Fidelity Connects

Navigating the Fixed Income Market in 2021

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

Today's podcast features fixed-income portfolio manager, Jeff Moore. Jeff, who first joined Fidelity in 1995, is a Canadian who now works out of Fidelity's fixed-income headquarters in Merrimack, New Hampshire. And today will walk through the importance of diversifying in fixed income in 2021.

Jeff and host Pamela Ritchie discuss what the impact of inflation could be, and Jeff touches on his newly launched fund that he co-manages with Mark Schmehl and Michael Plage – Fidelity Multi-Asset Innovation Fund.

Also, Jeff tackles the discussion on finding yield in this low-rate environment, including a recent increase to International exposure in the funds he and Mike manage.

This podcast was recorded on February 17, 2021.

[01:41]

Pamela Ritchie: Hello and welcome to Fidelity Connects. I'm Pamela Ritchie. Inflation expectations have been a major story through 2021 so far. We're only a couple of months in, not even a full couple of months, and it doesn't seem to be going away as a discussion any time soon. In fact, the discourse is now focused on not if there will be inflation, but how one might invest around inflation in its second and third-order events, including perhaps the Fed tapering its assets and causing a taper tantrum. To help you in this conversation with your clients on this topic and to share his take on what the scenarios are, more probable or less probable, and how he is preparing for them, we're very happy to be joined by fixed-income manager, Jeff Moore. Jeff manages all or portions of many of Fidelity's popular products including the Multi-Sector Bond and the all new Multi-Asset Innovation Fund. Great to see you again, Jeff. Welcome.

Jeff Moore: Thank you, Pamela. Nice to see you too.

Pamela Ritchie: I'm going to ask you right out of the gates, is the biggest risk that everything goes right, and we get some inflation? Or everything goes wrong, and we get deflation. Where do we sit in that conversation right now?

Jeff Moore: I think the biggest risk is everything goes wrong, and we get deflation. As much as inflation would be a problem short term, there's so many different types of assets that can over time on a discounted cash flow basis handle inflation, change pricing and so forth. Inflation is the known thing and it's the thing. If you're the Federal Reserve, and you ask the Bank of Canada, you'd rather have a little bit of inflation. Deflation is a whole different kettle of fish. Ask the Bank of Japan or the ECB. They would rather take inflation than deflation.

[03:26]

Pamela Ritchie: Is the inflation discussion what really keeps you up at night or is there another piece that we're not really looking at right here? Something that augments the risk out there in the market?

Jeff Moore: What keeps us up at night is not inflation per se, especially if you think it's inflation and it's 100 basis points extra, or it's interest rates up 100 basis points like a taper tantrum. Those don't keep us up because those are known nodes. We can handle those. We've demonstrated it the last multiple number of times when interest rates have gone up that we can handle that. Those aren't really big destructive events in the bond portfolio. The kind of thing that would be really upsetting to me would be a rollover in real growth, in the sense that we've put so much stimulus in the system. We have this massive reflation expectations curve today. Everybody thinks reflation's on its way and the reflation being asset prices going up. If we got to a point where we rolled over and our clients all said, "we're back at this again," that would be tougher because in that world it would kind of send the signal that the Fed is running out of bullets, the fiscal stimulus probably can't continue for as long as we wanted it to, and that we're into a slow growth economy. That would be what I would be most concerned about.

[04:50]

Pamela Ritchie: Kind of remind us the role of bonds. Because in a heady equity market, which some people feel it is, and some people feel actually there's a whole lot further to go, it's not particularly heady. Maybe there's risks to both views. From your perspective where does this fit? Where does a stable, you get your investment back plus a little, fit?

Jeff Moore: I would say the number one thing today, it's diversification. If you've decided that, hey you want to stay invested in stocks, and I would say to you our instinct would be to have your average amount of risk-on today for all the macro reasons that we think. But let's say you don't want to be all in. The nice thing about having bonds in your portfolio is you get paid to wait, which is to say you get a positive interest rate, you get diversification and then if there is some big pullback in stocks you have an obvious asset allocation. I like it.

[05:42]

Pamela Ritchie: At this point, it's an unbelievable time with interest rates. What do investors following the path that you're laying here, what can they expect in terms of return?

Jeff Moore: You have to be mindful that starting interest rates today are below where they were in the last decade, other than '08. When you start with interest rates this low, you should probably on a forward basis have a very low return expectation. What we would say is probably low single digits. It's going to be almost impossible in our mind, under almost any scenario we can envision, to get a double-digit return like last year and the year before. At the same time, under most of the scenarios you have enough income to offset a one standard deviation price decline, so it's even going to be hard to get a negative return. So you're kind of caught in this window of zero to a handful of percent, is our base expectation for bonds. And lots of liquidity.

