Fidelity Connects

Interest Rates, the Fed and Bond Markets in Focus

Jeff Moore, Portfolio Manager

Pamela Ritchie, Host

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

Veteran Fixed-Income Portfolio Manager Jeff Moore is today's guest. For Canadian investors, Jeff is involved with many Fidelity Canada funds, including Fidelity Multi-Sector Bond Fund, Global Bond Fund, U.S. Monthly Income, and NorthStar Balanced.

With the Bank of Canada announcing a 75-basis point rate hike, there are now questions around how other central banks will follow, and what affect this will have amongst investors.

The bond market has had an extremely volatile year, but is it now at a buying level? And what could the U.S. CPI print tell us about where bonds and yields are headed in the months ahead?

Jeff and host Pamela Ritchie unpack all of this and more today.

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Pamela Ritchie: Hello and welcome to Fidelity Connects. I'm Pamela Ritchie. Great to see you, Jeff. Are you in Canada?

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Jeff Moore: I am in Canada, yes.

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Pamela Ritchie: Good to have you back. That's great. What of the volatility? What do we do with it? Why is it so intense?

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Jeff Moore: Well, part and parcel of volality, let's just level set, is partly because the Fed and the Bank of Canada have pulled out of the marketplace in terms of doing any quantitative tightening or in this case, quantitative easing or tightening. Right now, they're doing very little of each. The bond markets are kind of on their own to price everything. With massive uncertainty about will the Fed's keep going, will they stop, the Bank of Canada, how many more? When you have

that plus the fact that the big buyers of government bonds in the last few years have just stepped away some, not too far away, but stepped away some, you're getting daily volatility of 5 to 10 basis points.

One thing I really want investors to think about is every day if the 10-year note in the U.S. moves 8 to 10 basis points, this is what we used to get in the 1990s. We're kind of back to that. I don't want to overthink it. It just is. There may not be a lot of signalling in that 8 to 10 basis points today. Two days ago, we had a big sell-off in rates, the last two days we rallied it all back. So, there was no signal in it. It was just the fact that big buyers stepped away for a short period of time.

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Pamela Ritchie: It's fascinating because it's hard… we are repricing everything, right? And as you say, that creates clarity. I know you've said that in the past. So it's a process. We're not very patient, though, ultimately. It really seems to be painful. What are investors meant to do with all of this?

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Jeff Moore: Well, you know, we're all win-now people. We like to win and win fast. We like high speed internet, we like everything fast. Here's the thing, when the Federal Reserve is engaged like it is, like the Bank of Canada is engaged, the ECB is now really engaged, when they're raising rates, the NPV of everything goes down. That is the most obvious statement. But I think it's important to realize the NPV of everything goes down or, at a minimum, it's a headwind to how much total return you can get. So you're kind of as an investor, caught in this vortex where you have to wait until we get enough info that we've rolled over on inflation so the central banks can slow down. Then your investment portfolios can roll again.

Well, I think you hit it on the head. I think you used the word big. What we're doing now as investors is we're loading on a couple of numbers. We decided that the numbers that matter are unemployment and employment and job creation and CPI. We decided those two numbers matter above almost all else in the marketplace. We're loaded on those because the central bankers are loaded on.

We're kind of in this rolling 30 days where every 30 days we're doing a check-up as a market to say, okay, is the Fed, the Bank of Canada, ECB on its way to getting inflation back to that 2% target they say they have. And so when you're at 7 or 8% depending on what country you're in every month when you're in that kind of inflation you need to be pointing down towards the 2%. The market long term says, hey, The Fed, the Bank of Canada, they're going to have inflation done and dusted. We're going to get it back. And it's true, the Fed and the Bank of Canada have all the tools they need to handle inflation. We may not like half those tools react to risk assets but they have the tools. What we're looking for every month now is confirmation that we're on the path to 2%. When we get that confirmation, risk assets can do well and when we don't get that confirmation we say, well, we have another 30 days, almost like Groundhog Day. We have another 30 days of this stuff.

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Pamela Ritchie: So confirmation meaning CPI print next week is less. I mean, we're going in the right direction. That's the confirmation we're looking for?

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Jeff Moore: To me, everything is about 8:30 on Tuesday. I don't think investors should worry about a thing until 8:30 on Tuesday. We should all be watching at 8:30. What you're looking for core is month-over-month a negative number, maybe used car prices falling off, we have some energy declines potential in the U.S., if you get the month-over-month number, it

comes in negative, my sense is you could get a very nice asset rally, a rally like they read about. But month-over-month, if the number comes at 0.5 or higher, basically that will say to the marketplace, ah, these higher rates are going to persist at least a few more months longer than I thought, and so the front end will have to sell off a little bit more and the curve will invert.

