

# Three Pillars Holding as Macro Crumbles

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## Key Takeaways

- We are positioned defensively as the macro outlook goes from bad to worse...
- But still-strong corporate fundamentals, less-demanding valuations and negative investor sentiment all provide some offsetting support
- We continue to overweight the US dollar, inflation-sensitive assets and short-term securities

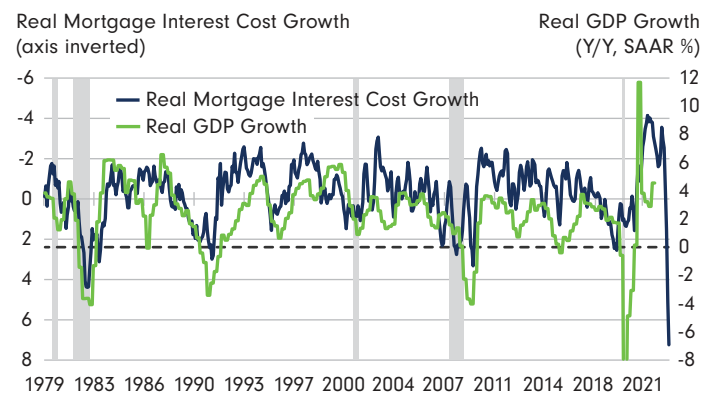
2022 continues to be a tough year for financial markets. Both stocks and bonds have fallen sharply, as central banks aggressively tighten policy aggressively to bring inflation under control. This is a daunting macro environment, and one that's likely to get worse, to an extent that markets are still not fully appreciating. In this context, we acted to reduce our equity exposure during this summer's bear-market rally and are now underweight risk. However, we are not underweight to the limits of our tactical allocation bands. That is because, as challenging as the economic outlook is, macro is just one of the four pillars we use to form our active allocation views. The remaining three pillars in our process – bottom-up, valuation, and sentiment – paint a comparatively less dour picture. To better understand our moderately defensive positioning, it is helpful to review the four pillars and identify the milestones ahead that would motivate a further shift.

## Woe is Macro

The primary motivation for our defensive positioning is the maturation of the business cycle as policy interest rates move into increasingly restrictive territory. Central banks are struggling to contain the rapid increase in inflation caused in part by excessively stimulative policy left in place from the COVID-19 pandemic. While we and the market expect headline inflation to moderate in the months ahead, we are less sanguine that core inflation will follow suit. Fearful that expectations of future inflation become unanchored, central banks will be inclined to keep policy tight to ensure inflation returns to target.

This inflation fight is very likely to cause a recession in many economies (Exhibit 1 shows what this could look like in Canada). What is less certain is the depth and

### EXHIBIT 1: Ominous



Real mortgage interest cost growth is the three month growth rate of mortgage interest cost deflated by total inflation, lagged nine months. Source: Statistics Canada, FMR calculations

duration of the downturn. In our view, the market has yet to fully discount the persistence of inflation and the resolve of central banks in dealing with it, which means a weaker economy than is currently priced. This view is the primary motivation for our defensive positioning, including a moderate underweight to equities, a modest underweight to duration, a continued out-of-benchmark allocation to inflation-sensitive assets, and a sizable overweight to the US dollar (USD).

While these themes are common across economies, differences in the details offer opportunities for regional asset allocation tilts. Canada's economy is likely to underperform, reflecting its heightened interest-rate sensitivity, in turn reflecting historically unprecedented levels of household debt and housing activity. Europe is challenged by ongoing geopolitical and energy strains, in addition to tighter policy. By contrast, the United States looks much better positioned to weather higher interest rates, and emerging market economies such as China are turning to policy stimulus. The regional equity market tilts that flow from this macro assessment include a sizable underweight

