Fidelity INVESTMENTS

Fixed Income Perspectives

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The big story

U.S. government bond yields have been in a range trade since last November, with the 10-year U.S. Treasury yield mostly between 4.0% and 4.5%. Inflation expectations in the U.S. have also been well anchored, albeit at a level still above the U.S. Federal Reserve's target, and recent economic data confirm steady progress toward the 2% target. One important feature of this range trade, wide as the yield band may seem for now, is falling interest rate volatility. The MOVE index has steadied and stepped back down to more normal levels and is far from the tail volatility. What we call the "dirty Sharpe ratio" (current yield/current volatility) is back to pre-pandemic norms. Said another way, interest rate "efficiency" is around average – giving a green light to risk parity investing.

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The higher-for-longer U.S. interest rate narrative has supported U.S. dollar strength. Nonetheless, we expect perceptions of currency manipulation to be a U.S. election issue. Markets have started to react to political developments, most recently the poor performance by President Joe Biden at the first presidential debate, as well as the possible actions of a Donald Trump White House, all against the backdrop of populism and fiscal implications coming from the French elections. Having said that, the upcoming election has still not generated any obvious investing theme, even regarding which party is "best" for markets. In our view, markets are likely expecting a split government at this stage, which would limit any bold new policy initiatives.

U.S. Federal Reserve (the Fed)

No rate cuts are likely until September, according to the market, and even then only a couple this year. Confirming low CPI data prints or signs of a visibly weakening labour market will be key for any material change to expectations regarding Fed moves. Financial conditions have recently tightened a bit, suggesting real interest rates are high enough.

European Central Bank (ECB)

One cut is in place, and no more are expected for quite some time. The ECB is data-dependent, like the Fed. Recent election results in France have caused a spike in government bond yields compared with German government Bunds, but not to an investable degree.

Bank of Japan (BoJ)

A new currency czar has been named. While Japan says timing the of the appointment is merely normal rotation, our guess is the new BoJ Governor and other officials recognize new thinking is required, after a very long period of heavy-handed government-driven zero interest rates and yield curve controls.

People's Bank of China

Real estate remains a long-tailed overhang for policy. We expect China's currency and exports will almost certainly be a U.S. election talking point. Debt levels across the country seem very large, and population decline is a big concern.

Bank of Mexico

The Bank has held interest rates at 11% for the time being, in part because of peso weakness following the country's presidential election.

Valuations

- **Leveraged loans:** We are reducing our overweight position. Loans have been the best-performing fixed income sector over the last one, three and five years. Issuers are refinancing loans at a record pace, reducing coupons even before the Fed starts cutting, which will further reduce income for investors in the sector. It is still the highest-yielding fixed income asset class, but it is heading in the wrong direction, with few prospects of capital gains.
- **High yield:** We are modestly overweight in this high-performing asset class, second only to loans over most recent time periods. Although spreads are nearly as narrow as they have ever been, defaults are low, and the overall yield is compelling. We continue to focus on idiosyncratic opportunities while we wait for a better entry point for a beta trade.
- **U.S. investment-grade corporates:** We are underweight. The sector is priced for perfection, as demand from yield buyers has made spreads as tight as they have ever been. A return to the long-term median spread would erase more than four years of spread income. Instead, we will own U.S. Treasuries, which currently earn 85% of the yield on U.S. investment-grade corporates, and wait for a better entry point.
- **International credit (hedged):** We are modestly overweight. Spreads are relatively wide and have lagged the recent rally in U.S. credit. We prefer short- and intermediate maturity spread duration. There are lots of interesting idiosyncratic opportunities. New issuance has been significant year-to-date. The relationship between U.S. Treasury yields and benchmark Bunds has been stable year-to-date.
- **Emerging markets debt:** Our preferred strategy with this asset class is to focus on idiosyncratic stories, rather than allocate to sector beta. Our top idea is to own local-currency issues from Brazil and Mexico. Both countries have yields at or near double digits and credible central banks that have demonstrated success in fighting inflation and that run current account surpluses, making them net creditors to other countries. We have a few U.S. dollar names, such as issues from the Dominican Republic and a few emerging market corporate names.
- **U.S. Treasuries:** We are largely overweight. 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 the potential to offer diversification for stocks. Our focus is seven- to ten-year key rates, but we will own longer duration when paired with floating rate sectors.
- **U.S. TIPS (Treasury Inflation-Protected Securities):** We have no exposure. Inflation break-evens have been in the 2.2%–2.4% range for almost two years. The market is confident that the Fed has won the inflation battle. We prefer nominal Treasuries.
- **Mortgage-backed securities:** We have no exposure. Spreads of 50 basis points are not compelling in comparison with our full opportunity set. There is no obvious catalyst for outperformance. We continue to prefer U.S. Treasuries for diversification and yield curve management.
- **Structured product:** We have selective exposure and 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. Foreign exchange volatility, even for developed market debt, is double or triple the U.S. Aggregate Bond Index volatility.

