FIXED-INCOME PERSPECTIVES – SIX-MONTH OUTLOOK

JANUARY 2018

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SUMMARY

Global growth

The next six months are likely to be about growth and profits. The period ahead will probably match or exceed 2017 in terms of economic output, if only for the next year or so. No major country faces recession, and global industry output is still expanding. Additional economic growth could stem from the fiscal stimulus of the large U.S. corporate tax cut, and there is the potential for other countries to follow suit.

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Risk assets: Non-government debt

Risk assets are likely to produce low but positive returns in the immediate future. A lot of growth is already priced into stocks and corporate debt; nothing is "super cheap," except perhaps for inflation protection. Risk assets such as high-yield bonds, leveraged loans and BBB-rated corporate bonds trade at exceptionally narrow spreads – the tightest that have been witnessed since the period immediately before 2008. Default

KEY TAKEAWAYS

- Corporate earnings and profits will be the story of 2018; the tax cut is additive
- Asset-backed security (ABS) and non-agency mortgage-backed security (MBS) markets are much smaller in size than they were during the pre-2008 period
- Inflation expectations are stable, but a contrarian can dream
- Global central banks continue to tighten financial conditions, but carefully
- Global liquidity conditions support financial markets
- Emerging markets (EM) benefit from global liquidity
- Commodity volatility is low, and the supply/demand balance is tipping to net shortage

rates are low and may fall further in the early part of 2018; this trend is a tailwind supporting spreads. Any volatility in spreads in the year ahead is likely to be a by-product of interest rate volatility, not deterioration in issuer fundamentals; even then, the resulting sell-off would most likely be muted and transitory. A sell-off of risk assets similar to that of 2008 is highly unlikely, given the fundamental strength of the systemically important banks and the relatively small amount of leverage in the financial system.

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Risk-free assets: Government debt

Risk-free assets are also likely to produce low positive returns in the immediate future, but a negative-return scenario is emerging. The new U.S. Federal Reserve (Fed) Chair, Jerome Powell, may want to demonstrate hawkishness. A repeat of the May 2013 "taper tantrum" is a remote possibility; recall that five-year real interest rates in the U.S. jumped 1.5% at that time. An elongated tightening cycle will raise short-term rates regardless; the market has priced in just two interest rate hikes in 2018. Tapering off global quantitative easing (QE) – including lessening the efforts of the European Central Bank (ECB) – means less financial repression. A key government tail risk is the return of higher inflation expectations; the mechanism for this scenario would be strong global economic growth combining with tax stimulus to accelerate hiring, lower unemployment, raise wages and boost price inflation, just as one would expect from Phillips Curve theory. An alternative scenario – albeit much more muted in terms of its effect on asset returns – is that higher U.S. fiscal deficits might require higher U.S. Treasury yields to attract global capital.

MAJOR THEMES

Corporate earnings and profits will be the story of 2018; the tax cut is additive.

Credit spreads on risky debt such as high-yield bonds, leveraged loans and BBB-rated corporate bonds are narrow at present; this pricing is based on a strong global economy and expectations of a low default rate. The large U.S. tax cut will further boost cash earnings for a majority of corporate entities. All things considered, this is a positive market environment for the lower-quality sectors, and valuations largely reflect this sentiment. Our investment thesis has been that it is now a good time to move up in quality and to focus on companies and sectors where the balance sheet is of key importance, because there are a number of securities that offer both compelling yield and capital gains potential. An additional wrinkle to consider is the recent changes in the U.S. tax code and the limitation on interest deductibility for highly leveraged companies. This factor may lower the debt metrics for some companies and provide a one-time boost for those of higher credit quality.

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Asset-backed security (ABS) and non-agency mortgage-backed security (MBS) markets are much smaller in size than they were during the pre-2008 period.

The reduction in the size of the ABS and MBS markets is the deliberate result of government regulation in the period following the 2008 financial crisis, and at this point, no relief from those regulations is anticipated. That said, certain corners of these markets do have value, but we are very cautious about these opportunities, in part because of their limited liquidity. These opportunities also tend to be an artifact of the low-interest-rate environment over the long term, and they could very well be a casualty of higher interest rates.

Inflation expectations are stable, but a contrarian can dream.

What accounts for the low level of volatility that has been such a persistent feature in the global financial markets over the last year? It could be investor overconfidence in the notion that interest rates will remain low indefinitely because inflation remains a non-issue. If investors' faith in this notion is ever tested, it could result in a sell-off of ten- and 30-year government bonds, and such a scenario has the potential to produce negative total returns for many core and long-duration bonds, bond funds and bond ETFs. We maintain a cautious, low-duration posture for this reason. We also own a significant amount of Treasury Inflation-Protected Securities (TIPS) to provide some defence in such a scenario.

Global central banks continue to tighten financial conditions, but carefully.

The Fed will be under new leadership in 2018. The question for investors is whether this change in leadership will result in a deviation from the current careful and slow pace of Fed hiking and QE tapering. The Fed interest rate dot plots imply a Fed funds target interest rate of 3% by 2020, which is unchanged over the past year. The current yields on short-term U.S. government debt are already approaching ten-year highs, although such highs are somewhat deceptive, in that the standard for comparison is the super-low yields of recent years. Meanwhile, a number of local currency bond markets around the world continue to feature zero yields or even negative yields; two of the big ones are Germany and Japan. The ECB and the Bank of Japan are likely to maintain their current level of quantitative easing, provided that market expectations do not force their hand. Global QE tapering is a story that is more likely to unfold in the second half of 2018.

Global liquidity conditions support financial markets.

Regardless of central bank activities, both Germany and Japan continue to be global liquidity providers of paramount importance, based solely on their export surpluses, and this situation is unlikely to change in the first half of 2018. Consequently, a global liquidity scare is unlikely to occur over the next twelve months, and especially in the first half of the year. China is absent from the list of major global liquidity providers, based on its weakening current account surplus and its tight capital controls. Currency volatility around the world is low at present, but we still continue to protect against it by hedging any existing currency exposures in our portfolios back to U.S. dollars, unless there is a compelling valuation argument for being long or short.

Emerging markets (EM) benefit from global liquidity.

If interest rates in developed markets continue to push higher, the higher interest rates – other things being equal – are likely to affect the global flow of funds to the detriment of emerging markets: funds that might have flowed into emerging economies might well flow into developed economies instead. That said, there is no sign that global financial conditions are tightening – just the opposite, in fact. In addition, EM government debt markets tend to be relatively independent of one another, which means that it is best to take a country-by-country approach to investing in this space, even if the sector as a whole faces a possible headwind due to higher U.S. interest rates.

Commodity volatility is low, and the supply/demand balance is tipping to net shortage.

The volatility of oil prices has often been in the range of 50%, but it is now half of that level and has been so for much of the past year. Our concern is that investors will become overly confident about projecting this recent experience into the future; in contrast, we stress-test our portfolios for 50% volatility just in case. That said, we are positive on commodities in general: global demand is rising while global supply is more limited, due to the knock-on effects of the 2015 downturn in commodity prices, which put enormous stress on corporate balance sheets.

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