Fidelity INVESTMENTS

Fixed Income Perspectives

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The big story

"Our scenario analysis still shows an envelope of potential returns that favours more positive outcomes than negative."

About a year ago we wrote, "If you don't like bonds now, maybe you just don't like bonds." The supporting arguments were numerous, but included high yields relative to history, the potential diversification benefit of bonds and the asymmetric return profile based on the output of our proprietary risk models. For the full year 2023, U.S. investment-grade bonds, as represented by the U.S. Aggregate Bond Index, returned 5.5% in U.S. dollar terms, yet the yield on the 10-year U.S. Treasury note remained unchanged, at exactly 3.87%. (Yes, there was plenty of volatility in between, but that is part of the reason we encourage taking a longer-term view.) We believe the reasons to own bonds at the beginning of 2023 still hold today: bonds remain a compelling part of a diversified portfolio.

We can argue, in fact, that those reasons are even stronger today. Yields for many fixed income sectors are still in the highest quartile over the past 20 years. The U.S. Federal Reserve (the Fed) has ended its hiking campaign and has hinted at cutting rates, now that inflation seems to be on a trajectory to reach the Fed's 2% target. And as the Fed becomes less relevant in terms of market risk and inducing volatility, the potential diversification benefit of bonds (based on a traditional inverse correlation with stocks) could re-emerge, as it did during the regional bank crisis last March. Also, our scenario analysis still shows an envelope of potential returns that favours more positive outcomes than negative.

U.S. Federal Reserve

The Fed appears to have pivoted, which means that given its economic projections, the next move will be to cut, rather than hike, the Fed funds rate. Late in December, several Fed speakers pushed back on market expectations of such a move, but the horse had already left the barn after the Fed's December summary of economic projections, statement and press conference. The next Fed meeting is scheduled for January 31, 2024.

European Central Bank (ECB)

Europe is close to, if not in, a modest recession. Yet ECB President Christine Lagarde stopped short of claiming victory on inflation or pivoting to a dovish posture like the Fed's. Rate cuts are not in the cards yet, but euro yield curves are starting to price them in.

The People's Bank of China

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

Bank of Japan (BoJ)

BoJ Governor Kazuo Ueda is in a tough spot, as the BoJ needs to move away from its negative interest rate policy and, eventually, its yield curve control. Just getting to a zero interest rate policy would be an important first step. Japanese government bonds rallied in December with bond markets globally.

Valuations

- **Leveraged loans:** This was a top-performing fixed income asset class in 2023, returning more than 13%. With the Fed on hold and 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 still adding. Returns soared in the fourth quarter on a Fed pause and market expectations of a soft landing, leaving the asset class with a sparkly 2023 total return over 13%, slightly ahead of leveraged loans. Still, yields in the 7%–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, higher-quality spread duration. Spreads are nearly as narrow as they have been in 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:** Our preferred process for this asset class is picking and choosing countries and 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. 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 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.
- **Agency MBS:** We have no exposure. 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 U.S. Aggregate Bond Index.

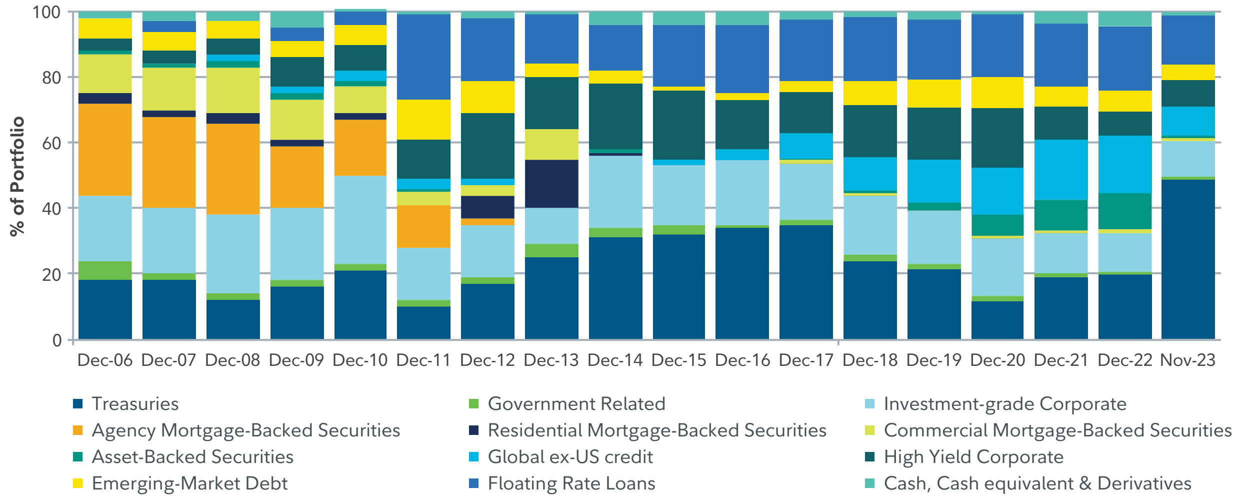
Performance

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	6.5	6.1	6.1	-3.0	-1.8	2.4	1.8
Fidelity Investment Grade Total Bond CN Fund – Sr. F	6.8	5.7	5.7	-3.8	-2.6	1.6	1.1
Fidelity Global Core Plus Bond ETF	6.7	6.4	6.4	-2.6	-1.4	–	0.3
Fidelity Global Investment Grade Bond ETF	6.3	4.6	4.6	-4.1	-2.8	–	-1.3
Fidelity Tactical Credit Fund – Sr. F	4.6	9.5	9.5	–	–	–	1.7

Source: Fidelity Investments Canada ULC. Performance shows annual compounded returns as at December 31, 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 November 30, 2023. The historical exposures shown are those of Tactical Bond Composite (the U.S. Fund) as at November 30, 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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