Fidelity Compass

Fixed Income Perspectives: The Rate Debate

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 been a very positive start to the week for U.S. equity and also bond markets as they continue really to digest the big move out of the Fed last week. The rate debate is still very much front and centre. What were the potential forces driving the Fed's decision and how is our next guest capturing credit opportunities while maintaining portfolio risk objectives? Happy to say joining us here today to unpack how he's navigating the fixed income landscape with an institutional lens is Fidelity Portfolio Manager Jeff Moore. Hi Jeff, welcome, great to see you.

[00:01:05]

Jeff Moore: Nice to see you too, Pamela.

[00:01:07]

Pamela Ritchie: Delighted to have you here. We'll invite everyone to send their questions in over the next sort of 25 minutes or so here.

We actually spoke yesterday and in 24 hours, 24 hours yesterday we were talking about the known unknowns which was sort of the U.S. election and we're going to talk about that and talk around that. Since then there's been rather major escalation in the Middle East front and we have huge stimulus from China, maybe not enough but it's certainly a signal and a departure. So, you see how much happens in 24 hours. I'm sort of curious where you sit with bond's low drama as the way you walk through this.

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Jeff Moore: I think you hit it on the head. Bonds are low drama here. With the Fed out of the way, they did their 50, there's more to come but the nice thing is now the Fed's gone from being a headwind to a gentle tailwind. With inflation rolling down nicely, slowly for some people but inflation rolling down nicely you have positive real yields in the bond market still which is to say this is the kind of environment the bond market feels very comfortable being in. This is a very traditional bond market environment and then when you add on a little event risk from around the world, certainly what's happening in Lebanon and the Middle East and so forth. Honestly, with China, China's slowing and it's hard...

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Pamela Ritchie: Even with this big stimulus, I mean, it's not the bazooka, apparently, or I was going to ask you what you thought of it.

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Jeff Moore: The hard part if you're the PBoC is you can't really do a bazooka because part of the problem is massive overinvestment in real estate. You got here because there is one entity, central government, who continued to take a good idea and went way beyond its best IRR, its internal rate of return, and because there's no off button for governments, they just drove it and overinvested in it. If you're the PBoC the kind of stimulus you're doing has to do kind of a dance says, we don't want to stimulate real estate because that's over investment, we want to stimulate other things. Good luck to them. That's going to be very tricky. That's why I think this stimulus will be a lot more measured than certainly '08 stimulus was for China.

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Pamela Ritchie: As we watch, Jeff, also things like consumer confidence numbers coming in, falling a bit basically on a labour outlook, as we watch these pieces of data come in I wonder if we watch them come in differently because you got a 50 basis point cut just days ago. Does the world of data streaming in look different, actually?

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Jeff Moore: Not so much. If you've been with us for the last year and a bit we've been talking about the everything rally and we've been talking about the rate market's not going to wait for the Fed, and it didn't. If you look at the last 12 months, it's been a double-digit return in the bond market. We wrote a paper saying if you don't like bonds now you just don't like bonds. That was over a year and a half ago. The thought process there is once that inflation starts rolling down and even slowly or quickly, whatever way, the market's going to like that. The market pivoted well before the Fed. This 50 basis point cut by the Fed is a little bit of housekeeping, just kind of catching up, maybe...

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Pamela Ritchie: A little bit of housekeeping. That's your sound bite. Really? A little bit of housekeeping.

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Jeff Moore: Bookend the fact that they raised rates a couple of years ago, now they're cutting rates so our rate cycle is over. So well done.

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Pamela Ritchie: Putting a lid on ... there are no more rate rises, I mean, not in sort of the predictable future.

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Jeff Moore: Correct. I think they wanted to take out any sort of tail expectations that rates might move further higher, and they did. I think the Fed kind of took 50 because that's what the market was taking and the Fed was, do we want to disappoint the market, do we care? We don't really care that much, 25 or 50 at this stage knowing there's more to come at some point, the Fed is comfortable doing 50. I don't think as a client you should go, aha, this is like nirvana for bonds. It's good. The best part was just 12 months ago. The market now is a solid market for the bond market within the context that you're getting 5 to 6% yields now.

