

## Reasons to be cheerful (as a bond investor)

What an eventful year it has been. Then you remember we have just ended March. With financial markets having shown signs of stabilisation at times of late, it remains to be seen whether the worst of the recent downturn has passed, or if we have simply entered the eye of this particular storm. Looking beyond exactly “what happens next” for a moment, it seems as good a time as any to share a few thoughts on the bigger picture for global bond markets. After all, many investors will arrive at a crossroads in the coming weeks and months, faced with some challenging portfolio rebalancing and/or asset allocation decisions. On the bright side, we happen to think there are a few silver linings for investors to consider from a fixed income perspective.

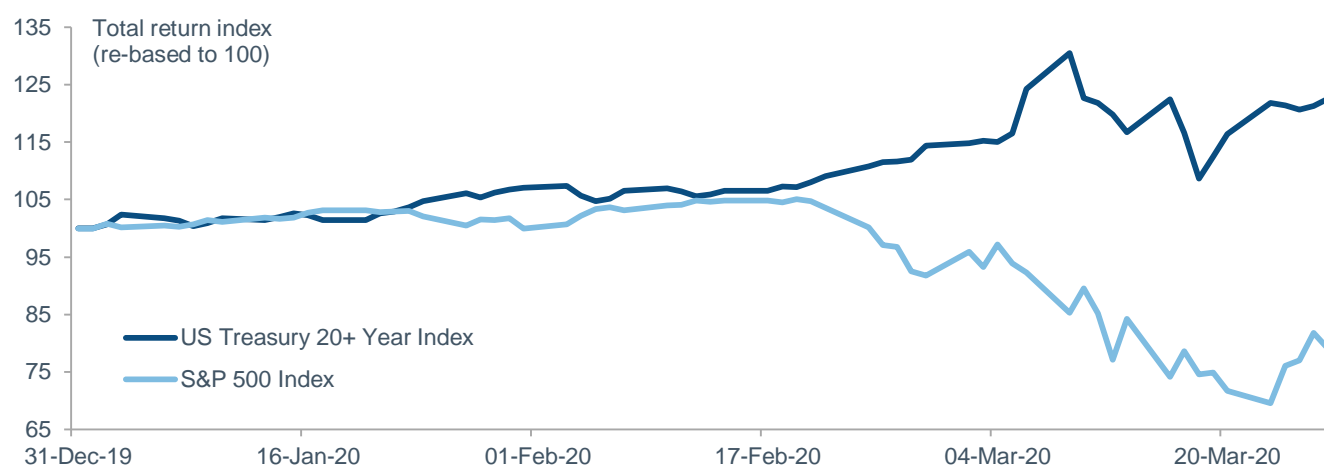
### High-quality bonds help dampen volatility

Many have pointed out that certain safe haven assets (most notably gold) did not behave quite as you would expect at the most intense phase of the recent market sell-off. While this might hold true on certain days, the good news for long-term investors is that gold is still among the best performing asset classes year-to-date and the US Dollar did not disappoint during said period. High-quality bonds have also played a crucial role year-to-date as part of a balanced portfolio.

As Chart 1 illustrates, long-dated US Treasuries have delivered a total return in excess of +20% since the turn of the year (the 7-10 year US Treasury Index has delivered +10%), while the S&P 500 Index is down around -20% over the equivalent period. High-quality corporate bonds may not have fared as well as government bonds in total return terms, but have nevertheless helped to cushion the fall from traditional risk assets. For context, at an index level, global investment grade credit has posted a mid-single digit negative total return year-to-date (-5.2%, in USD).

Put simply, if an investor had been fully invested from the start of the year in a diversified range of assets, the more high-quality bond exposure they had in their portfolio, the better they’d have performed on average. Hindsight is a wonderful thing of course. The important point here is that the traditional, core attributes of bond investing – namely being in a position to deliver a regular income stream, low volatility and diversification from equities – remain intact. With a huge amount of uncertainty on the horizon, we expect high-quality bonds and diversification more broadly to play a key role in investors’ portfolios going forward.

**Chart 1: Diversification benefit alive and well for long-term investors**



**Past performance is not a reliable indicator of future results. Returns may increase or decrease as a result of currency fluctuations.**

Source: Fidelity International, Bloomberg, as at 27 March 2020. Cumulative total returns are based on daily data in USD terms. See appendix table for 12 month rolling period returns.

