What will 2022 be remembered for?

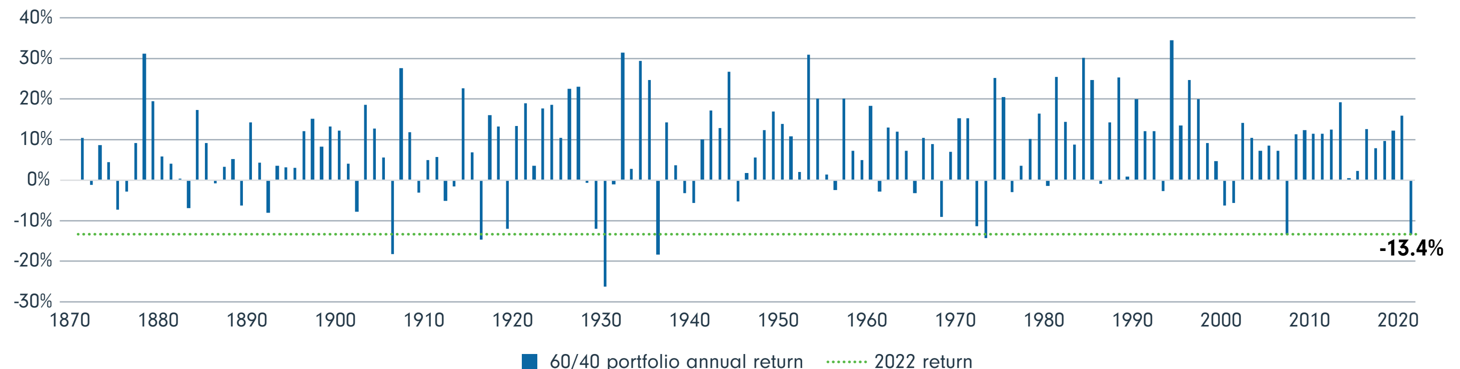
For markets, central banks were the talk of the town. Runaway inflation and aggressive monetary tightening by major central banks, spearheaded by the U.S. Federal Reserve (the Fed), dominated the market narrative for the year. The rapid rise in yields drove bonds to one of their worst ever years and caused longer-duration equity multiples to plummet. Slowing growth and tighter financial conditions weighed on equities more generally. In addition, the tragic war in Ukraine added to market volatility.

Chart 1: The year 2022 was an outlier, because both bonds and equities performed poorly.

Annual nominal returns of S&P 500 and US 10y Treasuries 1870–2022; data for 2022 are for the year to December 1, 2022. Source: Pre-2021 data from Òscar Jordà, Katharina Knoll, Dmitry Kuvshinov, Moritz Schularick, and Alan M. Taylor, "The Rate of Return on Everything, 1870–2015," *Quarterly Journal of Economics*, 134(3), 1225-1298, 2019. Post-2020 data from Refinitiv and Fidelity International, December 2022.

While not unique, the negative performance of both equities and bonds makes 2022 highly unusual, as the chart above shows. The chart below, meanwhile, reveals that there have only been a handful of times that a 60/40 portfolio of U.S. equity and fixed income assets has performed worse in the last 150 years.

Chart 2: No room to hide: The year 2022 was among the worst for a U.S. 60/40 portfolio in the last 150 years.



Annual nominal return of 60/40 portfolio of S&P 500 and U.S. 10y Treasuries, 1870–2022; data for 2022 are for the year to December 1, 2022. Source: Pre-2021 data from Òscar Jordà, Katharina Knoll, Dmitry Kuvshinov, Moritz Schularick, and Alan M. Taylor, "The Rate of Return on Everything, 1870–2015," *Quarterly Journal of Economics*, 134(3), 1225-1298, 2019. Post-2020 data from Refinitiv and Fidelity International, December 2022.

So what can we expect in 2023?

The year 2023 may mark a significant shift in how a generation of investors, policy makers and consumers will think about inflation and interest rates. It appears that the post-financial crisis era of cheap money and quantitative easing has ended for now, and it also seems that the era of low inflation and decreasing rates to which investors had grown accustomed may likely be over. Our investment management team continues to analyze the investment implications of this regime shift, from both a tactical perspective and over medium- and longer-term periods.

Chart 3: Market performance varies from year to year.

