Fidelity Compass

The Importance of Flexibility in Fixed Income Allocation

Jeff Moore, Portfolio Manager

Bryan Borzykowski, Host

[00:00:32]

Bryan Borzykowski: Hi, and welcome to Fidelity Compass. I'm Bryan Borzykowski. The Federal Reserve has raised its benchmark interest rate by 25 basis points to 5.25%. This move comes amid America's ongoing debt ceiling crisis and further regional bank woes. Despite these challenges our guest today says the bond market itself is not seeing a deep downturn or recession in the near term. What indicators is our next guest keeping an eye on for guidance and where markets are heading and which asset classes within fixed income are good complements to an equity portfolio? Joining me now to unpack what's shaping the fixed income landscape –including the importance of flexibility in fixed income allocation– is Fidelity portfolio manager, Jeff Moore. Jeff, thanks for being here.

[00:01:13]

Jeff Moore: Hey, thanks for having me.

[00:01:15]

Bryan Borzykowski: Obviously, the big news this week is the Federal Reserve's rate increase. Is it going to be the last one for a while? Will there be a cut? What do you make from the increase and what they said in the aftermath of that?

[00:01:28]

Jeff Moore: Our take is that this is the last rate increase for a while. We would need really, really bad data to force the Fed to go higher again. We think the Fed is kind of done here. Kind of like the Bank of Canada –they found their spot and they're going to sit there. Even though inflation is still sticky in U.S. –and particularly in owners' equivalent rent, which might fall at some point soon, and wages¬– Fed, I think, is saying "we're going to stick here for a while and then see where inflation is in three and six months."

[00:02:02]

Bryan Borzykowski: What was interesting in his comments is that Jerome Powell said "we're not going to cut." Yet, the bond market is still pricing in a cut in July. I guess, number one, why do you think he said that and why is there this difference between what the bond market is looking at and what the Federal Reserve is saying?

[00:02:19]

Jeff Moore: I think if you're Jerome Powell, this was a great chance just to be cautious, just be very cautious. Say there's no cuts coming and then at least you don't have to probably raise rates even further. So, you keep sort of that animal spirits at bay, would be his hope. But what's the bond market doing? Why do they have 25 basis point cut for July? More than anything else you have to look at the big picture. Pull out a second and say if the Fed's done, what's the next big trade in the market? The next big trade in the market is the yield curve steepener. We've had this inversion for a while, so when the Fed's [indecipherable] rates up the most obvious thing is the yield curve inverts. We had an inversion of

almost 1 1/4% [indecipherable]. Today that's flat, pretty much flat. In a normal world, "normal", which is to say the Fed's sort of sitting on the sidelines not doing a lot, maybe going up a notch, down a notch, but not really going anywhere… in a normal world that yield curve slope is 100 to 200 basis points steeper, which is another way of saying that the bond market's going, "hey, the steepeners were 7 to 14% return", just having the steepener on and probably happens over next 12 months. So, if you're an investor you're not really calling for July as a cut; that's just how the bootstrapping's working. You're really calling for a steepener.

[00:03:45]

Bryan Borzykowski: What does that mean then? I think there was this expectation that the yield curve inverted means a recession is coming. We haven't seen that recession yet. Does the fact that we're now going on pause and just the indicators that you're seeing, could there still be a recession? What are you looking at?

[00:04:02]

Jeff Moore: Well, the yield curve inversion generally means the Fed's yanking rates up and when the Fed raises rates it usually induces a recession. So, that was what the market was calling for and rightly so. If you look at a couple of sectors of the economy, they feel like they're in a pretty steep recession right now. I would say, though, with markets looking at right now, what are we looking at? We're looking at credit spreads. Credit spreads today are sort of in that 50th percentile. In the last couple of decades this is about the average amount of spread versus government [indecipherable] paid which is to say that you're not being compensated for a hard landing. If you think there's a hard landing coming, credit spreads have to be much wider. Just to give you a quick thought, two sectors, real estate and regional banks, are trading at their 100th percentile. The rest of the sectors are pretty much trading at their 30th or 40 percentile, certainly not indicative of a hard landing at the broader economy.

[00:04:59]

Bryan Borzykowski: Is it a soft landing? I mean, not to predict, but what's your view on…

[00:05:05]

Jeff Moore: You know how I feel about this. I think when the Fed raises rates, they're like a bull in a China shop and they're going to break stuff. They've started breaking stuff. I think other things will break. Whether or not we'll have every sector go into full recession, that's a high bar. But could we see a couple more sectors slip like real estate and regional banks? Absolutely.

