Fidelity INVESTMENTS

Fixed Income Perspectives

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The big story

"If, in the coming quarters, policies look as though they may fall short of the promises, rates have room to rally."

The U.S. election has come and gone, and once again we have been reminded how difficult it can be to predict the outcome; most pollsters had the race too close to call. The result was a decisive victory by the Republicans, taking the White House and at least the Senate, if not both chambers of Congress. Our strategy – not to position the portfolios for any particular outcome, but rather to maintain liquidity to take advantage of post-election volatility – was effective. The knee-jerk reaction to the surprising results was an aggressive sell-off in U.S. Treasuries when President-Elect Donald Trump's playbook was initiated, establishing an attractive entry point. But by the end of the week, the U.S. yield curve had retraced the entire move and closed essentially where it opened, effectively unchanged. Where the bond market goes from here will depend on fundamentals, growth and inflation, and it will be driven by fiscal and monetary policy and the natural tide of the economic cycle. The strong narrative that the policies outlined on the campaign trail (and experienced during Donald Trump's first term) should put upward pressure on rates, because of higher inflation expectations (tariffs and immigration) and supply considerations (funding the budget deficit), seems to be the consensus, which means that much of the impact has likely already been priced into the market. If, in the coming quarters, policies look as though they may fall short of the promises, rates have room to rally. In our view, the bond market remains compelling over the long term, despite certain near-term volatility.

The U.S. Federal Reserve (the Fed)

The Fed commenced its easing cycle with a 50-basis-point (bp) cut in September and a subsequent 25 bp cut in November. The market has reduced the expectations for easing through the end of 2025 to just 75 bps, given the Trump inflation narrative. At the most recent press conference, Fed Chair Jerome Powell committed to serving his remaining term through 2026 and emphasized the Fed's legal independence.

European Central Bank (ECB)

ECB President Christine Lagarde and the ECB continue cautious cutting, delivering a third round of 25 bp interest rate cuts in October, but making no commitment on future actions. Even so, the market is pricing in about 25 bps per meeting through mid-2025.

Bank of Japan (BoJ)

A virtuous circle of targeted inflation supported by higher wages seems to be in effect. The impact of unexpected changes in political power has yet to be seen, but bears watching. Weakness in the Japanese yen was driven primarily by interest rate differentials and resulting U.S. dollar strength.

Bank of Canada

The Bank has already cut interest rates 1.25% this cycle, and like other developed market central banks, it plans to continue to "normalize borrowing costs." Just like other central banks, the Bank may soon have a more uncertain political landscape to navigate.

Valuations

- **Leveraged loans:** We maintain a modestly overweight position after meaningfully reducing our position this summer. Leveraged loans gave up their spot as the top-performing fixed income asset class. The asset's floating rate nature, which had been an advantage, started to take a toll as the Fed began its rate cutting cycle, reducing the yield advantage of loans. How much further the Fed goes remains to be seen, but the direction of travel is clear.
- **High yield:** We maintain a modestly overweight position. The duration of high-yield bonds has propelled our investments in the asset class ahead of leveraged loans year-to-date 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.
- **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, after further richening following the presidential election. Solid fundamentals and demand for yield continue to support tight spreads despite high supply, which now stands at $1.3 trillion year-to-date after a robust October. That said, the risk/reward 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 by buying U.S. Treasuries of similar maturity instead.
- **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.
- **Emerging markets:** We have selective ownership of issues from countries such as Mexico and Brazil in local currencies and in U.S. dollars. This sector has had a tremendous run, to the point that many emerging market debt issues have spreads and yields at or below investment-grade corporate debt with similar credit quality.
- **U.S. Treasuries:** We are modestly long on duration, after leaning into the pre- and post-election rate sell-off. The U.S. 10-year Treasury yield has increased by 80 bps since mid-September on better economic data and the concern that, regardless of the election results, either new administration would increase issuance to fund a growing budget deficit. The 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. As a result, the intermediate part of the yield curve is our favourite. There are high potential total returns in several scenarios (geopolitical risk, deteriorating labor market, growth scare, etc.).
- **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 holding in 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.