2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	
CANADIAN SMALL CAP: 35.2%	CANADIAN BONDS: 9.7%	EMERGING MARKETS: 16.0%	U.S. SMALL CAP: 48.1%	U.S. EQUITY: 23.9%	U.S. EQUITY: 21.6%	CANADIAN SMALL CAP: 31.9%	EMERGING MARKETS: 28.7%	U.S. EQUITY: 4.2%	U.S. EQUITY: 24.8%	U.S. SMALL CAP: 17.9%	U.S. EQUITY: 27.6%	CANADIAN EQUITY: 5.8%	BEST
U.S. SMALL CAP: 20.2%	U.S. EQUITY: 4.6%	FOREIGN EQUITY: 15.3%	U.S. EQUITY: 41.3%	GLOBAL EQUITY: 15.0%	GLOBAL EQUITY: 19.5%	CANADIAN EQUITY: 21.1%	FOREIGN EQUITY: 17.4%	CANADIAN BONDS: 1.4%	CANADIAN EQUITY: 22.9%	EMERGING MARKETS: 16.6%	CANADIAN EQUITY: 25.1%	FOREIGN EQUITY: -7.8%	
CANADIAN EQUITY: 17.6%	U.S. SMALL CAP: -1.8%	GLOBAL EQUITY: 14.0%	GLOBAL EQUITY: 35.9%	U.S. SMALL CAP: 14.3%	FOREIGN EQUITY: 19.5%	U.S. SMALL CAP: 17.1%	GLOBAL EQUITY: 15.0%	GLOBAL EQUITY: 0.1%	GLOBAL EQUITY: 21.9%	U.S. EQUITY: 16.3%	CANADIAN SMALL CAP: 21.7%	CANADIAN SMALL CAP: -11.4%	
EMERGING MARKETS: 13.0%	GLOBAL EQUITY: -2.7%	U.S. SMALL CAP: 13.8%	FOREIGN EQUITY: 31.6%	CANADIAN EQUITY: 10.6%	U.S. SMALL CAP: 14.6%	U.S. EQUITY: 8.1%	U.S. EQUITY: 13.8%	U.S. SMALL CAP: -3.0%	U.S. SMALL CAP: 19.2%	GLOBAL EQUITY: 14.5%	GLOBAL EQUITY: 21.3%	CANADIAN BONDS: -11.7%	PERFORMANCE
U.S. EQUITY: 9.1%	CANADIAN EQUITY: -8.7%	U.S. EQUITY: 13.4%	CANADIAN EQUITY: 13.0%	CANADIAN BONDS: 8.8%	CANADIAN BONDS: 3.5%	EMERGING MARKETS: 7.7%	CANADIAN EQUITY: 9.1%	FOREIGN EQUITY: -5.6%	FOREIGN EQUITY: 16.5%	CANADIAN SMALL CAP: 11.7%	U.S. SMALL CAP: 13.8%	GLOBAL EQUITY: -11.8%	
CANADIAN BONDS: 6.7%	FOREIGN EQUITY: -9.5%	CANADIAN EQUITY: 7.2%	EMERGING MARKETS: 4.3%	EMERGING MARKETS: 7.0%	EMERGING MARKETS: 2.4%	GLOBAL EQUITY: 4.4%	U.S. SMALL CAP: 7.1%	EMERGING MARKETS: -6.5%	CANADIAN SMALL CAP: 16.1%	CANADIAN BONDS: 8.7%	FOREIGN EQUITY: 10.8%	U.S. EQUITY: -12.2%	
GLOBAL EQUITY: 6.5%	CANADIAN SMALL CAP: -14.2%	CANADIAN BONDS: 3.6%	CANADIAN SMALL CAP: 4.3%	FOREIGN EQUITY: 4.1%	CANADIAN EQUITY: -8.3%	CANADIAN BONDS: 1.7%	CANADIAN SMALL CAP: 4.0%	CANADIAN EQUITY: -8.9%	EMERGING MARKETS: 12.9%	FOREIGN EQUITY: 6.4%	CANADIAN BONDS: -2.5%	EMERGING MARKETS: -13.9%	
FOREIGN EQUITY: 2.6%	EMERGING MARKETS: -16.2%	CANADIAN SMALL CAP: -0.5%	CANADIAN BONDS: -1.2%	CANADIAN SMALL CAP: -2.8%	CANADIAN SMALL CAP: -16.3%	FOREIGN EQUITY: -2.0%	CANADIAN BONDS: 2.5%	CANADIAN SMALL CAP: -20.3%	CANADIAN BONDS: 6.9%	CANADIAN EQUITY: 5.6%	EMERGING MARKETS: -3.1%	U.S. SMALL CAP: -14.7%	WORST

Sources: Fidelity Management & Research Company and Refinitiv DataStream. Total returns in CDN$. Note: It is not possible to invest directly in an index. Asset class performance represented by: foreign equities, MSCI EAFE Index; global equities, MSCI World Index; emerging markets equities, MSCI Emerging Markets Investable Market Index; U.S. equities, S&P 500 Index; U.S. small caps, Russell 2000 Index; Canadian equities, S&P/TSX Composite Index; Canadian small caps, BMO Small Cap Blended Weighted Index (Price Return); Canadian bonds, FTSE Canada Universe Bond Index. As at December 31, 2022.

The following are the views of various Fidelity portfolio managers who have weighed in on what investors can expect in 2023.

Fidelity Canada's Chief Investment Officer and Portfolio Manager **Andrew Marchese** makes a few points:

The year 2022 was heavily influenced by macroeconomic factors. Global central banks tightened monetary conditions to combat higher and more persistent inflation, which had a negative impact on pricing for all major asset classes. Andrew believes there could be room for further monetary tightening, because additional progress toward the 2% inflation target may be more difficult to achieve in comparison with the initial improvement from peak levels. Still, the lion's share of tightening appears, fortunately, to be behind us.

Looking into 2023, Andrew expects that markets will focus more on profitability than on interest rates. Investors should be aware of the effects of higher interest rates, particularly on demand and prices for goods and services. The most important question is what the corresponding effect will be on corporate profitability. Companies that have better profitability profiles are more likely to be rewarded than those that might be at risk.

In Andrew's opinion, we will likely continue to see further economic slowing in 2023, which will be a challenging environment for investors to navigate. However, history shows that adding risk halfway through a recession, even when the economy feels bad, is accretive to long-term value creation in portfolios. Investors should use PMIs, negative earnings revisions and shifts in global central bank policy as guideposts to selectively add to risk in 2023, in Andrew's view.

Focusing on stock picking and valuations will be paramount, because timing a turn in the market with precision is nearly impossible. The price of individual securities is the best guide, in Andrew's experience. Instead of focusing on broad market turns, he plans to focus on individual securities that have asymmetrical risk/reward profiles, and where upsides outweigh downsides over a three- to five-year investment horizon.

