Fidelity INVESTMENTS

Fixed Income Perspectives

DECEMBER 2024

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The big story

> "However, more dispersion among fixed income sectors is likely, which will create asset allocation opportunities."

As we approach the end of 2024, we reflect on what worked and what did not during the year, and look ahead to the risks and opportunities that await us in 2025. The "Everything Rally" is on track to continue for a second year: all major fixed income sectors appear poised to post positive returns following the great interest rate reset of 2022. High starting yields can provide both a cushion against rising rates and a total return tailwind when rates are falling, which is why we were constructive on fixed income a year ago. That also helps explain why a majority of our proprietary simulations still show positive returns for the bond market over the next 12 months. However, more dispersion among fixed income sectors is likely, which will create asset allocation opportunities. U.S. Treasury securities offer compelling yield and diversification benefits, while many credit sectors are expensive from a valuation perspective and may be vulnerable to repricing at some point. Nobody can say for sure when that will happen, and spreads can stay tight for a long time, so it is important to be disciplined and patient. The new administration that is taking shape in the U.S. will undoubtedly be pro-business and will look to the equity market as a gauge of success, but investors should watch for longer-term risks building: there is no shortage of geopolitical risks across the globe.

The U.S. Federal Reserve (the Fed)

The Fed commenced its easing cycle with a 50-basis-point (bp) cut in September, made a subsequent 25 bp cut in November and will likely make a 25 bp cut in December. Changes in monetary policy in 2025 will depend on incoming data and on the fiscal and trade policies enacted by a Trump administration. The Summary of Economic Projections released at the December Fed meeting will not be helpful in this regard.

European Central Bank (ECB)

President Christine Lagarde and the ECB continue cautious cutting, and will likely deliver a fourth round of cuts in December, but is making no commitment regarding future actions. Even so, the market is pricing in cuts of about 25 bp at each ECB meeting through mid-2025.

Bank of Japan (BoJ)

Continued modest economic growth may motivate BoJ Governor Kazuo Ueda to hike rates again soon. The Japanese yen remains volatile, primarily trading with U.S. Treasury rates.

Bank of Canada

With inflation at target and growth coming in weaker than expectations, the Bank's Governing Council is committed to lowering its policy rate to Canada's neutral rate range of 2.25–3.25%. Given heightened geopolitical and trade risks, the Bank has an incentive to do this expeditiously in order to meet its mandate.

Valuations

- **Leveraged loans:** We maintain a modestly overweight position after meaningfully reducing our position this summer. Leveraged loans are slightly trailing high-yield bonds year-to-date, but with much less price volatility, given a lack of duration that is due to the floating rate structure. Nearly 70% of the broadly syndicated loan market has refinanced or repriced at tighter spreads year-to-date, leaving less income for investors in the future.
- **High yield:** We maintain a modestly overweight position. Year-to-date, the duration of high-yield bonds has propelled our investments in the asset class ahead of leveraged loans by approximately 100 bps in added returns. As with leveraged loans, the decline in credit spreads has reduced the appeal. Defaults have trended lower recently, and credit quality is stable, but valuations at the rich end of the asset class' history are keeping us cautious. We will prefer idiosyncratic opportunities to generate beta.
- **Investment-grade corporates:** We are underweight. This asset class is priced for perfection, with spreads as tight as they have been for the last 20 years, and it has run out of room to compress further, despite positive fundamentals and technicals. The risk/reward profile is unfavourable: a return in spreads to just the long-term median from their current values would erase over four years of excess carry. Investors can generally receive 85% of the yield investment-grade credit offers – with zero credit risk – by buying U.S. Treasuries of similar maturity.
- **Global credit:** We are modestly overweight. Spreads relative to U.S. investment-grade credit are close to the 12-month average. A small carry advantage remains, and alpha will likely be idiosyncratic in nature. The asset class is less correlated to U.S. Treasuries than domestic credit. European government bonds are also compelling now that central banks are easing.
- **Emerging markets:** We have selective ownership of issues from countries such as Mexico and Brazil in local currencies and in U.S. dollars. Changes in the U.S. trade policy could create a headwind, which keeps us cautious regarding foreign exchange volatility.
- **U.S. Treasuries:** We are modestly long on duration, after leaning into the pre- and post-election rate sell-off. Our U.S. Treasury exposure remains close to the highest level in the history of the strategy, with yields solidly in the top quartile relative to the past 20 years. Most of the yield curve now has a positive slope, but substantial further steepening remains possible as developed market curves continue to normalize. The MOVE Index (treasury implied volatility) is at multi-year lows, indicating a period of calm before the inauguration in the U.S..
- **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 also have a zero weighting in MBS. Spreads against U.S. Treasuries in the area of 40 basis points 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. We have a very small allocation to CMBS due to valuations. We continue to look for well-structured idiosyncratic exposure.
- **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. Mexican and Brazilian local currency bonds enjoy high yields.

