Fidelity Compass

How Canada's Economic Resilience Fares Against the U.S.

Ilan Kolet, Institutional Portfolio Manager

Pamela Ritchie, Host

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Pamela Ritchie: Hello and welcome to Fidelity Compass. I'm Pamela Ritchie.

Canadian and U.S. bond and Treasury yields are reacting to the tariff news and trade uncertainty that we're living amidst right now. U.S. 10-year Treasury yields jumped following Trump's tariff plans and the Canada 5-year bond, we saw it dip to its lowest level since 2022 before rebounding late yesterday afternoon.

As the markets continue to digest trade uncertainty how is our next guest navigating the latest movements and what, ultimately, does it mean for institutional investors? Joining us here today to unpack the latest market action influencing the Global Asset Allocation team is Fidelity Institutional Portfolio Manager, Ilan Kolet. Great to see you, Ilan. How are you?

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Ilan Kolet: I'm really well. Very nice to see you as well.

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Pamela Ritchie: Great to have you here, and everyone else has you here. They can send their questions in over the next little while, the next 25 minutes or so.

Let's go to the tariffs. It felt like no one got much sleep Sunday night or maybe even last night but here we have a breather. You used to work at the Bank of Canada. How would you sort of work through this first from a monetary policy perspective? What can be done?

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Ilan Kolet: I think that's a great place for us to start, the obvious place for us to start. I have never spent so much time on the weekend sort of reading analysis from various folks. Really, if I were sitting at the Bank of Canada today, and I was there and so was David Tulk and David Wolf.

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Pamela Ritchie: Predicting exactly such...

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Ilan Kolet: Exactly, sort of running the scenarios and risk analysis around what this might mean. There's really three assumptions you have to make from the start. The very first is how big are these tariffs. Is this a 25% tariff or is it zero? Now, 25% is large. Zero doesn't mean no shock because that cloud of tariffs can sort of hang overhead for some time. The second question to ask is what is the list of items that are going to face this tariff? Is it everything that we export from Canada or is it one line item? For example, about 96, 97% of the frozen French fries consumed in the U.S. come from Canada. Is it that one line item? A fact you didn't know you needed.

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Pamela Ritchie: They're delicious so I'm glad they're doing it here.

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Ilan Kolet: The first one is how big. The second one is what's the list and the third one is how long do these last. The honest answer to all of those things is, I don't know, I don't know, I don't know.

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Pamela Ritchie: So how do you do this?

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Ilan Kolet: Given that that's a fairly useless answer I think the first thing to do is sort of let's set up some parameters around trade. What's the importance of trade for Canada and the U.S. and that specific relationship, which is decades and decades kind of in the making.

From a Canadian perspective, exports represent a giant chunk of trade, 30% of Canadian GDP, 20 to 30% of Canadian GDP is exports of goods and services. That's large, that's really, really large, and that's important, critical. Seventy-five to 80% of those exports go to the U.S. That's huge. It's a big chunk of GDP and the bulk of them go to the U.S.

In terms of the buckets of our exports, you can think of a big chunk being energy exports, another chunk being other commodities, 14%, call it, consumer products. That would include those frozen French fries. Then another 10%, call it automotive. Now, those are sort of back of the envelope numbers for all exports.

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On the U.S. side, U.S. imports from Canada in aggregate are a small share of overall U.S. GDP. That sort of downplays another important point, which is the importance of Canadian oil exports for the U.S. The way to think about this, again, a little bit of a back of the envelope math, the U.S. consumes 20 million barrels a day of oil. Forty per cent of that is imported and 60% of those imports come from Canada. Call it 15 to 20% of U.S. oil consumption comes from Canadian imports. That's not insignificant and that's important.

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Pamela Ritchie: Let's just pause there for one second because there's this whole spare capacity story on oil. We can just jump off the rails here for a second. That would take a long time. Yes, they could pull it out of their ground but will they, and refine it. It's not going to happen in the next year.

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Ilan Kolet: No, exactly. Again, the folks who talk about this, Joe and Darren who run Global Natural Resources, experts in this area. I'm not an oil engineer but I know that you don't just pop more straws into the ground to pull this out of the ground. You don't just turn the dial to the right. This is not capacity that can come on instantly. There are different types of oil and refining, as you mentioned. It's not instant. Given the importance of the trading relationship and the unknowns, the other thing for us to think about is just how damaging this could be.