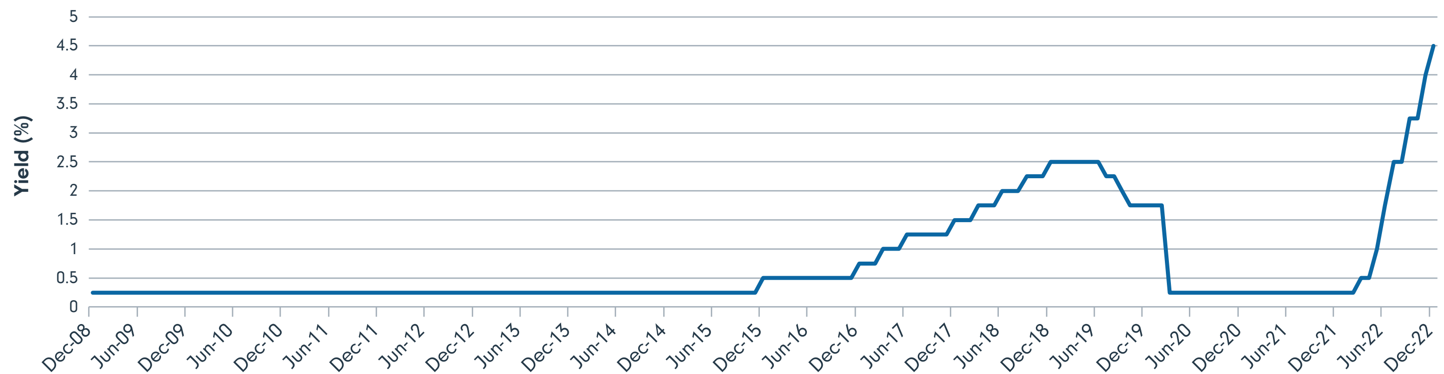
Director of Global Macro **Jurrien Timmer** expects 2023 to offer a choppy, sideways market. He believes value and small caps equities (and non-US equities) will continue to perform well on a relative basis in 2023, even if the market remains trendless or in a downtrend. Jurrien notes several themes that investors need to watch for in 2023.

Inflation: The market expects the Fed to raise rates to 5% next spring, before taking rates all the way back down to neutral (3%) in 2024. Even if inflation continues to drop, as it has done in recent months, it likely won't reach the Fed's 2% target as quickly as the Fed is expected to pivot back to neutral. Inflation has likely peaked for the cycle, but if it falls as quickly as the U.S. TIPS market suggests, the Fed may indeed turn out to be as market friendly as the forward curve is pricing in. In that scenario, it will be a lot easier for the market to "look past" the earnings contraction and on to better days.

Earnings: Jurrien believes earnings have peaked, and estimates are coming down. The percentage of companies seeing earnings downgrades keeps rising, and given the yield curve inversion, this could well continue. Estimate revisions can be tricky to pin down, because downgrades may just reflect a loss of momentum within a rising earnings cycle. There have been many times when revisions were as negative as they are now, and it proved to be just a slowdown within an up-cycle. But given how rosy earnings estimates still are, and given how inverted the yield curve is, we have to brace for a bigger wave of downgrades in 2023.

The Federal Reserve: Currently the market is expecting the Fed to take rates up to 5%, and then almost immediately start cutting them, all the way back to the neutral zone of 3%. Fed Chair Jerome Powell has been trying to explain that the Fed will stay in the restrictive zone for some time, but the market won't listen.

Chart 4: Fed funds target rate (upper bound) over time.



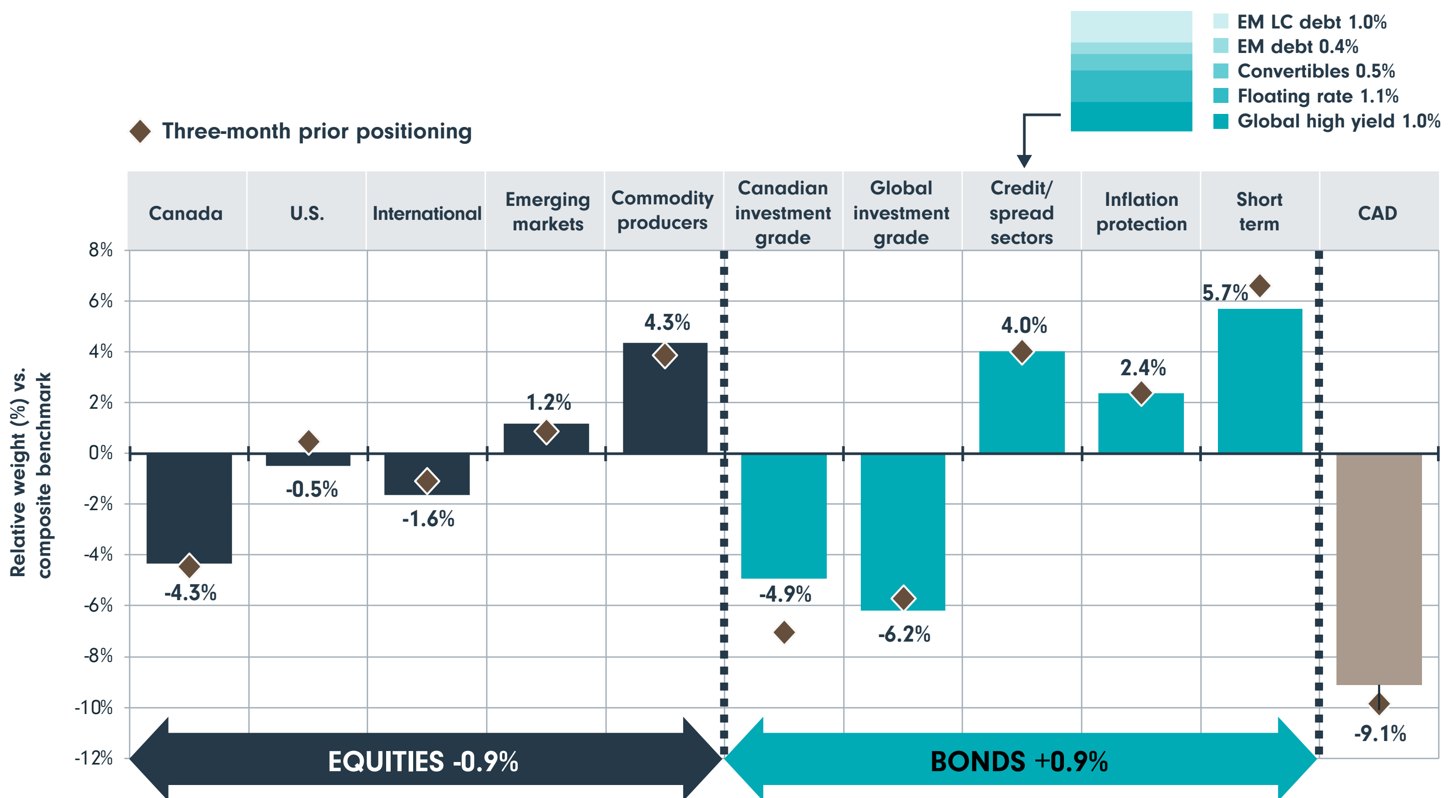
Source: Fidelity Investments Canada, as at December 31, 2022.

