Fidelity Compass

Fixed Income Perspectives: Navigating Market Shifts Amidst Trade Tensions

Sri Tella, Portfolio Manager

Lee Ormiston, Portfolio Manager

Pamela Ritchie, Host

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Pamela Ritchie: Hello, and welcome to Fidelity Compass. I'm Pamela Ritchie. Fixed income investors are being taken on a wild ride this week. Investors typically flock to Treasuries during times of market volatility. A bond sell-off yesterday caused yields to spike. And then President Trump later announced a reprieve on most tariffs, followed by this morning's cooler-than-expected inflation report, we saw yields swiftly lower. Now we do have announcements from the administration's Cabinet meeting.

How are our next guests digesting all of the latest market moves, and what do they think that this might mean, ultimately, for the Fed and other central banks moving forward? Joining us here today to discuss this and more through a fixed-income lens are Fidelity portfolio managers, Sri Tella and Lee Ormiston. Warm welcome to you both, Sri and Lee. Thank you so much for joining us here today.

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Lee Ormiston: Good afternoon.

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Sri Tella: Thanks for having us.

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Pamela Ritchie: Delighted to have you here. We'll open the lines up for anyone who wants to send in questions for Sri or for Lee throughout the next 20 minutes or so, 25 minutes or so. Pease do go ahead and send those in.

I'll begin with you Sri, if you don't mind, to just take a stab at the market action that we've seen really over the course of the last 24 hours. I mean, to some extent, we're kind of back to where we began. Just tell us a bit about how you try and digest this.

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Sri Tella: In terms of trying to approach the markets the biggest approach is trying not to get whipsawed by the latest headline. We've, obviously, seen a lot of volatility in the markets especially in the equity side but rates are no exception in the fixed income markets. The last week or so were being characterized by risk assets selling off, fears of what the impact of tariffs would be on the economy and on companies and performance. Also, we've seen the equity markets fall quite a bit.

As a result, fixed income originally kind of did what you would expect and we saw rates lower but, ultimately, with the move in risk assets there started to be some concerns in fixed income markets, especially in the U.S., of in the near terms some positioning and unwinds, levered money needing to raise money for margin calls and pushing rates higher as a result. There's also concerns over what it meant for foreign demand for U.S. Treasuries if the U.S's status on the global scale was changing as a result of tariffs.

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Those are kind of near-term impacts. On the longer term, concerns over inflation, slowdown in economy, that led to a steepening of the yield curve. We've kind of seen the yield curve whipsaw back and forth and rates move as a result of the latest headlines. Our approach has really been you try to look through the noise and look at broader valuations and think about how things will play out on the longer term and whether there are opportunities in the market.

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Pamela Ritchie: I might ask you, Lee, to add to that if you want but if you could also take us through a little bit about how you're positioned sort of coming into the last week or so, where your mindset was walking into what is undoubtedly a moment in the market.

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Lee Ormiston: Our positioning coming into all of this, like the market we thought the Trump presidency was going to be good for risk assets coming in, but we were looking at the level of spreads in our portfolio and we just decided we were dialing that risk down. That's been taken down quite a bit over the last year. We're at the lower end of our risk range so that's been helpful coming into this. We've seen a good bit of spread widening. Now you're watching spreads move by 10s of basis points intraday. We had a 20-basis-point swing intraday yesterday on certain bank names. The volatility is creating some opportunities for us but we're kind of sitting back and watching this unfold.

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Pamela Ritchie: We'll talk more about sort of all the different pieces here. I guess, Sri, that is an obvious question of whether you take a look now or, I mean, ultimately, what is your approach to getting in now or later?

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Sri Tella: I think the biggest thing we've done over the last week plus is kind of thinking about the ranges of the market and looking at where, for example, if you look at the corporate sector where spreads have been historically, what are some of the weaker periods for corporate spreads. You can look back to past analogues, like the global financial crisis and COVID as being kind of the two extremes. But then think about 2015, 2016 when we saw oil fall precipitously, spreads back up, risk of recession. [indecipherable] in Canada, we technically had a technical recession for a brief period. In 2018, when the Fed was sort of on course to potentially hike rates and we saw that holiday sell-off in markets. We look at those historical periods and think about where long-term value is. For example, in the Canadian corporate market, we're currently sitting around the 50th percentile of spreads since 2009, right around 130 basis points for the index. If you look at the tights, which was just inside of 100, and then kind of peak spread levels outside of COVID and the global financial crisis of around 150, 160, we're kind of in that middle of the range now. We're looking much more attractive than we did a few months ago.

