Fixed Income Perspectives

Fidelity INVESTMENTS

OCTOBER 2023

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

The big story

Government bond yields in the U.S. sold off in the third quarter to touch near 20-year highs, in both nominal and real yield terms. Driving this move higher was Federal Reserve hawkishness, as well as a steeper reshaping of the yield curve. We wonder if bond markets will become more vigilant, to take into account massive fiscal deficits and significant future debt issuance.

"'Higher for longer' interest rates should be a factor for new capital spending initiatives, again even at the margin."

The good news for investors is that core bond portfolios can now mix and match various bond sectors and maturities to arrive at useful nominal yields in the 6%–7% range, with enough extra real yield to account for current inflation. This is compelling.

We continue to position for a steeper yield curve, which both history and investor preferences suggest is very likely. We prefer owning more bonds in the five- to ten-year key rate range than in the "wings" of the curve. Much of the negative return last quarter was due to a steeper yield curve, led higher by 30-year U.S. Treasuries.

Heading into 2024, one of our expectations is that the U.S. economy will slow in comparison with 2023. Whether we get a full recession or a sector-by-sector recession is less clear. The reset in interest rates to higher levels should pressure consumer and corporate cash use, if even on the margin. "Higher for longer" interest rates should be a factor in new capital spending initiatives, again even at the margin. And if there is significant fiscal retrenchment, that would be a headwind for what was the pro-cyclical fiscal policy of the past four years.

U.S. Federal Reserve (the Fed)

In our opinion, Fed Chair Jerome Powell's threat to hike interest rates one more time in 2023 is about keeping bond markets from expecting any easing in financial conditions. Inflation is a battle the Fed believes it is winning. The inflation-protected market has inflation break-evens of less than 2.5% for almost every maturity.

European Central Bank (ECB)

Softening economies in Germany, Italy and France, as well as progress on inflation, should allow ECB President Christine Lagarde to slow-walk further hikes, or even hold off on them. She will not, however, want markets to price in any rate cuts.

The People's Bank of China

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

Bank of Japan (BoJ)

Governor Kazuo Ueda is stuck between a rock and a hard place: interest rates need to go higher, but market participants have largely been absent since yield curve control started years ago. The BoJ can do almost nothing practical in the near term. The yen is a concern.

Valuations

- **Leveraged loans:** Year-to-date, this is the best-performing fixed income asset class, up more than 10% through the first three quarters of 2023. With short-term rates apparently higher for longer, the sector's 11% yield, and commensurate returns in a soft-landing scenario, should persist for a while. We are watching for signs of fundamental deterioration as interest expenses increase relative to income.
- **High yield:** This sector has delivered a year-to-date return of around 5%, and yields are still above 8%. The exciting part about high yield at this stage (even in comparison with loans) is that its average credit quality is BB, pretty much the highest credit quality on record. The debt maturity wall is still out at 2025 and beyond; this means that, unlike with loans, issuers have some time before interest expense increases. Defaults, as they occur, are most likely to be sector specific, and we do not expect a broad-based default surge in the product at this stage. We are overweight.
- **U.S. investment-grade corporates:** Spreads have tightened over the past few months, and are now nearly as narrow as they have been over the past few years. We like to keep powder dry in this market, maintaining our lower-than-benchmark position in intermediate- and longer-dated maturities, and having the flexibility to buy in response to a market event. In the meantime, we own Treasuries for duration, while giving up little yield.
- **International credit (hedged):** Spreads are wide relative to U.S. investment-grade corporates but have tightened recently. We continue to own an out-of-benchmark allocation. The diversification is useful in a portfolio context, and there are a few beaten-down investment-grade sectors in Europe and the U.K. that are attractive. This sector is a useful place to hide from rising U.S. rates, as ten-year Bund yields have risen less than ten-year Treasury yields. However, the asset class will become less compelling as the yield gap continues to increase.
- **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 by 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. 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 "Emerging markets debt" above. Currency volatility, even for developed debt, can be double or triple that of the volatility of the U.S. Aggregate Bond Index, making it hard to control risk unless investments are made in moderation.

