



Fiscal policy lies at the heart of inflation

Fidelity International's outlook from the Fixed Income investment team

For investment professionals only

Executive Summary

US inflation continues to be higher than expected and the Fed has shifted course once more, signalling higher for longer rates. Bond markets are yet again scrambling to incorporate the changing policy direction. We have gone from six rate cuts forecast in 2024 to just one in the space of four months.

The Fed's guidance on the inflation outlook has not been consistent. It initially justified a lack of action given that inflation was transitory in 2021, to playing catch up with rapid policy tightening in 2022, to shifting to a soft landing and gradual disinflation in 2023, to the current higher for longer narrative. I'd argue that these directional changes were somewhat predictable given that the Fed appears to be misdiagnosing the underlying cause of inflation - or at least not vocalising it for whatever reason.

The restrictive monetary stance of the Fed faces a challenging obstacle - the loose fiscal policy of the government. The fiscal budget deficit stands at around 6.3% of GDP - a level that we're more accustomed to in times of war or deep recession, not during high employment and resilient growth. This level of liquidity in the system is helping to keep risk assets rising and adding to upward pressure on yields. But until these fiscal deficits are reined in, we may have ongoing sticky inflation and upside surprises as I've suggested before in these commentaries. However, any fiscal prudence is unlikely to occur before the US election.

The fiscal deficit must moderate otherwise the debt burden and debt service costs will continue to climb. The bond market will demand increasingly higher yields to compensate for lending to the government, and other factors including geopolitical events or political strife such as debt ceiling disputes could add to concerns. The conundrum for the government is that when the fiscal deficit is reduced, it could trigger a recession.

In the meantime, the Fed will taper quantitative tightening from June, which is the first acknowledgement that things might break (i.e. refinancing problems) if yields keep rising. We may even see the prospect of unorthodox measures such as yield curve control to stop debt service costs from spiralling upwards.

Confidence in the fiscal sustainability of the US is crucial and the recent rapid rise in the price of gold suggests that this should not be taken for granted. Over the past two years, the gold price has diverged from its long-held negative correlation with real yields and jumped higher this year. This could be an early sign that globally, US debt burdens are starting to chip away at the once rock-solid confidence in US fiscal policy. This is a gradual and long-term process, but we could be on this trajectory unless policymakers recognise and address the threat.

In the short term, US treasury yields could continue to float upwards as inflation stays sticky, but in the medium term we expect some moderation in fiscal policy, which would put the US economy under pressure and support duration. In the very long term, the current fiscal path of the US is unsustainable.

Steve Ellis
Global CIO Fixed Income



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Strategy summary

Our baseline is that there will be no Fed rate cuts at least until Q4 and perhaps not at all this year; then it will be data dependent. We continue to be overweight US and EUR duration, and neutral UK duration. We move towards neutral in EM FX given the continued divergence in rate cutting cycles between EM countries and the US.

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Macro and rates overview

Given the mix of sticky inflation, fiscal looseness and the upcoming election, US treasury yields may continue their path of gradual climbing or at least stay rangebound, but we believe the post-election risks to the economy from fiscal budget deficits, pressure on household spending, and high debt warrant a overweight to US duration in the medium term. We remain overweight EUR duration as it approaches rate cuts.

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Inflation linked bonds

US inflation surprised to the upside again, driven by sticky services inflation, leading to expectations for delayed rates cuts. UK inflation is moving in the right direction but is struggling with sticky services inflation prompting more uncertainty around a rate cut in August. We remain long 10y and 30y US breakeven inflation - the latter via inflation swaps and a cross-market view versus Euro 30yr inflation.

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Investment grade credit

Global IG credit returned -1.8% in April despite spreads tightening by 3bps, as global rates markets continued to sell off. New issues generally priced at or through secondary levels, which was then reflected in broader market tightening. In general, we prefer financials due to continued value in financial issuers over comparable issuers. Despite the higher rate environment, IG fundamentals are showing resilience.

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High yield

Global high yield returned -0.7% in April in local currency terms and spreads tightened by 3bps. However, firmer inflation in the US, a more hawkish tilt from the Fed and ongoing geopolitical risks weighed on markets. We are tactically underweight in global HY as spreads remain tight with increasing single name volatility.

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Emerging markets

Emerging market debt posted negative returns in April with hard currency corporates (-0.9%) outperforming hard currency sovereigns (-2.1%) and local currency debt (-2.1%). We are almost neutral in EM currencies, while long the US dollar and selective frontier market currencies. The delay in the Fed's easing cycle while EM central banks largely continue with their cutting cycles makes us more cautious towards this asset class.

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Quant appendix

Important Information

Reference to specific securities should not be construed as a recommendation to buy or sell these securities and is included for the purposes of illustration only.

Investors should note that the views expressed may no longer be current and may have already been acted upon.

The value of investments and the income from them can go down as well as up so you may get back less than you invest. Past performance is not a reliable indicator of future results.

Bond investments: The price of bonds is influenced by movements in interest rates, changes in the credit rating of bond issuers, and other factors such as inflation and market dynamics. In general, as interest rates rise the price of a bond will fall. The risk of default is based on the issuer's ability to make interest payments and to repay the loan at maturity. Default risk may, therefore, vary between different government issuers as well as between different corporate issuers.

Corporate bonds: Due to the greater possibility of default an investment in a corporate bond is generally less secure than an investment in government bonds.

High yield bonds: Sub-investment grade bonds are considered riskier bonds. They have an increased risk of default which could affect both income and the capital value of the Fund investing in them.

Overseas Markets: Overseas investments will be affected by movements in currency exchange rates. The value of the investment can be affected by changes in currency exchange rates.