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Pamela Ritchie: Let's go to the worst-case scenario because you have to measure all that way.

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Ilan Kolet: Well, exactly. Initially, when this sort of came out, thankfully in 2019 in the April Monetary Policy Report that the Bank of Canada published in April 2019, page 24 of the PDF for anyone who wants to look it up, they did a scenario using the full force of their econometric model. These are models that myself, David Tulk, David Wolf, we worked on or helped to build. In the 2019 Monetary Policy Report, they examined the effect of a 25% tariff on all Canadian exports. This would include all the retaliatory effects and the price effects and the depreciation. There are really four numbers to remember.

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A 25% tariff imposed on Canadian exports results in a 6% decline in Canadian GDP over a couple of years. To put that in perspective, that's bigger than the decline in GDP in the financial crisis, the '90 recession, or the '81 recession. This is hundreds of thousands of jobs, maybe as close to a million. So, 25% equals -6 on GDP, a 3% upward shock to inflation spread over a couple of years. Again, this is not the time for an upward inflation shock given what we've just experienced. The last one, and probably the scariest, is around a 25% depreciation of the Canadian dollar.

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Pamela Ritchie: From where we are now.

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Ilan Kolet: Exactly. People don't have to do the math at home. This takes the value of the Canadian dollar to the low 50-cent range. So 25, -6, +3 and -25. Now, in the Monetary Policy Report that was released last week, they kind of updated this and sort of softened the edges around some of these forecasts.

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Pamela Ritchie: They did. It didn't sound as dire, actually.

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Ilan Kolet: It didn't sound as dire but I would say directionally it's still sort of the same. It's a really big hit to GDP. Think jobs and growth. It's an upward shock to inflation, whether it's 3 or 2.5, we can argue about. It's a 17 to 25% depreciation of the Canadian dollar. This is a really significant shock that we should be taking exceptionally seriously. Thankfully, we've kicked the can but the can is still on the road. It's just further up the road.

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Pamela Ritchie: The response would be from what we hear, okay, so there's some version of retaliation but what the Canadian government could do, but what the Bank of Canada could do, really they just said we could help you adjust to a difficult reality, basically, is what they said.

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Ilan Kolet: Exactly. It's a particularly awful position for the Bank to be in because in addition to those really negative outcomes, something like this, without getting too nerdy, sort of lowers long term potential growth. Trade relationships are not reformed and diversified overnight. There is a possible silver lining in that, I don't know, maybe we establish new trading relationships with other parts of the world, and we remove interprovincial trade barriers but none of that happens instantly or overnight.

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Pamela Ritchie: Can the interprovincial trade barriers happen, relatively speaking, overnight? It's a faster system.

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Ilan Kolet: I would think it would be a faster system. There are a wide range of estimates on how much of a boost that would be. I think it would be undeniably an upward boost to growth both in the long run and probably in the cyclical short period as well. These are all the types of adjustments that don't happen instantly.

Again, I think the big takeaway should be this would be an exceptionally damaging shock but it's very, very hard to know whether it's a 0% or it's a 25% or maybe it's a 50% rate. We don't actually know. I think it's important to be honest around what we know and what we don't know.

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Pamela Ritchie: And honest about the threat because it's extremely serious even just because it remains a threat. As you say, it's been kicked down the road. From there let's take a look at what you are doing in terms of investment. Actually, congratulations on a fabulous last year. 2024 was a bit of a knock-out.

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Ilan Kolet: It was an exceptional year. We have a rule on our team of no celebrating--

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Pamela Ritchie: Yeah, don't celebrate.

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Ilan Kolet: –but it's not normal for 60/40 balanced funds to return almost 20%.

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Pamela Ritchie: So good job but get back to work.

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Ilan Kolet: Exactly. Really, it came from the two ingredients. It came from underlying managers that we choose, spectacular roster of managers. The Mark Schmehls and the Dan Duponts and the Dave Ways and the Will Danoffs doing an exceptional job, and then us leaning in to equities, particularly the growth side of things and particularly in the U.S.

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Pamela Ritchie: So U.S. growth equities is what you leaned into. You have the ability to tilt. Tell us a bit more about that.

