Fidelity Compass

The Power of Flexibility: Tactical Fixed-income Allocation Strategies

Jeff Moore, CFA, Portfolio Manager

Pamela Ritchie, Host

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Pamela Ritchie: Hello and welcome to, Fidelity Compass. I'm Pamela Ritchie. U.S. inflation for August came in, of course, hotter than expected; 8.3%, resulting in widespread market volatility. We did see the 2-year Treasury yield hit pretty much its highest level in 15 years. All of this, perhaps, pointing to another outsized interest rate hike by the Fed later on in the month of September. What does the current picture mean for multi-asset fixed-income portfolios? What levers can be used to generate alpha while managing risk for institutional investors? To answer some of these questions and discuss the importance of flexibility, ultimately, we're very happy to be joined by fixed-income portfolio manager, Jeff Moore. Jeff, great to see you. How are you?

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Jeff Moore: Great to see you, too, Pamela. I'm very well.

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Pamela Ritchie: Glad to have a chance to ask you about all this and help us unpack what we saw. We saw the market react -this is the equity market- and also the bond markets; fixed-income markets reacting kind of violently to the DPI numbers. Why was that?

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Jeff Moore: Because the CPI number yesterday -or the DPI number- was worse than it looks on the surface. I want to just unpack that a little bit in the sense that what happened is, if you just sort of pulled away from the headline and you looked at just a heat map of each sector's CPI, it got a little hotter, a little redder. What it suggests, if you're the Federal Reserve, is that you've entrenched inflation more, not less of late, and that what you've done so far isn't nearly enough.

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Pamela Ritchie: Would you call that sort of broad-based or how would you describe that?

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Jeff Moore: Very broad-based and into the services sector, which is *[inaudible]* inflation, that's the place where it's harder to get it out of. We've gone from having super high inflation -we're not at nine, that's great- but we're going to struggle now to get that five, six, just to get that down. I think the market is recognizing that this has actually put the Federal Reserve in a box and into a corner, and they're going to come out probably fighting, not just in terms of rate hikes, but in what they say. The market itself is going to feel that things like the Fed put are so far out of the money, they're not even close to the money.

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Pamela Ritchie: That's so interesting. I think there was a little bit of a thought that going into the midterms and, of course, there are two separate Houses and the twines don't meet, as we all think, but you just sort of thought that maybe some of this... the White House would obviously want under control by the time those elections roll around. Does that look pretty unlikely at this stage?

[00:03:25]

Jeff Moore: Yeah, it does. It looks like the data we saw, we just warmed up again in terms of inflation. Chair Powell, I think he's going to have to make a hard choice. I don't know if he goes too stark but I can imagine his commentary, and the Fed commentary, in the next weeks and months is not balanced. It's very much harsh and I think that markets are going to feel that. This is going to be a real challenge for risk assets. It's going to be a headwind, another headwind ... I think there was a hope two, three, four months ago, when we started raising rates, that this would be the "ah" market. We're actually probably not going to be in that.

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I think what also happens here, Pamela, is because of this inflation print -and we're going to see retail sales as well- these prints are sort of forcing the Federal Reserve to say "I'm not forecasting anymore, I'm nowcasting and I'm going to keep raising rates", so there will be no pivot by the Fed. In fact, the pivot will happen in markets well before the Fed will have a pivot and I think that's what we're going to have to watch for as investors.

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Pamela Ritchie: Okay. That's what we'll have to watch for as investors. What, ultimately, does that mean to you?

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Jeff Moore: To me, it means the 30-year Treasury will roll over and go lower in yield. I think that's where, if you're a client right now, I would have a barbell -and that's what we've done in our portfolio- floating rate notes and 30s and stay out of the middle, because the yield curve probably wants to invert and probably pretty substantially, especially after we hear from the Fed in the coming weeks. Again, this inflation print is going the wrong way. If you're Chair Powell, the path to much lower inflation, it's probably still there but it's pushed out a year or maybe more. So, you need to get that across. For us, what we're saying is 30-year bonds are going to look at long-term inflation, long-term demographics, long-term real interest rates and will discount some of what's happening today, whereas the front end has to go one-for-one with the Fed. So, if we have a Fed that's either more hawkish, or even going to just raise rates and then keep them higher for longer, the front end of the yield curve has to do the heavy lifting so the back end can do well.

