Fixed Income Perspectives

Fidelity INVESTMENTS

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The big story

The cracks in the U.S. job market are starting to open up and the U.S. Federal Reserve (the Fed) is taking notice. The July non-farm payrolls report was soft across the board, with weak labour demand, narrow breadth of hiring, slowing labour income and, perhaps most importantly, given the market's fixation on the Sahm Rule, a rising unemployment rate. While there are reasons to believe the weakness may have been overstated in the July report, the narrative seems to be shifting away from the benefits of a falling inflation rate to the fear of a deteriorating labour market and a slowing economy. Both scenarios would result in the Fed lowering the funds rate. But for the Fed to cut as a "mid-cycle adjustment," or to become less restrictive, is dramatically different from easing to stimulate the economy because the Fed detects weakness. We will see in the coming months if the Fed is behind the curve, but as we have heard from the Fed chair himself on many occasions, the Fed has the tools and knows how to cut very quickly if it feels it is necessary – and the market is starting to think it increasingly likely that it will be.

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The presidential campaign season is about to heat up. We will hear a lot of fearmongering on both sides, and uncertainty is typically not supportive of market performance. Positioning portfolios for specific political outcomes is generally not a winning strategy, but taking advantage of the market volatility induced by political narratives can be. Try to differentiate between campaign promises and potential policy.

The Federal Reserve

The Fed has been on hold at 5.25% since last July. A favourable CPI print, followed by a weak employment report, has led the market to fully price in a September cut, and we expect the Fed to meet those expectations. The market is starting to anticipate a more aggressive easing cycle, and current data trends appears to support the view. There would have to be multiple 50-basis-point cuts in 2024 to meet current market expectations.

European Central Bank (ECB)

The ECB is at 3.75% and data dependent, but is looking for signals in the way U.S. data evolve. If the Fed is behind the curve, expect markets to start pricing more cuts from the ECB, despite stickier inflation in the eurozone.

Bank of Japan (BoJ)

In contrast to other developed market central banks, the BoJ surprised markets and hiked rates by 15 basis points (bps) at its July meeting, to 25 bps. The move, coupled with lower U.S. Treasuries rates and several well-timed interventions, has strengthened the Japanese yen 10% against the U.S. dollar in the past few weeks. The Nikkei 225 is down 13% since the rate hike, so BoJ Governor Kazuo Ueda may be patient from here on.

Bank of Canada (BoC)

The BoC has two 25 bps cuts under its belt, while the Fed has remained on hold. The BoC will have an opportunity to cut again before the Fed meets, potentially opening the gap to a 1% differential, a potential negative for the Canadian dollar against the U.S. dollar.

Valuations

- **Leveraged loans:** We have reduced our overweight significantly. This has been the top-performing fixed income asset class on a 1-, 3- and 5-year basis. Spreads have narrowed materially from the widths of 2020 and now seem fair value, at best. We maintain an overweight position, but now with room to add. A falling Fed funds rate as early as this fall will cut the yield advantage of this sector.
- **High yield:** We maintain a modestly overweight position. Like leveraged loans, this has been a top fixed income asset class for a few years. And as with leveraged loans, the decline in spreads has reduced the appeal. Defaults remain low and overall credit quality is stable.
- **Investment-grade corporates:** We are underweight. This sector is priced for perfection, as demand for yield has driven spreads to very tight levels. If spreads were to return to just the long-term median from their current values, it would erase more than four years of carry. Investors can generally receive 85% of the yield on investment-grade credit by buying U.S. Treasuries of similar maturity instead.
- **Global credit:** We are modestly overweight. This sector is a nice substitute for U.S. investment-grade corporates, and a bit cheap. Having said that, spreads have rebounded nicely in this sector, and outperformance of U.S. investment-grade credit will be small and likely idiosyncratic in nature.
- **Emerging markets:** We have selective ownership of names like Mexico, Brazil and the Dominican Republic in local currencies and in U.S. dollars. This sector has had a tremendous run, to the point that a great many emerging market debt issues have spreads and yields at or below investment-grade corporate debt with similar credit quality. Mexican and Brazilian local currency bonds enjoy double-digit yields. Recently, the Mexican currency has been hard hit by the election of a new president with possibly radical views.
- **U.S. Treasuries:** We hold a large overweight position, with the highest exposure in nearly two decades of portfolio history. Real yields above 2% are compelling. Inflation remains above the Fed's target, but stable and in decline. Our favourite part of the yield curve is 7-year maturity, to capture the steepener trade. Most of yield curve now has a positive slope, with only maturities inside four years inverted. There are high potential total returns if geopolitical risk materializes. The U.S. presidential election is not an investable theme, and we do not expect it to be a source of rate volatility.
- **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 have a zero weighting in MBS. Spreads against U.S. Treasuries in the area of 50 bps 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. For the most part, holdings in CMBS holdings are very small, mainly due to valuations. AAA-rated CLOs could be interesting in the future, but only if leveraged loan spreads widen significantly.
- **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.