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Pamela Ritchie: With these things happening and literally explosions happening and then big versions of stimulus, are these catalysts for big change in the bond market or really is just the rate debate which we'll dig into right now?

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Jeff Moore: I don't think so. I think a lot of these events, the market's pretty comfortable that there's always bad things happening, right? There's always somebody doing something bad to someone. As much as we hate it, it's just the fact of the global world that we're in. I think, though, if you look at stuff like spreads, which we'll get into in a little while I'm sure, the spread markets aren't going to react to this. They need a lot more negative action to even consider widening into this.

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Pamela Ritchie: Well, let's go there, let's talk about that now because it doesn't seem like much has moved really. They were waiting, I guess we knew that this was coming, just come back to sort of the catalyst that it would take to see any major action, including spreads.

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Jeff Moore: You look at high yield, bank loans, emerging markets, even investment grade credit, those are all trading now at the lowest spreads they probably traded at in 15, 20, 25 years, pick your number. These are really low spreads. Now, they probably should be low spreads because default risk seems extraordinarily low, especially now that the Fed's kind of done-done. You're not worried about sort of the Fed pulling rates up that's going to lead to some catalyst to lead to defaults and so forth.

But more than that, the bond market has been wide open in the last year but even the last few months. If you're a company and you needed access to capital you've got it, in any way you want it. You can take it in the high yield market. You can take in the private credit market. You've had wide open access. If you're calling for a liquidity event that's going to widen spreads, I don't see how'd you win that battle. That's 12 to 24 months away easily.

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Pamela Ritchie: On that access to capital we've seen a lot of issuance actually already or announcements all over the place in the corporate market.

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Jeff Moore: You know what, Pamela? Every entity that's needed access to capital's got it. Even if you look at the banks and you say, well, okay, maybe the banks are going to restrict lending after the regional bank crisis a year ago, not at all. Banks have got plenty of capital. The banks have almost no loan losses. Now banks, if you were a bank a year ago that had a loss on your Treasury book, guess what, that loss is gone now. You don't even have to post any capital against that. If you're a bank you're feeling really comfortable here, which is to say you're not calling any of your clients saying, I need my line of credit back.

If anything, you're saying, well, yeah, we'll let that slide, that's okay. You have this period of time here, this sort of window, I don't know how long it lasts, where it's hard to call for a default spike. But, high yield isn't yielding 12% anymore, it's yielding 8 and 7s which is a much more traditional yield going back 25, 30 years ago. Not as much spread but still a traditional yield which is to say, I think if you're calling for some kind of event because of defaults you have to give me some kind of catalyst that it's hard for me to see.

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Pamela Ritchie: What is the mix at this point? What has changed in terms of positioning for you when you're looking at through the lens that you're looking at? What do clients want right now? I mean, high yield looks, as you say, sort of calm with a yield that's more reasonable. What are you mixing together within the positioning of some of the places that you're working for clients?

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Jeff Moore: If you've been with us for a while you know that one of the things we take care ... we're very valuation centric. The more yield you give us and the more reason to buy something the more interested we are to buy more for you. It's pretty simple that way. As spreads have really declined, and sharply declined, we've actually taken profits and cut our weights down. We've taken some of our risk-free weights, particularly government bonds, up. That's been very, very additive in the last 12 months. But more than anything else, we're trying to open up buckets of room so that if something surprises us we have lots of room to add. But we still want to have enough risk in terms of below investment grade (we're still around that 20% area), we still have enough risk that we comfortably can grab as much yield as the market has plus some upside here and there. It's been one of these sort of periods where you feel like, yeah, we got the call right in duration, we got the spread call right but the valuations now have just come in enough that we want to give clients as much flexibility as we can and yet still achieve as much yield as makes sense.

