Fixed Income
PERSPECTIVES

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The big story

> "Inflation is the key known unknown for 2023."

The bond market pivot that started early in the fourth quarter of 2022 has now generated an impressive 6.5%-plus portfolio return for Fidelity Multi-Sector Bond Currency Neutral Fund. The U.S. Federal Reserve (the Fed) has not yet pivoted and is unlikely to do so in the next few months, regardless of unemployment and inflation data. The 5,000-simulation model our quantitative team uses forecasts a 50% probability of a 2.5% or greater total return over the next three months. In contrast, in July 2021 the model placed the probability of a negative return at 40%. The base case in the simulation has radically changed due to the move higher in government yields and the decline in forward volatility.

Inflation is the key known unknown for 2023. Our macro team believes that peak inflation occurred in the second half of 2022. Using a ski analogy, the question now is, what is the downhill slope? Are we on a green or blue run, with a relatively gentle decline in CPI, or on a black diamond run, with a rapid CPI retrenchment? Goods inflation has rolled over and supply chains are no longer a source of anxiety. Commodity prices have likewise rolled lower and, for now, are stable. Consequently, the two key unknowns are the paths of wages and of owners equivalent rent (OER).

One sensitivity analysis conducted by our macro team is based on holding OER growth at either 5% or 1%. The 5% OER scenario suggests a green or blue slope for inflation. This would require the Fed to keep rates near the current highs for a long period, and it would be broadly supportive of a ten-year U.S. Treasury yield of 4% or so. The 1% OER scenario, in comparison, suggests the U.S. could face disinflation as early as the third quarter of 2023. This would be very supportive of lower yields and, all else equal, would likely raise the pressure on the Fed to pivot.

U.S. Federal Reserve

There has been no change to the Fed's stance. There are likely to be two more interest rate hikes, but no formal pivot. The Fed will wait and see the path inflation takes.

European Central Bank (ECB)

There has been no change in stance for the ECB either. There are more rate hikes to come, but the total amount will depend on the inflation path. ECB President Christine Lagarde is hopeful the eurozone can skirt recession. The euro is well supported, compared with the U.S. dollar.

People's Bank of China

A slow economy and having far too much real estate as a share of GDP are the main challenges. Population decline and slowing urbanization could pose significant labour force challenges. However, lower commodity prices are helpful for the currency.

Bank of Japan (BoJ)

The pivot away from yield curve controls has begun, but on a pace set by BoJ Governor Haruhiko Kuroda. Higher interest rates are in the offing. Analysts are watching for a change in BoJ leadership. The yen is well supported, compared with the U.S. dollar.

Valuations

- **Leveraged loans:** We are reducing our large overweight position. Loans were the best-performing sector over the past year: the floating rate structure is less sensitive to changes in long-term rates, and rising short-term rates increase coupon income. These advantages diminish as the Fed approaches the end of its rate hiking cycle. Higher debt service is a marginal negative for credit fundamentals, but we still expect defaults to remain low.
- **High yield:** We are adding to our position relative to leveraged loans. Spreads are only fair, but all-in yields for the asset class are attractive. High yield is benchmarked to the belly of the curve (three to ten years), so this sector fits within our overall duration exposure targets. Fundamentally, we expect defaults to remain low, with no industry exposed top to bottom; rather, the bottom few names in each industry may be at risk in the next downturn, which reinforces our preference for BB- and B-rated issuers.
- **U.S. investment-grade corporates:** We are underweight. This sector's recent outperformance seems driven by inflows to bonds, and will remain technically influenced for the near term. Our exposure is limited to our best BBB-ideas with identifiable catalysts for spread compression. There are better opportunities in high yield and loans at this juncture, in our view.
- **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 still relatively cheap, even after recent outperformance. We are watching regional inflation and for any divergence between the Fed and the ECB for potential asset allocation opportunities.
- **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 a few local-currency issues in a few specific countries (such as Mexico and Brazil) and on unique country and corporate stories.
- **U.S. TIPS (Treasury Inflation-Protected Securities):** We do not have any exposure and no plan to add any. The TIPs market believes either that the Fed will win the inflation fight or that the illiquidity of the sectors is driving down prices. Break-evens are below 2.5% across the curve.
- **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. Securitized sectors have outperformed recently.
- **Agency MBS:** We have no exposure. Sector spreads have snapped back after significant underperformance, reaching one of the widest points 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 monthly CPI prints and FOMC rate decisions and forecasts. 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 as the Fed funds rate approaches a "neutral" level.
- **Non-dollar:** The U.S. dollar has weakened with the slowing pace of Fed hikes and more hawkish central banks in other developed markets. Interest rate parity is driving currency volatility for now, which is elevated relative to fixed income markets.

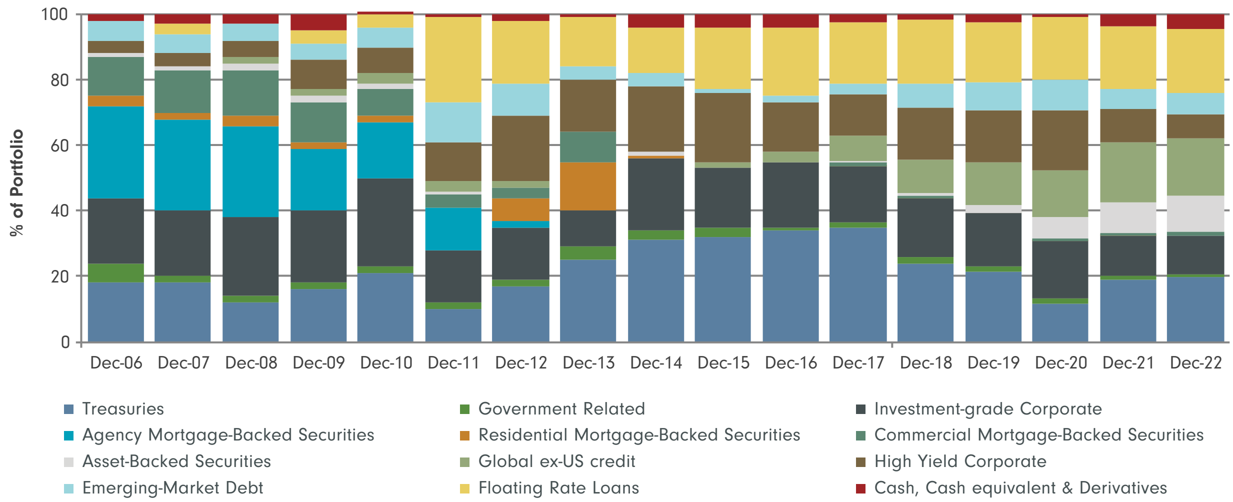
Performance

As at January 31, 2023	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	6.4	3.6	-6.9	-3.6	-0.9	1.6	1.7
Fidelity Investment Grade Total Bond CN Fund – Sr. F	6.6	3.5	-7.9	-4.5	-1.6	0.9	0.9
Fidelity Global Core Plus Bond ETF	6.7	3.6	-6.2	-3.1	-1.3	–	-0.4
Fidelity Global Investment Grade Bond ETF	5.7	2.9	-8.3	-4.5	–	–	-2.3
Fidelity Tactical Credit Fund – Sr. F	4.7	3.1	-2.6	–	–	–	-2.8

Source: Fidelity Investments Canada ULC. Performance shows annual compounded returns as at January 31, 2023, 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 December 31, 2022. The historical exposures shown are those of Tactical Bond Composite (the U.S. Fund) as at December 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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