11 Questions into 2025

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1. Who are the two new additional authors of this piece?

Bruno Crocco is Portfolio Manager and Jon Knowles is Institutional Portfolio Manager on Fidelity's ClearPath suite of Target Date funds. We welcome them as contributors to our Thought Leadership in Canada. The views expressed here reflect the broad views of the team and not necessarily the implementation in any given fund/pool, unless noted otherwise.

2. Why was 2024 such a good year in the funds?

In 2024, our multi asset funds generally produced their strongest returns in over a decade. The Fidelity Global Balanced Portfolio, our largest 60–40 mutual fund, returned 19% (net of series F fees).[1] Much of this owed to favourable markets. Global equities rose 28%, global bond returns were generally in the mid-single digits, and the depreciation of the Canadian dollar provided a further tailwind to returns on our foreign assets (the bulk of which we leave purposefully unhedged).

Across most funds, we were able to add further value above and beyond what the market offered us. Looking at the specific example of the Fidelity Global Balanced Portfolio, the fund outperformed its mixed asset benchmark by 289 bps on a gross basis in 2024. This reflects contributions from both elements of our active management approach. Active asset allocation – our research-based process of tilting in and out of asset classes, geographies, styles, etc. – added 95 bps, largely reflecting an overweight to equities and an underweight to the Canadian dollar. Security selection – the combined performance of our active equity and fixed income managers relative to their specific asset-class benchmarks – added 194 bps, largely reflecting strong contributions from our growth-oriented US equity managers.

We know that not every year will produce close to 20% absolute returns in a balanced fund. We also know that our active asset allocation and security selection processes will not both produce material outperformance in any given year. That is why we prefer to point to our longer-term track record, which includes both good years and bad. In that context, the Fidelity Global Balanced Portfolio has returned an annualized 7.6% over the past decade (net of Series F fees)[1]; Morningstar reports that this has beaten 92% of peers in the Global Neutral Balanced category in Canada, with cumulative outperformance of roughly 37 percentage points compared to the average fund in the category. We cannot guarantee that markets will continue to offer exceptional returns across asset classes, but we can guarantee that we will continue to apply our disciplined investment process seeking outperformance while managing risk in our multi asset class funds.

3. What is your view on equities?

We continue to have a constructive view of the stock market and remain overweight equities in our multi asset class funds. This result is consistent with mostly positive signals from the macro, bottom-up, valuation and sentiment pillars of our investment process.

Led by the United States, the macro outlook is relatively optimistic, marked by robust productivity-infused economic growth and resilient employment. Growth is more muted elsewhere, but as noted by our asset allocation researchers, recession probabilities remain low in most major economies (Canada is a notable exception). Central banks are no longer tightening monetary policy, and while interest rate cuts may not provide much support (see Question 5), fiscal spending is expected to provide an additional tailwind to growth. We do expect greater policy uncertainty in the aftermath of the US election, but this is likely to have a larger impact on regional economic and market performance, which is a theme we explore in Question 4.

The bottom-up intelligence from companies we gather from our equity and fixed income portfolio managers and analysts also paints a relatively upbeat picture. Measures of consumer demand, capital expenditures and hiring intentions are all consistent with the strength we observe in the top-down macro data. Moreover, corporate fundamentals also continue to hold up well with rising operating margins, healthy balance sheets and well-supported earnings.

Measures of equity market valuation do temper some of the optimism expressed thus far. Notably in the United States, price-to-earnings ratios look stretched relative to historical ranges, although this is almost exclusively due to elevated valuations among the largest companies; the median S&P 500 stock is not far above average valuations historically, as Exhibit 1 illustrates. While equity markets outside of the US look less expensive, a weaker economic outlook could justify this discount. Overall, we do not believe that current valuations are prohibitive across the markets in which we invest.

Finally, measures of market sentiment generally do not point to extremes in investor attitudes or positioning. This makes it less likely that reactions to unexpected events will drive outsized moves in the equity market. As a contrarian input to our investment process (cautious when the market is ebullient and optimistic when the market is pessimistic) the prevailing neutral setting of market sentiment offers little guidance.