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Pamela Ritchie: You're speaking to investors here today, probably, who have made certain calls; do you get the sense that investors right now are kind of scrambling to figure out how exactly to do this? This is a very tricky line to toe right now.

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Jeff Moore: Yes, it is in some ways. But getting with the portfolio, there's so much more portfolio yield today than there was a year ago. *[audio cuts out]* tactically, I love the bond market today much better than I liked it a year ago. A year ago, there were no capital gains, we were at all-time lows. Today we can put together a portfolio -and we have- that

yields comfortably over 6% and has so many scenarios where we have a positive draw for clients over 12 months. The issue tactically is: if you're loaded into a risk asset, maybe a stock or even something like high yield, you could be facing a headwind here, certainly the next 30 days, based on this inflation print and just the fact that it's going to have to just slightly move expectations of a path back to normal inflation out further. I think that's what makes things a little trickier.

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Pamela Ritchie: There are various narratives, of course, in the market. Some will say that the fact that the energy prices overall have come down; we know where that doesn't fit in core, but it is, obviously, the inflationary story of the year. What if those come down, stay down? I guess in that print, what you saw is that's not going to make a huge difference, I guess, at this stage.

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Jeff Moore: That's the hard part. In this inflation print we just had energy fell 10%. That was actually a decliner. That's the problem that the Fed has. The energy story is probably a little bit behind us. Remember, oil and gas prices are so volatile, the implied volatility of oil and gas is 50%. So, anything can happen. If you're the Fed, you were hoping that you were going to get some negative CPI prints here but the problem we have is that the energy piece, even though it helped, wasn't enough to offset these other warming-up areas. In fact, one thing I'd say is if you're an investor, you should be watching Cleveland median CPI. Remember, what median CPI does is cuts the tails out; the really low CPI and the high. It says "what's the core of inflation look like?" That was bang-on this month. That, I think, is a new thing for investors that don't look just headline anymore. You've got to go to the Cleveland CPI and that's available widely *[indecipherable]* from the Federal Reserve.

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Pamela Ritchie: I've been spending too much time in Georgian Bay, which is a terrible problem to have, of course, so I think about things like anti-venom because of the rattle snakes all the time and kids and so on. But the anti-venom for volatility is then flexibility.

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Jeff Moore: It's definitely that. Leave yourself wide open. There could be a great opportunity coming. It may not be. Maybe we continue to move along here at these levels, but I say keep lots of flexibility. I'll give you some thoughts here. High yield, in general, is trading at 400 over. Right now, the spread's 500 over, but if you take away the top -the widest 10% of high yield- the bulk of high yield, 90% trades at 400 over. That's okay. But that's not screamingly compelling. That doesn't have a ton of offset for defaults if any come. Where I would be as investors; sit on your hands a little bit with high yield. You don't have to sell it. It's just you should realize the high-yield market is very complacent here. It's at that 50th percentile in terms of valuation, so it's not extremes. Investment grade credit is the same way, 50th percentile, not at extremes.

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As an investor what I would say is have your base on -all that makes sense to me- have your right asset allocation. You probably should be dipping more into bonds just because this is probably the best point -like you said, Pamela- in the last decade plus for investors in bonds. But leave yourself wide open to flexibility. I'd have higher cash balances in the near term just so you can take advantage of potential dislocations in the market. I think yesterday's drawdown of 5% in the NASDAQ was a great example of the kind of volatility that's possible and could lead to some really, really great entry points.

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Pamela Ritchie: Within that power of flexibility discussion and the tools ... I think we mentioned in the introduction, the levers that you can help pull, that institutional investors can make sure they're looking at. It doesn't ultimately mean that that helps the portfolios that you build become riskier. I guess, it means that you can sort of get the same return ultimately, but the risk is taken out. I mean, just kind of go into that for us because I think we're redefining risk a little bit right now.

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Jeff Moore: Well, the first thing I'd say is our portfolio is less risky than it was six months ago. We've *[indecipherable]* a lot more diversification, a lot more places to go. Again, we have a five-step process. We started with macro and sector and asset allocation. But, within that five-step process we've been trying to make sure that we don't have any one bet that's too big. We use as much flexibility as possible and that's really helped. Even in a day where there's a big drawdown in rates, the portfolio goes down a lot less. We still go the same direction as rates, but we're trying to go down less. So, we've been careful about how much duration we have in the portfolio. We have almost no bonds between 2 and 10-years. We either have floaters or that 10+. Again, that's all for risk control because the heavy lifting has to be done by the front end of the curve and there's almost no sign yet that we're going to get a steep curve.

