Fidelity Connects

Fixed Income and the Fed: What's Next?

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Voiceover: Hello and welcome to Fidelity Connects – a Fidelity Investments Canada podcast – connecting you to the world of investing and helping you stay ahead.

Joining us today is Portfolio Manager Jeff Moore. Jeff unpacks the latest market activity from a fixed-income lens, including where he sees opportunities in the months ahead.

The curtains have closed on March, and the markets have been putting on a busy and unpredictable performance, leaving investors on the edge of their seats. The Bank of Canada announced a rate pause, the U.S. Federal Reserve raised rates by a quarter of a percentage point, and two banks collapsed.

With the markets still trying to piece together what the fall of SVB and Credit Suisse means for the bigger picture, what does it mean for you?

Jeff looks at all of this and more today with host Pamela Ritchie.

For Canadian investors, Jeff manages several Fidelity fixed income funds including Fidelity Multi-Sector Bond Fund and Fidelity Global Bond Fund and is based out of Fidelity's fixed income headquarters in Merrimack, New Hampshire. We caught up with Jeff during a visit to Toronto.

Today's podcast was recorded on March 30, 2023.

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Pamela Ritchie: Jeff Moore, great to see you. How are you doing?

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Jeff Moore: I am very well. Great to see you, too.

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Pamela Ritchie: I imagine it's been nothing but busyness for you over the last little while here, so thank you for making time.

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Jeff Moore: It has been so busy. We've been meeting around the clock, it seems like.

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Pamela Ritchie: Oh, my goodness. Let's go right into the heart of asking you to sort of clarify some things for us. The bond market seemed to be giving us all kinds of different signals. We know about the rates; we know about the collapses of the banks so far. Tell us a little bit about whether you're seeing a whole lot of opportunities out there or, actually, there's some red flags.

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Jeff Moore: I would say at this stage a lot of the bond market volatility –the MOVE index, we talked about that in the past– has spiked to levels that are indicative of crises. The hard part right now is the bond market's trying to decide "is the Fed done with rate hikes, does it have a few more to go, could it even be cutting this year?" Because that, we're getting a lot of whippy action at the front end of that yield curve, that 2-year note, 3-year note. That part of the curve is extraordinarily volatile right now.

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Pamela Ritchie: What is it reading back and forth? Some places be reading that "ah, the cuts are on the way" and suddenly you got all these rate cuts priced into the year, but then it sort of eases up. I mean, what are we to make of that?

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Jeff Moore: The hard part –and we should maybe level set– the Federal Reserve's at 5%, 2-year note's around 4% right now. The problem with that –and we've talked about this in the past, Pamela– is that a 2-year note in two years is cash. So, the time decay of that 2-year note is real and problematic. Every day that goes by and the Fed doesn't cut is a day the 2-year note sort of has to head north and get higher yield, which just say the price comes down. So, that leads to a little bit of whippiness in the marketplace where the markets going back and forth, are they going to cut? If they're not, we have the sell off. If they're going to cut, we can stay here.

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Pamela Ritchie: With that –and we'll talk more about the banking discussion– what is the case for bonds right now? And I might ask, is it too late to get in?

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Jeff Moore: I think the case for bonds is that the yield has... is tremendously higher today than it was a year ago. The Federal Reserve is almost certainly closer to the end of the rate hikes than at the beginning. I would even go one bit further. It looks... looks like we have the start of springtime in terms of inflation rolling over. We've gone from having peak inflation in the second half of 2022 to today –I call it the green run for ski slopes here. We're gently declining in inflation in U.S. and countries like Canada actually are on the blue run where inflation seems to be coming in a little bit better and allowing the Bank of Canada to go on hold. I think the case for bonds is yield and the Fed's kind of sort of getting out of the way, but not quite yet.

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Pamela Ritchie: So, things are breaking. We know what the central banks have done. You've been watching it. We do need you to kind of interpret what's going on with various banks that have failed. It's always the question of contagion. Is it contagion? Is that how we should read this?

