

Fidelity Compass

Canadian Economic Outlook: Signs of a New Regime

Ilan Kolet, Institutional Portfolio Manager

Pamela Ritchie, Host

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Pamela Ritchie: Hello, and welcome to Fidelity Compass. I'm Pamela Ritchie. July's U.S. CPI numbers have arrived showing a slight uptick in both core month-over-month inflation data. How will these figures factor into next week's Federal Reserve rate decision, if at all? And does a weakening U.S. labour market mean a large rate cut is still in play? Would it be more like 25 basis points? Joining us here today to discuss all of these factors and what, ultimately, it might mean for Canada's economy is Institutional Portfolio Manager and member of Fidelity's Global Asset Allocation team, Ilan Kolet. Warm welcome to you, Ilan. Nice to see you again.

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Ilan Kolet: Very nice to see you as well.

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Pamela Ritchie: Delighted to have you here. We'll invite everyone to send questions in for the next 25 minutes or so. Let's begin with the regime change that you've coined before that we are amidst. Rates is part of the picture, a big global macro piece of it and geopolitical pieces of it but what are you zeroing in on in regime change?

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Ilan Kolet: This is a great place for us to start. Thanks again for having me.

Regime change sounds like a dramatic term, it sounds like a pretty dramatic term...

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Pamela Ritchie: It does!

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Ilan Kolet: ...but we think something is underway now versus a year ago that is meaningfully different and we have kind of changed our positioning accordingly. When I was here last year on discussions like this with you, we were spending a lot of time talking about U.S. exceptionalism.

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Pamela Ritchie: Absolutely.

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Ilan Kolet: We were talking about a productivity expansion in the U.S. I spent almost a decade at the central bank, at the Bank of Canada, and between myself, David Tulk, and David Wolf, almost a combined 20 years of experience at the Bank of Canada. We look at a lot of things through the lens of potential growth.

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Potential growth is the intersection, or the combination, of productivity (how productive are you at making the things) and labour force participation. Not to get too nerdy this early on in the discussion.

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Pamela Ritchie: Yeah, no. We're delighted.

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Ilan Kolet: Last year when we were talking about the U.S. we were talking about higher rates of growth with slowing inflation, with a healthy labour market, with earnings revising higher, with equities doing well. We leaned into the U.S. last year. Fast forward to where we are now, really since the start of this year our view has been: we had growing concern that the underpinnings of U.S. exceptionalism were coming under attack and we removed those overweights, that leaning into U.S. equities and are now outright underweight U.S. equities. Now, to be clear, plenty of great U.S. equity managers in our mandates, both institutional and retail mandates, but we just believe that something has changed meaningfully here. Again, I can't stress it enough that things are meaningfully different today than they were just a year ago in the U.S., and we can't be dismissive of that.

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Pamela Ritchie: Is it expressed specifically and only through equities in terms of how you're leaning in or leaning out of that or is it a picture for all asset classes?

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Ilan Kolet: The story sort of permeates through many different asset classes, right? In the case of the U.S., again, concern over the largest stable sort of referee to the world, which is the U.S. really exhibiting behaviour that kind of mimics things you'd see in emerging markets, firing the head of a statistical agency, threatening to fire members of the Federal Reserve. These are concerning to us in terms of the underlying stability or credibility of the U.S. It doesn't mean we can't take advantage of the fantastic A.I. dividend with underlying managers. That's not what it means. It just means as asset allocators, perhaps we should shift our glance to other areas where we think there are opportunity. For us, that's been Europe, as well as what we perceive to be an environment in which Canada may not underperform like it has really for the last 10 years.

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Pamela Ritchie: So that's not a ringing endorsement for Canada but it's quite different to the lean out that you've had for such a long time.

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Ilan Kolet: Absolutely. Yeah, absolutely. One of the things people forget is, well, for the last 10 years, so 2014 to 2024, the U.S. decidedly outperformed Canada. But what people forget is 2004 to 2014, Canada outperformed the U.S. This point often gets omitted or missed. Now, the U.S. had a one-in-a-hundred-year financial crisis, millions of jobs lost, and Canada had a massive tailwind in the form of the commodity super cycle. I was at the Bank of Canada at the time covering commodities. I remember it very well. I lived through that. There was a huge tailwind for Canada and a massive one-in-a-hundred-year systemic shock to the U.S. But that was a 10-year period in which Canada outperformed the U.S.

