

Fidelity Compass

Fixed Income in Focus: Navigating Rate Cycles and Credit Opportunities in Canada

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Pamela Ritchie: Hello, and welcome to Fidelity Compass. I'm Pamela Ritchie. Base rates remain at the lower end of their recent range and well above zero, continuing to underpin strength across fixed income markets. Canada's upcoming budget now stands to influence the shape of the yield curve while investors continue to find selective value amid tight spreads. Why do our next guests say they expect a steady continuation of fixed income inflows and how are they adjusting their strategy and positioning in light of current yields? Very happy to be joined here today by fixed income portfolio managers, Sri Tella and Lee Ormiston, to help us unpack all of this and more. Warm welcome to you Sri and also to Lee. Thanks for joining us.

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Sri Tella: Good afternoon.

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Lee Ormiston: Good afternoon.

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Pamela Ritchie: Good afternoon, except for on the West Coast it's still the morning, but in any case, we're very glad to have you join us here and everyone can send questions in – for the next 25 minutes or so. Let's begin, actually, Sri, if you don't mind, with painting a picture of how you, from your investment purview take a look at this Canadian economy that we're sitting in right now.

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Sri Tella: Sure. I'd say going back six months to a year the focus was very much on high inflation and the impact that was going to have in terms of spending, the economy, and that was really the central banks' focus. Keeping rates maybe more elevated especially on the U.S. side. The Bank of Canada had already cut rates significantly, but what we've seen over the last little while is a bit of a change, where we've seen a little bit more of a stalling in the economy. The second quarter GDP did print negative, that was somewhat expected, but going forward it's more of a slow growth expectation. We've seen this shift from inflation concerns, while we've had some inflation, somewhat elevated, but it's come down from its peak and even more recent averages have come within the Bank of Canada's range, but what we are starting to see is a slowdown in labour.

Notwithstanding the last jobs print in Canada, we did see weakness both in July and August pretty sharply, and we're starting to see weakness in other sectors. Housing has slowed down a little bit; retail sales have been a little weaker. The way I would characterize it is it's not really a concern of a recession but more of a slowdown in growth and a stalling out as opposed to any significant weakness. Really what we've seen is the Canadian economy continues to be resilient and a lot of that has been the result of the Bank of Canada being aggressive over the last year and a half in terms of cutting rates.

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Pamela Ritchie: Okay, that's really interesting. What would you add to that, Lee? Sri was saying, particularly about resilience, which gets actually talked about quite a lot. Not everyone agrees with it, of course, but – in some ways – we expected things to be worse. Is that fair? Not that it isn't sectorally worse.

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Lee Ormiston: Yeah, Pamela, if you think about where we were in March, April, May, a ton of uncertainty. Canada has done pretty darn well through that. One of the factors driving that is back then we thought the tariffs were going to be substantially higher than where we are now. Effective tariff rate is coming in somewhere between 4 to 7%. Retaliatory tariffs have been removed. That's given the bank a little more comfort on the strength of the economy as well as forward-looking inflation. That's done well. We did have some negative economic surprises through the summer and that was part of the reason the bank was cutting. Sri mentioned job growth has been negative over the last three months. However, the economy's held up really well. Consumer confidence remains strong, well above average. The consumer is in a better spot than we probably would have thought. Growth is going to come in positive, it probably won't be negative, but it will be at the lower range of the bank's estimate for neutral.

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Pamela Ritchie: Sri, let's talk a little bit about spreads. I mean, actually, for some time now we've been saying that they're tight and when they get to that point really the only place to go is for them to widen. I guess I'd just ask you a little about catalysts for that, sometimes you can't see them, but I'm just wondering what would be, in theory, with an economy in Canada that's grappling with some new things, what could see the sort of spread story change?

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Sri Tella: I think my base case view is that we kind of continue to grind into this existing environment. There's no question that spreads are extremely tight. We are at the tightest levels we've seen since the global financial crisis in terms of credit spreads. That being said, when you look at all-in yields on a historical basis, they still look relatively attractive. While spreads are actually at their tightest levels, all-in yields are still probably in the third quartile of where they've been over the last period of time. There's a couple of things. One, fundamentals are actually not that bad. Earnings have been good, stocks have been doing well, companies have cut costs, and leverage has been relatively manageable, it's crept up a little bit. Generally, fundamentals are okay. The technicals have been very positive. Because of where yields are, there's been a lot of flows into fixed income. When you have money coming into fixed income, the fact that you can get a little bit of extra spread on owning corporates is a benefit.