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Pamela Ritchie: From that do we then ... I mean, the 5-year, 5-year forward is sort of a place that I know you've spoken to us about before as a very good place to sort of begin looking essentially.

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Jeff Moore: The 5-year, 5-year forward, think about a 10-year bond. You can buy a 10-year bond or you could buy a 5-year bond now and in 5 years buy another 5-year bond and then you bootstrap it, again, from your first year CFA, you'll see it has an implied inflation. The 5-year, 5-year forward is implying right now that the Bank of Canada and the Federal Reserve had this done and dusted. Inflation's dead in five years. What we don't know is the path there. In fact, if we do the 2-year, 2-year forward, we kind of think as a market that inflation will be done and dusted by then, which means we need a path to get to 2. In the next two years, we've got to go from 7 to 2% inflation. That's the path.

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Pamela Ritchie: That's painful, though, right? That sounds painful.

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Jeff Moore: It could be painful but we need monthly confirmations that we're on pace to that number. Otherwise, we're going to start pushing that date out, or you have to think the Fed gets more aggressive. In either case, it means the NPV of everything takes another hit. It's not just the bond market here. That's where on this rolling 30-day thing is where our head is at. Stay, watch the loaded number on CPI. That's probably the whole month and then you're going to get right into the Fed.

Don't call for pivots. The Fed and the Bank of Canada, we talked about this, you and I, a few times, Pamela, the Bank of Canada, the Fed and ECB do not have the credibility and more than that, their leadership, Chair Powell, Governor Macklem, they don't believe their forecasts in the short term are good enough to believe that they can call a pivot in a month. So, that means the market has to be at these stickier levels for a while until we get raging amounts of confirmation.

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Pamela Ritchie: The forecasting sort of goes to the whole discussion of credibility and where ... they've been very bad at it but I guess you say on the other side it's been an extraordinary time. So, I don't know what you do with all that.

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Jeff Moore: Well, I do think if you go back a year, I think if they had a do-over, the Bank of Canada would have started raising rates maybe at the end of 2020 not 2022. They would have raised rates a long time ago. Same with the Fed. I think that this has been humbling for every major central banker and even for Treasury secretaries like Chair Yellen or Secretary Yellen. I'm looking at that as, as we as investors, we're going to have to be more patient. It's hard. We're in

this rolling 30 days, watch the number, if core comes out negative that's a big deal and that'll at least give you some relief rally until the next month and we need the confirmation again. But as the months start piling up that we get the confirmations then somewhere in the offing is a pivot and when it happens it will be a big deal.

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Pamela Ritchie: Well, tell us about that. Tell us about other rate rising cycles, the pain, but then once you get through that, ultimately, what you're looking at.

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Jeff Moore: Well, maybe I'll step back and think about our portfolio a little bit. We've talked about our 5-step process and in step 3 of our 5-step process – I'm not going to go through it – step 3 is partly where we do stress testing and we have our hot shot, Stacie Ware, she's a PhD from Oxford or Cambridge. I think they're both good schools but one of the two. I can't remember right now. We have [Hugh Nguyen?] he's also a PhD, I think from Berkeley. What they're running right now, they're both saying to me, Jeff, that there is a massive number of high total return scenarios, like double-digit return scenarios in the bond market because the [indecipherable] were so great. A year ago, Stacie was saying, there's no capital gains in any markets, the bond market in particular. Just sit on your hands, diversify. She's now starting to say in our portfolios, hey, I'm running thousands of scenarios, she runs 5000 simulations a day, I'm starting to see all sorts of path simulations where there's double-digit positive returns.

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Which is to say, as an investor you should be getting more excited. Even though everything hurts and I know it's hard to talk to your clients, you're getting more excited today, not less. There's more paths here where the return profile looks fantastic. I don't think we're there yet but I'm certainly starting to build a lot more liquidity in the portfolio so that we can make some big asset allocation decisions when and if our macro team sees the all-clear or some kind of a pivot in the market.

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Pamela Ritchie: The overall question of TINA, "there is nothing else," does the rest of the world and how it feels through a recession, I mean, supply chains have been garbled but they are global. Do we not feel the pain from other parts of the world as they go through their own rate rising cycles?

