Fidelity Compass

2023 Global Asset Allocation Outlook

David Tulk, Portfolio Manager

Bryan Borzykowski, Host

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Bryan Borzykowski: Hi and welcome to Fidelity Compass. I'm Bryan Borzykowski. The latest jobs report out of the U.S. came in much stronger than expected, continuing to show the resiliency of the U.S. economy. As market participants analyzed the most recent string of economic reports for guidance, some economists aren't so sure that the outlook is a sunny as anticipated. With market uncertainty lingering, it's important for institutional investors to stay vigilant as they navigate uncharted waters. Going forward, will inflation fall as quickly as central banks are hoping? Where are the opportunities in 2023? To help answer these questions and more, I'm joined by Fidelity Global Asset Allocation portfolio manager, David Tulk. David, thanks for joining us.

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David Tulk: My pleasure to be here. Thank you, Bryan.

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Bryan Borzykowski: Let's start with the economic news that came out last week. I've got to say, as someone who's not an economist or a portfolio manager, seeing more than 500,000 jobs get added to the U.S. economy when I think economists were expecting something around 150 or so, was surprising. Is this a cause for concern? What did you make of that?

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David Tulk: That's a great way to start the conversation. I never want to read too much into any single data print but generally, I think if you look at the labour market, as you noted in your introduction, there still is some momentum under the surface in the U.S. economy. I think that has surprised the market in some sense because the market is really still focused on the narrative that the Federal Reserve will be able to engineer this immaculate decline in inflation so that inflation will come down and there won't be any lasting economic damage as a result of those actions. I just think that that view is ultimately misplaced. If anything, the labour market data is a reminder to the Fed that perhaps interest rates need to go higher still and that they need to do more to have confidence that the inflation story will come down as expected. That's sort of the message that we've heard from the Fed even earlier today from Jerome Powell who is giving a speech and also from the Federal Reserve's interest rate decision last week.

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I think the challenge, though, is that the market has been inclined not to believe that narrative. We've seen this in the past where the market occasionally tries to battle with the Fed but ultimately, I think, who wins is the Fed. As you want to gauge how much optimism or how much caution you should take for the year ahead, I still think the balance of risk is towards a more cautious outlook than maybe what the market had rallied on earlier this year.

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Bryan Borzykowski: Obviously, from a Canadian standpoint, we're still seeing job gains here, too. The Bank of Canada said, we're going to pause rates yet in the States it sounds like they could do more. Are we at a point here where you're going to start seeing a gap in the way central banks treat interest rates? How does Canada act now when you see these numbers out of the States?

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David Tulk: That's a great question. I think it really comes down to what the local conditions of the economy, what the two economies are telling you. One of the really big differences between Canada and the United States in this particular cycle is that the amount of household leverage and the vulnerability facing the housing market is much greater in Canada. This goes back not just through the pandemic but to the prior cycle where the U.S. really took their medicine after the 2008-2009 housing market fallout by taking about a decade or so to reduce their level of household debt, whereas Canada, through that entire period, continued to add to that debt burden.

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When you think about the two economies, Canada is much more interest-rate sensitive than the United States, primarily through the channel of the housing market and the consumer more broadly. When you think about how high interest rates have to go to effect the same type of deceleration in economic growth and inflation, it has to go much higher in the U.S. As a result, you still see the Fed pushing higher with rate hikes, whereas the Bank of Canada, as they've assessed the risk to the domestic economy, does suggest that they're closer to finishing their rate hiking cycle.

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If you want to think about an investment theme that falls out of that differential, it's a view that we in the team have had for quite some time is that we're pretty cautious on the outlook for the Canadian dollar and that can be driven, certainly, by differing economic narratives where I think Canada's economy does face more headwinds as a result of the housing market in particular, but also as that interest rate differential opens up in favour of the U.S. over Canada, that's another factor to anticipate that the Canadian dollar will struggle against the U.S. dollar.

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Bryan Borzykowski: We're going to dig into all of this and more. I just want to make note that you just released a first quarter 2023 asset allocation report, which everyone on the call will get a report, and this one is a little bit different than maybe some of the other ones. You did a Reddit Ask Me Anything, answering questions from people about all sorts of topics which I commend you, not every Portfolio Manager, I think, would go on Reddit and answer questions from the masses. But in this report you kind of detailed a lot of these questions that you answered and so I want to go through some of these, some of which you've touched on, but we'll dig into a bit more. I think one of the first questions is on this topic we're discussing is where is inflation headed? We've seen it come down a bit. Is it going to come down enough? What are your thoughts on inflation?

