfolio manager and an asset allocator. If we can bring up the slide

maybe we can just talk about kind of where are you finding opportunities now. How are you taking all of this information and putting it into the decisions that you're making?

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David Tulk: Absolutely. Just for everybody's benefit on the call, this is a diagram of our positioning for one of our portfolios. It's a 60/40 portfolio so 60% equities, 40% bonds. All the bars that you see represent the overweights and the underweights. So, what do we like, what do we shy away from relative to the benchmark? I'll make a couple of high level comments. I know there's a lot that we can dig into in terms of the individual overweights and underweights but as I hinted at earlier, in a word we're still defensive. We are somewhat underweight equities but as you can see not dramatically so because being consistently underweight equities is really just fighting risk premia and timing the market when it comes to some of these bigger themes about recession. I think that's very difficult to do. So, we've tried to calibrate our equity exposure to reflect the macro uncertainty but not overreact to it.

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The second element of the portfolio that you see is that we are overweight short term, so cash positions. This is something that, again, maybe touches on the wider debate we can have about bonds and duration. To say it succinctly upfront is that we think there's more comfort and certainty in the short-term part of the market relative to having that larger duration position as well. The best way that I think we can reflect that theme of defensiveness that we want shown in the portfolio is on the very right-hand side of the slide which is our positioning related to the Canadian dollar. We are underweight Canadian assets across the portfolio. By extension, that means that we're underweight the currency.

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This brings up the wider point about saying that the Canadian dollar is a relatively cyclical high beta currency. If we want to think of periods where the market is responding to stresses in the economy, those are periods typically where the Canadian dollar underperforms. I know this is an environment that we've seen in the last couple of months where in actual fact the U.S. dollar has retreated. But if we look at the Canadian dollar relative to the U.S. dollar and relative to the wider G10, the Canadian dollar really hasn't fared that much better than the U.S. dollar. The real appreciation in currencies we've seen are in the euro and the yen and the Swiss franc, not necessarily the Canadian dollar. When we think about that as a way to bring defence into this particular portfolio, I think that's the most efficient, effective way that we can do that. That's the way that we're responding to the environment and seeing an opportunity to protect the underlying capital of this portfolio.

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Bryan Borzykowski: You put out a quarterly white paper and there's a new one out and everyone on the call will be getting one. You are answering five questions in this. One question is about bonds. It's interesting, if you're still buying bonds given that rate hikes seem to be nearing their end. How do you approach bonds today?

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David Tulk: This is one of the big debates that we have on our team, it's the big debate that we have with our researchers across the Global Asset Allocation group. It reflects a lot of voices, a lot of opinions, a lot of theory, a lot of thought, a lot of market experience as well. Where we've come down on the debate is that at some point you do want to have a larger duration exposure across these funds. We just don't think that we're there quite yet.

Part of that, again, is the certainty that we have with respect to short-term cash levels. You're getting 5% with a high degree of certainty. Taking a flyer on, say, a 10-year bond at its current yield is maybe a little bit less compelling given that, again, if inflation were to find more momentum or if the economy doesn't slow over the horizon that the market thinks, those yields could be vulnerable to moving higher. That's really the core of the debate when it comes down to investing in duration, investing in bonds relative to short-term securities.

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But you will note, though, on that slide we do still have protection against inflation, again, just respecting the volatility embedded in future inflation prints and holding real return bonds or TIPS in these type of portfolios is a nice hedge against that. We also have some credit exposures as well. This is sort of one of the areas that we can be a little bit more optimistic or have some offence reflected where we're working with active managers. So, having a broad beta exposure to high yield into a slowing economy or into the likelihood of a recession, that could be risky but having access to underlying managers who benefit from an absolute army of researchers finding superior credits to bring into the portfolio, that alpha generation process through security selection, I think is a really powerful tool that we have that we can bring into those portfolios.

So, we can balance maybe some uncertainty on the beta front with the alpha that comes through security selection. We do have some of those plus or credit exposures still included in the fund to generate that yield to reflect positive corporate fundamentals under the surface.

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Bryan Borzykowski: A couple of questions on the equity side. Canada underweight relative to the benchmark, I'm wondering why is that, maybe if Canada's fiscal situation is bothering you at all or what you sort of make of where we're at with that respect?

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David Tulk: It's something that we've been worried about for quite some time not just on the fiscal side but certainly on the wider economy as well. Again, going back to the nature of the shock that the global economy is wrestling with it's a very dramatic increase in interest rates. We need to think about who's most vulnerable in that environment. If you think about Canada's household sector, obviously has added a great deal of debt over not just the current pandemic period but well before that. Canada never really went through the same kind of deleveraging that the United States went through after the great financial crisis or that Europe went through over that same horizon. It's a vulnerability as far as we're concerned.