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Pamela Ritchie: What is that yield at this point, are you thinking?

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Jeff Moore: Depending on what the client owns with us, if you're just in a straight-up tactical portfolio, it's nicely over 5, comfortably over 5. If you're in something more aggressive like tactical credit and stuff like that, it could be 8 at this stage. Those are fine yields, probably not a lot of capital gains under most draws in the market.

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Pamela Ritchie: Not a lot of capital gains, yeah.

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Jeff Moore: No, not now. There was capital gains, now we're at this point where we need some kind of energy to start moving us towards capital gains. We still have a great tail risk hedge opportunity but again, that opportunity requires something that's going to push us hard to the tail. At this stage it's hard to find that thing.

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Pamela Ritchie: Let's talk a little bit about government maneuver, regulations really is sort of the discussion. Earlier this year we saw that the amount the banks had to put aside, capital requirements came down a bit, that was a nice tailwind. Just maybe speak to that and a bit more broadly about what you're expecting. It kind of goes to the election one way or the other. What do you see there in kind of an either/or situation?

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Jeff Moore: I think that's incredibly insightful. A year ago, the government was ruminating and the Federal Reserve and the regulator of the big banks, a 20% increase in equity and capital for the banking system. After a lot of back and forth that became a 9% number. All the banks have that 9% already embedded, so it didn't force the banks change anything so there was no sort of tightening of monetary policy at the banking level. Think about this, banks are 100% of GDP in terms of their loan books and their scale, levered 10 times. Banks are 5 to 10 times more important than the Fed is. If you tell the bank that they don't have to do anything with their capital, again, levered 10 to 1, all of a sudden all the loan books keep going. That plus the fact that there's been almost no defaults, Pamela, really gives us that the banking system a comfort level that they're in good shape. Now the interest rates coming back down, all those losses at Citigroup and all those great names, those losses are turning around and they're gone. Those have been huge tailwinds to them.

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Pamela Ritchie: Going forward, I was just going to say, what do you see?

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Jeff Moore: Going forward you actually get this kind of world where you go, ah, okay, well, the banks aren't going to be a source of capital tightening and they're in a full scale battle with private credit so you have this world where you go, well, probably more the same for a while. Now, when it comes to the election, I think that's a really good point, I think there's a lot of folks that could be bent out of shape by the election. There's a lot of social media. I think the things that we take away in Merrimack is, one, we've had elections for 200 years in the U.S., this will be just another one. This isn't the end of days whoever wins, it's just not. That's not an investable theme. We talk to our analysts and stuff and make sure that everybody knows that if you think there's a story here I want to hear it but you can't really make one up. The hard part, though, for this election, is we're going to have a race that looks like it's extraordinarily close. You're likely to have divided government throughout the chambers, and if you're not divided no one's going to have a material-like position.

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When we think about that the biggest story we see in the election is really going to be on tariffs. I think you shouldn't sleep on that. I think there will be bipartisan support for tariffs because you're trying to win Wisconsin, Michigan, Pennsylvania, maybe some other states. Because they're battleground states for both parties, tariffs are going to be part of the conversation. I would say that I don't expect broad based tariffs but yeah, you're going to have some tariffs come the new year. A place like Canada will get sideswiped a little bit, although when we renegotiated NAFTA it kind of looked bad for Canada but it kind of worked out pretty well for Canada.

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Pamela Ritchie: I was going to ask you to what extent ... we'd love to just dig into your insight for a second on what it might mean for Canada in terms of tariffs.