I would say for clients today your short-term view of bonds should be a little bit lower than the returns that we've seen in the last three or four years.

[06:48]

Pamela Ritchie: Let's pick it apart a little bit. Let's start with duration. Lots of discussion about what you do or don't need, a crowded front end, which it is. What do you look at for duration being reasonable now?

Jeff Moore: I would like to say just your average duration. I think that the Federal Reserve, the Bank of Canada, the ECB, Bank of Japan, the PBOC in China, they're anchoring front end. There's no sign that the front end is selling off. So all the action, if you're worried about the bond market, is in the long end of the yield curve. The sell-off and even the rally, that's where all the action is. So we have this steepening, flattening curve, but we don't have a parallel shift curve. The good news for you as a client is you're only worried about where on the curve out there do you say that's far enough?

What we've done as a group is we've said "let's have our average simulated duration". The thing about stimulated duration, this is where we use our rapids-plus models and we say, let's say rates go up 100 basis points tomorrow or down 100 basis points, how does the portfolio really look like, how does it react? In that world our portfolio sort of looks like a really short duration, three, four duration. That seems okay to us for here and now. Having said that we have opened up tons of buckets in terms of cash buckets and near cash. We've got lots of different buckets so that if we decide to go buy the long end curve and take our stimulated duration way up, we can do that in a few minutes and really change the nature of the portfolio. So if there's a big fat pitch in the long end, we'll go get it.

[08:24]

Pamela Ritchie: Tell us about what kind of … you talked about known unknowns, and that is there. What other things could disrupt the market and therefore have you pulling levers that you have at the ready? What sort of catalyst do you model for that you can share?

Jeff Moore: One of the big catalysts today — we've talked about financial conditions, so we won't go into financial conditions, but I want people to realize that excess reserves in the system are over $1½ trillion *[indecipherable]*. Think of that. What is an excess reserve? That's money that's available to be lent whether if you want you can take some, and they can lend and buy an option on a stock. It's lent to go buy bonds, and what it means is the front end assets in the U.S., if you push me, I would say they want to go lower in yield, not higher. Just because there's such a huge demand, a huge amount of excess reserves, and now we're about to add another 1.9 trillion in fiscal stimulus, that's that piece.

If I'm a client here, I'm a little bit worried, not worried, I'm of the view that the liquidity runway's still there for this reflation narrative to continue. My colleague, Mike, always says this is THE most consensus thing. So anything that's the most consensus thing always makes me a little, okay there can't be that much upside to the most consensus thing. So that's the risk here, that we have all the liquidity in the system, there's no evidence that liquidity has gone away, and I don't think the Federal Reserve is going to take away the punch bowl even a little bit. And so in that world you're into the reflation narrative but it's consensus already, so your upside's probably capped.

[10:03]

Pamela Ritchie: With so much stimulus in the system, one of the arguments has been, among many, and more fiscal stimulus coming, is that things like defaults probably won't happen at the rate that some would say they should. You get into a conversation with zombie companies and so on, but your thoughts on different types of quality within the bond market and I guess the distortion effect of stimulus in there.

Jeff Moore: That's a great question. We just talked about duration. Duration really is about risk-free. It's about U.S. Treasuries, it's about Government of Canada Bonds, it's about Bank of England, it's about gilts, it's about bunds, so that's what duration is. When you talk about investing in high-yield, or triple-Bs or leveraged loans the first thing that comes to mind is that spread to the government bonds, and that spread is supposed to compensate you for some kind of default risk. I think you're absolutely right. It's hard to get defaults in a world where there's this much excess liquidity because rollover risk goes way down.

We have evidence of this. In the last couple of years, chapter 11 defaults, this is U.S. here, chapter 11 defaults have been less than chapter 7. Think of a chapter 11 is liquidity. Someone gets in trouble, they have to re-profile their debt, but they're still going to ultimately pay some cents on the dollar. Chapter 7 is full liquidation. You have no business, no one cares about your business, there's no restructuring that matters. You're just liquidating it and going away. So we now have really low defaults, but these defaults are chapter 7 defaults, businesses just going away.

I think that for clients, enjoy this ride, enjoy the liquidity, recognize you're only getting 4, 5, 6% yield on a high-yield loan, so you have to be mindful your upside isn't that much, but at the same time you're in a good space until the excess liquidity goes away at a minimum.