[00:05:26]

Bryan Borzykowski: Regional banks –that was the other big news this week with J.P. Morgan buying First Republic. Is this the end of the regional banking crisis or just the beginning? It's hard to know because it's been up and down and quiet and now back in the news. Where are we?

[00:05:41]

Jeff Moore: I don't think it's the end of the regional banking crisis. The hard part here –if you go all the way back to the crisis 2008– regulators, governments tried to fix that problem from '08. Along the way they came up with this idea of too big to fail, stress testing. By mistake… in the U.S. in particular, we have two levels of banks, safe banks and the other ones. The problem with regional banks is they're inferior goods just from first-year economics. You know that inferior goods just

don't survive – at least if they do survive, they have no pricing power. We gave the big banks this get out of jail free card. We didn't mean to. We called it SIFI, too big to fail, but it became get out of jail free card. We did not give that to the regional banks.

[00:06:34]

My sense of things right now, if you're a regional bank you've got to become a super-regional quick or go to a community bank. The middle is going to be gone at some point and we're just watching this Pac-Man approach to all of those regional banks that are caught in the middle. The problem with being caught in the middle is you're probably a regional bank that's done a great job of everything, but now, when it comes to a line of credit, which treasurer is going to go and say, "I'm going to get a line of credit from the regional bank" because you're not going to look at your board and say, "hey, I've got this line of credit from regional Bank X." Your board's going to say, "how about you get it from a SIFI 'cause we may need that bank line at some point." So, all of a sudden the business opportunity just falls; the NIM falls, and then the reason for the bank to exist --which is for equity holders, this isn't government- if equity holders see no reason for the business to exist, it can't exist.

[00:07:28]

Bryan Borzykowski: What happens, does the U.S. banking system start looking like Canada where you have five or six major banks and that's kind of it? Is that what we can expect?

[00:07:36]

Jeff Moore: Yes. Yes, I think you hit it on the head. Not now, but longer term. The regional banks isn't a crisis at the banking system. This is the anti-'08. I said this before. There's no widespread crisis in the United States, but there are certain parts of the economy that have been hit by the Fed raising rates so much and those groups have been exposed and it will be really hard to put this sort of genie back in the bottle.

[00:08:08]

Bryan Borzykowski: Let's move on to just inflation. What are you seeing there? We are starting to see it come down. I think Jerome Powell said in his speech that we're not out of the woods yet. What are your expectations going forward with inflation?

[00:08:22]

Jeff Moore: Chair Powell rightly has said that it's going to be hard to cut rates because inflation is a little bit higher than he thought it would be. In fact, if you're the Fed and your inflation number by end of the year was 3.8 -that was your hope- you're behind the pace right now. We're averaging 4, 4 1/4. So, not too far behind the pace, but certainly behind the pace. Unlike the Bank of Canada where they had the same kind of forecast, but they're a little bit ahead of the pace. The way I've talked about this to clients is the U.S. is on a green run, the old skiing run. It's not really much downhill. Inflation has peaked, we think it was last year. Goods inflation's rolled over; commodity inflation's rolling over. Having said that, owners' equivalent rent and wages are still high. We're on the green run which is to say that the Fed can maybe stop raising rates, but it can't cut them. The Bank of Canada, I would argue, is more on a blue run. They actually will have wiggle room at some point if they need to take it.

[00:09:21]

Bryan Borzykowski: Right. In Canada we haven't sort of seen mortgage rates roll over yet. The real estate sector here with rising rates is more vulnerable than real estate in the States. Could that mean Canada could take an action that's different than the States earlier on?

[00:09:37]

Jeff Moore: I think that is a very important point. If you think about in '08, 60% of mortgages in the U.S. –this is individual mortgages– were fixed rate Fannie, Freddie, Ginnie, and the rest were often ARMs which is what the Canadian system is. A lot of the U.S. system back then wasn't conforming mortgages. These were higher-risk mortgages, [indecipherable], all those things. That was a vulnerability to the U.S. Fast forward to today, 98% or 99% of U.S. mortgages today are fixed for 30 years. This rate rise from Chair Powell for ninety-something percent of Americans who have a mortgage, they haven't noticed it at all because they've still got 30 years to go at 2 1/2% yield on the mortgage. They're loving them. They can't move house, but that's a different issue.

[00:10:27]

In Canada, unfortunately, it's an ARMs market and one of the things that happens at reset is you can guarantee your total payment for two years, but you don't know the breakdown between P and I inside of that. Something like 20% of Canadian mortgages that are on the short end are already in I only, which means those Canadians are renting from their house. If this continues some of those Canadians will actually be borrowing from their future and they'll be adding debt to the back end of their mortgage. I think that's where it gets tough. I think Canada – it's not just Canada– Canada, England, the Netherlands, Germany and the Swedes, have the same kind of ARM system and this is coming through the system and it's a little bit of a delayed steal.

