Fidelity INVESTMENTS

Fixed Income Perspectives

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Jeff Moore, Portfolio Manager | **Michael Plage**, Portfolio Manager

The big story

Valuations in bonds and stocks seem "full" in terms of spreads and earnings multiples, resulting in the market's hyper-focus on central bank rate paths and tech earnings results. For the bond market, this valuation, in contrast to a "risk" focus, suggests that yield is expected to be the principal source of returns in coming periods rather than price action. In the bond market, a balance seems to exist between inflation declining to long-term trends and GDP growth that continues to surprise slightly on the upside. Our best thinking currently is to enjoy the yield in the bond market, but diversify across sectors and securities.

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The upcoming U.S. presidential election is not an obvious investable theme. Longer-term, however, the substantial run-up in federal debt and resulting large fiscal deficits will almost certainly result in less fiscal flexibility in the future. According to Reinhart-Rogoff's 2010 economic paper "Growth in a Time of Debt," the heavier current debt growth could turn out to be a headwind for future GDP growth.

The Federal Reserve (the Fed)

One interest rate cut by the Fed in September has been priced in by the markets – and Fed Chair Jerome Powell's Jackson Hole comments supported the bond market expectation. More interest rate cuts can be expected later in the year.

European Central Bank (ECB)

Further interest rate moves are almost certain, but ECB President Christine Lagarde will be cautious about "too much too fast." Inflation expectations are stable in Europe.

Bank of Japan (BoJ)

The BoJ has the most question marks of any central bank. The yen has bounced off multi-decade weakness against the U.S. dollar, but the case for an even bigger bounce will require the BoJ to hike rates at some point. We are cautious on this market.

People's Bank of China

Economic data continue to be tepid, with too much debt and too much central government overinvestment. The big external question revolves around expectations of more global tariffs.

Valuations

- **Leveraged loans:** We have significantly reduced our overweight in what has been the top-performing fixed income asset class on a one-, three- and five-year basis. Spreads have narrowed materially from the widths of 2020 and now seem fair value at best. We maintain an overweight position, but now have room to add. A falling Fed funds rate as early as this fall will cut the yield advantage of this sector.
- **High yield:** We maintain a modestly overweight position. The duration of high yield bonds has propelled the asset class ahead of leveraged loans year-to-date. As with leveraged loans, narrowing spreads have reduced the appeal of the asset class. Defaults remain low, and overall credit quality is stable.
- **Investment-grade corporates:** We are underweight. This asset class is priced for perfection, because demand for yield has made spreads very tight. If spreads were to return to just the long-term median from their current values, it would erase more than four years of 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. This asset class is a nice substitute for U.S. investment-grade corporates, and a bit cheap. Having said that, spreads have rebounded nicely in this area, and any outperformance compared with U.S. investment-grade credit will be small and likely 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, Brazil and the Dominican Republic, 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 hold a large overweight position, with the highest exposure in nearly two decades of portfolio history, but have reduced duration a bit, given the recent rally. Our favourite part of the yield curve is the seven-year maturity, to capture the “steepener” trade. Most of yield curve now has a positive slope, with only maturities inside five years inverted. There are high potential total returns in a number of scenarios (geopolitical risk, deteriorating labour market, growth scare, etc). The U.S. presidential election is not an investable theme, and we do not expect it to be a source of rate volatility.
- **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 and have now fallen below the lower bound of that range. 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. For the most part, holdings in CMBS holdings are very small, mainly due to valuations. AAA-rated CLOs could be interesting in the future, but only if leveraged loan spreads widen significantly.
- **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 double-digit yields.

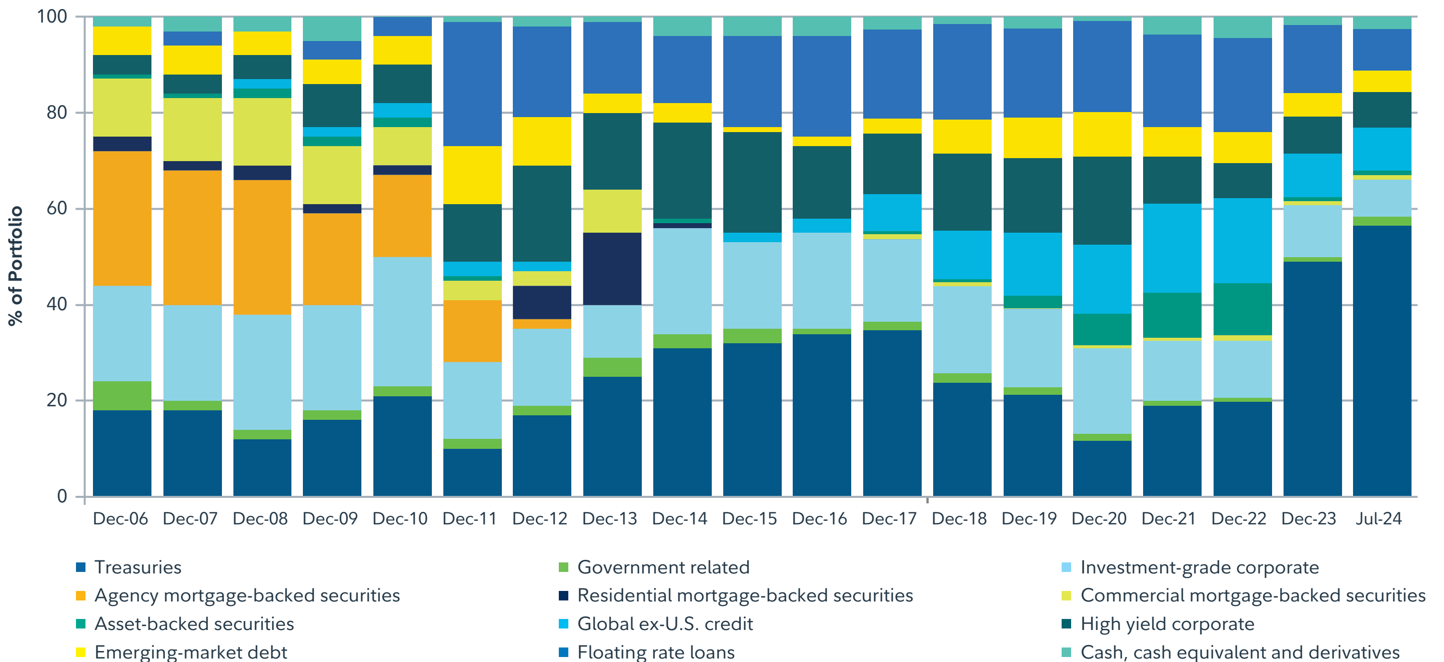
Performance

August 31, 2024	3-month	YTD	1-year	2-year	3-year	5-year	Since inception*
Fidelity Multi-Sector Bond CN Fund – Sr. F	4.1	3.0	6.8	3.5	-1.1	1.1	2.0
Fidelity Investment Grade Total Bond CN Fund – Sr. F	4.2	3.1	7.2	3.3	-1.8	0.5	1.5
Fidelity Global Core Plus Bond ETF	4.3	3.2	7.3	4.0	-0.7	–	0.9
Fidelity Global Investment Grade Bond ETF	4.5	2.9	6.6	2.6	-2.0	–	-0.4
Fidelity Tactical Credit Fund – Sr. F	2.5	4.0	7.7	6.2	–	–	2.8

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