Even with a new set of dots showing that the Fed will remain in the high 4s in 2023, and will only go down to the low 4s in 2024, the yield curve is betting on a fast reversion to neutral. The risk is that the Fed will be right and that financial conditions will remain tighter for longer. If that's the case, the stock market may have declared victory too soon, in terms of rallying ahead of its rate-driven fair value.

The Global Asset Allocation team, **Geoff Stein**, **David Wolf**, **David Tulk** and **Ilan Kolet**, note that aggressive monetary policy tightening has pushed the global economy deeper into the late cycle, leading to increased recession risk. Slower liquidity growth, persistent inflation risk, slowing growth momentum and greater monetary policy uncertainty raise the odds that market volatility will remain elevated in 2023.

Accordingly, the managers maintain a defensive posture in their multi-asset class portfolios, allocating less than the benchmark to equities and duration, while continuing to hold inflation-sensitive assets such as commodities and inflation-protected government debt. The managers believe that despite tightening financial conditions that are leading to greater risk in the market, corporate fundamentals do not warrant pushing their defensive posture to the maximum limits of their portfolios' asset allocation bands.

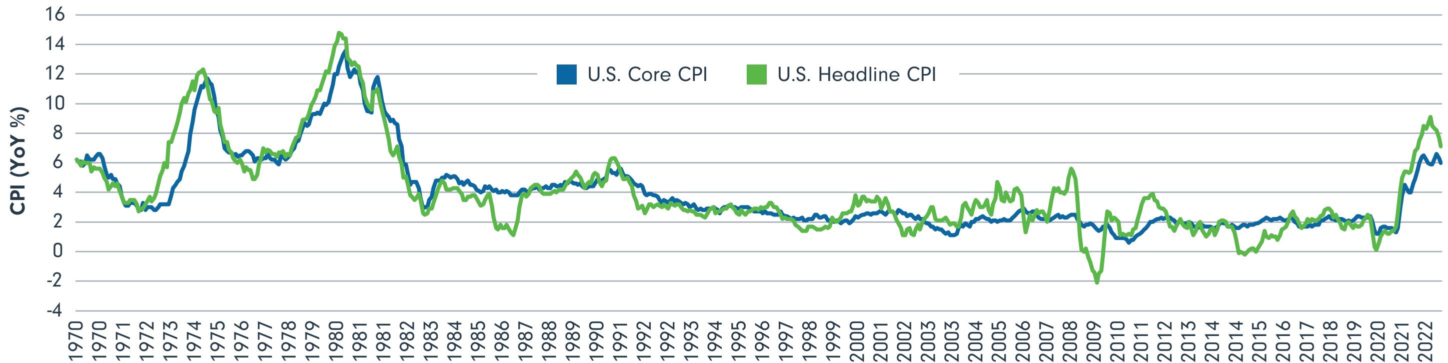
Chart 5: Global Balanced FMP positioning as at November 30, 2022.



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.

The managers believe that inflation risk continues to be more persistent than market participants perceive. While they expect headline inflation to moderate in the medium term, core inflation (ex food and energy) will likely be harder to control, as services costs remain elevated. The managers also note that inflation will likely remain above the Fed's 2% target in the medium term. Even though central banks are mindful of the damage aggressive policy actions will have on the economy and the labour market, their priority is to ensure that expectations of future inflation remain anchored.

Chart 6: Inflation has peaked, but it may take time for core to fall.

