Fidelity Compass

The Fed and the Balancing Act Ahead for Fixed Income

Jeff Moore, Portfolio Manager

Pamela Ritchie, Host

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Pamela Ritchie: Hello and welcome to Fidelity Compass. I'm Pamela Ritchie. Inflation is rising, of course, and so is consumer spending. That's part of the story. The latest CPI and PPI –and also retail data out of the US– all rose largely due to a big jump in energy prices. The recent figure indicates that consumers perhaps continue to hold up well despite rising prices and increasing levels of credit card debt. What ultimately, though, might it mean for the Fed and for you? Why is our next guest calling 2023 the anti-2008? Joining me today to discuss how he's navigating the fixed income landscape including the importance of flexibility in fixed income allocation is Fidelity Portfolio Manager, Jeff Moore. Hi, Jeff. Great to see you.

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Jeff Moore: Great to see you, too, Pamela.

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Pamela Ritchie: Great to have you join us here today and everyone joining us here today we invite you to send questions in for Jeff over the next half hour or so. Let's go straight to the inflation side of things and get your perspective. I actually think you're not even... you don't even really have protection for inflation at this point. Take us through sort of the inflation story from where you're standing.

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Jeff Moore: The bond market thinks that inflation has been done and dusted; the Fed has won. If you look at TIPS, the inflation-protected market in the U.S. break evens, that's the inflation component, all have 2% handles, low 2% numbers at almost every maturity. So, the bond market said the Fed has won the game; we just don't know the final score. Are they going to get there in 2023, 2024, 2025? I don't think it really matters for investors now. The good news is when inflation is on the path that it is, and there's only a couple sectors bubbling up at levels that are higher than we like them to be, this is a great opportunity for bond markets.

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Pamela Ritchie: Tell us how ultimately –because you feel like if the markets think that the Fed's won the game, certain things are priced into that, where do we go from here? Is there further to go, I guess?

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Jeff Moore: The way I look at the Federal Reserve and the Bank of Canada, they're both going to threaten rate hikes and they may do a few what I call tuck in rate hikes. What they do not want is the bond market to rally. They want to keep the forward markets, 2024, they don't want them to price in big rate cuts. They want the market to say, "hey, these levels could be here for a while because in both the Bank of Canada and the Federal Reserve they're feeling pretty lucky they

got here without breaking anything. They would like to stay here, keep financial conditions as tight as they are now for another 12 to 24 months instead of having to spike rates and break something." This what you do, you threaten rate hikes 25 here – so, my sense is in September the Fed won't go, but they may do something in November but it's more than anything else just to keep us from rallying in the out periods.

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Pamela Ritchie: Are corporations healthy? They've got to get used to the fact that the cost of capital is higher. Those companies that are run well have already done that; they've seen the train coming to an extent. Are we on the other side from the corporate side of things?

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Jeff Moore: Think about the high yield market right now. I think it's a great example because that's the market that you think that if something breaks it would break in something like high yield. The average coupon in high yield still starts with a three handle, 3% handle. Why? Because they termed out their debt two years ago. That's what the debt maturity wall moving out. Even 12 months from now using our own data we think that the average coupon in high yield will be 5 handle 12 months from now. Those are not stressed coupons for high yield managers. The high yield market now is at the highest quality possible. It's double-B rated. It's not a single-B market anymore; it's migrated to double B because, remember the last few years, Pamela, we've had nothing but [upgrades?/breaks]. So, if you're calling for high yield to break, I get you, that would be the place. I just don't think you're going to get a widespread high yield break easily because I'm not sure what would be breaking them, especially if the economy is sort of ticking along here because it's certainly not going to be the reset in rates.

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Pamela Ritchie: That's the corporate side of things. You like Treasuries a lot right now in terms of positioning. You have a lot of flexibility to move, but, at the moment, Treasuries are a big part of the positioning story for you.

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Jeff Moore: Yes. To me, like I was telling you, I think this is the most compelling bond market since I've been working in the 1990s partly because we have a lot of yield from Treasuries and that yield is at or higher than inflation. So, that means real rates are positive. Those are all great things. My hope for everyone is that the interest rates never rally again and that our clients can compound every day, every year with these nice interest rates. That is a huge win.

