Five Questions and Five Charts

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Last quarter we answered fifteen of the most frequently asked questions we get. This quarter, with the help of a few of our favourite charts, we answer some more.

Are you buying bonds now that rate hikes seem to be nearing their end?

Yes – but only selectively and gradually.

Let's go back to first principles here. Why do we own bonds in a multi asset portfolio? The first reason is for the income. 10-year Canadian government bonds are yielding roughly 3% as we write. That's better than anything we've seen for over a decade. But shorter-term instruments are yielding over 4%, as the yield curve is heavily inverted. We're preferring to take our fixed income exposure in those shorter maturities.

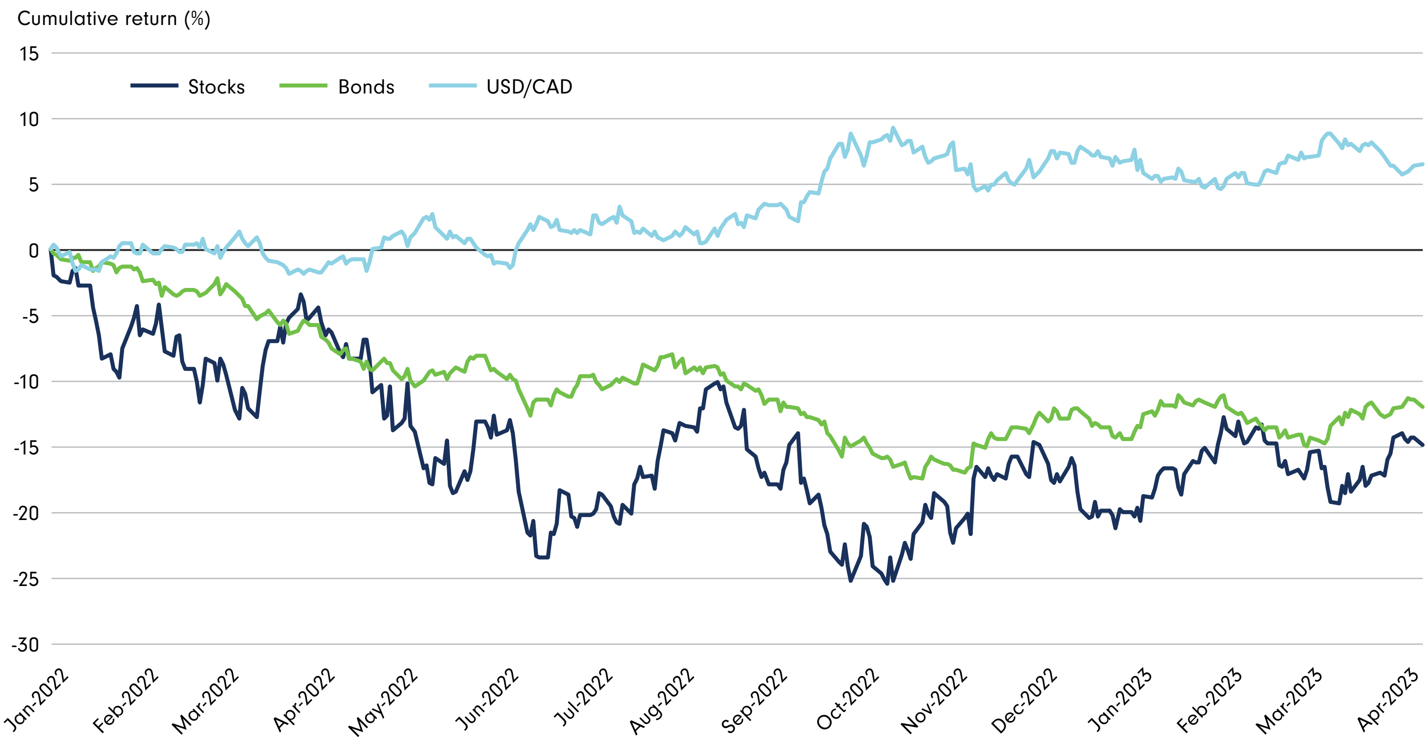
The second reason to own bonds is for the capital gains that can be realized when yields fall, a process that has enhanced total returns in bonds for a generation. But that inverted yield curve reflects the fact that markets are already discounting lower interest rates ahead, anticipating rate cuts by both the Bank of Canada and the Fed by year-end. So, for longer-term bonds to rally, we'll probably need to see those central banks cut rates even faster than markets expect. We don't think that's going to happen.