Currency Hedging: Currency hedging is used to substantially reduce the risk of losses from unfavourable exchange rate movements on holdings in currencies that differ from the dealing currency. Hedging also has the effect of limiting the potential for currency gains to be made.

Emerging Markets: Investing in emerging markets can be more volatile than other more developed markets.

Derivatives: Some fixed income investments may make use of derivatives and this may result in leverage. In such situations performance may rise or fall more than it would have done otherwise, and expose investors to the risk of financial loss if a counterparty used for derivative instruments subsequently defaults.

Hybrid securities: Hybrid securities typically combine both equity and debt sensitivities and exposures. Hybrid bonds are subordinated instruments that have equity like characteristics. Typically, they include long final maturity (or no limitation on maturity) and have a call schedule increasing reinvestment risk. Their subordination typically lies somewhere between equity and other subordinated debt. As such, as well as typical 'bond' risk factors, hybrid securities also convey such risks as the deferral of interest payments, equity market volatility and illiquidity. Contingent convertible securities ("CoCos") are a form of hybrid debt security that are intended to either convert into equity or have their principal written down upon the occurrence of certain 'triggers' linked to regulatory capital thresholds or where the issuing banking institution's regulatory authorities considers this to be necessary. CoCos will have unique equity conversion or principal write-down features which are tailored to the issuing banking institution and its regulatory requirements.

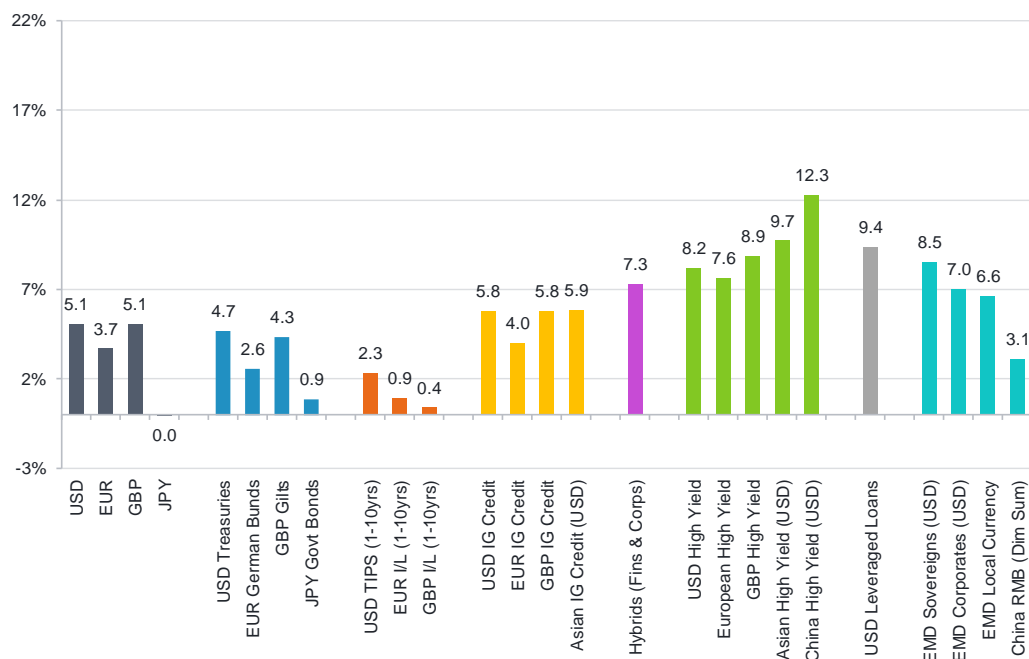
Strategy summary

The Fixed Income Monthly provides a forward-looking summary of the medium-term views from Fidelity's Fixed Income team. Our investment approach is multi-strategy, with portfolio managers given clear accountability and fiduciary responsibility for all investment decisions in a portfolio. Given this portfolio manager discretion, there may at times be differences between strategies applied and the views presented in this document. We believe in managing portfolios with a mix of active investment strategies, including top-down and bottom-up, such that no single strategy dominates risk.

Rates	--	-	=	+	++	Main views
Duration				●		
UST rates				●		<ul style="list-style-type: none"> Remaining overweight UST given the medium-term potential for pressure on economic growth.
EUR rates - core					●	<ul style="list-style-type: none"> Maintain strong overweight on EUR rates (core) given stabilisation in inflation and potential for rate cuts draws nearer.
EUR rates - periphery		●				<ul style="list-style-type: none"> Underweight on European peripheral duration with valuations still stretched and risk-reward skewed to the downside given expected supply will lead to significant spread widening.
GBP rates			●			<ul style="list-style-type: none"> Remaining neutral UK duration given market fairly valued.
Inflation	--	-	=	+	++	
Breakeven Inflation			●			
IL – USD				●		<ul style="list-style-type: none"> Despite higher than expected upticks in inflation data, the overall inflation trend is still moving downwards.
IL – EUR		●				<ul style="list-style-type: none"> Value is starting to emerge in breakevens, as they are currently priced for a benign inflation outlook. Longer term dynamics such as green transition costs, deglobalisation and geopolitical tensions pose threat to this outlook.
IL – GBP			●			
IL – JPY			●			
Investment grade credit	--	-	=	+	++	
Investment grade credit beta			●			
USD IG			●			<ul style="list-style-type: none"> IG spreads continue to grind tighter, with valuations on a spread basis looking expensive. We are, however, neutral on global IG corporates as they maintain an attractive yield.
EUR IG					●	<ul style="list-style-type: none"> More broadly, we prefer European IG with spreads still screening as attractive versus other regions.
GBP IG			●			<ul style="list-style-type: none"> We await better entry levels in US IG. Valuations remain exceptionally tight and though net supply for credit was neutral in April, we expect a pick up in the coming months.
Asian IG (USD)			●			
Financial and corporate hybrids	--	-	=	+	++	
Financial and corporate hybrids			●			
Contingent convertibles			●			<ul style="list-style-type: none"> Short call securities look attractive due to yield curve inversions and favourable convexity profile in the event of a call.
Investment grade corporate hybrids			●			<ul style="list-style-type: none"> After beta rally we see less scope for significant compression but still like short call AT1 given high propensity to call. Neutral in corp hybrids, given relatively resilient performance.
High yield	--	-	=	+	++	
High yield credit beta		●				
US high yield		●				<ul style="list-style-type: none"> Amid unappetising spreads and decreasing margin for error, we maintain an underweight position in US HY.
European high yield		●				<ul style="list-style-type: none"> Maintain our cautious stance on European HY as screen expensive, and a substantial increase in idiosyncratic risks raises the risk of contagion into the rest of the universe.
Asian high yield		●				<ul style="list-style-type: none"> Maintain underweight in Asian HY given continued grind tighter in spreads. Our positioning revolves around capturing income, remains light on credit risk and focuses on single-name selection.
Emerging markets	--	-	=	+	++	
EM hard currency sovereign debt				●		<ul style="list-style-type: none"> A small overweight in hard currency EM sovereign credit but have been reducing our overweight lately
EM hard currency corporate debt		●				<ul style="list-style-type: none"> Neutral in EM currencies, while long the US dollar and selective frontier market currencies..
EM local currency duration				●		
EM FX			●	←		<ul style="list-style-type: none"> Reduced our overweight position in EM local rates since the start of the year
China RMB debt			●			

