Fixed Income Perspectives

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The big story

November was an "everything rally": U.S. investment-grade bonds jumped over 4.5%, a move that rivalled the largest monthly return in U.S. history, while the S&P 500 Index rose over 9.1% in U.S. dollar terms. The exception to the rally was commodities, led by a decline in spot oil prices. For investors in cash-like investments, the return was a comfortable 0.4%, a reminder that reinvestment risk and opportunity cost could be important considerations.

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At current levels, Treasury Inflation-Protected Securities (TIPS) suggest that the market expects approximately 2.2% inflation over nearly every time horizon – that is to say, the U.S. Federal Reserve (the Fed) has won the inflation battle. Bond market confidence in November was buoyed by various global economic data showing softer price action and slower global growth. Importantly, the most recent core PCE, the favoured inflation measure of the Fed, declined smartly to 2.4% over annualized shorter time periods. We believe the bar is now very high for the Fed to raise rates from here on. And if the owners' equivalent rent rolls over, then talk of easing in coming periods is a very real possibility.

U.S. Federal Reserve

The everything rally was partly triggered by a dovish interpretation of future monetary policy. Last January's rally came on the premature expectation of a Fed pivot. Last month, the impetus came from Fed Chair Jerome Powell's apparent optimism that at current yields the economy could experience a soft landing and meet inflation targets.

European Central Bank (ECB)

Europe is close to, if not in, a modest recession. ECB President Christine Lagarde thinks rates are high enough, given the economic backdrop, to eventually meet inflation targets. Rate cuts are not in the cards, but rallies in various eurozone yield curves are possible as the market looks forward.

The People's Bank of China

The prospects for China's economy are rough due to slow economic growth, rampant real estate debt issues, questionable investment climate and the ever-present demographic headwinds – all enormous challenges.

Bank of Japan (BoJ)

Governor Kazuo Ueda is in a tough spot, as the BoJ needs to exit "hard form yield curve control" without triggering a dramatic yield curve move higher. We are very cautious on Japanese government bonds at this stage.

Valuations

- **Leveraged loans:** Year-to-date, this is the best-performing fixed income asset class, up more than 11%. With short-term rates higher for longer, yields should stay in the 10% range for now. With average credit quality in the B-rated range, credit deterioration and a modest uptick in defaults could be a headwind over the next 12 months.
- **High yield:** We are overweight and adding very modestly. October provided a brief opportunity to buy this asset class at yields above the 12-month range before they snapped back in November. Still, yields in the mid-8% range are compelling for what has become a BB-rated sector. Due to a debt maturity wall that generally starts in 2025 and later, default rates should remain low.
- **U.S. investment-grade corporates:** We are underweight in longer-maturity spread duration. Spreads are nearly as narrow as they have been for the past few years. The opportunity cost of an underweight position is now very low, and it presents great investment flexibility should market conditions – and valuations – change materially.
- **International credit (hedged):** We are modestly overweight. Spreads are relatively wide and have lagged the recent rally in U.S. credit. We prefer short- and intermediate-maturity spread duration, and there are lots of interesting idiosyncratic opportunities. Like the Fed, the ECB appears to be at the end of its hiking cycle, and sovereign rates are rallying as a result.
- **Emerging markets debt:** We continue to have highly selective exposure to emerging markets debt, preferring individual names that we believe have credit upside or lots of yield. We own local-currency issues from Brazil and Mexico. Both countries have yields at or near double digits, credible central banks that have demonstrated success in fighting inflation, and current account surpluses, making them net creditors to other countries. We also have a few U.S. dollar names, such as Dominican Republic issues, and a few emerging market corporate names.
- **U.S. Treasuries:** Our current allocation is our highest weighting in Treasuries ever. Yields are at 20-year highs, the Fed is credible on inflation, and Treasuries now provide return diversification potential for stocks. Our focus is on the seven- to ten-year key rates.
- **U.S. TIPS (Treasury Inflation-Protected Securities):** We have no exposure. Inflation break-evens have been in the 2.2%–2.4% range all year. However, longer-duration TIPS are sensitive to changes in the real rate (nominal Treasury yield less inflation expectations), which shot higher in the third quarter, hurting performance for the asset class. We prefer nominal Treasuries.
- **Agency MBS:** We have no exposure. This is the worst-performing fixed income asset class year-to-date. Spreads are not compelling relative to our opportunity set, and there is no obvious catalyst for outperformance, although we acknowledge that lower-coupon, longer-duration mortgages are near the widest spreads (for a government security) we have seen in a very long time. However, we prefer U.S. Treasuries, for diversification and yield curve management.
- **Structured product:** We are overweight in franchise bonds and airplane financing. We have very modest exposure to real estate. AAA-rated CLOs are interesting, but we do not own any at this time.
- **Local currency debt:** We are modestly overweight in a few currencies, but holdings total less than 5% of the portfolio in aggregate. Almost all our local-currency trade is described in the "Emerging markets debt" section above. Currency volatility, even for developed debt, can be double or triple that of the volatility of the Bloomberg U.S. Aggregate Bond Index, making it hard to control risk unless investments are made in moderation.