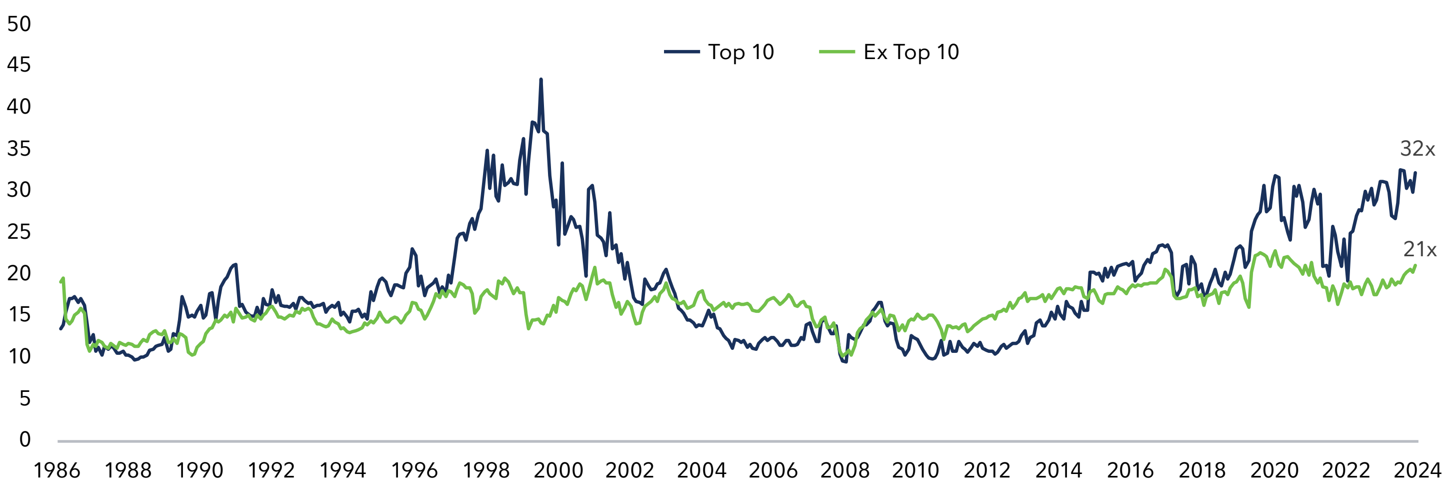
4. How are you allocating across different equity markets?

Our regional equity market allocation has evolved partly in anticipation of the policies expected to be introduced by the incoming US administration. The starting point for the US economy is already quite strong and the impulse towards more deregulation and additional fiscal stimulus further reinforces the theme of economic and equity market outperformance. As such, we have further increased our overweight to the US equity market. We have also broadened our exposure within the US somewhat to increase our exposure to small caps.

Outside of the US, the most significant impact of the incoming administration is expected to be on international trade. While we recognize the role that tariffs will likely have as a bargaining chip in wider negotiations, the marginal impact is expected to be towards greater protectionism and a further retrenchment in globalization. We expect countries in the EAFE region (Europe, Australasia and the Far East) to be adversely impacted, which compounds the long-standing challenges we see within their domestic economies. And while cheaper valuations relative to the US may price some of these challenges in, we nevertheless remain cautious and have significantly trimmed our overweight to the EAFE region.

EXHIBIT 1: Valuation across much of US market not extreme

Median price-to-earnings ratio, Top 10 U.S. equities vs. remaining equities in the S&P500



Source: Bloomberg. As of November 30, 2024.

Emerging markets, notably China, are also at risk of higher tariffs and further disruptions to international trade. But the challenges to these regions already look to be well-discounted, with much cheaper valuations and much more negative investor sentiment than in the EAFE region. Furthermore, we see the scope for more stimulative policy to improve upon very low expectations for the economic outlook. We also continue to use the combination of active equity managers with a short futures contract on the wider EM equity index to allow for greater security selection while limiting the exposure of the top-level fund to the region.

Our fundamental view of Canada has not changed – lacking a productivity tailwind, the domestic economy will continue to struggle as households curtail spending to instead focus on debt repayment. And while the Bank of Canada is likely to continue to cut its policy rate, we have less confidence that longer-dated yields – notably the 5-year maturity that underpins most fixed-rate mortgages – will fall in lockstep (see Question 5). This will force households to continue to repair their balance sheets and put more pressure on other parts of the economy to sustain growth. The pressure is even more acute if immigration – which has done a lot of heavy lifting in recent years – is curtailed (see Question 9). One natural candidate to fill the hole in growth is exports, and while we are mindful of US tariffs, we believe that Canada may end up better off than other countries facing even greater tariff pressure.

Global investors may also see Canada as a relatively safe destination among non-US equity markets to avoid the negative economic impact of broad-based US tariffs. These flows could prove to be sizable compared to the small Canadian market and push stock prices higher despite a challenging fundamental outlook. In appreciating this risk, we have further trimmed our underweight to Canadian equities but continue to hold a considerable underweight to the Canadian dollar (CAD) as the widening interest rate differential to the US is likely to be the dominant influence over the currency.

