Fixed Income
PERSPECTIVES

Jeff Moore, Portfolio Manager | **Michael Plage**, Portfolio Manager

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The big story

> "We have added a significant amount of duration over the month of November, using our elevated cash position as a source of funding."

This is the bond market pivot you have been expecting. November was a near-historic high total return month, with the U.S. yield curve "bull flattening." Many bond sectors saw spreads tighten, in addition to lower interest rates. Notable outperformance came from municipal debt, investment-grade corporate debt and mortgages. The catalyst for the rally was a better-than-expected CPI print in October. That was followed up by lower commodity prices and a sense that jobs data were weakening, if ever so slightly. Break-evens for inflation-protected bonds are now 2.5% or lower for almost every maturity.[1]

Our simple assessment is that the highs for U.S. Treasury yields have been reached. However, a surprisingly high CPI print in December (which is not our base case scenario) would lead to potentially violent repricing in the bond market.

We have added a significant amount of duration over the month of November, using our elevated cash position as a source of funding. We do not expect the U.S. Federal Reserve (the Fed) to cut interest rates any time soon. Consequently, we continue to favour a combination of floating rate notes and ten-year key rate risk.

This is not a replay of 2008, but we do expect the risk of interest rate resets to be a headwind for earnings in some U.S. sectors. At the same time, stress for some entities is very possible. U.S. households are in a strong position to weather a reset, since mortgages are now fixed in rate, set for many years and "conforming" (a code for reasonable loan-to-value ratios). Ultra-low mortgage rates for U.S. borrowers are effectively an equity injection. The rest of the world, however, is the risky spot where the chance of an interest rate reset is high. Canada, the U.K. and some eurozone nations are vulnerable.

U.S. Federal Reserve

Fed Chair Jerome Powell has not pivoted but he has downshifted forward rate expectations, and just a few more hikes are needed. Our concern is that a big CPI print miss would force him to reassess this position.

European Central Bank (ECB)

Inflation may only roll over from the second quarter of 2023, while policy rates will only become restrictive later this month. With elevated wage growth expected in 2023 and beyond, the ECB will feel it has more tightening to do, despite member economies beginning to slip into recession from this quarter onwards.

1 Federal Reserve Bank of St. Louis, 30-year Breakeven Inflation Rate [T30YIEM], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/T30YIEM, December 21, 2022.

People's Bank of China

Stimulating real estate assets while not driving other asset prices is a high-wire act. In the near term, the pace of economic reopening will determine the growth narrative.

Bank of Japan (BoJ)

BoJ Governor Haruhiko Kuroda has held the line and seems to have won the day. The yen is rallying hard versus the U.S. dollar.

Valuations

- **Leveraged loans:** We are maintaining our overweight position. Floating rate paper continues to reset higher as the Fed hikes interest rates, but we are starting to think about reinvestment risk. Spreads are still attractive, given our expectations of defaults in the coming year.
- **High yield:** We are maintaining our modestly overweight position. The high-yield market continued its strong performance in November, with spreads tightening through the median of the past decade. At this time, we remain focused on unique credit ideas, as opposed to generic beta.
- **U.S. investment-grade corporates:** We are underweight. As with high yield, we are focusing on unique stories that our credit analysts and trading desk recommend for their upside value and strong fundamentals. Generic beta is less compelling, as spreads have recovered to median levels.
- **International credit (hedged):** We are maintaining our overweight exposure. The bulk of our holdings is made up of European investment-grade entities with significant balance sheet manoeuvrability. Spreads are cheap relative to historical standards and U.S. corporates, having widened year-to-date on super-high European inflation, hawkish ECB rhetoric and the near certainty of a European recession.
- **Emerging markets debt:** We continue to have highly selective exposure to emerging markets debt, and no intention to add to it in any material way. Our focus is on local-currency issues in a few specific countries (such as Mexico) and on unique country and corporate stories.
- **U.S. TIPS (Treasury Inflation-Protected Securities):** We do not have any exposure. The TIPs market believes either that the Fed will win the inflation fight or that the illiquidity of the sectors is driving down prices. Either way, we will wait for a better entry point.
- **Structured product:** We are overweight. We favour AAA- and AA-rated CLOs for floating rate income and their relative defensiveness. We are adding aircraft ABS and various franchise ABS. Traditional auto and credit card ABS are too tight. CMBS issuance is relatively light as of late, but there are some single asset, single borrower (SASB) opportunities.
- **Agency MBS:** We have no exposure. Sector spreads have snapped back after significant underperformance, reaching one of the widest levels in history, along with nearly full duration extension. No coupon is currently prepayable.
- **Duration/curve:** Yield curve inversion should be nearly complete, in our view, and we could soon move from flattener to steepener. The key data will be the December CPI that immediately precedes the last FOMC meeting of the year. We have added duration, but remain cautious about adding very much interest rate sensitivity until it is clear that inflation is trending lower. For asset allocators, longer-dated U.S. Treasuries offer more useful negative correlation and event risk/insurance today than one year ago, especially as the Fed funds rate approaches a "neutral" level.
- **Non-dollar:** The U.S. dollar juggernaut continues. We are very cautious about non-dollar risk, because we think that some of the recent U.S. dollar strength is secular and could persist for a period of time, notably as U.S. interest rates stay high compared with rates in the rest of the world.

