Further along

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Key Takeaways

- The key question of 2022 is how comfortable central banks will be with persistently higher inflation.
- The answer will come from the evolution of inflation itself, inflation expectations, and the labour market.
- We remain overweight to equities and credit, but have reduced our risk posture somewhat. We are also prepared to become more defensive should central banks become more anxious about inflation.

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2022 dawned with... the resurgence of COVID clouding the outlook. The stock market and the economy are likely to turn out fine, though not without bumps along the way. And indeed, as the cycle matures, the bumps are likely to get bigger and more frequent.

Relative to a year earlier, 2022 began with much higher inflation and concerns about the monetary policy reaction to it. That has been the proximate cause of the market's volatility to begin the year. A tightening cycle is indeed forthcoming, likely beginning in March. But at this point, at least in the United States, it looks to be the kind of 'cautious normalization' that markets and the economy should be able to absorb. That should allow for some continued runway for risk assets; we have reduced our overweight to equities but not eliminated it. As inflation persists, however, at some point the Fed approach will likely have to move to 'purposeful tightening.' That would pose a more profound threat to stocks and the economy, and we are focused on anticipating when this transition is likely to occur.

Where Things Stand Today

The pandemic has not disappeared, but the global economy is better learning to live with it, allowing stimulative policy and strong fundamentals to extend the recovery. Consumer spending is expected to continue to benefit from the steady release of pent-up demand (especially for services) which in turn is supported by rising employment and incomes, elevated levels of household savings and positive wealth effects from higher housing and financial asset prices. Consumer strength underpins solid corporate fundamentals, elevating earnings and inspiring greater investment and hiring. And governments around the world have been given little reason to restrain their spending. Aggregate demand looks durably strong.

As we discussed in our last Thought Leadership piece, the constraint on overall economic growth is not demand but supply, which will only be ameliorated over time. Companies are reporting that supply chain issues are beginning to improve but that it will likely take a long time to get back to normal, particularly given that the new normal will include higher levels of inventory to guard against potential future disruptions. Companies are also reporting significant staffing issues as labour supply has been slow to come back, perhaps reflecting a more structural pandemic-inspired change in attitudes towards work. Both product and labour market tightness mean that the eventual improvement in the availability of supply will come only at higher cost.

Strong demand and limited supply mean higher prices. That has been the essential story of the past year and doesn't look like changing anytime soon. So, while some volatility in measured inflation can be expected, particularly as the price bursts early in the recovery drop out of the 12-month calculation, underlying inflation is expected to remain persistently higher than what prevailed prior to the pandemic.

The Big Question

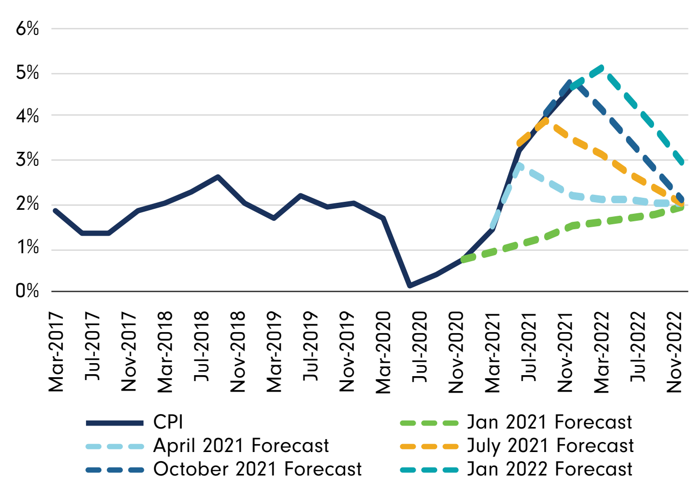
The degree of comfort that central banks feel with persistently higher inflation is the key question of 2022. Continued accommodation would further buoy financial markets and the economy but stoke even greater inflationary pressure, while a sharp tightening would rapidly reverberate through financial markets and potentially risk the wider recovery. As we write, markets are concerned about the latter, fretting that the Fed is about to kill the cycle. Understandably but prematurely, we think.

