Fixed Income
PERSPECTIVES

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The big story

> "For now, our take remains to hold off on bold asset allocation moves in terms of duration and risk sectors."

Navigating bond markets with too short an investment horizon risks portfolio whipsaws and dealing with fierce, sometimes counterintuitive, market moves. For now, our take remains to hold off on bold asset allocation moves in terms of duration and risk sectors. However, we are certainly ready to lean in and pick away at the bond market – taking a gradual contrarian approach – because government and risk sector yields have jumped to useful levels of correlation and total returns. A short-term perspective remains necessary largely because central bankers have chosen to be "now-casters" instead of "forecasters": they are essentially groping in the economic fog, hoping, rather than expecting, to avoid the policy error of doing too little, and allowing persistent inflation, or too much, and driving a deep economic recession.

Looking longer-term, we think a demographic lens is useful. The G10 population is aging rapidly, work force sizes are mostly in secular decline, and many countries now face sizeable population declines. Consequently, in the long term, it is hard to see rapid GDP growth in any G10 country, based on demographics. And since historically real GDP growth and real bond yields have been linked, a demographic perspective makes it difficult to expect runaway real interest rates. This should create a downward bias for long-term government real yield expectations.

U.S. Federal Reserve (the Fed)

Fed Chair Jerome Powell is done with forward guidance, although he did assert that the Fed funds rate is already neutral. His credibility on this will depend on the data over the next few months. He also suggested that quantitative tightening may not be a near-term event, and even suggested the balance sheet could stay very large into the future. Interest rates and risk markets liked what they heard from the Chair – but all of these assertions will need to be validated by actual lower and lower CPI.

European Central Bank (ECB)

President Christine Lagarde has all but committed to a minimum interest rate hike of 50 basis points (bps) in September and, for now, seems comfortable with further hikes later this year. The ECB has also committed to do "whatever it can" to keep sovereign and corporate borrowing costs within a tolerable range of the euro risk-free rate, referring to the fact that the ECB's so-called Transmission Protection Instrument (TPI) will step in to purchase bonds on any undue de-anchoring of credit spreads, on the condition that governments within the TPI's jurisdiction are meeting their fiscal and economic commitments to the European Union[1].

Will that be enough, and can the ECB continue hiking? Answers to both questions may appear quickly, with an energy crisis hitting the economy hard during the third quarter and beyond, and with elections in Italy scheduled for September 25.

1 European Central Bank

Bank of Japan (BoJ)

BoJ Governor Haruhiko Kuroda continues to repress ten-year JGB yields, which has led to a large decline in the yen relative to the U.S. dollar. For now, the BoJ is comfortable importing U.S. inflation, and Japan's CPI recently crossed 2%[2].

People's Bank of China (PBoC)

Real estate excesses continue to plague the economy, along with COVID-related lockdowns. It is hard to envision a fast-growing China in the future, based on demographics and heavy consumer debt loads. Targeted interest rate cuts will continue as needed. Could the currency also devalue some to recognize the yen move?

Valuations

- **Leveraged loans:** We are maintaining our overweight position. Fixed income markets rallied in July, including the leveraged loan sector, due to tighter spreads. This is still the top-performing asset class year-to-date. The benefit of the floating rate structure is playing out as short-term rates rise, thereby increasing coupon payments. Spreads are still attractive given the low default environment. Our position is paired with long duration Treasury exposure for flexibility in gaining exposure to risk factors.
- **High yield:** High-yield bonds bounced in July, posting returns of 6%, due to lower Treasury yields and tighter spreads[3]. Expected default rates have not increased meaningfully, and spreads had widened to the top quartile, making sector beta look appealing, but with spreads now retracing to the median, we will wait for another opportunity to add. We will continue to focus on select BB-rated issuers with strong or improving fundamentals. We maintain ample dry powder, by way of our Treasury allocation, to buy on significant weakness.
- **U.S. investment-grade corporates:** We are underweight. This sector remains one of the worst fixed income performers, down 12% year-to-date[3]. We have found some compelling opportunities in the new issue market, primarily in the BBB-rated space, but are not adding generic beta, with spreads still at the long-term median, well inside recessionary levels.
- **International credit (hedged):** We are maintaining our overweight exposure. The market quickly priced in a more hawkish ECB and a weaker European economy, causing international credit to significantly underperform the U.S., but some of the underperformance was offset by a strong showing in July. Increased spread dispersion still provides opportunity for alpha from security selection, and hedging provides some positive carry. We prefer shorter-duration BBB-rated industrials and, farther down in the capital structure, exposure to financials. Hedged yield is becoming enticing.
- **Emerging markets debt:** We continue to have highly selective exposure to emerging markets debt, and no direct exposure to Russia or Ukraine. Emerging markets debt remains the worst-performing asset class year-to-date, posting a 16% loss[3]. In addition to the impact of Russia and Ukraine, popular indexes are of high quality and long duration; consequently, they have a high degree of correlation to Treasuries, and have underperformed year-to-date. We are focused on large, liquid, BB- and BBB-rated sovereign, quasi-sovereign and corporate issuers. Most exposure is U.S. dollar-denominated, or hedged, to control volatility.
- **U.S. TIPS (Treasury Inflation-Protected Securities):** With the Fed's singular focus on taming inflation through aggressive monetary policy gaining credibility, break-evens have fallen and are approaching the lowest levels of the year. Real rates are closer to fair, with five-year and longer yields holding in positive territory.
- **Structured product:** We are adding exposure selectively. After trading at pre-COVID levels for most of this year, most sectors widened in May and June, including AAA- and AA-rated CLOs, conduit and SASB CMBS, and other ABS subsectors such as aircraft and whole business securitizations, and are starting to look interesting again. Like other sectors, structured product experienced something of a relief rally in July. We are adding selectively.

