Fidelity Compass

The Yield Story for the Third Quarter

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Pamela Ritchie: Earlier this month the Bank of Canada cut interest rates for the first time in four years. With the release of May's inflation print earlier this week showing that inflation did tick higher, doubts around another cut next month, for instance, are kind of looming. There's a question mark there. How is the macro picture impacting our next guests' core plus strategy and where are they seeing opportunity for institutional investors? Joining me today to discuss the case for core plus mandates and for insights on their yield curve expectations all through a fixed income lens are Fidelity Portfolio Managers Sri Tella and Lee Ormiston. Sri and Lee, great to see you both. Welcome.

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Sri Tella: Good to see you too.

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Lee Ormiston: Good to see you.

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Pamela Ritchie: Glad to have you join us here. We'll invite everyone to send their questions in over the next 25 minutes or so for Lee and also for Sri. Lee, if you don't mind, I'll begin with you to just take us through ... We've had some recent economic data that kind of impacts the rate story that we're going to talk about. Let's just get your thoughts initially on the CPI which came in earlier this week.

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Lee Ormiston: We got a bit of a surprise this week. CPI had been coming down in Canada much faster than it had in the rest of the world. That was obviously the impetus for the bank to cut. On Tuesday, we got a CPI print that was well above consensus, so headline year-over-year is around 2.9. So it's still within the bank's range, target range, but the thing that we focused on is inflation momentum, so a three-month seasonally-adjusted average. That three-month average went from 1.6 to around 2.5, so a bit above their target. So, inflation momentum started to pick back up and that's [*indecipherable/why?*] rates have been higher this week.

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Pamela Ritchie: Sri, before this number came in, and again you're sort of backing up looking at a longer period of time, but the rate cut story for Canada, we saw that cut there. Did it have to happen? What are your thoughts sort of around the rates cutting trajectory?

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Sri Tella: I think we've talked about this in the past but generally the exact timing of the cut is up for debate. It's really more about the magnitude and pace of those rate cuts. I think our opinion going into the last meeting was that they could have afforded to wait another meeting before they started cutting rates, but that being said, inflation data had gotten well within their range, and as Lee alluded to the three-month average over prior to the last print was well within their target, even below the mid-point of their target. I think they've gotten some comfort around the fact that inflation is more under control now. That made them comfortable to start cutting rates. Now, that being said, I think it's key to focus on the pace as opposed to the fact that they've started cutting rates.

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Pamela Ritchie: It's so interesting. Lee, has the story of divergence, which is obviously the global sort of relative story for banks, has that again changed because you've got this inflation print? The divergence story, I don't know, is anyone else closer to cutting and getting closer onto our page? We've got the Bank of England, we know...

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Lee Ormiston: I don't think it's changed but it's narrowed a bit. A month or so ago we saw inflation running a good bit higher in the U.S. than Canada, and the more recent print in the U.S. inflation momentum came down. So, it was running ... the three-month seasonally-adjusted average in the U.S. was 4.5 It came down to 4, so that's headed in the right direction. Now we're moving back up. We've kind of said all along we think the truth is somewhere in the middle between those two numbers. We do think that the last mile will be sticky.

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Pamela Ritchie: It will be sticky. Sri, to what extent are things priced in and therefore, I mean, do you expect ... There's stickiness; there's also volatility. Are we kind of in a bit of a zone here? Tell us about that story.

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Sri Tella: I think there's two aspects we can look at what's priced in. If we think about the yield curve in Canada specifically, term rates, you're looking at 5- and 10-year rates probably around 3.5%. If you assume a longer run neutral rate, a real rate of 1 to 1.5% and 2 to 2 .5% inflation, that gets you a 3.5% nominal rate which makes 5- and 10-year rates look relatively fair.

I think from that perspective, longer term rates look like they're fair value. Where you do see some opportunities in the front end of the yield curve as rates come down you will see short rates get lower and potentially the yield curve steepen out a little bit. That being said, when we are in a scenario of cutting rates the first reaction is always for all rates to go lower so you could see the whole yield curve shift down but over time I think term rates are going to be more rangebound and what you'll see is the impact more to the front end of the curve.

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And then point on divergence: we already have Canadian rates roughly, term rates 80 basis points through the U.S. This divergence can persist and it has, historically there have been periods so you could argue as well that that divergence is already fairly priced in in the relative prices of Canadian and U.S. bonds.

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Pamela Ritchie: Lee, what to add in on sort of what's priced in? There's a lot there to pick up on and where the Canadian market is versus others.

