Fidelity Connects

Jeff Moore: Fixed Income and the Fed: What's Next?

Jeff Moore, Portfolio Manager

Bryan Borzykowski, Host

Podcast Intro – Jeff More – November 8

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

Today we're joined by Fixed Income Portfolio Manager Jeff Moore. Jeff provides his insights on the fixed income markets for the short and long term, what the Fed's latest moves mean for the markets and what impact the election could have on investors.

In regards to the midterm elections, Jeff says if the house flips, it could be a positive for the markets. He says for the market to feel much better, it's going to need to see the median services CPI tool cool off.

Jeff explains to host Bryan Borzykowski that the Fed is keeping a close eye on the upcoming CPI numbers. Jeff says that the Fed is focused on the median inflation and mostly if the service sector is warming up. The service sector is important because the bulk of the service sectors cost of goods sold is people. No one wants to get rid of their people right now because it's hard to get them back.

Along with the Fed and the upcoming CPI numbers, Jeff also discusses the central bank and inflation and his overall thoughts on the bond market going forward.

Today's podcast was recorded on November 8, 2022

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Bryan Borzykowski: So, to get started, the FOMC meeting was last week. There was another rate hike as expected. What did you make from the move that the Fed made and what they said when they were announcing the hike?

[00:02:11]

Jeff Moore: Well, I think the key thing for the Federal Reserve, the CPI this Thursday. We have midterms today, CPI on Thursday, and the Federal Reserve is looking forward enough saying "we still have to net tighten; inflation is still a little bit too warm". For this Thursday, what you're looking for, Bryan, is what does the median inflation print look like? At 08:30 Thursday morning you're going to wake up and you're going to see; did the median inflation, and mostly the service sector, did it warm up again? Because, so far, only the good sectors are really falling off, rental car prices, stuff like that.

We think housing will fall off at some point with a lag, but really, what the Fed's focusing on is that median; is the service sector still warming up? Because the problem with services is the bulk of the service sector cost —the cost of goods sold for an entity— is people. No one wants to get rid of their people right now because they're hard to get back. We can speak to that later. I think what you're looking for in the next couple of days; midterms, if the House flips, it's a positive for markets because just like you said, that gridlock, and then on Thursday though, for the market to feel much, much better, it's going to need to see that median services CPI cool off a little.

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Bryan Borzykowski: Just before we get into the election... if it cools off, does that then calm the Fed down a bit for future rate hikes? Inflation, the number probably will still be higher than where they want it, so where do you think the Fed goes from here based on what could happen on Thursday?

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Jeff Moore: I think Thursday helps the Fed, especially with line of sight. Let's say the Fed on Thursday morning... we get either enough sectors cooling off or the services warming is less than it was last month. The Fed can basically look forward to June and say "we see a clear path to inflation at 4%, let's say, by next June. Let's put that out there". That seems reasonable to our team here at Fidelity that you could see a path of 4%. If you're already got interest rates over four and you look forward six months, you say "you know what? We actually have interest rates above inflation, that's repressive; that may be enough". In that world the Fed can probably say "hey, we can do our two hikes in December —that's already been priced— maybe we have to tag on a few hikes in 2023, but, for the bulk of, it we're kind of done, we're at that peak level". I think markets will feel better about that because part of what scares markets, Bryan, is this idea that if inflation keeps going and if fiscal spending keeps going, we've got 10% inflation, or 10% interest rates. Nobody wants that. This will be important Thursday; see that cooling, see line of sight to what I call that 4%. I think things could feel a lot better after that inflation print.

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Bryan Borzykowski: Focusing on today's big events, the midterm elections ... always feels like there's elections in the U.S.. What are you anticipating today and how might markets react to what happens?

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Jeff Moore: I'm very simple. I grew up in Canada, so you have to look at me as a transplant here. There's the President, the Senate, the House. No one cares if the Senate flips. It can flip, not flip. The Senate by itself can appoint judges, that's pretty much it. The President's definitely not going anywhere, so that means the House. I think the market would say "if the House flips and you get more gridlock, that would be important". So far, if you look at the last three years, governments —not just in the United States but in Canada, Germany, Japan— they spent like drunken sailors. It's truly impressive. We spent scads of GDP. The reason this matters is it was part and parcel of the inflation problem. It wasn't just a supply shock; which it was that. It wasn't just that interest rates went to zero; it was also this third leg that fiscally we just went after it even though there was nobody unemployed. I think that with gridlock, the markets will go "okay, that's one less thing to worry about". It doesn't mean inflation's done for; it just means that you don't have to worry about the Fed raising extra interest rates to offset fiscal stimulus. This is kind of the balance right now, the more fiscal you do the more the Fed probably has to raise rates. So, to the extent you put lockdown on that for a while —maybe a year— that'll present the markets with a better board, so to speak.