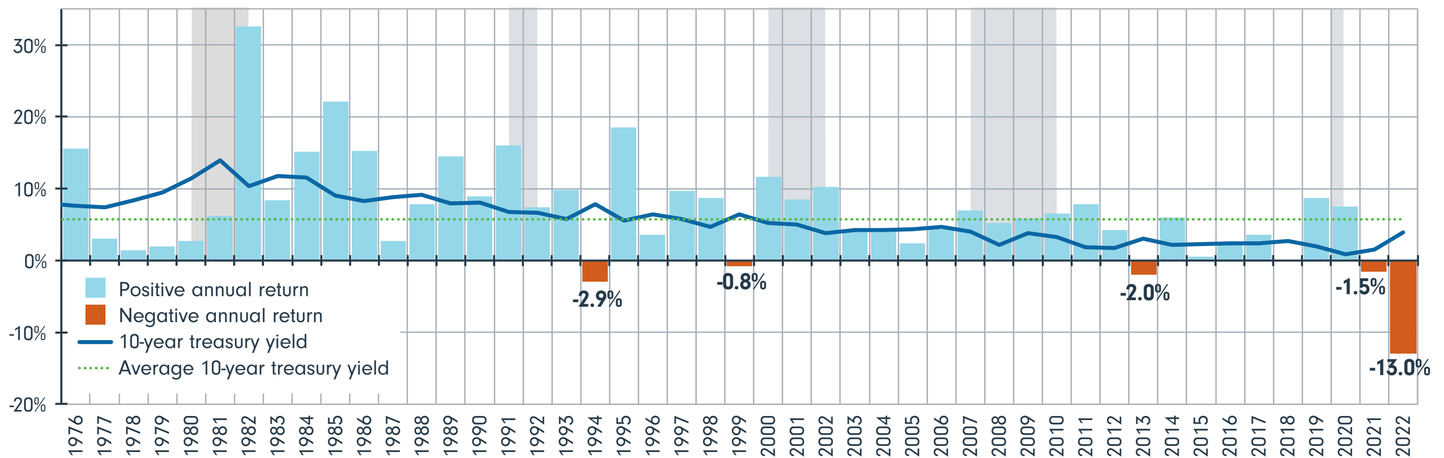


Source: Bloomberg. As at November 30, 2022.

What do our fixed income portfolio managers expect in 2023?

Portfolio Managers **Jeff Moore** and **Michael Plage** acknowledge that 2022 was a historically challenging environment for fixed income, but are optimistic about the asset class as we move forward.

Chart 7: Bond returns vs. interest rates.



Source: Barclays and Bloomberg, as at December 31, 2022. Bond returns are based on the Bloomberg U.S. Aggregate Bond Index. Shaded gray bars represent periods in which the U.S. was in a recession.

The yields on U.S. Treasuries, investment-grade credit, high-yield corporate bonds and global debt now match, and in many cases exceed, the best levels any time in the past ten years or more. Higher market yields imply that the bond investment return frontier will push upward, which will improve the prospects for compounding, total returns and diversification. The bond market is now poised for positive returns, even in a great many adverse stress scenarios.

With a persistently hawkish Fed, the managers continue to hold off making bold sector allocation decisions. The good news is that they are getting paid to wait. In fact, yields are so high that income can offset price declines in all but the most extreme tail scenarios over a 12-month period. The managers' analysis also includes scenarios featuring capital gains in addition to elevated income, but in order to achieve that kind of high return outcome, inflation must be contained, and the Fed must pivot.

The managers' simple assessment is that the highs for U.S. Treasury yields have already been seen. However, they acknowledge that any surprisingly high CPI prints would lead to potentially strong repricing in the bond market. The managers have added a significant amount of duration over the past couple of months, using their elevated cash position as a source of funding. They do not expect the Fed to cut interest rates any time soon, and are consequently continuing to favour a combination of floating rate notes and ten-year key rate risk.

Looking into 2023, Portfolio Manager **Adam Kramer** believes that higher interest rates and the resulting lower prices for many assets may make the new year bright for income-oriented investors. Adam sees the dividend-paying stocks of oil tanker operators, convertible bonds, investment-grade corporate bonds and preferred stocks as offering the best balance between risk and reward at the start of the new year.

Looking ahead, Adam sees a continuing opportunity for investors in tanker stocks: few new ships are being built, so tanker companies can keep the rates they charge to haul oil high. Because of what is occurring in Russia, permanent new routes are being created. There might be volatility, but many of these companies have very strong management teams, and they know how to lock in their high rates for the next one or two years.

Chart 8: Changing leadership among asset classes.

Best 1-year return | Worst 1-year return

ASSET CLASS	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Investment-grade bonds	8.4	10.3	4.1	4.3	2.4	4.3	7.0	5.2	5.9	6.5	7.8	4.2	-2.0	6.0	0.5	2.6	3.5	0.0	8.7	7.5	-1.5	-13.0
Emerging markets debt	9.7	13.7	22.2	11.6	10.3	9.9	6.2	-12.0	29.8	12.2	7.3	17.4	-5.3	7.4	1.2	10.2	10.3	-4.3	15.0	5.3	-1.8	-17.8
Floating rate debt	3.3	2.6	9.8	5.3	5.3	6.9	2.0	-29.3	52.5	10.4	1.5	9.8	5.4	1.8	0.1	10.4	4.3	0.6	8.7	3.5	5.4	-0.6
High-yield bonds	4.5	-0.5	28.0	10.9	2.8	10.8	2.5	-26.1	58.1	15.1	4.4	15.5	7.4	2.5	-4.6	17.5	7.5	-2.3	14.4	6.1	5.3	-11.2
Convertible securities	-4.4	-8.6	27.1	9.6	1.0	12.8	4.5	-35.7	49.1	16.8	-5.2	15.0	24.9	9.4	-3.0	10.4	13.7	0.2	23.2	46.2	6.3	-18.7
Preferred shares	9.8	7.7	9.4	5.1	1.0	8.1	-11.3	-25.2	20.1	13.7	4.1	13.6	-3.7	15.4	7.6	2.3	10.6	-4.3	17.7	6.9	2.2	-14.6
Equities	-11.9	-22.1	28.7	10.9	4.9	15.8	5.5	-37.0	26.5	15.1	2.1	16.0	32.4	13.7	1.4	12.0	21.8	-4.4	31.5	18.4	28.7	-18.1
DISPERSION OF RETURNS	21.7	35.8	24.6	7.3	9.3	11.5	18.3	42.2	52.2	10.3	13.0	13.2	37.7	13.6	12.2	15.2	18.3	5.0	22.8	42.7	30.5	18.1