Yields across fixed income asset classes

- Cash
- Government Bonds
- Inflation Linked
- Investment Grade Credit
- Hybrids
- High Yield
- Loans
- Emerging Market Debt



Source: Fidelity International, Bloomberg, JPM and ICE BofA Merrill Lynch bond indices, 30 April 2024. Yield to worst for high yield and EM, yield to 3yrs for USD Loans, real yield for inflation-linked bonds, yield to maturity for all others. The Yield to Maturity (also known as the Redemption Yield) is the anticipated return on a bond expressed as an annual rate based on price / market value as at date shown, coupon rate and time to maturity. Hybrids universe defined as 50% Corporate Hybrids and 50% Financial Hybrids indices.

Summary of returns as of 30 April 2024 (%)

Government	1 Month	YTD	2023	2022	2021	2020	2019
US Treasuries	-2.4	-3.3	3.9	-12.9	-2.4	8.2	7.0
EUR Bunds	-1.8	-3.1	5.1	-17.6	-2.6	3.0	3.1
UK Gilts	-3.2	-5.0	3.7	-25.1	-5.3	8.8	7.3
Inflation Linked							
USD	-1.6	-1.6	3.6	-12.6	6.0	11.5	8.8
EUR	-0.6	-1.0	5.0	-8.1	6.2	3.1	6.0
GBP	-3.8	-6.0	0.7	-34.4	3.9	11.3	6.5
Investment Grade Corporate							
USD	-2.3	-2.4	8.4	-15.4	-1.0	9.8	14.2
EUR	-0.8	-0.4	8.0	-13.9	-1.0	2.6	6.3
GBP	-2.0	-1.9	9.7	-19.5	-3.0	8.7	10.8
Asian Dollar	-1.6	-1.3	7.5	-11.0	0.0	7.6	11.5
Financial and Corporate Hybrids							
Contingent Convertibles	-0.5	3.1	5.7	-11.4	4.7	6.8	17.6
Investment Grade Corporate Hybrids	-0.5	1.7	10.2	-12.9	1.4	3.8	14.2
High Yield							
US	-1.0	0.5	13.5	-11.2	5.4	6.2	14.4
European	-0.3	1.0	13.1	-13.9	3.3	3.6	13.8
Asia	-0.3	5.9	-0.1	-13.3	-6.2	8.4	13.2
Emerging Markets							
EM USD Sovereigns	-2.1	-0.1	11.1	-17.8	-1.8	5.3	15.0
EM USD Corporates	-0.9	1.4	9.1	-12.3	0.9	7.1	13.1
EM Local Currency (USD unhedged)	-2.1	-4.2	12.7	-11.7	-8.7	2.7	13.5
China RMB	-0.0	1.3	4.8	1.9	3.2	3.7	5.6

Source: Fidelity International, ICE, Datastream, 30 April 2024. Total Returns based off JPM and ICE BofA bond indices. Custom index used for Asia High Yield (ICE BofA Merrill Lynch Q490 Index).

Macro and rates overview

Monthly review

- The Fed maintained rates at its May FOMC meeting but signalled rates would stay higher for longer following PCE inflation was 2.7% in the year to March.
- The ECB kept its policy rates stable at its April meeting but sent a clear indication that a June cut is likely.
- UK CPI fell to 3.2% in the year to March from 3.4% in February, but was still above expectations.

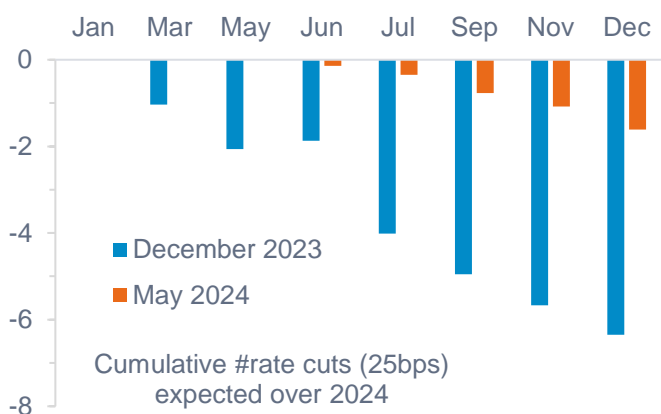
Outlook

Global growth continues to be robust with surprises to the upside. US data appears resilient with strong demand and growth is tracking at around 3% in Q2 despite high interest rates in most markets. But the key focus remains on inflation.