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I think from our perspective you're starting to get to the point where you wanna dip your toe back in the water but knowing that there's a lot of volatility so maybe we move our positioning from that low level of risk that Lee talked about to incrementally adding it, because we're not gonna be able to time the market perfectly, with the goal of if we do see that spike and spreads and get back to sort of these ceiling levels that we might have seen in other recessionary periods that's where the opportunity is to really start getting more aggressive in terms of adding [audio cuts out].

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Pamela Ritchie: Keeping that idea of going from a low level of risk to perhaps something else, Lee, introduce us to where the central banks at this point are sitting. We'll talk about the Bank of Canada. Certainly, there's been discussion about whether the Fed needed to step in with some sort of relief over the course of the last several days but just talk to us a little bit about where the central banks are sitting at the ready even for recessionary moments because of tariffs.

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Lee Ormiston: The Bank of Canada has been proactive. The last two cuts, the cut in January is because inflation was relatively stable. The cut in March was because of consumer inflation expectations, business concerns. The bank's been a little more proactive whereas the Fed, they've got a dual mandate, employment and inflation, and right now the risk is stagflation in the U.S. To the extent that we see a downturn in growth, but not that steep, we'll probably run below trend, but we have a spike in inflation. Fed's gonna be really worried, does that feed into consumer expectations and then does it move from something that's just transitory?

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If growth falls by quite a bit we enter into a recession, then you're probably less worried about inflation and you can be more worried about the employment side of their mandate. Fed's in a tough spot. They have been on the sidelines. Powell's been on sidelines saying they will wait and see. You've heard this from a number of Fed speakers. I will note, though, we've seen some of the regional bank presidents start to talk about this no longer being transitory. There is some concern at the Fed that this won't be transitory.

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Pamela Ritchie: That was the word, and that was the big news, it seems like years ago, but it was just a few weeks ago. Sri, just to add to that, if you would, for us, what the central banks will need to do because the game has changed in terms of where we thought we were even a few months ago.

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Sri Tella: I think Lee covered a lot of it but if you look at outside of the tariff risks we were on course to basically probably see a pause in the rate cutting cycle. Growth had been better than expected. Even in Canada, it came in much stronger. Both the Bank of Canada and the Fed had kind of indicated that they were likely going to be slowing down the pace of cuts or even be on hold. Then you have this element of tariffs added in which create uncertainty and run risks to the growth outlook. Now, I think the concern still is, especially because of where we came from on elevated inflation and kind of the last leg of inflation coming down being somewhat persistent, is that the central banks are going to err on that side of being cautious on the inflation front. They acknowledge there are risks in both directions but I think they're going to be hesitant to be too aggressive to cut rates until they start to see data turn and have an impact on sort of the overall inflation level as Lee outlined.

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Pamela Ritchie: Lee, the subject of correlations, yesterday was sort of a rough day because there was a lot of selling across the boards. I'm sure you get asked this by clients, how steady is the fixed income market to offset other major upheavals?

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Lee Ormiston: I mean, it works. The negative correlation is there in price terms. However, when we get a major shock then all correlations go to one. If you use COVID as an example, the bond market was predicting this. You saw rates falling into the event in March of 2020 and fell by quite a lot. When there was the large meltdown in the equity markets, we actually saw bond yields go up. That was a combination of factors. One is that just people were concerned about everything, so they were trying to get liquidity. They were selling their equity, they were selling their bond funds. The other thing that was happening at that point in time is we saw rebalancing out of those 60/40 portfolios. You need to rebalance; you need to sell bonds to buy equities. That exacerbated the move in the fixed income market. We did see a spike in yields; bond prices fell. Then, of course, the correlations actually stayed positive as we came out of that once we saw monetary and fiscal support. Then you saw bond yields continue to fall as well as equity prices going up.

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Pamela Ritchie: That was at that point. Two things Lee mentioned there, Sri, if you would pick up on is just this question of liquidity and whether it is a question is more the point, and the rebalancing. There was some, I think, point at which if risk assets start to look really good again, which through much of yesterday afternoon the equity story was there, the rebalanced piece of it, so liquidity and rebalance.

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Sri Tella: I think the liquidity aspect, there's, obviously, different references to liquidity. As I mentioned earlier, you look at the markets and what was happening in fixed income and sort of levered funds needing to raise money for either margin calls or things like that which drove sort of rates higher as we saw some selling. There's that aspect, and then whether central banks are at the ready. We've seen in historical periods where they may bring programs in place to help with that. That's sort of the one aspect of liquidity.

The other thing from our perspective that we think about is especially to be ready for some of these flows. If our clients do need to raise money, we could potentially see outflows, or the rebalancing, as we talked about, could lead to outflows from fixed income. We want to make sure that we have ample liquidity in our portfolios to be able to provide that money when it's needed but also knowing that we want to be able to provide money for outflows but we also want to be able to take advantage of opportunities. If we see further weakness in the market we want liquidity to be able to take advantage of that. That's one of the things that we're definitely making sure that we have that dry powder in our portfolios to add risk.