[00:11:13]

Bryan Borzykowski: I'm certainly jealous of the 30-year mortgages, I will tell you right now. The other big news in the States is the debt ceiling seems to be picking up steam in the media and just on more peoples' minds. We've seen the story before where the governments are sort of battling back and forth over whether to raise the debt ceiling. How concerned should we be?

[00:11:40]

Jeff Moore: I would say that even if you want to be concerned, I don't know what you're going to do about it. I wouldn't know what to guide you to do if you said, "I know you're going to default," and even if I was told, "I would say, okay, now what?" The problem is this isn't just some individual. This is the risk-free note for the United States defaulting. The banking system's 100% of GDP depends on the risk-free note. All Americans do. The global system has enormous U.S. presence. We've had debt ceiling for 40 years since President Kennedy. I'm going to say this one is going to be handled the same way. There will be a negotiated settlement. There'll be a kick the can down the road. I think President Biden is a very astute politician. Because of that, he knows how the game's played. He knows how much he can battle for and then at the same time at what point does he just stop playing the game. I think that'll work out.

[00:12:40]

I'll also say this. I know there are people saying, "oh, the debt ceiling is terrible, why don't we get rid of it?" If you're the House of Representatives, you should never get rid of this. This is the only way to force the president to come back and talk to you. Remember, the House is supposed to be a place where all legislation starts. It's endowed with massive power and yet it's been usurped by the presidential suite. In a lot of ways, just like the prime minister versus his own caucus, the power differential is massive. The only way to get the president to come back is through debt ceiling. I understand why there is a debt ceiling. It gets the president to come back to the table and maybe you get a few goodies if you're a House member.

[00:13:22]

Bryan Borzykowski: So, you're not concerned. I don't see any panic on your face, so I'll take that as a good sign. I won't worry then. Just moving on to the bond market and your mandates, where are you finding opportunities today given it's still a pretty wild environment?

[00:13:41]

Jeff Moore: The good news is there's a lot of yield in the marketplace. We really like the yield, especially versus last year. Where we're finding places to go, portfolios are yielding comfortably over 6% and we are not even close to putting our back into it. We've pretty much taken our below investment grade way down, high graded the portfolio, waiting for great opportunities because, again, sort of that 30th to 50th percentile in spreads just doesn't do it for us. We think something else could break and we want to be able to take our clients and go get those sectors where it happens. We way, way increase the number of Treasuries in the portfolio –the highest level I've ever had– because we're putting a steepener on and we want to be right where sort of the fulcrum is which I think is 7 to 10 years.

[00:14:28]

In fact, I'll say this, I think the aggregate bond benchmark is ground zero for the highest total return in benchmark in the next 12 months just because that's the benchmark, [indecipherable] duration, enjoy the most steepening. This is its chance to stay in the sun, that benchmark stay in the sun. We're there in a big way. Globally, we're looking for a few pieces here and there, but you know how we do it globally, we're very careful. We look at very much like precision hits rather than do something more generic.

[00:15:04]

Bryan Borzykowski: If you're in Treasuries more than you have been in the past what does that mean kind of for the risk profile of your mandate? This must be much less risky. Are there areas to take more risk to get more yield or is it not there?

[00:15:19]

Jeff Moore: In terms of credit risk, our risk is way, way down, our track year's way down. The hard part – we're all practitioners here, it's one thing to say, "okay, high yield's a beta, you can buy beta." If you're the actual person building a portfolio high yield today, it's extraordinarily difficult. Actually, I'm going to pick on bank loans for a second. The bank loan market yields 10.5%. That's one of our biggest positions. We really like bank loans here. At 10.5% yield, that's a per cent a month. You've got to hate... you've got to think that everything's going to default and soon to think you're going to make any money shorting that. That's way too high a return. Here's the problem. When you talk to the bank teams that are building it and the credit teams, the bank loan market is made up of bonds that yield 8 and 14% to get you to 10.5. This has become a much trickier problem.

[00:16:14]

The way I look at that –because for my clients we consider ourselves multi-sector; we're not into anyone– I said, "just go buy the 8%, 9% stuff. You don't have to go buy all the 14 stuff in terms of bank loans." We can go pick our spot and then if you see a great chance in one of those 14%ers where that management team's found a way to take control then let's go get those as well. We're playing it with a very opportunistic eye, but I would not want to just go buy a straight up benchmark here because you could look at the beta and say one thing and then go, "how come my returns don't look like what I was thinking?"