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We'll change our mind when we think there's a steepener coming and we'll get into the front end, but for the here and now, clients need that barbell for now; good risk control. And then have some Treasuries, have some cash and then have some credit. I think you should have credit because we could be here a long time in this market going back and forth. One of the things we've done, again, that I really like about our process is the lessons of '08: stress test your portfolio for anything that could go wrong. That's what our hotshot, Stacie Ware, who I think went to Oxford herself, and Stacie... she stress tests and what we're trying to do is give clients as many positive draws as possible from here.

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In some ways we take the benchmark. We want to wiggle like it or maybe have a little less wiggle than the benchmark, but we want to see how do we take that risk that's been assigned to the benchmark -that beta- and then how do we provide our clients with a better experience? Year-to-date we've been able to offset a very nice chunk of this drawdown in rates and that's been very intentful in the sense that we've been stress testing for as many positive returns as possible and not just to beat a benchmark in the short term.

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Pamela Ritchie: You mentioned credit and we could be here for a long time. What's that mean, what's a long time?

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Jeff Moore: I think that's a great question. What does a long time mean? I think that every 30 days we're getting new data on CPI and unemployment. And I think as long as the Fed is engaged, it's going to be hard for risk markets to really pull ahead and go on a run.

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Pamela Ritchie: Engaged means hiking?

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Jeff Moore: They're engaged in hiking or just hiking or threatening to hike in the future. You can imagine a world where the Fed is done hiking but is nowhere near cutting. And you can imagine a world where the Fed is hiking and doing quantitative tightening, leading to a little more vol around markets in general -the efficient, functioning markets-. All this says to us is leave yourself flexible as a client, have your buckets. I think your normal allocation should be in play because these are better valuations than they were a year ago. I wouldn't be massively underweight anything at this stage. I would be trying to fill buckets up. And then leave yourself some tactical room to really buy if one of the sectors gets dislodged. So far, the only sector that feels dislodged to me a little bit is the rates one. That's the one I would say, probably want to own more 30s if you can do it, 30-year Treasuries, 30-year Government of Canada bonds; try not to be sucked into buying too many 5s and 10s here at this stage.

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Pamela Ritchie: It's interesting. You've been talking about the Fed being in the market, being a big buyer for some time; the quantitative tightening story that began in March -this March, wasn't it? It was the same time as rates, or was it a month later?-. In any case, that buyer gone and other central banks sort of in the same situation... has that gone any better or worse, differently in your mind? How do you look at how that's going?

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Jeff Moore: This has been one of the great stories so far; quantitative tightening. Remember that what the Federal Reserve owns, they're chock-full of mortgages, agency mortgages, U.S. Treasuries, inflation-protected bonds. Those are what they own on the balance sheet and it's at a very high level. There's hardly been any selling, Pamela, so far. They've been kind of pulled back from buying, which I think has led to some vol, but there's been hardly any selling. I think that's another piece of this puzzle. If they decide to start selling, which we could hear from the Federal Reserve; that could be part of the commentary that not only the rate hikes part is, but QT is going to get accelerated. The total excess reserves in the banking system right now are about a trillion dollars, which is to say -this is inside baseball- you could suck those reserves under the banking system up to a trillion dollars and you should still have great lending and things going on. I think the Fed has a plan or a playbook that can get to a trillion dollars decline in the balance sheet.

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Pamela Ritchie: Is it strong enough, I mean, the financial system is strong enough to withstand.

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Jeff Moore: And has enough liquidity to pay for that. Remember, the Fed has to sell those, and someone has to buy them. That's what the excess reserves are, someone buying those securities. Now, those securities are all risk-free assets. Treasuries are obviously the best 'cause they can be posted by collateral, that's the kind of thing ... that's a trillion dollars. After a trillion dollars this gets really, really tricky because now you have to have someone sell something else to buy these. And that's where...

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Pamela Ritchie: Has that begun, really?

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Jeff Moore: No, has not. The Fed's just sat on its hands so far. Imagine they have to get this done. Now, just to make clear, this is not an issue for the Bank of Canada because they don't have the balance sheet problem. They never got in the game of balance sheet. The people who have balance sheet problems are Bank of Japan, ECB, the Federal Reserve. Just in case you thought there was just a few small banks in there.