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Jeff Moore: I don't think it is contagion per se. Let's go back. I agree with you; when the Fed raises rates like it did –even the Bank of Canada– they're like a bull in a China shop. They break a lot of stuff and they're breaking stuff right now in the China shop. One of the things they broke is the regional banks. But not because there's a banking crisis. The credit books of regional banks are in great shape. So, from that perspective, this is the anti-'08. Now, the thing that they broke with the regional banks is they broke the perception in the marketplace that regional banks were the equal to the SIFI, the big banks. The hard part now is the market's looking at regional banks saying they're inferior goods. I'm looking at the SIFIs over there and they're better, and so I'm just going there. Unfortunately for the U.S., the regional banks right now are just the place that you leave. You don't stay.

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Pamela Ritchie: People are taking their money out and going to other banks; the big banks, kind of like Canada's fortress.

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Jeff Moore: Absolutely. Well said. If you think about the big sort of five in Canada –you can make it maybe the big six in Canada– they're basically considered all too big to fail. They're SIFIs –systemically important– and so, in a way, the government of Canada has stamped safe on them. If you're not stamped safe, you're not. In the U.S. they did the same thing. They have the stress test, the big banks. The regional banks don't have the stamp safe on them and this is a challenge right now when volatility hit. In a lot of ways regional banks were an issue waiting to happen. We just happened to get the shock that was started when the Fed raised rates and their ALM book –that's a fancy way of saying their asset liability match– went against them. So, it's not a banking crisis; I don't feel like that at all. I think the bond markets coming to that point, too. I think a week or two ago they said, "yeah, we got a crisis in banks" and now they're going, "ah, no, really what we have is just inferior good being priced out of the market."

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Pamela Ritchie: It's really interesting. The asset liability mismatch is allowed, actually. It's not regulated. I mean, in some places, actually, you have to mark everything to market, but in North America, that's sort of broadly allowed, right?

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Jeff Moore: Well, exactly right. In the ALM world, in Europe you have to have tight ALM mismatching, but not North America, per se. Think about the regional banks. Think about something like an SVB, the Silicon Valley Bank. In 2008, that ALM mismatch actually saved the bank. Credit was under stress in '08. The ALM mismatch interest rates plummeted and the ALM mismatch went to a positive for them. The thing that saved an entity in '08 today is the Achilles heel.

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Pamela Ritchie: Why? Is that because regulations? I mean, there are a lot of people regulating after 2008, obviously, and they did a good job. I guess this is the other side of it.

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Jeff Moore: Yeah. The more you regulate, the more you make it difficult for an entity to have earnings because they have to have rules and structures. For a lot of entities out there, they have what I call generic earnings. They're good, solid entities, well-run, well capitalized, but their earnings aren't something that an equity holder or someone says, "I just got to have; I can buy something that looks pretty similar." So, the more generic your earnings the more generic your multiples and all that pieces. Think about the regional banks. Their NIM and interest margin was tiny on their credit book. Their ALM mismatch, if that goes away –let's say the regulators really step on that, and they probably will, that would be my guess– you're going to be looking, "okay, what earnings are left? How can you grow earnings if you're one of those entities?" In a lot of ways, my personal view is we're going to have either super regional banks or community banks. There won't be anything in the middle because you won't be able to make a living in the middle because the equity market won't give you the love you want.

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Pamela Ritchie: The super community bank. I don't know if they're co-ops or what you call them, but I do they become publicly listed players?

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Jeff Moore: It becomes something interesting like that. Whether we get credit union-like pieces that we see in Canada, it'll be interesting to see how this all emerges. It depends on regulation. But you can almost imagine a world where *[unintelligible]* savings and loans really don't exist today; that in some point the regionals are either getting bigger –the super regionals– or they've decided not to get bigger and stay community banks or even get smaller. I think the number is 50 billion in assets is a community bank. You can imagine: that group gets bigger; the number goes up, but those are really focused on local municipalities and so forth.

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Pamela Ritchie: Really fascinating. You can sort of see how that fits with the global story, too. We could spend forever here and we will certainly come back to it, but I would just like to get your thoughts. Having, I think, interviewed you –and you've said over the past several years–that banks look great. From a bond perspective it's strong. It's fine; it's not an issue. So, you sort of were looking at the fortress banks and thinking that a lot of things were fixed for those types of banks. Where do you see opportunity right now?