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Now, as asset allocators the question that we're asking ourselves is not: is Canada going to do well? That's part of the question. The question is: how is Canada going to do versus fill in the blank. That's the question we need to think about as asset allocators, who's going to win the race, essentially. Our view right now is the environment is set up such that in many parts because of what we're observing in the U.S. but also in Canada, we don't believe that the underperformance in Canada that we've observed for the last 10 years will necessarily continue because of what's happening in the U.S. Now, I should mention this doesn't mean that the issues that we've highlighted for a long time in Canada have magically disappeared. Canadians have too much debt. Too much of the growth has been just housing and housing construction. We haven't had productivity growth in 40 years. We have these systemic issues. They haven't gone away but policy appears to be geared now towards solving some of these longstanding secular issues instead of not.

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Pamela Ritchie: Solving some of those issues, as you say, we are also hearing, and again, it's from a particular government talking to a particular audience, that we're on the cusp of a new commodities boom, a new super cycle, or Canada could be part of that super-, I mean, do you believe that? You lived through one.

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Ilan Kolet: Maybe. I don't want to throw too much cold water on this idea but, again, as investors our job is to not necessarily buy all of the talking points all of the time. What do we know and what do we not know? We know that between 2014 and 2024 commodity extraction, oil and gas extraction fell by 50% in inflation-adjusted terms.

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Pamela Ritchie: It was a nothing.

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Ilan Kolet: It was worse than a nothing; it was a drag. It was a drag on growth pretty much in every single year. One of the ideas we need to think about, I have colleagues who probably phrase it a little bit better but sometimes there is a tremendous amount of opportunity from an asset allocation perspective when things go from really bad to bad.

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Pamela Ritchie: Less dire.

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Ilan Kolet: Less dire. That phrase is probably why I'm not in sales. This is an example of an asset allocation opportunity. For example, if the resource sector, which has been hamstrung for 10 years, gets even slightly better or slightly more productive that is an area that we could view as opportunity.

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Pamela Ritchie: Let's ask you, in terms of the directional discussions of the red tape that we think is going to be lifted, it seems like the government is organizing itself accordingly and announcing new projects and so on, that's kind of what you're talking about. I mean, that is one layer of the productivity story. There are many layers but it's one of them.

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Ilan Kolet: Exactly. Again, I worked for Carney when I was at the Bank of Canada. It's important to just lay this out and talk about it. My colleague, David Wolf, was his advisor when he was at the Bank of Canada. We've worked with him. I would say, again, we're cautiously optimistic that someone with Carney's background is very well versed in the detrimental and damaging impact that low productivity brings. The reason economists continually talk about productivity is because it is the magical ingredient to long-term growth and raising standards of living. If you don't have it, because we haven't had it in about 30 years in Canada, it is problematic. Honestly, it erodes standards of living slowly over time because everyone else kind of moves forward while you don't. Addressing that productivity problem, the productivity gap, is, I think, the number one priority for ... and I think it's showing up in these sort of shovel-ready type of infrastructure projects to push us forward.

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Pamela Ritchie: Does it also move the capital away from housing? Housing probably is going through its own moment right now but you would be inclined to be more entrepreneurial, which is one of the pieces of this, if you didn't just want to invest in condos because that worked very well for you.

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Ilan Kolet: Exactly. That's an excellent point that I should have hit on. For a very long time in Canada, the most productive capital, or productive capital went to the least productive sector which is housing. It makes sense. If you and me are about to start a company that takes a huge amount of our personal wealth and leverage and takes a decade before we see a dollar, we say, no thank you, instead we're just gonna buy condo assignments and flip them every year for 10 or 15%. It's a highly unproductive type of place to sort of park your capital. But capital moves to where it achieves the best risk-adjusted return which for 15 years in Canada was one thing and it was the housing sector. So housing is absolutely going through its own moment right now. That's the nicest way I think you could have put it. I think it would be very, very healthy if productive capital were to move to other parts of the economy.

