Fidelity Compass

Jeff Moore's 2024 Fixed Income Forecast

Jeff Moore, Portfolio Manager

Pamela Ritchie, Host

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Pamela Ritchie: Hello and welcome to Fidelity Compass. I'm Pamela Ritchie. As 2024 kicks off, all market participants are eagerly anticipating how the bond market will move this year in relation to last year. Notable upcoming events like the U.S. presidential election along with key factors like an ageing population, so the demographic story, and obviously, growing debt all are key drivers impacting bond market performance. How are these factors influencing our next guest's investing strategy? Very happy to say that joining us here today to discuss how he's navigating the fixed income landscape is Fidelity Portfolio Manager Jeff Moore. Happy New Year. How are you doing, Jeff?

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Jeff Moore: Happy New Year, Pamela.

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Pamela Ritchie: Great to see you, great to see you. Are you in Boston? Looks like you're in Boston.

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Jeff Moore: Actually I'm in New Hampshire today.

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Pamela Ritchie: You're in New Hampshire. There are lots of yellow walls.

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Jeff Moore: Yes, yellow walls. This is my office. How nice. I don't sit here often.

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Pamela Ritchie: You don't because you move around a lot I get the sense. You're chatting to people on research, gathering info.

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Jeff Moore: Exactly. We have a great trading floor so I try to be out there as much as possible.

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Pamela Ritchie: Fantastic. Let's see if you'll give us or glean a little bit of what you've learned and share with us a little about what some of the most important factors are for this year. We seem to have inflation coming down but there's pieces of that story that don't fit perfectly. What are you looking at most closely?

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Jeff Moore: We're in the sort of idea of keep it simple right now. Inflation is falling and not just is it falling – inflation is clearly on the run. If you look at the TIPS, the inflation-protected market, their breakevens for inflation are 2%. The bond market's saying the Fed's won and when you have bond yields of 4% and inflation 2, real rates at 2%, that's as compelling as any time since the 1990s.

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Pamela Ritchie: Let me ask you about that. Real rates at 2%: is that too high?

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Jeff Moore: It's high versus history. Real rates are usually the thing that slows economies, not inflation per se but real rates and so real rates at 2%, this is a pretty steamy spot for the real rate market. I remember in 1991, '92 when real rates touched 3%, they didn't stay there very long so it's unlikely that they're going to stay at this kind of level.

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Pamela Ritchie: Give us the thesis. We're talking about flows and how people were investing last year, lots of interest in bonds last year as you well know. Tell us what would interrupt, in your mind, the interest that investors would have for this year. Does it grow? Is it the same? Is it less? We're at a very different point we were at January 2023.

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Jeff Moore: Well, yeah, we say we're at a different point but you know that if you look at January 2023 yields for U.S. Treasuries and compare them to today, they're basically exactly the same. There's been no rally and the bond market last year returned between, depending on what you own, between 6 and 10% and there was no rally in rates. We still haven't had a rally in rates on a year-over-year basis. Just keep that in mind, okay?

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Pamela Ritchie: Okay, but will we?

[00:03:45]

Jeff Moore: We really could. So, great point, I think we really could. The question for the market, to get a rally here we're just watching inflation data. I think that's what clients have to do. Every month put the inflation data for the U.S. and Canada in your calendar and make sure you're watching. If you get inflation data that looks like it's rolling lower faster, which it very well could especially two things, owners' equivalent rent and wages look like they're capped or falling. In either of those or in both, you're looking at inflation numbers that are well, well below where we are today and could even be below that 2% threshold that central banks have set which would be a big market move. The way we're looking at it, enjoy the yield, just like last year just have as much yield as you can put in your portfolio, diversify the heck out of it and don't lever it and you should be fine. If something changes in CPI, if it comes down which I think it really could, I'm watching these next two prints very closely, you could get a big rally in rates.

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Pamela Ritchie: And is it an everything rally…

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Jeff Moore: Yes.

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Pamela Ritchie: ...once that happens?

