Fixed Income
PERSPECTIVES

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The big story

Buy the rumour, sell the news. That was the case leading up to, and following, the FOMC meeting on February 1. The market widely expected a downshift in the pace of tightening, which would presumably precede a pause and future cuts. That sentiment, coupled with the consensus view that bonds were cheap, drove bond yields lower to start the year. The meeting marked the local low yield in bonds and the highs in stocks. Since then, however, a string of surprises in economic data (reacceleration of inflation, robust strength in the labour market, no sign of weakness in the consumer) and the accompanying U.S. Federal Reserve mantra "we may have to do more" has reversed the January "everything rally" in stocks and bonds.

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Fixed income plays an important role in an investment portfolio for many reasons, including income, capital preservation and diversification. We continue to find bonds compelling in all three respects. Although stocks and bonds have been positively correlated during the hiking cycle, we see longer-duration Treasury bonds as offering downside protection in tail risk scenarios.

U.S. Federal Reserve (the Fed)

Recent inflections upward in inflation and employment data have spurred renewed hawkish rhetoric from the Fed, and the market consensus seems to be building to at least another 25 basis point (bp) addition to the 5.1% terminal rate. There is increasing noise about a 50 bp hike at the March FOMC meeting, but we think that is unlikely without another round of positive data on inflation and jobs in early and mid-March, respectively.

European Central Bank (ECB)

The ECB is nudging the expected terminal rate up to 3.50% as President Christine Lagarde and the ECB battle persistently hot services prices, amid solid wage inflation and no sign of job layoffs. Quantitative tightening begins this month.

Bank of Canada (BoC)

Financial conditions tightened earlier in Canada, as the Bank of Canada was the most aggressive central bank in the G7, quickly stepping up the pace of interest rate hikes at the beginning of the cycle. The BoC is expected to hold interest rates at 4.5%; the resetting nature of Canadian mortgages makes the Canadian consumer, and the economy, very sensitive to rapid changes in short-term rates.

Bank of Japan (BoJ)

The BoJ will have a leadership handover in April. The current nominee for the Governorship, Kazuo Ueda, will likely bring a fresh pair of eyes to the trade-offs involved in continuing extraordinary policy against what looks to be a changing inflationary backdrop. In the past, and more recently during parliamentary hearings, Ueda has commented on the need to consider the side effects of extraordinary monetary policy. Accordingly, we think it is just a matter of when, and not if, further tweaks will be made to yield curve control, or to find another exit from the current policy. An end to the BoJ's negative interest rate policy might also be considered, but we do not expect rate hikes as part of the base case for now.

Valuations

- **Leveraged loans:** We remain overweight but have significantly reduced our position. Selling off some of the position is more of a yield curve trade than a sector call. We want to add duration, and selling a floating rate sector is an obvious choice. Loans have been among the best-performing sector over the past year as interest rates have risen. Defaults continue to be low in the sector, although we expect the reset higher in yields will be a negative for corporate debt service.
- **High yield:** We are overweight with a focus on BB-rated securities. We are not adding exposure, however, because spreads have rallied to the bottom quartile in terms of valuations. Current fundamentals are supportive of these better-than-average valuations unless the scenario becomes one of a hard landing in the U.S. Our decision to move up in credit quality offers an extra layer of default protection, for the most part.
- **U.S. investment-grade corporates:** We are underweight. Valuations have returned to the bottom quartile. Our exposure is limited to the best BBB-rated 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 overweight but have reduced our exposure. As with investment-grade corporates in the U.S., a rally in international credit spreads has resulted in bottom-quartile valuations. The bulk of our holdings is made up of European investment-grade entities with strong balance sheets.
- **Emerging markets debt:** We continue to have highly selective exposure to emerging markets debt. The resurgence of the U.S. dollar is a significant headwind to this sector. We prefer to pick individual names, and have no exposure to Russia. We own local-currency issues from a few specific countries (such as Mexico and Brazil), partly because of the local central banks' aggressive inflation posture, which mirrors the Fed, but at much higher yields.
- **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 and real estate investments are being considered, but there is a higher hurdle rate than in past years, given interest rate reset risk and changing work preferences. We are interested in 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 continues, while the inflation outlook is unclear, 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 remains strong, although it is off its highest levels. In large part, the BoJ's decision to raise its ten-year yield target (and Governor Haruhiku Kuroda's retirement), as well as the ECB's more aggressive rate stance, has brought about a better "big three" foreign exchange balance. Many emerging market countries will struggle with the strong dollar.

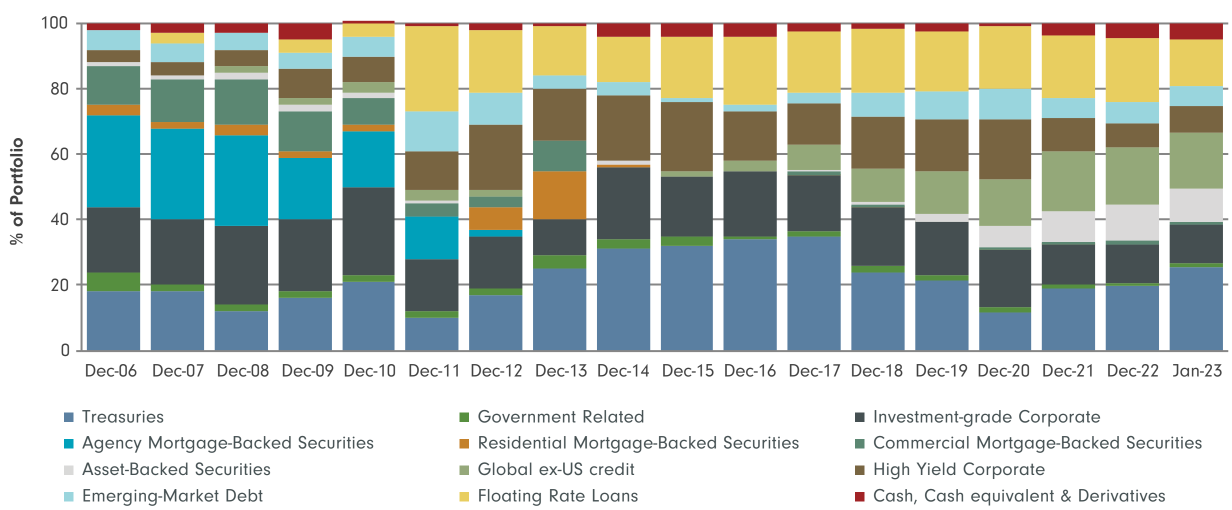
Performance

As at February 28, 2023	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	1.2	1.8	-7.2	-3.9	-1.5	1.4	1.3
Fidelity Investment Grade Total Bond CN Fund – Sr. F	1.0	1.6	-8.2	-4.9	-2.3	0.7	0.5
Fidelity Global Core Plus Bond ETF	1.6	2.0	-6.4	-3.4	-1.8	–	-0.8
Fidelity Global Investment Grade Bond ETF	0.5	1.0	-8.6	-4.8	–	–	-2.9
Fidelity Tactical Credit Fund – Sr. F	1.8	2.2	-2.7	–	–	–	-3.3

Source: Fidelity Investments Canada ULC. Performance shows annual compounded returns as at February 28, 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 January 31, 2023. The historical exposures shown are those of Tactical Bond Composite (the U.S. Fund) as at January 31, 2023. 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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