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Pamela Ritchie: We're plowing through at this point sort of at what, what would you say? I may have just lost you there. We're plowing through at this stage at what, clipping coupons? I think you've used the expression sort of plowing through the water or something. It's some smoothness here.

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Jeff Moore: Yeah. That's what's going on right now, we're just plowing. Right now, the portfolio has a yield of around 6+%. We're not really pushing it; we're massively diversified. We've got a lot of Treasuries. We've been adding to duration because I feel like duration is a better place to be now than it's been in a long, long time. We're almost at the 100th percentile over the last 25 years. But the bond market is not rallying here because the Fed doesn't want it to and you know what, as clients, you don't care. You don't care if it doesn't rally. That's only in a crisis and then you want us to go up

in value a lot so you can sell us and buy stocks back or something, which is cool. I'm just saying for the here and now the bond market is just compounding and clipping. Year-to-date the bond markets have a couple of percent comfortably. If you look at even a year-over-year we're up 5%. It's fine. You're not getting rich, but it's the bond market.

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Pamela Ritchie: So, it's doing the job of making sure there's a secure investment, ultimately, on the other side, the diversification element is there in spades.

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Jeff Moore: Yes. One of the reasons we have so many Treasuries right now –we're almost half Treasuries; we've never been this high before, never been this high before. More than that [crosstalk]. Never. It's because the Treasury market is the cheapest thing out there. The bank loan market, high yield market, even investment grade corporates are sort of the 30th percentile. They are not priced for a hard landing. So, part and parcel in this portfolio for clients is we want to be mindful of where could there be a lot of return that's a little unexpected and hard to see if something breaks in the economy. Again, it's hard to see it, but we've really ramped up our ownership of government bonds and then we've been buying more duration as the data – even the most recent CPI, that most recent CPI makes duration safer. It just does.

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Pamela Ritchie: It makes duration safer. The world is more realistic at this point.

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Jeff Moore: Yeah. Think about that, the data point we just got. If you think that owners' equivalent rent, which is the big unknown is the thing, it still was up 7% year-over-year. Most of us in the market will make an argument that it's hard to imagine how households are going to get 7% higher year-over-year for their house. Maybe they can. So, at some point when that rolls over and if OER in the U.S. instead of growing to 7 it just grows at 3, inflation in the U.S. has a[2] handle, that could be the next CPI report. It could be.

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Pamela Ritchie: Tell us, is the story the U.S. at this point not Canada? I mean, we have a different story, as you well know, on the housing front.

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Jeff Moore: Yes. The U.S. I think is rock solid. You said I call this the anti-'08, '08 was the U.S. banking crisis and there was a number of instruments that polluted banks around the world, but that was a U.S.-centric crisis based on the fact that Chair Greenspan raised rates 350 basis points and broke housing in California, Texas and Florida. Fast forward to today, never let a good crisis go to waste, the governments didn't, almost 99% of American households now are fixed rate and conforming mortgages. Which is to say they haven't even noticed this rate hike. Most Americans have 27 years left to go on their mortgage at 2.5 or 3.5%. This is an anti-'08 for the U.S. Now, rest of world, though, Canada and the Netherlands, the Brits, Germany, Sweden, they have a lot of reset risk and that will, will crimp consumption in Canada and those countries without a doubt.

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Pamela Ritchie: Take us into sort of the fiscal side of things as we're talking about the government position. First of all, we're hearing narratives within the market. The world is just awash in debt; can't handle it anymore. Where does the fiscal story land here? A year ago, Britain literally fell apart because they tried to go too far with unfunded policy changes. Where's the world of fiscal from here?

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Jeff Moore: We do know we've added a lot of debt globally. The U.S. had added a lot of debt and so has Canada. We know from even the studies by Rogoff and Reinhart out of Harvard that countries with a lot of debt grow slower. I think as investors we should all be assuming that the forward markets around the planet for forward growth prospects are all down, partly based on all the debt was just issued that has to get paid for at some point, whether through spending cuts or taxation. That's going to crimp people. That's gotta happen then. Remember, demographics are always there. We have population decline in the G10, population decline. We're talking about China's population falling something like 30 million a year in the next few years and never coming back from that. By 2050 China's population could be over 300 million less.

