Fidelity Compass

Rate Cuts and Plus Sectors Through a Fixed Income Lens

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Pamela Ritchie: Hello and welcome to Fidelity Compass. I'm Pamela Ritchie. The Bank of Canada, of course, held its key interest rate at 5%. The Fed makes their announcement next week and many economists are speculating the same move or non-move pretty much will be in the offing. How is the macro picture impacting our next guest's core plus strategy and where do they see opportunity for institutional investors?

Happy to say that joining me today to discuss the case for core plus mandates and the geopolitical considerations impacting markets, all through the lens of a fixed income perspective, are Fidelity Portfolio Managers, Sri Tella and Lee Ormiston.

Sri and Lee, nice to speak to you both. How are you?

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Lee Ormiston: Good, thanks.

[00:01:09]

Sri Tella: Good afternoon.

[00:01:10]

Pamela Ritchie: Great to have you joining us here. We'll invite everyone to send their questions in over the course of the next 25 minutes or so. Let's begin, Sri, if you don't mind, with just kind of a quick take on CPI numbers that came out of the U.S., and really the market reaction to them. What do we take away from that? Just a little hotter than expected.

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Sri Tella: I think generally the market's been looking for inflation to continue to come down. The Fed's been commenting that inflation is getting to where they want it to be, and they've been sort of hinting at this notion of changing gears and cutting rates. I think the stickiness of inflation which has been evident for quite some time just doesn't seem to be going away. I think today's numbers sort of pointed that out. We never want to hang our hats on just one number but the trend of stickiness has kind of continued and so I think in a nutshell it points to that rates may not come down as quickly as people are expecting.

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Pamela Ritchie: Ultimately, what does that do for sort of the case for why now looking at bonds? I mean, we've got high rates here. It's an interesting moment. Take us through it.

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Lee Ormiston: Inflation has been stickier but the reality is that yields in fixed income are quite attractive just overall. I mean, we're at a level that we haven't seen since the GFC, frankly. Absolute level rates are very attractive, competitive with equities at this point.

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Pamela Ritchie: It's really interesting to sort of watch this. Sri, how would you maybe add to that? Even a year ago it was sort of this you need to get it now, rates are going to be higher and then they won't be. There's sort of maybe a little bit more patience to this story now, is there?

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Sri Tella: If you think about where we are now, over the past year, or if you go back to the beginning of last year the trend was to higher rates and we didn't know when central banks were going to be done hiking rates. Now we're at a situation where we've gotten a clear message where rates are unlikely to go higher but central banks have felt that inflation is heading in the right direction. Especially the case of the Fed, and the Bank of Canada to some extent, are starting to think about or looking at when they might start cutting rates at some point.

We're unlikely to see sort of the large sell-off in rates that we had seen previously during the hiking cycle and it's going to be hard to time the exact inflection point. In the meantime, while we're waiting to see what progress is made, you're earning a good yield. Yields on fixed income are attractive. They provide a diversifier back to a level where they provided diversified benefits to a portfolio. Given that we're closer to that inflection point and you're getting paid to wait, that's why fixed income is fairly attractive at these levels.

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Pamela Ritchie: I wonder if you could comment just a little bit here, and it speaks to sort of the overall investment, just the issuance itself. The U.S. story, the Canadian story, there is demand; there's no question. Take us through again.

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Lee Ormiston: You're absolutely right. What you're talking about is corporate supply has been quite robust. If you think about what was going on last fall, we had rates quite a bit higher, we had spreads quite a bit higher and so that meant that a lot of corporate issuers were on the sidelines waiting it out. They were hoping that the spreads in rates would come down. We've seen that since then and they're taking advantage of that, and it's being met with pretty good demand. The reality is that we've seen inflows into fixed income over the last year, probably a little more so in the U.S. than in Canada. Money's coming into the space. You had a number of active managers who were worried about a hard landing so they might have derisked. Ever since the end of last year, you've seen spreads and rates come down quite a bit and so they've been chased into the market. That's what's helping the demand.

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Pamela Ritchie: Ya, this chased into the market. Pick up on that, Sri, a little bit because the issuance story also, it's interesting where the demand is coming from. So, being chased into the market, new money from the sidelines that's been sitting there or a lot of money that's already there. What is the make-up?