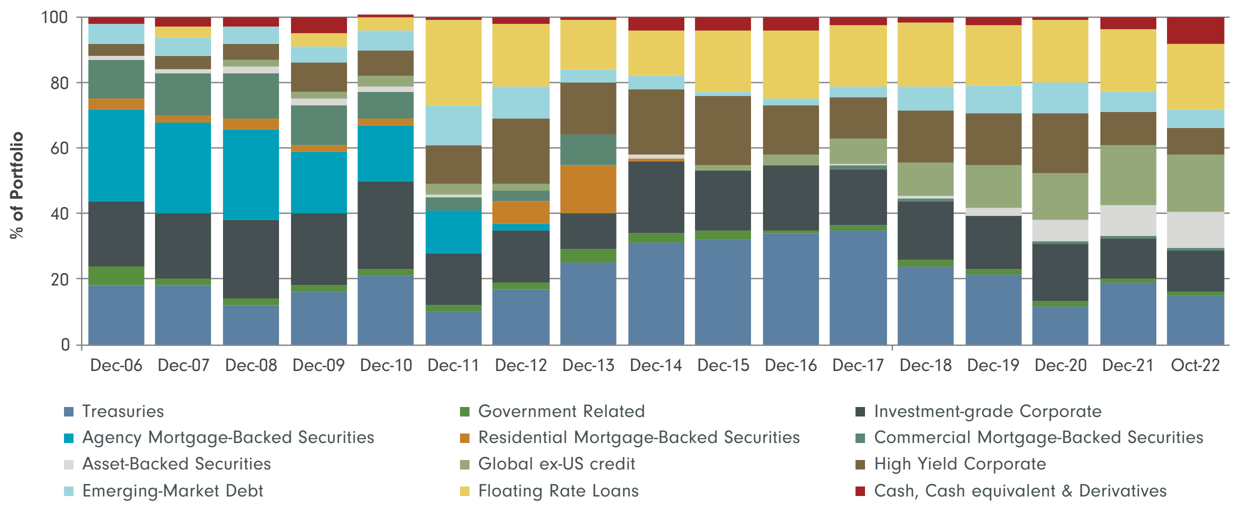
Performance

As at November 30, 2022	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	-1.4	-10.8	-10.7	-4.9	-1.1	1.0	1.2
Fidelity Investment Grade Total Bond CN Fund – Sr. F	-1.6	-12.0	-11.9	-5.9	-1.9	–	0.3
Fidelity Global Core Plus Bond ETF	-1.1	-10.4	-10.1	-4.6	-1.6	–	-1.3
Fidelity Global Investment Grade Bond ETF	-1.6	-11.7	-11.4	-6.0	–	–	-3.4
Fidelity Tactical Credit Fund – Sr. F	-0.7	–	–	–	–	–	-5.3

Source: Fidelity Investments Canada ULC. Performance shows annual compounded returns as at November 30, 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 October 31, 2022. The historical exposures shown are those of Tactical Bond Composite (the U.S. Fund) as at October 31, 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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