Fidelity INVESTMENTS

Fixed Income Perspectives

NOVEMBER 2023

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The big story

"An extended period of high interest rates is the base case; for investors, this means more income from their bond investments than they have seen in decades."

Financial conditions have tightened significantly in the past few months, even with the U.S. Federal Reserve (the Fed) on hold since its last interest rate hike in July. Borrowing costs for both investment-grade and high-yield corporates have increased by more than 1%, yet credit spreads are not showing signs of stress. Thirty-year mortgage rates in the U.S. are pushing 8%, and although housing activity has slowed to a crawl, home prices have held up well. Fed Chair Jerome Powell and the FOMC are focused on the impact tighter financial conditions will have on the economy and are most interested to see if persistently higher long-term rates do more to slow the economy than the rapidly rising short-term rates that the Fed controls directly. Unlike the sudden global economic shutdown we experienced due to the pandemic, the bite from higher interest expense takes time to pressure consumer and corporate balance sheets.

An extended period of high interest rates is the base case; for investors, this means more income from their bond investments than they have seen in decades. Daily and weekly price volatility will remain elevated, so when evaluating fixed income, it is prudent to do so using a longer horizon; we use 12 months in our scenario analysis. Bonds are still a very compelling part of a diversified portfolio. The flow of the tide has been pushing up rates as the "higher for longer" expectation has taken hold, but in a risk-off event we still expect a negative correlation to stocks to re-emerge, as we saw with the regional bank event back in March.

U.S. Federal Reserve

In our opinion, the Fed is done – or very close to done – with its interest rate hikes. The normalization of the yield curve through much higher long-term rates is tightening financial conditions, and that will allow the FOMC to pause and look at the impact over time. Of course, new divergent data or a renewed easing of financial conditions could change that.

European Central Bank (ECB)

We believe that for now, the ECB will join the Fed on hold, amid some early signs of weakening data. We do not expect changes to balance sheet policy.

The People's Bank of China

The prospects for China's economy are rough, and monetary stimulus is unlikely to be useful. We see too much debt in the Chinese economy.

Bank of Japan (BoJ)

Yield curve control was loosened at the margin, using 1% as a "reference point" rather than a hard cap for ten-year Japanese government bonds. The yen is a concern.

Valuations

- **Leveraged loans:** Year-to-date, this is the best-performing fixed income asset class, up more than 10%. With short-term rates apparently higher for longer, the sector's 10%-plus yield could persist for a while. The average credit quality is low B. We believe defaults and credit deterioration could be a headwind over the next 12 months.
- **High yield:** We are overweight and adding very modestly. Yields have crept higher over the last few months, mostly an interest rate-related movement. Yields approaching 9% are compelling. While defaults and credit deterioration need to be watched, average credit quality is BB, pretty much the highest credit quality on record. The debt maturity wall is still an event for 2025 or later, which is a strong positive for the asset class.
- **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 spreads, materially change.
- **International credit (hedged):** We are modestly overweight. Europe is close to recession, which means the ECB may be closer to ending its hiking cycle than the Fed. A yield curve rally in the eurozone is not out of the question if inflation falls as we expect. Spreads are wide to U.S. investment-grade bonds but have tightened nicely of late. We prefer short- and intermediate-maturity spread duration.
- **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.

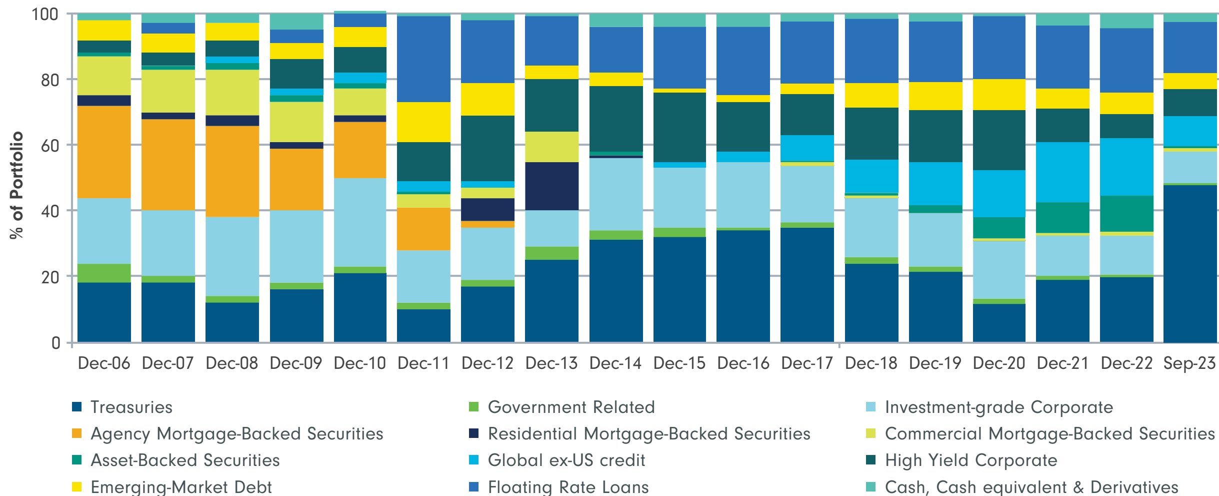
Performance

As at October 31, 2023	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	-5.0	-2.1	0.6	-6.7	-3.4	0.8	0.6
Fidelity Investment Grade Total Bond CN Fund – Sr. F	-5.0	-2.8	0.1	-7.7	-4.4	0.0	-0.3
Fidelity Global Core Plus Bond ETF	-4.8	-2.1	0.8	-6.3	-3.1	–	-1.6
Fidelity Global Investment Grade Bond ETF	-4.8	-3.3	-0.7	-7.7	-4.6	–	-3.6
Fidelity Tactical Credit Fund – Sr. F	-2.0	3.5	5.2	–	–	–	-1.4

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