Fixed Income
PERSPECTIVES

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

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The big story

> **"The market 'fog' that has held us back year-to-date is clearing."**

Why not "ring the bell" and go all in on bond market risk? Yields on U.S. Treasuries, investment-grade credit, mortgages, high yield and global debt now match, or in many cases exceed, the best levels any time in the past ten or more years. Our portfolio yield is approaching 6%, with the year-to-date drawdowns having juiced yield. Higher market yields portend a bond investment return frontier pushing upward, which improves the prospects for compounding, total returns and diversification. We believe the bond market is now poised for positive returns even in a great many adverse stress scenarios. And importantly, the five-year, five-year forward inflation expectation rate touched 2% – exactly in the middle of the Federal Reserve range. Inflation-protected bond break-evens have declined significantly year-to-date, suggesting market confidence in the U.S. Federal Reserve (the Fed)*.

Our delay in adding to duration (we remain well short of benchmark) and to credit risk (our non-investment-grade holdings remain near historic lows and heavily weighted in BB-rated issues) is tactical. The market 'fog' that has held us back year-to-date is clearing. The Fed's shift to focus on lower inflation expectations (remember that last year it had a single-minded focus on lower unemployment) is so complete that success now seems to require evidence of tighter financial conditions. That is, the Fed "put" seen in 2008, 2015, 2018 and 2020 is further out of the money in 2022; consequently, risk assets remain vulnerable to another drawdown, perhaps as recession expectations rise.

U.S. Federal Reserve

The market expects another hike of 75 basis points at the July meeting. From this Fed, what the market wants, it gets. We have made no change to the thesis that Fed Chair Jerome Powell expects tighter financial conditions and higher unemployment as a tradeoff for lower inflation. Quantitative tightening has begun, but is slow in ramping up, so the near-term consequences should be limited to higher rate volatility.

European Central Bank (ECB)

Interest rates in the E.U. have jumped, with a first official rate hike – perhaps 50 basis points – expected in July. The ECB faces a dilemma: the need to raise interest rates, and let the markets price risk, while still "protecting" lending spreads against sovereigns. (In particular, Italian and periphery market access needs to be guaranteed at a maximum spread against Bunds). This central bank two-step will be a headwind for euro strength.

Bank of Japan (BoJ)

BoJ Governor Haruhiko Kuroda has not blinked. He is fully committed to a 25-basis-point cap on the ten-year JGB, despite enormous market selling against him and a jump in imported inflation. The yen has weakened significantly – we are beginning to wonder if there is any yen level that would be too weak for Governor Kuroda?

People's Bank of China (PBoC)

The end of COVID lockdowns could help global supply bottlenecks. The currency has been under downward pressure. While the end of the lockdowns seems likely to improve GDP prospects, the overhang of too much real estate investment and many anti-growth policies will be problematic. The PBoC is cutting interest rates in specific sectors. Inflation in China is not yet the problem the rest of world faces. It's not clear whether a weak yen and won will affect the FX peg.

Valuations

- **Leveraged loans:** We are maintaining our overweight position. Despite a pullback in May and June due to wider spreads, this is still the top-performing asset class year-to-date, demonstrating beneficial loan characteristics such as protection from rising interest rates, due to the floating rate structure; some of the highest yields across fixed income sectors; low realized and expected defaults; and technical demand. Coupons and yield are expected to increase following Fed interest rate decisions. The position also complements our Treasury exposure.
- **High yield:** This sector underperformed over the first half of the year, due to the double headwinds of rising Treasury rates and widening credit spreads. Expected default rates have not increased meaningfully; consequently, beta is starting to look attractive again as all-in yields improve the total return prospects over the next 12 months. 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. The dramatic underperformance of 2021, due to a high correlation to Treasuries in a rising-rate environment, continues in 2022, and U.S. investment-grade corporate bonds remain one of the worst-performing fixed income sectors, down 15% year-to-date.[1] We have, nevertheless, found some compelling opportunities in the new issue market, primarily among short- and intermediate-maturity BBB-rated issues, but are not adding generic beta, with spreads still lower than the long-term median, well inside recessionary levels.
- **International credit (hedged):** We are maintaining our overweight exposure to this sector. The market quickly priced in a more hawkish ECB and a weaker European economy, causing international credit to significantly underperform the U.S. Increased spread dispersion 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 18% loss.* 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 solidly 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, 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. We are adding selectively.
- **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.

1 Fidelity Investments Canada.

- **Duration/curve:** We are currently short of the benchmark, but have added duration, as the ten-year U.S. Treasury remains between 3% and 3.5%*. 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.

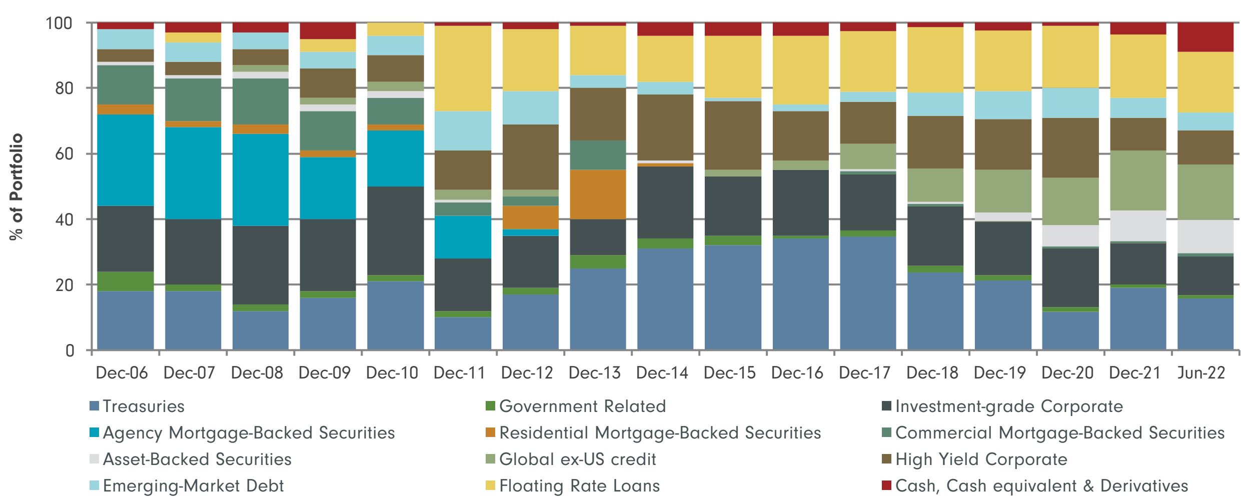
Performance

As at June 30, 2022	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	-6.8	-10.7	-9.9	-2.9	-0.3	1.2	1.3
Fidelity Investment Grade Total Bond CN Fund – Sr. F	-7.1	-11.7	-11.3	-4.2	-1.1	–	0.4
Fidelity Global Core Plus Bond ETF	-7.3	-11.1	-10.1	-2.9	–	–	-1.8
Fidelity Global Investment Grade Bond ETF	-7.2	-11.1	-10.4	-4.2	–	–	-3.7
Fidelity Tactical Credit Fund	-5.4	–	–	–	–	–	-6.7

Source: Fidelity Investments Canada ULC. Performance shows annual compounded returns as at June 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 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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