Source: Fidelity Investments Canada ULC, as at December 31, 2022. Indexes: investment-grade bonds, Bloomberg U.S. Aggregate Bond Index; emerging markets debt, JPM EMBIG; floating rate debt, Morningstar LSTA U.S. Performing Loans Index; high-yield bonds, ICE BofA U.S. High Yield Constrained Index; convertible securities, ICE BofA All U.S. Convertibles Index; preferred shares, ICE BofA Fixed Rate Preferred Securities Index; equities, S&P 500 Index. Returns in U.S. dollars.

Because rising rates often increase the volatility of stocks, they also create opportunities in convertible bonds. Convertibles not only pay interest but also reduce some of the potential drawbacks of both stocks and longer-duration bonds: convertible bonds are generally less sensitive than high-yield or other bonds to the risks posed by higher interest rates. Convertible prices can fall if interest rates rise and stock prices decline, but they are less sensitive to such changes than both stocks and traditional corporate bonds. However, the convertible bond market is both small and specialized, and conditions in it can change quickly.

Investment-grade bonds are offering historically attractive yields: in some cases, investors can get 5% to 6% on some shorter-dated investment-grade corporates of blue-chip companies, and closer to 7% on longer-dated bonds from those companies. Investment-grade bonds also present relatively little credit risk. Even if the economy gets worse, investors could still earn income, with lower volatility than stocks.

Preferred stocks issued by big banks and utilities also offer an attractive alternative to the common stocks issued by the same companies. Preferreds are investment-grade-rated assets that offer income and potential capital appreciation regardless of what happens to the underlying common stocks. They are also currently paying yields up to three times that of those stocks.

What do our equity portfolio managers expect in 2023?

For active managers, periods of volatility create opportunities to purchase stocks that may be mispriced due to fear rather than fundamental reasons. Here are some areas of opportunity our equity managers are focusing on in 2023.

Canadian equities

Going into 2023, Portfolio Manager **Dan Dupont** believes that tightening monetary policy and the potential for an ensuing recession could continue to have a variety of short-term impacts on the market. It is difficult to predict market movements accurately; instead, Dan remains focused on positioning his portfolios to be prepared for a variety of market outcomes.

He notes that in 2023, the focus will likely shift toward corporate profitability and individual companies' ability to mitigate these impacts effectively to ensure their long-term profit generation. As markets continue to balance the effects of tightening monetary policy with inflationary concerns, Dan is focusing on valuation dislocations – both long and short opportunities – that may present themselves amidst increasing volatility. He believes this environment to be favourable for active stock pickers, and emphasizes the importance of selecting stocks as opportunities arise.

Portfolio Manager **Don Newman** notes that the market environment remains delicate. Despite inflation coming off from its peak, it remains elevated, and interest rates could stay high for longer. With excess liquidity continuing to come out of the system because of tighter monetary policy, the global economy has begun to slow down, as anticipated. In an environment of interest rates higher than they have been for years, along with continued inflationary pressure, dividend-paying equities remain attractive.

Don notes that markets do not like uncertainty; aggressive inflation came as a surprise to many in 2022, contributing to a volatile environment. However, the central bank's policy rate is potentially approaching close to its terminal rate, and this has started to provide a bit more certainty in the market. Although continued periods of volatility are likely, Don notes that valuations have become more reasonable and, in certain cases, even compelling. He remains aware of the effects of valuation compression and earnings quality. Don continues to invest prudently, focusing on the strength of balance sheets and overall business quality.

U.S. equities

Portfolio Manager **Will Danoff** notes that higher interest rates generally present challenges for stock valuations, especially for stocks that are more reliant on longer-term future cash-flow expectations (e.g., long-duration growth), because a higher discount rate is used in calculating present values for future cash flows, a metric commonly used by financial professionals for valuations.

Many stocks were down 50% or more in 2022, presenting opportunities for long-term investors. On the optimistic side, Will believes that the bulk of the interest rate moves has taken place, and that the current high rate of U.S. inflation may be peaking. He is monitoring the situation closely and is trying to focus on how much earnings growth will be affected by a potential economic slowdown as we move into 2023, and further out into 2024. Based on the uncertain outlook, he favours profitable companies with strong balance sheets, good free-cash-flow generation, leading and growing market share and experienced and reputable management teams. Will believes that 2023–2024 may provide a better environment for stock selection and exhibit stronger equity market performance overall.

During times of volatility, Will aims to upgrade his portfolio and add to holdings in high-conviction ideas that may be trading at more attractive valuations. Looking ahead, Will sees a tremendous opportunity to analyze thousands of firms in the market and try to determine which will emerge as bigger and more valuable in a few years. It has been a challenging period, but Will has successfully managed through periods of major market and economic disruptions for more than 30 years. He continues to work with the Fidelity research team to capitalize on the current market volatility and seek constructive long-term positions for the Fund.