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Bryan Borzykowski: I've got to ask you, what's it like being a bond manager today? It wasn't long ago that people were sort of saying "we don't even need bonds in a portfolio. The yields are not great. Yields are going to go up; it's going to hurt bond prices". Things have changed over the last little bit. What is it like to be in your position today versus maybe even a year or two ago?

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Jeff Moore: A year ago the Fed had pinned interest rates at zero and the 10-year yield in the U.S. —the 10-year government bond— was yielding 1%. We were telling clients a year ago "there's no capital gains left in the bond market, so diversify. Be careful with duration; be careful not having a big idiosyncratic event just because you can't get it back". That was a year ago. Then we've had a massive drawdown, which has obviously hurt a lot of clients. No one disputes that. On the flip side, this drawdown has turned into nothing but yield. This yield now is really, really at the point of being attractive. If you look at the Tactical Bond or the Multi-Sector Bond... well over 7% yield and a duration sub five. We're now at that point where you go "okay, there's a lot more to like here".

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In fact, I would say one of the thought processes I had is if a year ago was a low return, no capital gains environment... where we are today is there are scenarios, even if I can't point to the exact one, where there's high returns in excess of that 7% return. For clients, this is a great opportunity. The hard part for clients, though, is they go "well, I've just lost double-digit amounts in my bond portfolio and maybe in my stock portfolio; I'm not feeling like taking a lot of risk". Well, how does a client go and say "I want to add some risk on a portfolio and when do I do that?" That's kind of our conversation here. At these yields and with the scenarios that are out there, there's a lot to like in the bond market even though, for the here and now, we can all point to five or six things and go, I don't like those things.

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Bryan Borzykowski: With bonds, even if, I guess, you're holding on to something that doesn't have as high of a yield, you're still making a return by hanging on to it. I'm just wondering, when you're positioned, do you sell and kind of trade up or do you hang on? How does it work when it comes to just holding these things to maturity?

[00:09:06]

Jeff Moore: That's an insightful comment. If I'm going to lose money, I'd rather lose it in the bond product than something else. With bonds I'm just making a bunch of loans. We talked about in the past. I make a loan to someone at 5% for five years; you know what it's worth, 25 points, 5 x 5. You lent them $100, at the end of 5 years they owe you a hundred bucks back. Now, let's say you made that same loan —we'll do a little math here but not too much—, let's say you made that same 5% loan and then the next moment the Fed raised rates 100 basis points, so you should have made the loan at 6% for 5 years. What happens? You should have made a loan that was worth 30 points, 6 x 5; but you made one 5 x 5. Did you lose money? Yes and no. The bond, that loan at 100, I have to mark that back down to 95. So now you have 25 points, 5 x 5, plus the 5 points and now you have a market bond. It's got 30 points of upside. That makes sense. Simple math.

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Now let's see, three years go by and everything's going well and they pay the coupons. Now what's the new price of the bond in three years? Well, we actually know this; we don't have to guess. Remember that 5 x 5 —that's the loan

you made— so you have 10 points left in your bond, just 10 because 3.3 years have gone by. The loan you should have made… and let's assume nothing changes and interest rates are completely flat, which is not possible, but whatever. Now the bond is 6 x 2. You should have made a loan at 12 points, but you made one at 10. What's happened to your bond in that three-year period? It's gone from 95 to 98. At maturity it's going to 100 because you're paying me back, whoever it is, is paying back. Did you make money with three points? No, not really. Did you lose money? Not really.

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The thing about bonds is opportunity costs when you make a loan when rates are too low. What I do for clients —and you should know this— is when interest rates go up like they did this last year, a lot of the dollar prices fall very much, we just sit on those and put them in our buying hold. It's not truly buying hold, but it's my buying hold bucket. I'm not going to sell those because as far as I'm concerned, it's the client's money. They're going to get that money back. I just have to wait for maturities. I don't have to do anything. I just have to let time go by and this thing will go up. I can go golfing. This is the nice thing; if you're going to lose money, I'd rather lose it in the bond market if you're taking care of defaults.

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Bryan Borzykowski: You hang on to those; they mature and you put them into a product that has a higher yield and there you go.