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Jeff Moore: First of all, Canada will definitely get sideswiped. We're net exports to the U.S. Having said that, Canada is not in the sort of ... you're not allowed to say gun sights anymore, that's not the right word anymore, but Canada is not ground zero for the U.S. If anything, the U.S. has got more focus on anything with China, anything with Mexico, anything with Brazil. In a lot of ways, the things that U.S. will be concerned about are things that Canadian auto workers and so forth would be very happy if they negotiated something higher. That gives the relative value of a Detroit worker and a Windsor worker the kind of benefit that he wants. So, I don't actually see tariffs being a huge problem. If you think that there's going to be few food tariffs, which I think there will be, I just don't see how Canada gets too sideswiped by that at this stage, especially with Canada is a huge net importer of fruits and vegetables.

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Pamela Ritchie: Yes, we need those in February, obviously.

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Jeff Moore: Yes, we do.

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Pamela Ritchie: Tell us a little bit about the rates, back to the rates, the discussion of the lags of it inevitably coming in to the economy and then the cuts ultimately ushering out some of the tightness that was in there. Everything seems to have changed. I don't know how long these lags are but are we still going to feel some pain really is the question from the hikes that are still working their way through?

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Jeff Moore: If I think about corporate America, it's not. I would say to anyone who's on this call, if you're an investor in high yield the one nice thing you can really bank on here is almost no company in the high yield universe, we follow like 1,000 of them, has levered up here. There's no MBOs, LBOs in any material way, which is to say most companies have not changed any of their financial policy mix in a decade. Even though interest rates got to all-time lows three years ago they still didn't issue a lot more debt. Even when they went up they really didn't issue more stock. They've kept their policy portfolio, if you want to use, at the corporate level much more consistent with whatever is the way to maximize shareholder return.

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I think that's a huge positive because there hasn't been any bad actors in there ... or I shouldn't say, there's always bad actors but there haven't been any sort of levered financial bad actors in the corporate market, especially in high yield. Now, a few of the high yield companies will have obsolescence risk. They'll be at risk of too much competition. That's altogether different than a financing problem. I look at the corporate world and say, yeah, it's probably okay here. The risk, I think, is going to be on things like services and maybe some households. In Canada, obviously households at risk for housing prices.

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Pamela Ritchie: There's a lot of discussion by bulls to say that you can look through the mortgage issues in Canada. What do you think?

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Jeff Moore: Well, as long as the Bank of Canada can cut rates enough. The Bank of Canada started their rate cut cycle but again, they're going to go really slow. They're going to slow walk this partly because they don't want the Canadian dollar to get too weak so they kind of have to keep one eye on the Fed. You know that someone like Governor Macklem, he's really plugged in to what what's happening at the Fed, so he'll keep his rate cut sort of in line. He'll be hoping the Fed does more not less but at the same time he's well aware of that.

I think when it comes to the Bank of Canada the good news is they're going to be measured but probably on a downward trajectory, which is to say at some point it should help that marginal household. I think the issue with housing is you'll get another takeoff on housing prices. I think that's almost soul destroying for some young people because they're saving and saving and saving and I don't care what the amortization period is, you can't save that much.

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Pamela Ritchie: Which is why it's a political discussion at this point because there's such a divide.

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Jeff Moore: Correct. Such a massive political discussion.

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Pamela Ritchie: Tell us a little bit about the debt issues in the U.S., whether we need to ... there's another headline today about Moody's [indecipherable]. I don't know to what extent ... you used to work for a ratings agency ... but I don't know to what extent the market listens to rating agencies or you listen to them anymore, I don't know. But there's another headline and so the question of debt. This goes to generational stories as well but when do we worry about the U.S. debt servicing costs?

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Jeff Moore: You know, I don't. If this continues for another 20 or 30 years I get it. But for the here and now I don't. Think about this, because we've had debt ceiling crisis since like 1967, '68, whenever it was, because we've had so many of them, we've actually made it so that even if there was a debt-ceiling full halt and even if the rating agencies cut ratings, there wouldn't be any impact on the markets.