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Jeff Moore: Yeah, it'd be like the fourth quarter of last year, just the everything rally. Rates go down Think about it, when interest rates fall the net present value, everything on earth goes up. That's just the discount rate from first year math in high school. That's how stocks are calculated on NPVs too, so this would be an everything rally if CPI comes in at these lower levels.

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Pamela Ritchie: Is it too late to get into bonds at this point if you haven't?

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Jeff Moore: Well, this is the point. Bonds haven't even moved on a year-over-year basis; they're exactly where they were a year ago. In my personal view, no, they're where they were a year ago. You'll be happy as a bond investor if they stay here because last year we had a really, really strong year in the bond market. We're setting up to have another one in the bond market now and that's without any great rally.

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Pamela Ritchie: That's fascinating. That, it sounds like the catalyst that either we're waiting for one way or the other. What about something like, you know, we'll talk about catalysts that make recessions happen or don't or hit you as a shock. Oil, for instance, we may be past those days but we are watching the oil price. It's sort of coming down. It's got a few different stories to it. We might see it go back up.

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Jeff Moore: Well, we might. I look at oil prices and think that if the Middle East, if any kind of de-escalation happens in the Middle East oil prices might want to go down as much as they want to go up. So, I think there's a sense that people think that, I think there's a sense that oil prices are just waiting to go soaring higher. It may not be the case. It may be that they're at this level because of the Middle East issues and concerns and the risk and if we get any kind of de-escalation oil prices could fall further.

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Pamela Ritchie: Right. Just take us through what you see if, again, so CPI will do what it does, if we start to see the rate cuts, this seems to be the question. Some will say market participants got a bit greedy thinking there will be six rate cuts in a year and that's a bit outrageous and then they sort of bring it back to maybe three. Where do you sit in this spectrum, guide us through this discussion a little bit.

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Jeff Moore: I think where we are right now is the Federal Reserve and even the Bank of Canada are happy to keep rates where they are for longer just because the economy seems to be handling it and it allows you to have a little bit more control and it allows you more time just to make certain that you've beaten inflation back into the bottle, so to speak.

Having said that, if some of these CPI prints are as light as I think they might be — and again, I can't prove it because these are survey data and we have some ideas, we run tons of simulations, all we can say is the possibility is not trivial that the next inflation print or two are much lower.

Japan just came out with core, came out right at 2%. The reason I'm saying that, Pamela, is that if you're a client here and you're thinking about catalysts think about the central banks as well. Central bank's goal, especially the Federal Reserve, is price stability and employment stability. Once you get price stability and if it looks like you've overshot the mark you have room to manoeuvre and there's no way if you're this Fed that you want to look like you're going to be over tightening and hurting employment if there's no inflation. So, my instinct would be that the market's ahead of itself, sure, on the rate cuts but the directionality is right.

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Pamela Ritchie: Okay. I want to come back to the job market in a second but I wonder if you can compare and contrast Canada and the U.S. because obviously — so you're saying the Fed, also the Bank of Canada kind of like rates where they are. If it can be sustained why not just to make sure that inflation really is going in the right direction but they're quite different countries in terms of their debt profiles and this is sort of the personal debt of Canadians, bring this to the fore for us. The Bank of Canada versus the Fed, who might need to move first?

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Jeff Moore: My instinct would be the Bank of Canada would move first if something looks like it's going to break. That's just because housing prices, and especially housing prices in a handful of the biggest MSAs like Toronto, Vancouver, they're out of sight. Even in Calgary, and you think about different cities, with housing prices and cost of debt refinance being a burden you can imagine the Bank of Canada feels like it would have to move first. The Federal Reserve will have flexibility to move if it has to. So far the U.S. economy seems like it's okay. There's a few sectors that probably are looking like they might have a recession coming but in general most sectors in the U.S. economy look like they're just slowing down, so the Fed has room and time on its side. But you have to realize that the Fed's other box is it's got a big election coming up and this one will be contentious.

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Pamela Ritchie: You said it, not me. I just want to put that out there. Tell us about this.