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Jeff Moore: By the way, a lot of things happen in the bond market over time. Companies come in and tender for bonds. There's a massive tender today with General Electric, billions. These bonds are below par. They're going to tender for them at par. It's better than a stock. That's the kind of thing … a lot of good things can happen when you're in the market and so, when they go to those deep distress, even though I've lost you money this year and I'm not happy with that, the fact is nothing broke in the portfolio and it's all sitting there in the portfolio. It's still your money and I'm not touching it. I'll fool around with stuff that's above par, but below par I kind of sit on my hands. Once in a while we'll sell something that's below par to buy something else that's below par. What do we care? Below the par is below the par, so you can jump on one horse and get on a fresh horse if you think it's going to do better.

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That's kind of where our heads are at. We're not using any leverage in these portfolios. That's another strength. For clients, you can sleep at night. You don't like the mark-to-market and I know you're probably hating talking to your clients; they're not liking it. The good news here is once we get to where the Fed is kind of done —CPI print comes back—, then the market can start to feel a little bit better about the forward look and a lot of the stuff in your portfolio can, over time, just do its job again.

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Bryan Borzykowski: What about the relationship now between stocks and bonds? You can get a decent yield; you might as well take the less risky asset. That's probably what some people might be thinking. Does the higher yields impact the stock market? How do you kind of see that relationship today?

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Jeff Moore: I've heard this story "oh, bond market's usually negatively correlated to stocks". That's not true and it's never been true. There's very few assets that are negatively correlated. First of all, the idea of wanting to be negatively correlated to the stock market, which over 100 years has done nothing but go up, is kind of insane. A low correlation is different, but a negative correlation to the thing that goes up for 100 years in a row, I'm not sure you want to be negatively correlated to that. You won't be in asset class *[indecipherable]*. The bond market is positively correlated to stocks and always has been. Treasuries, once in a while, can be negatively correlated. They can be the risk-on, risk-off. But the rest of the bond market, that great bond market, corporates and stuff like that, that's positively correlated to stocks.

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More than that, when the Federal Reserve is raising rates, '98, a little bit in 2015, 1993, 1994, when the Federal Reserve is raising rates —and this is the discount rate— the NPV of everything on earth falls. That's just math. The risk-free rate is the Federal Reserve's; it's the risk-free rate because the government has decided that the banks —who are 100% of GDP in size— the banks can use it as risk-free so they don't have to have any capital or collateral against it. That's why it's risk-free, right? Everything goes back to this big … we gerrymandered the systems of government Treasuries, Government of Canada bonds and U.S. Treasuries are risk-free, and that's not changing, not probably in your lifetime. In this world Treasuries can be negatively correlated once in a while, but for the here and now, when the Fed's yanking rates up, we're all going for a ride.

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Bryan Borzykowski: Let's dig into some of the opportunities here. We're actually starting to get some questions in about different parts of the markets. Where are you seeing those opportunities? There is some questions about high yield relative to corporates and sovereigns. Let us know where you're kind of looking here.

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Jeff Moore: Overall, yield is fantastic. This is as good a yield opportunity as I, personally, have seen in my career. I've been investing money in Fidelity since May 2000. This is a great point entering into the marketplace. Where would I go? Right now, government yields are very high relative to history although, rightly so, given inflation … again, if we get that inflation back down to 4% and we're at four and a half is the overnight rate; I think we're all going to feel that that's probably pretty repressive and at some point that four and a half is coming down. So, I like government bonds at some point. We're going to have to go get them and we're going to have to buy duration at some point.

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Keep that in the back of your mind that right now if you're in floating rate notes or things that don't mark-to-market very easily, your biggest decision is going to be this reinvestment risk. This is front and centre and so, think about that. Maybe not yet your time, but, sometime next six months, my opinion, you're probably going to have to make a choice on buying more duration. I'm running my portfolios very short duration. I have the same question you have. I have to buy duration; I just don't know how yet.

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Where do I buy? Which sectors do we like? Most of the sectors in the market where there's high yield, bank loans, emerging markets, investment-grade credit, global credit, mortgages, asset-backed securities, CMBS, your gamut; they're trading at the 60 to 80th percentile in terms of spread wides. If they're not at the 100th percentile, which is all-time wides.

So, the good news is they're a lot more attractive than they were last year because they're at the one percentile, now we're at the 60 to 80th, but they're not distressed. This is, again, your challenge. I think you kind of want to be in the mix, whatever your normal mix is, is kind of my mind, have your average risk-on at least, and at the same time what we're doing is leaving buckets open just in case something goes bump in the night.

