Fidelity INVESTMENTS

Fixed Income Perspectives

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The big story

The "everything rally" resumed in May, with equities and all fixed income sectors advancing. While the broad equity markets may continue to climb, with a positive economic backdrop allowing earnings to take the baton from the AI-fuelled multiple expansion, certain parts of the bond market may be running out of steam – specifically, higher-quality, longer-duration corporate bonds, which offer little value relative to U.S. Treasuries. We have done some basic bond math, and at current levels for investment-grade credit, if spreads simply return to the long-term median, that could wipe out four years of excess returns. Put differently: if spreads return to the median within the next four years, we might be better off holding Treasuries and waiting until then for an entry point. High-yield bonds are not likely to fare much better, despite wider spreads and shorter durations.

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This gives us confidence that patience is the right strategy: we will be disciplined and wait for episodic asset allocation opportunities that could inevitably arise in due course. To be clear, we still find fixed income to be a compelling asset class, for a number of reasons, but our enthusiasm is currently driven by the high yields on Treasuries and specific alpha opportunities based on security selection in various spread sectors.

U.S. Federal Reserve (the Fed)

Fed Chair Jerome Powell and the FOMC have still not seen the economic data they hoped would give them the confidence to cut interest rates. "Higher for longer" and continued patience is the plan for now. The market is still pricing in one cut toward the end of the year.

European Central Bank (ECB)

Our analyst Tom Nolan expects a handful of cuts over the next year, but he cautions that an extraordinary rate cycle is unlikely.

Bank of Japan (BoJ)

Inflation is bringing a normalization of monetary policy to Japan. Urgency to tighten is evidenced in the foreign exchange markets. The BoJ recently reduced Japanese Government Bond (JGB) purchases in a kind of "stealth" QT, in an attempt to steepen the curve, reduce interest rate differentials with the U.S. in the belly of the curve, and support the domestic currency. We believe it is likely that the BoJ is preparing for a hike in July. If the central bank is successful in enticing capital flows back home, there could be implications for JGBs, U.S. Treasuries and the Japanese yen.

Bank of Canada

We expect the Bank to take a similar path in interest rate policy as the Fed. Core inflation is now in its target range; however, the monetary policy of the two central banks will not likely deviate much.

Valuations

- **Leveraged loans:** We are overweight. Once again, loans are the best-performing fixed income asset class, enjoying a combination of higher-for-longer short-term rates and an economy that supports low default rates. Robust CLO demand is also a nice technical factor supporting the asset class.
- **High yield:** We are modestly overweight. High-yield bonds have easily outpaced U.S. Treasuries so far this year, but spreads are now in the bottom quartile of historical valuations. Excess return from here on is all about carry; capital gains will be tough to generate. The current valuations are supported by a still-strong economy and a solid core composite of companies that have respectable balance sheets, favourable financial policies and stable management teams.
- **U.S. investment-grade corporates:** We are underweight in longer-maturity, higher-quality corporate bonds. Spreads are nearly as narrow as they have been in the past 25 years. The opportunity cost of an underweight position is now very low. We prefer to capture 85% of the yield of investment-grade credit, with no credit risk, by owning U.S. Treasury securities instead. New issuance has been massive so far this year, as with loans and high yield. To note the obvious: we would want to buy this asset class on any material widening of spreads.
- **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-duration bonds. There are lots of interesting idiosyncratic opportunities. Like the Fed, the ECB appears to be at the end of its hiking cycle, and sovereign rates are rallying as a result. New issuance has been significant year-to-date. As with investment-grade corporates, we would want to buy on widening spreads.
- **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 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 Colombia.
- **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. We will like this asset class more and more if yields go higher.
- **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. The U.S. dollar is a beast.

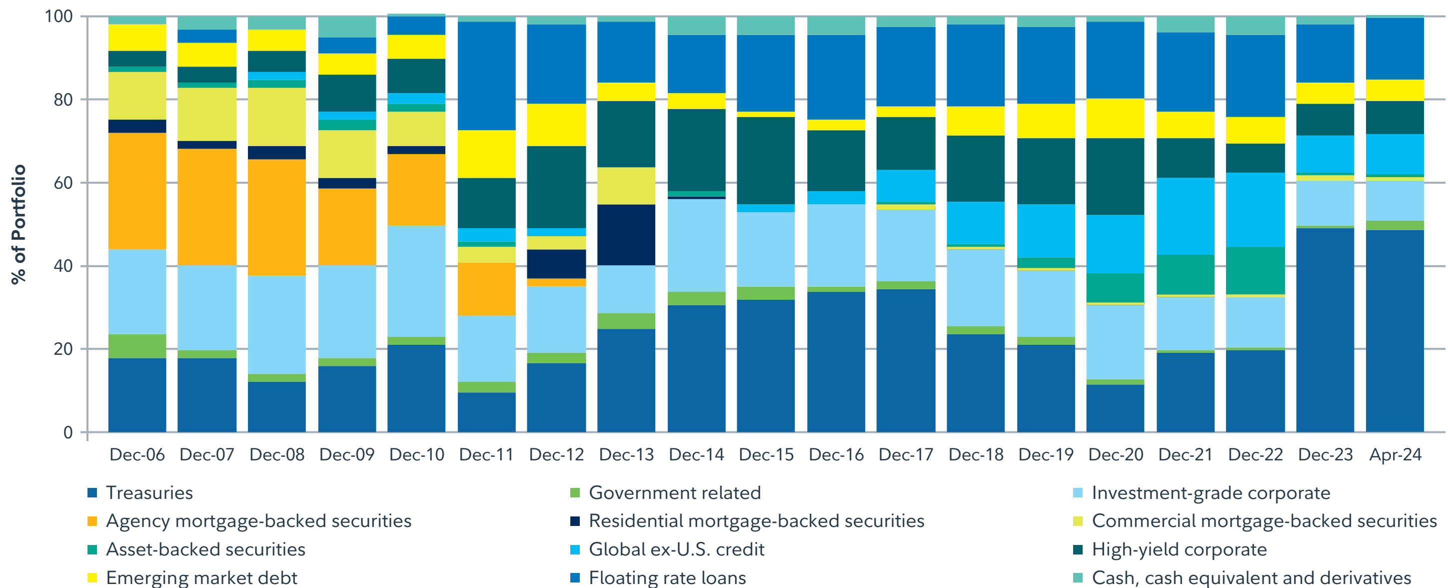
Performance

As at May 31, 2024	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	-0.1	-1.1	2.2	0.7	-1.7	1.0	1.5
Fidelity Investment Grade Total Bond CN Fund – Sr. F	0.1	-1.1	2.1	0.2	-2.4	0.3	0.8
Fidelity Global Core Plus Bond ETF	0.0	-1.1	2.4	1.1	-1.3	–	0.1
Fidelity Global Investment Grade Bond ETF	-0.2	-1.5	0.8	-0.7	-2.6	–	-1.5
Fidelity Tactical Credit Fund – Sr. F	1.1	1.5	7.5	4.3	–	–	2.0

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