15 Questions to Start 2023

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David Wolf recently hosted an "Ask Me Anything" session on Reddit. In that spirit, we offer our answers to the questions we've been getting most frequently from advisors and investors as we move into 2023.

1. Is 60/40 dead?

The principle of 60/40 portfolios – diversification – remains unchallenged. That said, in this environment, we think one has to be more creative in how to diversify a portfolio. 60/40 (code for the standard stocks/bonds balanced fund) had a very tough time in 2022. It's not just that both stocks and bonds went down, it's that they went down together. So, the nice 'hedge' of bonds cushioning stocks hasn't been there.

Why has that happened? The answer is that inflation volatility has emerged for the first time in a generation. Taking a step back, there are broadly two types of macro 'shocks' that hit markets – growth shocks (where the economy is stronger or weaker than expected) and inflation shocks (when inflation is higher or lower than expected). For the past 30 years or so, inflation was low and stable, so almost everything was a growth shock. Growth shocks tend to produce the negative correlation between stocks and bonds that we've come to know, because a stronger economy, say, pushes both earnings and interest rates up, so stocks up and bonds down. But inflation shocks, like we're living through now, give you a positive correlation, because higher inflation is bad for both stocks and bonds. That inflation volatility is probably not going away any time soon.

So just buying some stocks and bonds and closing your eyes isn't going to work as well as it has historically. On our team, we have the advantage that we have access to a wider range of asset classes with different risk characteristics that can still provide diversification. One example is currency. The US dollar has remained negatively correlated with equities, because it's still where capital goes when markets are under stress, and because the source of that stress – higher US interest rates – also benefits the US dollar. So, we've been overweight US dollars, which has still provided some cushion to fund performance as stocks and bonds generally have been under pressure. We wrote in greater detail about this in a piece published in late 2021.

2. How do you think about growth versus value in the context of the portfolios you manage?

As above, a key objective of our 'balanced' funds is to provide diversification and, not surprisingly, balance. While our active allocation decisions will tilt the portfolio to reflect our views on the market and the economy, the selection of the sleeves making up the fund is designed to balance many different investment characteristics. Both across and within a regional equity allocation (which itself reflects a geographical balance within the wider fund), we will

include portfolio managers who span the growth-value style and size spectrum. We also make use of sleeves and out of benchmark allocations with specific risk management characteristics such as low vol equities. On the fixed income side of our funds, we use a range of alternative sectors such as emerging market debt, high yield bonds and floating rate debt to enhance return but also provide diversification relative to a standard investment grade benchmark. Monitoring and adjusting the size of these various exposures falls under the oversight function that we as asset allocators undertake. Exhibit 1 provides an example of the range of investment styles of the equity portfolio managers we use in the Fidelity Global Balanced Portfolio.

3. How do you think about adding or removing underlying managers or asset classes from the funds you manage?

One of the advantages we have as asset allocators is access to a wide range of asset class vehicles we can use. The list of capabilities available to us has increased over the years, as new products are developed and launched in the Canadian market. In considering a new capability (and after we've done our due diligence), we first want to ensure it enhances the return and/or mitigates the risk of the wider fund by increasing diversification. This involves not just looking at a capability in isolation but also understanding how it interacts with the other allocations in the fund.

We rarely remove a portfolio manager sleeve from our funds, but it does happen from time to time. As noted in Question 2, we are very deliberate in choosing a diversified set of allocations that we believe will outperform the benchmark while delivering the characteristics that the investor seeks. We aim to bring the best capability available to us to fulfil that allocation. But we also recognize that a portfolio manager in a given region or style will underperform at various points in a cycle. We are patient with that, so long as we retain conviction in the strength of their process. It is only if that process changes, if the manager deviates from the 'role' that motivated their inclusion, that we would seek an alternative capability to reestablish balance within the fund.

EXHIBIT 1: Fidelity Managed Portfolios utilize a range of investment styles

Style positioning as of November 30, 2022

For illustrative purposes only. Please see end of document for full disclosure.

4. What are your thoughts on GICs (guaranteed investment certificates)?

GIC's aren't part of the opportunity set for the funds we run. But we do have access to short-term interest-bearing securities, which are effectively the same thing. We're holding more of that than we usually do in the funds, not only because of their carry/defensive characteristics but also as a ready source of liquidity we can deploy quickly to take advantage of market opportunities, which often don't last long. We're also holding more of our short-term instruments in US dollars than we usually do, which adds a layer of defensiveness to the position (see Question 1).