Finally, we recognize that market conditions can and will change. 2025 presents some unusual risks, not least related to US policy under the new administration. As always, we will adjust our active fund positioning in accordance with the evolving outlook as the year unfolds, in line with the discipline of our four pillar process above.

5. Where are interest rates going?

We don't consider this a 'falling interest rate environment' in the United States. Yes, the Fed is cutting. But we don't expect it to get very far, for three primary reasons. First, the neutral short-term interest rate (so-called r-star[2]) has almost certainly risen in recent years, primarily reflecting booming investment against a dearth of national savings. Second, monetary policy should probably remain somewhat on the tight side of that neutral rate, with inflation remaining above target and the economy near full employment. Third, risks to inflation from the incoming administration's policies suggest that the Fed should tread carefully. All of this leaves little room for the Fed to cut from the current 4.25–4.5% overnight rate.

The risk to longer-term bond yields in the US looks to be to the upside. The key here is the term premium, which is the compensation bond investors require to lend money further out the curve. The term premium actually went negative through the past decade (see Exhibit 2), probably reflecting aggressive central bank intervention in the bond market and the effective elimination of inflation volatility. Both factors have unwound in recent years. The restoration of a term premium, coupled with the limited scope for Fed easing discussed above, suggests upward pressure on bond yields and a steeper yield curve. In that context, we are underweight fixed income duration in our multi asset class funds, avoiding long bonds and leaning towards shorter maturities and selected credit exposures.

The situation in Canada is different. The factors pushing the neutral rate higher in the US don't look to apply in Canada; the Bank of Canada's central estimate for r-star is 2.75%, which seems reasonable to us. Also unlike in the US, monetary policy in Canada should probably be on the easier side of the neutral rate, with inflation near target and the economy well short of full employment. Additionally, the incoming US administration's policies (particularly tariffs) may be disinflationary for Canada given the prospective hit to demand. All of this leaves considerable scope for the Bank of Canada to cut further from the current 3.25% overnight rate. The BoC may have even further to go if a term premium is restored in Canada as well, limiting the impact of monetary easing on Canadian 5-year bond yields and thus the prospective relief for borrowers through the wave of mortgage renewals ahead.

Putting all of this together, we will not be surprised to see the Canada-US interest rate differential move to its widest level in a generation, beyond -200 bps. By stark contrast, current market pricing expects virtually no widening from the current level near -125 bps. This is a primary driver behind our view of expecting a further depreciation in the Canadian dollar.

EXHIBIT 2: Upside risk to long-term bond yields in the US

10 Year ACM Term Premium, %

Source: Bloomberg, Federal Reserve Bank of New York. As of November 30, 2024

6. How will the more positive correlation between stocks and bonds affect bond yields?

The correlation between stocks and bonds has shifted from negative to positive in recent years (see Exhibit 3). This owes, in our view, to the return of inflation volatility and uncertainty after years of quiescence. A positive stocks-bonds correlation diminishes the attractiveness of fixed income as a diversifier to equities, meaning that bond investors should demand higher yields in compensation. This is a primary source of the 'term premium' which we expect to be restored ahead (see Question 5), with long-term bond yields thus likely to remain elevated even after short-term interest rates return to more neutral levels.

To explain, we observe that growth and inflation are the primary macro drivers of asset class returns. Higher growth surprises are positive for stocks since they tend to increase earnings growth expectations but are negative for bonds because higher growth usually leads to higher yields which translate into lower prices. Higher inflation surprises are negative for both stocks and bonds because they usually imply tighter monetary policy which increases real interest rates and causes the discount rate of both stocks and bonds to rise (and their prices to fall).

When inflation is stable and near-target, investors worry more about growth uncertainty, and in this environment stocks and bonds tend to move in opposite directions; this is the regime we experienced through the 2000s and 2010s. When inflation is uncertain and moves away from target, investors tend to worry more about inflation than growth, causing stocks and bonds to move in the same direction; this is the regime that persisted through much of the 1970s, 1980s and 1990s, and one we have returned to again since the pandemic. With inflation uncertainty likely to persist, we expect the more positive stocks-bonds correlation regime to persist as well.