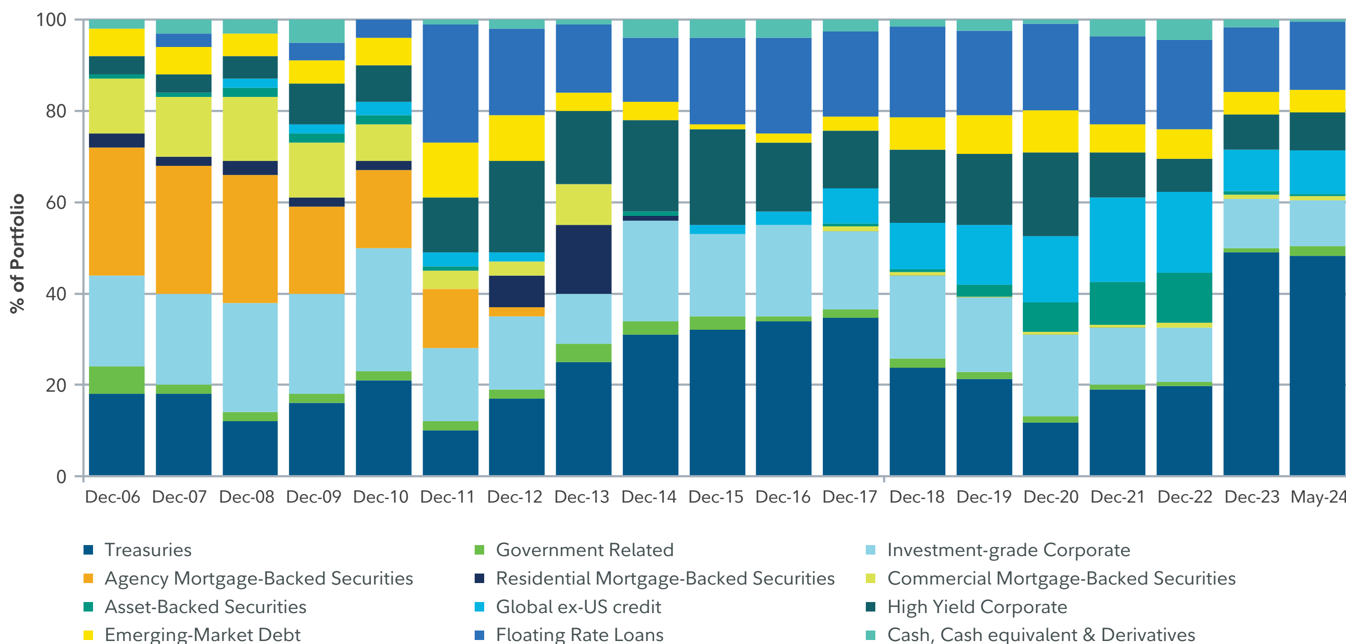
Performance

As at June 30, 2024	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	-0.2	-0.4	2.6	2.5	-1.8	0.8	1.6
Fidelity Investment Grade Total Bond CN Fund – Sr. F	-0.1	-0.3	2.9	2.2	-2.5	0.2	1.0
Fidelity Global Core Plus Bond ETF	-0.3	-0.5	2.9	3.1	-1.5	-	0.2
Fidelity Global Investment Grade Bond ETF	-0.3	-0.8	1.9	1.3	-2.8	-	-1.3
Fidelity Tactical Credit Fund – Sr. F	0.7	2.0	6.4	6.3	-	-	2.2

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