Point of view – Market volatility update

"The major tenets of the global growth story have not yet been shaken; that said, we are witnessing a cyclical challenge to a secular trend."
– Bob Haber, *Chief Investment Officer, Fidelity Investments Canada*

Investors continue to face challenges in 2008, and the events of the last several days have added to mounting concerns. Fidelity arranged a live conference call on September 16 with Bob Haber, portfolio manager and Fidelity Canada's CIO, and Brian Miron, portfolio manager for Canadian fixed-income products. Here are their perspectives on recent events.

Recent events

"We are seeing things occur that have not been seen in at least 70 years."
– Bob Haber

- The events in the U.S. revolving around de-leveraging and housing are making for a truly extraordinary period in American financial history.
- As the financial system tries to right itself, there are key changes to look for:
  - *Stabilization* – U.S. residential and commercial real estate prices must stabilize, but this is not expected in the near term.
  - *Financial sector recapitalization* – Assets must be repriced and new capital must flow into markets.
  - *Easing of monetary policy* – Globally, central banks need to shift from tightening to easing rates.
- A decision by the Federal Reserve (the Fed) to lower rates would be a signal of intention rather than an effective action at this point. Another 25- to 50-basis-point drop would not solve the economic issues.
- The Fed has changed its modus operandi, using more than half its balance sheet and lowering rates in an attempt to stabilize the current situation.
- The work the Fed and the Federal Treasury are doing behind the scenes, specifically in arranging financing and bailouts, has been as or more important than interest rate policy.

Update on global growth and the "Go Canada" theme

- For the first time in seven years, we are witnessing synchronized declines in global growth rates.
- Europe has been aggressive in raising rates, and emerging economies have also been tightening monetary policy. This has led to lower growth rates and lower commodity prices.
- However, China's central bank has shifted to easing and seems to be moving to an accommodative policy.
- If Europe begins to reduce rates, the major economic zones could become synchronized in easing monetary policy, and this would bode well for global growth.
- Regarding the "Go Canada" thesis, Bob expects Canada will continue to benefit from global demand for commodities.
- While equity and commodity prices have experienced a correction, emerging countries continue to invest in their infrastructure and require the raw materials needed for this build-out.

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Canadian financial system and credit markets

> "We met with the Canadian bank CEOs last week and talked about how credit trends appear quite healthy. They are not seeing any significant signs of an uptick in writeoffs yet; however, they are expecting it. Even with the expectation that things may get tougher, the capital base of the banks remains rock solid."
> – Brian Miron

- Compared with their U.S. and European counterparts, Canadian banks are solid. Key strengths include
  - a high double-digit return on equity (ROE)
  - net profits, with trailing 12-month earnings between $17 and $20 billion for the "Big Five"
  - healthy loan books
- From a funding perspective, Canadian banks continue to rely more on deposit (retail) funding than on wholesale funding, which is where U.S. and European banks are experiencing their challenges.
- Canadian banks therefore have more financing options, and are under far less pressure, than their global counterparts.
- Within credit markets, Canadian corporate issuers have not, in general, had to issue any debt, relying instead on their own free cash flow, or turning to banks for any required funding.
- With no significant new issuance of Canadian corporate debt, there is little pressure on spreads in the Canadian bond market; however, U.S. corporations are being forced to raise money in the bond market, paying what are in some cases extreme premiums.
- From a balance sheet perspective, the Canadian corporate sector remains in good shape.

What are Fidelity portfolio managers doing?

Fixed income

- We review the portfolio, position by position, and ask: "Does the credit story make sense? Does the valuation make sense?"
- We manage position sizes, staying liquid and trading up to higher quality where possible.
- As opportunities arise, we will add industrials with free cash flow and good business stories. We are also looking at regulated utilities with attractive valuations.
- Over the last three to six months, Canadian bank names have been added, because spreads have widened dramatically.

Equities

- We stay in touch with the companies we own, keeping up a constant communication. We do this in every sector, every industry, every day.
- From an asset allocation perspective, we underweighted equities in the early summer, shifting more money to the fixed-income team to put into the high-grade bond market.

Key take-aways

- Expect volatility to continue.
- Corrections are healthy as long as deeper secular themes are not broken.
- It is too early to jump into U.S. financials; there are still many unknowns.
- It may be a good time to buy on weakness – where we have strong conviction about the stock. The global growth theme remains the principal source of our convictions.