The third reason to own bonds is as protection. Bonds have tended to appreciate in value when risky assets go down. That's the traditional bonds-hedge-stocks relationship that has helped investors for a generation. But that negative correlation turned positive in 2022, with both stocks and bonds falling, owing to the resurgence of inflation volatility. Regardless of one's view on the direction of inflation, it seems pretty clear that the volatility of inflation is not going back to its prior near-zero level any time soon, meaning that a highly negative correlation between stocks and bonds is likely a thing of the past. To be sure, bonds still have a defensive and diversifying role to play in multi asset portfolios, but less reliably so than we're used to.

So, what else can we do to mitigate risk in a market environment that we think will remain challenging? One tool we're making greater use of at present is currency. As the chart below shows, the US dollar has remained effective as a diversifier to equities, even as bonds and stocks have been moving more together. We expect this to persist. The US dollar remains a safe haven for investors in times of stress.

And the paramount reason for that stress – Fed tightening to combat inflation – is also positive for the US dollar. Contrast the Canadian dollar, which tends to fall in periods of stress, and where the scope for further increases in interest rates is more limited, given the greater interest rate sensitivity of the domestic economy. As a result, we maintain a significant overweight to the US dollar, as part of our overall defensive positioning.

EXHIBIT 1: The U.S. Dollar has been a reliable diversifier



Source: Bloomberg. Stocks are U.S. S&P500 Index, Bonds are the U.S. Aggregate Bond Index.

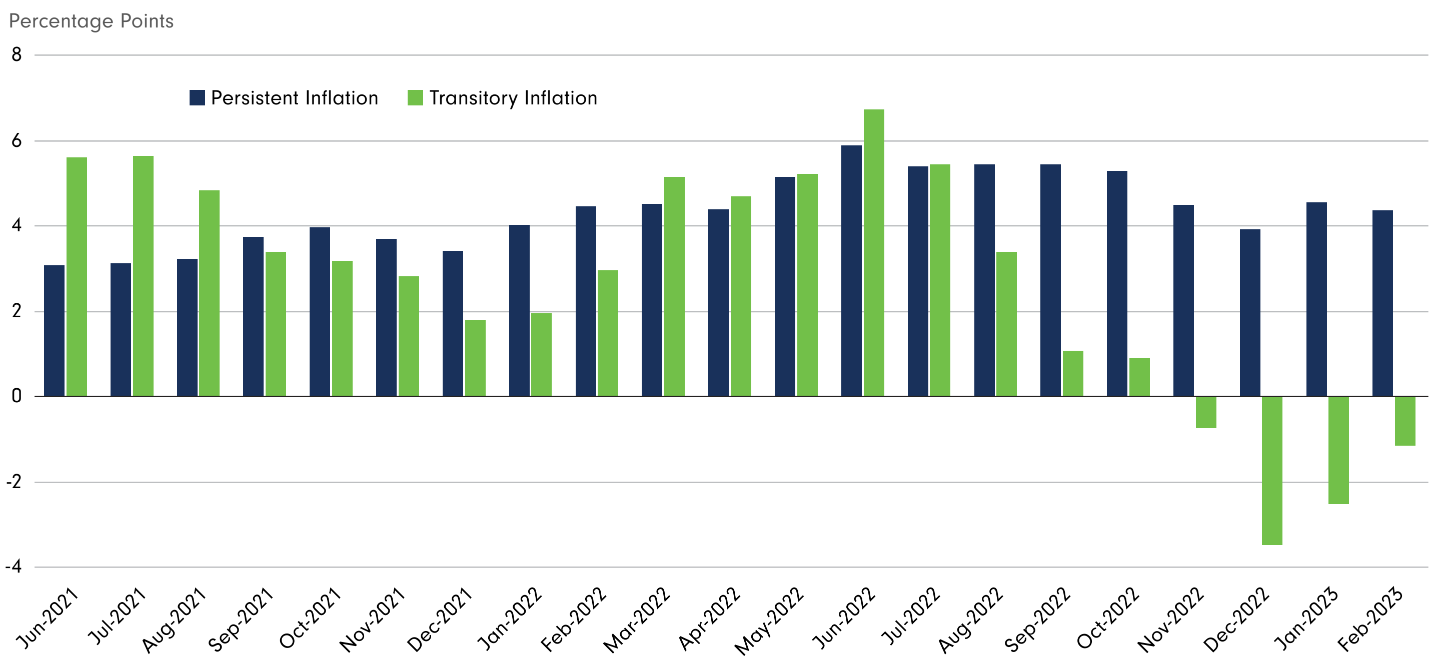
Why do you expect inflation to remain elevated?

