Reacting to the reaction function

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Key Takeaways

- Fed pivot may suggest a more dovish reaction function
- Equities and inflation-sensitive assets prospective beneficiaries
- Global tilt remains warranted even if Canadian risks deferred

A terrible Q4 for financial markets gave way to a fantastic Q1. As we write, Canadian, U.S. and global stocks have all traded back up to near last summer's highs, representing a rebound of 20% or more from the late-December lows. Credit spreads have narrowed in tandem with the bounce in the stock market, and declining bond yields have provided a further tailwind to fixed income.

The main cause of the rebound is not hard to find. As of the end of September, the plurality of U.S. Fed voters expected five interest-rate hikes through 2020. As of the end of March, they expected none (see Exhibit 1). Fed policy, and its consequences for U.S. dollar liquidity, has effectively been the tap that feeds global growth and asset prices. The Fed was moving to turn off that tap. Now it's not. The resulting loosening in financial conditions was further supported by dovish turns elsewhere, most notably in China, where monetary and financial stimulus looks to be ramping back up.

The market reaction has been impressive, with stocks cheering the potential extension of the business cycle and bonds cheering the lower implied path of U.S. interest rates. Both asset classes surged in Q1, leading to strong quarterly returns for multi-asset strategies. Our Global Balanced Portfolio, for example, returned 7.3% (net of Series F fees) in the first quarter, the best quarterly result in four years, and more than offsetting the 4.4% drawdown in the fourth quarter of 2018. But frankly, one didn't need to be much of an asset allocator to do well in Q1 when everything went up.

Fidelity Global Balanced Portfolio, Performance, Series F, net of fees

Entity name	Period ending	Expense methodology	3 M cum	1 Y ann	3 Y ann	5 Y ann	10 Y ann
Fidelity Global Balanced Portfolio – Series F	March 31, 2019	Net	7.3	4.9	7.2	7.1	10.4

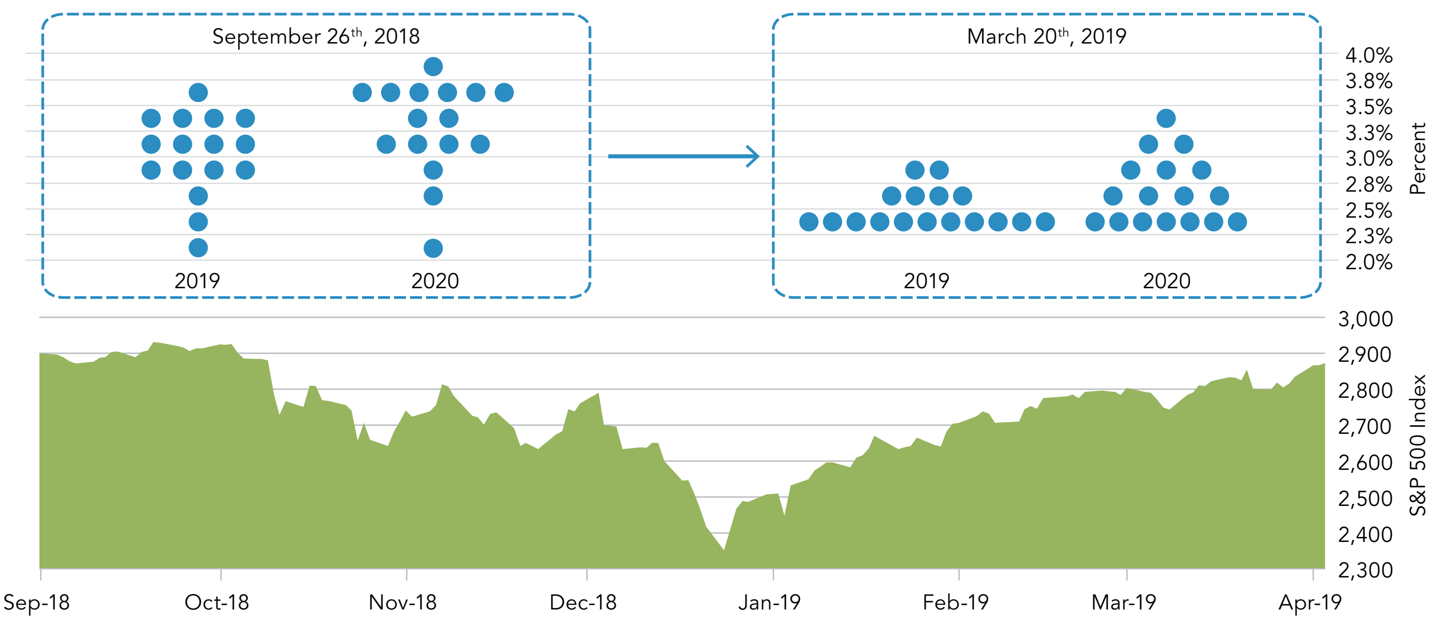
That is likely to change ahead. Markets appear to have priced in *what* the Fed has done, but not necessarily *why* it has done it. Put another way, we suspect that the Fed has not just reacted to the data in its usual fashion, but that the Fed's (implicit) reaction function itself may be changing. After a prolonged period of undershooting inflation, there may now be a greater tolerance for letting a tight economy "run hot," and accepting, even encouraging, a rise in inflation above the 2% target.