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Pamela Ritchie: Where do you look if it's not…

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Jeff Moore: I think it's fortress North America, still is our investment philosophy. It's the U.S. and Canada which have the best demographics. We have a lot of flexibility on fiscal. We've used some of it, but we have a lot more to go. I think it's Mexico and Brazil as well. If you say who's eating China's lunch, it's Mexico and Brazil.

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Pamela Ritchie: Really. I think you've said that before. Has that accelerated at all?

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Jeff Moore: Yes. Pretty much every entity when we talk to company after company… they're trying to do as much as they can. It's called onshoring, just because it's a lot cleaner and you're not going to start worrying about supply lines and things like that. I think there's also this notion that China is going to sell all U.S. Treasuries by the way. They did that to President Trump, they hated him, so they sold those already and so Chinese banks, what they own in Treasuries are all 1-year and [indecipherable] bills and stuff, so even then, you can't explain 5 and 10-year Treasuries based on China. I'm not worried about that if you're worried about Treasuries in China; that's not on.

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Pamela Ritchie: Take us into a bit more on the duration front; how you're thinking about this because this sort of ties into the world's awash in debt. Some people will say duration, go into it now and others are a bit more hesitant. Take us through that a bit further.

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Jeff Moore: This gets down to the word reinvestment risk. Reinvestment risk. This is what clients have to decide. If you own just cash, which is great, it's the cheapest part of the yield curve right now. The problem we have is in Canada if one person, Tiff, changes his mind you get a lot less yield the next day. That's just it. So, it's not a market, it's just a handful of people making a choice on the overnight rate. The Fed's the same way. The question for clients isn't if they get out the yield curve; it's just how and when. That's my view. Out the yield curve you can lock in some of these higher rates, you can lock in some of these gains.

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Think about it this way. If you think about a 5-year bond in the U.S. and you can get, let's say, 4% on that, you know it's worth 20 points over the next 5 years if you just buy and hold it. That's the break even, next 5 years you have 20% return. If you have a million dollars invested, you got 200 grand coming that way –sorry 20 grand coming– and you don't have to worry about it. That's the easy, easy part –50 grand coming, my math is terrible. The point here is that that's the easy part of the story.

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I think for clients it's just not if they go out the curve, it's how and when. But you've got to go out the curve especially if you think the world's got too much debt; it's going to grow slower and if you think demographics are bad, which I do, and it's going to crimp the rest of the world, in that world it's hard to get fast GDP growth and if you think that 10-year nominal yields and GDP growth kind of go together, which I do, you probably want to lock in some of these yields at some point. I don't know how you do that, but that's every client.

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Pamela Ritchie: It's interesting if you say that you kind of hope the bond market is essentially stay… well, rates stay where they are. If there's a rally situation that's what the Fed is trying to stop. If we sit around here, come down a bit, this really looks like the future to you at this point, barring something massive happening.

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Jeff Moore: Yeah, for the next while, certainly to the end of this year. It's all going to be predicated on "does something break, when do we get inflation under control?" The Fed and the Bank of Canada, they've won the game; they don't have to blink, and they ought not to. They'd be out of their minds to. If they don't like now, they don't have to raise rates later. I think that's where their head is at so, hold the fort here. That's why if you're into short-term debt right now you have time to decide when to reinvest out the curve because I think the Fed and the Bank of Canada will be here for a while. All I'm saying is if something happens and it breaks something you have to move out the curve as quick as you can.

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Pamela Ritchie: Is that something breaking potentially the energy story or related to it?

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Jeff Moore: Energy is one of those things. If you think about BTUs –British thermal units– and say, "how much energy will we need on earth by 2040?" We're almost going to double the number of demands for energy. It's like all of our cell phones and you're always updating your phone and things like that. There's so much demand for energy and it's almost inconceivable that we don't have to almost double our energy. Where are we going to get that?

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Pamela Ritchie: There's so many headlines that say peak oil then right now.