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The catalyst to that vulnerability ultimately is higher interest rates. We have seen at least the housing market cool pretty sharply. There are some seasonal factors that might give it a little bit of a renewed breath as spring takes hold but I think the wider trend, unfortunately, is where Canadians realize they've taken on far too much debt. They're struggling to pay that back as that sort of five-year-mortgage term starts to roll through the data in the next couple of years. That's, in our view, a contributor to the expectation of slow economic growth. That's certainly a motivation for us being underweight Canada.

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On the fiscal side, again, this goes back to the release of the budget where on one side you have the Bank of Canada trying to slow the economy down and there's still a fair degree of fiscal stimulus coming on the other side of that and that stimulus has also been accompanied by a pretty significant forecast for deficits into the future.

I can argue that maybe this is not the right macro environment to really be adding that kind of stimulus. Also, it doesn't leave us in a particularly strong financial position. In spite of some of the net debt figures that are represented in the budget, those typically will incorporate the assets within CPP or other provincial pension plans. So, that's maybe not as clear of what the true debt dynamic looks like on the part of Canadian governments.

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I think the other part of the story that extends from that is that Canada doesn't have the largesse that's afforded to the U.S. economy in terms of running high levels of deficits and debt. Canada still is a small open market commodity-linked economy. The prospect of a fiscal risk premium at some point returning to Canada, that can't be entirely dismissed. That's another motivation from our perspective of being underweight Canadian assets. That was maybe more relevant on the bond side of the portfolio but it can also extend to the currency as well.

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Bryan Borzykowski: You are overweight emerging markets. Why is that? Are there certain areas that are looking interesting to you?

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David Tulk: This goes back to, I think, some of the optimism or offence we want to have in the portfolio. When you run balanced portfolios, there's certainly an advantage to having elements of defence that are consistent with our overarching macro view but we also want to have selected allocations that can provide that offence as well. Emerging markets as well as the credit piece that I mentioned earlier, those are examples of that.

When it comes to emerging markets, I think again this is a little bit more idiosyncratic to the current cycle where you think about how far China and other emerging markets have progressed through their own independent business cycles. China's adding stimulus into the economy. That's pretty unique among other central banks when we think about it through the monetary lens. There is, again, the reopening narrative that accompanies the expiration, or at least the termination of the zero-COVID policy. There's a little bit more of a positive growth impulse that I think can exist within emerging markets.

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Obviously, there is still a very tight elastic that binds emerging markets to the rest of the economy or the global economy which means that there's a limit to how far EM can outperform, especially as the rest of the world is slowing down. From a tactical perspective, I think there is some appeal in having that exposure reflected today. The specific way in which we're trying to get that, again, same way we think about credit that emerging markets is a very diverse set of economies, so we want to certainly use an active manager as the building block in that allocation because they're able to really leverage all of the security-specific research that we have access to bring really positive securities or stories into the portfolio. So, we're not just taking blind beta risk, we're, in fact, taking that more nuanced view of having strong securities that can complement what we do from a top-down perspective.

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Bryan Borzykowski: I'm going ask you one more question. We've just got a minute left. You answered this in more detail in the white paper that you'll see but what are you feeling good about? There's lots to be concerned about. What are you optimistic about right now?

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David Tulk: Maybe it's not something that everyone should feel optimistic about but I'm optimistic about the volatility. I am optimistic about the fact that we have such a diverse range of opinion reflected in the market because from the perspective of an asset allocator with all the research that we have access to it's this type of market where we can develop an edge, where we can see what the market is thinking, especially if sentiment is playing a big factor in how it's swinging from one extreme to the other. That gives us opportunities.

Broadly speaking, having that uncertainty and having something that we can respond to as long term investors where we can see through short periods of volatility to express medium-term themes fills me with the optimism of responding to that by bringing decisions into these portfolios.

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Bryan Borzykowski: Great. I'm going to leave it there. I'm sure we could talk for another half an hour or even longer but we'll save that for our next chat. Thank you so much for being here.

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David Tulk: It's my pleasure. Thank you.

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Bryan Borzykowski: Thank you everybody for tuning in today. As I mentioned before, all attendees will receive a copy of the quarterly white paper, so look for that.

As always, if you have suggestions on future topics or guests you'd like to see on the show please share your ideas with us. In the meantime, stay tuned for more Fidelity Compass webcasts in the weeks and months ahead. I'm Bryan Borzykowski. Thanks for tuning in.

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