

# Diversification amid the disconnect

David Wolf | Portfolio Manager

David Tulk, CFA | Portfolio Manager

## Key Takeaways

- We see an unprecedented disconnect between the stock market and the economy
- We are focused on diversification over directionality in this uncertain environment
- We have reduced our nominal bond holdings in favour of gold, TIPS and EM assets

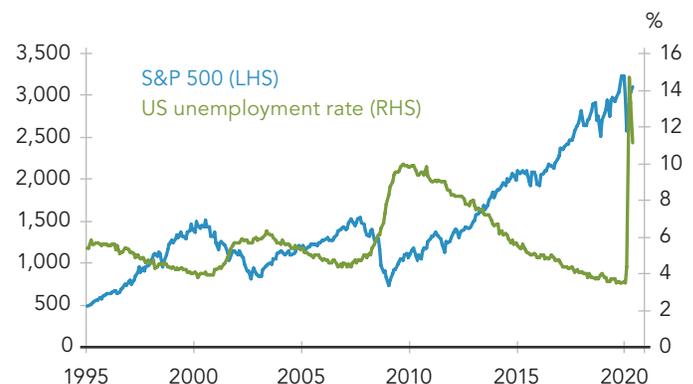
Three months ago, we wrote that we would be scaling into equities in our Canadian multi asset class funds, with dislocations and attractive valuations having emerged amidst the panic. That proved smart. We also wrote that we would be buying only gradually as we expected the market to take some time searching for a bottom. That proved not so smart. The market's recovery was nearly as powerful as its sell-off; the 44% rise in the S&P 500 from the March lows to the June highs was the largest such rally in a century.

Now major market indices are not far off their record highs. The unemployment rate is also not far off a record

high. This is the opposite of what we tend to see and what we would expect (see Exhibit 1). The stock market and the economy have become disconnected in an unprecedented way.

We can rationalize this disconnect. The stock market is forward looking, so has been able to look past the induced coma into which the global economy was placed beginning in mid-March to factor in the inevitable recovery. Furthermore, the monetary and fiscal policy response has been very aggressive; the resulting flood of money has clearly made its way into asset prices rather than spending, at least initially. One can also argue that the nature of this unusual economic shock may actually be helpful to the large companies that dominate the

**EXHIBIT 1: Unusual to have both stocks and unemployment near the highs**



Sources: Bureau of Labor Statistics, Standard & Poor's, Haver Analytics, FMR Co.

equity markets; the disproportionate hit to smaller businesses may lessen competition, and the technology companies leading the market may benefit in particular from what look to be durable changes in the way we work and live.

But we could also rationalize a market returning to the lows. Even on optimistic projections (for COVID19 and otherwise), the economy will take years to recover to its prior growth trend, and that trend itself is challenging – demographics remain a persistent headwind, and the inevitable-looking reconfiguration of supply chains as globalization retreats will hurt productivity. Moreover, the share of the economy claimed by company earnings may decline from its lofty level, particularly if the November elections in the US usher in more labour-friendly policies. And while fiscal and monetary policies are highly stimulative, you can only go all-in once. For us, statements like ‘stocks look fair on projected 2022 earnings’ that are used to justify the current level of the equity market are presumptuous regarding just what that 2022 environment will look like.

Under these circumstances, we think making an aggressive call on the direction of equities from here is inappropriate. As we have written many times, one of our core tenets is not to try to call the uncallable. Rather than focusing on one particular outcome, our approach is to build portfolios that are resilient to a wide range of outcomes. We believe that constructing portfolios that are well-diversified across asset classes, styles and regions is the right way to both grow and protect capital over the long run.

Diversification is itself a greater challenge in the current environment. Over the past few decades, a reliable way to achieve diversification has been to combine positions in stocks and bonds, with the latter providing a cushion to the former. But that strategy may not be

as effective now – just simple arithmetic shows that the prices of bonds at near-zero yields have limited scope to increase to offset drawdowns in equities.