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Jeff Moore: This will be contentious, well, all U.S. elections seem contentious even though at the end it seems like whoever wins will get 52% and the other one will get 48 of the vote. But this will be contentious and so if you're the Federal Reserve you kind of don't want to be cutting rates into the election. The election is November, you back up to October, September. To my mind — and this is why I think the market was so aggressive on rate cuts early for this year for the Fed — is that the market's sort of guessing that the Fed will want to cut at some point this year and they won't want to get embroiled in the election, so they're going to go earlier not later. I have a lot of sympathy for that thought process, so don't sleep on that either.

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Pamela Ritchie: Okay. What does that mean, don't sleep on that either? If you're going to invest and you want the rate cuts just get in there sooner, is that what you're saying?

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Jeff Moore: Yeah. The bond market's going to like that a lot. The money markets won't like that because obviously your cash in overnight and GICs will fall in yield and they'll have less coming in U.S. In Canada, it's the same way. You can imagine the Bank Canada cutting and making money markets a tougher sell. In fact, one of the stories of the last 12 months is that bonds handily outperform money markets and cash. It didn't look like it, right? It didn't look like it but it's one of those things, it was like a coiled spring and the bond market just had to do well.

When you think about it conceptually, if you are the central bank the one thing you don't want people to be able to do is hang out in money markets. Why? Because you want them to be moving out the curve, deploying their capital into things that are going to be productivity-enhancing for the economy. So, whether you're the Bank of Canada or the Fed chair and the old Fed chair, Chair Yellen who's now Secretary Yellen, she was really clear about that. She always wanted money markets to trade at below inflation because she didn't want anybody staying there as an investment. One thing for liquidity and cash.

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Pamela Ritchie: Yeah, because it's sort of like stuffing it into your mattress in the sense of it's not going into the economy itself in that way.

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Jeff Moore: Right.

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Pamela Ritchie: Let's get into... You'll hear these two arguments on inflation, where it's going. You've pretty much outlined it but I would like you to set us straight on this whole COVID was a crater in the economy. Obviously fiscal and monetary stimulus was fired out and they've soaked it up and that's that and it's transitory, or this sort of the world is just more inflationary. We have maybe a different political chessboard and maybe an energy transition will be inflationary, hard to know. It's sort of the continuing inflation story versus the transitory. I am interested in your thoughts on that and sort of pricing that has changed throughout COVID. Does that stay high for a long time? It's kind of an interesting piece of it all.

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Jeff Moore: COVID and the response to COVID by not just the U.S. and Canada but around the world was extraordinarily aggressive whether it was central bankers cutting rates to zero, places like the U.S. doing massive quantitative easing, and then places like the U.S. and Canada just throwing massive amounts of money, almost reckless amounts of fiscal money at everything. At first we were all scared so I got it but as time has gone on, this mountain of liquidity that went into the economy definitely had a repercussion that was inflation. As time is going on now and we start resetting interest rates higher, U.S. is cutting back on its QE and trying to do some QT, it's not there yet, and governments around the world are going to have to start wrestling with who pays back these deficits and debt.

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Pamela Ritchie: Who does pay back these deficits and debt? Let's just ask that.

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Jeff Moore: You know what, it's going to be taxes because it's hard to cut spending. Once you've given something to someone people hate you when you take it away. If you're a government, a politician, the path of least resistance, even though there's resistance, is probably future taxes.

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Pamela Ritchie: Regardless of who wins the election in the U.S.?

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Jeff Moore: I think regardless. I think if one party wins, there's higher taxes but if another party wins, I think the box is still tight and they're both going to need higher taxes down the road.

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Pamela Ritchie: Interesting. So again, how do we invest for that?

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Jeff Moore: In that world, to me it feels suspiciously like COVID and the response to COVID was the reason we had inflation and the Federal Reserve I think kind of believes it and that's why they called it transitory. Having said that, the one outcome of all of this, Pamela, even though we're going to talk about inflation falling and potentially having a one handle on it at some point in the next few months, the price level has still gone up 30%. So, we've locked in all of these higher prices for everything, so inflation is just the change month-over-month from here. It doesn't mean, unless we get deflation, you're not actually going to cut into that COVID price level spike.