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Because when you raise rates this fast and this hard, and you cut fiscal this fast, you can imagine something gets broken and you want to be able to take advantage of that as a client. That's where our heads are at. But the yields are so compelling that if you're just saying "okay, high yield, I think defaults are going to be 4.5% next year". If you think that, high yield's yielding nine, you're going to way outrun four and a half. You've got to go buy a yield.

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Bryan Borzykowski: Tell me more about that. What are you saying there? You think defaults will rise, so should you take advantage of those high yields? You're saying yes, even if defaults are going to rise.

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Jeff Moore: *[audio cuts out]* minimize those defaults, you've got a great story there. This is, again, for all of us. I'm liking credit here, but I'm not coming out of my shoes for it yet. But I am coming out my shoes for yield.

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Bryan Borzykowski: You mentioned floating rate notes and I just want to get your thoughts, maybe dig into that a bit. What are your thoughts on floating rate notes and how are you positioning them in a multi-sector bond fund?

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Jeff Moore: Floating rate notes and, again, people are going to say "well, he's kind of disingenuous here". I'm going to tell you a story. Around 40+% of the portfolio floats right now. It's either floating rate notes, bank loans, CLOs, high-quality CLOs, cash. I know I have all this floating rate, which is terrific. It's got a lot of yield, but when I look forward to five years and I see demographics, and I see the G10 and population decline and a labour force decline, I just don't see great GDP growth. I don't know much but that seems like that works. It's going to be hard to keep these interest rates here so somehow I have to term out this 40% bucket and get into the fixed rate because that's actually the risk-reducing trade for my clients. The fact that I'm still dragging around 40% shows you I'm still a little worried about inflation, still a little worried about the Fed, but at some point I need to move for our clients, so term out and add duration to the portfolio. I like floaters, comfortable with them right now, but I see a clear and present danger out there.

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Bryan Borzykowski: Great question coming in just about ...'we've been talking about inflation this whole thing, but do you think the central bank could adjust its target inflation rates?

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Jeff Moore: Oh, this is a great cocktail conversation. Yes, for sure. Remember, we kind of made up the inflation number. If you go back to Canada —which we're talking to a bunch of great Canadians here— and you go back to 1990 and the governor of the Bank of Canada is a guy named John Crow. John Crow, they call him a monetarist. Someone can push back on me there. But he believed in 0% inflation, 0, 0, 0. You have to beat inflation down. But then StatsCan came along

and said "you know, our surveys aren't that good. They're kind of kludgy. It's a big economy, we don't have a lot of money and so we think our error term may be 1 to 2%". When you're targeting zero, you actually may have deflation going on in the economy and we can't tell you that's the case. I don't really mean to pick on StatsCan because that's not fair.

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Think of the U.S. as the Bureau of Labour Statistics. Same thing no one spends any money on them anyway, and they probably should but good golly, try to get a politician to say "I'm going to spend money on the Bureau of Labour Statistics and not on people". I think they'd get mad. In 1990 we decided on the one to three band and you know who was... *[it]* was Sheila Copps. Remember? From Hamilton? I think her father was there and she was long-time Liberal. I think we got ... the 2% was kind of like "yeah, there's 2%, seems like reasonable". It takes into account statistical error; gives it something to shoot for that's stable, but not too low and here we are. We made it up then, so why couldn't we make it up now?

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Bryan Borzykowski: So, the answer is yes, they could change it, I guess.

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Jeff Moore: Oh, absolutely, absolutely. In fact, you'd have a royal commission; you'd have all sorts of economists from all the great universities in Canada and they parade through with all their econometric blabiddy-blah and say a new number.

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Bryan Borzykowski: What would it take... how would that happen, do you think? I mean, they could just do it but...

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Jeff Moore: When the price of going from 4% to 2% gets too big. When it becomes too-too hard. When governments can't take it; public can't take it. The hard part with that, though, the risk you have is if you look what happened to Turkey —and they have 80% inflation now and things like that— you can go from this low inflation where we still are and it's trending down; if you're not careful you can lead to a spiral. It has to be done well; it has to be done with some thoughtfulness to it, but it's very possible. I wouldn't make it my base case. I just watch for it in 2023 because politicians won't like this.

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Bryan Borzykowski: Moving on to GICs, which I've been writing about personal finance and investing for a while; nobody really wanted to talk about GICs for a long time. Now, again, something may be different there. What are your thoughts on GICs and how should maybe advisors approach those for a portfolio?