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Ilan Kolet: In order to really dig into this I think we have to rewind to September 2023. September 2023, we put out a paper called Potential. We write these quarterly thought leadership papers. We put out this paper called Potential and in it we put forth the following thesis. Maybe some combination of advancements in AI or investments in CapEx, significant investments in CapEx and clean technology, or sort of blowing up the standard 09:00 to 5:00 work week, maybe some combination of those three had raised the stall speed of the U.S., meaning the U.S. could grow at a 2.5 or 3% rate instead of a 1.5, 1.8 rate without stoking inflation. You'd have stronger growth with slowing inflation with a healthy labour market with earnings revising higher, which would be remarkable for equities.

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What we did in the fall of 2023 is we pulled down our cash position and we leaned into an overweight to U.S. equities. That remains in the funds to this day. It's a high conviction view. We're optimistic. We're overweight equities and that overweight primarily resides in the U.S. That was, obviously, tremendously beneficial last year. Again, now there are some concerns. We can talk about the valuation concerns and stuff like that but one of the questions is will this policy, this indigestion that we're seeing in policy (need a better name for that) will that derail what we're witnessing in the U.S. and our answer is, I don't think so, we don't think so. What we're witnessing right now in the U.S. is a two- or three-times-in-our-lifetime productivity expansion. The stats bear that out. We were talking about this.

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Pamela Ritchie: Even if our dollar ... well, it's linked, but even if our dollar wasn't the issue is there any thought that the productivity will reach us?

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Ilan Kolet: I would hope so, but the way that we're positioned right now to the answer is no. This productivity puzzle could take up ten of these webcasts and we wouldn't have an answer. The productivity graph in the chart for the U.S. looks like that since the '60s and is a flat line in Canada since the '90s. We've been very productive in researching productivity, but we haven't actually solved the puzzle.

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Pamela Ritchie: Well done.

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Ilan Kolet: When I started at the Bank more than 20 years ago this was on the research agenda then. We haven't really cracked the nut on why there's a significant productivity differential between Canada and the U.S. For that reason, this is something actually we addressed in that September 2023 paper, we decided we think this is happening, we think it's most likely to be happening in the U.S., let's move that equity risk budget into the U.S. and not so much Canada. We're still cautious on Canada and we're still really significantly underweight the Canadian dollar.

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Pamela Ritchie: There's a number of things that continue on the U.S. equity, perhaps growth side of things. Let's talk about styles and different areas and perhaps cap spectrum. What are some of the differentiators within the U.S. equity story for this coming year that may be different from last year?

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Ilan Kolet: In general, in our funds what we want to try to do is combine managers with different styles. We never really want to have a heavy style bias. The reason for that is we would be whipsawed by the style given in any month, quarter, year, decade. We don't ever really want to have a significant bias. We want to combine a U. S. growth manager with a U.S. value manager in such a way that we still exceed and beat the benchmark, but we do that in a way that's a smoother ride for the end investor, instead of getting whipsawed by the style.

Now, I will say last year managers like Mark Schmehl and Will Danoff were really significant contributors to our excess performance last year. One of the concerns I've heard a lot about in January, (in January I spent a week in B.C. and a week in Alberta and this came up in really every conversation) is frothy valuations.

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The way that we think about that, something we address in our most recent paper is if you look at the P/E ratio for the top 10 stocks in the S&P 500, that has moved significantly higher. It's at sort of a local high. It's not as high as it was in, say, 2001 but it's moved a lot higher, and it does look sort of extreme. Valuation is an important input into our process, into our four-pillar research process. When you look at the other remaining stocks in the S&P 500 and their P/E ratios it looks sort of more in line. One of the things that we've done is we've trimmed the U.S. equity overweight slightly from its maximum, number one, and number two, it's sort of more evenly balanced across the market now through the cap spectrum, just to take advantage of this broadening.

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Pamela Ritchie: Within that broadening discussion and cap spectrum take us into the potential for small-cap. Small-caps tend to do very well sort of out of the depths of recession. I don't see any recession in the U.S. happening but...

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Ilan Kolet: Nor do we.

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Pamela Ritchie: ...what's the discussion there?