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David Tulk: I think peak inflation is in and that's not a particularly controversial thing to say given what we've already seen from the data and given the consensus of opinion out there. I think the next question is to say, well, where is inflation going to settle once it's finished accelerating? Is it going back to the happy 2% level that's at the core of central bank mandates, so the rainbows-lollipops-sunshine type of outcome, or is inflation likely to remain a little bit sticky above that

central bank target, which ultimately means that central banks won't be able to pivot and cut interest rates. Where we come down on that analysis is that I think inflation will prove to be stickier and more persistent than what the market believes. To dig into that a little bit, I'll borrow from the Fed their breakdown of inflation really into three different buckets.

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First there is the goods bucket, which were things that were most impacted through the pandemic as a result of supply chain issues. We remember the used car story with microchips. That has already started to disinflate. Most of those shocks are behind us. That part of the price picture has improved materially, so we can set that to the side and if the Fed was only looking at that, they can commend themselves for doing that correctly.

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The next piece is around the housing market and housing related services. That is starting to maybe show some really, really preliminary signs of rolling over but the data on the housing market, at least some activity data has slowed, but it will ultimately take a fair bit of time for that to show up in the rent data. Ultimately, that is what will impact that component of inflation. So, that, I think, is still in sort of the neutral category where at least it's not going up further but to really expect it to come down dramatically, I think is still a bridge too far.

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Ultimately, then, it comes to the third bucket of inflation which is the most worrisome from the perspective of the Fed, and that is non-housing core services. That has shown a great deal of persistence. When we dig into what drives that part of the inflation bucket and it's a large part of the bucket, ultimately, that comes down to wages. Wages have remained elevated. There's still an imbalance in the labour market where if you look at the JOLTS data, still lots of openings, it's been hard to bring people back into the labour market. Wage pressure is there and that's the primary driver of that big piece of core inflation that will remain sticky.

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Going back to the labour market data that we talked about earlier, that was also a feature of the report suggesting that wages in the most recent month are still elevated. That is ultimately the part of the inflation story that the Fed needs to look at to have confidence that inflation will come back to 2%. That hasn't really shown any signs of decelerating at the level of which I think the central bank will be happy with. It really comes down to the central bank story that inflation is likely to decelerate but just not nearly as fast as what the market or, indeed, even the central bank expects today.

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Bryan Borzykowski: Is their target still that 1 to 3%. If it came down to 4%, would they start feeling better or do you think they're really going to try and get it down, you mentioned 2%, really down to that level?

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David Tulk: I think operationally, the closer they get to their target, the better, because that does suggest that they're seeing the type of evolution in the economy that they can be comfortable. The risk of having an inflation perpetually above target is that it starts to creep into expectations. When workers bargain for higher wages, they can point to inflation and say, well, I deserve something higher than what I had last year or the year before. Firms start to see that as well in the sense that they're seeing higher input prices, so they know that they can maybe increase output prices. What that does through the expectations channel is keep inflation high and reinforce the stickiness of inflation.

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That was really the big lesson through the 1970s and the 1980s is that inflation was sticky and high and that was something that when the Federal Reserve had to think about interest rates, they needed to hike interest rates not only to bring inflation itself down, but they had to anchor inflation expectations at that low and stable level which ultimately, required a lot more economic damage than had inflation expectations been rooted at that 2% level. I can say that central banks would be happy to see inflation closer to that target but I think a related question that you asked is would that target ever change?

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I think today Jerome Powell was very clear, and central banks around the world have been very clear that that target, whether it be 1 to 3% or 2% or price stability in the case of the European Central Bank, that is sacrosanct. We know the first thing that happens if you start to lose control is if you say, ah, we're okay with 4% and the market will say, well, if you're okay with 4% let's try to take a run at you and say, are you okay with 5%? That becomes something that's very destabilizing. Central banks are very clear in this and they will not rest until inflation is low and stable back at target levels.

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Bryan Borzykowski: What about gold? Gold has not been the inflation hedge as many have expected. Why is that?