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Pamela Ritchie: And sort of spread it out. It does seem like some of these shovel-ready projects maybe will spread it. I mean, this is the question. Would you invest in that?

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Ilan Kolet: Exactly, we'll have to see. The truth will bear out in the statistics. There's no way to hide from good statistics. They're kind of the most obvious and honest indicator.

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Pamela Ritchie: Can you hide from bad statistics more easily?

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Ilan Kolet: You can't hide from good or bad statistics — well, unless you fire the head of the Bureau of Labour Statistics.

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Pamela Ritchie: I was sort of setting you up for that one.

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Ilan Kolet: The question on how's this going, which we can answer in a year or two, will be very, very clear. We will have distinct numbers on whether or not that productivity challenge has turned and if we're seeing kind of an increase in dynamism which has been lacking for a while.

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Pamela Ritchie: Let's talk a little bit about the disconnect which you mentioned before. You mentioned that certain elements of what's going on with Fed independence are worrying. Let's kind of come back to that for a minute. How worrying, and I guess to a certain extent this is all about the debt in the U.S.

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Ilan Kolet: It's seriously problematic. When I worked at the Central Bank the division between the Central Bank and the federal government was...

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Pamela Ritchie: This is in Canada, obviously.

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Ilan Kolet: ...in Canada was absolutely critical and untouchable. When Governor Carney was asked questions about the budget he would say, "That's not something I talk about. Please ask my colleague, Minister Flaherty." When Minister Flaherty was asked questions about monetary policy, he would basically do the same thing. This division is critical. Why is it critical? I mean, everyone on this call will know this but governments have an incentive to overspend because...

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Pamela Ritchie: It makes people happy.

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Ilan Kolet: It makes people happy.

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Pamela Ritchie: Voters.

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Ilan Kolet: It makes voters happy. It juices the economy. It pushes job growth higher. It pushes the unemployment rate lower. It pushes growth up. The problem is inflation. Inflation is awful for the consumer and really terrible for the investor. If you need a proof point, 2022. 2022, a year none of us want to go back to...

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Pamela Ritchie: Everything went down.

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Ilan Kolet: Exactly. Bonds and stocks was down and downer. The reason for this division, this very, very important division, is just that. What we're observing right now in the U.S. in our view is problematic. It's another one of these points in the point around the underpinnings of U.S. exceptionalism kind of coming under attack. It's problematic. It's seriously problematic. It's not a direction that I would say we thought a year ago that we would be heading in, and for that reason we're more cautious around the U.S.

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Pamela Ritchie: There's an awful lot, I mean, maybe we follow this and it's kind of interesting and fascinating to see all of the communications from the Federal Reserve. There are a lot of them. It's a little bit of a marked difference from, let's say, 15 years ago. Is that good for everyone to have so many Fed governors talking so often?

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Ilan Kolet: It's interesting, there's actually a whole stream of research just on central bank communication.

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Pamela Ritchie: That's fascinating.

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Ilan Kolet: It really is. There was a move I would say from the '90s until the early 2000s, 2010s, where more was better. You saw some of the Nordic central banks put out full forecasts and forecast bans. That was generally the direction of travel. More information the better. Don't surprise market participants. I mean we've learned that surprises are bad but I do think there is a point at which inconsistent communication across a wide swath of Federal Reserve members, voting and non-voting, can be difficult for investors and market participants to kind of digest. We work very closely with a research team based in Merrimack, New Hampshire, that helps us parse and dissect and think about central bank communication from voters, from non-voters, and what is the underlying thread that's coming through. That's a skill; that's a skill and an art.

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Pamela Ritchie: It's a skill and an art and it's, obviously, a decision on some level to have more communication rather than less. I mean, you can think of other Fed situations, different governors who decided not to be so chatty.

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Ilan Kolet: Exactly.

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Pamela Ritchie: It's a strategic decision.

