Fixed Income
PERSPECTIVES

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The big story

The year 2023 begins with debt market yields at ten-year highs and arguably as compelling as at any time in the past 30 years. Debt yield is again very useful relative to the S&P 500 earnings yield (just the inverse of P/E), which is to say that the tool of cross-asset class diversification is likely available again.

"To realize the very high annual total return bond scenarios, our macro and sector teams say, a steep and persistent decline in realized inflation is a necessary, although not sufficient, condition."

Fidelity Multi-Sector Bond Fund's gross portfolio yield is over 7%. Food for thought: every quarter we have a positive return "head start" of more than 1.5% income. We consider this head start against a bevy of portfolio price-movement scenarios (step three of our five-step process). For example, in June 2021, our proprietary simulation model predicted that the probability of a negative quarterly return in bonds was almost 40%. Today there is just over a 10% probability of a negative return. Similarly, the probability of an annualized quarterly return of at least 10% for the year in bonds was 12% starting in mid-2021. It is now just over 50%.

To realize the very high annual total return bond scenarios, our macro and sector teams say, a steep and persistent decline in realized inflation is a necessary, although not sufficient, condition. The bond market expectation is that the U.S. Federal Reserve will have inflation back to 2% in two years. Our teams caution that there are still many other possible inflation paths, which means that every month the bond market needs to "check in" with monthly inflation data. And the process of checking in will continue to induce volatility.

To realize annual negative return bond scenarios, our macro and sector teams suggest, a combination of radically off-course inflation and/or significant spread widening could do the trick. Risk markets such as high yield, bank loans, investment-grade corporate debt and structured product are nearer the middle of the historic spread range. Tail risk is not priced in. The markets seem to have bought a soft landing, for now.

U.S. Federal Reserve (the Fed)

Fed Chair Jerome Powell is guiding to 25-basis-point moves from this point on, and the market expects only a few more. We think the Fed will act coincidental to inflation data and financial conditions. In the short term, this stance will keep market volatility higher than it will be six months from now.

European Central Bank (ECB)

ECB President Christine Lagarde says more half-point rate hikes are coming, as stickier services inflation in 2023 limits the relief available from the better energy prices we are seeing. Negative interest rates are a distant memory, and quantitative tightening is slated to begin in March. With sovereign issuance also at all-time highs, 2023 could prove a challenging year for any heavily indebted real estate or credit market in the eurozone. For now, the euro is supported by some expectations of rate convergence with the U.S. and short-term balance of payments relief. However, these factors may yet reverse, if greater contractionary forces catch hold in Europe, or energy import bills head higher again.

People's Bank of China

The next six months or so will be dominated by the impact of the post-COVID reopening. In the longer term, the outlook for China GDP is daunting, given terrible demographics and too much real estate exposure.

Bank of Japan (BoJ)

BoJ Governor Haruhiko Kuroda has started the process of raising interest rates. Inflation in Japan remains very low by global standards, so the full extent of the hikes should be limited. The BoJ continues to use quantitative easing extensively for rate control. The yen has a solid base.

Valuations

- **Leveraged loans:** We are maintaining our large overweight position. Loans were the only major fixed income asset class to come even close to breaking even in 2022. Floating rate coupons continue to reset higher with the Fed hikes, 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 has been range-bound since November as spreads drift near the median of the past decade. At this time, we remain focused on unique BB-rated credit ideas, as opposed to generic beta.
- **U.S. investment-grade corporates:** We are underweight. As with high yield, we are focusing on unique BBB-rated stories that our credit analysts and trading desk recommend for their upside value and strong fundamentals. A strong recovery in November held throughout December, with spreads hovering near the median, and offering little upside in aggregate.
- **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, even after outperformance in late 2022.
- **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.
- **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 come off the boil. We are still 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. Interest rate parity is driving the currency volatility for now.

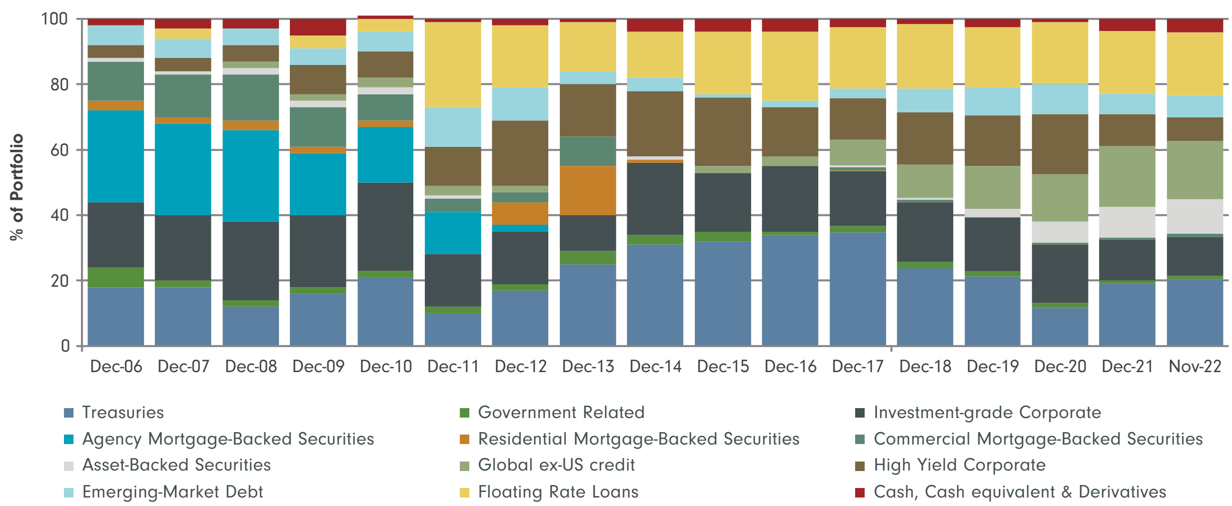
Performance

As at December 31, 2022	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	2.0	-11.4	-11.4	-5.6	-1.5	0.8	1.1
Fidelity Investment Grade Total Bond CN Fund – Sr. F	2.2	-12.5	-12.5	-6.5	-2.2	–	0.2
Fidelity Global Core Plus Bond ETF	2.6	-10.8	-10.8	-5.1	-2.0	–	-1.4
Fidelity Global Investment Grade Bond ETF	1.8	-12.1	-12.1	-6.3	–	–	-3.4
Fidelity Tactical Credit Fund – Sr. F	2.0	–	–	–	–	–	-5.7

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