It is difficult to quantify the impact of this correlation shift on the term premium and thus longer-term bond

EXHIBIT 3: Positive correlation here to stay

Correlation between S&P 500 and U.S. Treasury Bond Index

Source: Bloomberg, rolling 40-month correlation of S&P500 and Bloomberg U.S. Treasury Index. As of October 31, 2024.

yields, but it is likely on the order of 100–200 bps, assuming recent correlations persist and investors seek the same return-for-risk tradeoff in their portfolios as previously. If this is correct, long bond prices could face a meaningful drawdown. We continue to largely avoid them in our portfolios.

7. What are the implications of political uncertainty in Canada?

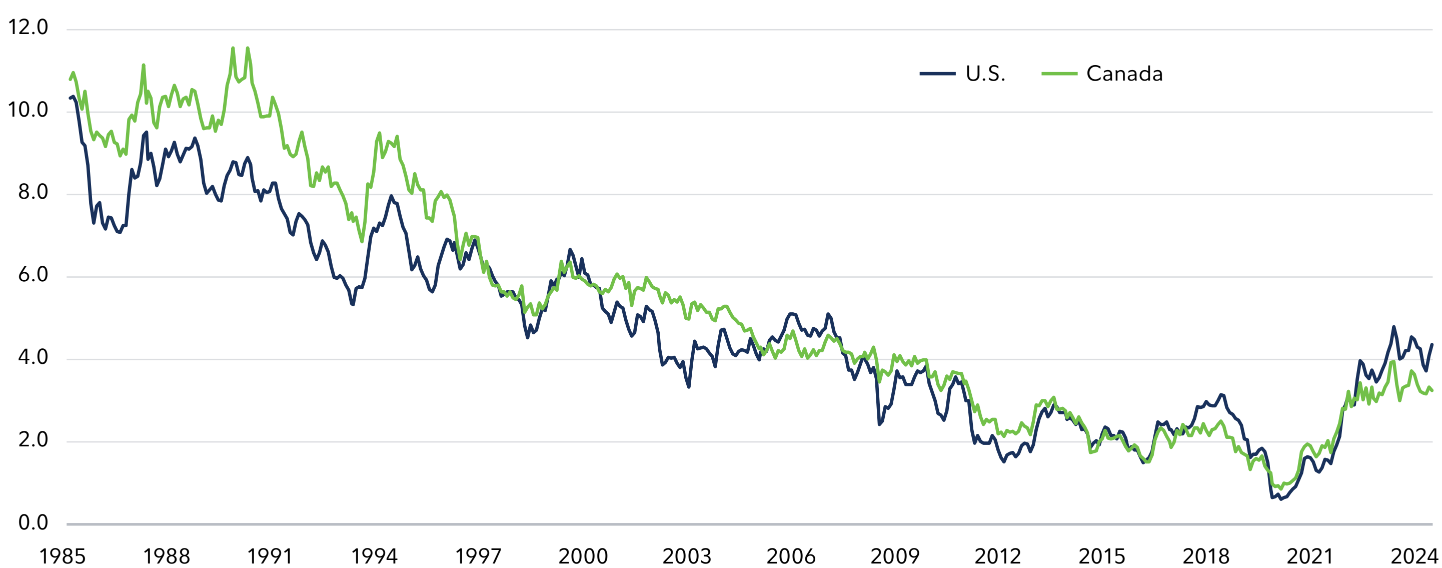
Political uncertainty in Canada is heating up as we write. That uncertainty probably isn't going anywhere anytime soon; we know there will be a federal election in 2025, but we don't know when or even who the players will be. Polling in recent months has clearly pointed to a large Conservative victory, but even if that is the destination, both the path to get there and the policy consequences of that outcome is unclear. All of this is unfolding with Canada in the most awkward position in memory vis-a-vis the United States.

In this context, the risk is that markets will increasingly demand a risk premium to hold Canadian assets. This is often seen in emerging markets, but we've seen it before in developed markets. For example, Italy has often traded at a discount to Germany, and Canada itself experienced this in the 80s and early 90s (see Exhibit 4). This risk premium is generally associated with fiscal sustainability and thus creditworthiness, which has to do not only with the current path of government finances but also the broader political and economic environment in which it is embedded. It is only when markets saw that the Paul Martin fiscal consolidation in the mid-90s would succeed that Canada's country risk premium was eliminated in 1996.

What happens if a country risk premium is reintroduced in Canada? It means Canadian assets will trade at a discount. That means a lower Canadian dollar and lower Canadian bond prices (ie higher long-term yields). The impact on shorter-term interest rates is less clear

EXHIBIT 4: Will a risk premium return in Canada

Yield on the 10-Year Government Bond, %



Source: Federal Reserve Board, Bank of Canada. As of November 30, 2024.

and depends on whether the Bank of Canada would abandon stimulus to protect the currency, as it did (disastrously) in 1998. We suspect it would take a lot for the Bank of Canada to do that again.