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Jeff Moore: The best opportunity, again, from my perspective is going to be in the rate space. When the Fed has raised rates like it is, it's in the China shop and it's breaking stuff, and there's going to be more stuff break. We just don't know exactly what it is. Maybe it's commercial real estate, maybe it's something else that has rate reset risk. The opportunity right now, I think, is to sort of hide out, if you will, inside of government duration as much as you can and then when there's an opportunity of something –the Fed's broken something by mistake– you have an opportunity to make a decision, "do I want to go grab that or not?" I think that's what we're doing; just trying to make sure that our portfolios have as much liquidity as we can use and at the same time are set up to enjoy a rate move if the market says, "hey, there's been a policy mistake made and it's pretty obvious."

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Pamela Ritchie: What should investors...? I won't say worry about, but let's get your perspective and dig or take apart the idea of inflation because there are just so many different angles to look at it from. Could we look at it and sort of get your thoughts on the overall picture of whether the deflationary picture comes in here or there's just some deflation overall? And then just looking at the different pieces of it. So, everything to do with supply chains; obviously, the stickiness of jobs is a question. In Europe, the commodities, the oil, energy crisis is a bigger issue. There's a lot of different ways to look at it. How do you see it?

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Jeff Moore: I always blame my analyst Dee D. and I tell her she's got the ski slopes and she's got those in my mind. In the U.S., I think we're on the green run. That's my assessment. Inflation has ticked down modestly because goods has rolled over, supply chains are better, commodities rolled over. But OER ¬–owners' equivalent rent– and wages are still really sticky. So, we're on that green run. You compare it to Canada. Canada looks like they're on a blue run here, which is to say it's marching over a little bit faster in Canada. The most recent CPI number in Canada gave the Bank of Canada a get-out-of-jail-free card for at least the next little while. They can sit on their hands. I think that's what we're waiting to get more confirmation, where is the U.S. inflation structure going?

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The real question –let's assume that wages stay sticky because we have ultra-low unemployment. I think that we probably would all agree that demographics are rearing their head. We just don't have enough young people; we have a lot of people retiring. Let's assume wages stay where they are– The question then for the U.S. is what's owners' equivalent rent and what's housing do? Does it roll over at all? If you think about the last couple of years, we've watched OER –this little piece of the CPI which not little, it's big– it's basically had double-digit increases. Even the most recent CPI print was 7% or so with OER. If that stays high then we're on the green run and you could make a strong argument that if the OER stays at 7%, then the Fed is probably behind the curve a little bit by 1231 this year where they think they'll get to 3 1/2% inflation, they're probably not on that track, they're probably on a 4+ inflation number, where the Bank of Canada on contrast is on track for its target.

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Now, let's do one more thing, though. Let's say OER goes flat, and we can probably all make a story of why are... rents probably shouldn't be accelerating here. It's hard to imagine that real estate is rocking and rolling in the U.S. in general. If OER just goes flat to 1%, there's a scenario where the U.S. has deflation by the summertime. That's not that far away. This is the challenge. We're going green run, green run; we're going to black run. Or do we just sit in this green run for a long period?

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Pamela Ritchie: Should we start with what the market is trying to figure out? I mean, 'cause that is part of the flip-flop, right? Suddenly there's a gazillion cuts that are priced-in and you think "oh..."

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Jeff Moore: Bang on. You hit it on the head. That's exactly what the market's looking at. And the market's kind of looking at the credit volatility associated with regional banks. *[audio cuts out]* where regional banks matter. There's 60% of lending CRE. You know, regional banks are actually really useful. We will miss them when they're gone. Why? Because

they help us get bespoke lending. They know their customers may be a little bit better. They're not generic cookie cutter lending. They can do something that's a little more targeted. Again, they're not the end of the world if they're gone; it's just we'll miss them. So, the question for the Fed right now –and they don't know the answer to is, "is our credit conditions tightening a lot or a little, or are credit conditions only tightening on a few sectors right now?" The Fed doesn't know. Chair Powell was super clear he didn't know and he's waiting. So, next month's Fed meeting, the question for Chair Powell, that will be "do we have any more information on credit conditions?"

