

## Fidelity Compass

### The Fed Holds: Fixed Income Perspectives

**Jeff Moore**, Portfolio Manager

**Pamela Ritchie**, Host

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**Pamela Ritchie:** Hello and welcome to Fidelity Compass. I'm Pamela Ritchie. It's a bit of a mixed picture today for North American equity and bond markets as investors await key economic data here at home and also south of the border.

With corporate profits, also the PMI is still showing expansion our next guest says that a significant market breakthrough is unlikely to come in the next quarter, perhaps even two quarters. Where, ultimately, is he seeing opportunity for institutional investors and why does he say that today's market environment is the anti-'08? We'll dig into that.

Happy to say that joining me today to discuss the fixed income landscape with an institutional lens is Fidelity Portfolio Manager, Jeff Moore. Hi Jeff. How are you? Great to see you.

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**Jeff Moore:** Great to see you too, Pam.

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**Pamela Ritchie:** Great to have you join us here today. Let's get to the anti-'08 in just a second here. I do want to talk just a little bit about the volatility in the bond market. There's ruminations about are we going to hit some of those 10-year Treasury yield highs of 2023, of last year? We got a little close. Do we need to worry about this? There's some vol.

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**Jeff Moore:** Yeah, there's some vol but I wouldn't focus on it too much. I think there's great entry points all along. My sense is it's kind of like an up-and-down S here. We hit some highs and we rally some. Right now, what we were looking for in the bond market isn't the Fed. Don't worry about whether the Fed cuts two or three. They're going to do what CPI says they can do. I think we're all watching the CPI print. So, just keep your eye on those. If they come in you sort of 0.3 or less rate, that's the sort of expectation, that means things are okay for the bond market. If they come in a lot hotter, it probably has some negative implications for the bond market but not a lot. I would honestly say this is a period of time here where you're just watching the data because that's going to drive the Fed and the market's going to run really, really fast to try to guess where the Fed's going.

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**Pamela Ritchie:** That's really, really interesting. Let's go to the anti-'08. Let's talk about that. Some will say '08, '09, that's where we sort of got this beach ball under the water of making sure that interest rates just stayed ultra low. It's a long time ago now. Why is it not the same?

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**Jeff Moore:** If you think about it, it's anti-'08 from a perspective that the banking system is much stronger, obvious, but more than anything else, in the U.S. especially, U.S. consumers are in great financial health today. Why? Well, they all have jobs but most of them as well would have a mortgage, have a fixed-rate mortgage that goes for 20, 30 more years at 2 and

3%. They may be locked into their house, but they have an easily affordable mortgage. So much so that unlike '08 when sort of half the market in the U.S. was ARMS, adjustable rate mortgages, the bulk of the U.S. market's fixed rate right now and for most U.S. homeowners they haven't even noticed these higher interest rates, other than the fact that instead of paying down a mortgage now they can go buy Treasuries direct or something, government bonds from the U.S. and have a positive carry for their mortgage. You've actually, on a net basis for most homeowners in the U.S. they've had an equity injection from the Fed in the last two years.

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**Pamela Ritchie:** You said there isn't really a great breakthrough to be seen here one way or the other. That's sort of a calming statement. We just truck along here a bit?

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**Jeff Moore:** For a while, I think until something big, maybe global, that comes and knocks us on our tookus or something but until then, I think right now we're just wandering along. Everyone has a job. [audio cuts out] homeowners in the U.S., I think the number is there's \$37 trillion in home equity created in the last decade in the U.S. That's just money sitting there that's possible to borrow against if you ever needed to or if nothing else it makes you feel richer as a consumer. Consumers are sort of 70% of GDP. That piece of it for the here and now looks pretty darn good.

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**Pamela Ritchie:** What are you seeing in terms of flows? We read a lot about demand, that there is tons of demand. What are you seeing on your side? Clients coming in, the flow story.

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**Jeff Moore:** Over the gunnels. I think the last year is an almost record year for inflows from clients. Institutional clients, a lot of my institutional clients are already fully funded or close to. They're big public pensions or corporations. They're fully funded. There's no extra marks here for being more overfunded. You know what I mean? What you do then is you get back to whatever your base allocations are which is to say you start adding to bonds. We're seeing this in retail as well. Our ETFs which we have for retail investors are just attracting so much money. Just to give you an example, just the other day one of our ETFs got 900 million in. That's retail. That was a retail investors.