With US CPI printing 3.5% and PCE 2.7% in the 12 months to March, respectively, both were above expectations and indicate there are no signs of continued disinflation or acceleration and US data on average points to sticky inflation at levels higher than what the Fed would be comfortable with. At the Fed's May FOMC meeting, Chair Jerome Powell acknowledged the stickiness of inflation, signalling that the central bank is not yet ready to cut rates.

The bond market is taking its cues from the Fed, trying to align with its views. The market is currently pricing in around one interest rate cut in 2024, which is a drastic change from the six that were predicted at the start of the year.

Market sharply reduces rate cut expectations in 2024



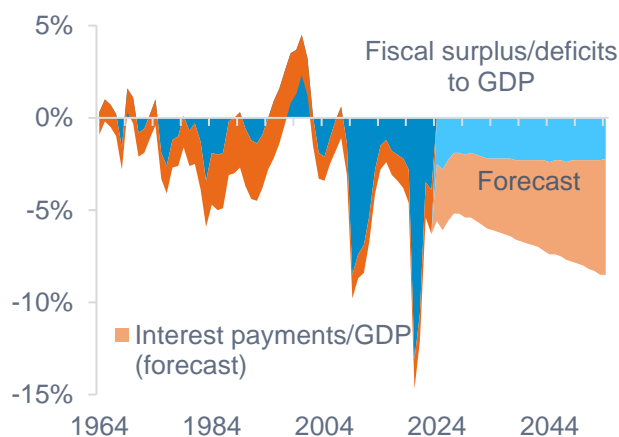
Source: Fidelity International, CME Group, 2 May 2024.

Our baseline is that there will be no Fed rate cuts at least until Q4 and perhaps not at all this year; then it will be data dependent. The US economy is strong and the stickiness in inflation shows little sign of giving way, especially in services, which are demand sensitive. Rate cuts are consistently being delayed and we are not seeing any meaningful progress towards the 2% inflation target. However, the bar for hiking to restart from here is high and we may need to see inflation prints tick up before that is considered.

Strategy	--	-	=	+	++
Duration				•	
UST rates				•	
EUR core					•
EUR periphery		•			
GBP rates			•		

The market is likely to switch focus to the election in the summer months, which means only a narrow window while the market trades on traditional measures of inflation and growth. Given the mix of sticky inflation, fiscal looseness and the upcoming election, US treasury yields may continue their path of gradual climbing since January or at least stay rangebound, but we believe the post-election risks to the economy - concern around high and rising fiscal budget deficits, pressure on household spending, and high debt burdens - warrant a overweight to US duration in the medium term.

US fiscal deficit set to rise



Source: US Congressional Budget Office, Fidelity International, April 2024.

In Europe, GDP figures in Q1 surprised to the upside, particularly in Germany. China is seeing a moderate acceleration in growth and contributing to global growth, which Europe is a beneficiary of. European flash PMIs are also suggesting better acceleration in this cycle.

The ECB strongly hinted that it wants to start cutting rates in June, and given that the region's inflation reading is hovering slightly above target, the central bank will feel justified in acting. However, a complication thereafter will be the divergence between a higher for longer Fed and Eurozone policy. We continue to be overweight core Euro duration.

The Bank of England's positive surprise on March CPI and some opposing views emerging from different representatives of the central bank suggest the path forward is unclear. With high inflation and weak growth, there is a risk of stagflation. We remain neutral UK duration.

Inflation linked bonds

Monthly review

- US inflation surprised to the upside causing a sell-off in real and nominal bond yields.
- Inflation expectations rose during the month across US, UK and Euro markets.
- We continue to see value in real duration and breakeven inflation.

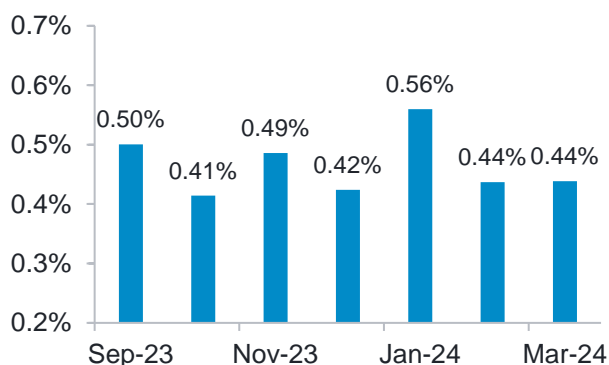
Strategy	--	-	=	+	++
Breakeven inflation			●		
IL – USD				●	
IL – EUR		●			
IL – GBP			●		
IL – JPY			●		

Outlook

US inflation surprised to the upside again, driven by sticky services inflation, leading to expectations for delayed rates cuts. UK inflation is moving in the right direction but is struggling with sticky services inflation prompting more uncertainty around a rate cut in August.

European inflation remains on track and a rate cut in June is still the base case. US data drove inflation expectations (breakeven rates) higher and a sell-off in real yields. Inflation-linked bonds outperformed their nominal counterparts during April. Ten year US, UK and Euro real yields rose to 2.3%, 0.6% and 0.4% respectively, while breakeven rates rose to 2.4%, 3.8% and 2.2%.

US CPI OER normalises but above pre-Covid trend



Source: Fidelity International, Bloomberg, May 2024.

US headline and core CPI rose by 0.4% mom, exceeding market forecasts of 0.3% and marking the third consecutive rise of +0.4% for core CPI. The uptick is due to sticky core services, which rose +0.5% while core goods returned to deflation, falling 0.2% mom, driven by a decline in used car prices (-1.1%).