Now, I think the valuations warrant a little bit of caution. You need to be smart about where you take that corporate risk and how much of that exposure you have because the risk-reward from a spread perspective still leans more towards the risk side as opposed to the reward. In the meantime, in this fundamentally sort of stable environment for now, you're going to earn that extra yield and that's what's making money flow into the corporate market.

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Pamela Ritchie: I was going to ask Lee a bit about the flows. You've mentioned it there. I mean, there's just lots of demand, isn't there?

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Lee Ormiston: Yeah, we're continuing to see flows come into fixed income, both in the U.S. and Canada. It's been a really strong technical and it's actually helped support all the supply that we've seen over the last year. A year ago, we had a record year for corporate supply and that included some really large deals that we don't normally see. This year we haven't had a large deal. We've seen a lot of smaller deals, a lot of new issuers come to the market. We're on pace to break another record for fixed income supply in the corporate sector again this year. Issuance is strong but it's been supported by inflows into fixed income.

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Pamela Ritchie: Let's go to a little bit what is quite topical right now which is the Canadian budget. This is going to be the new budget from the Carney government. It's a minority government so there's always a concern that if it doesn't go well, it could technically get voted down. There are a lot of big discussions and big projects that seem to be in the offing. Sri, again, from your sort of investment perspective in the country, and maybe even in projects themselves, but first of all let's start from sort of your perspective of investing in the country. What would be good to see from your perspective?

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Sri Tella: I think a lot of the ideas have already been floated out there which is why there are sort of predictions on how big the deficit may be. I think ideally what's good longer term for the economy is investment in infrastructure. The government's talked a lot about breaking down barriers across interprovincial trade, investing in infrastructure projects and things that will lead to long-term growth. There's a lot of capital expenditure investment from the government which I think will be good. The issue will be that the government has to balance the long-term rewards that come with that with more near-term support and things that the general public is going to be looking for in order to support things in the present as opposed to things that we might not see the benefit of for a few years. The balance between those two is going to be important.

The government's also talking about separating out operating expenditures and capital expenditures in the budget. Also, they're going to provide an outlook for, not just this year's budget, but also next year's because they've changed the timing of when the budget is going to be tabled. So, there's a lot of things. The key from a market standpoint is going to be "what is the ultimate budget deficit going to look like?" "How is it going to be funded?" And then, "what's the projection, in terms of out years, in terms of getting back to sort of a more balanced budget framework?" Those are kind of the keys that will be important from a market standpoint.

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Pamela Ritchie: Lee, if we were to ask you just sort of what would be good from your perspective in terms of how it would be funded, what would be the sort of thing you'd like to see from an investment perspective? There are lots of different ways of doing this and probably lots of bad ways of doing it, what would you like to see?

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Lee Ormiston: There are a couple of things on that. A year ago, the deficit was around 1% of GDP. Right now, most private sector estimates are that it's going to go to 2, maybe 2.5% of GDP. What we've seen over the last year plus is that Canada is issuing more and more long bonds. They had been issuing too few in the long end of the curve. We've actually seen long Canadian rates rise a lot by Canadian standards. The slope of the 10s, 30s curve has gone to 50. Plus 60 is normally the top. If you take a look across the G7, you'll see that the change in 30-year rates in Canada have actually outperformed.

Our long end has actually outperformed what's going on in the U.S., Japan and in Europe. We've actually done a pretty good job of balancing more long issuance against the entire curve. To the extent that we see the deficit go to 3%, I think that it's pretty easily managed. We could see issuance spread across the entire curve. It would be pretty well taken down so I don't see a whole lot of pressure coming on base rates or the Canadian curve, even if we saw a 3% deficit. It's not necessarily going to hurt us that much. As Sri alluded to, we'd like to see that spending in infrastructure, investing in Canada.

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Pamela Ritchie: From your perspective, at what point does a project that is promised or eventually permitted, get some investors around it? I mean when could you invest in some of these big projects? Not soon, presumably.

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Sri Tella: From our standpoint "no", because the funding for these things usually happens well after permitting and so on. From that standpoint, we wouldn't necessarily be investing directly in any of these projects. I think that the key from an overall market perspective will be how quickly can they get through that process. That's one of the things the government has said that they were going to try do, to cut the red tape, the bureaucracy, get projects shovel-ready and get them going. Theoretically, if they can do that, then that would potentially increase the number of jobs that are associated with it and increase investment spending from the private sector as well concurrently. I think the ability to cut the red tape could be something that could be a bit of a boost if they're able to follow through with what they've said.