Global equities

Portfolio Manager **Mark Schmehl** believes that despite continued volatility in global markets, visibility has improved compared with six months ago, with more clarity regarding central bank actions and the state of the economy. Prices for commodities, especially crude oil, suggest we have likely reached peak levels as we begin to see demand disruptions and improving supply responses. Energy prices make a key contribution to headline inflation, which may imply some easing of inflationary pressure going forward, in Mark's opinion. However, it is important to note that this does not necessarily mean inflation will not persist, or that it may not stay higher for longer.

Looking ahead, Mark believes that we will likely be in an inflationary environment with slower GDP growth and higher interest rates for the foreseeable future. It is possible that markets will oscillate, keeping volatility elevated. It is important to analyze companies with a long-term perspective, looking beyond just 2023, and focusing on what earnings could look like in a more normalized environment, in his opinion. Management teams that seek to drive efficiencies and improve profitability can be catalysts for change and could provide attractive opportunities. Against this backdrop, Mark is spending a lot of time looking at long-term secular growers that he believes present good risk/reward over the long term. He is excited about ample opportunities across various sectors and is focusing on the ones that he wants to own when the economy eventually recovers. He plans to make incremental additions to risk, slowly and methodically increasing offensive exposure in his portfolios while trimming defensive names. In his view, markets are forward-looking mechanisms, and often lead actual economic behaviour, so it often pays to become more positive even as economic conditions worsen.

Portfolio Managers **Joel Tillinghast**, **Sam Chamovitz**, **Morgen Peck** and **Salim Hart** manage their funds with macro awareness, but don't position them for a particular macro outcome, because they don't think that will achieve sustainable outperformance.

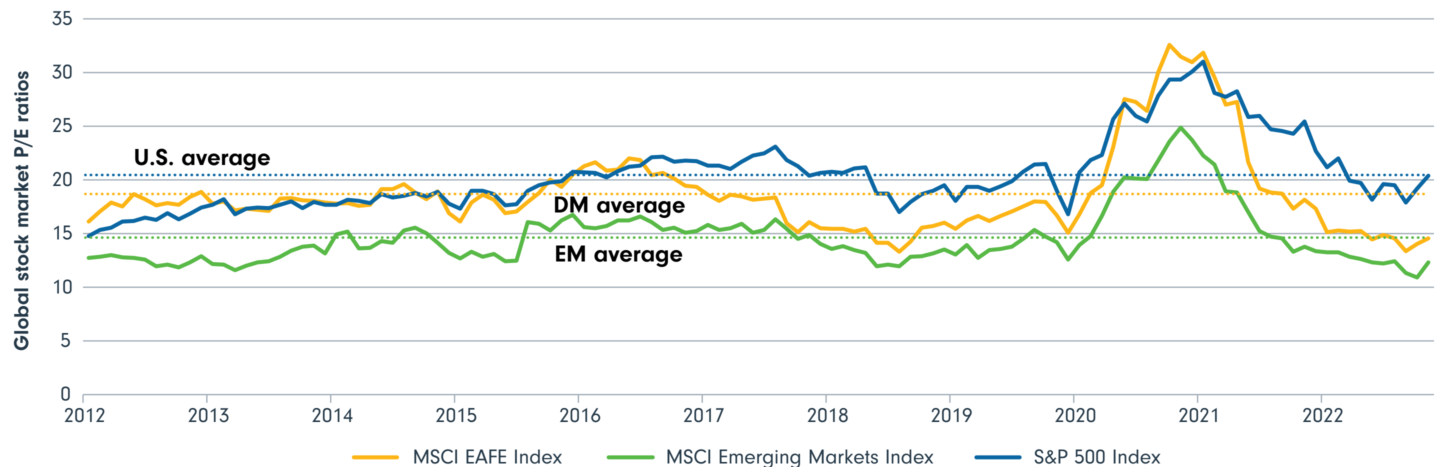
They are concerned that the U.S. may go into a recession because of inflationary pressures and higher rates. Given the strength of the labour market, they don't think it will be as bad as the global financial crisis, but they also know they can't predict the magnitude, duration or timeline of any U.S. recession. The managers also remain worried about the health of the European economy, and especially the U.K., given persistent inflation and a tenuous energy supply situation. Having said that, the markets have sold off meaningfully from prior peaks, and valuations have become more attractive globally, especially in the more cyclical areas.

Stocks increasingly are trading on macro data points, which is causing more stocks to trade at prices below what the managers consider fair value, leading to opportunities. The managers are searching for the stocks that have become the most mispriced but still satisfy their quality criteria. They are slowly leaning into more risk and are finding opportunities in industrials, materials, consumer discretionary and energy, while pockets of health care and consumer staples have become marginally less attractive, given that their defensive attributes are better recognized by the markets.

Emerging markets equities

Although macroeconomic uncertainty continues to persist going into 2023, Portfolio Manager **Sam Polyak** believes emerging market equities may be poised to outperform their developed market counterparts. Along with the diversification benefits emerging markets typically possess, this asset class continues to trade at historically cheap levels, while showing strong corporate earnings growth potential relative to slowing developed equity markets. Developed equity markets, like the U.S., have benefited from stronger earnings growth over the past decade, but profits are widely expected to be challenged as the economy slows due to increased interest rates.

Chart 9: Compressed valuations make emerging market equities more attractive than developed markets equities.