Shelter inflation remains sticky, but it is non-shelter that could reaccelerate, primarily due to the increase in motor vehicle insurance and medical care insurance (+2.6% and +1.2% respectively). These items feed through to CPI but not PCE, which explains why core services ex-shelter CPI is much stickier than PCE. We believe that these items should still be acknowledged as they indicate broader persistence in inflation and could challenge the Fed's confidence in inflation convergence. Moreover, US TIPS are indexed to CPI,

not PCE so these items will impact the performance of linkers.

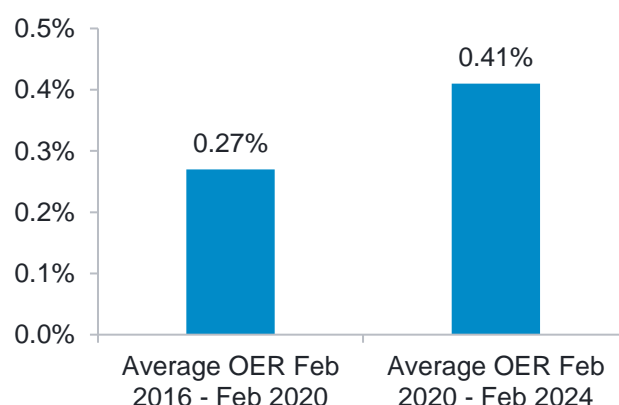
While rents are not rapidly increasing as implied by January's OER print, they are still elevated to pre-Covid levels and have not been decelerating as fast as we anticipated, reinforcing our caution around longer term upside inflationary risks. We remain long 10y and 30y US breakeven inflation - the latter via inflation swaps and a cross-market view versus Euro 30yr inflation.

UK headline and core CPI fell from 3.4% yoy to 3.2% and 4.5% to 4.2%, respectively. The prints were 0.1% higher than expected due to stickiness in services. Services inflation only eased from 6.1% to 6.0% yoy, with spikes in communications and accommodation causing the overshoot.

If we exclude volatile components, supercore services inflation is still running close to +5% annualised, indicating that there is still some persistence in inflation. However, the UK remains on the right path with the trimmed mean and median figures down, helped by easing in core goods CPI. Air fares were broadly unchanged and we did not observe any clear Easter impact.

While the upside surprise has caused some uncertainty around an August rate cut, we do not expect this inflation beat to have a material impact on monetary policy as we continue to move in the right direction.

Owner's equivalent rent is elevated (MoM)



Source: Fidelity International, Bloomberg, April 2024.

Investment grade credit

Monthly review

- Global investment grade credit posted negative total returns in April, despite a small tightening in credit spreads.
- Sterling IG credit spreads underperformed following volatility in the utilities sector.
- Within US IG, low levels of intra-issuer and intra-sector volatility continued with spreads across many sectors at 5-year tights.

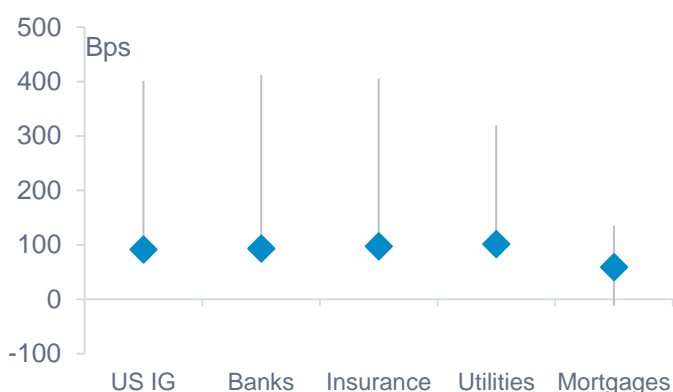
Strategy	--	-	=	+	++
IG credit beta			●		
USD IG			●		
EUR IG					●
GBP IG			●		
Asian IG (USD)			●		

Outlook

Global IG credit returned -1.8% in April despite spreads tightening by 3bps, as global rates markets continued to sell off. New issues generally priced at or through secondary levels, which was then reflected in broader market tightening. In general, we prefer financials due to continued value in financial issuers over comparable issuers. This was exemplified in the primary market in late April, with a BBB+ rated GSIB (globally systemically important bank) coming to the market at a similar spread to a BBB- rated corporate issuer at risk of rating agency downgrade.

Despite the higher rate environment, IG fundamentals are showing resilience. Consequently, levels of intra-issuer and intra-sector volatility continue to be low in most markets. With an absence of volatility, valuations on spread basis are at 5-year tights across many sectors. However, we believe that the high yields on offer mean that the asset class remains attractive from a risk-reward perspective.

US IG spreads at post-Covid tights in most sectors



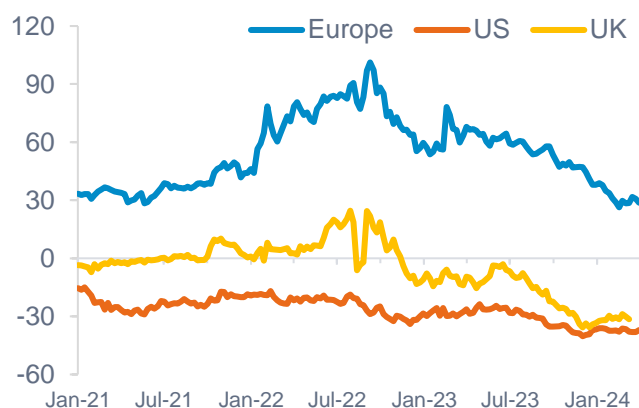
Source: Fidelity International, ICE corporate bond indices, 30 April 2024.