5. What are your thoughts on alts (alternative investments)?

Alternative asset classes offer us an additional set of tools to enhance the diversification of our funds. They include market instruments that employ leverage to deliver specific investment outcomes such as market neutral or long/short funds (including those launched by Fidelity Canada in recent years) as well as non-market assets that are typically considered long-term holdings such as direct real estate and private debt.

When evaluating capabilities that are categorized as "alternatives", we seek to understand each exposure's underlying return drivers and how the exposure's attributes may affect portfolio diversification. This includes considering the complexity, liquidity, and fees of the alternative asset. In our view, many alternatives have properties that are attractive to long-term investors and can provide an independent source of risk and return relative to traditional equity and fixed income assets.

6. How are you currently positioned?

The funds we are responsible for are positioned moderately defensively. We're slightly underweight equities and duration (interest-rate risk), overweight US dollars, overweight inflation-sensitive assets like commodities and Real Return Bonds, and we hold more cash than we usually do. We've been taking the opportunity of market bounces like we've had recently to reduce risk. We think it's still going to be bumpy ahead.

As always, this positioning derives from our four-pillar process:

We think the **macro** looks quite daunting, which is the primary factor motivating our defensive posture. Markets have cheered the recent resilience of the economy. But the stronger the economy remains, the more central banks will need to do to produce the slack needed to bring inflation down, making recession an inevitability that's not fully priced into markets, in our view.

By contrast, the **bottom-up** looks pretty good. Corporate profitability remains strong and margins in aggregate are holding in at high levels. Our analysts are reporting that, for the most part, companies are preparing for a downturn but are not seeing one in their businesses.

Valuation signals are mixed. Equities in aggregate are clearly cheaper than they were but arguably not cheap enough, given the outlook for the discount rate and the likelihood that the earnings projections on which those valuations are based may need to come down.

Sentiment looks fairly neutral. Investors were clearly fearful at the near-term market bottoms in June and again in October, with the associated bearish positioning producing the powerful counter-trend rallies we've seen thereafter. This is a common pattern in periods of market stress, and sentiment remains a key contrarian indicator we take account of in the calibration of our own positioning.

7. Where is inflation headed?

While we generally believe that the year-over-year inflation prints have peaked, we must stay humble on just how accurate we or anyone else can be when it comes to these

sorts of forecasts (the Bank of Canada's recent forecast history is in Exhibit 2). We believe inflation will continue to ease, but at a slower pace than what most are expecting, and we anticipate that it will be difficult to get inflation all the way back to the 2% target.

This view is grounded in the drivers of underlying inflation, most importantly services prices. Roughly three-quarters of the CPI basket is accounted for by services prices, and movements in these prices tend to be more persistent than movements in goods prices, making services prices particularly important to the inflation outlook. These prices tend to reflect labour market dynamics, specifically wage growth – when the labour market is tight, as it is today, firms are forced to pay higher wages to attract and retain workers. These higher wages get passed along to the end consumer in the form of higher services prices. So even though supply chain disruptions are improving, and goods prices are starting to normalize, labour market tightness is likely to continue keeping inflation relatively elevated via higher services prices.

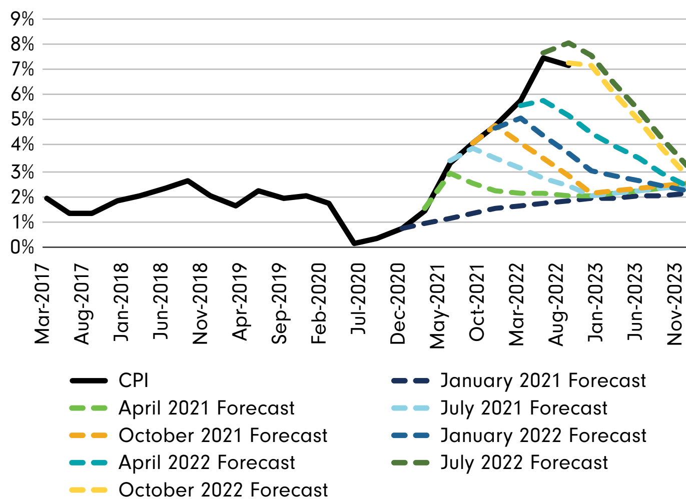
Eventually, we expect tight monetary policy to slow discretionary consumer spending, housing activity and business investment. This should lead to a loosening in the labour market, which would ease wage pressures and ultimately bring underlying inflation back under control. That said, monetary policy has 'long and variable lags', and so we expect inflation to remain stubbornly elevated for a while.