We have therefore become more creative in our approach to portfolio diversification. First, we have reduced our holdings of nominal bonds. We do not think government bond yields can increase much – central banks will almost certainly be persuaded or forced to maintain low interest rates across the curve – but they cannot fall much either, and so as noted above cannot provide much diversification in the portfolios (nor income for that matter).

While nominal yields cannot fall (much) below zero, however, real (inflation-adjusted) yields can. We saw this in the post-WWII era, which shares many similarities with the current environment of high debt and financial repression (see Exhibit 2). Falling real yields provide significant scope for appreciation in assets like gold and inflation-linked bonds (TIPS in the US, Real Return Bonds in Canada), thus providing a more useful diversifier against equity weakness; we have expanded our holdings of these assets in our funds.

**EXHIBIT 2: Real yields can decline further**



Note: Real yield prior to 2003 calculated as nominal yields adjusted for CPI inflation, TIPS from 2003 onward. Sources: Federal Reserve, Bureau of Labor Statistics, FMR Co.

We are also using currency positioning to enhance portfolio diversification. We are maintaining our longstanding underweight to the Canadian dollar, whose value is correlated with equity market movements. We have, however, adjusted the profile of the currencies we hold as offsetting overweights, shifting away from the US dollar towards euros and Japanese yen. In our view, the US dollar looks overvalued in an environment where the dollar’s status as the world’s reserve currency is coming into greater question.

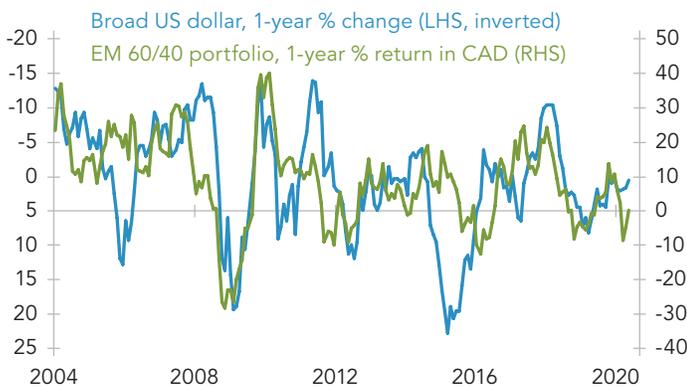
The prospect of a weaker US dollar has also made us comfortable in diversifying further into both emerging-market equities and debt, which tend to do well in such an environment (see Exhibit 3). These are cyclical assets so they will vary with equity market movements, but the higher incomes on these instruments can offset the effects of broader drawdowns. Moreover, we expect the retreat of globalization to reduce the correlation among regional economies and markets, enhancing the diversification potential of emerging market assets vis-à-vis developed market assets.

To conclude, we have an historic disconnect between the economy and the equity market, whose resolution is uncertain. In that context, our active positioning is focused less on market direction and more on portfolio diversification, all with the unwavering goal of managing risk while maximizing performance in our Canadian multi asset class funds.

David Wolf and David Tulk, July 16, 2020

 Follow Fidelity Canada on Twitter @fidelitycanada

**EXHIBIT 3: Emerging markets like a weaker USD**



Note: Broad dollar represented by DXY index, EM 60/40 portfolio composed of 60% MSCI EM equity index and 40% GBI-EM Diversified local currency bond index, returns converted to CAD. Sources: MSCI, JP Morgan, Bloomberg, FMR Co.

## Authors

### David Wolf | Portfolio Manager

David Wolf is a portfolio manager for Fidelity Investments. He is the co-manager of Fidelity Managed Portfolios, Fidelity Canadian Asset Allocation Fund, Fidelity Canadian Balanced Fund, Fidelity Monthly Income Fund, Fidelity U.S. Monthly Income Fund, Fidelity U.S. Monthly Income Currency Neutral Fund, Fidelity Global Monthly Income Fund, Fidelity Dividend Fund, Fidelity Global Dividend Fund, Fidelity Income Allocation Fund, Fidelity Balanced Managed Risk Portfolio and Fidelity Conservative Managed Risk Portfolio. He is also portfolio co-manager of Fidelity Conservative Income Private Pool, Fidelity Asset Allocation Private Pool, Fidelity Asset Allocation Currency Neutral Private Pool, Fidelity Balanced Private Pool, Fidelity Balanced Currency Neutral Private Pool, Fidelity Balanced Income Private Pool, Fidelity Balanced Income Currency Neutral Private Pool and Fidelity U.S. Growth and Income Private Pool.