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For the rebalancing, it's a little early right now especially with the volatility in the market. As we get closer to month end if equities stay at these lower levels, despite yesterday's increase we've seen a big sell-off today, we're likely going to see some money go from fixed income into equities. We've seen some inquiries from our clients just asking about liquidity and the ability, as we get into month end, about repositioning some of their portfolios. We are cognizant of that. We haven't seen it *en masse* yet but it is likely going to come if markets stay as they are going into the end of the month.

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Pamela Ritchie: Fascinating. Let's talk a little bit about earnings, more what it signifies, and perhaps sectors as well within the corporate world. So, earnings begin tomorrow, Lee. It's kind of a question of forward guidance. It seems like balance sheets, for some time now, have been in pretty good shape but is there anything that you sort of need to see out of earnings or would look at some, or does it seem pretty sound to you? Yesterday we heard one company just not issuing forward guidance and we wonder if that would be the same for others.

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Lee Ormiston: That is the concern that you see people just throw up their hands and say, we just can't do this. We heard from one major U.S. retailer that this situation is untenable, that it's unworkable, the level of tariffs. That's going to create challenges for them. But at the same time, they probably don't say anything because they also know they're going to make at least half of their customers unhappy. They're unwilling to comment publicly but we've heard privately that from a forward-guidance perspective there is some concern. The longer the uncertainty exists, the more permanent it becomes. From a balance sheet perspective, the companies that we look at, for now at least, this is more of a hit to the income statement than it is the balance sheet.

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Pamela Ritchie: That's huge.

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Lee Ormiston: That's what we're doing with our fundamental analysts, looking bottoms up, looking at company's balance sheets, liquidity, making sure that they have liquidity for years. We just did this exercise five years ago, so we know most of the answers but we need to check. That's what we've been doing.

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Pamela Ritchie: That's your approach to this set of earnings, anyway, because it does seem like there might be a few question marks that just aren't answered.

Sri, take us through into the sectors a little bit, to the extent that you can take us further into positioning. You've given us some ideas but, again, the sectors that you're happy to be in in a world such as this with a lot of moving parts.

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Sri Tella: Like anything when you enter a period of uncertainty but valuations start to look a little bit more attractive, our first move is to kind of look for sectors that have been beaten up but also are somewhat defensive. Again, we did this during COVID. Even though the whole economy had shut down, basically, there were certain companies that you knew were still going to be making money or be able to survive sort of the stress period. We look for sort of more defensive, long term, stable companies that have widened and cheapened up. The first thing that comes to mind is, obviously, the Canadian banks being very resilient. Yes, they may take a hit from earnings if we see a slowdown, but they have rock solid balance sheets. They have a lot of capital and they're in good shape. They also are shorter duration issuers so that's a good place to be in short corporates.

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The other sectors that we like, securitized product, for example, and again, another short duration, high quality triple-A rated trades like triple-B corporates but have a lot of protection with the collateral that backs the securities and very cheap and attractive. We kind of view those as core holdings as well.

When we think about the government markets, provincials had cheapened up in the first quarter because of concerns over increased deficits and the risk of tariffs. They've actually outperformed in this scenario in the last couple of weeks just given that the weakness has really hit the corporate markets. They still, on a long-term basis, are much more defensive and even though they've outperformed over the last week or two, on a historical basis valuations look attractive and they're going to be less volatile. Those are some of the areas.

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Areas that are getting more interesting, cable telecom, the energy sector, those are starting to look interesting, but we haven't really decompressed enough from higher quality credits to really start looking aggressively in those sectors.

At the same time, we saw yesterday how things can turn in an instant, which is again going back to my other point, you want to start dipping your toe in because you could theoretically ... on a long-term basis valuations, are looking better both in yields and spreads so you want to be able to take advantage of that, just maybe not to the full extent that you would if things were even cheaper or we were seeing any weaker period in the markets.

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Pamela Ritchie: Lee, add in the federal side of things. Sri was mentioning the provincials. We're in the middle of an election campaign so, if you can, put that to the side. Is there room there? There's a lot of sort of big projects being discussed or promised in the context of an election campaign, but how do the other levels of government and their issuances look at this point?

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Lee Ormiston: There's certainly scope for deficit spending at the federal level. Deficit of 1% of GDP doesn't sound great but it's running below where nominal GDP is so that's stable. If you look south, the U.S. is running a deficit of 6% GDP and it's untenable. That is part of the reason that we've seen long Treasury rates sell off and it's moved along Canada rate. As far as fiscal latitude in Canada we think it does exist. We think that there is scope for temporary programs for unemployment insurance and then longer term you could see some projects like a west-east pipeline.