8. Why hasn't gold been the inflation hedge we'd expected?

While the price of gold has not kept pace with observed CPI inflation, its performance in 2022 has outpaced virtually every other asset class including other traditional inflation hedges (Exhibit 3). The outperformance is even more pronounced for a Canadian investor, as the price of gold benefited from the depreciation in the Canadian dollar this year. But what did act as a headwind to the price of gold is the rising real interest rate environment which raised the opportunity cost to holding a zero-yielding asset like gold.

EXHIBIT 2: Bank of Canada inflation forecast revisions

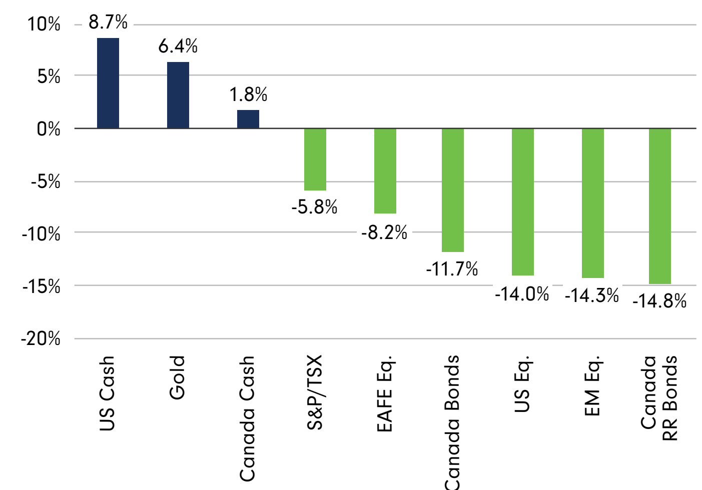
Consumer Price Index (YoY,%)



Source: Statistics Canada, Bank of Canada

EXHIBIT 3: 2022 Asset Class Performance

% Change in CAD



Source: Fidelity Investments, data as of December 31, 2022.

We maintain an allocation to gold in many of our funds both as a hedge against the risk that inflation will be more persistent than the market currently expects and that geopolitical tensions remain elevated.

9. Why are central banks tightening when inflation seems to be coming from supply problems?

We 100% agree with the premise here – central banks can't do anything about supply-side problems. Monetary policy is a demand-side tool. But they still need to use it. Controlling inflation means balancing supply and demand. If supply is constrained, policy needs to be tightened to constrain demand to match. If you don't do that, if you say 'well I can't do anything about supply so I'm going to keep stimulating the economy', you're not going to get any more 'stuff', you're just going to raise the price of that 'stuff'. Which is what's been happening. And if you don't address it, you're just going to get prices spiraling ever higher, which is going to be even worse for the economy.

10. How high will policy interest rates have to go?

Policy interest rates will need to increase to the point where central banks are confident that inflation is on course to sustainably return to target. What makes that a difficult exercise is that the time it takes for interest rates to impact inflation is effectively unknowable. So central banks will hike into restrictive territory and scrutinize economic activity data for signs of a slowing economy that should bring inflation down. Should activity remain resilient, or inflation remain persistent (which is our view – see Question 7), central banks will need to tighten further. And as we have heard from central bank officials, they view the risk of hiking too little as being greater than hiking too much. As we write, the market expects policy interest rates to peak near 4.5% in Canada and 5.0% in the US; the risk is that markets are still underestimating how high they will ultimately have to go.

11. Are we going into recession?

We think we are going into recession. The public narrative seems to be 'the central banks may make a policy mistake by causing a recession.' That narrative is misguided in our opinion. If you're a central bank with a big inflation problem, recession is a feature, not a bug. Monetary policy works to reduce inflation by introducing slack into the economy to reduce pressure on prices and wages. When you have an unsustainably high level of activity/employment, as you do now, you need to reduce it. That's regrettable but necessary. Otherwise, inflation becomes more entrenched and you have to cause even more unemployment down the road to restore price stability, as in the early 1990s when unemployment hit 12%.

Many have observed that it doesn't 'feel' like a recession right now. Here it's important to distinguish level and rate of change. Recession is a rate of change – the economy moving backwards and unemployment going up. We're starting from a very high level of activity and low level of unemployment. So, things have a lot of room to move backwards and still feel OK. Ironically, things generally feel worst when the recession ends – that's by definition the peak in unemployment and the trough in output.