[11:56]

Pamela Ritchie: In terms of a strategy, listening to what you're saying, what type of strategy can Fidelity, through balanced approaches, sort of offer within this? As you say, there is all this liquidity which could be upside, downside risk, but then you have the side that you're managing. What's on offer?

Jeff Moore: One of the things that we have on offer is our brand new tech-balanced product that is super-duper. This has got half of it invested in bonds. You think about what that does. It moves your beta in the stock to tack down by 50% or so, and it allows you that if you get a pullback, you *[indecipherable]* obvious asset allocation. So that one I like. You can do those asset allocations in a day, which I think gives you and your client lots of protection. Even if there's a drawback, you can use those drawdowns as a chance to reload rather than otherwise.

At the same time, if you think about Multi-Sector Bond or our Global ETFs, what we're trying to do is go around the world, find bonds that yield 3, 4% that we think can generate that return in most scenarios that we can see. So if someone says, "I don't want to own high-yield anymore. I owned it, it did well", but you don't want to go try to buy short-term debt because short-term debt literally is yielding zero. A nice sort of place to end up is in our multi-sector products where we have great sector diversification, great global diversification. We're using all of our analysts at Fidelity to find good bonds, and you can sit there and wait, and you're paid to wait, until that day comes when you see an obvious trade for your clients.

[13:32]

Pamela Ritchie: As you were mentioning the global nature of things, I just want to touch on that. We've got Mario Draghi who looks like he's the new guy in Italy saying things like, yeah Europe has to have a common budget. There's all sorts of changes going on around. For instance, in the currency markets are there opportunities to be more allocated to Europe because you like the euro? What are the subtleties within there, are they worthwhile or not?

Jeff Moore: As you know, we talked about this, we've really taken our allocation to international credit up. It's not EM, I want to make it clear. We're not going down in quality, we're going just across the ocean in quality. We're buying what I call investment grade companies, mom and pop companies out of Europe and then we're hedging them back to dollars. Partly because our inflation expectations are higher than Europe's and for good reason. You get a nice positive carry on the hedge, an extra 1+%, and you can buy bonds that are a little bit cheaper than in the U.S., for instance. So we can put together a bond portfolio that has yields around 3% for what we think is investment-grade quality.

Again, part of this whole narrative, we want to pay our clients to wait, we know it's hard to be patient but right now, given all of the excess liquidity, everything's okay. We're going to do this, pull in, and then when there's young opportunity we'll take it, but international is clearly part of our game plan here.

[15:02]

Pamela Ritchie: Your thoughts on real return bonds or TIPS. Is it related to what you just said, being maybe more exposed to different currencies, same backdrop?

Jeff Moore: Inflation protected bonds, whether they're real return in Canada, whether they're TIPS in the U.S., it had a nice run. They've had a nice run. If you remember back in March, they got all the way down to .6%, .7% break- even. That was what was expected. Inflation expectations have now soared to over 2%, which is sort of the Fed and the Bank of Canada's sort of soft target. Think 2 to 3%. I like them a lot better at .6 but now there's a lot in price. I feel like this is part of the whole reflation trade, whether it's reflation in TIPS prices or just reflation in stock prices or reflation in all the credit bonds that I own in the portfolio. We've had the same underlying theme. So if you buy inflation protected bonds, in my mind right now you're buying at fairly high levels and, more importantly, you're buying into something that's probably not as diversifying as you think it is.

[16:15]

Pamela Ritchie: Let me ask about that, and maybe we'll use it as an example 'cause that's what one of the investors joining us right now is asking specifically on that. That question, is everything co-related? Are there too many co-relations? Just speak to the diversification again that is available.

Jeff Moore: This is a huge issue for all of us. I think there's this view that oh, I could just diversity my stock portfolio. I'll have my stock portfolio, and then I'll have a few investments over here, and they'll offset, and I'll never have a negative return. That's not really possible especially in a world where you have so much central bank stimulus and it's global. Every central bank's doing the same trade, it's not one, this is all. Okay, maybe there's a random one that I don't know, if you can find it, great. But we're caught in where the most of the base risk here is all the net present value of everything. When interest rates go down the NPV of every asset goes up. Makes sense, right? Just 'cause now longer-term cash flows matter more. This is our first-year university finance course.

[17:29]

Pamela Ritchie: I was going to ask is that related to what we're seeing in the rise of cryptocurrencies?

Jeff Moore: Yeah. I think it's related to pretty much everything. If you're full-on U.S. dollar, or you're full-on the Canadian dollar, you have an option. You can go buy euro, if you can get a bank account you can go buy something in China. But if you can't, you can go buy gold, you can buy gold in ETF form and now cryptocurrency comes along and it's electronic gold. It's a *[indecipherable]*, it's not exactly what it is. So yeah, I think a lot of this is related. These are all *[indecipherable]* together.