Market volatility at the outset of a rate hiking cycle is common. It is particularly understandable in this case, given how important zero interest rates and ample liquidity have been to the surge in financial asset prices in recent years. But the beginning of a tightening cycle rarely marks an end to a bull market. In 10 of the last 11 cycles since the 1940s, the US equity market has made fresh highs in the months following the first rate hike. That is generally because, while the change in the direction of policy is scary, the stance of policy is only transitioning from 'loose' to 'less loose'. The real concern is when it gets 'tight'. At this point, the Fed is not signaling it will get 'tight' and fixed income markets are not discounting it. Interest rate forward curves currently anticipate that the Fed will stop at around 2% while the inflation rate is closer to 3%;* that's a negative 'real' Fed funds rate that is well below neutral. As a result, the recent market volatility is better explained by changes in sentiment and the revaluation of asset classes based on a somewhat higher discount rate, both of which have hit previously high-flying growth stocks with long-duration cash flows disproportionately hard.

The Fed does not want to get 'tight' and put the economy and financial markets at risk. But eventually it may feel it has no choice. We are looking at three primary areas to judge the likelihood that the Fed and other central banks will be motivated to tighten more aggressively.

The first is **inflation** itself. The Fed and the Bank of Canada keep expecting inflation to fall; it keeps not doing so (see Exhibit 1). Their forecasts remain sanguine, expecting inflation to fall back near their 2% targets by mid-2023. But

EXHIBIT 1: Bank of Canada inflation forecast revisions



Source: Statistics Canada, Bank of Canada

* Source: Bloomberg

the longer inflation remains stubbornly persistent, particularly if there is evidence of a broadening of price pressures, the more the central banks will feel the need to get 'tight' to regain control of inflation.

The second is **inflation expectations,** which can become a self-fulfilling prophecy as in the 60s and 70s, when the anticipation of sustained inflation fed into wage demands and pricing decisions. The indicators we track disagree on the extent to which inflation expectations have already risen; markets have remained relatively sanguine, but businesses are already anticipating a higher run-rate for inflation, with consumers somewhere in between (see Exhibit 2).

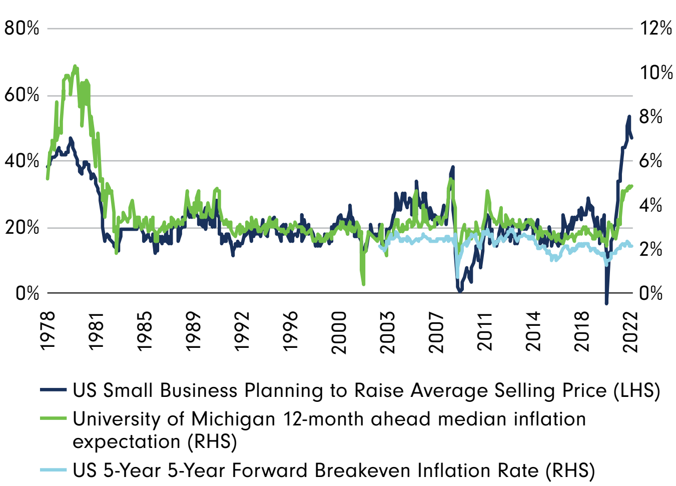
The third is the **labour market**. There is already evidence of tightness in the labour market, with unemployment rates back to near pre-pandemic lows and unfilled job openings at record levels. But central banks have given themselves some 'wiggle room' with recent mandate changes that focus on more inclusive definitions of full employment. Still, the closer we get to those expanded definitions, particularly if accompanied by accelerating wages, the more central banks will be motivated to act (see Exhibit 3).

In addition to the above, we will be monitoring closely the sensitivity of the economy and markets to tightening. The explosion in public and private sector debt means every quarter-point of rate increase will bite harder. This is particularly true in an environment of retreating globalization and ageing demographics, which is constraining the economy's speed limit and has reduced the 'neutral' rate of interest. What looks like a 'normalization' in policy may be more tight, which may not be clear until after the fact given the lags in monetary policy. We will be looking for evidence that the Fed is squeezing the economy harder than it realizes.