2 Bloomberg

3 Fidelity Investments Canada.

- **Agency MBS:** The potential impact of Fed tapering and quantitative tightening remains to be realized. The negative convexity and sensitivity to volatility of this sector is in focus, because rising base rates have caused the duration/interest rate sensitivity of MBS to increase.
- **Duration/curve:** We are currently short of the benchmark and have tactically moved duration around, given large swings in Treasury yields. With noise in the components of nominal rates (real rates and break-evens), we expect slightly higher Treasury yields, although the potential future path for longer-term rates is certainly more balanced, with scenarios for lower rates emerging. The diversification benefits of longer-duration Treasuries have improved, and they should provide some protection in a higher-volatility market environment.

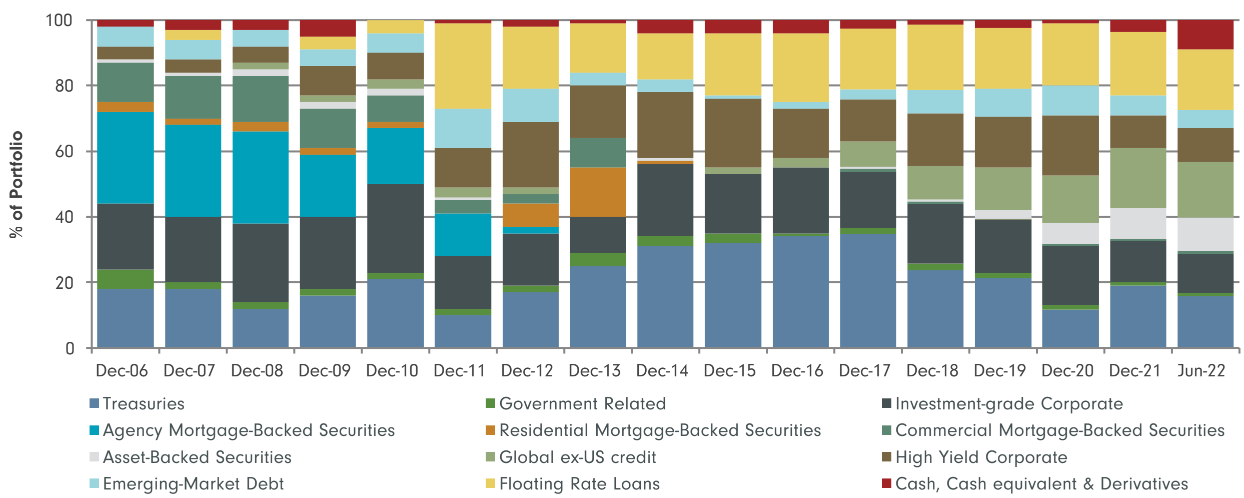
Performance

As at July 31, 2022	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	-1.1	-8.3	-8.4	-2.9	-0.5	1.7	1.8
Fidelity Investment Grade Total Bond CN Fund – Sr. F	-1.0	-9.1	-9.7	-3.9	-0.2	–	1.0
Fidelity Global Core Plus Bond ETF	-1.4	-8.4	-8.3	-2.7	–	–	-0.7
Fidelity Global Investment Grade Bond ETF	-1.6	-8.7	-9.0	-3.9	–	–	-2.4
Fidelity Tactical Credit Fund – Sr. F	-1.6	–	–	–	–	–	-4.3

Source: Fidelity Investments Canada ULC. Performance shows annual compounded returns as at July 31, 2022, net of fees, in Canadian dollars.

* Since-inception date for Fidelity Multi-Sector Bond Currency Neutral Fund is May 10, 2017. Since-inception date for Fidelity Investment Grade Total Bond Currency Neutral Fund is January 24, 2018. Since-inception date for Fidelity Global Core Plus Bond ETF is September 20, 2019. Since-inception date for Fidelity Global Investment Grade Bond ETF is June 5, 2020. Since-inception date for Fidelity Tactical Credit Fund is January 25, 2022.

A flexible approach to fixed income: Fidelity Tactical Bond Composite (the U.S. Fund) historical exposure



Source: Fidelity Investments Canada ULC. As at June 30, 2022. The historical exposures shown are those of Tactical Bond Composite (the U.S. Fund) as at June 30, 2022. The U.S. Fund is not available to Canadian investors. The exposures of the U.S. Fund should not be interpreted as those of Fidelity Multi-Sector Bond (the CDN Fund), which is available to Canadian investors. The exposures shown above are used to illustrate the historical allocation changes to the portfolio over the period shown above. It is not meant to illustrate allocation or exposures within the CDN Fund, which follows a substantially similar investment approach. While the CDN Fund follows a substantially similar investment approach to the U.S. Fund, the CDN Fund may hold different investments and have different geographic exposures. In addition, the U.S. Fund and CDN Fund are subject to, among other things, different regulatory and tax rules, fee structures, timing of trades and investment restrictions. These and other factors will cause the U.S. Fund and the CDN Fund to have different returns. **Benchmark: Bloomberg U.S. Aggregate Bond Index.**

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