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Jeff Moore: Well, for sure we felt it through China with COVID lockdowns over and over and over. If you actually look at China, its demand for oil and gas fell 15% in the last six months. You've basically seen an impact that China is not exporting as much, so its demand for energy is down as well. One of the reasons, by the way, my personal view on this is that if you think that Germany and you've got all the storage and gas and it's not a European issue anymore, I don't think that's fair. I think Germany just got super lucky that China switched to coal and it has had supply chain interruptions allowing demand. So Germany was able to restock their LNG and get gas. We should not assume that that was anything but luck. The reason I'm saying that is...

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Pamela Ritchie: That's fascinating because when China comes out of lockdowns does demand go up again?

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Jeff Moore: I would think. It would be hard not to go up just as more people are doing more things. Again, this gets to a point that when you look globally, supply chains do matter and they've certainly been a big piece of our inflation story. The ECB has been the most aggressive on that front and with that narrative. But I will say it's not like it's an obvious thing for some regions, especially Europe, on how they're going to easily navigate the next six months. The question for them will be will they have to go into a hard recession first which could affect ... even if you said the ECB can stop, it still may not feel like a great environment for risk assets for a while.

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Pamela Ritchie: Whereas perhaps in other parts of the world once those levels are reached it may start to feel like an interesting risk environment.

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Jeff Moore: Yeah. In fact, I was looking at, I think about Canada and the United States, I call it Fortress North America and it's probably not a good answer but I feel like when you look at demographics, whether it's population growth, ageing, Canada and the U.S. stand out as having the best demographics. They're not as good as the demographics we used to have but they're better than the rest of the G10. In fact, our populations are growing. The reason I say that is when you think about population decline in a lot of countries like China, Japan have total debt levels 3 to 400% of GDP with fewer people, that's just going to be a huge headwind to growth in the future because you're going to have to prioritize debt repayment to new initiatives and new growth.

The reason I say is I think there's this notion that, oh, all of what you've seen on the currency markets with Canada and the U.S. soaring versus the euro and the yen and the renminbi is sort of all just a cyclical thing. I don't think so. I think a chunk of that is secular. And it's because, you know, we've talked about this, Canada and the U.S. are on an absolute relative basis pulling ahead of the planet.

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Pamela Ritchie: Let's talk about the positioning a little bit, your ability to be very tactical in moments. Again, I mean, with the example of, say, next Tuesday, the CPI number coming out, you walk into this, you'll tell us the right words, but balanced with some patience but at the ready to ultimately, when we get there, what does that mean? What are you able to do to be at the ready?

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Jeff Moore: Well, that's a great question. A year ago, there was basically no capital gains. We had high yield trading at all-time tights, investment-grade credit, all-time tights, Treasuries were 1% for 10-year Treasuries, there were just no capital gains to be had. So, we built a portfolio that was very diversified, that had a lot of floating rate notes in it and we still pretty much have that portfolio today. But at the margin, what we've been doing is taking away and buying bonds yielding 5% if they're really short, 6, 7 and 8% where we think they're kind of recession proof and that they have, you know, those bonds are going to turn into a lot of gains in the future. We just don't know the timing. We've been picking away, there's been a bit of a new issuance calendar here and there but we're not ringing a bell.

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Pamela, if you go back to sort of March to April 2020, if you remember we went into lockdowns and so forth and the market started selling off and then the Fed got involved and we took breaks to zero, the Bank of Canada as well, and then we had fiscal policy got super stimulative with all the cheques, we were telling clients, in April, buy everything that's not locked down because it was a ring the bell moment. There's no ring the bell moment for investors yet. There might be coming but there's not one yet. The reason I'm stepping back to say, and I'm reminding you, because of that you pick away, I would say keep your liquidity high because it's not just for your investors' mental health it's more for you as an investor that you can say, okay, when something becomes a ring the bell moment, I can do a fast trade that's not going to cost my portfolio.

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The big thing I've been telling all my teammates is keep your financial leverage as low as you can. Don't be levered in any trades here. We're not levered, as you know, because you want to have flexibility and what you don't want to have happen is you have to sell something before you can actually attack and take it. That's a painful process because you're not going to like the price of it you sell at, potentially. So that's what we've done. Massive diversification, the portfolio yield for us is comfortably over 6%. By the way, because I have 30% of the portfolio floating, it's like 35, if the Fed does 75 the next three weeks, we're going to reset 30% of the portfolio, it's another 75 basis points. So our yield is going to go up by another 25 or 30 basis points at the portfolio level and we haven't done anything.