12. What is your outlook for the Canadian housing market?

We think the Canadian housing market has further to weaken, particularly in Ontario and BC. The widespread 'housing shortage' narrative is wrong, in our opinion. The data is pretty clear on this. We're building plenty of housing units. What we lack is affordable housing. So where has the demand come from that's made it unaffordable? It couldn't have

been immigration – the biggest price gains were during the pandemic when nobody came (Exhibit 4). It has to have been investor demand. Some of that is foreign demand (which is a whole other topic). But much of it has been domestic investor demand, fueled by cheap money and expectations of ever-rising prices. Both of those are now gone. With that demand removed, we think (some) affordability will ultimately be restored, in the only way it really can be – by prices going down. They could go down a lot, but it will take some time.

13. What would you do to fix housing?

We think policymakers need to think more creatively about how to address the housing crisis in Canada. One thing that could be done is to use the property tax system as a tool to help reduce the 'excess demand' from foreign investors and speculators that's made housing less affordable for Canadians. For example, you could hugely increase property taxes BUT make them deductible against other taxes paid. So if you're a hard-working Canadian family already paying your fair share, you wouldn't pay any more, but if you're just sitting on property it would cost you a lot more. Beyond helping affordability, this is about fairness. The value of real estate comes primarily from the society it's in (how much do you think the average Toronto house would be worth if plopped down in Topeka?). We think that if you're benefitting from society through the value of real estate that you own, you should contribute something to that society, not free-ride on the back of highly taxed Canadians who may never be able to afford a house.

14. Where is the Canadian dollar going?

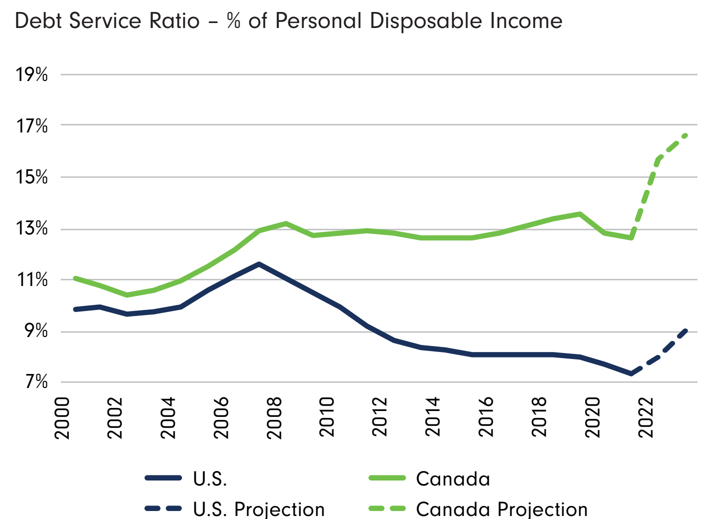
We think the Canadian dollar has further to fall. Canada's economy is more interest rate sensitive at this point relative to the US, given higher debt levels and greater reliance of the economy on housing (see Exhibit 5). So, rate increases are going to hit harder here. Ultimately that means the Bank of Canada probably won't be able to keep up with the Fed. So, you'll get a rising interest rate advantage for the US dollar, which we're already starting to see. We think that has further to go, as market participants come to recognize

EXHIBIT 4: Immigration and home prices have been negatively correlated

Source: Statistics Canada, Canadian Real Estate Association

EXHIBIT 5: Canada is more vulnerable than the U.S. to interest rate increases

Debt Service Ratio – % of Personal Disposable Income



Source: Bank for International Settlements, FMRCo

that their models have failed them again (the models aren't catching the consequences of Canada's higher interest rate sensitivity because it's never happened before). Obviously, there are a lot of other considerations that go into the currency's path, like oil prices and geopolitics (themselves linked). Those are particularly hard to call. But the economics are pretty clear, in our view.

15. Isn't energy a big positive for Canada's economy?

As we all know, Canada produces and exports a lot of energy. Energy is in short supply globally and prices are high. So that should be good for Canada's economy. But it's not likely to be as good as it has been historically. The reason is that much of the reason high energy prices spur economic growth is by stimulating new investment. But it's not feasible do big new oil & gas projects at this point, because of environmental and other reasons. So, we're not going to get that usual kick to growth. What high energy prices have done is improve Canadian cash flows, not only for the energy companies themselves but for the economy as a whole, including the government. We worry about what the fiscal situation will look like when it's not being flattered by these revenues. But overall, we think the boost to Canada from energy is being overestimated, while the hit from interest rates is being underestimated – leaving the economy likely to underperform expectations.

David Wolf, David Tulk and Ilan Kolet, January 4, 2023

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