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David Tulk: I think maybe there was that perception last year that gold would move in a one-for-one relationship with inflation and it didn't, certainly. I think every asset class, with the exception of cash, really was under a great deal of pressure last year. When we look at it on a relative basis, though, and maybe compare gold to other asset classes, gold actually ended up outperforming. It didn't keep up with inflation, virtually nothing did, but it did outperform other inflation hedges and other more traditional asset classes. That, to us, still warrants a type of allocation in our portfolios. That's a view that we think still is warranted today where you want to have an allocation to commodities and to gold in particular, but maybe another part of the relationship with gold last year is that gold is not just a hedge against uncertainty and inflation, but it also has a correlation with real interest rates.

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As we saw interest rates increase pretty dramatically last year from central banks, that acted as a headwind to gold. If you want to say broadly, there are three drivers of gold, two were positive, one was negative, and that last one being real rates that was negative, that probably had an outsized impact on the overall price of gold, which is why it didn't perform necessarily to peoples' expectations in an absolute sense. Again, on a relative sense, it did exactly what we wanted in terms of an allocation in a portfolio.

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Bryan Borzykowski: One of the questions that was asked on the AMA is just how high policy interest rates have to go. We talked a little bit about this before but how far can central banks push this?

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David Tulk: Technically, the sky is the limit. When we think about what central banks want to see, again, they need to see inflation come down reliably and they need to see that expectations of future inflation are anchored. Until that happens,

certainly central banks can continue to raise interest rates. We think, certainly, if you want to think of it in the baseball inning analogy, we're in the later innings. There is evidence that economic growth is slowing down and ultimately, that will spill into wider parts of the economy and that in itself will start to bleed into the labour market and inflation should, again, begin to moderate. The question maybe isn't how high interest rates will need to go but I think the really relevant question is how long do they need to stay high?

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That, again, really conflicts with the market narrative where they're pricing in cuts from the Bank of Canada, from the Fed later on this year. I think that's the narrative that's misplaced and will be really challenged because ultimately, if inflation doesn't come down and if growth remains sort of sticky and elevated, that, to me, suggests that central banks won't be able to pivot because, again, the inflation story won't allow them to. We can certainly see another couple of rate hikes but again, really what stands out in contrast to the market is the view on their part that central banks will be able to cut interest rates at the first sign of economic weakness.

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I would definitely fade that narrative and the only way to really, in my mind, see interest rate cuts this year is if we see a really, really dramatic slowing in the economy. In the sense that anything is possible, and there are certainly lots of shocks out there that could drive that, but as the base case or as the most likely outcome, our sense is that interest rates are going to stay sticky, stay elevated, and not provide that relief for the market.

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Bryan Borzykowski: We had before, central banks were aggressively increasing those rates by 1%, .5, if they continue to increase do you think it'll be — everything feels a bit maybe aggressive now to the public but will it be that .25 or could they do something bigger if they really can't get things under control?

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David Tulk: I think the closest they get to what they would estimate as being a neutral interest rate or even something that's somewhat restrictive to try to bring the economy down, I think naturally as you get closer to those levels you're going to be a little bit more judicious in how much you raise policy rates. You can picture the story a year ago when you were basically on the floor for interest rates and inflation was through the roof and growth was really strong. It's easy to play catch-up at that point to say, okay, we're going to move by 100 basis points, a string of 75-basis- point increases but as you get closer and closer to the point where it matters, that's where you need to be a little bit more careful. I'm trying to remember who had this analogy but it's a great analogy that when you're driving your car up your driveway into the garage you don't want to go as fast as you would at the beginning of the driveway as you get right to the garage. So, slowing down certainly is the appropriate thing and, again, we'll see where it goes from there.

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Bryan Borzykowski: You mentioned Canadian housing before. This does tie into a lot of the discussion we're having, especially with Canadian rates, how high can they go. What is your outlook for the Canadian housing market given where things are right now?

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David Tulk: In a word, I think it's going to "struggle" and I think it's going to struggle largely because we have these imbalances on our balance sheet. When you think about, again, that period from 2008 into the pandemic, we just whistled by the graveyard as a lot of other countries took steps to bring their debt burdens down. We continued to add to our collective debt burden. That was a vulnerability, right? As you see that progress that can continue to build but absent a catalyst it just remains a vulnerability. As we've seen with the aftermath of the pandemic, not only do we have the vulnerability but we now have a catalyst in the form of higher interest rates to bring housing back down again. I think this is an inevitable period of adjustment. If you look at the very high-frequency indicators of real estate activity the market seems to have really ground to a halt. Listings have even come off the market as sellers want to take a bit of time to reconsider the backdrop. Again, interest rates are elevated from the perspective of a new borrower.

