Fixed Income Perspectives

MAY 2024

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The big story

> "The lesson for bond investors is that at times, market sentiment regarding monetary policy is more important than any actual policy changes."

The U.S. Federal Reserve (the Fed) has been on hold for nine months and counting. Although the Federal Open Market Committee (FOMC) has not changed the Fed funds rate, the rhetoric coming from the group has certainly vacillated regarding the options for the committee's next move, which has been the primary driver of longer-term interest rates. The third quarter of 2023 was characterized by the "higher for longer" mantra and repeated threats to resume hiking, which drove the 10-year U.S. Treasury yield to 5%. The fourth quarter of 2023 encompassed a "pivot" in which Fed Chair Jerome Powell proclaimed financial conditions were sufficiently tight to deliver a soft landing while achieving the Fed's inflation objectives. In response, equities rallied, and the 10-year U.S. Treasury yield fell 1% in two months. Year-to-date in 2024, the Fed has shifted from signaling multiple cuts in the coming months to acknowledging that progress on inflation has stalled, and that the less restrictive monetary policy that had all but been promised would be delayed. As a result, the 10-year U.S. Treasury yield is once again approaching a multi-decade high. The lesson for bond investors is that at times, market sentiment regarding monetary policy is more important than any actual policy changes.

U.S. Federal Reserve

Fed Chair Powell and the FOMC have not seen the economic data they hoped would give them the confidence needed to cut interest rates. "Higher for longer" and patience is the plan for now.

European Central Bank (ECB)

ECB President Christine Lagarde says rate cuts are possible as early as June. While our analyst Tom Nolan thinks a cut or two is possible this summer, he cautions that an extraordinary rate cycle is not likely.

Bank of Japan (BoJ)

The BoJ is normalizing monetary policy at a glacial pace. It has intervened multiple times to stabilize the Japanese yen, but that will be an uphill battle, given the wide interest rate differential.

Bank of Canada

We expect the Bank to take a similar path in interest rate policy as the Fed. The Bank may cut a little sooner, because 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 the 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, as with loans and high yield, so far this year. 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, 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 still prefer U.S. Treasuries, for diversification and yield curve management.
- **Structured product:** We have selective exposure. We 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.

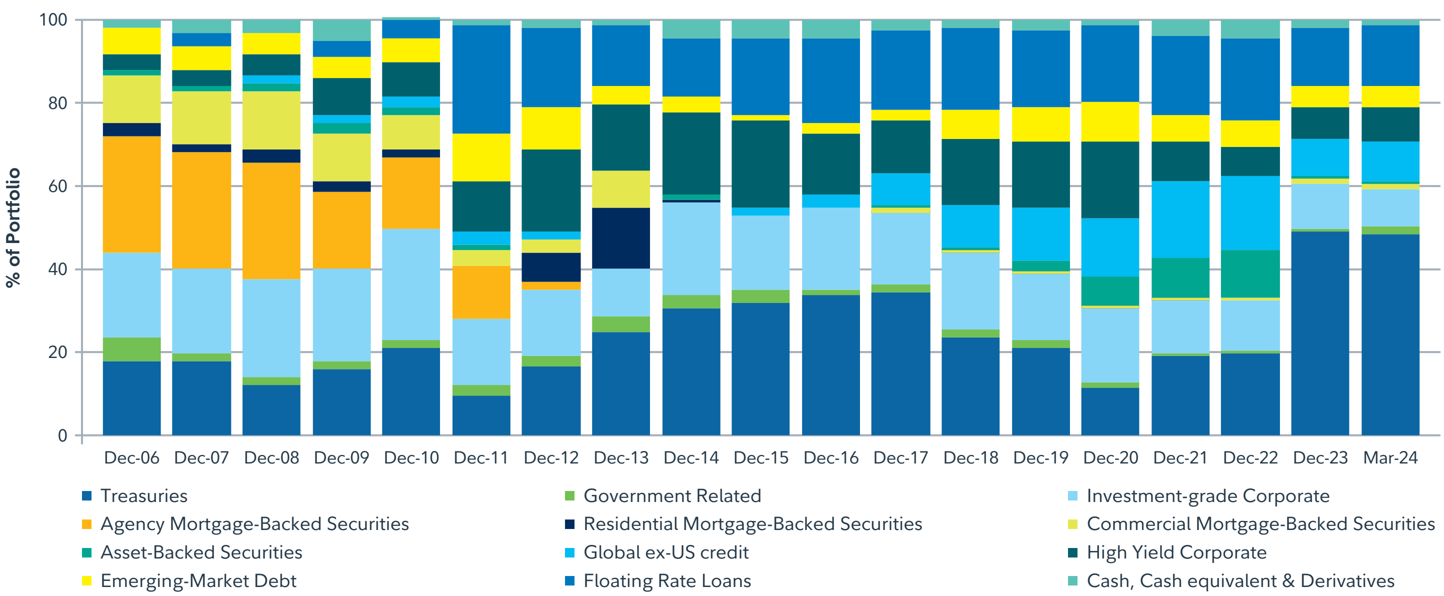
Performance

As at April 30, 2024	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	-2.4	-2.6	-0.5	-0.6	-2.1	0.8	1.3
Fidelity Investment Grade Total Bond CN Fund – Sr. F	-2.6	-2.7	-0.6	-1.0	-2.8	0.2	0.6
Fidelity Global Core Plus Bond ETF	-2.4	-2.6	-0.3	-0.3	-1.7	–	-0.3
Fidelity Global Investment Grade Bond ETF	-3.0	-3.0	-1.9	-2.0	-3.0	–	-1.9
Fidelity Tactical Credit Fund – Sr. F	0.3	0.4	5.5	3.3	–	–	1.6

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