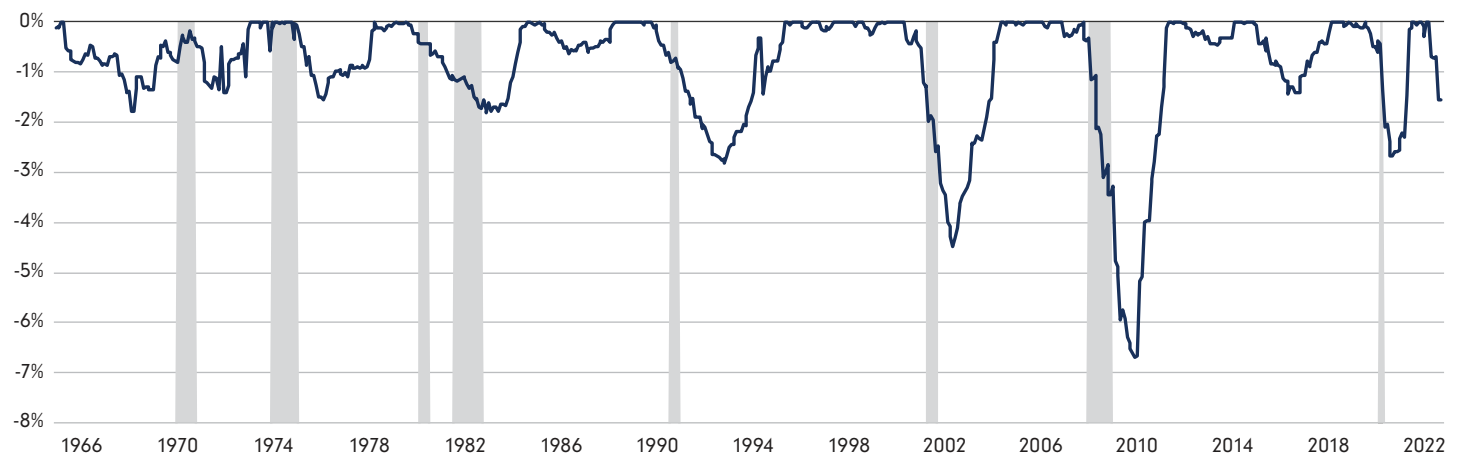
to Canada and the EAFE region against more neutral positions in the United States and emerging markets.

### Bottom-Up Brighter than the Top-Down

An unparalleled source of information for us is the access that our building block portfolio managers and analysts have to companies. Their 'on the ground' insights are critical in confirming or challenging the macro data. The general message at this point is that companies are not yet seeing significant economic strains in their businesses, significantly owing to the success they've had in passing on price increases, thereby helping to preserve margins (Exhibit 2). Hiring intentions have been pared back in some cases, but demand for labour remains elevated and wage pressures are continuing to grow. Firms also took full advantage of very low interest rates in recent years to term out their debt, reducing the risk of a sharp increase in borrowing costs now that interest rates have risen. Moreover, the well-telegraphed tightening by central banks have allowed firms to develop contingency plans to respond to the inevitable slowing in economic growth.

#### EXHIBIT 2: Bottom-Up Not as Dismal as the Top-Down

US Equity Profit Margins, Decline from 3-year Peak



Source: Haver Analytics

We expect corporate fundamentals will soften as the wider economy cools. However, a relatively healthy starting point and the absence of the kind of imbalances that have marked the later stages of prior economic cycles does warrant some tempered optimism that the worst-case outcome consistent with a larger equity market underweight can be avoided.

### Valuation Looking Less Stretched

The richness that defined almost every asset class during the reopening phase of the recovery from the COVID-19 pandemic has faded as markets have retrenched in a simultaneous fashion. While not a timing tool, valuation metrics provide a measure of vulnerability in the face of a macro or market catalyst. Now that equity markets are closer to historically fair valuations and have priced in a softer outlook, there is less of a valuation-based case to take a larger underweight position (Exhibit 3).

In the bond market, the move higher in interest rates has clearly restored some value. It's not clear how much, however, given our expectation for continued central bank tightening and the risk of a higher secular environment

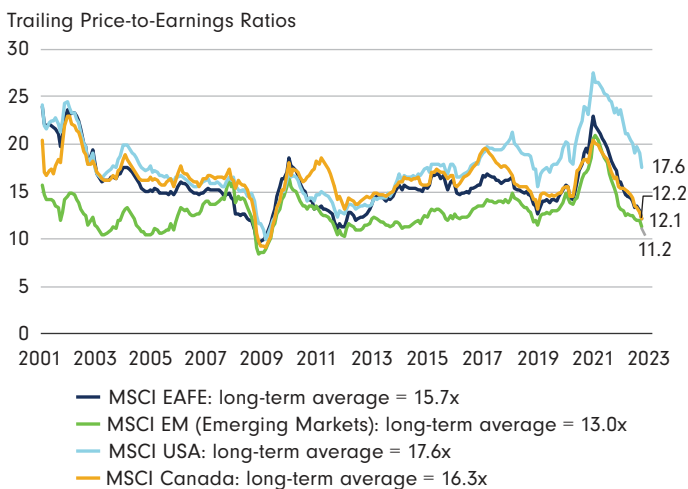
for inflation. As a result, we continue to hold a modest underweight to duration as the expected end of the tightening cycle remains too far over the horizon.