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Ilan Kolet: For us, the way that we can tap into that is through a number of ways. Number one, there was a time last year where we had a futures position, a futures short to the Russell 2000. That was removed, we removed that. That's one way to kind of express it. The other way is through the underlying manager. Again, we really believe in this division of labour and it's not a way for me to sort of back away from the question. We want the underlying managers in our funds that we pick to follow their process and use their research and beat their benchmarks. We would never dictate to them, oh, please, own this instead of this. We want them to win. If they win and they follow their process, which they certainly have over the one-, three-, five-, seven-, and ten-year period, and we own them in our funds it boosts the performance of our funds. That's kind of how we think about that as well.

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Pamela Ritchie: One more question on sort of the U.S. equity side of things. One of the many things that you pointed out there is there's a monetary story, there's everything else, there's the bottoms-up, there's also a fiscal story. This is what we think will be some version of tax cuts. There's the deregulation trade going on, the Trump trade, so-called. To what extent are you looking to that, relying on that, adding it into the ingredient list?

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Ilan Kolet: One of the things we thought about prior to the election was, okay, we don't know who's going to win at the time, and we would never try to position for a certain person winning, but one thing we can be fairly certain of is we think there is going to be a fiscal spending, whether it's this person or this person. It will take a different shape and form.

For one it would be sort of tax cuts and maybe a wall. For the other, it takes some other form. We thought there would be fiscal spending, and sure enough we still believe that. I think the way to think about fiscal spending right now in the context of the U.S. economy is as follows.

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The U.S. economy is basically running at potential. There's not a lot of slack in the U.S., if any. The labour market is running at its potential. Now, the labour market has expanded, which we'll talk about in a little bit, but any sort of pro-cyclical fiscal spending in the U.S. right now would result in an upward shock to demand. An upward shock to demand would show up as an upward shock for the demand for labour, and that would show up as an upward shock to wages and that would show up as an upward shock to service prices. Again, three-quarters of the underlying inflation pie..

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Pamela Ritchie: Inflation.

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Ilan Kolet: ...are service prices. The price of a service is dictated by the price of the person doing the service. If their wage increases the service price accelerates and that would push underlying inflation higher at a time when the Fed has sort of thought mission accomplished on this. That's kind of how I'm thinking about that. In the context of positioning, this underpins the reason to own commodities. We own oil and gold, for example. There's no better inflation hedge, I think, than commodities and that is a principal motivation for that position.

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Pamela Ritchie: Okay, that's fascinating. Unless you have something else to say let's just park equities for a second. Taking a look at the correlation story, the 60/40, what's in the 40 these days? There is this correlation with bonds and it's been bad and good. Now what?

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Ilan Kolet: Again, 2022 was the year in which a positive correlation was hurtful, stocks and bonds moved this way.

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Pamela Ritchie: It was quite painful to watch.

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Ilan Kolet: Exactly. From a bond and stock perspective for multi-asset class investors it was sort of down and downer. Then in 2024 we saw a positive correlation result in the other way, up and more up. Not the most sophisticated language but up and more up.

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Pamela Ritchie: At least you didn't say upper or something.

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Ilan Kolet: That was also an example of that positive correlation. Now, one of the things we've talked about is how to better diversify these multi-asset class portfolios in the presence of positive correlation. There are a number of different ways to do that.

For us, there's a few things to think about. 2022 is a great example, you needed to own commodities. That was an important tool for us to preserve basis points. That was also the case last year, again, with gold performing quite well. The second one is our underweight to the Canadian dollar. Our underweight to the Canadian dollar is a really significant lever for us.

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Pamela Ritchie: It has been for years.

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Ilan Kolet: It has been for years, right. We are meaningfully underweight the Canadian dollar now, which we can talk about, but that's an important diversifier as well, especially in the presence of stocks and bonds being positively correlated.

The third one, and this speaks to more sort of the research agenda underpinning our funds, I like to always say that our funds (I don't get to talk about this all the time) but there is a team of researchers that are helping us sort of sharpen the tool all the time, meaning are there managers that we don't have that we should be researching, and if so, let's do the research and maybe add them. That's Will Danoff eight, nine years ago. Two, are there asset classes that we don't have access to or they're not in the funds? If there are and we have the capabilities, we should do the research and we should add them.

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The middle of last year, for example, we added allocations to alternatives. In the managed portfolios, we added a small allocation to three Fidelity Canada liquid alternatives. In the private investment pools, we added a 5% allocation to Brookfield Asset Management to manage a sleeve of private real estate. I think 2022 was the lesson, those are important uncorrelated sources of return and diversifiers for us in the funds that we manage.