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Pamela Ritchie: A lot of that being discussed right now. To what extent is inflation just the thing that you're looking at most closely at this point? Because it just sounds like, Sri, inflation is going to be, I mean, I don't think a lot of people have looked at CPI this morning, there's so many other pieces to take a look at, but just your thoughts. It was actually a good report in the U.S., but to what extent are you expecting that to move around?

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Sri Tella: I think it was a bit of a secondary story, obviously, given everything that's been going on. The numbers did look good, but I think the Fed is going to be careful in terms of looking at one report, especially when you have the impact of tariffs not having sort of kicked in as of yet and won't show up in the numbers for a while. On top of that, if you look at the components of today's numbers more persistent parts of inflation are still kind of sticky and they're not really coming down. We saw more things like airfares and energy sort of contributed a little bit to the weakness in inflation. That's really more from sort of the growth concerns and potentially things coming down there. I think one report is not going to change things for the Fed's landscape and they're really going to be thinking about it longer term and these concerns over inflation expectations.

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Also, it would be remiss about not mentioning Canada. Canada saw a big spike because of the drop-off or the end of the GST tax holiday. Then you're going to have more noise because of the fact that the carbon tax has come off and gasoline has dropped. I think what I would point out is both CPI in the U.S. and Canada over the next number of months is going to be quite noisy because you've got things coming in and out and base effects from last year. It's going to create a lot of volatility in the numbers and people will make adjustments but it's gonna be hard to read into any one print at any given time. You really have to think about the longer term trajectory. I think the focus right now is what's the impact of all of these tariffs, in terms of long-term inflation.

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Pamela Ritchie: Lee, would you add to that just in terms of sort of being able to read the data or how clearly it is laid out in these data point announcements in terms of trade, because there's a lot of pull forward from countries around the world but for Canada too?

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Lee Ormiston: There has been that. I think if there was a takeaway from the CPI print in the U.S. this morning it's that the downward pressure to CPI in the U.S. was three factors. Energy for headline and then to the extent the economy slows that'll continue to exert further downward pressure on CPI. Then that's sort of the forward-looking element that you could argue is a forward-looking element is that airfares, hotel bookings, travel, those are forward-looking, people are making plans and that put downward pressure on CPI today. Anecdotally, flights into the U.S. have plummeted on a year-over-year basis. Foreigners are not going to the U.S. right now.

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Pamela Ritchie: We'll ask you just to wrap up as a bit of a final thought, Sri, from your perspective right now for investors who need to look longer out because there's an awful lot of short-term noise in the markets right now. What would you say to sort of keep an eye on?

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Sri Tella: I think the key is, and I mentioned this a couple of times already, but is really thinking about long-term valuations and sort of what the role of fixed income, or any of the investments in the portfolio, play on a longer term basis. Thinking about where things are now, where we were and where we could potentially go to and, think about more longer term, are we at attractive levels? As I pointed out at the outset yields are still on the more attractive side of history. Spreads are kind of middle of the road but getting there but things could turn quickly so you do want to have a little bit of exposure, given that we've definitely looked more attractive now than we did a few months ago. Those are kind of things to focus on.

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I'd be remiss, one thing I noted we didn't really talk about was plus sector exposures. If you look at something like high yield in the U.S., for example, has gone from a tight of 260 to in the mid-400s now. I talked about investment-grade corporates in Canada and kind of that 150, 160 area in kind of periods of weakness. For U.S. high yield, it's more like in the 500 to 600 range, let's say 550 to 600 outside of COVID and the global financial crisis. Yields in high yield are north of 8%, leveraged loans are north of 9%. On a long-term basis, those start to look attractive. I'm not saying they can't get cheaper in the interim but over time they will pay off which is what our approach has been. We're going to incrementally lean into sort of this weakness in the markets and that's proven over time that over a longer term that's going to provide attractive returns.

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Pamela Ritchie: Lee, final word to you, just about 30 seconds. What would you add?

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Lee Ormiston: I would add to Sri's point, just focus in on valuations, use that as your anchor. Think about where things are and does it look attractive. Probably the other biggest challenge in these kind of markets is to remain dispassionate. You may fundamentally disagree with what's going on, but you need to stay calm, level-headed about it and stick to that long-term vision.

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Pamela Ritchie: Thank you for both being anchors here today amidst all of this. Very grateful for your time, Sri and Lee.

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Sri Tella: Happy to.

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Lee Ormiston: Thank you.

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Pamela Ritchie: All the best. Thank you for joining us on Fidelity Compass and, of course, if you have any suggestions for future topics or guests that you'd like to see do go ahead and share those ideas with us. In the meantime, stay tuned for more Fidelity Compass webcasts in the weeks ahead. Thanks for watching and joining us here today. I'm Pamela Ritchie.