Positioning

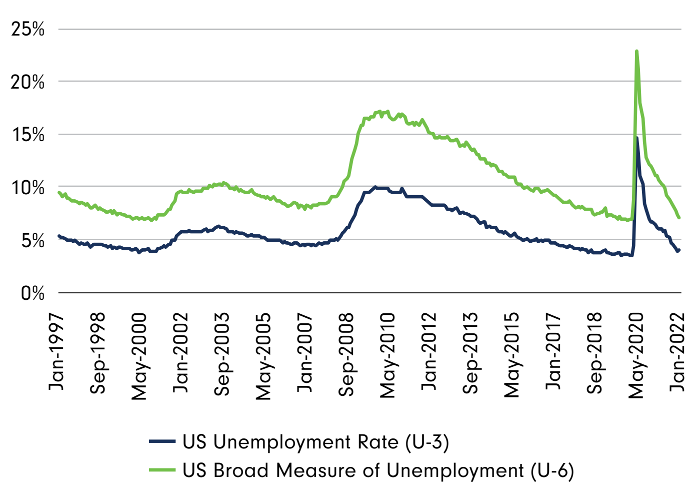
Our expectation that policy will not yet derail further global economic recovery remains the primary motivation for our overweight to equities and credit. However, the unfolding maturation of the cycle, and the market volatility that can be expected to accompany it, have led us to reduce our overall risk posture somewhat (see Exhibit 4). The prospect of policymakers becoming more anxious about inflation remains the key threat to the cycle and risky assets; as above, we believe there remains some runway there, but are

EXHIBIT 2: Bond market still sanguine about inflation



Source: NFIB, UMich, FRB

EXHIBIT 3: US labour market healing near complete



Source: Bureau of Labor Statistics

prepared to adopt a more defensive stance if and when that threat becomes more salient. We have also adjusted how we play defense in the portfolios, with the combination of still-low yields and higher and more volatile inflation mitigating the protective value of government and investment-grade bonds; we retain an underweight to this asset class, instead favouring inflation-protected bonds and cash.

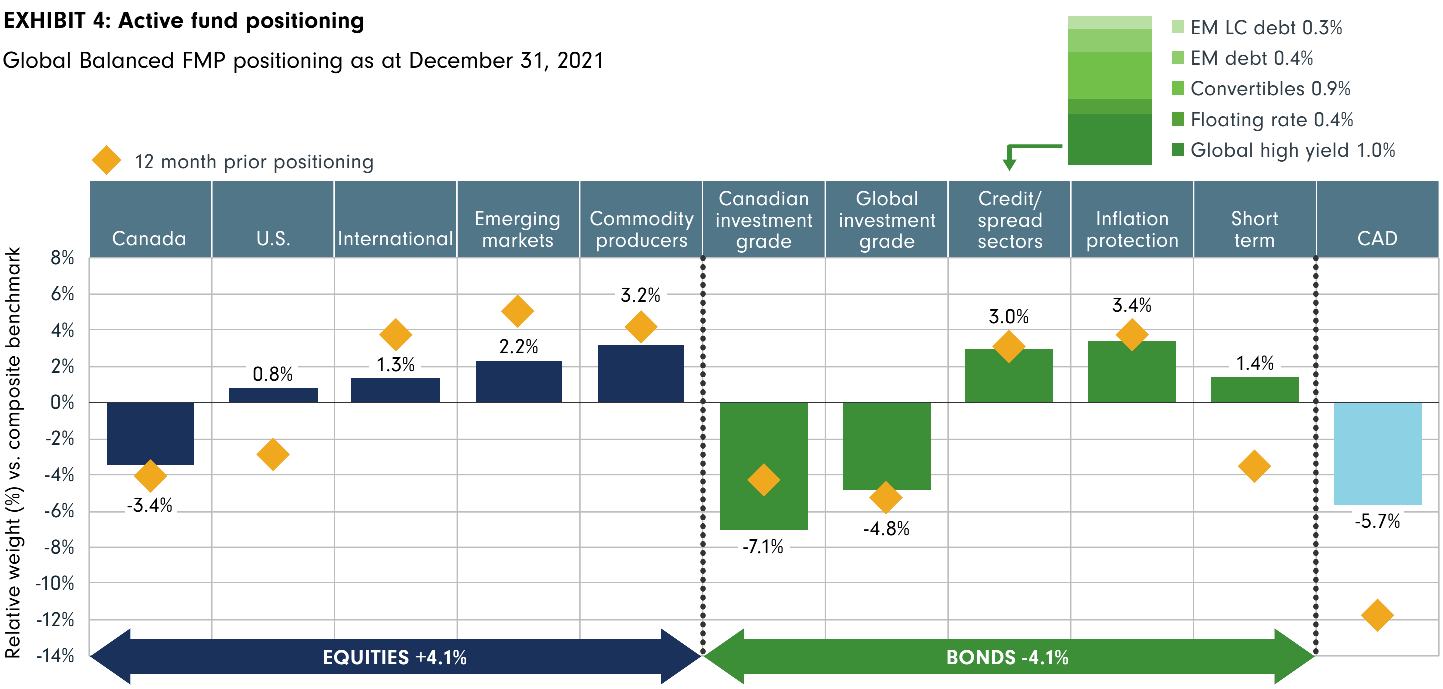
We have also reduced, but not eliminated, our underweight to Canadian dollar-denominated assets. Two major dynamics are at play here.