It is unclear whether any of this will happen. But we can't rule it out, and it is a factor contributing to our fund positioning in preferring investment opportunities outside of Canada.

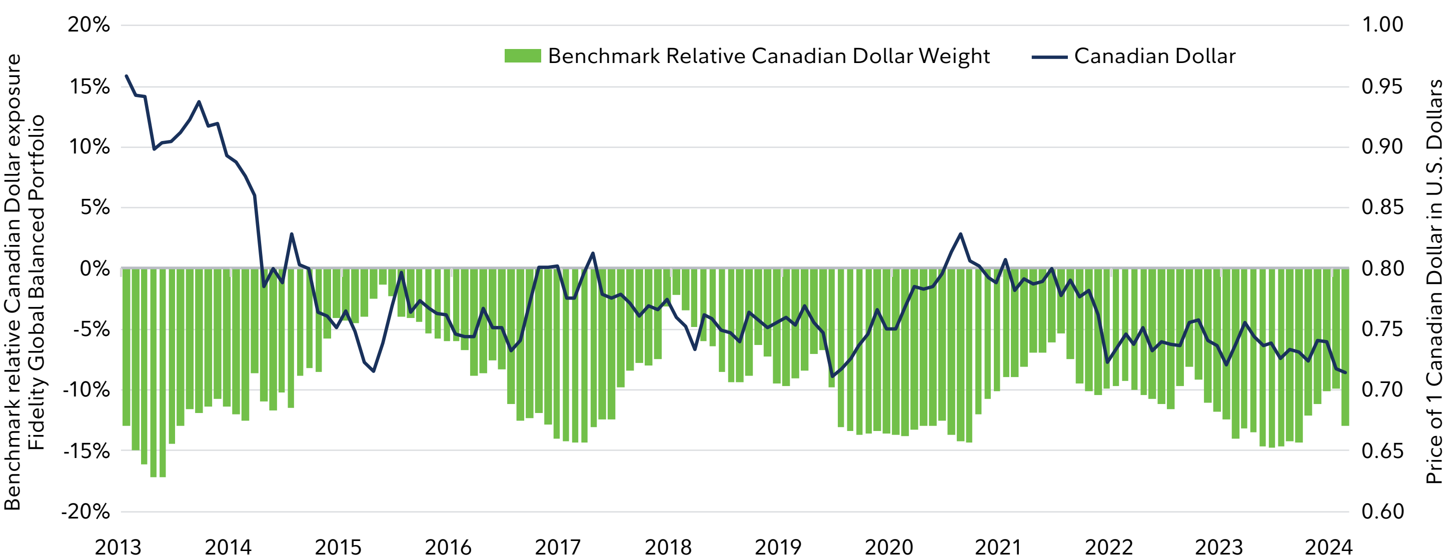
8. What would make you want to be overweight Canada?

We have generally been underweight Canada in our multi asset class funds for over a decade. We think this has made sense from two perspectives. From a structural point of view, being underweight Canada relative to our strategic asset mix does two things for us – it allows us to sell a cyclical currency (CAD) and thus mitigate overall volatility in the funds, and it allows us to diversify more extensively from the small, narrow domestic equity market. From a tactical point of view, the Canada underweight respects the longstanding challenges to the domestic economy related to its persistent overreliance on debt-fueled consumer spending and housing investment.

Our underweight to Canadian assets has added materially to performance in the funds – since late 2013, when we introduced active allocation in our funds and established that Canada underweight, the Canadian dollar has fallen from near-parity to around 70 cents US, and the total return in the TSX has underperformed that of the S&P 500 by a cumulative 155 percentage points (!).

We are not Canada permabears. In fact, we look forward to a time when we can close our underweight to Canadian assets, as we did (briefly) in 2016 when the currency dropped below 70 cents US (see Exhibit 5). The critical criterion for us, as in every asset allocation decision, is the potential for an asset class to contribute to fund performance. No matter how daunting the outlook for an asset class, there is always a price at which it can make sense from an investment point

EXHIBIT 5: Less CAD, ain't all bad



Source: Fidelity Investments, Bloomberg. As of November 30, 2024.

of view. It's never easy to be precise about what that price is, but at this point we believe it's well south of current valuations, particularly for Canadian stocks and the currency. Unless and until those levels are reached and higher expected returns restored, we expect to retain our underweight to Canadian assets.