Think about this, why do credit ratings matter? Well, for collateral, posting collateral, your [indecipherable]

Treasuries and things like that. If you're an investor in a bank which has all its collateral posted in U.S. Treasuries, a U.S. bank, you're set to go because it has nothing to do with the rating agencies anymore. We decoupled them. Partly we looked at the Japanese and said, oh, the Japanese rating is like single A something or A minus, nobody cares anymore. In Japan, JGBs are the risk-free asset by [indecipherable]. Same in the U.S. In Canada it's the Government of Canada regardless of the rating. Having said that, one of the issues you have with credit ratings is that for a lot of people it'll make them a little bit more nervous about things. My sense is Moody's might send a shockwave, kind of a notch or something, but where are you going to cut to? If you look around the world what country is sort of gaining on the U.S. here?

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Pamela Ritchie: The relative story, isn't it, yeah.

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Jeff Moore: The relative story and I don't think there's anybody gaining on the U.S. I can't name one. Certainly it's not Canada and it's not Japan, it's certainly not China, so you'd be cutting to where? Nowhere?

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Pamela Ritchie: Deep liquidity in the U.S. is still the story. Bring the inflation call in for us because it's sort of the duration call really and nobody's going too far duration-wise but we're all supposed to be thinking about it.

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Jeff Moore: We've had a big duration run in the last 12 months. The other bond market's done double-digit returns, done a good job, and that's in the 6 to 8 duration. The problem with going all the way to just buy 30-year bonds or maybe just buy zero coupon bonds and have a 30 duration is a little bit of interest rate move is so much volatility. For the bond market at large, a 6 to 8 duration is kind of home base. That's inside of 10 years. It's enough that you can play a curve steeper, which we've got, and you can do a few things there. We do have a positively sloped yield curve now which is to say bonds are starting to roll down the yield curve so when you take a 5, 6-year bond and you wait a year it's 20 basis point lower because it's a 5-year bond. It's not that hard. On a 5.5 duration and 20 basis points is an extra point.

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Pamela Ritchie: It's the reinvestment story.

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Jeff Moore: So it's nice it's back. You're paid to wait in the bond market now but way out in the long end of the yield curve, way out there that's mostly for liability matching. That's for maybe a pension fund that says to me, hey, we're fully funded, we're getting out of Dodge here. We're in an asset liability match and we're going to use 30s to help us do that, I get that. In fact, for that group makes all the sense in the world and they're going to sell the pension assets to an insurance company to manage.

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Pamela Ritchie: Really interesting. Do TIPS play a role in that, just sort of keeping a handle on whatever the worries about inflation are one way or the other.

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Jeff Moore: Yeah, TIPS can. TIPS are incredibly difficult to use as a hedge, though, because the whole world's a nominal world. Even though we pretend we're a real interest rate world, we're not. We can't really observe real interest rates easily. We can observe nominal rates. So using TIPS brings into a degree of tracking error and volatility. If you can handle it, I think they're a great investment, but at the same time you look at today, the TIPS market, the breakevens which is the inflation expectations for TIPS in the U.S., are below 2%. The breaks are saying that the Fed is already tightened too much and interest rates are going to be heading below that 2% number.

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Pamela Ritchie: What do you think about that, this sort of deflation story that could be part of the picture? Who knows?

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Jeff Moore: What I like about TIPS is that's where people who are really betting real money invest like that. On the other side of it, though, the TIPS market's just going to have tracking error to nominals, it can be tortuous a little bit.

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Pamela Ritchie: That's fascinating.

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Jeff Moore: By the way, Canada doesn't have a linkers market anymore. That was eliminated.

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Pamela Ritchie: We have inflation ... what do they call it?

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Jeff Moore: No, we don't issue anymore in options. We just stopped that a year ago. U.S. does but Japan's linkers market is long gone so it's basically the Brits, the Aussies, and the Americans now.

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Pamela Ritchie: Why did we get rid of them here?

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Jeff Moore: They say there weren't cost effective. You know what I think they were, it was no fun for the Department of Finance in Ottawa to try to size bond auctions. It's just annoying.

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Pamela Ritchie: It sounds like a really complicated job and they're like, yeah, we're not going to do that anymore.