There were enormous gains. If you were a homeowner in Canada or United States, you've watched your home value explode. You may not go up anymore from here but you're probably going to lock in versus where you were in 2018, '19. I think that extra cost is going to be a huge question mark because people have to pay for that. You want to buy that house from someone like you or me the new person, probably a young family, is going to have to pay the higher prices. Even if the prices aren't going up from here, they've got to pay that price jump that we saw.

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Pamela Ritchie: That's fascinating. Do you think ultimately if you're sitting in a 60/40, what does the 60/40 look like? This is not necessarily what you're doing, you're not constructing the portfolios for everyone in that sense but at one point last year it looked like maybe you'd pull ahead, the 60 would be more the fixed income side and the 40… I'm just kind of curious how you're seeing things right now. Is there a classic sense to investment right now?

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Jeff Moore: I've never been a big 60/40 fan in terms of things. Having said that, it makes sense to me that if you think stocks have done really well you might want to make sure you have some powder dry to buy them when they cheapen and they're a nice place to wait, especially if we're right about anything on the inflation side and so forth, a nice place to wait would be the bond market. You'll have to figure out what part of the bond market, whether you want to go to

high yield, you can still get 10% yield in bank loans, or do you want it to just be in governments where you get that 3 to 5% number. It's a good place to hide out and then if there's a drawdown of stocks you have an obvious asset allocation. Along the way I like the bond markets chances here because we have high enough real rates already and we should see some continued easing on the inflation side.

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Pamela Ritchie: Interesting. When you're looking at sort of the job markets, the wage piece or component of what we've been talking about, are the jobs numbers that come in... We saw the ones for December; they were what they were and actually, I don't think we're going to have another one in the U.S. until after the Fed makes its next decision. Is that right?

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Jeff Moore: Yes.

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Pamela Ritchie: What we got already is it in terms of the jobs number...

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Jeff Moore: Yeah.

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Pamela Ritchie:...that they're going to be working with. Are these useful to what you're looking for right now? You've been talking about CPI being really the key. What is the key of the jobs market report?

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Jeff Moore: Well, we do know the jobs market can be market moving and can drive rates around. If you look at some of the data though, whether it's the Bureau of Labour Statistics jobs numbers or even the JOLTS data which is private, there are so many seasonal adjustments and last month adjustments because it's really difficult. The JOLTS data, for instance, is one that we like to sort of look at and say, okay, that's done by the private sector and yet a lot of times the responses, the number of responses to JOLTS can be very low, so you're not really sure what you're seeing. The way I look at the jobs data is like a crooked yardstick. We're using it over a long period of time and the yardstick's always been crooked and it's still crooked but don't get too hung up on any of the one, like the data pieces. You almost have to look at the raw data and make a question.

The last data point we had on jobs in the U.S. we had a massive increase in jobs from government. Now, the question is that sounds okay but we know governments can't create wealth. They can create conditions for wealth generation but they can't create it, so most of us aren't super excited when you think that most of the job creation is coming in the government sector. You'd rather see it in the private sector. Those are the kind of things we'll be watching for on that. I think look at ISM. ISM is basically services and look at the price paid data because sometimes that gives you a sense are companies able to pass through their costs onto the consumers and so forth. That data has been weakening, which is to say company after company is finding it a little harder to pass through their costs right now.

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Pamela Ritchie: That should help bring inflation down too.

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Jeff Moore: Yeah. And if you're a company, if you can't pass costs through then you start thinking about reorganizing, restructuring and that often leads to rifts and layoffs.

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Pamela Ritchie: Let me ask you about issuance because you mentioned government jobs there and maybe growth in that because of some of the stimulus that we've seen. What are you seeing in terms of issuance? I mean, for small companies at these rates we know the story. It's harder to refinance at these levels. Even for big companies it makes a difference everywhere in between. The government has taken over some of that. They've done their own issuance. There are lots of questions about who was going to mop that up and who was going to buy it and so on but talk to us a bit about issuance, what you're seeing, what you expect to see in this potentially rate cutting environment we're going into.