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Pamela Ritchie: And it will probably take a few data prints. There'll be a few that still have things in motion, I assume, because they are also worried, I guess, about inflation going higher and having to react to that. You mentioned stickiness of jobs and so on being part of that story.

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Jeff Moore: I haven't even talked about the idea that inflation could go higher. This is something that we as investors have to be somewhat flexible. You look at what's happened in the UK; we've just had a little bit of a roll over inflation. I would argue a ton of that roll up in inflation was food prices in the London area, not necessarily widespread inflation. Be that as it may, the Bank of England may not be able to ignore that. This is the challenge you're into for this month. The 2-year note is just up and down. It can go up a lot. If someone said to me the 2-year note went up 50 basis points in a handful of days, I'd say, "yeah, that can happen." We just changed our expectations for when the Fed cuts can happen.

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At the same time, if we get any indication that credit conditions are pinching, and then OER is going to pinch, in that world you could easily imagine we're back on that black run and the inflation is falling fast and the Fed's ahead. So, in the market the nice thing right now is the bond market is pretty well priced for a lot of yield. Right now, we're just bumbling along. We've gone up, we've gone down and you're kind of just getting your yield out of the marketplace. That feels all right to me at this stage. And then there's a little bit of an option that says, "hey, they may just get to the... we may just break the back of inflation, we just don't know exactly how or when."

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Pamela Ritchie: When you are describing that kind of volatility –and that's what people are experiencing, obviously– how do you compare now and this cycle to sort of historic cycles of where investors make sure that they have exposure to bonds?

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Jeff Moore: This is a great question. If you think about 2020-2021, in almost every way we had a bubble of sorts. We had extraordinary fiscal policy spending at a level that we've never seen other than in wars. We had monetary stimulus of the first order. We took rates to zero; Europe took them negative. We did quantitative easing at a level that we never even contemplated. Only the Bank of Japan had ever tried something like that. We had all those things come together, so it was kind of a perfect storm. And then when you underlaid it, there was no unemployment, and everybody had a job that wanted one. You basically just had too much stimulus in the system.

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How does this unwind here is the question. My sense is it kind of unwinds the way it started, probably all at once. Everything all at once; sounds like a movie. When I think about it, this is the challenge for clients right now. You've got a lot more yield today. That feels pretty decent that way for me personally, and now you're just sort of waiting to see what inflation looks like. But there's almost no more stimulus going into the system. I think there's this notion, "oh, by the way, look at the Fed's balance sheet of late, because of all the bank lending they're doing to regional banks, there's spike in QE" It's way different feel to me, that QE, because this is really short term. It only forestalls deposits that are going somewhere else. I don't see this as a huge QE spike by the Fed for regional banks. I would argue if you believed that I think that would be a mistake.

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Pamela Ritchie: Interesting. Often, we'll hear the way the Chinese government has done very targeted [indecipherable], for instance, over the course of the last few years. It's a different type of stimulus. This feels like targeted pieces of stimulus, essentially, on some level.

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Jeff Moore: Almost certainly this is just all-around regional banks. It's a temporary piece because as time rolls on, we just get over the regional bank issue and either the regional banks have merged with someone else, they've merged with each other, they've gotten through it. I think a lot of this, time will take care of that. You talk about the PBOC –the PBOC makes a living targeting what they need to do. That makes them a pretty unique central bank. The Federal Reserve – that's not their game or not the Bank of Canada's game. It is the PBOC's game. I think those are two different stories and I wouldn't want to flag what the PBOC does and think that the Fed's trying to ape that because I don't think they can.

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Pamela Ritchie: No, no, no, no. Good point, well made. Just while we're talking overseas, where do you see opportunities overseas, if at all? Are there greater or lesser opportunities, generally speaking?

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Jeff Moore: This is a great question. I actually think that because I feel like this is the anti-'08; this is not a credit crisis. In fact, in 2008 a lot of the problems came out of the fact that U.S. raised rates from '04 to '06. Chair Greenspan raised rates and broke the back of housing in the U.S. At that time, something like 40% of housing was either subprime or nonconforming. You fast forward to today; you're in the high 90% that is conforming and fixed rate. For many, many Americans, the rise in rates –I'm talking about homeowners here– a rise in rates, it's been like an equity injection for them. I talk about how one of my traders on the floor has a 2 7/8 mortgage for 30 years. Well, instead of paying that off, he's just going to go buy government bonds and get a positive carry. He's just had an equity injection. He's got locked in. This is the anti-'08 this way.