[00:16:55]

Bryan Borzykowski: The title of our chat today, we're talking about flexibility. What does that mean to you? How do you remain flexible? What does that mean?

[00:17:05]

Jeff Moore: The number one thing, have lots of liquidity. We are loaded with liquidity and have a lot of ways to go depending on what comes next. When you think about regional banks and real estate, that's not an issue for us. At some point though we're going to want to get after some of those, especially some of the real estate names. I can tell you that it's really piquing our interest. The question is, what does that look like? How do we do that? We can actually work really well with a lot of the big REITs themselves and be sort of a solution to work with them. This could be a great opportunity to partner, and our clients could benefit in a massive way. So, it's flexibility right now. Don't be too much into any one thing because if something goes awry, you'll just wear the loss and then you won't be able to add more or take advantage of what is [audio cuts out].

[00:17:56]

My lesson out of 2008 when I was there is 2008 was the greatest opportunity for clients and investors to reset their total returns; to put them back on the path being fully funded. I always say to people," if you didn't lose money in '08 shame on you because you had a chance to reset the course of time because everything was cheap." Everything is not cheap right now. We're not priced for crisis. My view is take what's given, leave lots of buckets open because if the reset does happen, if the Fed is that bull in a China shop and if they start breaking even more sectors than they've already broken you're going to want to take advantage of that because it could be extraordinary total returns. Not there yet, but we're watching.

[00:18:38]

Bryan Borzykowski: I'm just curious about real estate. To me, real estate impacts interest rates. Commercial real estate, office space is having trouble with people coming back. Why is that a place that could start looking attractive?

[00:18:51]

Jeff Moore: Real estate's a great example. Real estate, it's under stress now. It's pretty much office space and it's downtown urban office space that's really distressed, and it's really kind of affected by the fact that with COVID a lot of people haven't returned to work. For the number in New York, 50% of the office space is vacant. It may be leased but if you're the REIT, you can't drive revenues higher because you need a vacant space or you're competing against your leasee to re-rent the space, you can't drive it higher. For a few real estate firms, they have too much debt. They got caught. They're going to have covenants. They could violate some covenants, maybe not now, but in a year or two. This could be a great opportunity for us to help out for our clients. We're here to help, that kind of thing.

[00:19:44]

But more than that, why real estate? A lot of it is just an NPV calculation. We can get a pretty good handle on what things are worth especially since most REITs don't have terribly big developmental pipelines. If you think about the 1980s and '90s in Olympian York, it was really the developmental pipelines that caught a lot of those developers. Today, a lot more of them are stabilized. It becomes, okay, I can't afford to pay 8% cap rate on interest rates; I can pay 6, what can we work with?

[00:20:18]

Bryan Borzykowski: Given that more people are in more pension funds and institutional investors are in bonds, they're probably making a lot of money in interest. Are you finding that they have to redeploy those dollars? What are you seeing there when it comes to kind of getting that interest and where is it going?

[00:20:38]

Jeff Moore: Well, I think one of the questions I had from a client maybe six months ago is how come the bond market's not selling off more? Part of the reason is we have so much coupon now that when I get a coupon, I reinvest it back in the market. If I'm yielding 6% and I'm not even working that hard, that's 1/2% a month that I just have to go buy the market. I'm buying something in the market. I'm not a loan. If you're in a bank loan and you get 10.5% you're buying the market back on average all the time. Whereas a year and a half ago when we were at 1s and 2s it's galactic, slow; nothing was going on. So, for our team we think that just the demand from interest is big, so don't sleep on that because the other part is companies aren't stupid. They've prefunded a lot of their debt, so there's not a lot of new issuance in the market. When I get a cash flow now it's not like I'm buying a new issue. I'm buying something that's already out in the market.

[00:21:41]

Bryan Borzykowski: When you have those interest payments are you deploying them back? Are there specific areas or just across the board? You said [audio cuts out] a lot of money in Treasuries, is it going back into that? Where do you put it?

[00:21:52]

Jeff Moore: We're happy having some accumulate in cash at 5%, but you can't stay in cash. The problem you have is you know at some point the Fed's going to turn tail and cut. When they do your rollover risk will be maximal in cash. That's why we like cash. On one hand is a giver and it's a taker. We want to get the money out the curve unless we have

a strong view the Fed is going to keep raising rates, which we don't. We want to get money back out the curve and we really want to own 7s and 10s because just that curve slope reshape is worth so much that we feel like we just need to be there.

[00:22:29]

Bryan Borzykowski: We were talking before –and I thought this was an interesting point you made– you actually said it's difficult to build a diversified portfolio today. Why is that?

