# Fixed Income Perspectives

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## The big story

Turning points matter because valuations are the most "off," or, as our colleague Hien would say, valuations are vulnerable to "surprise." Interest rate hikes ended last summer. The question now is when overnight rates might start to tumble, not just in the U.S. but in Canada and Europe as well. In our minds, the most likely data-driven surprise could come from inflation data, with the next few months seemingly offering near-term opportunity. More specifically, our research suggests that as housing inflation slows, we could see lower inflation despite continued resilience in labour markets.

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Positioning for lower inflation and, consequently, higher real interest rates is one of our top ideas. The Multi-Sector Bond portfolio has about 6% yield, which means clients are being paid to wait and can enjoy the luxury of patience. We have also diversified the portfolio, because risk asset valuations are pretty full, and while they are likely fair value for what we know now, do not provide protection in a hard-landing scenario.

## U.S. Federal Reserve (the Fed)

Fed Chair Jerome Powell suggested near-term interest rate cuts are unlikely. The next few CPI reports will solidify the Fed's timeline on rate cuts: these 8:30 a.m. releases are must-watch TV for investors.

## European Central Bank (ECB)

ECB President Christine Lagarde pushed back on near-term rate cuts, leaving markets to assume a first move in the summer. The ECB will also be data dependent, and she might well be monitoring Fed Chair Powell's timeline.

## The People's Bank of China

There are many issues to handle, including population decline, massive overinvestment in real estate and managing foreign exchange settings for trade versus capital.

## Bank of Japan (BoJ)

Exiting yield curve control is slow: BoJ Governor Kazuo Ueda has a very long-dated challenge. Interest rates currently offer investors very little compensation compared to the challenges of making Japanese government bond auctions relevant.

## Valuations

- **Leveraged loans:** This was a top-performing fixed income asset class in 2023, returning more than 13%, and still yielding around 10%. The Fed has been on hold since July and claims cuts will come slowly. Although lower rates will reduce the income realized in the sector, fundamental credit quality may improve at the margin as interest expenses decline. The market is wide open for issuers, and many are refinancing. We expect default rates to remain low.
- **High yield:** We are overweight and adding selectively. Fourth-quarter returns soared on market expectations of a soft landing and a Fed pause, permitting rates and spreads to rally, but the sector then took a breather and traded sideways in January. Yields in the 7%–8% range are still compelling for what has become a BB-rated sector. The debt maturity wall starts in 2025 and later, a positive in that default rates should remain low.
- **U.S. investment-grade corporates:** We are underweight in longer-maturity, higher-quality corporate bonds. Spreads are nearly as narrow as they have been in the past couple of decades. The opportunity cost of an underweight position is now very low, and it presents great investment flexibility should market conditions – and valuations – change materially. We are being patient.
- **International credit (hedged):** We are modestly overweight. Spreads are relatively wide and have lagged the recent rally in U.S. credit. As in U.S. investment-grade corporates, we prefer short- and intermediate-duration bonds. There are lots of interesting idiosyncratic opportunities, particularly in financials. 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:** Our preferred process for this asset class is to pick and choose among countries and quasi-sovereign/corporate names that we believe have credit upside or lots of yield. Our top idea is to 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.
- **U.S. Treasuries:** Our current allocation is our highest weighting in Treasuries ever. Yields are at 20-year highs, providing positive real income; the Fed believes the inflation fight is nearly over, and is preparing to ease; and the potential to offer diversification for stocks is lurking beneath the surface. We expect the yield curve to steepen (normalize) over time.
- **U.S. TIP**S (Treasury Inflation-Protected Securities): We have no exposure. Inflation break-evens were in the 2.2%–2.4% range all year and have recently slipped to nearly 2.1%. The market is confident the Fed has won the inflation battle; however, we prefer nominal Treasuries, given similar expected yields with better liquidity.
- **Mortgage-backed securities:** We have no exposure. Spreads are not compelling relative to our opportunity set. The sector seems range bound, with no obvious catalyst for outperformance and a limited availability of alpha from security selection that meets the threshold for the strategy. 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.

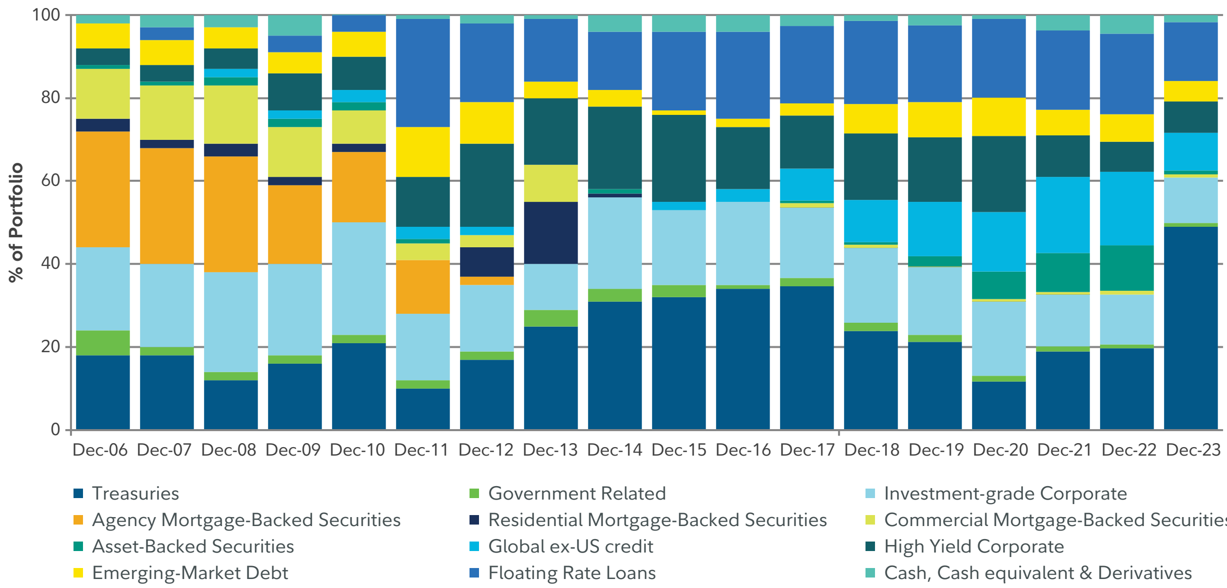
## Performance

| As at January 31, 2024 | 3-month | YTD | 1-year | 2-year | 3-year | 5-year | Since inception* |
|---|---|---|---|---|---|---|---|
| Fidelity Multi-Sector Bond CN Fund – Sr. F | 8.2 | -0.2 | 2.3 | -2.4 | -1.7 | 1.9 | 1.7 |
| Fidelity Investment Grade Total Bond CN Fund – Sr. F | 8.6 | -0.1 | 2.0 | -3.1 | -2.4 | 1.2 | 1.1 |
| Fidelity Global Core Plus Bond ETF | 8.4 | -0.2 | 2.5 | -2.0 | -1.3 | – | 0.3 |
| Fidelity Global Investment Grade Bond ETF | 8.1 | 0.0 | 1.6 | -3.4 | -2.5 | – | -1.2 |
| Fidelity Tactical Credit Fund – Sr. F | 6.0 | 0.1 | 6.5 | 1.8 | – | – | 1.7 |

Source: Fidelity Investments Canada ULC. Performance shows annual compounded returns as at January 31, 2024, 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 December 31, 2023. The historical exposures shown are those of Tactical Bond Composite (the U.S. Fund) as at December 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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