Fixed Income Perspectives

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The big story

Over the course of the last two months, the market has swung strongly in the direction of fewer cuts and higher yields out along the curve. This has been supported by a string of fairly strong economic data prints, along with uncertainty relating to the impact of the policies of the new U.S. administration. This may prove a bit shortsighted, because we know the underlying economic data have some degree of volatility, compounded by noise from seasonal adjustments, weather and, in some instances, low survey response rates. Much remains to be decided, implemented and seen with regard to policy impact. The U.S. Federal Reserve (the Fed) hit the pause button on rate cuts in January (at least temporarily); the market seems to be taking this as confirmation of "higher for longer." Fewer cuts are now priced in, and a higher-yield narrative is predominant. But all that can change swiftly, and we can envision many scenarios in which the bond market produces a capital gain.

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That said, a big movement lower in yields is not necessarily what we are rooting for. For fixed income investors, high yields are your friend, and we shouldn't forget the power of compounding, especially in an asset class that has relatively low volatility. Looking over the course of the last couple of decades, we haven't seen many periods with yields as high as they are now. Yields that stayed at these levels for a prolonged period of time would create a great environment for fixed income and long-term compounding. The only constant in markets is change, however, so it may wishful thinking to expect a continued run of high yields. Still, even if that doesn't happen, high yields right now give us a big head start, and could increase the chance of positive returns. So it's hard not to get excited about fixed income right now.

U.S. Federal Reserve

Having already cut 100 basis points, the Fed is comfortably assured that it is in a good place to continue to see inflation trending down, without hurting the labour market. We characterize the current stance as a dovish pause. The risk is that economic policies from the Trump administration will start to have an inflationary impact, limiting the Fed's ability to cut.

European Central Bank (ECB)

ECB voters will likely begin a more vigorous debate about how restrictive their policy rate is. However, our analysts still anticipate several more rate cuts into the summer – notwithstanding a probably short-lived uptick in CPI through the first quarter of 2025.

Bank of Japan (BoJ)

Japan is seeing a return of inflation, driven by wage gains and corporate pricing power. The BoJ increased its policy rate in January, as well as its inflation outlook, thereby setting the backdrop for further increases to the policy rate. The political calendar, foreign exchange and Trump's tariff policies will affect the timing.

Bank of Canada (the Bank)

In January, the Bank became the first central bank to end quantitative tightening, and it continued to lower its overnight rate. In a scenario that features no new tariffs, interest rates are near or at an appropriate level. However, the Bank is not providing any guidance heading into March, due to extensive uncertainty regarding tariffs.

Bank of Mexico

Given the current data, it is likely that Mexico's central bank would ordinarily be preparing to lower its 10% overnight rate, due to slowing inflation and moderate growth. Instead, however, U.S. policy uncertainty could lead the central bank to be more cautious, and to cut less than the macro conditions warrant.

Valuations

- **Leveraged loans:** We are modestly overweight. Nearly 70% of the broadly syndicated loan market has been refinanced or repriced at tighter spreads over the past year, leaving less income for investors in the future. The Fed's being on hold has attracted inflows to the asset class, as the base rate, in this case the secured overnight financing rate (SOFR), may keep yields elevated for a while. Demand from the collateralized loan obligations (CLO) machine remains strong. The majority of loans are priced at or above par, leaving little to no capital gain opportunity, given structural callability.
- **High yield:** We are modestly overweight. As with leveraged loans, the decline in spreads has reduced the appeal. Defaults remain very low and credit quality is stable, but valuations at the rich end of the asset class' history are keeping us cautious. We prefer idiosyncratic opportunities to generic beta.
- **U.S. investment-grade corporates:** We are underweight. The sector 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 is unfavourable: a return in spreads to just the long-term median from current levels would erase over four years of excess carry. Investors can earn roughly 85% of the yield on investment-grade credit – with zero credit risk – by buying U.S. Treasuries of similar maturity. While we remain patient, we are finding some idiosyncratic opportunities.
- **International credit (hedged):** 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 potential alpha from security selection is available due to spread dispersion. This sector is less correlated to U.S. Treasuries than domestic credit, but European government bonds are also compelling, with central banks easing.
- **Emerging markets debt:** We have selective ownership of issues in Brazil and Colombia and in names such as PEMEX. Changes in U.S. trade policy could create a headwind, which keeps us cautious regarding foreign exchange volatility.
- **U.S. Treasuries:** We maintain a long duration position after leaning into the significant rate sell-off over the fourth quarter of 2024. Treasury exposure remains close to the highest level in the history of the strategy, with yields back to the high end of both the recent and the long-term range. Most of the yield curve now has a positive slope, but substantial further steepening remains possible as developed market curves continue to normalize.
- **U.S. Treasury Inflation-Protected Securities (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 weight in MBS. Spreads against U.S. Treasuries in the area of 40 basis points are not compelling for this strategy, 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 commercial mortgage-backed securities (CMBS) due to valuations. We continue to look for well-structured idiosyncratic exposure, using our research edge.
- **Local currency debt:** We only own idiosyncratic exposure, and the total size of the allocation is below 2%. Currency volatility is significantly higher than rate volatility (approximately three times higher). We own overweight positions in Brazil and Japan. Brazilian local currency bonds currently yield approximately 15%.