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Pamela Ritchie: For both of you perhaps, I'll put this to Lee initially, the situation of the consumer in Canada, how things are going. There's a slowing, which you mentioned off the top. The U.S. markets, a lot of what we do is that we sell into the U.S. markets, which is doing better, generally, than our markets. I'm curious how you see the sentiment story in Canada. How you look at Canadian consumers probably through the lens of the banks and your investments, if you take a look at financials. I'm sort of curious on the health, the sentiment side of things of the consumer.

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Lee Ormiston: The consumer sentiment surveys continue to come in strong, well above average. So that's the first thing we would look at, just to gauge how they're doing, how they're thinking about things, how they've managed all this uncertainty. When you look at banks and talk to them about what their average borrower looks like. When you're talking about someone that has a mortgage, the bank's looking at their total portfolio, they're looking at all their other assets. From that perspective, those borrowers are in a really strong position because not only are they seeing growth in their house prices, they've seen growth in their investment portfolios.

So that's probably one of the bigger supports to sentiment. The Canadian equity market has done very, very well, so that's helping the consumer, especially the upper income cohorts. There are things going on in the very lower end of the spectrum, but across the economy they're in a pretty good spot.

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Pamela Ritchie: The equity market is something that I'll bring to you, Sri, mostly from sort of a flows perspective. Nobody's immune to the conversation of whether there is or there isn't an equity bubble. I won't ask you that specifically, but it does speak to sort of investor sentiment and where they want to park their money if they feel that they've had a pretty hot run-up in equity markets. How does that translate into what some of your clients are saying on sort of the flows side of things?

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Sri Tella: I think that's been part of the factor driving fixed income, positive fixed income flows. When you think about the run that the equity markets have and, if people are sort of keeping to a rough range in terms of asset allocation, there has to be a natural rebalancing because broadly speaking, even though rates have moved over the last little while, they've been much more range bound than the equity markets. We have seen on kind of constant monthly basis, seen reallocation of money out of equities and into fixed income. I think that should continue provided that the equity markets stay strong, or even remain where they are, we'll continue to see some of that diversification and money going into fixed income.

The other thing, I think related, which is worth noting, is that there's also been – on the margin – some diversification away from U.S. assets just over the last year plus. Canada, while maybe a small part of that on a global scale, is also seeing some benefit with money coming into Canada out of the U.S. as money gets more diversified outside of the U.S. and into other markets.

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Pamela Ritchie: It is part of sort of the international story or the everything else story to an extent. Lee, tell us a little bit about positioning broadly. How, ultimately, you're looking. I know you don't go specifically necessarily to just a sector, you'll be much more particular in that and picking through things. I don't know how you want to slice and dice it, but tell us about your positioning.

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Lee Ormiston: In general, we're still overweight credit. We're going to do that, we still favour it, but we are at the lower end of our longer term range from a weighting perspective. Where we own credit is in that short to intermediate part of the curve. We're favouring certain sectors, but we're also looking at tickers and individual bonds that we're digging our way into to try to add alpha. Then, as you go across sectors we're going to look more in financials, probably banks a little more so than insurance companies. That's on valuation more than a fundamental view about them. Then, we've also looked at valuation, we're looking at pipelines and then to a certain extent REITs. Again, that's going to be ticker-specific, where we're looking for a ticker in the REIT sector that we feel pretty comfortable with even through a downturn.

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Pamela Ritchie: Sri, do you want to add to that? It's interesting just to pick up on the pipeline story, well, all of those stories, what do you want to add?

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Sri Tella: I would say that, as Lee pointed out, we're focused more on the short end in terms of corporates. So, offsetting that in the long end of the curve where we are underweight corporates just given that overall valuations and long credit is less efficient from a spread perspective. Also, we're favouring provincial bonds out the yield curve. We know provinces have had a lot of funding to do, but they've managed to get ahead of sort of their funding needs. When you look at how tight corporate valuations are, high-quality corporates are relative to provincials, we feel that that's a much better spot to get your extra spread in the long end. That would be another thing I would point out.