[18:07]

Pamela Ritchie: What is the total float outstanding of 10-year bonds, and what percentage approximately is the Fed currently buying? You spoke a lot about maybe more work the Fed has to do in buying at the front end, but now this is a question on this end.

Jeff Moore: When it comes to new issue, how much debt is the Fed buying, you think about the Fed's doing over 20 billion a month in treasuries. They're doing a whole bond auction in TIPS, and they're doing another 20 billion a month in mortgages. When you think about the Fed, the Fed is probably of the U.S. deficit financing right now 50% of it, and plus minus depending on what your deficit outlook is. As a percentage of the total outlook, you think of the total debt in the U.S., let's call it $20 trillion, and the Fed balance sheet's probably 6 trillion of which, say 3 or 4 trillion is treasuries, so still in the 20, 25% of the total. Interestingly though, if you're saying how long can this go on. Think about the Bank of Japan. Bank of Japan's been at this since the 1990s. Bank of Japan owns over 50% of all the JGB. The Bank of Japan just now owns over 50% of the Nikkei.

[19:30]

Pamela Ritchie: It's such a domestic example. That was always the argument, that don't worry, they're owning their own debt. It's not a globally exposed debt market in the same way that … How does that fit comparison-wise now with the Fed being such a big buyer? You said 50%, so it's actually changed, right?

Jeff Moore: And it just sucks volatility out of the system. No one wants to fight that here. By the way, let's look back at what happened in March. You look at March, we had a crisis, obviously a COVID crisis. We had a response function from governments which is to close borders which, as someone who was born and raised in Canada, the idea that they closed the Canadian border is still to me the most amazing thing. I would never have thought of that. We went through world wars, and that didn't close. So the response function was extraordinary on GDP. Think about what the Fed was able to do. Within a few weeks they mustered all the resources they needed, all the lessons learned from '08, and they got control over every risk asset including U.S. yield curve and then pretty much every price fell into order.

One thing I want for clients is, if you think the Fed is going to lose control now, I'm not there. That is not on. If they got control in March and April, this is a walk in the park. Now they're deciding, okay are Fed expectations 25 basis points too high, too low, this is all nuance stuff. This is a low total return environment because of that.

[21:00]

Pamela Ritchie: High yield; you touched on that earlier. Some will say it's closely related to the equity side of things. How do you look at that in terms of growth within your strategy?

Jeff Moore: High yield is to us something that's fairly core to our strategy. But high yield's not one thing. There's double-Bs, single-Bs, triple-Cs, heck there's Ds. Think about different types of companies being in the high-yield marketplace. For a lot of companies that are double-B, they've chosen double-B because that's the place that optimized the total return on their? stock. If you like the stock — and I think the S&P 500, what is it, 15 to 20% of the S&P 500 are junk-rated companies.

Pamela Ritchie: Although they're big names they don't really belong in that, right? Some of those are big names.

Jeff Moore: Netflix is a great example. How about Tesla? There's a lot of names down there that you can say, well, that's an okay name, I like that name. This is what we do too. When we look at high-yield, we don't see it as one monolithic thing. What we do though when spreads are low like they are, and default expectations and reflation expectations are so entrenched, what we do is we cut the tails off. We start going up in quality, buying into the names that are kind of where that management team is in high-yield opportunistically. They didn't fall there, they wanted to be there, and if they have to leave they will.

[22:23]

Pamela Ritchie: That's good to get some of your thoughts on high-yields. So is the Multi-Asset Innovation Fund, which you mentioned, the technology side of things, will you buy convertible debt issued from the innovation side?

Jeff Moore: The answer is no. When Mike and I take our multi-sector approach we buy only bonds. And what we do is we leave the stocks and stock volatility to our stock team. They're an award-winning stock team, you want them handling it, and that includes if they want to go into converts they can. We can buy preferreds, but the preferreds we're going to buy are much more stable entities and probably not what you're thinking of in terms of technology. But we're the diversification, the ballast so to speak, and pay you to wait part of it, and we know our job, and we're going to just isolate our job.

[23:17]

Pamela Ritchie: Question here, is real estate/the infrastructure sector a protection from inflation?

Jeff Moore: Not per se. Over time I guess it is. It depends on the duration of whatever bonds you buy off that infrastructure. So if you buy 30-year bonds in anything, there's not a lot of inflation protection per se, especially if there's no spread. Having said that, if you're buying something like a REIT, a real estate investment trust, they're going to have a lot of ways to offset surprise inflation over time. There's a lot of things I would say to this. If you got a surprised anything, like the COVID crisis, you get disruption in asset values, but it doesn't take long for company management teams and sectors to get their ducks in order, so to speak, and get back to making money.

