Fixed Income
PERSPECTIVES

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The big story

"The good news is that we're getting paid to wait: yields across fixed income sectors are as high as they've been since the peak of the global financial crisis."

Are we there yet? Are we there yet? Are we there yet? "Not far now," is the familiar refrain. But that is not what the U.S. Federal Reserve (the Fed) is telling the impatient market. "Not even close," or "We will get there when we get there," may be more accurate. With the data yet to reflect slowing inflation and Fed rhetoric persistently hawkish, we continue to wait. The good news is that we're getting paid to wait: yields across fixed income sectors are as high as they have been since the peak of the global financial crisis. In fact, yields are so high that income can offset price declines in all but the most extreme tail scenarios over a 12-month period. Our analysis also contains scenarios featuring capital gains in addition to elevated income, but in order to achieve that kind of high return outcome, inflation must be contained and the Fed must pivot – and we are not there yet. But don't fall asleep on this journey: stay liquid and nimble, and keep asking, "Are we there yet?"

U.S. Federal Reserve

Although there was no FOMC meeting in October, Fed spokespeople continue to remain aligned on the intention to move policy rates further into restrictive territory, and hold them at high levels for a while. Fed representatives uniformly acknowledge the lag that changes in monetary policy have on the economy, and emphasize their ongoing attention to the data and market conditions. Many board members have started to talk about two-sided risks to the economy, and the natural next step would be to slow the pace of rate hikes, perhaps as soon as in December. The turmoil in the U.K. Gilts market and the potential cumulative impact of a globally synchronized rate hiking cycle must be weighing on the Fed as well. The market is still expecting five or six increases in November and December, and at this point we don't see any reason to think differently.

European Central Bank (ECB)

Inflation remains high and accelerated further in October, with the ECB delivering another 75-basis-point (bp) hike in late October, as expected by the market.[1] Meanwhile, real economy data are generally deteriorating, although there is no sign yet of softening in the all-important labour market. The ECB is expected to hike rates by 75 bps again in December, and may well still be tightening in the first quarter of 2023 as European governments ramp up fiscal spending to limit the ill effects of the energy crisis. The ECB will also be keenly aware of what markets can do to a central bank viewed as being behind the curve, as in the U.K.

Bank of Canada (BoC)

The Bank of Canada surprised with a 50 bps hike, 25 bps less than expected, as growth risks increase.[1] The BoC cut its GDP forecast for 2023 in half, to 0.9%; the economy is expected to stall for the next three quarters due to sharp declines

1 Bloomberg.

in housing activity.[1] Given high debt loads and the shorter-term structure of residential mortgages, Canadians have higher interest sensitivity than their U.S. counterparts. The BoC is very concerned about the lagged impact of cumulative rate increases that now total 350 bps in seven months.[1] The decision in favour of a lower-than-expected rate increase may ultimately have been due to a reduction in inflation projections. In a significant change, headline inflation is now expected to be at 2.8% by year-end 2023, which is inside the 1%–3% inflation control band.

Bank of Japan (BoJ)

BoJ Governor Haruhiko Kuroda continues to repress ten-year JGB yields through the BoJ's yield curve control policy; this has led to a steep decline in the yen against the U.S. dollar that will likely persist so long as U.S. Treasury and JGB rates diverge and oil prices remain elevated. For now, the BoJ is comfortable "importing inflation" through the currency channel; Japan's CPI recently crossed 2%.[1] Meanwhile, to introduce some tension in the yen-U.S. dollar exchange, and perhaps to buy time for a BoJ pivot, Japan's Ministry of Finance has intervened four times since the September FOMC, to the tune of 9.2 trillion yen, by selling U.S. Treasuries and buying yen with the dollar proceeds.[1]

Valuations

- **Leveraged loans:** We are maintaining our overweight position. Floating rate paper continues to reset higher as the Fed hikes interest rate. 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 had a strong October, with spreads tightening through 500 bps. Further tightening is not likely until after a Fed pivot.
- **U.S. investment-grade corporates:** We are underweight. Our focus is on unique stories that our credit analysts and trading desk recommend for upside value and strong fundamentals. Generic beta is less compelling; it is fairly valued, but brings with it significant duration.
- **International credit (hedged**): We are maintaining our overweight exposure. The bulk of our holdings are U.K. and European investment-grade entities with significant balance sheet manoeuvrability. Spreads are cheap relative to historical standards, 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 were under significant pressure in October, with widths not seen in many, many years, but still rich relative to corporate bond peers. No coupon is currently prepayable. We do not expect a material increase in qualitative tightening sales from the Fed balance sheet (a positive for the sector), but there is no compelling catalyst for tighter spreads at this stage.
- **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 November and December CPI numbers. We 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.

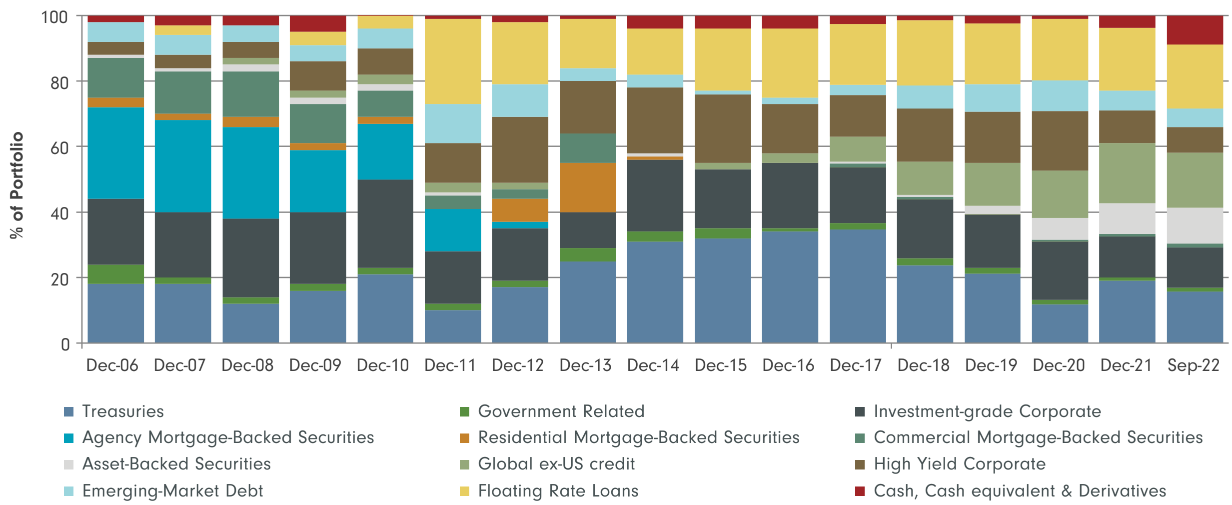
Performance

As at October 31, 2022	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	-5.9	-13.7	-13.5	-5.4	-2.2	0.3	0.6
Fidelity Investment Grade Total Bond CN Fund – Sr. F	-6.5	-15.0	-14.8	-6.5	-3.0	–	-0.4
Fidelity Global Core Plus Bond ETF	-5.4	-13.3	-13.0	-5.0	-2.7	–	-2.4
Fidelity Global Investment Grade Bond ETF	-6.3	-14.4	-14.1	-6.6	–	–	-4.7
Fidelity Tactical Credit Fund – Sr. F	-3.1	–	–	–	–	–	-7.2

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