Fixed Income
PERSPECTIVES

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The big story

September was the worst month for the investment-grade bond market since the 1970s, when Paul Volcker's U.S. Federal Reserve (the Fed) was raising interest rates by multiple percentage points at a time and the Wall Street mantra "Don't fight the Fed" was coined. Perhaps an addendum should be "while the Fed fights inflation," because in both cases the central bank was singularly focused on controlling price increases, despite the potential for disruption in the real economy and the financial markets. For now, as goes inflation, so goes the Fed, and as goes the Fed, so go the markets (equity, credit, rates, currencies, etc.). The important dates this quarter, therefore, are the CPI releases in October, November and December and the Fed meetings in November and December. Given the challenge in forecasting monthly inflation, we expect the historically high level of volatility will continue, and we remain cautious.

> **"For now, as inflation goes, so goes the Fed, and as goes the Fed, so go the markets."**

U.S. Federal Reserve

The concerted narrative, initiated by Fed Chair Jerome Powell in his Jackson Hole speech, is that the Fed will not stop hiking until inflation is under control ("getting inflation back down to 2%"). At the September press conference, Powell emphasized a willingness to inflict economic pain in the process. He was also very forthcoming about the inability of the Fed (or anyone) to forecast where the economy will be a year or more from now, supporting a meeting-by-meeting approach to decision making – and our own one-month-at-a-time approach to managing our funds through this tightening cycle. That said, the market is projecting four or five more hikes this year, and one or two hikes early next year, which is in line with the Fed's median dots.

European Central Bank (ECB)

Inflation has remained high and accelerated in September, with the ECB likely to deliver another 75-basis-point hike in late October, according to market expectations. Meanwhile, real economy data are generally deteriorating, although there is no sign yet of softening in the all-important labour market. The ECB may well still be tightening in the first quarter of 2023, with European governments ramping up fiscal spending to limit the ill effects of the energy crisis, and with it now being clear what markets can do to a central bank – such as the Bank of England – viewed as being behind the curve.

Bank of England (BoE)

The sacking of Treasury officials, followed by a debt-funded fiscal splurge by the new government (with a commitment to do more), has triggered a confidence crisis in U.K. assets. The pound and the prices for U.K. government bonds and U.K. corporate bonds have fallen dramatically since mid-September. The BoE has scrambled to acknowledge market concerns, and is now committed to a "significant policy response" at its early November meeting, which markets now anticipate as being around a 100-basis-point hike. In addition, the BoE has been forced to buy long-dated U.K. government bonds, after hedged carry positions at sterling insurers and pension funds saw massive margin calls in the wake of the gap higher in U.K. rates, which also spilled over into the long end, creating a nasty reverberation. While this "not QE" has managed to send long-dated U.K. rates much lower, and so put such margin requirements more onside, the Bank intends to wrap up these "market-maker of last resort" interventions on October 14. We shall see.

Bank of Japan (BoJ)

BoJ Governor Haruhiko Kuroda continues to repress ten-year JGB yields through a yield curve control policy, which has led to a steep decline in the yen-U.S. dollar exchange rate that will likely persist as long as Treasury and JGB rates diverge and oil prices remain elevated. For now, the BoJ is comfortable importing U.S. inflation (Japan CPI recently crossed 2%[1]). Meanwhile, to introduce some tension in the yen-U.S. dollar cross, and perhaps to buy time for a BoJ pivot, Japan's Ministry of Finance intervened shortly after the September FOMC meeting with a small purchase of yen, using cash at the Fed.

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 modestly overweight and have trimmed our exposure recently. Spreads have rallied significantly over the quarter and are now fair value given expected defaults. We currently favour BB-rated securities over lower quality, as these issues offer an added downside cushion in case of worse-than-expected economic outcomes.
- **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 and have no intentions of adding any, even though long break-evens may fall below 2% soon. The TIPS market either believes the Fed will win the inflation fight or thinks the illiquidity of the sector 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 is 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 September. No coupon is currently prepayable. We do not expect a material increase in QT 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. We could soon move from flattener to steepener. 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 definitely offer potential for high total returns in various recession scenarios. This is an important change from 2021, when longer yields offered limited opportunities for capital gains.

1 Bloomberg.

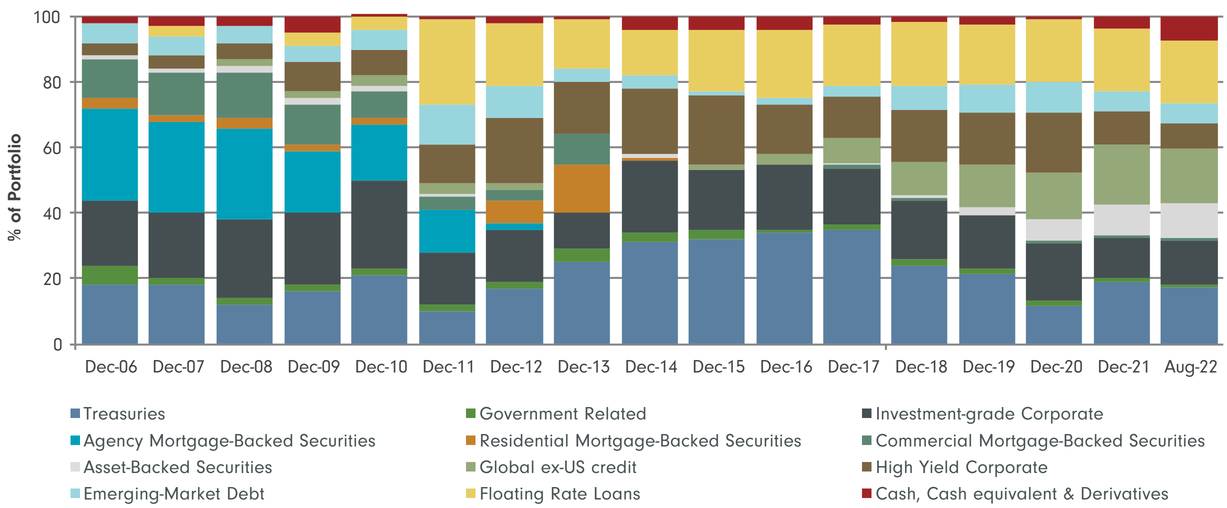
Performance

As at September 30, 2022	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	–2.7	–13.1	–12.7	–5.2	–1.8	0.5	0.7
Fidelity Investment Grade Total Bond CN Fund – Sr. F	–3.0	–14.3	–14.1	–6.3	–2.7	–	–0.3
Fidelity Global Core Plus Bond ETF	–2.1	–13.0	–12.5	–5.0	–2.4	–	–2.4
Fidelity Global Investment Grade Bond ETF	–2.9	–13.7	–13.2	–6.3	–	–	–4.5
Fidelity Tactical Credit Fund – Sr. F	–0.9	–	–	–	–	–	–7.6

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