Because the labour market is still too tight.

While demand for labour has fully rebounded from the pandemic, supply remains constrained, reflecting both demographic pressures and changing attitudes towards work. This has contributed to higher wages, which are the most important driver of services prices, in turn accounting for about three-quarters of underlying core inflation. Services prices are also the slowest-moving and most persistent part of the inflation basket. As the chart below shows, the contribution to headline inflation from these persistent components has remained stubbornly elevated. By contrast the lift from transitory components has faded appreciably in recent months largely as the rate of goods inflation has returned to pre-pandemic levels.

To loosen the labour market sufficiently to reduce services price inflation, we will likely need a significant recession, with accompanying increases in unemployment and more muted wage increases. All of these things happen with a lag, and the recession has yet to begin. As a result, while inflation is likely to decelerate further in the months to come following its peak in mid-2022, we nevertheless expect it to remain uncomfortably above central bank targets for longer than the market believes. In that context, we continue to see value in inflation-sensitive assets like commodities and inflation-protected government debt and hold them as out of benchmark allocations in many of our funds.

EXHIBIT 2: Persistent vs transitory U.S. inflation contribution



CPI: Consumer Price Index. LEFT: Contribution to expected CPI indicates the estimated contribution to Year-over Year CPI over the next six months. Persistent Categories include areas where, historically, inflation has taken longer to dissipate, such as Housing and Food & Beverages. Series are 6-month averages at an annualized rate. Source: Bureau of Labor Statistics, Haver Analytics, Fidelity Investments (AART).

When will policy interest rates be cut?

Not any time soon, in our view.

The market is expecting rate cuts in the United States (and Canada) later this year, expecting the Fed to ride to the rescue once again in response to strains in the US financial system. But that seems a lot less likely to happen than in the past. The obvious reason is inflation.