9. What are the consequences of a sharp slowing in immigration to Canada?

Canada's population has grown by nearly three million people over the past four years. This increase, driven largely by a surge in non-permanent residents, has had significant consequences on the Canadian economy. This issue, which we termed 'demographic volatility', was covered in detail in our Q3 paper from last year.

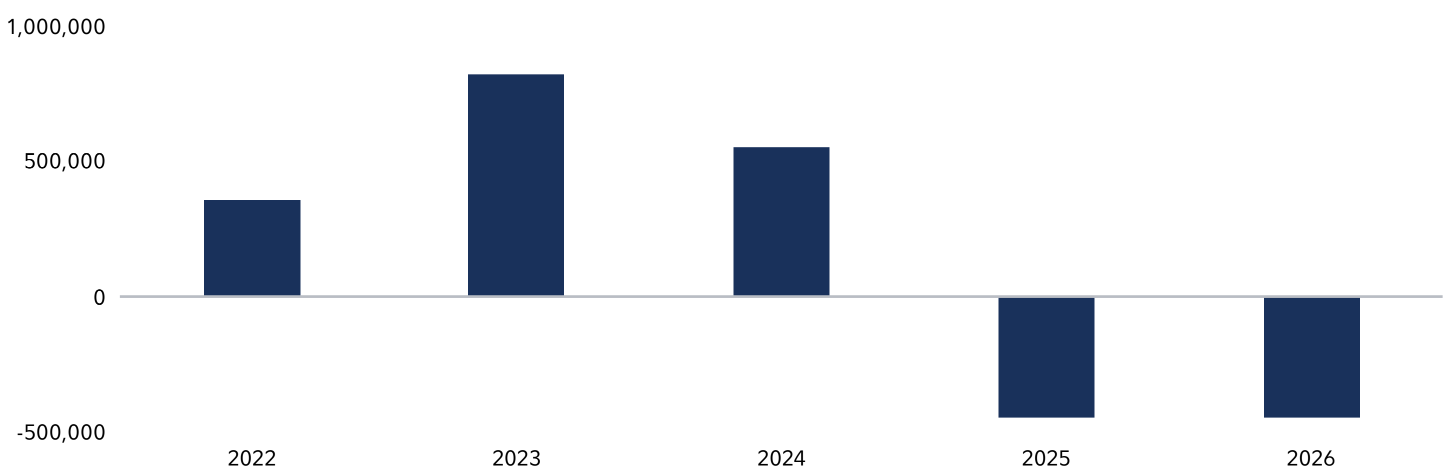
That surge in population now looks set to unwind somewhat, as the federal government has introduced targets aimed at reducing the number of temporary residents in Canada (see Exhibit 6). The most obvious outcome in our view would be a significant slowing in the Canadian housing market. The runup in housing construction, particularly at the entry-level, over the past few years was based on certain demand assumptions. Those demand assumptions are based primarily on the number of people looking for a home. If this demand were to evaporate, the large pipeline of new homes coming to market in the next two years could push home prices lower.

Inflation, particularly through the wage channel, is another likely effect of a sudden decline in population or population growth. With fewer immigrants, it is possible that we see (again) shortages in certain sectors in the Canadian economy, particularly those sectors that rely heavily on immigrant labour. If shortages arise, wages are likely to push higher, which would push service inflation and overall inflation rates higher as well.

This demographic volatility is linked to both growth and inflation surprises which makes policymaking more difficult and increases the risk of an error. It is also an important factor in explaining our ongoing concern about the Canadian economy and our underweight to Canadian assets.

EXHIBIT 6: Demographic volatility to continue

Annual change in temporary resident population of Canada[3]



Source: Bloomberg, Statistics Canada, Official Government Targets. As of October 31, 2024.