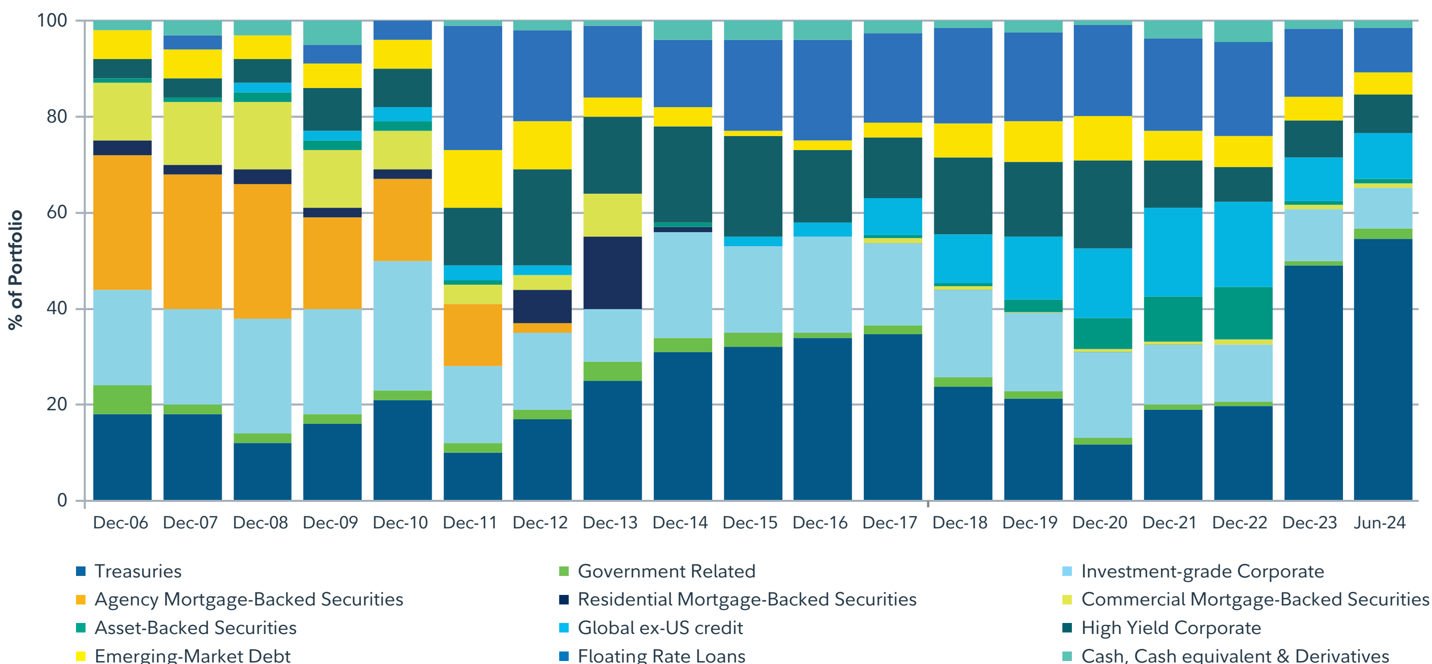
Performance

As at July 31, 2024	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	4.5	1.8	4.8	2.2	-1.5	1.1	1.9
Fidelity Investment Grade Total Bond CN Fund – Sr. F	4.6	1.8	5.2	1.8	-2.2	0.6	1.3
Fidelity Global Core Plus Bond ETF	4.7	1.9	5.3	2.7	-1.1	–	0.7
Fidelity Global Investment Grade Bond ETF	4.9	1.7	4.6	1.2	-2.4	–	-0.7
Fidelity Tactical Credit Fund – Sr. F	2.7	3.2	7.0	5.5	–	–	2.6

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