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Sri Tella: As Lee mentioned, thinking about last year and the outlook for potential hard landing, recession, I think that's softened up to some extent. You've had a lot of fixed income managers that have been somewhat cautious and have maintained some dry powder. In addition to that, you have an attractive rate environment and a more benign outlook going forward. That plus the inflows that we mentioned are keeping fixed income investors and money managers with a lot of cash on the sidelines to invest. If we're in this environment where patience is kind of your friend and you're kind of earning your yield to get that incremental yield from corporate bonds is a benefit. Corporate fundamentals have been healthy, balance sheets look pretty good. That's one element of it.

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The other thing is with the issuance has been predominantly in the front end of the yield curve so short-to-intermediate maturities and those ... Yields are attractive, spreads you can argue are on the tighter side of history but when you're talking about shorter duration exposures you have much more cushion because of the yield and spread you're getting relative to withstand some volatility and still have positive returns despite being somewhat rangebound and the risk of potentially marginally wider spreads down the road.

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Pamela Ritchie: It's interesting. Lee, you were mentioning sort of the idea that in the U.S. we'd seen some of this ... I mean, just Canada farther to run a little bit at this point. When you look at demand and people getting in, we were a bit slower to this particular sort of demand story and therefore there might be further to go.

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Lee Ormiston: The absolute levels present Canada are more attractive than they are in the U.S. We've seen the U.S. come into a level which is at or near the all-time tights whereas in Canada we're off that. I don't know if maybe now is probably the appropriate time to throw that slide up there. It's got various yields across the different types of investment mandates you could have but across the bottom is really what I point you to, the spread rights. If you look at spread rights in Canada, Canadian corps were around the 50th percentile whereas if you look further to the right, what you see in the U.S. is we're in the lower, the bottom decile. Canada looks a lot more attractive on a spread basis than it does in the U.S.

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Pamela Ritchie: So interesting. Sri, with the stability, I don't know if you want to call it stability, I'll let you call it what you want to call it. There seems to be an ability to sit around where we are on the interest rate side of things from central banks' perspective that perhaps they won't go higher and they might sit here for a little longer. I don't know if you call that stability one way or the other but what does it allow for when you look at sort of flows, investment decisions, so on.

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Sri Tella: I guess there's two ways you can look at stability. From an investment standpoint, we acknowledge that there are potentially risks down the road. We have higher rates right now which will continue to have an impact as we move further along in time. That stability, though, allows us to have some risk in the portfolio in order to earn that return.

We're never going to be able to time the exact inflection points in the market, so I think that that stability, we want to make sure that we're enhancing the yield in our portfolio and earnings and finding sectors that provide a little more than just kind of the base rate but at the same time acknowledging that there are risks down the road.

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The other element of stability, I think, is important from an economic standpoint when you have a lot of businesses, and this is an issue in Canada with business investment and kind of being sidelined because of the cost of capital and impact for sort of economic prospects. I think once you get that stability it allows businesses the opportunity to feel more comfortable about planning down the road and adjusting their capex plans and spending and allows businesses to be proactively investing in economic development.

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Pamela Ritchie: That's amazing. So, you would call it stability because you used it twice there so I'm thinking...

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Sri Tella: To some extent. Now, I will acknowledge there's still some volatility ahead especially as we get inflation data and numbers across the board. I think you could say that the near-term, the medium-term outlook right now is some stability just given that we made progress on inflation but the economy's been quite resilient to higher rate levels and so we could be in this environment for some time.

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Pamela Ritchie: I wonder, Lee, if you'll take us through a little bit how this all kind of works into the story again for looking at Canada. This is a core plus strategy. To what extent are you adding outside of Canada to this? What is sort of the case for Canada at the moment?

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Lee Ormiston: How do we think about it from the Canadian perspective? Just to highlight what Sri was talking about is the markets have taken the hard landing out of the narrative so we're probably a lot less worried about that. And so that's going to allow us to have a little more risk in the portfolio we probably otherwise would, although we do have a good amount of dry powder right now.

One of the things we're doing in a core plus mandate is ... one of the things we're doing that's really exciting and what we can do at Fidelity is we can buy investment-grade bonds in U.S. dollars. We can take our top picks from our U. S. and European analysts. We can take those top picks, investment-grade picks, put them into the portfolio and that allows us to add some diversity to the portfolio. The reality is the Canadian corporate benchmark is pretty heavily concentrated and so this and a core plus mandate will allow us to add some IG exposure that we think is going to outperform over time in idiosyncratic names.