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Lee Ormiston: Sri made a great point that 3.5% is probably the right number we're going to see. Another number we look at is the 1-year rate [*indecipherable*] and it's around 3.20 right now. That says that the markets are pretty fairly ... the markets are in line with our thoughts that the bank needs to cut into that 3.5 range. We've got two cuts, nearly two cuts in the market right now for the end of the year and then another two cuts in the subsequent six months.

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Pamela Ritchie: [inaudible] your expectations. That's what you thought.

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Lee Ormiston: I think that's fair. Maybe we get one cut this year. Macklem was pressed on this at the presser: how fast are you going to cut, going to just do this every meeting? His answer is, we're going to cut as fast as inflation continues to come down. We're in the camp that the last mile is relatively sticky so it's not every meeting.

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Pamela Ritchie: He was also pushed on when the next cut is pretty hard, wasn't he?

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Lee Ormiston: Yeah, he was.

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Pamela Ritchie: Could barely sort of begin the press conference before this question started flying. Sri, let's get into a little bit of the story of Canada. Rate cuts on the horizon for sure. Where does the risk of recession sit at this point? We go to GDP, we go to growth. What's priced in? What are you seeing? '

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Sri Tella: I think right now when we think about the Canadian economy, the growth is still positive. Maybe more recently it's been a little bit below trend, what the Bank of Canada considers trend. You are seeing a bit of a slowing in growth, but you have to remember it is still positive. The labour market is strong. You're seeing strong population growth through immigration. Demand for housing, etc. has been pretty resilient. When you look at kind of the backdrop things are still relatively stable. That puts a recession probability fairly low. We might see a slower period of growth going forward and that could still warrant cutting of rates to some extent because if we're running the growth below trend. I would personally say that the recession risk is a lot lower than we would have expected maybe a year ago when we were talking about where rates were and where rates had to go.

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Pamela Ritchie: What does that mean for investors, Lee? This is attractive, there's less of a recession risk. Talk that through as an investment.

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Lee Ormiston: The hard landing discussion has been taken off the table for the most part. That's helped reduce interest rate volatility so that gives you comfort. The other thing that gives you comfort is that we now know that we're at the end of the hiking cycle and the bank has been able to start cutting. That's going to be a tailwind as well.

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Pamela Ritchie: Let's get into the discussion of how the markets are looking on the corporate side, on the provincial side. Lee, actually I was going to ask you about this so I'm doubling up my questions to you. Take us through a little bit again how attractive things are looking, where you're seeing a fair amount of demand.

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Lee Ormiston: We've seen corporate spreads come down quite a bit in the first half of this year. We still look attractive relative to the U.S. but we've come down quite a bit. That's happened in the face of massive amounts of supply both at the provincial level and at the corporate level. Year-to-date, we've seen about 80 billion in corporate supply. Normally we're running around 60 billion so we're well ahead of pace to break prior records. The other thing that's interesting is we haven't seen this from the bank. It's been non-fin supply that's been pretty heavy. Through all of that the market has digested it really ... Despite this record supply, spreads have tightened in, the markets have digested it well. Part of that is, and we've talked about how attractive fixed income is, we think it's attractive. Other people seem to as well because both in the U.S. and in Canada, money is coming into the asset class, and that's been a tailwind for us.

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Pamela Ritchie: Sri, tell us a little bit about how things look in terms of the liquidity story, the supply story, the demand from even outside of Canada for Canadian assets.

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Sri Tella: I think, generally, the markets have been fairly active. I would say that right now the demand for fixed income, and if you're thinking about credit products it makes it easier to sell bonds than it is to buy bonds more broadly speaking. We're in this kind of rangebound environment both on rates and spreads more broadly because we are seeing, as I said, the market is relatively fairly priced. We've been kind of in this sideways range until we get some kind of a catalyst to break out. I think that's created a decent two-sided market more broadly in fixed income. As I said, with corporate bonds because of the demand as Lee alluded to, the secondary market liquidity is more skewed towards people looking to buy so it's easier to sell bonds. But then the supply offset that Lee mentioned has given us opportunities to add exposure as well.

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When you're looking at outside of Canada and demand from overseas investors, I think Canada generally is still seen as a safe, high-quality haven to invest in. The rate differentials and with growth prospects slowing and productivity challenges I think on the margin there is some money that's being reallocated to other jurisdictions. At the same time, Canada is seen as a very stable spot to put money so you do have sort of a steady interest in the Canadian markets.

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Pamela Ritchie: Lee, anything to add there.

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Lee Ormiston: We're seeing foreign investors liking non-Canadian dollar denominated bonds. I talked about the banks or the big six have been issuing in dollars. The provinces have been very active as well issuing in dollars, in euros and sterling, and even Aussie dollars. There's been a pretty good demand for Canadian fixed income outside of our market.