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Pamela Ritchie: I feel like people listening are going to want us to just back that up and have you say that again. Comfortably over 6%, is what you said?

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Jeff Moore: Yes, we're already over 6%. That's not an issue. As the Fed raises rates, floating rate notes are priced off of Fed funds. Well, it's Fed funds plus a number, in the old days, the old days, a few years ago we used to call it LIBOR, now we have different words for it but you're still priced off a floating rate from the government. When they price 75 higher and I think I have like 35.5% in floating rate notes now, so you take 35% of the portfolio and it's going to get another 75 basis points in yield in about three weeks and all that happened is the base underneath the stock reset. That's it. So the portfolio yield will rise.

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Pamela Ritchie: This feels like a good moment then to ask, thoughts on the use of GICs in this environment. We actually hadn't heard much about them for a long time for lots of reasons. There are different risk stories out there. Why not have a GIC, for instance?

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Jeff Moore: What I would say, this is, again, personal view of GIC, is if you get to a world where there's no capital gains left, GIC is great because there's no new opportunity costs, other than you have to wait till they mature and that could be a long, hard wait, especially if things are rallying. So as opportunity set goes up, you don't want to lock yourself in long term here because the opportunity to make some really big returns … think about my quant, Stacie, she's saying to

me, listen, there are more and more draws. Not saying they're all positive. There are more and more 10% return draws off in the marketplace. So, I can't see how we're going to get to that necessarily yet, because I'm not a visionary like that, but when my portfolio team is saying, listen, the dispersion here is high and there's draws that are meaningful and probabilistic, possibly, at 10% the idea of locking in a GIC doesn't make sense. So, I would say if you think there's no capital gains in markets, GICs make sense but the day you think there's capital gains back I would be out of those and into the marketplace.

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Pamela Ritchie: How much higher could rates go, Jeff?

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Jeff Moore: I'm already surprised they're as high as they are now. You should know that and every client should know that. Having said that, once we see the inflation numbers start rolling over that will be a huge positive for the marketplace. But we need to see a little bit more of that. It's hard to see, for me, I look at the long end and I feel like 10- and 30-year rates feel pretty good here for all I can see.

With the risk here is the market is already saying, okay, we got this inflation thing done and dusted in 10 years for sure. If we don't, then rates have to go higher. So you're kind of on this rolling 30-day thing, Pamela, where clients have to sort of, okay, we're not going to make a huge forecast here, we're going to see what CPI looks like Tuesday at 8:30 and then I'll make another decision. Because you should know this. The Federal Reserve is going to be watching it on Tuesday at 8:30 as well or whenever they get up… and they'll be making the same decision you are. They're not ahead here. They're using coincidental data or even lagging data to make a decision.

So for all of us, this is our challenge, Pamela, is that there's no forecasting going on, we're nowcasting. What I say for people, I would just stay flexible. I would definitely not want to lock in a fixed-rate note here for a long period of time that you can't get out of because that could be painful just owning it.

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Pamela Ritchie: Many of those, perhaps, that are invested in other parts of the market just kind of want to get the one, two, three, so what higher yields ultimately mean for fixed income investors. What is that going to mean as we watch rates rise? What does it mean?

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Jeff Moore: Well, I think, first of all, for people who are retired it's a great thing because your savings work harder and you do less and you can retire earlier. One of the reasons I don't think rates can stay at these high, high levels for very long is we just have too many 60-year-olds. I've talked about this. We're going to add 100% more 60-year-olds in the next 10 years. That may not sound like a big number but the absolute value of that number, the number of actual people is so extraordinary.

Think about 60-year-olds. They go from being in the workforce to out of the workforce so they immediately change the fiscal situation for governments because people who are working pay into the system and generally when you retire you pay a lot less into the system. We know that the bulk of health care costs soar after the age of 60 – not the 20 and 30-year-olds, they do a little bit better job – and so the more 60-year-olds we have we know health care costs are going to rise. So you don't have to guess that higher interest rates in the long term doesn't necessarily compute in our system.

With the number of sixty-year-olds, I think they would love it. I just don't think we're going to able to grab it. I think we're going to keep this for a while and then we'll get some big total returns on the other side of all this and we could easily be back to another low-rate regime some point, whenever we can get comfortable that we've got inflation doused.

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Pamela Ritchie: This is a question on the risk of recession, the ultimate, what you see as the landscape for the economic environment. Here's a question Jeff, thoughts on high yield at this point.