US IG credit returned -2.3% in April with spreads tightening by 3bps. As 1Q24 earnings began, consumer facing corporates such as Starbucks and McDonalds hinted at a weakening in US consumer demand. Given this pressure, we await better entry levels. Valuations remain exceptionally tight and although net supply was neutral in April, we expect this to rise in coming months.

US mortgages have lagged the strength seen in IG corporate bonds in recent months. Subsequently, an overweight to mortgages has become a crowded position and not one we believe is attractive. Tight spread levels on IG credit make us wary, but strong yields and fundamentals skew us to be in favour of the asset class as a whole.

Euro IG credit returned -0.8% in April with spreads unchanged. We believe that on a quality adjusted basis, current Euro IG spreads look attractive as there are fewer external risks to European credit compared to historically. We anticipate that tightening swap spreads could prompt continental buyers to step into the market as valuations look more attractive on a z-spread basis, creating a further positive technical for European credit.

Narrowing European swap spreads could drive rally



Source: Fidelity International, ECB, Indeed Hiring Lab, 31 March 2024.

Sterling IG credit returned -2.0% with spreads broadly unchanged. UK utilities remain under pressure with spreads widening by 6bps over the month as the default of high yield issuer Kemble Water rocked the sector. Despite this, we see value in the wider sector as water companies remain highly-regulated entities with stable customer bases.

Asia IG credit returned -1.3% in April. Spreads tightened by 6bps driven by the broader credit rally and the removal of certain China property names from the index. We remain constructive on Asia IG and think that bonds are attractive from a total yield perspective with additional spread compression potential.

High yield

Monthly review

- High yield bonds posted negative returns, but outperformed investment grade bonds in April.
- Credit spreads (except US) tightened as macro and corporate fundamentals remained broadly favourable.
- US high yield spreads marginally widened as an upside surprise in US core CPI tempered market expectations around US interest rate cuts.

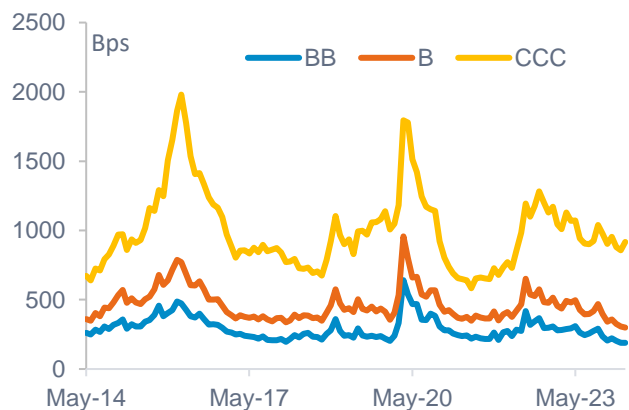
Outlook

Global high yield returned -0.7% in April in local currency terms and spreads tightened by 3bps. However, firmer inflation in the US, a more hawkish tilt from the Fed and ongoing geopolitical risks weighed on markets.

Stressed and distressed capital structures are experiencing elevated price volatility as creditor-unfriendly tactics emerge. The migration of 'creditor-on-creditor violence' that is typical in the US to Europe via idiosyncratic single name volatility is a warning to investors. These aggressive situations stem from creditors competing for position ahead of refinancings, rather than fixing their capital structures. Therefore we are tactically underweight in global HY as spreads remain tight with increasing single name volatility.

US HY returned -1% and spreads widened by 3bps. Strong data prints indicate that the economy remains robust although monetary policy challenges remain. Without a material slowdown in the labour market or an exogenous shock, many sectors of the US economy can operate at positive real rates. The market continues to see dip-buying from yield buyers and tactical allocators. If higher quality (B and higher) companies can preserve margins, they will prove less rate sensitive than anticipated. That said, we are underweight US HY as spreads are unappealing in a historical context.

US high yield spreads falling



Source: Fidelity International, ICE BofA Indices, 30 April 2024.

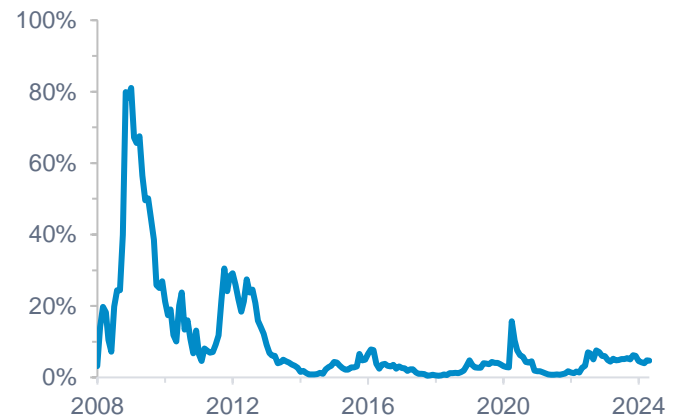
European HY returned -0.3% in euro terms and spreads tightened by 5bps. Creditor-on-creditor

Strategy	--	-	=	+	++
HY credit beta		●			
US high yield		●			
European high yield		●			
Asian high yield		●			

violence, a phenomenon uncommon in Europe, is a distinct possibility. While markets continue to treat these incidents as largely idiosyncratic, there is the risk of a more negative impact. European trailing defaults remain contained at around 2–2.5%, but we are close following some names that have dominated headlines recently. Furthermore, distressed credits face similar challenges in a higher-for-longer regime.

However, the asset class still has a large share of high rated (c.70% is BB rated) and high performing, non-distressed bonds; 95% of the EHY market trades with a spread of <1000bps. Moreover, strong macroeconomic and risk sentiment, robust technicals, and a big cohort of rising stars (>€20bn in YTD 2024) point to resilience in the majority of the EHY market. That said, we remain cautious given increasingly negative idiosyncratic price action in the context of rich overall headline spreads.