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Jeff Moore: I think, Pamela, you've hit something that's critically important for clients and that's that if you think about the last few weeks the bond market is wide open. If your company is investment grade, you're in Europe, even if you're in high yield to a certain extent, you're getting your get out of jail free card right now. You're terming out of your debt. You're moving your debt maturity wall. That's the thing you might default to someday. You're moving that out as we speak. The bond market is wide open for issuance. If you're thinking about high yield which has had some issuance, not as much, but mostly because companies don't want to come. I would argue that high-yield borrowers are being smart because they know that lenders like us are desperate to lend and use some of the cash and reinvest some of the cash we're getting every day from these high yields.

The bond market is wide open. I would say if you're someone who's saying I think there's a big default crisis coming I think you can say that but not this year now. You have to now say as the weeks go on here it's now a 2026 event because there won't be anything to default to. Now, someone who issues debt at these higher levels may have an earnings-per-share issue, which is to say costs are going to go up but that's not default. That just means you're going to have less left over for shareholders.

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Pamela Ritchie: Right. There's so many questions coming in but you're answering a ton of them as you go along here. It's really interesting. When you look at the U.S. versus Canada, we'll go back to the government spending just for a minute, the, what's it called, the IRA? It seems like a weird name for it, anyway, the green spending bill in the U.S.

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Jeff Moore: Yeah. Inflation Reduction Act.

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Pamela Ritchie: What's it called? Inflation Reduction Act, there you go. Yeah, it seems wrong. But anyway, when you look at what is being done there and there's intentions and then there was actually big borrowing to put to actual projects and so on, how do you compare Canada and the U.S. on that front? Canada talks a good game then it gets criticized for not doing it. I don't want to get too deep into it but I'm just curious in terms of big projects being funded in this general vein what do you see? Is money happening for these projects?

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Jeff Moore: When I first started my career, and this is like a long, long time ago, I had a job as an intern and I had the chance to run into the Minister of Finance, this is the government in Canada, and he was on the elevator and going down...

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Pamela Ritchie: Was it Michael Wilson? Who was it?

[00:22:12]

Jeff Moore: Actually, Don Mazankowski. I was just new. He just happened to be in the elevator and he's going to give his budget. He looked at me and I said, oh, good luck today. He goes, well, he said, you know, the key thing in life is if you don't have a lot to put in your budget make it look good. So, he had a really pretty budget and so I think that's the Inflation Reduction Act. It's kind of toothless and so you make it sound good. That's kind of how I look at it.

There's definitely some important ideas in there but if you think about just sort of green and things like support for the auto industry, those are really important political as well. Even if there weren't great green initiatives, there's probably great political reasons to make sure that the UAW is satisfied, especially if you're one of the parties. You can imagine that we've done a lot of these things that they may not turn into GDP but they won't probably hurt us long term other than the debt level will be a little higher than it would otherwise be. It's not pretty but I think this is how big countries, Canada and U.S., they do things that way. They've done it this way for a long time and I don't get too bent out of shape either way about them.

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Pamela Ritchie: Interesting. Sometimes we talk to your colleague, Sri Tella, about the provinces in Canada. I'm just curious again, across sort of the country itself, anything interesting in terms of investment by you?

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Jeff Moore: In terms of Canada, we think Canada looks fine overall. I think that the debt levels of households are at that point where there's a chunk, that tail chunk that are feeling uncomfortable right now and any kind of job losses would be very difficult on that group. Having said that, so far the economy continues to tick along and I think the Bank of Canada has enough flexibility to be master of its own destiny, so to speak. Having said that, the currency is something they're going to want to take into account.

The Canadian dollar has not done as well as you would think it should have done given some of the outcomes in the last three or four months with U.S. rates. Part of that is I think the market sees that the Bank of Canada may need to cut rates at some point and that could come at the cost of the Canadian dollar.

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Pamela Ritchie: There's always that question of why there's a rate cut and it sounds like what we've discussed in terms of the U.S. is mostly that they're just too high, the economy doesn't need it, inflation is coming down, whereas in Canada, I don't know to what extent you feel it's because they must cut because the economy is hurting. Where is that line between the two?