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Pamela Ritchie: That's fascinating. Did you want to add to that? I have a different question for you, Sri, but did you want to add to that?

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Sri Tella: Lee hit the nail on the head in terms of the diversification aspect. The Canadian universe is fairly concentrated. We talked about how the Canadian corporate market looks relatively attractive to the U.S., it is somewhat concentrated in specific sectors like financials, for example, whereas being able to look beyond sort of Canada's borders allows us to diversify that industry risk. It provides us with a lot of different names.

We have two aspects to our core plus strategy which we can benefit from too. We can either take sort of broad market exposures to the various sectors like high-yield leveraged loans, investment grade credit or we can buy very specific targeted securities in those sectors. When we think about an environment now where valuations generally look tight and rich, we spend more time looking for those idiosyncratic exposures, specific names that we really like that have catalysts to outperform potential upgrade candidates, for example, or other things that diversify. The other thing we can look at, which we saw on the slide that we had up...

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Pamela Ritchie: Let's pull that up, just quickly.

[00:13:45]

Sri Tella: If you look at that slide and look at high yield and leveraged loans, for example, you see that, yes, high yield is at kind of its richest ... It's in the bottom decile for historical spreads. Loans is also on the richer side.

If you look at the yields that those sectors generate for short duration exposures, they're still somewhat attractive, especially when you have an inverted yield curve. When you have shorter duration you can buy something like high yield and loans and really boost the yield in your portfolio and then offset that by owning long government bonds which get you your duration protection but also gives you your safety in a flight-to-quality scenario.

With high yield and leveraged loans, we have reduced our exposure because of where spreads are but there's still attractive sectors because the yields more than compensate you for any sort of risk of spread widening. Even a lot of people will talk about how defaults may pick up but we're still well below historical default rates. Fundamentals look pretty strong. Those are other cases to be made, again, being paid to wait for the time being in sectors that give you a lot of yield.

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Pamela Ritchie: I feel both you and Sri are kind of answering this question but the tactical ability and some of the areas that you can move in and out of, I guess, explains why an investor looking to try to derisk would have some real options there. Do you want to add anything to that?

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Sri Tella: I think that the tactical nature that I kind of alluded to when we talk about we're having broad market exposure or more targeted exposures. The other thing is we can look at, for example, if we think that Canadian credit looks attractive we can kind of focus our exposures on sectors within Canada that we really like and then complement that with sort of the plus sector exposures that diversify the portfolio, give us that extra yield. The other thing that I would point out in terms of derisking, if we think about clients that are looking to derisk that generally will mean moving from equities into fixed income. You might view going your core plus in an environment where spreads are tight as being maybe not as an attractive entry point, but at the same time if you think about what you're coming out of, which is a much riskier asset class with more volatility, to something that has lower volatility but has some sort of linkage to equities you're getting that fixed income benefit to have that rate protection as you derisk but still have had some yield enhancement and some credit exposure that gives you a little bit more of a boost than just base fixed income or base government bond yields.

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Pamela Ritchie: Just to take that a bit further because you mentioned the derisking process may well be coming out of a heavier allocation to equities, there's a little bit of gun shyness, I think, in some investors' minds that there's just going to be these correlations that stick together as they did a few years ago. What do you say to that?

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Sri Tella: If we look at, and we had a colleague of ours that pulled up some data on this recently for the U.S., and when you have inflationary shocks, obviously as we've seen over the last couple of years, you do see correlations of equities and fixed income turn positive and you have stocks and bonds going down together or, in more recent cases, we've seen them going up as the inflation shock has kind of come off the peak.

What we looked at was if you look at historical periods where you have large drawdowns in the S&P 500, for example, generally in most scenarios the majority of the time fixed income does act as that diversifier and has that negative correlation that protects your portfolio against those equity drawdowns. If we think about, especially now that we're no longer at 0% rates where you have that upside for bonds to rally and rates to go down in a risk-off environment, you're likely to see that defensive nature or negative correlation between equities and bonds that protects your portfolio.

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Pamela Ritchie: Lee, one of the other consequences of rates perhaps having some stability and where they are right now, at least for a little while, is the currency story, is the U.S. dollar particularly and how it works vis-a-vis the EM trade essentially which is that it makes it tough. Broadly, there are geopolitical issues that we talk about every day, and they are in the headlines every day. No one could miss them. Again, from sort of a broader fixed income point, where do you sort of see this particular fund, this strategy ultimately in a flight to safety for a few different reasons but including geopolitical?