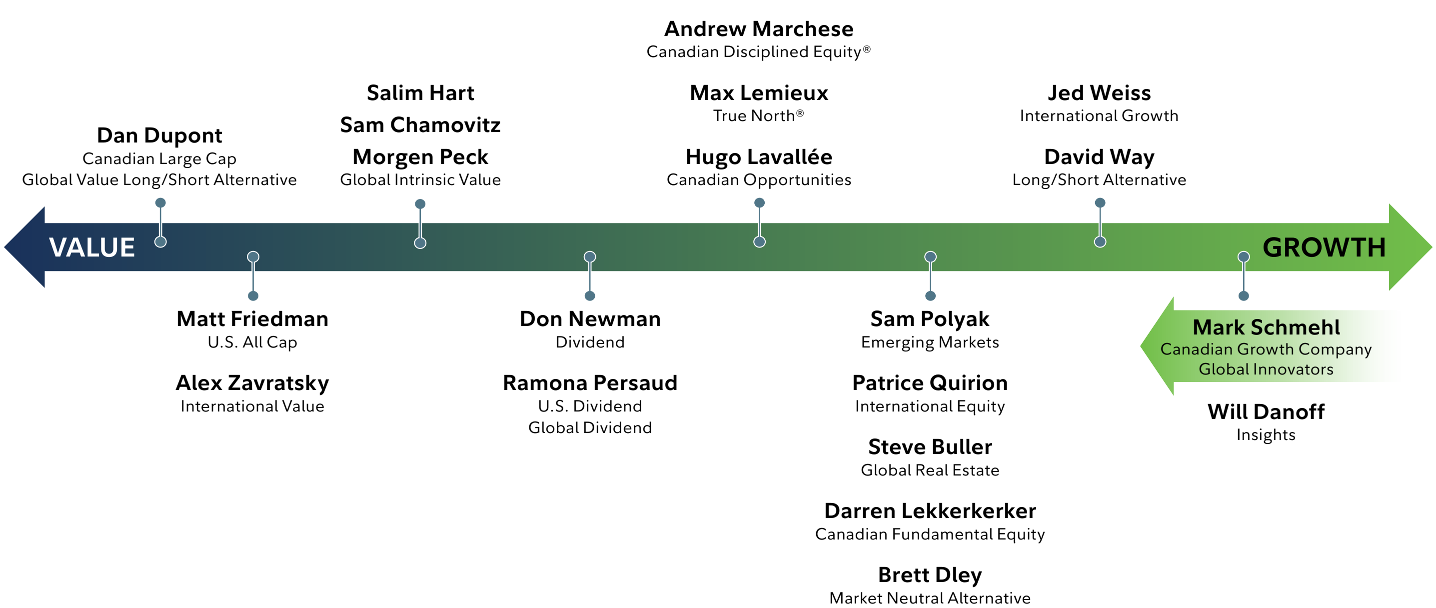
10. How do you decide to incorporate or remove a manager from your funds?

One of our key advantages as asset allocators is having access to a broad array of asset class vehicles (see Exhibit 7). Over the years, our capabilities have expanded as new products have been introduced to the Canadian market. When considering a new capability, we examine the manager and their process (in conjunction with our internal manager research team) and evaluate the behaviour of the strategy both on its own and in the context of all of the other capabilities we have in the funds (the more track record we have that way, the better). If the fit is right, meaning we can be confident that the new capability will enhance returns and/or mitigate risk for the fund as a whole, we calibrate the appropriate allocation and proceed. Examples of capabilities we've introduced into our multi asset class funds over the past year include the Brookfield private real estate capability, three liquid alternatives and an International Value equity sleeve.

We do also occasionally remove managers from our funds. This generally isn't due to performance – we recognize that even a great manager will have periods of underperformance, if for example their style is out of favour. So long as we retain confidence in their process, we are inclined to be patient (although not indefinitely). But that requires that the manager 'stay in their lane.' Our multi asset funds are carefully constructed to provide a diversified set of exposures across asset classes, and we require that a manager adhere to their role in providing exposure to a given asset class (we're looking for their beta as much as their alpha, so to speak). If a manager that we rely on, say, for EAFE value starts buying US growth, we may remove the capability in favour of one that more faithfully provides exposure to the asset class we seek. The goal

EXHIBIT 7: Fidelity Managed Portfolios utilize a range of investment styles

Style positioning as of November 30, 2024



For illustrative purposes only. Arrow indicates that Mark Schmehl invests across the style spectrum.

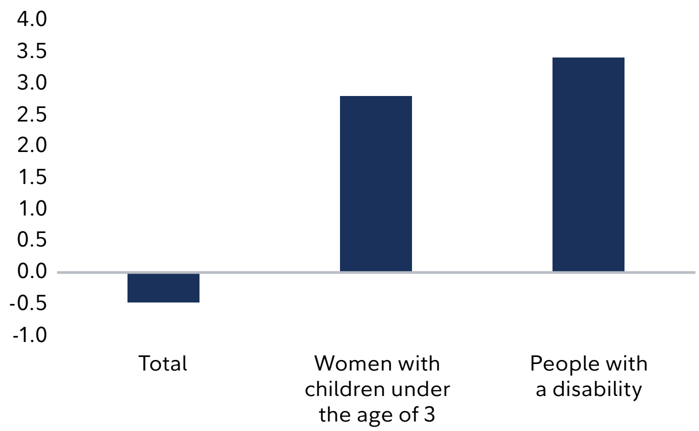
in this is to preserve the diversification we need to drive returns in a risk-controlled manner.