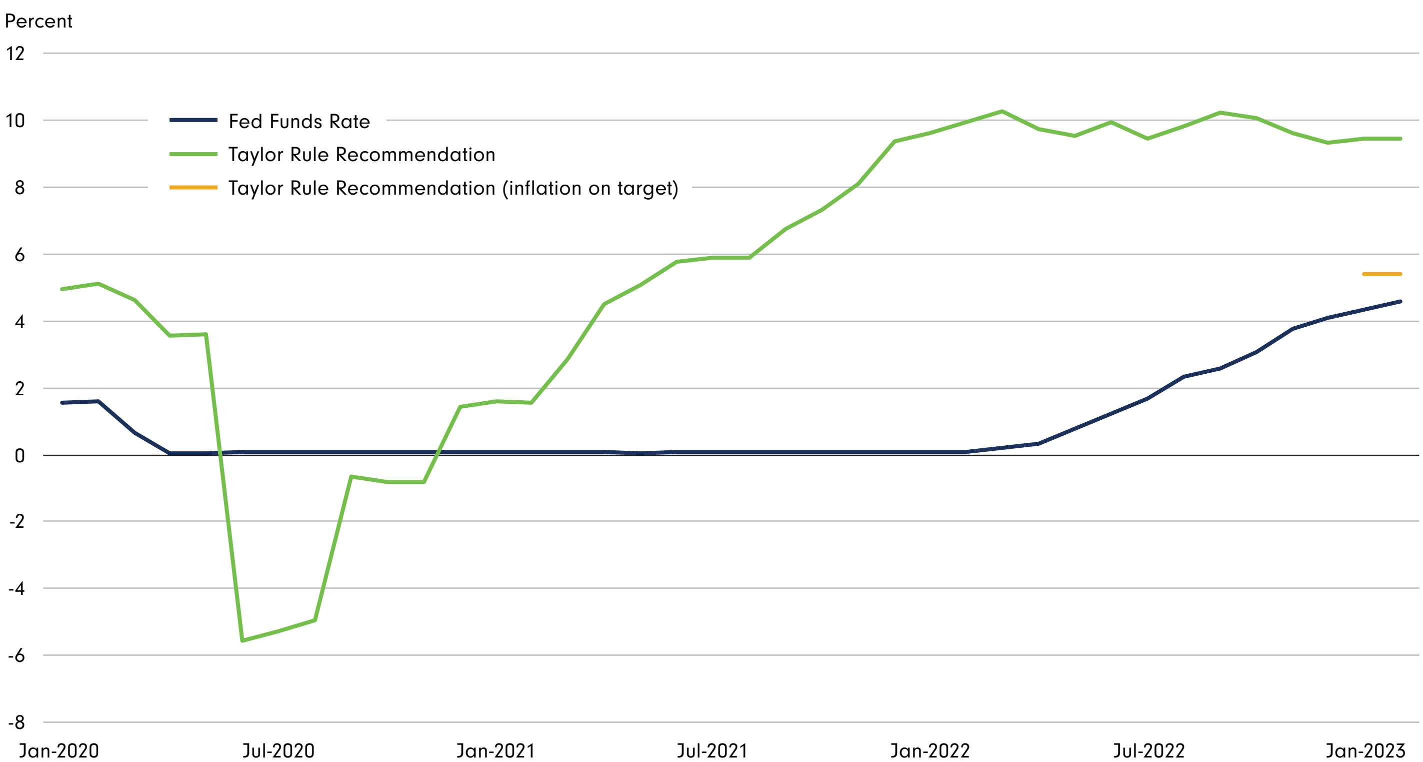
Low and stable inflation permitted (in fact encouraged) the Fed to respond to financial stresses and associated recession risks in 2000, 2008 and 2020. But for the first time in a generation, inflation is too high, and we expect it to stay that way. While this doesn't rule out Fed cuts if financial strains become acute, we have no doubt that it will make the Fed more reluctant to do so.

It's not just inflation, however. The economy is too hot. One way to see that is to apply the old Taylor Rule, which links the recommended policy setting to both the rate of inflation and the state of the economy. Using the most recent data points, the Taylor Rule would suggest a Fed Funds rate of over 9% (!). If we plug in an inflation rate of 2%, though, we still get a recommended Fed Funds rate of around 5.5%, close to the current actual rate (see chart). In other words, *even if inflation wasn't a problem, interest rates may still be too low.*

The Taylor Rule, like any policy rule, is obviously a coarse measure of the right setting for interest rates. But it's directionally intuitive. Monetary policy should be tight with inflation too high and the economy too hot. Both of those things will have to change for the Fed to be comfortable in cutting rates. If financial stresses intensify, leading to credible expectations of an inflation-killing recession, the Fed will no doubt respond. It will, however, take a lot more to get there than in any cycle we've seen for 30 years.

Markets appear to be currently discounting interest rates cuts amid a soft landing. As above, though, we think it's highly unlikely that we can get both. The Fed will cut if and only if a hard landing is underway, in our view. That puts current valuations in both equity and fixed income markets at risk, which contributes to our overall defensive positioning in the multi asset class funds.

EXHIBIT 3: Taylor rule would have called for much tighter monetary policy



Source: Bloomberg, FMRCo.

Does Canada's fiscal situation concern you?

Yes.

The recent Federal Budget again advertised the apparent strength of Canada's government finances. But we believe there's more to be concerned about than meets the eye.