### David Tulk, CFA | Portfolio Manager

David Tulk is a portfolio manager for Fidelity Investments. He is the co-manager of Fidelity Balanced Managed Risk Portfolio, Fidelity Conservative Managed Risk Portfolio, Fidelity Conservative Income Fund and Fidelity Conservative Income Private Pool.



Commissions, trailing commissions, management fees, brokerage fees and expenses may be associated with investments in mutual funds and ETFs. Please read the mutual fund or ETF's prospectus, which contains detailed investment information, before investing. The indicated rates of return are historical annual compounded total returns for the period indicated including changes in unit value and reinvestment of distributions. The indicated rates of return do not take into account sales, redemption, distribution or option charges or income taxes payable by any unitholder that would have reduced returns. Mutual funds and ETFs are not guaranteed. Their values change frequently, and investors may experience a gain or a loss. Past performance may not be repeated.

From time to time a manager, analyst or other Fidelity employee may express views regarding a particular company, security, and industry or market sector. The views expressed by any such person are the views of only that individual as of the time expressed and do not necessarily represent the views of Fidelity or any other person in the Fidelity organization. Any such views are subject to change at any time, based upon markets and other conditions, and Fidelity disclaims any responsibility to update such views. These views may not be relied on as investment advice and, because investment decisions for a Fidelity Fund are based on numerous factors, may not be relied on as an indication of trading intent on behalf of any Fidelity Fund.

Certain Statements in this commentary may contain forward-looking statements ("FLS") that are predictive in nature and may include words such as "expects", "anticipates", "intends", "plans", "believes", "estimates" and similar forward-looking expressions or negative versions thereof. FLS are based on current expectations and projections about future general economic, political and relevant market factors, such as interest and assuming no changes to applicable tax or other laws or government regulation. Expectations and projections about future events are inherently subject to, among other things, risks and uncertainties, some of which may be unforeseeable and, accordingly, may prove to be incorrect at a future date. FLS are not guarantees of future performance, and actual events could differ materially from those expressed or implied in any FLS. A number of important factors can contribute to these digressions, including, but not limited to, general economic, political and market factors in North America and internationally, interest and foreign exchange rates, global equity and capital markets, business competition and catastrophic events. You should avoid placing any undue reliance on FLS. Further, there is no specific intention of updating any FLS whether as a result of new information, future events or otherwise.

"Fidelity Investments" and/or "Fidelity" refers collectively to: i) FMR LLC, a US company, and certain subsidiaries, including Fidelity Management & Research Company (FMR Co.) and Fidelity Management & Research (Canada) ULC ("FMR-Canada") - which carries on business in British Columbia as FMR Investments Canada ULC; and ii) Fidelity Investments Canada ULC ("FIC") and its affiliates. Fidelity Management & Research (Canada) ULC ("FMRCanada") commenced business in Ontario on February 1, 2018. FMRCanada is registered as a portfolio manager with the Ontario Securities Commission ("OSC") and as a portfolio manager with the other Canadian securities commissions. The scope of FMR-Canada's business is currently limited to offering the Global Asset Allocation ("GAA") strategies through a discrete portfolio management team at FMR-Canada. The GAA strategies are offered by FMR-Canada on a sub-advised basis to accounts advised by Fidelity Investments Canada ULC ("FIC"), with FMR-Canada acting as either direct sub-adviser to FIC or as sub-sub-adviser through non-Canadian Fidelity advisers, including (and principally) US SEC-registered investment advisers, such as FMR Co., Inc. ("FMRCo"). FMR-Canada does not offer these strategies directly to investors in Canada. FMR-Canada has also registered "Fidelity Investments" as a trade name in Canada.