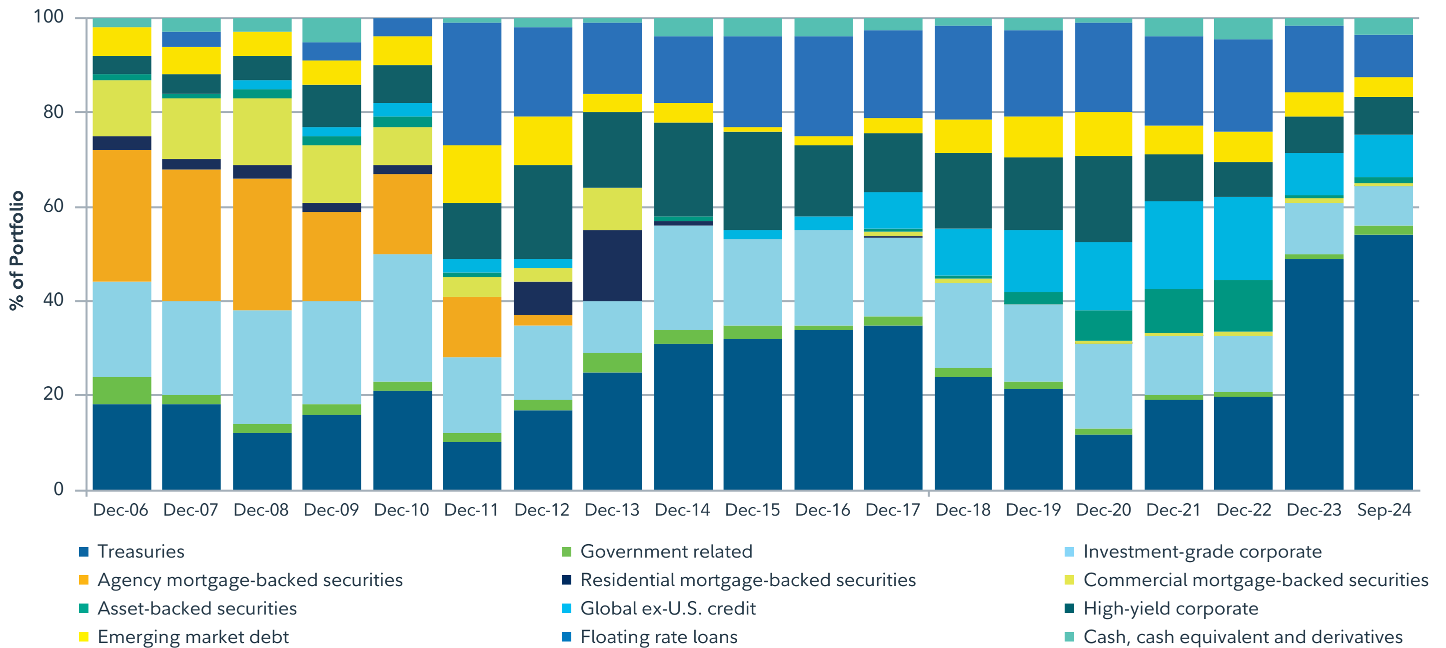
Performance (%)

As at October 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	1.9	10.5	5.4	-1.3	0.8	1.9
Fidelity Investment Grade Total Bond CN Fund – Sr. F	0.1	1.9	10.8	5.3	-1.9	0.2	1.2
Fidelity Global Core Plus Bond ETF	0.2	2.1	10.9	5.7	-0.9	0.6	0.7
Fidelity Global Investment Grade Bond ETF	-0.1	1.6	9.8	4.4	-2.2	–	-0.7
Fidelity Tactical Credit Fund – Sr. F	1.5	4.7	10.8	8.0	–	–	2.9

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