11. Some good news please?

Working arrangements – where, when and how we work – have tended to become more flexible in recent years. The pandemic blew up the antiquated nine-to-five, Monday-to-Friday, in-the-office paradigm that was unnecessarily rigid for a lot of today's jobs. For many people, this has been a 'nice to have', allowing us to arrange our lives better (e.g. more time with family). But for some, this flexibility has been a 'have to have' in order to participate in the labour force at all, such as those who can't spend a full day at a work site. Two groups for whom this may be particularly relevant are people with disabilities and women with small children. As Exhibit 8 shows, for those two cohorts in the United States, the labour force participation rate – the percentage of working age people who are available to work – has soared since the pandemic. A similar dynamic has been observed in Canada. That translates into millions more Americans and hundreds of thousands more Canadians who are now able to work, which is meaningful not only to them but also to overall growth in the economy. Amid the economic challenges we face, we think that's some unambiguously good news.

EXHIBIT 8: A larger and more inclusive labour force

Change in US Labour Force Participation Rates, 2019–2023 in percentage points



Source: Bureau of Labor Statistics

David Wolf, David Tulk, Ilan Kolet, Bruno Crocco and Jon Knowles

January 10, 2025

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Standard period returns (%)

	1-year	3-year	5-year	10-year
Fidelity Global Balanced Portfolio	19.1	6.5	8.0	7.6
Blended Benchmark*	17.5	5.9	7.5	7.4
Peers Beaten (%)	96%	96%	92%	92%
MSCI ACWI ex-Canada	28.3	10.1	12.4	11.7
S&P/TSX Capped Composite Index	21.7	8.6	11.1	8.7
Bloomberg Global Aggregate Bond Index	7.2	-0.3	0.1	2.3
FTSE Canada Universe Bond Index	4.2	-0.6	0.8	2.0
FTSE Canada 91-Day T-Bill Index	4.9	3.8	2.5	1.7

Source: Fidelity Investments Canada. As of December 31, 2024. Data shown for Series F, net of fees, and in Canadian dollars. Periods greater than one year have been annualized. Past performance is no guarantee of future performance. *The blended benchmark for Fidelity Global Balanced Portfolio consists of 21% S&P/TSX Capped Composite Index, 39% MSCI All Country World ex Canada Index, 23% Bloomberg Global Aggregate Bond Index, 12% FTSE Canada Universe Bond Index and 5% FTSE Canada 91-Day T-Bill Index. Morningstar Global Neutral Balanced Category: one-year (1,677 funds); three-year (1,508 funds); five-year (1,297 funds); and ten-year (768 funds). The index returns are shown for comparative purposes only. Indexes are unmanaged, and their returns do not include any sales charges or fees, as such costs would lower performance. It is not possible to invest directly in an index.

Authors

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David Wolf is a Portfolio Manager for Fidelity Investments. He is the co–manager of Fidelity Managed Portfolios, Fidelity Global Equity+ Fund, Fidelity Global Equity + Balanced Fund, Fidelity Canadian Asset Allocation Fund, Fidelity Canadian Balanced Fund, Fidelity Monthly Income Fund, Fidelity U.S. Monthly Income Fund, Fidelity Global Monthly Income Fund, Fidelity Global Dividend Fund, Fidelity Income Allocation Fund, Fidelity American Balanced Fund, Fidelity Conservative Income Fund, Fidelity NorthStar®, Fidelity NorthStar® Balanced Fund, Fidelity CanAm Opportunities Class, Fidelity Inflation-Focused Fund, Fidelity Canadian Monthly High Income ETF Fund, Fidelity Global Monthly High Income ETF Fund and Fidelity Tactical Global Dividend ETF Fund. He is also portfolio co-manager of Fidelity Conservative Income Private Pool, Fidelity Asset Allocation Private Pool, Fidelity Balanced Private Pool, Fidelity Balanced Income Private Pool, Fidelity U.S. Growth and Income Private Pool, Fidelity Global Asset Allocation Private Pool and Fidelity Global Asset Allocation Currency Neutral Private Pool.

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Endnotes

[1] See Standard period performance data chart on page 11.

[2] R-star is the short-term interest rate that would prevail when the economy is at full employment and stable inflation: the rate at which monetary policy is neither contractionary nor expansionary.

[3] 2024 reflects an estimate based on data through 2024Q3, 2025–2026 reflects Government targets.

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