## Opportunities in credit markets for active investors

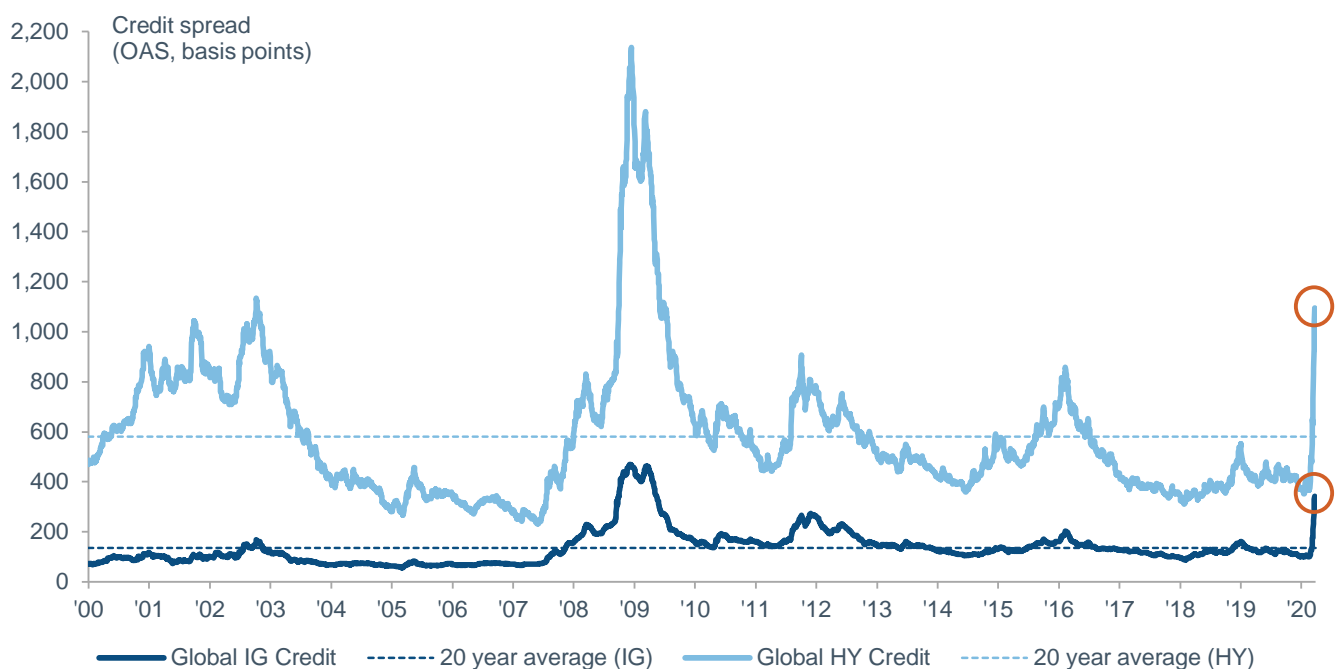
A “normal” recession playbook might have projected global investment grade (IG) and high yield (HY) credit spreads to widen by say 250 and 1,000 basis points respectively. Though a recession is on the cards, market moves in recent weeks can be described as anything but “normal”. Credit spreads widened to more eye-watering levels at their recent peak, particularly in IG which posted a wide of 341 basis points, while global HY spreads touched 1,094 basis points (see Chart 2). The rush to raise cash among cohorts of the investor community is believed to have further distorted valuations in credit markets, as well as other asset classes (including gold).

Though most of us were stuck indoors at the time, you could pretty much hear the collective sigh of relief from credit investors when central banks around the world announced they would be buying corporate bonds in tandem for the foreseeable future. In the US alone, the Primary Market Corporate Credit Facility (PMCCF) and Secondary Market Corporate Support Facility (SMCSF) could translate into \$200bn of IG corporate bond purchases before the end of Q3 2020. This will be front-end purchases too, sending a constructive message to existing/prospective holders of high-quality, short-duration USD IG credit.

However, despite what is a remarkably powerful backstop for credit markets, QE purchases do not necessarily represent a silver bullet. Downgrades and defaults are inevitable from here, with “fallen angels” expected to be a key theme in the coming months. Automotive and commodity-related sectors are expected to lead the way for downgrades from the credit rating agencies. The good news for bondholders is that debt servicing payments take priority on repayment of capital in any liquidation event, while share buybacks and dividends seem likely to be deferred or suspended by a number of companies. We also believe systemically important IG companies will receive the support they need from the authorities.