In currency markets, the USD looks rich on a historical basis following its significant appreciation in recent months. It can get richer still, however, owing both to the relatively resilient US economy (prompting the Fed to go where other central banks cannot follow) and the currency's safe-haven status in times of stress. We continue to hold a material overweight to the USD, against both the Canadian dollar and other major currencies.

### Sentiment Simply Stinks

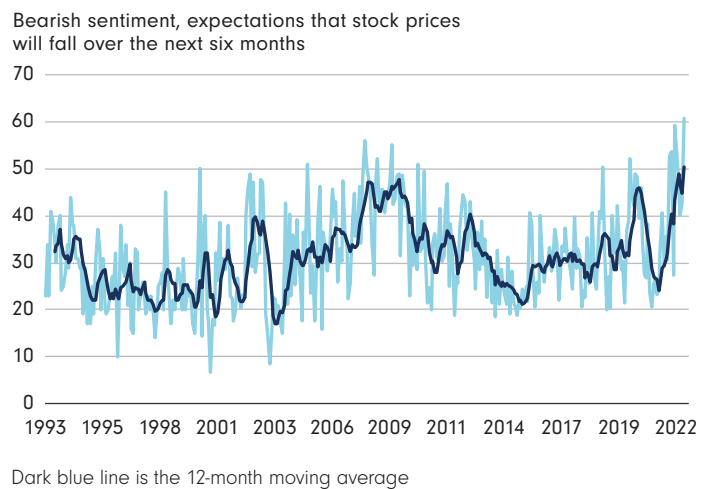
Investor sentiment is an important contrarian input to our process. Sentiment today across a wide range of asset classes is exceptionally poor (Exhibit 4). Investor surveys show extreme levels of bearishness while flows show a clear preference for safe-haven assets. These sorts of extremes in sentiment often produce (sometimes abrupt) reversals. Such reversals are often of the temporary 'bear market rally' variety, though sentiment extremes can also mark

**EXHIBIT 3: Equities Have Cheaped**



Source: FactSet, FMR. Data as of September 2022

**EXHIBIT 4: Sentiment has Become Very Negative**



Dark blue line is the 12-month moving average

Source: Bloomberg, American Association of Individual Investors  
Data as of September 2022

fundamental market turning points, which we must allow for the possibility of given the damage that the macro environment has already inflicted on both stocks and bonds. The fact that investors are already quite bearish is a factor limiting the size of our own underweight at this point. As in July, if a rebound in sentiment takes markets with it absent a fundamental improvement in the outlook, we expect to take the opportunity to reduce risk further.

### Where We Go from Here

The evolution in the four pillars of our framework will continue to inform our asset allocation positioning. The macro pillar is the primary motivation for our defensive positioning at this point, given the view that central banks will have to inflict more damage on the economy to restore inflation to target. Should we see a deterioration in the other pillars of our process – a weakening in corporate fundamentals that is not reflected in earnings forecasts, an unfounded rebound in sentiment and/or a corresponding richening in risky assets – we will reduce risk further.

At the other end of the spectrum, a faster than expected retreat of inflation would likely motivate less defensive

positioning. Should the increase inflation prove to have been ‘transitory’ all along, central banks would finally be able to indulge the long hoped-for ‘pivot’ towards easier policy, reducing both economic pressure and market angst. We judge this sort of ‘immaculate’ decline in inflation to be unlikely but certainly not impossible. Valuation is another potential catalyst for us to increase our risk posture. Outside of the US, equity valuations are starting to look cheap; we think they are cheap for good reason, but are arguably at levels that are long-term buys even given a daunting short-term outlook.

As we navigate the economic and market aftermath of the COVID-19 pandemic and face the inevitable and unknowable shocks to come, our active allocation views will always balance the information provided by the four pillars that underpin our investment process. Remaining disciplined in the face of uncertainty is fundamental to our objective of maximizing return while managing risk for our Canadian investors.

**David Wolf, David Tulk and Ilan Kolet, November 3, 2022**



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