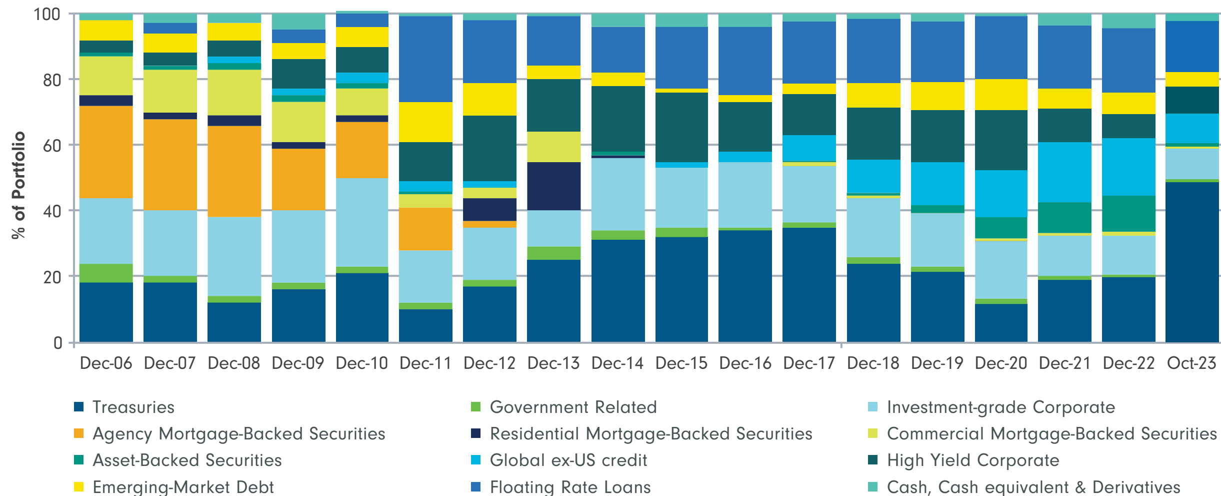
Performance

As at November 30, 2023	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	-0.2	2.2	1.5	-4.8	-2.8	1.7	1.2
Fidelity Investment Grade Total Bond CN Fund – Sr. F	0.1	1.7	1.2	-5.6	-3.6	1.0	0.5
Fidelity Global Core Plus Bond ETF	0	2.3	1.9	-4.3	-2.5	–	-0.6
Fidelity Global Investment Grade Bond ETF	-0.1	0.9	0.4	-5.7	-3.9	–	-2.3
Fidelity Tactical Credit Fund – Sr. F	0.9	6.8	6.3	–	–	–	0.4

Source: Fidelity Investments Canada ULC. Performance shows annual compounded returns as at November 30, 2023, net of fees, in Canadian dollars.

* Since-inception date for Fidelity Multi-Sector Bond Currency Neutral Fund is May 10, 2017. Since-inception date for Fidelity Investment Grade Total Bond Currency Neutral Fund is January 24, 2018. Since-inception date for Fidelity Global Core Plus Bond ETF is September 20, 2019. Since-inception date for Fidelity Global Investment Grade Bond ETF is June 5, 2020. Since-inception date for Fidelity Tactical Credit Fund is January 25, 2022.

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



Source: Fidelity Investments Canada ULC. As at October 31, 2023. The historical exposures shown are those of Tactical Bond Composite (the U.S. Fund) as at October 31, 2023. The U.S. Fund is not available to Canadian investors. The exposures of the U.S. Fund should not be interpreted as those of Fidelity Multi-Sector Bond (the CDN Fund), which is available to Canadian investors. The exposures shown above are used to illustrate the historical allocation changes to the portfolio over the period shown above. It is not meant to illustrate allocation or exposures within the CDN Fund, which follows a substantially similar investment approach. While the CDN Fund follows a substantially similar investment approach to the U.S. Fund, the CDN Fund may hold different investments and have different geographic exposures. In addition, the U.S. Fund and CDN Fund are subject to, among other things, different regulatory and tax rules, fee structures, timing of trades and investment restrictions. These and other factors will cause the U.S. Fund and the CDN Fund to have different returns. **Benchmark: Bloomberg U.S. Aggregate Bond Index**.

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