One, we expect the Canadian dollar will benefit from the Bank of Canada normalizing monetary policy more aggressively than the Fed, pushing up the Canada-US interest rate differential. The boost to the Canadian dollar is likely to be temporary, however, with higher interest rates representing a likely catalyst for the realization of long-standing risks to the domestic economy. While rate increases may look modest, such is the leverage in the Canadian system that we project it will take only a 100 bps increase in interest rates to push the household debt service ratio to its highest level in a generation (see Exhibit 5), putting at risk what has essentially been the sole engine of Canadian growth over the past two decades. This is different from in the U.S., where growth has been more balanced and households repaired their balance sheets following the 2008 financial crisis. We are humble about our ability to forecast how significant and durable the support to the Canadian dollar from higher rates will be, and have greater conviction in their negative medium-term consequences.

Two, we expect the currency position can still play an important, albeit diminished, role in providing protection to the portfolios against the risk of a declining equity market. As we have discussed many times, the Canadian dollar

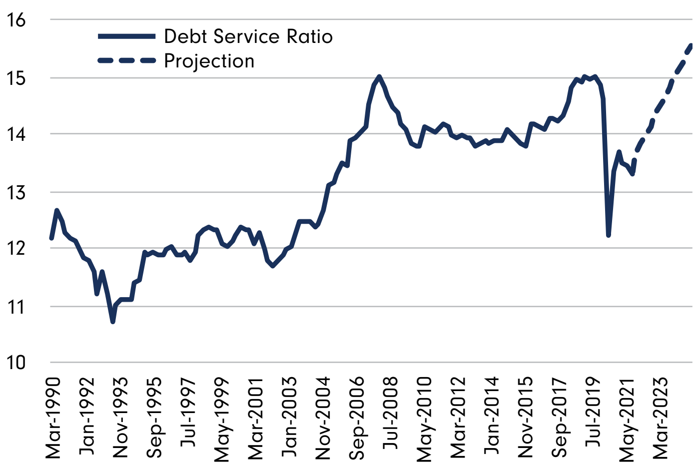
EXHIBIT 4: Active fund positioning

Global Balanced FMP positioning as at December 31, 2021



Source: Fidelity Investments Canada ULC. Fidelity Global Balanced Portfolio's blended benchmark 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. Positioning is as at the date noted and is subject to change.

EXHIBIT 5: Rate hikes and household debt service ratio



This chart is based on several important assumptions. We assume a 25bp increase in the effective interest rate each quarter, the level of household debt and disposable income grows at the 2016-2019 pre-Covid average quarterly growth rate. Source: Statistics Canada, Bank of Canada, Author calculations.

is a cyclical currency, correlated with global growth and risky asset prices, meaning that diversification into more defensive foreign currencies like the US dollar, euro and yen can mitigate portfolio volatility in a risk-off environment. That diversification is even more *valuable* at present given that, as above, bonds are less likely to provide their traditional degree of buffer to multi-asset portfolios. However, it may be less *reliable* in the current environment; the Canadian dollar is also positively correlated with inflation (primarily via commodity prices), so if it's inflation that's causing the market stress, the Canadian dollar may be more resilient. Still, we expect that our currency positioning will provide a degree of protection. And in an environment with asset prices generally both more expensive and more correlated, we must make use of all of our tools of diversification, as always with the view to maximizing return while managing risk in our Canadian multi-asset funds.

David Wolf, David Tulk and Ilan Kolet, February 9, 2022

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Ilan Kolet is an Institutional Portfolio Manager for Fidelity Investments. In this role, Mr. Kolet serves as a member of the investment management team, maintaining a deep knowledge of portfolio philosophy, process and construction. He assists portfolio managers and their CIOs in ensuring portfolios are managed in accordance with client expectations.

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