Fixed Income
PERSPECTIVES

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The big story

The credibility of the U.S. Federal Reserve (the Fed) is essential in its fight against inflation. It shapes the behaviour of consumers and capital allocators and affects growth and corporate profitability.

> **"Until we see clear evidence that inflation is approaching the Fed's target, and the end of the hiking cycle is in sight, we will remain cautious."**

Forecasting inflation is incredibly challenging, so we look to market-implied data and work out scenarios based on that information. The University of Michigan survey has improved, and near-term inflation expectations have fallen, as have the breakeven inflation rates for short-maturity TIPS and inflation swaps: all are well below current CPI and PCE trends, implying the market believes the Fed will be able to bring inflation down at the current projection for the Fed funds rate. In other words, the Fed appears credible.

Our early view that employment will remain strong seems to have become the consensus; consequently, the critical data to watch is the CPI. The CPI needs to trend lower, and quickly, to track market expectations, or else the Fed will lose its current credibility and market expectations will need to shift. Until we see clear evidence that inflation is approaching the Fed's target, and the end of the hiking cycle is in sight, we will remain cautious.

U.S. Federal Reserve

After the July press conference, when Fed Chair Jerome Powell indicated that the Fed funds rate was already in the neutral range, markets rallied on the assumption that a Fed pivot was near. In the days that followed, speeches by other Fed governors and, more importantly, Chair Powell himself, at Jackson Hole, reminded the market that the Fed's job is not done. Inflation remains high, and the Fed will do whatever it takes to bring it down, sending stock and bond prices lower – a stern reminder not to fight the Fed. September also marks the end of the ramp-up period and beginning of a full $95 billion per month in quantitative tightening.

European Central Bank (ECB)

Delivered inflation has accelerated, and expectations have risen in Europe despite the ECB's increasingly hawkish rhetoric. The market is now projecting a higher likelihood that the central bank will increase policy rates by 75 basis points at its next meeting, after discussions of a jumbo hike began at the end of August. The euro seems to have found some support at parity with the U.S. dollar. The eurozone outlook is even more cloudy than the U.S., given the added impact of volatile energy prices on the economy.

Bank of Japan (BoJ)

BoJ Governor Haruhiko Kuroda continues to repress ten-year JGB yields, which has led to a large decline in the yen relative to the U.S. dollar. For now, the BoJ is comfortable importing U.S. inflation, and Japan's CPI recently crossed 2%[1].

People's Bank of China

Real estate excesses continue to plague the economy, along with COVID-related lockdowns. It is hard to envision a fast-growing China in the future, based on demographics and heavy consumer debt loads. Targeted interest rate cuts will continue as needed. Could the currency also devalue somewhat to recognize the move in the yen?

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 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.S. and European investment-grade entities with significant balance sheet maneuverability. 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 direct exposure to Russia or Ukraine. Our focus is on local-currency issues in a few specific countries (such as Mexico) and unique country and corporate stories.
- **U.S. TIPS (Treasury Inflation-Protected Securities):** We do not own any exposure. The Fed is in the inflation fight. TIPS break-evens have been very volatile. The market is struggling with valuation. Separating real interest rates (which could well be negative a long time into the future, based on demographics) from long-range inflation is tricky. Quantitative tightening will be an additional source of uncertainty for the asset class.
- **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. Spreads are too low, and there is potential for quantitative tightening to overhang sector liquidity. The duration/interest rate sensitivity of MBS remains high.
- **Duration/curve:** Continued yield curve inversion remains the most likely near-term outcome. Significant front-end uncertainty exists due to near-term unknowns regarding the Fed and inflation, while longer yields expect much lower future inflation and real interest rates. 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.

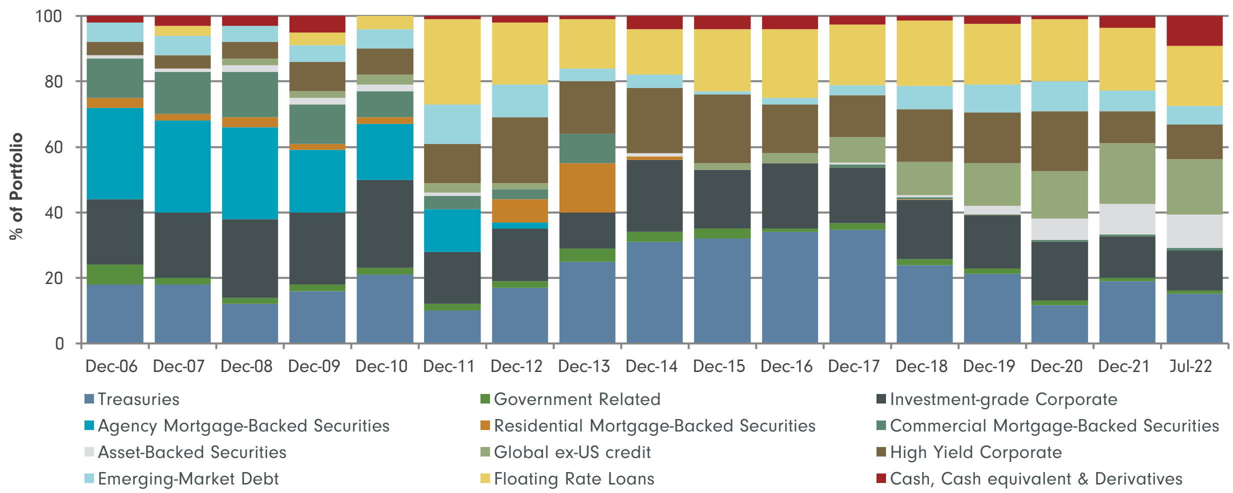
Performance

As at August 31, 2022	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	-1.5	-9.5	-9.8	-3.4	-0.5	1.3	1.5
Fidelity Investment Grade Total Bond CN Fund – Sr. F	-1.7	-10.5	-11.1	-4.4	-1.3	–	0.7
Fidelity Global Core Plus Bond ETF	-1.2	-9.4	-9.5	-3.0	–	–	-1.1
Fidelity Global Investment Grade Bond ETF	-2.3	-10.2	-10.6	-4.5	–	–	-3.0
Fidelity Tactical Credit Fund – Sr. F	-0.9	–	–	–	–	–	-4.7

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