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Even for like, think about the Silicon Valley Bank and other banks where their ALM mismatch in '08 saved them; this time it got them. The way I look at it, who's vulnerable here? Any entity that has interest rate reset risk, so your floating rate and it's turning over on you, but I think it's rest of world. I even look at here in Canada, one of our Achilles heels is going to be the fact that we have so many Canadians that are on either floating rate mortgages or their fixed-rate term is edging

towards floating and the reset's going higher. We've heard stories about all the Canadians who are on IO right now, interest only payments. They're basically renting from themselves. It's not just Canada; England, Netherlands, Germany, Sweden... these countries where these residents who bought a home in the last few years even, almost certainly paid too much and are facing reset risk. I think it's rest of world this time, which makes it, again, not like '08. In '08 it was really U.S.-centric and then it just happened that products like CDOs and all those three-letter words polluted banking systems around the world. That hasn't happened this time.

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Pamela Ritchie: Let's start with the Canadian dollar. Is some of the risk that you just mentioned there attached to the floating rate story?

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Jeff Moore: Yeah. So, I think currencies are definitely volatile right now; we've seen that. In my personal opinion, I think the U.S. dollar remains really strong. The Canadian dollar remains strong, but it's going to be hard for the Canadian dollar to accelerate versus the big dollar –especially if U.S. has to keep going after higher rates and higher rates. The risk to the Canadian dollar would be inflation in Canada: instead of going down on the blue run, currency goes back up forcing the Bank of Canada back into the game in a big way. In that world, now you've got real interest rate reset risk for Canadians and you've got the Bank of Canada potentially forced to consider options that are very unpalatable. In that world you could easily imagine the Bank of Canada's going to have to decide how to look through inflation, and in that world the Canadian dollar would be under pressure.

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But again, those are out of the money; I don't want to heighten/hype on those scenarios, but I would point out that there's a sort of negativity to the U.S. dollar and I wouldn't go there yet. To me, the U.S. dollar –remember we talked a little bit about inferior goods– the U.S. dollar is a superior good so, when things go volatile and things break, that's what people like to buy. At least temporarily in a rush.

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Pamela Ritchie: Tell us about energy just broadly –we won't go into it for too long. I'm curious just on the inflation piece of it. Are we going to continue to see that?

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Jeff Moore: When I think about my portfolio and things like that in the last 12 months, we had a useful investment in Europe, and it was kind of based on the fact that we thought rates would stay lower than they would stay in the U.S. This is a year and a bit ago. I did not expect Russia to invade Ukraine; I didn't expect gas prices to spike. That's led to price levels in Europe really selling off. You fast-forward to today, European returns hedged back to dollars and U.S. dollar returns are kind of the same "yuck, not great." That's a bit of a surprise. When I think about commodities, commodities do matter. They can move a lot. The implied volatility of oil is something like 50%. When I look at my portfolio, my implied vol is like 3 to 6%. You think money market's at 0, I'm 3 to 6, sometimes 7. Oil's 50. It's at another level of risk. That's what makes commodities so challenging for all of us. Right now, commodities are very well behaved, but I would never sleep on commodity prices.

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Pamela Ritchie: Tell us a little bit about the divergence we might see here. As credit conditions, I mean, they're tightening, as you say –might be towards the end of the rate rising cycle– but the holding of that, what kind of things will we see? And again, the case for bonds while that all unfolds?

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Jeff Moore: Credit conditions may be tightening. We don't know. Especially with respect to the regional banks, I wouldn't look at what happened in Switzerland and say, "okay, credit conditions are tightening massively." You can make an argument that those entities were doing commodity work; that was commodity lending, and so it's not going to be a big factor in the marketplace. But when I think about U.S. regional banks, I'm not sure how much credit conditions are tightening. You just don't know. Is there a substitution effect? Have the big SIFIs decided, "hey, I'm going to go try to make some hay and get after that clientele and see if we can win those clientele in-house and get them into our wealth management programs." They're not going to sit there. These are really smart bankers and so forth. So, it may not be the case of credit conditions are tightening.