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So, I think it's definitely a pretty pronounced headwind facing the Canadian economy and arguably one that's more pronounced here than in many other countries around the world. When we think about it from an asset allocation perspective, if we choose between different regions we want to allocate to, Canada doesn't score particularly well because of its direct vulnerability and a headwind to growth. We would much prefer to find opportunities in markets overseas, whether that be maybe the U.S. for a sense of defence or emerging markets for a sense of offence. That's where we would see the opportunities largely because of that dynamic impacting growth here at home.

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Bryan Borzykowski: There was another question that was asked on the Reddit chat, is what would you do to fix housing? I'm sure if you could just snap your fingers and fix it, you'd be on all the webcasts. But how do you think you would fix housing?

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David Tulk: There's no easy one solution. Unfortunately, the imbalances that have existed in housing have existed for a while and only become more challenging. Obviously, with immigration policy bringing new people to this country, there just simply may be not enough homes available. That's a very common narrative. The one thing that I would think of, at least in terms of the price behaviour of housing, that through the pandemic where nobody was coming to the country, the borders were effectively shut, you still saw price increases that were pretty dramatic, which makes you think there's got to be something else that's going on in the background. That's an interest rate story. That's maybe something to do with the amount of speculation that took place within the real estate market.

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You can't point to any one factor per se but the confluence of these different factors have led us to where we are today. In the AMA, yeah, we talked about the notion of perhaps making mortgage interest costs tax deductible. If you wanted to think of something that could perhaps reward domestic borrowers and maybe act as a disincentive for the investment community or foreign investment, that would be one way that you could potentially look at it. To your point, there isn't a silver bullet that will magically cure the housing challenges we face. I think there's a lot of really smart people in all parts of the policy framework, whether it's in governments or in the private sector, that are spending a lot of time trying to think about these issues. But these are legitimately thorny issues. I think that one little idea has some cute appeal but I don't think it'll get us to where we need to be overnight.

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Bryan Borzykowski: I would not mind deducting my mortgage interest. One of the things that I've always wondered in this debate is just where do people want housing prices to go? Are we talking pre-pandemic prices, back to 2008 prices if interest rates are up above 2008? Is there a level there that would say, okay, this is where we'd want to stop?

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David Tulk: Certainly, there's no policymakers that themselves are trying to target a level for home prices. I think obviously, if you're a longstanding homeowner, the higher's the better from your perspective. If you're a new entrant into the housing market, you would like the exact opposite scenario. There's no easy way to say this is a level of price that's appropriate. As we even talk about the notion of prices, we can think about national statistics but Canada is such a varied country from coast to coast to coast that every local market will have its own eccentricities and its own nuance. Ultimately, I think what policymakers would like to see is the sense of a balanced housing where there is at least enough housing supply to meet income demand and that prevents maybe some of the dramatic increases in prices that make affordability an issue. There's a lot of different ways that that can be addressed and just trying to find a one price for housing to bring that all under control is probably not going to happen.

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Bryan Borzykowski: Moving to a different sector of the Canadian economy, energy, it has done well from a stock market perspective, at least over the last little bit. Where do you see energy going? And is that a big positive for Canada's economy?

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David Tulk: That's an interesting question. When we think a little bit about how we've approached our allocation to Canada, I mentioned earlier in the sense that we're not particularly favourably inclined towards the Canadian economy, I say that from the context of where we sit as asset allocators where our choice is saying, okay, do you want to be in Canada versus these other geographic regions? That's not to say that every single company in Canada is not a good investment.

When we think about our building block portfolio managers who operate in the Canadian space, they see lots of interesting stories, whether that be in energy, whether that be in financials. That's an important point I wanted to stress that even as we are maybe cautious on Canada, there's still lots of really compelling stories that take place within Canada's economy that investors can bring into their portfolio. That just sort of sets the ground for how we would view energy.

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When I look at the global energy market, I still think there's a pretty big mismatch between demand and supply. Supply really hasn't been able to keep up with the rebound in demand and that's one of the reasons you can see that commodity prices have been elevated through time. Obviously, the risk of a global recession will hurt that demand side of the equation, so we could see a little bit of weakness there but I think structurally, if you abstract away from those cyclical dynamics the global economy is still under supplied. So, we would say that we would want to have an allocation to energy. Now, the question is, well, do you want the Canadian energy or do you want maybe global energy players?