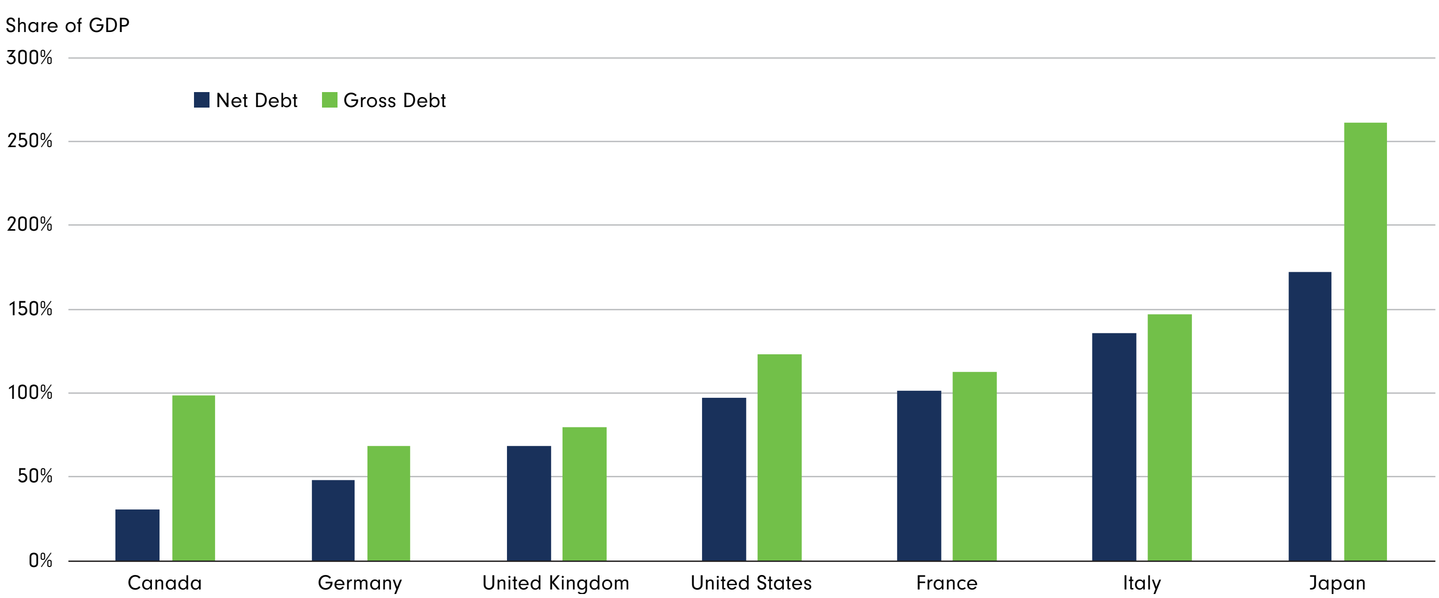
Chart 27 in the Budget shows Canada's net public debt position to be best in the G7, according to IMF indicators. Those numbers are correct. But they also don't tell the whole story. These IMF net debt figures include the assets of public pension plans. But it would be unthinkable (hopefully) for governments in Canada to raid the assets of CPP/QPP to fund current spending. So, what matters more from a practical perspective is gross public debt obligations. On that metric, as shown in the chart below, Canada is closer to the middle of the pack among developed countries – not terrible, but clearly not great, particularly given that gross debt across all developed countries is close to record highs.

The federal government and the provinces are also not adding significantly to debt, i.e. deficits have shrunk to (relatively) low levels. But that's also not as reassuring as it seems. Government finances in Canada have been flattered by a remarkable 39% surge in nominal GDP over the past two-and-a-half years, reflecting both the recovery from the pandemic and the unanticipated surge in inflation. Neither is repeatable. The inflation-taming recession that central banks are being required to court will send the tide back out, laying bare a more challenging fiscal situation. Put another way, this is about as good as it gets for the economy and its impact on government finances. If budgets cannot be balanced now, it's not clear when they can be.

The risk is compounded by the potential need for Canadian governments to effectively offer their balance sheets to offset deleveraging in Canada's stretched household sector. The US went through that process in the aftermath of 2008. That challenge may yet still lie ahead in Canada.

To be sure, public finances aren't the biggest thing to worry about in Canada at this point. But they're also not the strength they appear to be, in our view.

EXHIBIT 4: Canadian public finances aren't as good as they seem



Source: International Monetary Fund.

What are you optimistic about?