Distressed constituents in European high yield



Source: Fidelity International, ICE BofA Indices, 30 April 2024.

Asia HY returned -0.3% in April in local currency terms and spreads tightened by 7bps. The asset class has been benefitting from a broad-based rally with a default rate (ex-China property) over the past two years of less than 1%. There has been an uptick in idiosyncratic headlines around auditor concerns but individual names have not spilt over to the rest of the universe and earnings have been resilient. We believe that its crucial to stay invested in quality parts of the universe (BB and high-quality B) to capture risk-reward. We therefore maintain our tactical underweight in Asia HY as spreads have tightened over the last few months.

Emerging markets

Monthly review

- Emerging market debt generated negative returns in April.
- A rise in US treasury yields weighed on hard currency bond returns.
- Local currency bonds also suffered due to higher local yields and negative currency returns.

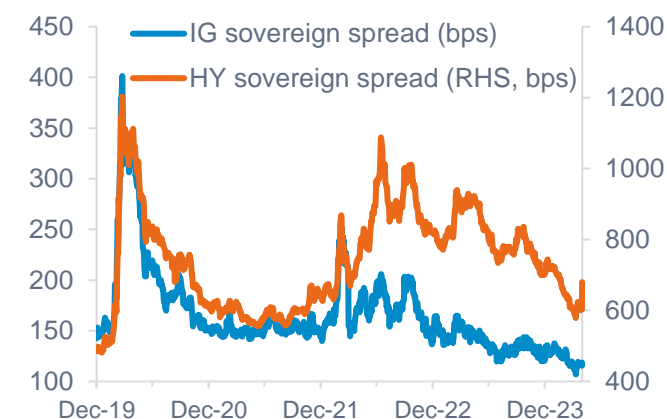
Strategy	--	-	=	+	++
HC sovereign				•	
HC corporates		•			
LC duration				•	
EM FX			•	←	
China RMB			•		

Outlook

Emerging market debt posted negative returns in April with hard currency corporates (-0.9%) outperforming hard currency sovereigns (-2.1%) and local currency debt (-2.1%). Higher US treasury yields restrained the performance of hard currency bonds, drove a similar rise in local yields, and led to weaker EM currencies against the US dollar, which weighed on local currency debt returns.

We still hold a small overweight in hard currency EM sovereign credit but have been reducing the position. We still have conviction in the HY/IG compression trade where the distressed part of the index has continued to outperform amid some fundamental developments including debt restructuring, greater access to the market, and announcements of IMF support. The virtuous circle of multilateral support and market access can keep turning for now, and good fundamentals may help to weather a broader risk-off period.

Spread compression between HY and IG grade



Source: Fidelity International, Bloomberg, 30 April 2024. JPM indices.

We remain overweight in names at the weaker end of the credit spectrum with an outright underweight in investment grade. We are now flat on US dollar duration given recent US data prints have increased the chances of no cuts this year while ultra loose fiscal/supply continues to keep rates high.

We have reduced our overweight position in EM local rates since the start of the year. EM long duration positions have been highly correlated to US rates despite cutting cycles being well advanced and desynchronised from the US. We have reduced some lower-beta, lower-conviction EM rates positions to lower the overall active duration overweight.

EM local yields followed spike in US yields



Source: Fidelity International, Bloomberg, 30 April 2024. JPM EM index.

We still have overweight positions in Mexico, Brazil and South Africa among others. While some of these positions have had idiosyncratic issues such as budget deterioration in Brazil and pre-election uncertainty in South Africa, the sell-offs are in line with the US rates sell-off, despite the difference in progress in rate cutting and real rates being near extreme highs.

We are almost neutral in EM currencies, while long the US dollar and selective frontier market currencies. The delay in the Fed's easing cycle while EM central banks largely continue with their cutting cycles makes us more cautious towards this asset class.

We are underweight a large number of low-yielding currencies especially in Asia, and our long exposures are mostly in currencies with very high nominal yields and recent devaluations that reduce the risk of further devaluations such as Nigeria, Egypt and Turkey. We have selective exposure in other currencies such as the Mexican peso and Brazilian real.

Quant tactical scorecard

Fidelity Fixed Income quantitative scorecard

30 April 2024

Credit beta and asset allocation

	TOTAL	Macro-economics*	Sentiment	Valuation	Seasonality
USD investment grade credit	0.30		0.6	-0.1	-0.7
EUR investment grade credit	0.39		0.6	0.1	-0.7
USD high yield	0.29		0.5	0.1	-1.0
EUR high yield	0.30		0.5	0.1	-0.7
EMD sovereigns (USD)	0.34	1.0	0.5	-0.1	-0.7

Comments: The model remains long credit with sentiment continues to be strong. Seasonality turning bearish this month and reduced the conviction on USD HY and EUR HY.

*The developed markets do not follow the macro signal in this model

Asset allocation	TOTAL	Macro-economics	Fundamentals	Sentiment and liquidity	Valuation and reversion
Investment grade credit	0.57	0.3	0.3	0.6	0.7
High yield	0.23	0.3	-0.3	0.6	0.0
US loans	0.49	-0.3	-0.3	0.7	0.7
EM sovereign debt (USD)	0.30	0.3	0.0	0.6	0.0
EM local currency debt	0.55	0.3	0.0	0.2	1.0
EM corporate debt (USD)	0.17	0.3	1.0	0.8	-0.7

Comments: The model remains positive on taking credit risk. Fundamentals have weakened for High Yield and US loans.