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Jeff Moore: Advisors know their clients way better than I do and I would never *[indecipherable]* advisor. Some clients just can't take *[audio cuts out]*. They'll hate you for it and so for those clients a GIC is a necessary evil. The way I look at it, the time to buy GICs is a year ago when interest rates were nothing and there was no capital gains. There are scenarios and, again, I can't tell you this is the path for sure, there are scenarios in the marketplace in the next handful of years that could be very high total return for the fixed-income markets. If you look at the portfolio that we run for clients, in 2019 and 2020 we returned 9%+ a year two years in a row, so outran our coupon. I don't see how we get there yet, so I'm still in floaters, but at some point we kind of get there and what I think is like anything; if you spend the money in a GIC you're

going to be locked up and your client, their chance to come back and bounce back goes away. I would say when capital gains get close to zero again, that's the time to buy GICs. I don't think in this yield and this spread environment I would necessarily want to lock up my money *[inaudible]*.

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Bryan Borzykowski: You talked a bit about duration throughout our chat here, but maybe let's dig into it a bit more. How do you look at duration going forward?

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Jeff Moore: Duration is just interest rate sensitivity. Said another way, it's just rollover risk. Think about this; remember we were just in a period a year ago where the 10-year U.S. Treasury is at 1%. Well, nobody cared; the rollover is there. How long would it take to double 1% yield? Like, forever? I don't even know. I'm a bond guy and I don't even know. I will tell you this; at 7% where the portfolio is today, it doesn't take very long to double. This is what duration? Duration is all about how long can you lock in yields at this high level because that interest rate sensitivity is the story. Floaters are great when interest rates are going up because they keep their price. But when interest rates start to fall, floaters are bad because they keep their price and the rest of the portfolio starts generating big capital gains. You're going to need duration at some point; you're going to have to take your duration off. You're going to want to, you're going to want to lock in some of these fairly high rates.

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How do you do that? That's where it gets tricky because if you think about it historically, the stock market... the volatility took 20% and the volatility of the portfolio I run is like four to six, so I'm much less volatile. With stocks, people have a plan. They have I average in... investors have an idea how they add stock risk and take it down. They have a plan for that because there's so much vol. If you think about it, money market account with the vol 0.0, you can put all your money in today and take it all out tomorrow and you don't care 'cause it's just the overnight rate and it's one day money; it's not going to matter. The bond market now, because of all this vol, has a little bit more vol, so you need a little bit more of a plan now on how to buy and sell your bonds than you did five years ago.

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That volatility is, I think, here for a while because the Bank of Canada and the Federal Reserve... the one thing they like about the bond market's volatility is it takes leverage out of the system, makes the world less risky and it takes speculation away. They realized that one of the ways to get rid of speculators is to put volatility in the system and the speculators, a lot of times, use financial leverage and so, they borrow. And they always have to mark-to-market and they're always giving collateral and it's no fun. We could be here in a bit more of a volatile marketplace, more like the 1990s than the last 10 years, and in that world you're going to want to have a little bit of a plan for how you buy and sell your bonds. I think averaging in seems like a reasonable idea, but, at the same time, with these yields, you can convince me of a lot of things as a client.

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Bryan Borzykowski: What about just as a fund manager, what are you doing? What are the strategies that you're employing right now?

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Jeff Moore: We're kind of averaging in. What we have right now is we've left all of our buckets with room to manoeuvre upside, but we're trying to add in. Having said that, I haven't really added to duration as clients will know... from just the difference in return versus the bond market because we've been shorter and that's worked out for clients. I'm going to have to at some point start stepping up and doing big lumps in the bond market in duration.

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Bryan Borzykowski: We've got just a minute left, I just wanted to get some final thoughts. You sound positive on bonds, which, again, may have been different than a year ago. What are some sort of last pieces of advice for investors or just your thoughts overall on the bond market going forward?

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Jeff Moore: My number one thing is there's recency bias in everything we do and your clients are going to be facing that. Again, that's why they hire advisors. Advisors see through that. The recency bias says "oh I hate bonds". And I don't think that's where you should come out. I don't think you should love bonds either, but I think bonds just an instrument; it's just yield instruments and there's a lot more to like now in the bond market. My instinct is, in your mind you should be trying to find a way to add more bonds, not take them away.

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Bryan Borzykowski: I will leave it there. Looking forward to seeing where the market goes and our next chat at some point in the future. Thank you so much for being here.

[00:28:09]

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