Developed markets (DM), MSCI EAFE Index; emerging markets (EM), MSCI Emerging Markets Index; U.S., S&P 500 Index. Source: Fidelity Investments Canada, as at November 30, 2022.

The potential for a weaker U.S. dollar and prospects for increased growth in cheaply trading emerging economies may provide tailwinds for these securities going into 2023. This presents a unique opportunity to invest in rapidly growing emerging market economies trading at historically cheap levels. The investment landscape remains uncertain, with many central banks continuing to tighten monetary policy and growing fears that it will take a recession to subdue inflation. However, Sam avoids basing his choices on these uncertain macro factors, and focuses instead on discovering a company's fundamental drivers of value. He believes the current short-term uncertainty may lead to security mispricing that can allow emerging market equities to outperform over the long term.

To close

The importance of diversification

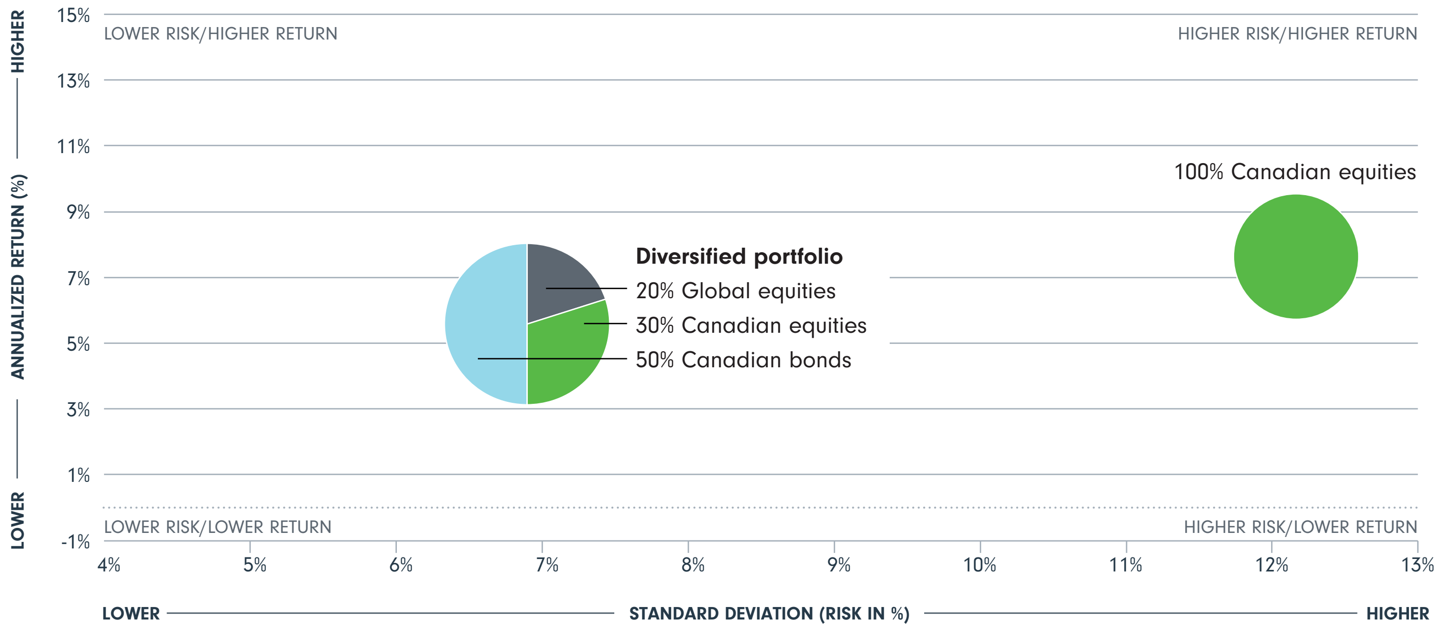
There is a tendency for investors to find, and to pile into, popular investments. That can be great while things are going well, but all companies, sectors, industries and countries go through cycles. When things go south, having an overly concentrated position in any one area of the market can be problematic. This can be seen throughout history, with the most recent examples including technology stocks in the late 1990s, financial stocks during the Great Financial Crisis and broad equity markets in the COVID pandemic.

The best way to protect your portfolio from this risk of over-concentration in one market segment is to have a policy of diversifying across many asset classes. While such a strategy may lead to holding some investment laggards, it may also ensure that you also have relatively high-performing investments within your portfolio as well. This slow-and-steady approach is a sensible way to ride out market volatility.

As the chart below shows, by combining bonds and stocks in your portfolio, you can lower your risk levels, while still adding enough growth to help reach your investments goals.

Chart 10: Diversification = Less risk.

Ten-year risk and return for the period ending December 31, 2022



Source: Refinitiv. Ten years ending December 31, 2022. Canadian equities represented by the S&P/TSX Composite Index. Annualized return: 7.7%; standard deviation: 12.1%. Diversified portfolio represented by 20% MSCI World Index (global equities), 30% S&P/TSX Composite Index (Canadian equities) and 50% FTSE Canada Universe Bond Index. Annualized return: 5.8%; standard deviation: 6.9%. All indexes are based on total return. It is not possible to invest directly in an index. All returns are in Canadian dollars.

For long-term oriented investors, staying invested and being well diversified while not losing sight of your investment goals – is key. Diversification and working with a financial advisor can help manage short-term risks while pursuing long-term investment goals.

For more information, please visit **fidelity.ca** or contact your Fidelity team.

As at December 31, 2022.

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