Spring. And emerging markets.

While our active positioning remains moderately defensive, we also have several 'offensive' allocations to procyclical asset classes where we see greater risk-adjusted return potential. This includes a regional overweight to emerging market (EM) equities and allocations to emerging market debt, both hard currency and local currency. While the expected slowing of the global economy poses a challenge to EM, we identify four factors favouring an overweight to EM asset classes:

- Many emerging market economies are further advanced through the business cycle relative to their developed market peers. Aided by China's delayed pandemic reopening and supported by increasingly stimulative monetary and fiscal policy, many emerging market economies are experiencing a cyclical upturn in growth.
- We believe this desynchronization of economic cycles will be more common ahead as globalization continues its retreat. As a result, positions in emerging markets will tend to be better diversifiers in our multi asset class portfolios.
- As shown in the chart below, EM equity valuations are relatively cheap. While valuation is not a reliable timing signal, it does indicate the magnitude of a potential reversion to mean following an appropriate catalyst. In this example, a stronger-than expected cyclical upturn may serve as such a catalyst.
- Secular growth prospects in emerging market economies remain relatively favourable. The aging demographics that seem destined to slow developed market economic growth in coming decades are less of a challenge in EM, which may also benefit from a greater scope for productivity growth.

In sum, EM is cheaper with a better outlook in the shorter-term, and more diversifying with a better outlook in the longer-term. We're underweight risk generally, but we're overweight EM.

David Wolf, David Tulk and Ilan Kolet, April 10, 2023

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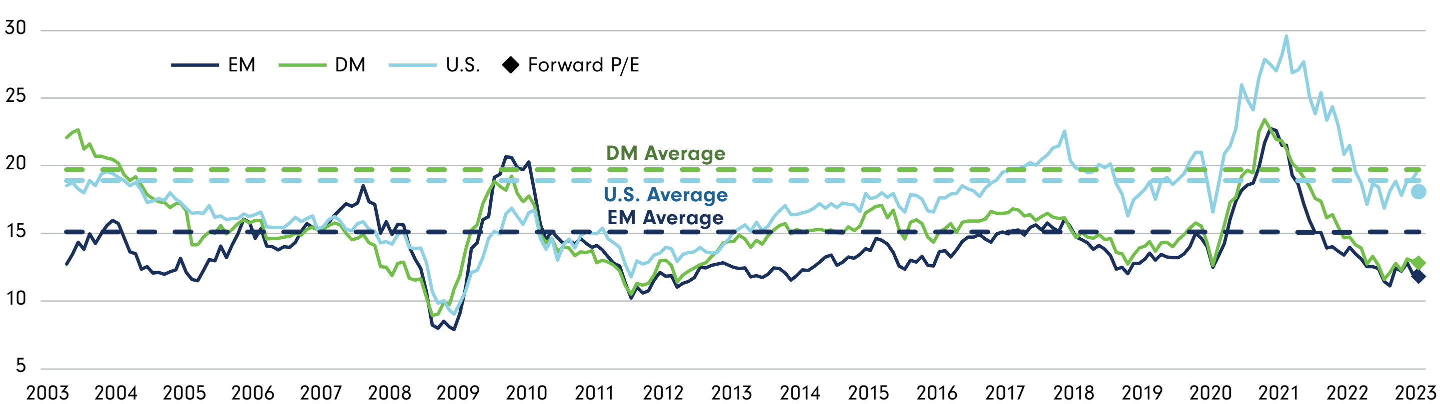
EXHIBIT 5: Emerging market valuations are more attractive

Global stock market P/E Ratios



DM: Non-U.S. developed markets. EM: Emerging markets. Chart includes Trailing 12-month P/Es. Past performance is no guarantee of future results. It is not possible to invest directly in an index. All indexes are unmanaged. Price-to-earnings (P/E) ratio (or multiple): Stock price divided by earnings per share, which indicates how much investors are paying for a company's earnings power. Long-term average P/E includes data from 9/30/95 to 3/31/23. Indexes: DM – MSCI EAFE Index; EM – MSCI Emerging Markets Index; U.S. – S&P 500. Source: Factset, Bloomberg Finance L.P., Fidelity Investments (AART).

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