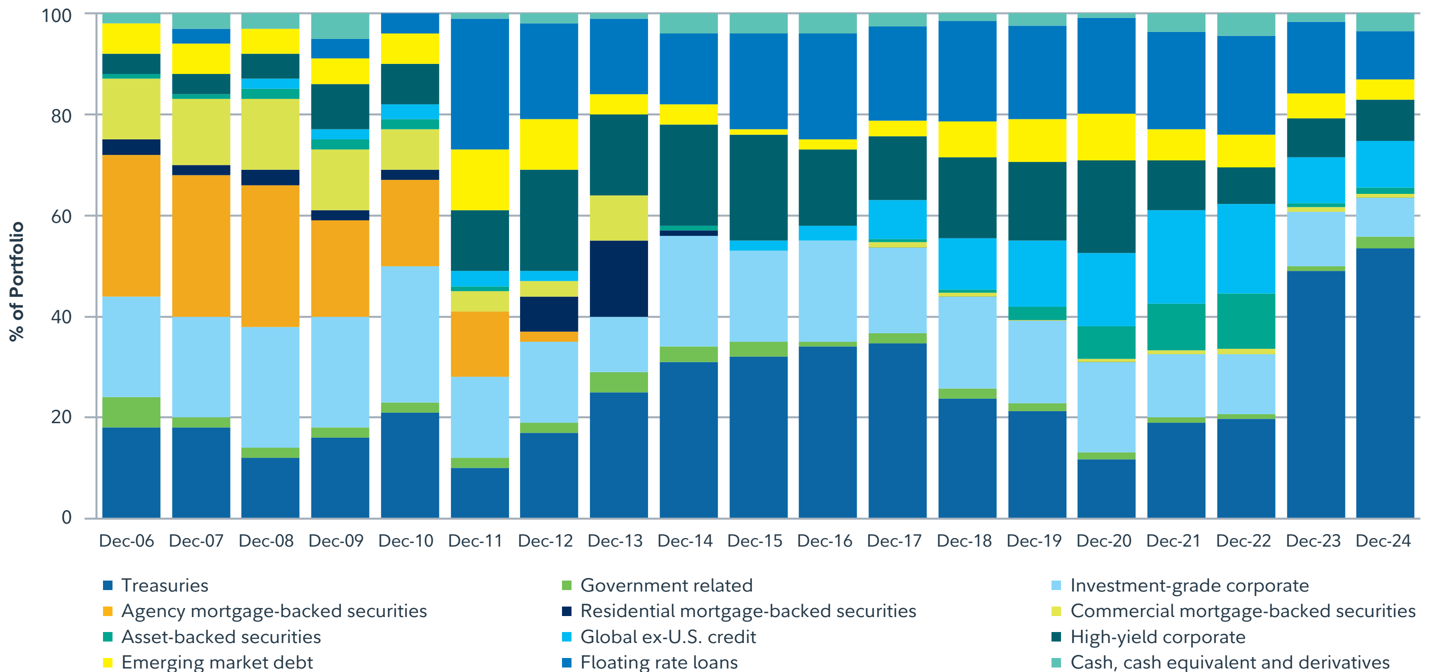
Performance (%)

As at January 31, 2025	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	(0.6)	0.6	1.5	1.9	(1.1)	0.2	1.7
Fidelity Investment Grade Total Bond CN Fund – Sr. F	(0.4)	0.6	1.6	1.8	(1.5)	(0.3)	1.1
Fidelity Global Core Plus Bond ETF	(0.4)	0.6	1.9	2.2	(0.7)	0.1	0.6
Fidelity Global Investment Grade Bond ETF	(0.5)	0.6	1.1	1.4	(2.0)	–	(0.7)
Fidelity Tactical Credit Fund – Sr. F	0.8	0.6	5.3	5.9	3.0	–	2.9

Source: Fidelity Investments Canada ULC. Performance shows annual compounded returns as at January 31, 2025, 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 December 31, 2024. The historical exposures shown are those of Tactical Bond Composite (the U.S. Fund) as at December 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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