Fixed Income Perspectives

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The big story

As Yogi Berra once said, "It's tough to make predictions, especially about the future." Actually, making predictions is easy; being accurate from a quantitative perspective is challenging. When incorporating forecasts into one's investment process, it is important to consider not only the expected values but also the error bands around those expectations. The wider the dispersion of potential outcomes, the less useful the prediction becomes. Although we do model thousands of possible scenarios to build a full distribution of potential outcomes, we keep our horizon short, and prefer "near-casting" or "now-casting" during uncertain times. In the U.S., the transfer of power from the Biden administration to the Trump administration will certainly bring changes to many government policies, yet the impact (both direction and magnitude) of those changes on the economy and markets during 2025 is unclear. Nevertheless, there is a wide range of seemingly reasonable, yet sometimes contradictory, narratives attempting to justify certain predictions about the future.

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The U.S. Federal Reserve (the Fed)

The Fed commenced its easing cycle with 100 basis points (bps) of cuts through the end of 2024. The market now has less than 50 bps of additional cuts priced in through late 2026. The median Fed "dot" released in December indicates two cuts in 2025 and an additional two cuts in 2026, albeit with a high degree of dispersion, reflecting the uncertain fiscal agenda and its unknown economic impact. This shift higher in forward guidance, as well as the market pricing of the terminal rate, led to a tough December (and a hard quarter overall) for the bond market.

European Central Bank (ECB)

President Christine Lagarde and the ECB continue cautious cutting, delivering a fourth round of cuts in December, but making no commitment on the future path. However, the market continues to price in about 25 bps of cutting at every ECB meeting through mid-2025.

Bank of Japan (BoJ)

The sustained virtuous cycle of wages and inflation remains intact; that may motivate BoJ Governor Kazuo Ueda to hike again soon, as the BoJ will have been on hold for nearly six months by the time its next decision is announced later in January. The market is pricing in 50 bps of hikes in 2025. The Japanese yen remains volatile, primarily trading with U.S. Treasury rates.

Bank of Canada (the Bank)

Starting in June 2024, the Bank lowered its policy rate from 5.00% to 3.25%, creating a historically wide interest rate differential with the U.S. With headline inflation coming in at target for four consecutive months, the end of the Bank's cycle is likely only 50 bps away. But in a very fragile political situation, with Prime Minister Trudeau and perhaps the Liberal Party on the ropes, U.S. tariff threats and the negative impact they would have on growth may start to factor into rate setting, pushing the end-of-cycle interest rate even lower.

Brazil Central Bank (BCB)

To combat rising inflation expectations, the BCB responded swiftly in December with a surprise raise of its policy rate by 100 bps, and signalled two more consecutive hikes of 100 bps to come. Pressure on the currency intensified from rising fiscal concerns that prompted the central bank to intervene to prevent disorderly price action, with $21.5 billion in foreign exchange auctions and $11 billion in credit line sales. The BCB remains vigilant and continues to issue restrictive forward guidance.

Bank of Mexico

In December, Mexico's central bank voted unanimously to lower its overnight rate by 25 bps, to 10.0%. With headline and core inflation expected to reach target in mid-2026, the board of the central bank is considering accelerating the pace of cuts as global shocks fade and activity weakens. The Mexican peso is primarily trading with U.S. Treasury rates.

Valuations

- **Leveraged loans:** We maintain a modestly overweight position after meaningfully reducing our position this summer. Leveraged loans put in a strong year in 2024, with returns very close to those of high-yield bonds, but with much less price volatility, given the lack of duration due to the floating rate structure. Nearly 70% of the broadly syndicated loan market refinanced or repriced at tighter spreads last year, leaving less income for investors in the future.
- **High yield:** We maintain a modestly overweight position. As with leveraged loans, the decline in credit spreads has reduced the appeal. Defaults have trended lower recently, and credit quality is stable, but valuations at the rich end of the asset class' history are keeping us cautious. We will prefer idiosyncratic opportunities to generate beta.
- **Investment-grade corporates:** We are underweight. This asset class is priced for perfection, with spreads as tight as they have been for the last 20 years, and it has run out of room to compress further despite positive fundamentals and technicals. Abundant supply last year – about $1.4 trillion – was absorbed smoothly by the market. The risk/reward profile is unfavourable: a return in spreads to just the long-term median from their current values would erase over four years of excess carry. Investors can generally receive 85% of the yield investment-grade credit offers – with zero credit risk – by buying U.S. Treasuries of similar maturity.
- **Global credit:** We are modestly overweight. Spreads relative to U.S. investment-grade credit are close to the 12-month average. A small carry advantage remains, and alpha will likely be idiosyncratic in nature. The asset class is less correlated to U.S. Treasuries than domestic credit. European government bonds are also compelling now that central banks are easing.
- **Emerging markets:** We have selective ownership of issues from countries such as Mexico and Brazil in local currencies and in U.S. dollars. Changes in U.S. trade policy could create a headwind, which keeps us cautious regarding foreign exchange volatility.
- **U.S. Treasuries:** We are modestly long on duration, after leaning into the significant rate sell-off in the fourth quarter of 2024. Our U.S. Treasury exposure remains close to the highest level in the history of the strategy, with yields back to the high end of the recent and long-term range. Most of the yield curve now has a positive slope, but substantial further steepening remains possible as developed market curves continue to normalize.
- **Inflation-protected bonds (TIPs):** We have a zero weighting in TIPs. Inflation break-evens have been 2.2% to 2.4% for the better part of two years. We prefer the liquidity of nominal U.S. Treasuries.