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Jeff Moore: So high yield is at 500 over. A few weeks ago it was at 400 over? We actually sold some high yield a few weeks ago because it was 400 over. So here's the thing you have to realize, 90% of the high-yield market, 90% of the names in the high-yield market, traded under 400 over still. Ten percent of the names traded like 600 over. So, we're still not getting a ton of compensation. Having said that, for that 90% of names, the bulk of them are free cash flow positive, so their bank accounts are getting bigger every day, they've already turned out their debt, so there's no obvious defaults coming for that group in the next 12 months.

Even though I would say here, keep powder dry in the high-yield space, it's not because I'm calling for cats and dogs living together. That's not the case at all. It's just the opposite. You may have to wait and get some love from that. Short-traded high yield could take months and months and months. High yield's already okay for now. The way I would look at high yield is if you get high yield with a 700 on it, that's pretty much back up your truck and buy it and right now we're not there. So I'd be more patient on high yield for now.

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Pamela Ritchie: There were a lot of discussions earlier in the spring about ... and this goes to the cryptocurrency discussion, stablecoins, the role, its interactions versus money markets and that sort of got shelved. Is there anything that we need to know about that in terms of being insulated, the money markets being insulated from that story?

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Jeff Moore: In the crypto space, my number one issue – we talked about this almost two years ago – is when crypto had a market valuation of $3 trillion, the whole U.S. banking systems is less than 2 trillion. My point is, well, that can't be because you don't think crypto takes over for the U.S. banking system, that would still require crypto to go down 50%. I'm still in the same camp. I think crypto can be sort of half the size of the U.S. banking system. Ultimately, the hard part is a lot of what crypto will want to do is replace financial intermediary assets. That's the banking system. It's hard to have a huge equity valuation. It doesn't mean it's going to zero, not that kind of play at all, it has to be sized appropriately in terms of what you're trying to take over.

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Pamela Ritchie: Let's go back. We kind of started with the discussion, you discussed volatility, the reason for it, some of the reasons for it. There are some big players that are not really in the market in the same way. The Fed, all of the central banks are less so. Have we hit peak vol or is there a lot more to go? Just kind of bring us back to the way we started so we remember that message.

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Jeff Moore: What I think with the daily volatility, how much the 10-year Treasury moves, we're all kind of watching that. I think we should just be ready for it not to move like it did in the last decade, 3 or 4 basis points but it's going to move like it's 7 to 8 is a normal day. That's more like the 1990s. It's a lot more and yet if you're Governor Macklem, if you're President Lagarde, if you're Chair Powell, when you talk to your team they're saying, that's not necessarily a bad thing because having a little bit more daily vol keeps people from doing more tail things that are a little bit more aggressive, taking on too much leverage, it can actually force central bankers, not in the short term, but over the long term make it a safer investment platform for most of us.

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Pamela Ritchie: That's interesting. The more vol there is, the less, that makes sense, less likelihood of people getting overleveraged.

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Jeff Moore: Yeah, you just don't get sucked in it that you can trade everything for a basis point. You realize, oh, trading has costs and so you take more of a medium-term investment horizon, you start using leverage a little bit less, not maybe going to zero, just use it less because you realize that there's exit costs right now.

If you think about one of the big issues, think about the ECB now because the ECB wants to pull back a little bit, trying to raise rates and then trying to contain its own QE. We'll see about the Italian elections and how that goes. The hard part is we look at swap spreads in Europe, they really disassociated, they've sold off a lot more versus government bonds.

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One of the things that's happening is there's not a great two-sided market in the swaps market in the European space, partly because the central bank's not there. Again, if you're using leverage in Europe, it's been more expensive for you and it hurts because you're doing worse than the actual Bund cash market. You're selling off more. That will stop at some point but it will also, though, when you have higher rates and you use leverage, collateral becomes a bigger issue mark-to-market and you're forced to [move?] up every time there's a move, that just pulls a little leverage out of the system. I think that's something as rates go higher we should assume … probably nobody on the call uses a lot of leverage but think about big investors that are using leverage. It's more painful and they're probably using less now and probably we use less into the future which is a good thing for stability.

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Pamela Ritchie: Which is a good thing for stability. Thank you, Jeff Moore, for giving us a little bit of a map of sort of how to traverse some very volatile times and maybe just reminding us to use a little patience as your approach invariably takes investors along that road. Thank you for your time. Good to see you.

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Jeff Moore: Bye, Pamela.

[00:27:323]

Pamela Ritchie: Thanks for joining us. I'm Pamela Ritchie.

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