On the yield curve, Lee touched on it earlier, with the yield curve being as steep as it is now in Canada and kind of at some of the steepest levels outside of a crisis period. So the risk-reward now is starting to favour being in a bit of a flattener out the yield curve. We had been positioned for a steeper curve, earlier this year and that did play out a little bit for us. Now we have a bias towards probably shifting a little bit more neutral to eventually looking at more flattening trades, especially as the Bank of Canada gets closer to the end of its cutting cycle.

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Pamela Ritchie: If you say eventually, does that mean you have a bit of dry powder on hand?

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Sri Tella: Yeah, when we think about yield curves, we're still going to be relatively cautious from a duration perspective. We're fairly neutral, so it will really be just reallocating positioning from one part of the curve and into another. In terms of our credit exposure, as Lee pointed out, we're at the lower end of our historical range. While we're trying to clip that coupon in extra yield right now, we are leaving ourselves a lot of dry powder because the risk-reward is sort of against us right now. We're looking for an opportunity, if we get a shock or some kind of valuation rerating, we would then be looking to add more credit exposure in that instance.

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Pamela Ritchie: That's really interesting. Lee, can I ask you to take us to sort of the U.S. story a little bit, the slope itself, the discussion of fiscal dominance and who's really in charge and is the Fed less or more independent? We're not really sure. The discussion of Scott Bessent, who's head of the Treasury, taking a pretty significant role seems to be there. What would you say about the slope in the U.S. as kind of a comparative story.

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Lee Ormiston: That's actually also part of the reason we're looking at the slope of the Canadian curve. The slope of the U.S. curve will have an effect on the Canadian curve. That's a great point. Secretary Bessent, he's been more focused on the 10-year note than the long end, because it has a direct read through to mortgage rates in the U.S. He has been looking at trying to figure out ways to bring that down. We would expect that the Treasury issuance in the U.S. will start to grow next year. There's probably no way around that. As you kind of hinted at, we're expecting they will try to manage the slope of the curve in the U.S. through issuance, through managing issuance. That's probably bill issuance, an increase in bill issuance, an increase in 2s and 3s out the curve, probably a little less increase in 10s, 20s and longs. That should help put downward pressure on the slope of the curve in the U.S. as well.

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Pamela Ritchie: So, it'll be sort of a volume thing. What would you like to say, Sri, just to sort of leave with investors at this moment? You've got some dry powder. You spoke about how you're positioned and, though credit spreads are tight, you're kind of comfortable with the overall fundamental story here. What would be something you'd leave with the investors?

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Sri Tella: I think the biggest thing, and we go to this a lot in past calls and everything, is just thinking about fixed income in a broader allocation framework. Rates, whether they're fair or cheap, I think they're at a more attractive level than they had been a few years ago. That's being backed up by a lot of the flows that are coming into fixed income. I think the all-in yields look attractive. While valuations on credit are on the rich side, there's a lot of things supporting those valuations for the time being. So, we're probably going to be in this sideways environment for a while and, in the meantime, you're going to earn your coupon, earn your spread.

But then, given where we are in valuations and risk-reward, the way we're thinking about our portfolios is being more focused and methodical on specific names that we hold – as opposed to having more sector biases or investments. So, we're thinking more about specific names that we like that have catalysts to outperform. That's where we're choosing to take our risk right now.

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Pamela Ritchie: I might ask you, Lee, to just lay out – there is a discussion of having gold in the portfolio maybe at the cost of bonds. Gold has had a rough couple of days. That said, just sort of remind us, the place of fixed income. You're speaking to people who do this every day, so it's not so important, but gold does seem to have a hold on the market a bit right now.

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Lee Ormiston: Gold has clearly been a focus. It's been on a run since the Russian invasion of Ukraine, as global reserve managers start to diversify away from the U.S. dollar. I would say that has a lot less to do with what we're thinking about from a Canadian fixed income standpoint, though. You said it at the top, base rates are relatively high, even though we're at the lower end of our range. To the extent that we saw a risk-off moment, yes, credit spreads would be wider. Sri talked about us having dry powder to add in that instance, but I would also note that – in that instance – base rates would probably go a good bit lower, so then you're still probably going to earn your coupon.

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Pamela Ritchie: Fantastic. Great to speak with you both. Very glad that you could join us here in this forum and I wish you a very good rest of your day. We'd like to speak to you after the budget and see what you saw in it, but that'll have to wait.

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Sri Tella: Thank you.

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Lee Ormiston: Thank you, happy day.

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