- **Mortgage-backed securities (MBS):** We also have a zero weighting in MBS. Spreads against U.S. Treasuries in the area of 40 basis points are not compelling, and we prefer the liquidity and stability of U.S. Treasuries.
- **Structured product:** We are selectively overweight, specifically in franchise bonds and airplane financing. We have a very small allocation to CMBS due to valuations. We continue to look for well-structured idiosyncratic exposure.
- **Local currency debt:** We only have idiosyncratic exposure, and the total size of the allocation is below 3%. Currency volatility is significantly higher than interest rate volatility (approximately three times higher). We own overweight positions in Mexico, Brazil and Japan. Mexican and Brazilian local currency bonds enjoy high yields.

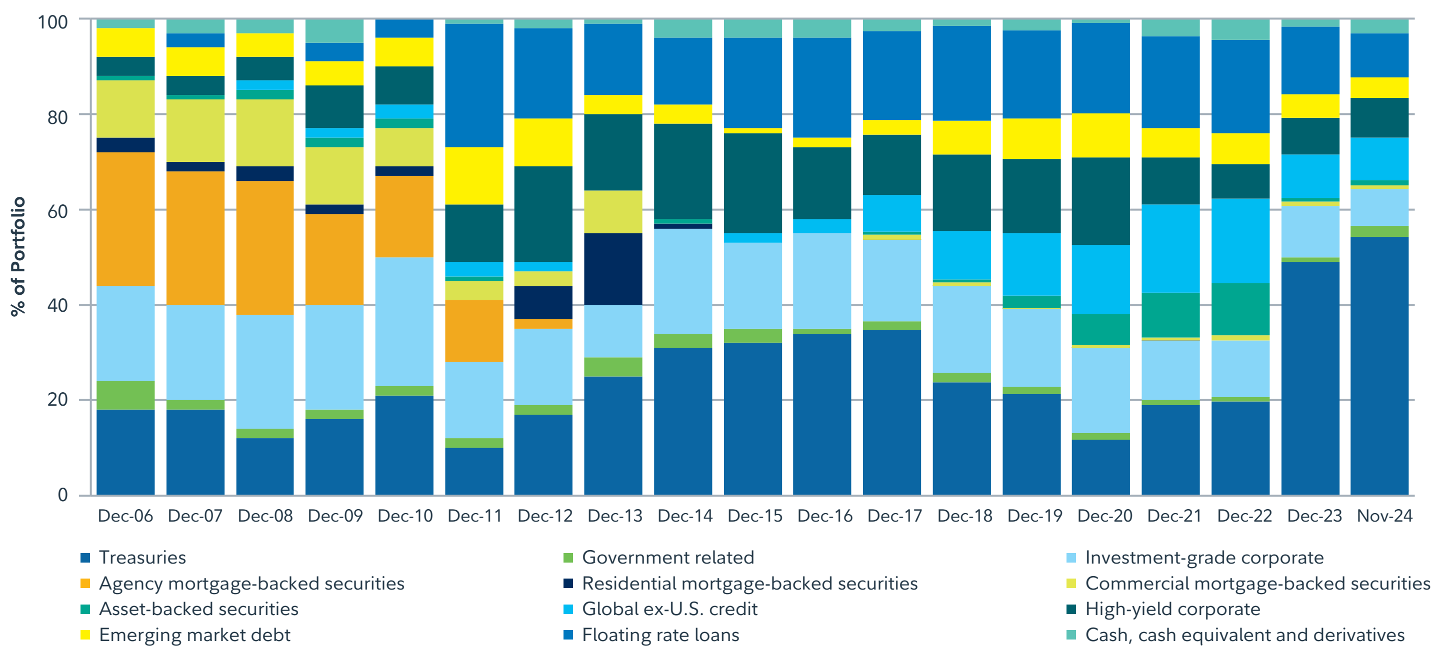
Performance (%)

As at December 31, 2024	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	-3.4	0.8	0.8	3.4	-1.8	0.4	1.7
Fidelity Investment Grade Total Bond CN Fund – Sr. F	-3.3	0.9	0.9	3.3	-2.3	0.0	1.1
Fidelity Global Core Plus Bond ETF	-3.4	1.0	1.0	3.7	-1.4	0.2	0.5
Fidelity Global Investment Grade Bond ETF	-3.6	0.5	0.5	2.5	-2.6	–	-0.9
Fidelity Tactical Credit Fund – Sr. F	-0.3	4.9	4.9	7.2	–	–	2.8

Source: Fidelity Investments Canada ULC. Performance shows annual compounded returns as at December 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 November 30, 2024. The historical exposures shown are those of Tactical Bond Composite (the U.S. Fund) as at November 30, 2024. 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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