Fixed Income Perspectives

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Jeff Moore, Portfolio Manager | **Michael Plage**, Portfolio Manager

The big story

> "Economies generally don't play out exactly as the Fed models anticipate, and markets can't price in the unknown; the longer the horizon, the more likely it becomes that unexpected and meaningful events will materialize."

Is the market correct or is the U.S. Federal Reserve (the Fed) correct? The debate picked up steam after the December Federal Open Market Committee meeting, when the median "dot" implied three interest rate cuts by the end of 2024 – while the market was pricing in six interest rate cuts. In practice, neither the Fed nor the market is very good at predicting where rates will be 12 months on. Economies generally don't play out exactly as the Fed models anticipate, and markets can't price in the unknown; the longer the horizon, the more likely it becomes that unexpected and meaningful events will materialize. In December 2018, the Fed and the market both expected short-term rates to continue to rise for the next 12 months, but by the end of 2019, the Fed had cut interest rates three times (in response to China trade policy). In December 2021, both markets and the Fed expected interest rates to rise modestly (given transitory inflation); as we all know, the Fed raised interest rates 425 basis points (bps) over the course of the year (inflation was not transitory). The market is probably correct that interest rates will move down, and most likely a lot, but it may not be in the near term without a risk-off event. The Fed has expressed a willingness to be patient, holding interest rates high until it is confident that inflation will reach the 2% target, and recent jobs and inflation data are not helping the Fed achieve that level of comfort. However, all this makes for a rosy outlook for fixed income investors, who will continue to earn some of the highest yields the bond market has seen in the past 15 years.

U.S. Federal Reserve

The Fed is looking for additional data to bolster its "confidence" that inflation is sustainably heading toward its 2% target. Mixed inflation and employment data of late may push interest rate cuts out even further. Balance sheet discussions will commence this month.

The Bank of Canada

Markets are expecting the first interest rate cut in June or possibly July, but the Bank has repeatedly said that it wants ample evidence of sustained softening in underlying inflation. Bank officials are concerned that progress toward the 2% inflation target could stall, and new developments could fuel renewed inflation.

European Central Bank (ECB) and the Bank of England

Both central banks are expected to lower interest rates during the summer of 2024, and to move gradually from a restrictive to a more neutral policy stance. Inflation risk is better balanced this year; however, the economies have not yet materially improved.

Bank of Japan (BoJ)

A watched pot never boils. Moving from NIRP (negative interest rate policy) to ZIRP (zero interest rate policy) is likely in the near term, but it is unlikely that yield curve control will go away anytime soon – keep watching!

Valuations

- **Leveraged loans:** This was a top-performing fixed income asset class in 2023, returning more than 13%. The Fed being on hold, maintaining high short-term interest rates, will keep yields in the 10% range for now, which is still very compelling. Credit quality in the B range means that credit deterioration and a modest uptick in defaults could be a headwind, but it has been a year of massive refinancing so far (almost 20% of the outstanding market), which should push back the date of a "hard landing" for the asset class.
- **High yield:** We are overweight. Fourth-quarter returns soared on market expectations of a soft landing and a Fed pause, leaving the sector with a sparkly 2023 return of over 13%, slightly ahead of leveraged loans. Yields in the 7%–8% range are still compelling for what has become a BB-rated sector. The debt maturity wall has been extended once again following massive first-quarter issuance, 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 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. New issuance has been massive so far this year, as it has for loans and high yield.
- **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. Like the Fed, the ECB appears to be at the end of its hiking cycle, and sovereign rates are rallying as a result. New issuance has been significant year-to-date.
- **Emerging markets debt:** Our preferred strategy with this asset class is to pick and choose among countries and 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. We have a few U.S. dollar names, such as the Dominican Republic, 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 the potential to offer diversification for stocks. We prefer 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. We prefer nominal Treasuries.
- **Mortgage-backed securities:** We have no exposure. Spreads of 50 bps are not compelling relative to our opportunity set. 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) in a very long time. We still prefer U.S. Treasuries, for diversification and yield curve management.
- **Structured product:** We have selective exposure. 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.

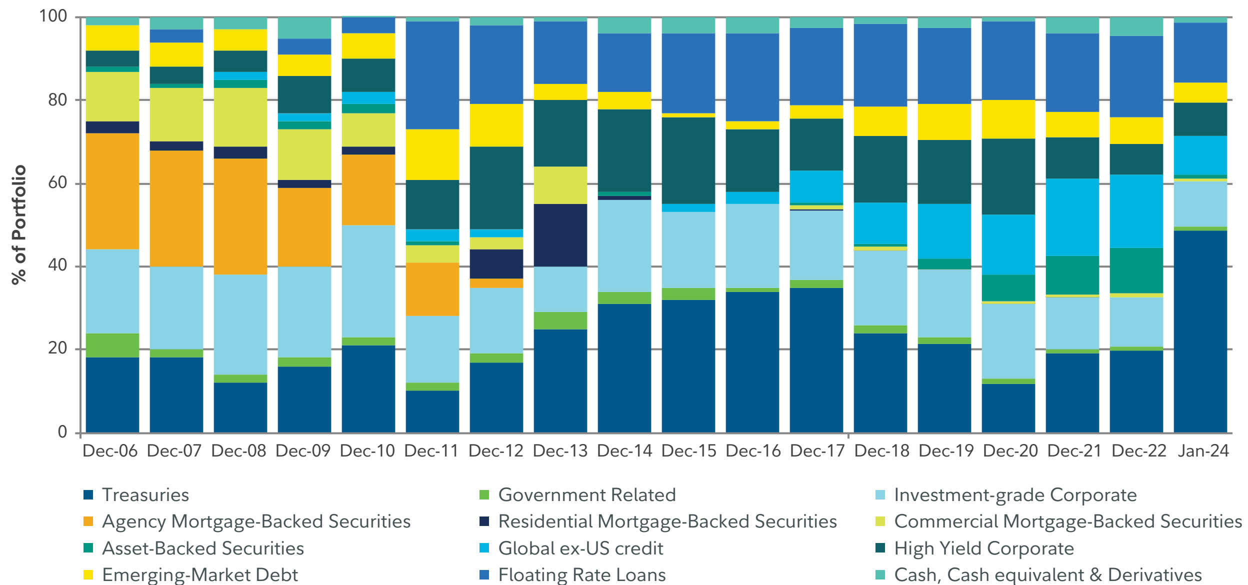
Performance

As at February 29, 2024	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	2.8	-1.0	3.2	-2.2	-1.6	1.6	1.6
Fidelity Investment Grade Total Bond CN Fund – Sr. F	2.7	-1.2	2.8	-2.9	-2.4	0.9	0.9
Fidelity Global Core Plus Bond ETF	2.8	-1.1	3.1	-1.8	-1.2	–	0.1
Fidelity Global Investment Grade Bond ETF	2.3	-1.3	2.1	-3.4	-2.6	–	-1.6
Fidelity Tactical Credit Fund – Sr. F	3.0	0.4	7.6	2.3	–	–	1.7

Source: Fidelity Investments Canada ULC. Performance shows annual compounded returns as at February 29, 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 January 31, 2024. The historical exposures shown are those of Tactical Bond Composite (the U.S. Fund) as at January 31, 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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