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Ilan Kolet: Exactly. Every Fed chair has their own style of communication. I would say my experience with Chair Powell has been ... I think he's very open; he's very clear; he's a clear communicator. I would expect next week with the Fed and the BoC, I expect rates to move lower. I know we're going to get into this, but the discussion will really be around this trade-off between being stubborn in hitting the inflation objective and trading that off with shoring up the labour market in what looks to appear now as a much weaker labour market than we once thought.

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Pamela Ritchie: It does seem that that is just, I mean, that's centre stage. It has been since Jackson Hole. That is what they're making the decision on. Is there any reason to think that, well, rates will go down, I guess the question is the reaction of inflation.

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Ilan Kolet: This is exactly the question. I brought a few notes just so I don't muddle the numbers here. What do we know about the U.S.? We had 22,000 jobs added in the last month. That was the labour market report from August that we got. (We get this report first Friday of every month, as we know.) Important thing to remember here I think that sometimes gets lost is the standard error on the monthly jobs estimated in the U.S. is 100,000, roughly 100,000, so that 22 could have been 122 or minus 88.

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Pamela Ritchie: But we saw that with the bolus revisions that came through. 900,000.

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Ilan Kolet: Exactly. The other thing that came through was almost a million fewer jobs created through March which is a very sizable annual revision. Annual revisions, they're not new and they've never been politicized but this is something ... this was a big one.

What the Fed is tasked with doing is trading off a labour market that appears weaker than they thought and weakening. Unemployment rate is now 4.3%, a year ago it was 3.4%, with inflation that is not yet where they want it to be. What do I mean by that? Inflation, the CPI is 2.9, core is around 3, 3.1 so that's not exactly where they'd want it to be, even if you take the PCE measures. But inflation moves very slowly and gradually. The labour market can move quite quickly. What I believe we'll get next week, then again in October and December is a rate cut and the communication will be exactly with that tone, shoring up kind of concerns in the labour market but remain vigilant on inflation. As you mentioned, Pamela, the worst-case outcome is these rate cuts do too much in terms of shoring up the labour market and the consumer, that leads to more consumer spending, higher wages, that pushes inflation higher. That's the worst case scenario.

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Pamela Ritchie: Now, investors can invest into that, of course, and a little of inflation is good for the equity markets and there's a period of time in which it's sort of okay. Let's take a look at the Canadian story because it looks like the job picture here is ... it's not dire but it's serious here.

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Ilan Kolet: It's really evolved over the last couple of months. What do we know? Over the last two months the Canadian job market has shed 106,000 jobs. Sixty-six thousand of those are in August, but over the two month period we've lost just over 100,000 jobs.

I would say more concerning is the trend on unemployment. Again, these numbers are pretty striking. The unemployment rate today is 7.1%. It was 4.8 in July 2022. That was probably too low below its natural rate but we've gone from a low of 4.8 to 7.1 right now. Over that period, just to put it in perspective, there have been 600,000 more people added to the unemployment line between that July 2022 and where we are today. Again, I love to look at the micro data, the underlying data. The unemployment rate in Alberta is 8.4%. The unemployment rate in Toronto is 9%.

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Pamela Ritchie: So the biggest metropolis in the country running at 9% unemployment.

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Ilan Kolet: Exactly. Significantly higher than just a few years ago. What this means for the Bank of Canada is, again, rates are much lower in Canada than they are in the U.S. The overnight rate in Canada right now is 2.75%.

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Pamela Ritchie: Because the idea was that they sort of got all the cuts in there, you know, as tariffs were unfolding.

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Ilan Kolet: Exactly. For the right reasons they front-loaded those cuts because of vulnerability, because of the tariff threat, because 20% of our GDP is just exports to the U.S. I know we're going to talk about tariffs but this was a concern and rates moved lower, and rates are lower in Canada than they are in the U.S. but rates are going to continue to move lower this year.

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Pamela Ritchie: They have to, because of those numbers. So is this the impact of tariffs? Go ahead, take some water. Is the impact of tariffs in the form of we thought inflation? We thought all kinds of different things. The fallout is the labour market which is not like a huge surprise but is this what we're looking at for tariffs?