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Jeff Moore: This is a challenge. I would like to think it's peak oil. Wouldn't that be great for all of us? But it probably is not. More than that you're going to have to say, "where's the energy going to come from?" We're going to need all hands on deck to supply that kind of BTU. That means every type of energy is going to get invested, from the greenest green stuff to some of the dirtiest stuff… still going to get used. That's where I would be, I'd be much more circumspect as an investor at the end of the energy cycle because I'm not there yet, unless you tell me, okay, "how are we going to be able to double BTUs." Are we going to double the number of nukes and stuff like that? That's a lot of infrastructure, a lot of dollars, 10-year lead periods. That's the challenge.

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Pamela Ritchie: That's the challenge, but does it do something fundamentally to the inflation story at this point or do you think it'll be headlines but we'll bounce around these levels for now? I mean, does it matter basically? Is the question.

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Jeff Moore: I think it doesn't matter as much. It is the most volatile part of the stack in terms of CPI, so from that perspective on a headline basis, it'll matter. The Fed's watching OER, owners' equivalent rent is almost 40% of the CPI basket. It's a lot less than the PCE deflator.

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Pamela Ritchie: A little bit around what you've been saying, this idea [indecipherable], Fed going to cut rates just delayed therefore we'll see lower interest rates. How would you lean into that? And conversely, if we sit here for the higher for longer –you kind of explained that– but take us through, like there are those that think that interest rates will come down because inflation is getting absolutely crushed; take us through how you would act in either of those scenarios.

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Jeff Moore: Right now, we have flexibility to do a lot of things. We're always trying to control our risk. We don't take a lot of risk in this portfolio. We want it to be bond market friendly. Right now, we're almost half Treasuries. We're kind of like that 6-6.5 duration, 6-6.5% yield, that's kind of where we think is a great place to be. We want to be 5 to 10-year Treasuries if we can be, play the steepening curve because in a crisis you can't see it, but when it happens the first thing you know the yield curve has steepened like a son of a gun. You want to be where the most movement is in that 5 to 10-year. We're there. We like that piece of it in terms of giving us what I call scenario risk help. In general, while we're waiting, we grab the coupon, and you enjoy the ride. Like I said, I think, and this is my view, that duration is as safe as it's been in a long, long time.

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Pamela Ritchie: The credit markets themselves are telling us what at this point? There's lots of people that are sort of watching that very carefully.

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Jeff Moore: I think the credit markets are right now giving the signal we have a soft landing and that's fine because a lot of the companies in the credit markets, they're well-run, these management teams aren't stupid. This has been a very telegraphed rate hike, so they haven't... it's not like the management teams in the companies are missing the boat here. Things are just viewed as somehow economists like to think that company management teams aren't aware. That is the furthest thing from the truth. They're very aware of everything including the cost of funds for debt and equity. Did I lose you?

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Pamela Ritchie: No, I've got you, carry on. You say they're very aware.

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Jeff Moore: Yes, they're very aware. From that perspective, the longer this goes even more so companies will be saying, "okay, maybe I won't issue debt into this market; I'll use a little bit more retained earnings and equity and then at some point, 2, 4, 5 years from now when rates are lower, I'll issue a whole bunch of debt and do a levered recap." Those are all things companies can do and they will do. We like corporate credit here. We think it's mostly fine.

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We have pulled our corporate credit inside of 10 years in general, so the bulk of our lending is shorter –so intermediate and short for companies, not longer– on the view that if something does go bang!, credit spreads will have to widen a lot and that long key rate will be the hardest hit. The portfolio is extraordinarily defensive right now. We have a few sector weights in different sectors up and down the cap structure, couple of local currency trades, but in general, Pamela, the whole point of this portfolio is flexibility. So, grab your 6 or 7% if nothing happens. If something happens, we'll have an obvious asset allocation for our clients.

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Pamela Ritchie: I'm kind of fascinated by the currency story today because the ECB did –it's been called sort of a dovish hike essentially... felt they had to do one more, but it doesn't look like a great situation in terms of growth there. We saw the euro initially tank off it. What do you think? You haven't mentioned Europe at all.