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**Pamela Ritchie:** That's a flow story for you. It's interesting just to kind of get a sense of how this is all coming in. The other piece of it not being '08, is there a different global story right now? When you look at the central bank story, this sort of relative story, it often comes back to your fortress North America. We are seeing a lot of other banks trying to get a hold on inflation and therefore figure out when their rates ultimately can come lower as well. Talk about the relative story for us.

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**Jeff Moore:** If we look at the ECB, President Lagarde's been pretty clear that there's likely a rate — pretty clear, but she's hedged her bets a little bit — there's a rate cut likely coming in the ECB in June. They are way more likely to cut than the U.S. Fed. Having said that, President Lagarde has also said this is not the start of a big rate cut cycle. From that perspective she's kind of got the same worries that Chair Powell has been using.

If you look at the Bank of Canada, the Bank of Canada has a lot of flexibility right now. The Bank of Canada looks like it's got inflation on the right trajectory. It doesn't have to worry about massive fiscal stimulus coming out of Ottawa. There's a lot of nice pieces for the Bank of Canada. They have flexibility. If Tiff needs it, then he's got it. If you look around the world, Bank of Japan is really tricky. They have the new governor.

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**Pamela Ritchie:** Interesting. What do we do with ... I mean, it's a full change of course, really, isn't it?

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**Jeff Moore:** For the Bank of Japan, yeah. It's a massive change and I don't think that the Bank of Japan knows what they're doing exactly and they're not sure ... they don't have a lot of confidence in what they're doing and so they're kind of creeping along. Remember, the Bank of Japan pretty much bought every JGB printed in the last five years as it went from yield curve control to targeting interest rates. They announced they're not going to do either of those. They're not going to target interest rates or yield curve control. Having said that, they're still doing a lot of that because their bond auctions basically have no one show up other than the Bank of Japan. That was a good idea a year ago, not so good now. So, Japan's tricky and I would just say for most investors, sit on your hands.

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**Pamela Ritchie:** It's still Fortress North America and still sort of sit ultimately with what you're looking at here. Let's go into sort of some of the stories around the world. Part of the story certainly for keeping a hold of something that's safe is there is a geopolitical story out there, we all know the headlines certainly. I keep reading tons of demand again, even demand for things like defence bonds ultimately because companies might ramp up. Tell us about some of the different themes that are going around where money is being raised for new stuff.

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**Jeff Moore:** If you look at the corporate bond issuance, record amounts not just in the U.S. and Canada but in Continental Europe in January and February. Bulk of that, 75% or more was just refinancing. No one's leveraging up here. There's no sort of LBO, MBO story (managed buyout story) where they're adding a lot of leverage to the balance sheets. That's not on right now. If you're an investor, there's been a lot of issuance, but it's just been refinancing stuff that's coming due. High-yield, bank loans, same thing. There's no evidence that there's leverage being added in high yield or bank loans. It's just the opposite, in fact. They've also refinanced. This is one of the problems that if you're an investor right now and you're trying to decide where your next asset allocation is, you can't hate high yield or bank loans. Their spreads should be tight, they should be tight. Maybe they shouldn't be this tight, but they should be tight.

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**Pamela Ritchie:** That's fascinating. You can't hate that, right, you've got to stick with it and that's because you've got a Fed put there, I mean, risk is okay.

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**Jeff Moore:** Well, I think that's so insightful. This is...

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**Pamela Ritchie:** That's your idea, obviously, I didn't come up with that. I got that from you.

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**Jeff Moore:** When interest rates get to this height, and if you look at where breakevens are from inflation-protected bonds, 2.5% in the U.S. for the next five years, you've got a really big positive real interest rate. That's the Fed put. The Fed, if something breaks, can move really fast, really far. Now, that would be great for nominal bonds but what it also does is I think it kind of makes people in risk assets feel like a big, big downshift is more out of the money, which is to say the net present value of all risk assets has gone up because rates are higher and the Fed has this power if something breaks.

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**Pamela Ritchie:** Again, coming along to sort of how the allocation needs to look you'll also hear that there are other options for something that is less correlated with equities. This is always the story, the 60/40. We do hear that there are other options for the 40. What's your story on that? What do you think? How do you push back on that, if you do?