In our judgment, there are a number of areas of the market where the possibility of a more dovish Fed reaction function has not been fully discounted:

- Equities may have more room to run – at least in the near term – as investors underestimate the extent to which the Fed will permit the business cycle to extend. This view is further reinforced by the emerging stabilization in global growth (see Exhibit 2), due in part to policy action elsewhere and an apparent moderation in some of the geopolitical tensions that weighed on investor confidence through the end of 2018.
- The back end of the (famously flat) yield curve has priced in neither the prospect of higher inflation nor the risk premium appropriate to the non-negligible chance of more volatile inflation expectations.
- A more durably dovish Fed suggests a structurally weaker U.S. dollar, which has tended to drive higher relative returns on equities outside of the U.S., particularly in emerging markets.

In response to these developments, we have adjusted the active asset allocation tilts in our Canadian multi-asset class funds. The likely extension of the business cycle warrants a somewhat greater allocation to equities, particularly in emerging markets. Meanwhile, the longer-term consequences of the Fed's potentially more dovish reaction function reinforce an allocation to inflation-sensitive assets and away from interest-rate risk.

EXHIBIT 1: Fed's U-turn leads to V-shaped recovery



Note: Upper panel "dots" show FOMC participants' assessments of appropriate monetary policy as of the dates indicated. Sources: Federal Reserve, Standard & Poor's and FMR Co.

Finally, a few words about Canada. Our longer-term thesis – that the daunting imbalances in the economy threaten both the domestically oriented elements of the Canadian equity market and the value of the Canadian dollar – remains firmly in place (see Exhibit 3). The lagged effects of tighter monetary and regulatory policies will weigh on the overextended household sector for some time, and the externally oriented elements of the economy remain unlikely to pick up the slack.

However, at least in the near term, the environment looks more favourable for Canadian assets. An extended business cycle would provide support for Canadian exports and business capital expenditures, and the household sector that has concerned us so much may find some relief in the downward reversal in interest rates. In addition, the prospect of a weaker U.S. dollar mechanically implies a boost to anything measured in its terms, including the Canadian dollar and commodity prices. All of this warrants greater tactical exposure to Canadian assets, and we have shifted our allocations marginally in that direction.

That doesn't mean we've gone overweight Canada, however. We can't know exactly when our long-term thesis for Canada will play out fully, and as a result we retain a core underweight to the domestic market. But we can and do take into account shorter-term developments that could delay or hasten the realization of this thesis. So while we calibrate our active positioning based on the evolving near-term environment, our broader positioning remains firmly focused on the longer-term balance of risk and reward, which continues to favour a tilt toward foreign assets.

David Wolf and David Tulk, April 26, 2019

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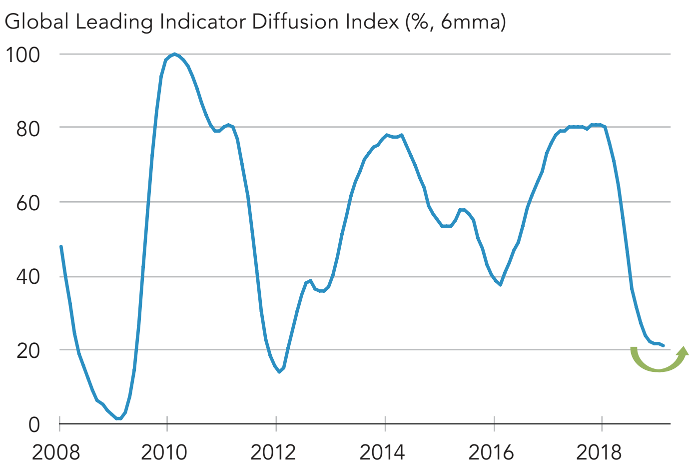
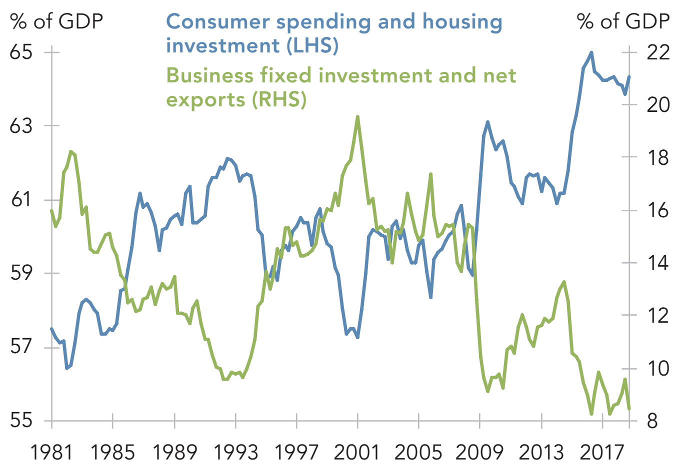
EXHIBIT 2: Signs of a bottoming in global growth



Sources: AART and FMR Co.

EXHIBIT 3: Canadian imbalances as daunting as ever



Sources: Statistics Canada, Haver Analytics and FMR Co.

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