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Jeff Moore: That's always a question for clients. Rate cuts given how our portfolios are set up are great because we have a lot of Treasuries and duration in there. Having said that, rate cuts that are because economy is rolling over and too many sectors are in a recession that could be painful for some part of the risk assets. We haven't seen that.

The everything rally that we just saw and the one that we just talked about, Pamela, that could happen, that's predicated on a slowing economy, not a recessionary economy. Just a slowing economy, that's all good for that group. I think the central banks now have a little bit more leeway than maybe clients think to take control of that destiny. Don't bet against it at this stage but leave yourself some flexibility just in case. Who knows what could happen.

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Pamela Ritchie: Just quickly, regionally, when you go around the world, you've spoken about fortress North America a lot. I think we know some of your views on China, maybe not great right now from a debt perspective. What about the rest of the world, though? Is there anything of interest?

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Jeff Moore: Around the world, again, fortress North Americans, I like Canada and U.S. Mexico, Brazil is a convergence story. Mexico and Brazil are eating China's lunch and China's got a bevy of issues that are monstrous, not just the debt they have, the real estate debt they have, but even how local governments in China are funded, monstrous issue. I think China is one of these difficult like you go in there with your peril. I think Japan is one of those ones. Wait on Japan here. The central bank got a new governor at the Bank of Japan. The governor wants to sort of start the normalization but it's been forever that Japan's had yield curve controls. The market's not really ready for it. As a client, I really don't see an easy win to be in the bond market in Japan and I'd just be cautious unless you have some insight that I don't have there.

Europe, I'm okay with Europe at this stage. ECB President Lagarde, I think she is ready to cut rates, doesn't want to, thinks there's some latent inflation out there. If you think about even Germany, their biggest economy, Germany's flat on its back because it exports to China. If you can't get comfortable with where China is, Germany's just going to have more headwinds than you think. That's a place where I think you're okay to hide out there. I think interest rates will be fine there overall, plus/minus, and the chance that she cuts rates which could be positive. We still have a nice allocation to global, these are developed countries and then hedging it back to U.S. dollars.

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Pamela Ritchie: There's a question here about is it time to or how do you look at allocating away from TIPS? Is this the time?

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Jeff Moore: TIPS have been troublesome if you think about it. Think about in Canada, we don't have a real return auction anymore. That was cancelled by the Department of Finance. The inflation-protected market now is down to basically the U.S. and the Brits. The Canadians are gone, the Japanese are gone. Those are the two like those other markets. The reason I think that matters is inflation-protected bonds in U.S. have not done that well. They've been okay but if you think about it, go back three years ago and you owned inflation-protected bonds you think you would have nutted it. You would have said, I got this right. You've lost as much money as the nominal market. That's brutal performance for investors. As far as I'm concerned, I think you buy the inflation-protected market in the U.S. when it's extraordinarily cheap and not before. To me that means when CPI has a one handle on it, I'm more interested.

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Pamela Ritchie: Fascinating. Final thoughts for investors, bond investors, either those that have been with it through last year and are looking to stick with it or those that haven't been there yet, just a final thought, Jeff Moore.

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Jeff Moore: I think that the big thing here is that the bond market has lots of yield. We had the same amount of yield we had last year but we've moved a long way along in getting through that COVID bubble, if you want to look at it like that, so that's supportive. You still are going to have higher rate volatility than we're used to in the past, in the last 10, 20 years but that's not necessarily a bad thing. High rate volatility can actually turn out very well for clients.

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Pamela Ritchie: Brilliant. It's great to see you. Thank you. Happy New Year. And we'll speak again soon, I hope.

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Jeff Moore: Thank you Pamela.

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Pamela Ritchie: I want to thank you all for joining us here on Fidelity Compass today. As always, if you've got any suggestions for future topics or guests that you'd like to see here on the show, feel free to share your ideas with us and you can always stay tuned for more Fidelity Compass webcasts in the weeks and the months ahead. I'm Pamela Ritchie.

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