It is incredibly difficult to time the bottom and once we have, it may well take a while to realise the value emerging (as we saw back in 2009). But the silver lining of recent dislocations is that credit valuations are as optically attractive now as they have been at any time since the Global Financial Crisis. This presents a great opportunity for active bond managers to add exposure in selective names, regions and sectors. It is also an opportune time for active managers to re-assess issuers that look vulnerable to various economic and business risks, some of which may previously have been masked by broader market risk appetite and ample liquidity. On a one-to-three year view, the prospect of strong risk-adjusted returns from credit at these spread levels (and wider) is high based on historical experience. So, for investors looking to add risk in a more selective manner, corporate bonds seem a good place to start.

**Chart 2: Credit spreads reach their widest levels in a decade**



Source: Fidelity International, Bloomberg, ICE BofA Merrill Lynch, as at 27 March 2020. Chart data references ICE BofA Merrill Lynch indices: Global IG Credit = “GOBC Index”, Global HY Credit = “HW0C Index”.

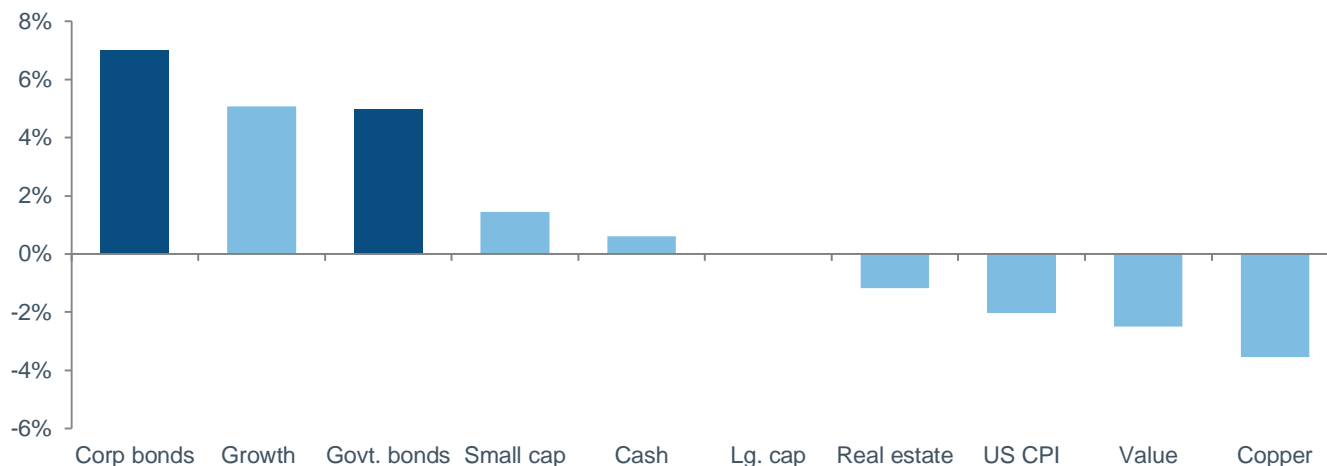
## Lower for longer and longer and longer ...

Following the deluge of recent action from central banks, both short and long-term interest rates are at their lowest levels in over 5,000 years (kudos to the Bank of England for scouring the archives!). With rates anchored for the foreseeable future and GDP expectations having nosedived, our long-held “lower for longer” thesis remains unchanged. Unprecedented worldwide fiscal stimulus does of course present a risk of higher government bond yields. So, why do we expect them to remain low? And why do we think any sell-off in yields might represent an opportunity for investors to add duration? 1) Yield curve control seems to be the next logical step for policymakers to implement, capping the extent to which yields might back-up. 2) An ever-increasing global debt burden means the global financial system is increasingly sensitive to changes in interest rates. 3) Japan’s experience suggests high government debt combined with low growth will keep yields low.

Japan will have other lessons for us when we emerge from this crisis, including the prospect of government bonds continuing to post positive, real returns from much lower starting yields. It is also worth noting that the low rate structure will be broadly negative for pensions, insurance companies and savers, which should have a positive spill over effect for higher yielding corporate bond markets in the medium to long-term. But focusing on the here and now, emergency rate cuts from the Federal Reserve have historically coincided with recessions and not been a welcome development for stocks in the 6 to 12 months following a cut. Government bonds on the other hand have tended to fare better during such periods.