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Pamela Ritchie: Sri, what does all this mean for the core plus mandate? For those that want to make sure they have exposure to this what at this point in terms of positioning, what are you getting exposure to?

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Sri Tella: It's interesting because like I said, fixed income overall is attractive because of yield levels. When you look at credit spreads which core plus mandates often rely on a lot of credit and spread sectors, you can look at historical valuations and they actually look fairly rich when you think about spreads. That being said, with base yields so high from the government sector, there are still good opportunities in some of the plus sector allocations in our core plus funds. For one, there's good demand for fixed income, as I mentioned. When we think about plus sector allocation, things like leveraged loans still look attractive because they take advantage of a high short-term rate because we've got an inverted yield curve. When you've got floating rate short-dated product that's based off of short-term rates, you have a very high base rate there.

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High yields to a certain extent even though the spreads are tight the absolute yield levels of higher yield could also look attractive because you're looking at a three-year duration, so less interest rate sensitive and again, in an environment where you want to clip your coupon and earn your yield. Those are really good sectors.

That being said, we're cautious of where spreads are, so our exposures overall are probably a little lighter than they would be if those sectors were more attractive from a spread standpoint. We want to make sure we have allocations to those plus sectors in terms of generating additional yield in return. Especially when you're in this sideways environment, you want to be earning your yield, not too worried about excessive volatility and so again, you just get your income that you want from fixed income.

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Pamela Ritchie: Lee, what is the impact of a cut? We started out this conversation talking about sort of what the expectations are for this year, which is probably another cut, you mentioned. What's the impact there one way or the other for the core plus mandate and broadly.

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Lee Ormiston: I think if the bank cuts and the Fed hasn't cut yet, then I think we start to see the divergence continue to widen. I think that once the Fed that's sort of the all-clear signal to the broader market. As soon as the Fed starts cutting financial conditions should be easing a good bit on that so that's a tailwind for both equities, credit spreads, alts, you name it. It's the all-clear so it should be a tailwind. Even though we're seeing money come into fixed income, we'll probably see more come in. People probably don't want to miss that train.

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Pamela Ritchie: About missing that train, X number of months ago, and you'll remind me what it was, there was sort of this if you don't like bonds now you don't like bonds, that discussion was there. Then things fell off there a little bit. We seem to be in a new window. To what extent does this window sort of last, or there's this discussion of there's still time for people to get back in if they missed first time around. Just speak to that Sri, if you don't mind.

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Sri Tella: If we go back to that period of time where rates were higher than where they are right now at that point in time you argue there was very little priced in in terms of rate cuts. That was when we kind of had a reversal and the market started thinking that, okay, rates are going to stay high for a lot longer. At that point in time, there was nothing priced in. It looked really attractive because both you were earning a high yield and you had the prospect for capital gains from an appreciation in bonds.

I would say that now maybe the capital appreciation side is less clear because as we talked about the market's relatively fairly priced. That being said, your risk-reward is still skewed positively for fixed income. You're earning enough of a yield where you're most likely going to generate positive returns over the course of a year or a longer time frame because when you're earning a yield. For example, if I look at the Canadian universe which yields a little over 4% but our core bond funds yield about 4.5%. If you look at a 60-basis point rate move in either direction, on the way up your bond yields would get wiped out and you would end up with roughly flat returns. If you had a 60-basis point move down, you would essentially double your yield to 9%. Go back two years that was skewed towards basically a very small positive return versus a very negative return. Now you're in a much better place. While we may not have that capital appreciation, may not be as obvious as it was a while back, at least now you know you're going to probably earn your coupon and earn your yield and that's a reasonable expectation going forward.

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Pamela Ritchie: That's really interesting. Neutral rate, Lee, I think you mentioned it earlier but you see this, say a year out from now, you see how many cuts. This year maybe a couple?

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Lee Ormiston: We probably won't get to neutral in the next year. If we think that neutral is somewhere between 3 and 3.5 within the next year the market's pricing us to get to around 3.85. That's almost four cuts a year from now. Within a year, we're going to be very close to neutral. That assumes that inflation continues to come down more slowly, slowly not dramatically, and we end at that soft landing of 2% and they hit target.

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Pamela Ritchie: Sri, I just wanted to come back to the divergence story. It's a big one in the markets; it's a global story. You mentioned it's okay for Canada to diverge from the Fed. That happens, there's a lot of history there. Is there anything different about this time, I guess is the question, for your portfolio?