[24:10]

Pamela Ritchie: I want to ask you to layer on demographics, which was actually something that you would speak about quite often prior to the pandemic. Demographics really haven't changed, it's just that other things were a little bit more flashing light for a while there. Where are we in the demographics discussion? Has anything changed?

Jeff Moore: I think there's been a lot changing and demographics, as you know, is a really slow moving train, but lately that train has been accelerating its downshift. Think about just what happened here. We now have at least six of the G10 countries with population decline. Think about GDP - the number of people you have times the output per person is GDP. If the number of people is going down, that's a headwind to GDP. All the lifting has to be done by productivity.

[24:56]

Pamela Ritchie: I've seen headlines of birth rates going down as well, and I guess that was the overall trend, but this seems to be something even leaning into that trend further I guess.

Jeff Moore: We're getting initial data from the U.S. at this stage, we'll get it from Canada and others soon, where it looks like we've had a baby bust. Probably not unexpected when you scare people and scare them in terms of medical and health. They're not going to look to have bigger families. A lot of people say "let's wait a month, or six months" or you know what I mean, which turns into fewer children over a long period of time at the big level. We now have the potential in the U.S., is what we're thinking right now, that we are actually in population decline in the U.S. starting now. Which means of the G10, South Korea has definitely gone into population decline. If our numbers are right, they're going to go from 50 million people today, in 25 years they'll have 36 million so they'll have less than Canada. And of that amount you're talking about something up to 20% could be over 60. It's unbelievable the shift that's going on. That's South Korea.

Think about Germany's in population decline, Russia is in population decline. China, we think almost has to be. We thought they would go into decline 2027, 2028. I think we're pulling that forward, I don't see how they're not either. When you look at the planet and you say, wow, the G10, which by the way the reason we focus on the G10 is it's a great amount of the total GDP of earth, if the G10 is in population decline, it's hard to see how we get real fast growth.

So I guess the worry I would have for clients is we've got all the stimulus in the system; we've got all this liquidity in the system; we've got the reflation expectations going for us; we're all in; we've got the U.S. fiscal stimulus and President Biden saying here's 2 trillion more, and on the other side of this at some point it's like, oof, wow, we can be slower than when we went into this. That would not be a surprise to me.

[27:01]

Pamela Ritchie: Geopolitical shifts with the Biden administration? There's a lot of chatter, but do you actually see fundamental shifts that people need to be concerned about or watch for?

Jeff Moore: I really don't at this stage. He's got a massive domestic agenda and so I don't think he's going to spend a lot of time on international issues. I don't think he will walk back a lot of things that have happened the last couple years. He just won't talk about them or change them is my instinct. I don't get any sense he feels like he has a lot to do in that front yet. I'm not calling for trade and things like that to be as big an agenda item as they were in the President Trump era. I also think that if you think about President Biden, he's been in government for a long time. He's extraordinarily seasoned, and he knows everything about how to get bills moved through, and so in that world I think he will be prioritizing right now what he has planned, and I think what he has planned is domestic more than anything else.

[28:05]

Pamela Ritchie: Does he have tax rises in that plan?

Jeff Moore: He said he did, and the tax code he talked about is W2 income, which is payroll income. He's talked about restoring the top income tax rate to 40%. He's talked about potentially adding to social security and Medicare payroll taxes and so, depending on the state you're in, for a lot of people there's a potential that somewhere in this administration your margin of tax rate could be crossing 50%.

[28:35]

Pamela Ritchie: There's questions to ask about ESG and shifts, and how quickly, how slowly. Is there a bit of a sentence that you could talk about this shift through a focus on ESG? That seems to be pretty pervasive.

Jeff Moore: ESG's a big deal. I think for clients it's morphing, and so we don't have all the answers yet exactly what it will look like, but think about this. Things like governance, which we've always done, now our analysts are expanding their work into things like how diversified is the board, how diversified is the C-suite because there's a lot of feeling that hey, if we have more diversification, we get better team outcomes. So it's all happening for bigger and smaller amounts. The E, the environmental piece is almost all becoming so far, it's about your use of water and net carbon emissions, so if you're a company you better have a plan for both of them.

[29:31]

Pamela Ritchie: Very interesting. There's more to talk about on that front. Jeff Moore, always a pleasure to get your wisdom. Thank you for joining us today. We'll see you again soon. All the best.

Jeff Moore: Thanks Pamela.

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