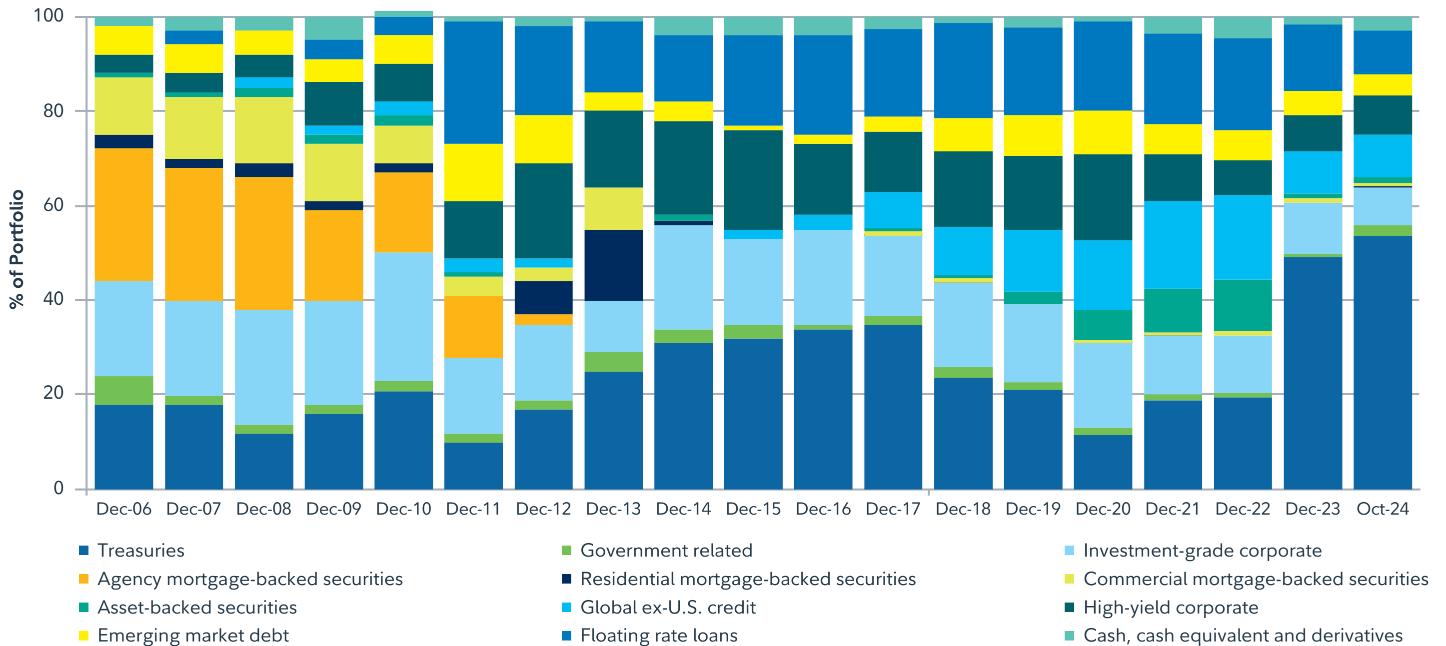
Performance (%)

As at November 30, 2024	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	0.0	2.9	6.9	4.2	-1.0	1.0	2.0
Fidelity Investment Grade Total Bond CN Fund – Sr. F	-0.1	3.0	7.0	4.1	-1.6	0.4	1.4
Fidelity Global Core Plus Bond ETF	0.0	3.2	7.4	4.6	-0.6	0.8	0.9
Fidelity Global Investment Grade Bond ETF	-0.3	2.6	6.4	3.3	-1.8	–	-0.4
Fidelity Tactical Credit Fund – Sr. F	1.7	5.8	8.5	7.4	–	–	3.2

Source: Fidelity Investments Canada ULC. Performance shows annual compounded returns as at November 30, 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 October 31, 2024. The historical exposures shown are those of Tactical Bond Composite (the U.S. Fund) as at October 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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