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Sri Tella: In terms of our portfolios I guess you would look at wanting to have a little more exposure to Canadian rates broadly. If you think the risk-reward is still skewed towards that divergence persisting and the chances are that Canadian rates could outperform in certain scenarios. Obviously, the Canadian economy is a little more vulnerable to rates because of the structure of mortgages and the indebtedness of consumers. That divergence story, it has favoured, you've already seen a lot of that. Canada has outperformed the U.S. in terms of fixed income rates over the last year plus. That can persist. In our portfolios where we do take a lot of U.S. exposure, we can either choose to hedge out the U.S. rate risk or not. I would say we probably skew more in favour of favouring Canadian domestic positioning versus U.S. just because of that, I guess the tailwind for Canadian rates tend to stay lower relative to the U.S.

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Pamela Ritchie: Lee, in terms of exposure to the short versus long you're kind of in the belly. Where would you say?

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Lee Ormiston: On the curve we've tended to favor the 10-year sector a little more so than the belly just because of the way that the curve is priced. In the past, we would have had a lot more exposure in the long end just from a risk-off standpoint. That is where we would see in the largest move both in price and yield but with the curve inverted 10s, 30s in Canada and not that way in the U.S., we're seeing a little less value in that in the long end. Most of it's in the 10-year note. We do like the belly. To the extent we could use more leverage in the portfolios, we probably have a little more front end just because there have been times when the market hasn't priced enough cuts.

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Pamela Ritchie: Sri, anything to add in there in terms of just taking a look at sort of big positioning on one side or the other? Just comment on that. I think you have a way that you normally are doing this. That's what I'm looking for.

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Sri Tella: In terms of our yield curve positioning, I would agree with Lee that we would love to be invested in the very front end of the curve because that's where the opportunity is as rates come down and, as mentioned, the price of the yield curve steepen out. At the same time we want to be cognizant if we're biased towards fixed income and biased towards rates being lower you want to make sure you have ample duration in the portfolio. We're managing relative to benchmark so we don't want to be running short to that benchmark, which is why we need to favour more the intermediate 7 to 10-year part of the curve in order to maintain duration and have that exposure to rates.

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As Lee mentioned, being underweight the long end just given where ... even though an inverted yield curve can persist for a long period of time in this sideways environment over time as we start to see rates in the front end normalize you should see the curve steepen out, especially given that we talked about how term rates are relatively fairly priced. While the near term they may drop as rates get cut but ultimately we should settle in around these levels with the front end outperforming. Our bias is to kind of be in that short ... ideally in the short end? but because of the way our portfolios are constructed we're focused more on that intermediate part of the yield curve.

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Pamela Ritchie: Just to close out, Lee, just a little bit on what you have exposure to. You mentioned ex-fin looking at the corporate market was looking pretty good.

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Lee Ormiston: We do like fins. Probably we're less overweight that sector than we once were probably six to nine months ago. It's done what we'd hoped. It normalized after quite a bit of supply that we'd seen in the prior few years and so fins have come in. We're probably a little less heavy on pipelines right now or the energy sector. The sector is in a great spot but valuations have come in to the point that we really haven't like that as much. What we are liking a little more right now is the cable telecom sector and that's just because it hasn't performed. With all spreads tightening, it hasn't tightened as much. That's been a sector we've been adding to.

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Pamela Ritchie: Okay, great. Just one final thought, Sri.

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Sri Tella: I guess I would kind of close out with just our sort of positive outlook for fixed income. If you look at the sort of risk-reward profile, as I mentioned earlier, it makes an argument that fixed income has its place in sort of a diversified portfolio. It's proven over time, especially at these kinds of rate levels, to sort of protect against volatility.

Just one little anecdote I think worth mentioning: when you look at historical worst periods for the equity market, a lot of people talk about the positive correlation recently due to inflation between bonds and stocks. But when you look back over the last 40 years and look at the largest drawdowns in equities, fixed income generally rallies 75% or more of the time. Given where yield levels are you've got that strong diversification benefit to fixed income. Given that we are at the tail end of the rate hike cycle, or beyond it now because we're starting to see rates get cut, that risk-reward outlook for fixed income is quite positive.

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Pamela Ritchie: It's great to have this time to speak with you both. Thank you so much for joining all of us here. Sri and Lee have a great rest of your day.

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Lee Ormiston: Nice talking to you.

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Sri Tella: Thank you.

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Pamela Ritchie: Thanks for joining me here today on Fidelity Compass. If you have any suggestions for future topics or guests certainly that you'd like to see on the show do go ahead and share your ideas with us. Stay tuned for more Fidelity Compass webcasts coming through the pipeline in the weeks ahead. I'm Pamela Ritchie.

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