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Jeff Moore: The hard part about Europe, it's very inflexible economies. They're heavily, heavily taxed, heavily, heavily burdened with debt and the labour markets are relatively flexible. All that's to say is that market is going to have trouble being robust. If you're Germany –Germany's biggest export market for a long time was China¬– as China's slows down, now Germany's gonna get cold. The way we're looking at Europe; we still like owning there. We have around 10% allocation. We buy in local currencies then we hedge the currency out. We still like that diversification; there's still great companies in Europe that are well managed, and these are mostly investment grade. Having said that, there's not a lot of excitement. We're able to buy those companies, hedge it back to dollars and grab like 7.5, 8% yield. That's what we're kind of looking for there. We're not very excited about Europe; it's just we think there's enough there to warrant a nice allocation.

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Pamela Ritchie: When you see comments in the media like everything's either priced in or there's too much debt in the world is that almost a signal to equity markets?

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Jeff Moore: I think so. I often wonder why someone who thinks there's too much debt on the planet wouldn't buy bonds because too much debt, if [indecipherable] is right that we're going to grow slower, suggest a slower economy not a faster economy, which is probably better for bonds and worse for stocks. I often wonder why they don't like the bond market when they say that. It seems internally inconsistent to me, and I think there's people just worry about everything; they're just worriers. I call them the charlatans of finance; they're always on TV. The charlatans [audio cuts out] will run you into the ground.

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Pamela Ritchie: That's right. You have to stay optimistic for heaven's sakes. Tell us a little bit about if we go into the charlatan's finance scenario, though, what would you do? Let's say something goes bang literally; you go shopping, you find it as an opportunity? What do you do there?

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Jeff Moore: Here's the one thing you know; when something happens that's unexpected it'll happen very suddenly, and the bond market yields will fall like an elevator that's lost its way. There really isn't a lot of time to reallocate from one risk asset into... so it's kind of a come-as-you-are market, at least originally. Part of the reason we have so many Treasuries is we recognize that everything – what's the old saying, I went bankrupt very slowly and then suddenly – that's how the markets go. It's slowly and then one day it's suddenly and it's going to be hard to reallocate. We've reallocated in there already. Our view is we'll do more depending on what that market looks like or less, or take profits. I was around for '08, '02, '98, '96... these markets when they happen, they happen quickly.

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Pamela Ritchie: You, in those situations are able to sort of let it be because it's bonds and the safety is there.

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Jeff Moore: Yeah, and that's where we are. We're a bond product for clients. The goal here is if something big happens we will change our asset allocation. We write the two-pager every month to let you know where our heads are at and let you know how we'll be changing our asset allocation, which is, I think, important for clients so that if that doesn't dovetail with what they need to do at that moment, that's important. Think about '08. I remember in October '08 happening, Lehman's failing and my view is that clients should do nothing but buy everything. A lot of clients were pretty scared, and they were getting redeemed, there was stuff happening. Their C-suite was giving them all sorts of heck.

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Pamela Ritchie: Forced sellers.

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Jeff Moore: The reason we want to communicate with clients is to say, "this is where our head is at; this is what we're about to do. If that doesn't dovetail with what you need, let us know." Best example, in 2020, April 2020, we're telling clients "Buy everything that's not nailed down because it's COVID, but all of the policy reaction functions from the Fed cutting to the fiscal stimulus was all going to be just a massive surge of liquidity." We're saying, "buy everything that's not locked down." We had one client, big state in U.S., said to us, a teacher's fund, said, "listen, our equity and our private equity is all locked and just getting crushed. We need to start paying some of the payouts from the bond." They said, "can you do us a favour; you love the market, can you just take the thing that's rallied the most –which in that case was Treasuries, and just sell that?" We were able to work with our client and our client ended up at the end of it putting all the money back in a year later. Having said that, we stayed up with the marketplace because we went where we wanted to go but worked with the client and it worked very well.

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Pamela Ritchie: It's amazing. We'll end on that. Jeff Moore, the time goes by so quickly, thank you very much for joining us here at Fidelity Compass. We'll see you again soon, I hope.

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Jeff Moore: Thanks, Pamela.

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Pamela Ritchie: All the best. Jeff Moore joining us today on Fidelity Compass. Thank you for joining us. If you've got any suggestions for future topics, guests that you'd like to see here, please go ahead, and share your ideas with us and keep an eye out for more Fidelity Compass webcasts in the weeks and months ahead. All the best. I'm Pamela Ritchie.

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Ending:

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