Fixed Income
PERSPECTIVES

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The big story

> "Our take is that we are a large part of the way through the fog."

Investing is daunting in a time of heightened investment fog and on the heels of large drawdowns. Periods like today – or 2018, 2015, 2013 and even 2000, to point out a few – can encourage an intense "win soon" investing attitude. For us, the key to navigating these periods is relying on our multi-disciplined, proven, five-step process and our great confidence and trust in our experienced teammates, who know their jobs and have invested opportunistically, calmly and profitably, through many credit cycles.

As a now distant example, we know that in 2000, on the heels of the U.S. Federal Reserve (the Fed) injecting Y2K liquidity in 1999, the market priced in ten Fed rate hikes, but only six occurred. In the interim, the stock market drew down significantly and high yield and credit spreads widened materially. However, once the height of the market uncertainty was more behind than ahead, total return opportunity arose. Today has very much the same feel: that is, we are trying to figure out how many interest rate hikes will be needed to tighten financial conditions sufficiently that inflation expectations fall sustainably toward historic norms.

Our take is that we are a large part of the way through the fog. Government and credit yields have jumped to compelling levels, and are even a bit cheap, relative to recent history and taking into account many possible quant scenarios. The fog likely still has some near-term room to persist, because the Fed, the biggest buyer, by far, of mortgages, inflation-protected bonds and U.S. Treasuries, is beginning its quantitative tightening.

U.S. Federal Reserve

The Fed delivered what the market wanted in June and hiked interest rates by 75 bps (basis points). Fed Chair Jerome Powell recently met in person with President Joe Biden. Inflation was no doubt front and centre, and our bet is that President Biden will have likely noted, perhaps ruefully, that the fiscal deficit should not be a source of inflationary pressure (that is, he had done his part), since it is back to the normal 4% of GDP, down significantly from the 13% number just a year ago.

European Central Bank (ECB)

ECB President Christine Lagarde has pulled forward rates hikes into the early third quarter. The market expects two hikes in July at the time of writing. Recall that just a few months ago, the market expectation was for one hike late in 2022. Inflation is much more of a structural concern in Europe, with snarled supply chains and surging energy prices.

Bank of Japan (BoJ)

The yen has recently traded as low as 130 to the U.S. dollar, which is unprecedented in recent decades. Governor Haruhiko Kuroda's decision to pin ten-year JGBs at 25 bps is definitely not in sync with the Fed or the ECB. High energy prices, which have eroded much of Japan's trade surplus, are a factor in the yen's weakness.

People's Bank of China

China's GDP growth continues to be revised lower; the first quarter was not impressive. Demographics are a headwind for longer-term GDP growth. The real estate sector is massively overleveraged, such that targeted and tiny interest rate cuts have been made for the sector. The end of COVID lockdowns could help global supply bottlenecks. The currency has been under downward pressure.

Bank of Canada

The Bank of Canada raised interest rates by 50 bps on June 1. It also noted that this pace may not be forceful enough, opening the potential for a 75 bps hike.

Valuations

- **Leveraged loans:** We are maintaining our overweight position. Despite a pullback in May 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 at the start of this 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. A sharp rally in the last week of May points to a positive technical due to pent-up demand and lack of supply. Still, we 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 over 12% 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 beta, with spreads still lower than the long-term median.
- **International credit (hedged):** We are maintaining our overweight exposure to this sector. The market quickly priced in a more dovish ECB and a weaker European economy, causing international credit to 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.
- **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 14% loss[1]. 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):** We have no exposure. Russia-related disruptions in oil and gas supply caused break-evens to widen on expected higher energy prices, but that was relatively short-lived, and they have returned to pre-conflict levels. We are not quite as negative on the asset class now that real rates are positive across much of the curve.
- **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.

- **Agency MBS:** We have no exposure. 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.
- **Duration/curve:** We are currently short of the benchmark, but have added duration as the ten-year U.S. Treasury hangs around 3%, with eight more hikes priced into the market for this year[2]. 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. The diversification benefits of longer-duration Treasuries have improved, and they should provide some protection in a higher-volatility market environment.

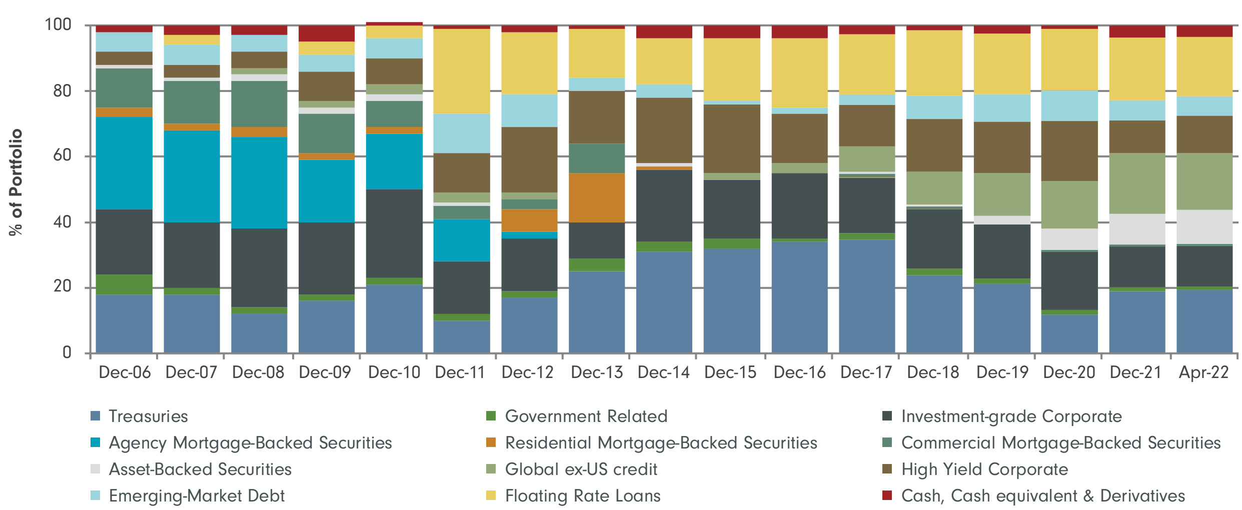
Performance

As at May 31, 2022	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	-5.6	-8.2	-6.3	-0.9	1.2	1.7	1.9
Fidelity Investment Grade Total Bond CN Fund – Sr. F	-6.0	-9.0	-7.6	-2.0	0.4	–	1.1
Fidelity Global Core Plus Bond ETF	-5.6	-8.2	-6.1	-0.8	–	–	-0.7
Fidelity Global Investment Grade Bond ETF	-5.4	-8.1	-6.3	–	–	–	-2.3

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

A flexible approach to fixed income: Fidelity Tactical Bond Composite (the U.S. Fund) historical exposure



Source: Fidelity Investments Canada ULC. As at April 30, 2022. The historical exposures shown are those of Tactical Bond Composite (the U.S. Fund) as at April 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.**

[1] Fidelity Investments Canada

[2] Bloomberg

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