For those with an extremely bearish view (sorry, we did mention this piece would carry a more positive tone), we could always look to the 1930s for a few pointers. The winners in a decade of economic depression and deflation were corporate bonds, followed by growth stocks and government bonds (see Chart 3). This would, however, represent a much more extreme scenario than is currently being priced by markets. We also find it difficult to ignore inflation hedges completely, as there is a chance the reflation trade gets some traction in the short-run.

**Chart 3: US asset class returns in the 1930s**



**Past performance is not a reliable indicator of future results. Returns may increase or decrease as a result of currency fluctuations.**

Source: BofA Global Research via: BofA Global Investment Strategy (“The Biggest Pictures”), report published 26 March 2020.

## Last but not least...

From a macroeconomic, general health and humanitarian perspective, there is still a lot we do not know about what’s to come and it would be naïve for us to suggest otherwise. Should the economic impact worsen, we do however think central banks will be ready to step in with even more QE and experimental policy measures. We also think there is a growing need to invest somewhere (given the excess savings glut and record low interest rates), but businesses and financial markets more broadly are facing a whole host of challenges in the short to medium-term.

So, as tempting as it has been in recent years for cohorts of the investor community to “underweight” fixed income at a portfolio level, we think there are good reasons to maintain and add to bond allocations at this juncture. Just keep in mind that not all bonds are created equal. For now, all that’s left to say is look after yourselves, and beyond that, look after your bond portfolios - there are reasons to be cheerful after all.

**Appendix table (Chart 1): 12 month rolling period, index total returns (%)**

	31.03.15 – 31.03.16	31.03.16 – 31.03.17	31.03.17 – 31.03.18	31.03.18 – 31.03.19	31.03.19 – 29.03.20*
US Treasury 20+ Year Index	+2.5%	-5.2%	+3.9%	+6.2%	+34.7%
S&P 500 Index	+1.8%	+17.2%	+14.0%	+9.5%	-8.6%

Source: Fidelity International, Bloomberg, as at 29 March 2020. \*Data to 29 March 2020, data for prior years taken over a full 12 month period to end of first quarter. Total returns are based on a daily time series in USD terms. S&P 500 Index (dividends reinvested in the index). Past performance is not a reliable indicator of future results. Returns may increase or decrease as a result of currency fluctuations.

**Important Information:**

- 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.
- Investors should note that the views expressed may no longer be current and may have already been acted upon.
- Past performance is not a reliable indicator of future returns.
- Investments in emerging markets can be more volatile than other more developed markets.
- There is a risk that the issuers of bonds may not be able to repay the money they have borrowed or make interest payments. When interest rates rise, bonds may fall in value. Rising interest rates may cause the value of your investment to fall.
- 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.
- Fixed income funds do not offer any guarantee or protection with respect to return, capital preservation, stable net asset value or volatility.

**Disclaimer:**

This information must not be reproduced or circulated without prior permission.

Fidelity only offers information on products and services and does not provide investment advice based on individual circumstances, other than when specifically stipulated by an appropriately authorised firm, in a formal communication with the client.

Fidelity International refers to the group of companies which form the global investment management organisation that provides information on products and services in designated jurisdictions outside of North America. This communication is not directed at, and must not be acted upon by persons inside the United States and is otherwise only directed at persons residing in jurisdictions where the relevant funds are authorised for distribution or where no such authorisation is required.

Unless otherwise stated all products and services are provided by Fidelity International, and all views expressed are those of Fidelity International. Fidelity, Fidelity International, the Fidelity International logo and F symbol are registered trademarks of FIL Limited.

Third party trademark, copyright and other intellectual property rights are and remain the property of their respective owners.

**Europe:** Issued by FIL Pensions Management (authorised and regulated by the Financial Conduct Authority in UK) / FIL (Luxembourg) S.A., authorised and supervised by the CSSF (Commission de Surveillance du Secteur Financier) / FIL Investment Switzerland AG / FIL Gestion, authorised and supervised by the AMF (Autorité des Marchés Financiers) N°GP03-004, 21 Avenue Kléber, 75016 Paris. For German Wholesale clients issued by FIL Investments Services GmbH, Kastanienhöhe 1, 61476 Kronberg im Taunus. For German Institutional clients issued by FIL (Luxembourg) S.A., 2a, rue Albert Borschette BP 2174 L-1021 Luxembourg. For German Pension clients issued by FIL Finance Services GmbH, Kastanienhöhe 1, 61476 Kronberg im Taunus.