[00:22:39]

Jeff Moore: It's this bifurcation that's just starting and its only just started. Again, when you look at bank loans –and I'm picking on them just because it's so stark– your 10.5 % yield is 8 and 14. So, you buy 80% at 8 and 20% at 14. If you're buying those 14%, they're distressed. There's something wrong with the business, the management team; something's wrong in the sector and that's why they're at 14. It takes a ton of research time and usually legal effort as well to get yourself in the right part of the cap structure for those because those 14% yielding things are probably going to be in some version of default at some point, either inside bankruptcy or outside. The reason I'm saying this is, so how does someone build a portfolio that gets you 10.5? If you're just buying index, it just goes and buys them all.

[00:23:33]

Bryan Borzykowski: We just have a couple of minutes left and I wonder if we look out into the future a little bit. We talked about this before, about demographic issues, when you look sort of forward in the economy, what are some of the challenges or risks that maybe people on this call should be thinking about?

[00:23:51]

Jeff Moore: I think that regardless of your view of how far the Fed goes from here and whether they cut in 2023, when you look out 2026-2027, the demographic challenges in the G10 are extraordinary. We're in population decline in all countries but U.S. and Canada. Population decline.; we haven't seen that in 300 years. This is new. We're in labour force decline. Remember, our whole tax code is designed to tax labour not retirees. The tax code issues that we see – or not tax code, with the labour force in decline as well– if you think GDP is the number of workers times the output per person, if that's GDP, if the number of workers is going down GDP is going to have trouble going up unless you're calling for a productivity miracle.

[00:24:40]

The U.S. is going to add, I think we're at 30 million more 60-year-olds over the next 10 years. If you think that we're going to get a productivity miracle from a bunch of 60-year-olds, I don't know if I believe in that. That's a stretch for me. So, when I look forward, if you think the level of GDP and interest rates kind of go together over long periods, I have real trouble seeing really high rates into the future. If anything, I see a world that's a lot slower growing and the places we used to go, whether it was China, Germany, those kinds of places, they're just going to grow slower and that means more sectors are always in permanent recession.

[00:25:22]

Bryan Borzykowski: Do you plan with that in mind? How do you kind of prepare for that?

[00:25:27]

Jeff Moore: We're spending a lot of time thinking about that, what's the future look like? If I think about myself as an investor in the last 25 years, I sort of grew up with China being the engine of growth in the planet where we went from rural to urban. Population was growing. This was an enormous story. That's not the China today. The China today is older than U.S. and Canada and it's in population decline. 30 million a year in the next handful of years, declining population. The whole of Canada could go away every year in China. That's going to be really hard for China to be a fast grower. It's not going to fall in the ocean –it's a $10 trillion economy. It's just the pie is not growing like it was in the last 20 years. There's a great example, where's your growth coming from?

[00:26:16]

Bryan Borzykowski: Great. We are at time, unfortunately. Always a pleasure talking to you, but I will leave it there and we'll chat again soon. Thank you so much for being here.

[00:26:25]

Jeff Moore: Thanks for having me, Bryan.

[00:26:27]

Bryan Borzykowski: Thank you everybody for tuning into today's episode. As always, if you have suggestions on future topics or guests you'd like to see on the show, please share your ideas with us. In the meantime, stay tuned for more Fidelity Compass webcasts in the weeks and months ahead. I'm Bryan Borzykowski, thanks for tuning in.

Issued by Fidelity Investments Canada ULC ("FIC"). Read this important information carefully before making any investment. Speak with your relationship manager if you have any questions. This document is based on information believed to be reliable and is provided for information purposes only. Fidelity, its affiliates and related entities are not liable for errors or omissions or for loss or damage suffered.

Fidelity portfolio managers, analysts or others may express views about a company, security, industry or sector. Their views may not represent the views of Fidelity and should not be relied on as an indication of Fidelity's trading intent or strategy performance.

This document may contain statements that are "forward-looking statements," which are based on certain assumptions of future events. Forward-looking statements are based on information available on the date hereof, and Fidelity Investments Canada ULC ("FIC") does not assume any duty to update any forward-looking statement. Actual events may differ from those assumed by FIC when developing forward-looking statements. There can be no assurance that forward-looking statements, including any projected returns, will materialize or that actual market conditions and/or performance results will not be materially different or worse than those presented.

Past performance is no guarantee of future results. An investment may be risky and may not be suitable for an investor's goals, objectives and risk tolerance. Investors should be aware that an investment's value may be volatile and any investment involves the risk that you may lose money.

Fidelity does not provide tax or legal advice and this webcast is not an offer or solicitation to buy. This document cannot be reproduced without the prior written consent of Fidelity.