Interest rates

Duration	TOTAL	Global Growth	CFTC	Commodity	Cyc vs. Def	Reversion (return)	Reversion (yield)	Global momentum	Slope	Seasonality
EUR	-0.36	-1.00	0.40	-0.50	0.67	0.00	0.88	-1.84	-0.65	-0.55
USD	-0.10	0.33	0.40	-0.50	0.67	1.00	1.18	-1.84	-0.54	-0.15
GBP	-0.12	-0.33	0.40	-0.50	0.67	1.00	0.95	-1.84	-0.35	0.17

Comments: The model added to its bearish rates view this month. A strong commodity rally in March added to inflation concerns, whilst seasonality is turning against Bund and Gilt. The model reduced its bearish rates view this month. The commodity signal has turned less bearish with oil coming off from its recent peak. Global bond momentum is near max short to reflect the view that cuts are getting pushed back. The cyclical vs defensive signal is currently positive on duration with the recent outperformance of defensive sectors vs their cyclical counterparts.

Cross-market duration	TOTAL (beta-neutral)	TOTAL	Slope	Real yield	Fair value	Growth	Inflation	Unemployment
AUD	0.00	0.13	-0.03	0.57	0.33	-0.13	0.10	-0.04
CAD	0.00	0.14	0.03	0.36	0.57	-0.10	-0.32	0.28
CHF	-0.14	-0.23	-0.26	-0.37	-0.80	0.10	0.23	-0.27
EUR	0.00	-0.26	-0.42	0.05	-0.66	0.19	-0.14	-0.54
GBP	0.13	0.16	0.24	0.30	0.42	0.14	0.03	-0.19
JPY	-0.24	-0.22	0.38	-1.48	-0.60	0.74	0.14	-0.53
NZD	0.08	0.31	0.38	0.45	0.47	-0.22	0.17	0.58
SEK	0.10	0.11	-0.10	0.13	-0.31	-0.29	0.31	0.90
USD	-0.13	-0.13	-0.22	0.00	0.58	-0.43	-0.52	-0.20

Comments: The model continues to be long in GBP/SEK and is short CHF/JPY. It closed out the EUR long and is now receiving NZD as a result of changes in the real yield, slope and fair value signals.

Quant tactical scorecard explained

Fidelity Fixed Income quantitative scorecard

Credit beta and asset allocation

Credit beta:

1. Sentiment: Technical indicators including trends in credit spreads
2. Valuation: Levels of spreads relative to history, expecting reversion to the mean
3. Seasonality: Indicator driven by historic returns in the corresponding period

Credit asset allocation:

1. Macro: Leading indicators including economic survey data
2. Fundamentals: Aggregated trend of single company forecasts for credit fundamentals
3. Sentiment and Liquidity: Technical indicators including trends in credit spreads
4. Valuation and Reversion: Deviation of spreads from their historic averages including adjustments for potential default losses and credit fundamentals

Directional duration:

1. Macro Future Activity Tracker: worsening economic outlooks are dovish, lead to lower rates.
2. CFTC: signal tracking the Treasury futures contract holdings of institutional investors.
3. Commodities momentum: a proxy for state of the economic cycle
4. Cyclical stocks outperformance: a proxy for economic optimism
5. Reversion (Return): deviation of price from their average historic value, expecting reversion to the mean
6. Reversion (Yield): deviation of yield from their average historic value, expecting reversion to the mean
7. Momentum: measures large moves in a single direction, taking advantage of autocorrelation of flows and returns
8. Slope of the yield curve: steep curves earn a higher risk premium
9. Seasonality: technical indicator driven by historic returns in the corresponding period

Cross market duration:

1. Slope of the yield curve: steep curves earn a higher risk premium
2. Real yield: yields adjusted for inflation, tend to revert to the mean
3. Fair value: forward yields adjusted for GDP trend, tend to revert to the mean
4. Growth forecast momentum: lower forecasts dovish, lead to lower rates
5. Inflation forecast momentum: lower forecasts dovish, lead to lower rates
6. Unemployment forecast momentum: lower forecasts are hawkish, lead to higher rates

TOTAL	1	Sentiment	2	Valuation	3	Seasonality
0.35		0.5		0.1		-0.7
0.17		0.4		0.1		-1.0
0.01		0.1		0.1		-0.7
0.17		0.2		0.1		0.0
0.17		0.5		0.1		-0.7

TOTAL	1	Macro-economics	2	Fundamentals	3	Sentiment and liquidity	4	Valuation and reversion
0.08		0.8		0.0		0.0		0.0
0.64		-1.6		0.5		1.5		0.5
0.75		-1.1		1.5		1.6		0.0
0.58		-0.9		1.5		1.6		-0.5
-0.34		-1.5		-1.5		-0.7		1.0
-0.07		-1.5		-0.3		-0.1		0.5
-0.09		-1.3		-0.5		-0.1		0.5

1	2	3	4	5	6	7	8	9
Global growth	CFT C	Commodity	Cyc vs. def	Reversion (return)	Reversion (yield)	Global momentum	Slope	Seasonality
0.46	1.42	-0.10	0.17	2.00	1.79	-1.84	-0.95	0.51
0.46	1.42	-0.10	0.17	2.00	1.28	-1.84	-0.69	0.14
0.46	1.42	-0.10	0.17	2.00	1.67	-1.84	0.09	0.07

1	2	3	4	5	6
Slope	Real yield	Forward yield	Growth	Inflation	Unemployment
-0.2	-0.1	-0.4	-1.1	-0.4	0.0
-1.3	0.5	0.4	0.4	-0.3	-0.2
1.0	0.1	0.5	0.4	-0.1	-0.5
0.8	-0.3	-0.1	0.6	-0.3	0.0
-0.6	0.4	0.3	-0.7	1.1	0.2
0.8	0.1	-0.2	0.3	-0.4	0.0
0.6	-0.6	-1.1	0.1	-0.1	0.1
0.3	-0.5	-0.4	0.5	0.5	0.1
-1.3	0.4	1.1	-0.6	0.0	0.2

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