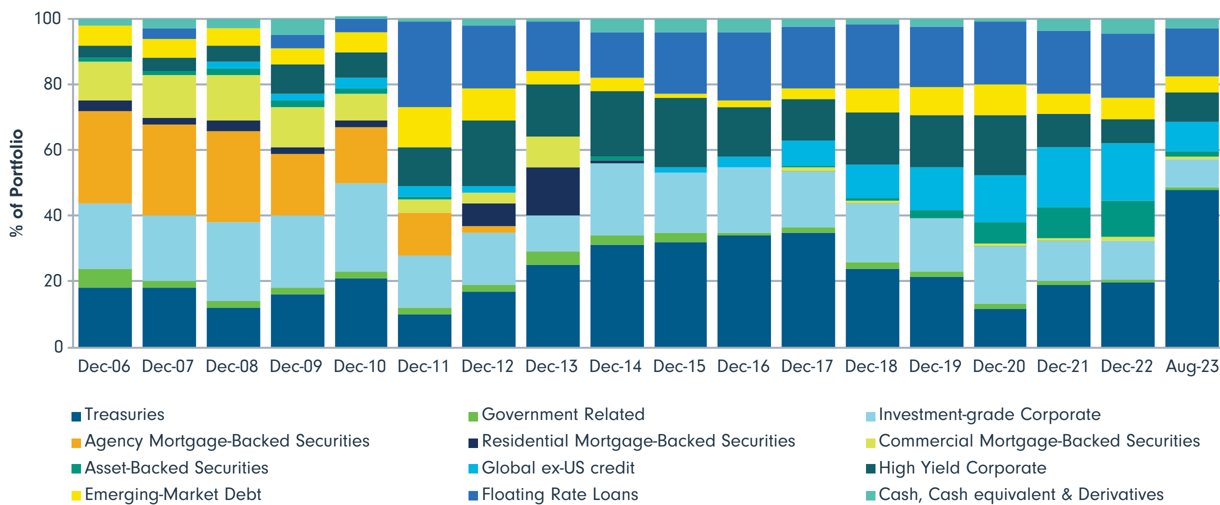
Performance

As at September 30, 2023	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	-3.2	-0.3	1.7	-5.7	-3.0	0.9	0.9
Fidelity Investment Grade Total Bond CN Fund – Sr. F	-3.3	-1.1	1.1	-6.8	-3.9	0.1	0.0
Fidelity Global Core Plus Bond ETF	-3.1	-0.3	2.3	-5.4	-2.6	–	-1.3
Fidelity Global Investment Grade Bond ETF	-3.3	-1.6	0.2	-6.8	-4.2	–	-3.2
Fidelity Tactical Credit Fund – Sr. F	-0.2	4.7	6.8	–	–	–	-0.7

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

Commissions, trailing commissions, management fees, brokerage fees and expenses may be associated with investments in mutual funds and ETFs. Please read the mutual fund's or ETF's prospectus, which contains detailed investment information, before investing. The indicated rates of return are historical annual compounded total returns for the period indicated including changes in unit value and reinvestment of distributions. The indicated rates of return do not take into account sales, redemption, distribution or option charges or income taxes payable by any unitholders that would have reduced returns. Mutual funds and ETFs are not guaranteed. Their values change frequently, and investors may experience a gain or a loss. Past performance may not be repeated.

If you buy other series of Fidelity Funds, the performance will vary, largely due to different fees and expenses. Investors who buy Series F pay investment management fees and expenses to Fidelity. Investors will also pay their dealer a fee for financial advice services in addition to the Series F fees charged by Fidelity. The rate of return or mathematical table shown is used to illustrate the effects of the compound growth rate and is not intended to reflect future values of the fund or returns on investment in any fund.

The statements contained herein are based on information believed to be reliable and are provided for information purposes only. Where such information is based in whole or in part on information provided by third parties, we cannot guarantee that it is accurate, complete or current at all times. It does not provide investment, tax or legal advice, and is not an offer or solicitation to buy. Graphs and charts are used for illustrative purposes only and do not reflect future values or returns on investment of any fund or portfolio. Particular investment strategies should be evaluated according to an investor's investment objectives and tolerance for risk. Fidelity Investments Canada ULC and its affiliates and related entities are not liable for any errors or omissions in the information or for any loss or damage suffered.

From time to time a manager, analyst or other Fidelity employee may express views regarding a particular company, security, and industry or market sector. The views expressed by any such person are the views of only that individual as of the time expressed and do not necessarily represent the views of Fidelity or any other person in the Fidelity organization. Any such views are subject to change at any time, based upon markets and other conditions, and Fidelity disclaims any responsibility to update such views. These views may not be relied on as investment advice and, because investment decisions for a Fidelity Fund are based on numerous factors, may not be relied on as an indication of trading intent on behalf of any Fidelity Fund.

Certain statements in this commentary may contain forward-looking statements ("FLS") that are predictive in nature and may include words such as "expects," "anticipates," "intends," "plans," "believes," "estimates" and similar forward-looking expressions or negative versions thereof. FLS are based on current expectations and projections about future general economic, political and relevant market factors, such as interest, and assuming no changes to applicable tax or other laws or government regulation. Expectations and projections about future events are inherently subject to, among other things, risks and uncertainties, some of which may be unforeseeable and, accordingly, may prove to be incorrect at a future date. FLS are not guarantees of future performance, and actual events could differ materially from those expressed or implied in any FLS. A number of important factors can contribute to these digressions, including, but not limited to, general economic, political and market factors in North America and internationally, interest and foreign exchange rates, global equity and capital markets, business competition and catastrophic events. You should avoid placing any undue reliance on FLS. Further, there is no specific intention of updating any FLS, whether as a result of new information, future events or otherwise.

© 2023 Fidelity Investments Canada ULC. All rights reserved.

FIC-1560693 10/23 797351-v20231018