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Pamela Ritchie: Incidentally, as you mention Canada and really North America; is that regionally where you're looking? Are you looking any further afield?

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Jeff Moore: No. We're basically ... I hate to use this, but I call it fortress North America and it's still one of our big thematic stories that, for the near term, we'll buy companies issued in Europe and if we do, we'll definitely hedge out the currency, but we're tiptoeing through all that because Europe's almost certainly in recession and it's not a little one. This could be very large. Germany will have a lot of headwinds to hit with energy. What's going to happen, there's enough gas in Germany right now to keep it from having blackouts, but you can imagine energy prices have soared and companies in Germany are on the hook to pay those and just profitability -the marginal profitability companies- is tilting down again, so they're going to pull back on the number of hours. Europe is almost certainly in recession. Japan, I think it's almost, unfortunately, in a permanent recession. The Bank of Japan has been very aggressive, capping rates at 25 and ignoring all inflation and they've been *[audio cuts out]* 3%.

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Pamela Ritchie: Is it just too unclear to go into that? That is priced in, to an extent; is it not? It seems to be priced in.

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Jeff Moore: It is priced in, but the thing about Japan, it's a great example; maybe you want to buy the yen dollar, it actually looks pretty cheap, but I wouldn't want to buy any rate risk in yen here because Governor Kuroda, who's the Bank of Japan governor, he's retiring next year. That means somewhere in the next two months they're going to appoint a new governor. Will that governor have the guts to stick with Governor Kuroda's policy? That person could change it. The risk there is that interest rates go from 25 to something higher. Don't know what that would be, and you lose money just holding rates [audio cuts out]. I would be very careful with having any rate risk in the Japanese yield curve just because rates are repressed and the problem we have is it's not a democracy; it's one person will decide. If this person changes his mind, the next day you lose money and that's very difficult. I would stay away from Japan other than maybe buying the Japanese yen here because higher rates should lead to the yen coming back down and becoming a very nice depreciation versus the big dollar.

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Pamela Ritchie: What are you doing with currencies, actually?

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Jeff Moore: We're very careful with currencies. This gets into risk controls and how much volatility... remember, we want to wiggle like a core bond product which is like that 4% vol, so very low vol, lots of yield and low vol, so we give you as

many positive trades as possible. When you add in currencies, even the Canada U.S. dollar, which I would argue is the most liquid cross between two countries *[that]* have almost identical economies, fiscal policies... heck, we almost have the same vacation schedules. That volatility is 10% a year, which is 2 1/2 times riskier than what I'm doing with clients. So, a little dab of FX will do, so we pretty much hedge everything. So, if we go to Europe, we're hedged, so that's helpful and we get the carry from the hedge, which is a great carry trade right now. We have put on a small Japanese yen trade because we think it'll work, but, again, it's going to be very constrained. It's going to be like 1%; it's not going to be a huge driver. It'll be an alpha trade, not a beta trade.

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Pamela Ritchie: You're speaking to institutional investors right now. The crux of this narrative isn't necessarily appropriate, but it goes to the overall story of with rates rising you can see how some investors *[are]* just going to stash things, cash balances into savings accounts. You're going to be talking more about cash balances. Just go a little further with that for us, where that story needs to land and how much fear is in that particular narrative?

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Jeff Moore: I think one of the things that's nice for institutional investors right now, there's stiff accounts -what it's called- the cash account is generating a little bit more yield and I think because it is, and because of the recency of the CPI data, I think you can sit in this cash account a bit longer. If you're feeling like you've just got to allocate the bond market's a great place. I like our chances of having a positive return next 12 months in almost all the draws I can imagine. But if you can be patient as well, you can actually put yourself into an even better position and potentially put yourself in a position to reallocate and rebalance into stocks at some point. Stocks have come off a little bit year-to-date but not that much based on how far rates have come. Maybe there's a bit more to do there.

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You can have more money in your cash account, in your stiff account; or you can actually come to a bond manager like us who's very careful with how we use duration and rates and diversifies. If you feel like you want same tail risk hedge, then I still think 30-year Treasuries are the place to go. We have way more yield today than we did, so they're a much better diversifier than they were a year ago because there's a capital gains opportunity. You can imagine scenarios where if the Fed has to break something, that the bond market will start tilting down and 30s could rally a long way and could be the only thing that we're *[indecipherable].*

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Pamela Ritchie: I just want to ask... we saw this August print as we started off discussing and said in the introduction. It sort of has shocked the market into perhaps we're here for longer and you've mentioned that. How long have you seen that for?