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Jeff Moore: They didn't want to issue ... too many TIPS, 10-year TIPS, but then they wanted to have an option that was of useful size and at the end they said, who cares? We don't care anymore.

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Pamela Ritchie: Fascinating, fascinating. Let's swing back to the reality of what a lot of countries are dealing with. This comes back to the debt story, but it sort of has to do with the fiscal story that you're expecting again. It's the either/or of the American election but it might be the either/or of most economies: the tax question. However that comes to fruition, it just seems like it's out there lingering. The U.K. is talking all about what they need to do and what they're promising not to do but it sure does include the word tax ultimately.

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Jeff Moore: I think the hard part for all of us to hear right now is that pretty much the story of the next four years could be all about taxes. It's hard to cut spending, extraordinarily hard, and most people who go into government are activists of a sort and they don't want to cut spending because this isn't why they got into government. Then taxes, they really don't want to raise your taxes either because people hate you for raising their taxes, but we have large deficits. We've spent so much in the last four and five years on fiscal stimulus and in monetary stimulus. We spent so much into what is a full employment economy. We didn't quite know it at the time and so we kind of did the anti-Keynesian thing. We stimulated into full employment and then we got a price level shock. The price level went up 25% in the last four years.

We know what would happen there. We monetized it with fiscal expenditures. The problem is we pulled forward our debt usage. We're going to have to pay some of that back. With demographics, Asian demographics, certainly in the U.S. Social Security has to be funded. That is a clear and present burden in addition to all the debt stuff. I think the taxes will be a headwind to the economy and because we have so much debt. As Rogoff and Reinhart have said out of Harvard, we'll just grow slower than we otherwise would.

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Pamela Ritchie: Give us again the case for like noise is everywhere, there's an election, we've got the Fed on the road here. It just sounds like we come back to the no drama place to be in the markets, which is no small thing.

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Jeff Moore: It is no small thing. I would never tell a client you should be at your max long in bonds here just because rates have come down and we've had a lot of good pull forward. I also think, though, you probably shouldn't be max short anything either. You should probably be finding that wherever you think is neutral because you could be here a while, and you want to leave markets open so that you and your asset allocation team can make decisions when the opportunity arises. At this stage, we just talked for the last 20 minutes, you and I, it's hard to see how you break something sort of in a heart attack kind of way. That requires a liquidity crisis.

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If you go back to '07, 2007, what really broke in the markets in July of '07 was the ABCP market.

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Pamela Ritchie: That was Canadian.

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Jeff Moore: It was a $1.2 trillion market that basically within 60 days because the people who were lending to it couldn't ascertain the collateral value in the market, that market went from 1.2 trillion to about 700 billion. All of a sudden there was 500 billion in liquidity, left the system in a heart attack. Most of that money was lent to European institutions who were buying subprime or things called SIVs. We could talk about those later if you want in some other date. The reason that matters is those SIVs then had no liquidity, and they had to liquidate and they all had to liquidate together so they started selling the same assets.

Bad assets were subprime, they got in trouble early, but as soon as the ABCP market shrunk it was the SIVs and others who had good assets, but they had no place to go and the banks were all broken already because they had lost all their capital for home eq[uity]. They weren't there to pick up the ball. The Fed was extraordinarily slow in '07, like at another level of glacial. The reason I say all this is we don't have that today.

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Pamela Ritchie: Not today. That is amazing. It's an amazing comparison and it's a great place to leave it on looking to the bond market for all of this. Jeff Moore, thank you so much for joining us on Fidelity Compass today.

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Jeff Moore: Thanks Pamela.

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Pamela Ritchie: That's Jeff Moore joining us here today. Thank you for joining us on Fidelity Compass. As always, if you've got suggestions for future topics or guests that you'd like to see here do share your ideas with us and stay tuned for more Fidelity Compass webcasts in the weeks ahead. I'm Pamela Ritchie.

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