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**Jeff Moore:** Let me think, if something can make you money, I'm very interested in it. But if you're buying something purely for defence then I have some questions, and then I want to know how complicated you want to be and how illiquid do you want to get. A lot of times when people are saying to me, "Oh, I don't like 60/40, I want to have real assets" and things like that, that's great if the real assets are part of your equity bucket but if they're part of your liquidity bucket you want that sort of total return if and when something breaks. Then generally what people do, investors do is they put what I consider almost minute amounts in, 1%, another 1%. It's really just tricking up the bond, the portfolio a little bit. As an investor, I'm a keep-it-simple kind of person. If you're looking for defense, make sure it's truly defence and get paid as much as you can in that bucket so you're paid to wait which is nice things for bonds and then when something breaks you have an obvious asset allocation.

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**Pamela Ritchie:** When you look around the world, let's go back to sort of the global story but from a different angle, basically investing, looking at bonds around the world. Are there currency stories, are there international countries stories that are of interest or in fact, are there places to avoid? There are always places to avoid but there's some big-ticket places to avoid is sort of what I'm getting at.

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**Jeff Moore:** I would say that two or three of the countries that concern me the most are in Asia. I would say Japan and the yen and then China and the renminbi are one. Both those countries, China and Japan, have currencies that are basically at the wide end of their bands and are going to be tricky to bring down to the band. I think with China, in particular, it's going to be, I hate to say it, like the whipping boy, so to speak, for this election because of..

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**Pamela Ritchie:** Sort of a political story.

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**Jeff Moore:** If you're the Democrats or Republicans, Michigan matters and Michigan and the UAW matter. You saw what they did in '16, you saw what the UAW was able to do in '20, China could pay the price for that. If I were a client I would say this could be a little trickier for them and yet the currencies are in themselves so weak and there's so many question marks around policy frameworks, not just in Japan but in China as well, to me, I would say that those are two countries where it's going to be trickier to make money and you have to have a really long horizon to be there.

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**Pamela Ritchie:** Interesting. Just while we're on currency quickly, the Canadian dollar, if we do see interest rate cuts here, which they are expected from the Bank of Canada, we have one coming up in the next several hours, I mean, not the cut, the decision, where does the Canadian dollar go if we have to start cutting?

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**Jeff Moore:** The Canadian dollar has been a bit weaker than I kind of thought it would [audio cuts out] the last year or two. Basically, it's against the U.S. dollar. The U.S. dollar is a juggernaut right now and I don't see any reason that that stops. I don't want any clients to walk away thinking the U.S. dollar should weaken here. There is no story for that. The U.S. dollar is as strong today on a relative basis relative to other currencies as it's probably been in the last 15 years. This is a really strong currency. The Canadian dollar just can't keep up with that. Having said that, if the Bank of Canada has to cut more and faster and earlier than the Federal Reserve, yeah, Canadian dollar can come under even more dire pressure.

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**Pamela Ritchie:** Let's go into investment grade. You talked a little bit about some of the other asset classes itself with the corporate bond market but investment grade more stable. Do we need to be stable? You've already said that exposure to risk is probably fine at this point. Take us through sort of the IG world.

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**Jeff Moore:** The IG world is in fantastic shape, whether it's corporate bonds, securitized bonds, structured product bonds. There's more than enough demand for everybody who wants to issue in the marketplace. In the investment corporate market in particular, spreads should be kind of tight, and they are. Why? Because most companies are in decent shape. You look at PMIs, PMIs, they're over 50 are saying that most companies have some pricing power. They can raise top line revenue.

In general, in any marketplace, especially for investment grade corporates, that means spreads want to do well. That's kind of where we are today. There's no story, by the way, for investment grade companies adding leverage. That's just not on. I think there's this notion somehow companies are riskier today than they were 10 years ago. That's untrue. If there's no evidence at all that corporate America or corporate Canada has added net leverage, to jimmy up the returns in their stock. If you think about how much debt a company has, it wants to maximize the jewel in its crown. Stock. That's what all the debt is for. That's what I'm for is to help elevate that jewel so it's worth the most for shareholders. That's all they're focused on. They're not going to have too much leverage because that will actually hurt the jewel. So, we have no evidence right now that corporate Canada or corporate U.S. has added leverage. Even the banking systems has been delevered.

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**Pamela Ritchie:** Are we about done with any concerns about the default cycle? We're past that now? We've never past that but...

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**Jeff Moore:** Well, especially for high yield and bank loans, they've refinanced so much, I think the number's almost 30% of the bank loan market refinanced in the last two months. If you think defaults are coming, it's not a 2024 event. I don't even think it's a 2025 event just because you have to have something to default to, which is usually a debt maturity. If you're a client and you've been holding out hope here for a big default surge, it can happen but it's not likely to happen soon. If bank loans are still yielding 10%, enjoy the ride.