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Jeff Moore: It'll be interesting to see how long we go. I kind of have us on this rolling 30 days. I'm looking at two data points that are really driving things: CPI and jobs. With jobs we need to see some higher unemployment. Even some of the best thought leaders are saying right now that to get inflation down you probably need unemployment to be 2% higher than it is today and stay 2% higher for next two years. Well, the hard part is we've had a lot of people turning 60 and 65 -that's demographics- and guess what, they're leaving the workforce because they can, or they're more marginally attached to the workforce because they may...

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Pamela Ritchie: Demographic story, bring this in, because I'm very curious how this fits into the overall what the Fed needs to do.

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Jeff Moore: When I look forward two, three, four years, I think demographics take over. What we're facing today will be sort of into the background and ether and we'll look at it "well, this is based on COVID, supply chain disruptions and massive government stimulus and then central banks going to zero". We'll say all that and we'll say "well, we're not doing that". When you look four, five years, its demographics take over. The G10 is in a demographic tough time. The G10 is in population decline right now. That includes China and Russia. In fact, the UN just came out and said that China's population almost certainly is starting to fall, and they had live births -which is children- ten and a half million, which is half of where it was just 20 years ago, 10 years ago. Even though China's got a number of policies to try to increase fertility, it's just not taking, for, I think, a lot of social issues more than just money, but we can talk about that later. So, you have population decline in China. In fact, China's right now not the largest country on earth by population, that's India. The Chinese numbers fall so dramatically ... we forecast and you get a sense of births versus deaths. You can imagine the Chinese population starts to fall very, very fast each year from now. By 2050, we think China could have 300 million less people. Think about that. The whole United States will go away in China in the next 27 years.

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Pamela Ritchie: That's not accounting for ... not that we completely know what reopening looks like, but we are further along, obviously, in the process. There's still a lot of reopening stories to come out of their economy and that will come soon. Jeff, as we take it from sort of the international story it goes to flexibility, staying in a place *[indecipherable]* but ultimately in North America. Is that sort of what you want to leave with institutional investors at this point?

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Jeff Moore: For right now, tactically, North America is a very strong story and the rest of the world is probably, in the next few years, going to grow slower than North America. The rest of the world's productivity numbers aren't great. Ours aren't great either; that's inflationary, but they're better than the rest of the world. When we hold this demographic story and when we talk about people ageing, what you're talking is labour force is getting smaller.

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Pamela Ritchie: Less taxpayers.

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Jeff Moore: That's tax dollars, the taxpayers are our workers. Retirees generally pay less taxes and they generally get more services provided to them. In a world where we're going to have as a group a 100% increase in the number of 60-year-olds in Canada and the US, and we have the best demographic. You put it together and you think of GDP as the number of workers times output per person, first year university, honestly, if the number of workers is going down you're going to have a heck of a time getting GDP to be positive. So, again, when I look forward I actually look at these interest rates and go *[audio cuts out]* really decline.

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Pamela Ritchie: Fascinating. The barbell is sort of at this stage while in some sense we're sort of wading through this, probably the best strategy that you're offering at this point.

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Jeff Moore: Yeah. I like the barbell in terms of putting a portfolio together because I think the market's going to show you when Fed needs to pivot before the Fed will, which means the market will start tilting down on the long end and it will start to rally and then, some point after that, the Fed and the Bank of Canada will say "oh, we're going to pivot" and then the front end will start rallying as well. But that is secondary. Right now keep the barbell, even though there's an inversion, and be ready though; be flexible with cash so you can go buy that when central banks come along later. I think where we are now in the data points, we've just gotten CPI; it's just the Fed is in a corner. Things are just getting a little hotter and they can't take it.

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Pamela Ritchie: Fascinating to get your thoughts. Jeff Moore, thank you very, very much for joining us here today. I look forward to seeing you soon.

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Jeff Moore: You, too.

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Pamela Ritchie: Jeff Moore joining us here on Fidelity Compass. Very glad you could all join us as well. Please do send in suggestions for future topics or even guests that you'd like to see on this show in this place to debate and discuss. Please share your ideas with us. In the meantime, certainly stay tuned for more Fidelity Compass webcasts in the weeks and the months ahead. Thanks for joining us. I'm Pamela Ritchie.

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