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Ilan Kolet: I hate to give an economist answer but the answer is maybe.

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Pamela Ritchie: You're an economist though.

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Ilan Kolet: It's very difficult to do a perfect accounting of a job category and a tariff. We'll try and we'll get more clarity over time but this is more than just one month of data. This is now two months of data. I'm not going to say that's a long-term trend of any kind but it's a concerning signal. So too is the push higher in the unemployment rate. It would be intuitive and natural to think of some of this as a tariff impact. Again, if you and me were starting a steel company and we were about to open our second plant and we had hired a bunch of people for that plant, we would kick the can on opening that plant and we would lay off everyone who we had just hired. That's a natural thing to gravitate to. It will take a little bit of time before we can say with certainty this is tariffs but it certainly wouldn't surprise me at all.

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Pamela Ritchie: When you look at productivity, which you did for years, you still do, and there are, again, these promises to sort of ... the idea is that productivity will kick in as the job cuts come. I mean, it's never going to hit directly, it is not hitting directly. That said, productivity because of technological change, because maybe more people are doing other jobs other than housing, how quickly can this get off the ground in your mind?

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Ilan Kolet: Productivity is a quirky statistic; it's a really weird statistic. It's very, very easy to measure in the goods sector. If we were stamping widgets on a production line, we would know very quickly that adding this new cool machine made us twice as productive, or retraining the workforce made us twice as productive. It's much harder in the service sector. In the sector that most of us work in in developed countries, it's very hard to measure productivity. But I'm optimistic, again, I'm cautiously optimistic that we will have, perhaps, not as dire of a productivity scenario as we've had in the last while. I've joked that the one place we've been very productive is talking about productivity but we need the productivity to actually materialize in the economy.

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Now, there are a couple of important differences between Canada and the U.S. that are unlikely to change which affect productivity. We are a more regulated economy; we're less diversified across sectors; our labour is less mobile. Economists have tried for a long time to put their fingers on exactly the factors that contribute to the wedge between productivity between Canada and the U. S. There's a whole soup of factors. Some of those won't change but we're hopeful that some of them will change and lead to less underperformance by Canada.

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Pamela Ritchie: I just want to squeeze in a quick commodities question here. To the extent at which commodities continue to be what we export where do you see the manufacturing side come in there to sort of have the value added, and to add jobs, frankly?

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Ilan Kolet: Historically in Canada we've been very good at digging stuff out of the ground and selling it to our neighbours. Where the real profit margin accrues, where the real value gets added is in the next stage of commodity production or commodity finishing. It's not just chopping down the tree, and I'm going to speak kind of crudely here, it's not just chopping down that tree it's finishing that into the two-by-four that goes into the Home Depot. You need to move up that value chain. Canada historically has had a tough time getting there. We've always just kind of dug that raw commodity out and then sent it off. I would think we need that manufacturing sector to do more of that refining or to move up that value chain. That's really where we'll accrue the kind of valuable profits.

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Pamela Ritchie: What do you want to leave investors with? We know it's a big week next week, obviously, what you've got your eyes on. What do you want to leave people with, sort of a message?

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Ilan Kolet: We've talked a lot about this. I was actually talking with the guys in the office this morning about the type of environment we're in right now. Last year was a year in which, to be quite frank, we were talking about a U.S. productivity boom and we were leaning into that story. In a year that we're in right now, we're sort of sticking close to the knitting, close to our strategic allocations. We're still finding areas for opportunity but this is a year in which you want to preserve those hard-fought returns that you may have achieved in previous years.

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Pamela Ritchie: Fascinating to get your thoughts. Ilan Kolet, thank you very much for joining us here on Fidelity Compass. Thank you for joining us on Fidelity Compass. Glad that you could. As always, if you have suggestions for future topics or guests that you'd like to see here on the show go ahead and share those ideas with us and stay tuned for more Fidelity Compass webcasts in the weeks and months ahead. Thanks for watching and joining us. I'm Pamela Ritchie.

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