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**Pamela Ritchie:** Fantastic. Just going back a little bit to the fortress North America and telling us a little bit where we want to sit here. Tell us a bit about how you want to take a look at some of the markets themselves and what's of interest in Canada and probably the U.S. Let's go to the government side of things in Canada and the U.S.

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**Jeff Moore:** I really like U.S. Treasuries and I like Government Canada bonds. I really prefer bonds in that 5-to-10-year part of the yield curve. I think at some point in the future yield curve should steepen. I have no idea when. Yield curves reposition like paint drawing. It can be a long arduous process. But the nice thing about the 5-to-10-year part of the yield curve, you have a lot of yield and you can just wait and keep rebalancing once a year, whatever it is. What we've done is we basically own cash-like securities at the front end, as many bank loans as you can have, even triple-A CLOs are useful for clients. Then we want to barbell all the way around to the 5-year. The problem with the yield curves with the up piece is if interest rates don't fall in the next year your bond is starting to roll up in yield, which is to say the price is going down. It's just a drag on your portfolio. My sense is own cash and cash-like instruments, barbell over and then buy 5-to- 10-year securities.

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**Pamela Ritchie:** Fascinating Is there a theme to play in the U.S. election?

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**Jeff Moore:** I don't think it's an investible theme. I think if you're the stock market you have two people that are gonna be cheerleaders for you both claiming victory about how great the stock market is and how good they are for people's wealth and so forth. There's no obvious theme here and...

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**Pamela Ritchie:** Well, why not? What are the elements in the landscape here that make that...

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**Jeff Moore:** If we just compare to back to 2020. In 2020 President Biden had a monster infrastructure initiative, monster, and he campaigned on it. It was the be-all and end-all. In hindsight he probably shouldn't have done hardly any of it just because by the time he got into power we didn't need it anymore. The economy is already heating along. Having said that, if you look at today there's no big announcements coming from either party. They're chucking mud at each other but that's what they do. There's no big announcements coming. The U.S. deficit is going to fall in the next 12 months and fall pretty fast. Now, it's still going to be too big but it's not going to be sort of a story here.

The last thing is in the election it's highly likely that one of the two Houses will flip, probably the Senate just because two-thirds of the Senate seats up for grabs are Democrats and if they slip one or two, they lose the Senate. You can easily imagine a president who doesn't have all three chambers, which if you go back to President Obama in his first term, he basically had all three chambers, his chamber and then Senate and the House for two years and then never got them back again. Same thing happened, President Biden had two years, hasn't got it back, may not get it back. President Trump was the same way, he had a very short window, he never actually had the whole thing. I kind of think that's the story for clients. I wouldn't be making big allocations based on it unless you have a trade-related thought process because in 2020 and 2016, these elections did spin on your position on trade.

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**Pamela Ritchie:** Anything to add there or [crosstalk]?

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**Jeff Moore:** Let me just say, in 2016 President Trump renegotiated NAFTA, remember that, and cancelled the Pan-Pacific Partnership which I think drove a lot of big unions around the bend, and so he was able to win the presidency. 2020, President Biden who's an excellent politician said, I'll never let that happen and so he didn't pull back on NAFTA at all and he's talking tough on trade right now. He even has Secretary Yellen in China talking about the fact that we're going to have to have fair trade. That's code word for be ready for us to be tough on trade here because Michigan is a battleground state and the blue wall, if you're President Biden you need Michigan or you don't win the presidency.

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**Pamela Ritchie:** That's so interesting. But beyond that it's not an obvious tradeable theme.

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**Jeff Moore:** Not for most things.

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**Pamela Ritchie:** Okay, I think you've straightened us out here. A lot of the message is sort of stay where you are to an extent. A final thought for everyone here.

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**Jeff Moore:** The bond market, we're able to put together a portfolio of bonds yielding over 6%, depending on how much risk you want to take, with a duration around 6. This is actually a nice place to be. You're paid to wait in the bond market. Just hang loose and then if and when something does break globally, hopefully you'll have an obvious asset allocation.

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**Pamela Ritchie:** Jeff Moore, a delight to speak with you. Thank you very much for joining us today on Fidelity Compass. We'll see you soon.

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**Jeff Moore:** Thank you.

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**Pamela Ritchie:** All the best. That's Jeff Moore joining us today on the show. Of course, if you have any suggestions for future topics or particular guests that you'd like to see here on Fidelity Compass you can always share those ideas with us. In the meantime, stay tuned for more webcasts in the weeks ahead. I'm Pamela Ritchie.

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