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Pamela Ritchie: Apart from this time when have you ever walked inside the asset that's in the fund?

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Ilan Kolet: That's a good question. What you're referring to is, again, that Brookfield position, that 5% allocation of the private investment pools...

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Pamela Ritchie: You can stay in the building.

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Ilan Kolet: Exactly. These are actual bricks, these are the actual buildings. These are unencumbered assets. We started this portfolio from the ground up, literally, and we added private real estate capabilities with Brookfield in this portfolio. It is sort of fascinating.

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Pamela Ritchie: It is kind of fascinating. That's sort of the 40 itself. Within that discussion we need to pull out the Canadian dollar a little bit further. You can be sure Tiff Macklem is worried about it just falling like a stone as well. I mean, it already has. Let's go there. What would make you invest in it? What would make you sort of come back to the Canadian investment thesis? Is it all currency?

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Ilan Kolet: I mean, it really is the price. Just as a refresher, the Canadian dollar, there's a couple of important points there. How do we use it in our funds? We talked about this in the previous question. The Canadian dollar for us is an important risk management tool. The Canadian dollar is a cyclical currency; it's not a safe haven currency. In periods of stress the function of a flexible exchange rate is for it to depreciate. If we believe the direction of travel for the Canadian dollar is lower, and we do believe that, and we are underweight the Canadian dollar, our funds get hurt less in the presence of a depreciation. This is exactly what has happened last year and the previous year. It's a good protector of capital for us to be underweight the Canadian dollar.

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The drivers of the Canadian dollar have historically been the interest rate differential. The Fed has cut, and they're probably done. The Bank has cut quite a bit. We saw 250 bp cuts last year in Q4 of last year...

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Pamela Ritchie: And they're still going.

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Ilan Kolet: ..and they're still growing. The Bank will probably end up, well, we believe they will end at a lower rate than the Fed. A higher interest rate in the U.S. means capital inflow into the U.S. that bids up the value of the US dollar. Again, we're underweight the Canadian dollar.

To your question about what would make us be overweight Canada, something we've talked about is we're not perma bears on Canada. If the price gets to the right point, if there is a significant adjustment in the Canadian equity market or in the value of the Canadian dollar, and I think it would probably be the second one, then that is the time for us to pull in that Canadian equity underweight, which we've actually done a little bit.

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Pamela Ritchie: How much do you keep your eye on, we've only got a couple of minutes left, but it sort of brings in the political uncertainty that we're living with right now and a few other things. How much do you keep an eye on the currency based on the first half of this year is going to be crushing for all kinds of reasons. There may be reason for hope at the end of the year for Canada and the currency.

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Ilan Kolet: It's interesting, this Canada hope trade, this is something that came up a few weeks ago when our research team was up here from Boston, in Toronto and we met folks at the highest level from the Bay Street banks, chief economists as well. This idea of a Canada Hope trade came up. The thesis behind it is there's a lot of political uncertainty in Canada now, that should be cleared up at some point this year and if we think it's going to go the way that sort of consensus thinks could result in a totally different environment for the resource sector, and that could result in resource extraction pushing higher and a Canada Hope trade. That's an engaging idea and I would certainly love to see it. What I would say, though, this dark cloud of tariffs hangs overhead and dominates the story versus this Canada Hope trade.

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One clarification I want to make there is sometimes we talk cautiously about Canada. I want to be really clear that there's still plenty of Canadian equities in our funds. Two, we have a fantastic stack of underlying managers managing that Canadian equity stack. The Andrew Marcheses, the Dans, the Dons, the Hugos, the Marks, If they, over the long run, beat their benchmark and we own them in our fund, they boost the performance of our fund.

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Pamela Ritchie: Ilan, this has been an amazing update and so grateful for your time here today. Thanks for joining us on Fidelity Compass.

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Ilan Kolet: Thank you.

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Pamela Ritchie: That's Ilan Kolet joining us here. Thank you for joining us on Fidelity Compass. If you have any suggestions for future topics or guests that you'd like to see here on the show go ahead and share your ideas with us. We'd like that. Stay tuned for more Fidelity Compass webcast in the weeks ahead. I'm Pamela Ritchie. Have a good day.