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On the other hand, like the Fed said, "maybe it is." We're just watching; we're spending enormous amounts of time with our team trying to find any sort of inkling of what's going on with credit conditions. It's probably likely that in some sectors credit conditions are tightening more than in other sectors. That's probably the most obvious thing I've said today. The question is how much tighter and how persistent all of that stuff. And we just at this stage don't know. I would suggest that they're tightening; in my instincts they're tightening. Tightening credit conditions should, all else equal, lead to more pass to lower rates longer term, financial conditions tightening. But that at this stage is a bit of a guess. So, one of things we're doing is we're trying to be flexible. We still think inflation's rolling over. We think we're on the green run, but we may be on something much more steep. I think the market will know at the same time as the Fed. That's the hard part, right? because the Fed's nowcasting. That's the challenge.

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Pamela Ritchie: Why ultimately do you want to make sure that you have the diversification of bonds, just so investors know what's correlated? What's less correlated? Last year, everything was correlated, so there is sort of a shyness, obviously, to being too close to fixed income for a lot of investors. That's changed but just kind of drive that home.

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Jeff Moore: One of the things that's changed in the last 12 months is interest rates have moved up a lot with the Fed. A year ago, bond yields were so low that it was hard for them to rally any more on any news. So, all you were getting is a little bit of yield in the marketplace, so bonds weren't so valuable in a portfolio as a diversifier. Fast forward to today; rates have gone up a lot. Even with the churn in the market today the bond market still is putting out okay results in general; not the big negative returns that people were expecting. The bond market, what we've noticed, –especially ourselves in the last few months at Fidelity– I've noticed how much the negative correlation of rates to stocks has come back on big days. That makes it useful diversifier again. The way I'm looking at bonds is today you have more yield, so it's compelling just from a total return, and because that yield is coming from the rate space and because inflation looks like it's under control –maybe not this year but maybe in the future– it's going to be useful diversification in a portfolio today. It can work, to be a counterbalance or at least support a broader asset allocation.

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Pamela Ritchie: Why would investor be more inclined to go towards tactical bond? You've mentioned flexibility or perhaps Global Bond Fund.

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Jeff Moore: Yes. If you take Tactical Bond, what we've done is we've taken the bond market. We have a broad opportunity set. We have around the same volatility as the bond market, maybe a little less, and we're spending a lot of time trying to make our portfolio a useful diversifier, which is to say adding to interest-rate sensitivity of government bonds and not adding at this stage to credit. So, we have a lot of flexibility if something breaks. Again, that bull in a China shop is bouncing around there breaking stuff. If they break enough stuff, there's going to be an opportunity. So, we've got lots of flexibility for clients.

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At the same time, we've got a nice yield advantage and it's turned out pretty well, not just year-to-date; in the last six months there's been a decent bounce in bonds. I think that continues here, especially when there's toing and froing in the bond market here about where is the Fed's next move. Part of the problem the bond market has is the Fed doesn't even know what its next move is.

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Pamela Ritchie: What do you think about the income story for those that have used perhaps dividends for that versus yields? Just clarify that for this particular marketplace.

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Jeff Moore: One of the nice things about life is if you can get a lot of fast compounding that works really well. Right now, the yield in the portfolio we have is above inflation. It's compounding fast; we can see it working. Even if you go back a year and you say... even if you knew that the greatest sort of bond market drawdown in history is just about to happen, think about what's happened: in 12 months of rate hikes -and then we just add three more months on- you basically got a negative return in the bond market at 3%. The greatest bond market collapse in history, you've lost 3% of your money if you just waited 15 months. That actually is an amazing story for the bond market. That's like the story of, "wow, it's not a bad asset class." Now that we're still yielding these nice high numbers and compounding is still ahead of you, if and when the Fed is done and if and when we're all comfortable -we're not on the green run; we're on a blue run and black run- the bond market could be a very nice place to be.

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Pamela Ritchie: Fantastic. Jeff Moore, thank you very much for spending your time. I know you're very busy. We really appreciate you spending it here.

[00:30:09]

Jeff Moore: Nice to be here. Thanks, Pamela.

[00:30:11]

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