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Our reasoning there is to suggest that, again, thinking about how we choose regions, as much as you might see a positive element that would lift Canadian energy, I would think that the housing market story impacting the economy as a whole is the bigger story. That's a bigger headwind than whatever tailwind you might be able to get through energy. Our preference is to still have that commodity allocation but think about it maybe in more of a global commodity allocation or a global energy allocation as opposed to increasing our allocation into the Canadian market.

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Bryan Borzykowski: Does China's reopening make commodities more favourable than maybe they were before?

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David Tulk: That's absolutely part of the narrative. We have a very robust debate in our team about that very reopening narrative and what it can do in the context of slowing growth elsewhere. Where you come down on that, you can say, well, what's the best way to play China's reopening? Do you want to own China specifically? Do you want to own emerging markets broadly? Do you want to maybe own energy as a proxy to that? Do you maybe want to even own Europe as sort of a bounce pass into the EM story? Basically where we have come down on that debate is to say we want to have an overweight into emerging markets. We want to do that with an active manager because we want to be able to stick handle around maybe the less favourable parts of China's market in particular, so maybe I would cite ongoing risks to the property sector is something we want to avoid.

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An active manager can do a security by security analysis to figure out what's the best way to play the Chinese reopening story. We do have an overweight into emerging markets. I think that's probably the most pronounced piece of offence that we're playing right now because generally the rest of our portfolios are structured to be somewhat more defensive. As we always try to seek balance between different drivers and different themes, the EM story is one that we're favourably inclined towards. That's the one piece of optimism that certainly is expressed on the overall portfolio allocation.

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Bryan Borzykowski: What about stocks versus bonds and diversification? The bond story has really changed over the last several months. How do you view bonds in a portfolio versus stocks today? How important is diversification right now?

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David Tulk: I think we saw last year that trying to find diversification was exceptionally difficult. It was basically the worst year for 60/40 since the Great Depression. We talked a lot about the reasons why in terms of stimulus from central banks that was taken away very aggressively, concerns around recession, all of that is really what drove the correlation between stocks and bonds from being negative, such that it has through long periods of time, to being positive and with both asset classes declining. That's really the worst case outcome for a 60/40 or a balanced type of portfolio. When you get to the core of what makes that balanced fund work it is, again, trying to achieve diversification. We still believe in diversification. I think everybody should certainly continue with that belief as well, but you want to be a little more careful in how that's achieved.

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As long as you can say that maybe there's stresses facing the equity market if earnings adjust lower, as economic growth slows, and maybe there is risk still facing fixed income, you want to be a bit more creative in saying, well, how do I get insurance in this type of portfolio? One of the tools that we use, that we've always used is to, for example, use currency. One of the big contributors to our relative performance last year was being overweight U.S. dollars. Bonds weren't going to do it for you, equities certainly weren't helping either, so if you have that rally into the U.S. dollar, that flight to safety move in the market, that was one area that we were able to use. I still think that 60/40 will live, it's just how you get the 40 is important, what kind of diversification you can do within the bond side of your portfolio, and then being a little bit more creative in how you manage the correlation between stocks and bonds. In our case, that involves using currency and that's something that I anticipate that we will continue to do.

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Bryan Borzykowski: I could have asked as the beginning but I'll end it off with this. The big question is, are we going into a recession? There's still a lot of people who now are thinking maybe not. Or is it going to be really deep? It's hard to predict these things but what's your view?

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David Tulk: I think the immaculate soft landing where inflation can come down without there being any economic damage, I think that's a fiction. Ultimately, central banks will need to engineer a recession. That's unfortunate, that's just the nature of the way the economy works and interaction with how central banks operate. For central banks to feel comfortable and where they need to get inflation, unfortunately, they do need to drive a reduction in growth which will result in a recession. I think it's an inevitability. Whether it happens this year or maybe a little bit later in the year to follow, I think that's still open to debate but ultimately, it's something that we will have to face. We, on our side in terms of our portfolio allocations, are anticipating those dynamics and we'll move to position accordingly.

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Bryan Borzykowski: We're at time, so I'm going to leave it there but there are definitely more questions that you answered than we got to, in the report that everyone on the call is going to receive. David, thank you for joining us and looking forward to chatting again soon.

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David Tulk: It was my pleasure. Have a great day.

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Borzykowski: Thank you again for everyone for tuning in. Next week on Fidelity Compass, fixed income portfolio manager, Jeff Moore, will discuss the Fed, bonds and much more.

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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