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Lee Ormiston: Sorry, you're just talking about the fact that if you have a risk-off event how do we think this will perform in that kind of environment? Sri laid out a number of the things that are out there. In our core plus sectors, I talked about how we use that for US IG. Sri talked about how we are buying shorter dated exposures so that the risk there is a little bit lower. The other thing I'd add to that is that one of the unique ways we employ core plus is we allocate to both a high-yield pool as well as a high-yield individual bond. So, we're looking at potential rising stars or solid double-B's that we have really good visibility on their cash flow so when you're putting your money into a core plus mandate, we're buying idiosyncratic names that we think will stand the test of any kind of storm.

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Pamela Ritchie: Just sort of taking that to the global exposure, where ultimately do you sort of enhance the core plus, like if you do go abroad where is it? Sri, we'll put that one to you.

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Sri Tella: One thing I think worth mentioning too in our strategy is it is all Canadian dollars. Even though we are investing in foreign securities and foreign exposures it is all hedged back in our strategy to Canadian dollars. We don't have any sort of general sort of currency risk in those exposures. It's really more about diversifying and finding attractive opportunities. A lot of our global exposure right now is centred around U.S. investment-grade corporates. Again, as Lee mentioned earlier on it's really focusing on our analysts' top picks and ideas that have catalysts for outperformance.

We're looking for two things usually. One, is it a diversifier in our portfolio outside of the Canadian core that also gives us an attractive level comparative to what we can earn on a domestic security in Canada? The second thing is we're looking for either something that we think is fundamentally strong but is mispriced and trades very cheap, or a name that might have a catalyst, for example, an upgrade or some kind of catalyst that's going to improve the performance and [inaudible] tightening. Usually, we're looking for kind of the top picks from our analysts and ones that add a diversified quality to our portfolio but also give us a yield level or spread that we generally wouldn't be able to achieve by investing in the domestic market.

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Pamela Ritchie: That's great. Lee, just as we sort of close up a little bit, I just wanted to make sure we sort of circle back to there's the income lens, obviously, sort of the story of patience that is a good one right now, and just also the idea of flows, of investors coming out of cash-like investments from last year particularly, many of them still now. There's going to be a best-before time on that overall holding things in cash. How close are we to it, I guess, is the question.

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Lee Ormiston: Maybe you're worried, like how long can people wait, is that what you're saying?

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Pamela Ritchie: Kinda, yeah.

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Lee Ormiston: I don't think you're supposed to wait especially if you're in derisking mode. If you're in a derisking mode, you're supposed to take advantage of it now given the current level of rates. The outlook is pretty stable and you're going to get paid for that. So, there really isn't a good reason to wait. You can keep your money in a very short investment but the reality is that you'd probably be better off keeping it out the curve.

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Pamela Ritchie: Sri, anything to add to that?

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Sri Tella: Echoing that I would just say that people always ask us, well, why not just stay in cash and earn 5%? In sort of a core, core plus strategy you're earning a similar yield, but you also have that protection from sort of a risk for a rate rally that gives you sort of upside. You can have 5% yield in money markets can quickly disappear if we see rates lower.

We already talked about how the likelihood of rates going significantly higher is generally off the table in the current sort of scenarios because we've reached the peak of the rate-hike cycle and the next move is likely lower. Now, we might trade in that range and have rates move up or down 25, maybe even as wide as 50 if we get some volatile data, basis points but I think yield levels are high enough now that you're still looking at good returns down the road and being invested as opposed to being in cash does protect you against the asymmetric, I would argue right now, the asymmetric view that rates could be moving down at some point.

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Pamela Ritchie: Fascinating. There's so many different things. It's been almost a year and three months so far this year. It's wonderful to get both of your perspectives. Lee and Sri, thank you for joining us here on Fidelity Compass.

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Sri Tella: Thank you.

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Lee Ormiston: Thank you. Happy day.

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Pamela Ritchie: All the best. Thank you all for joining us on Fidelity Compass. As always, if you have any suggestions for future topics or guests do send those into us and share them with us. You can always stay tuned for more Fidelity Compass webcasts in the weeks ahead. Have a great afternoon. I'm Pamela Ritchie.

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