June 2022

Fixed Income Monthly

For Investment Professionals Only

Fidelity INTERNATIONAL

Executive Summary

This year has been a difficult environment for risk assets driven by central bank rhetoric and action, which has tightened financial conditions in order to dampen inflation expectations. But it's important not to automatically extrapolate the current environment into the future. Economic conditions can and do change, and we may see both growth and monetary policy shift sooner than the market expects.

Central banks rarely succeed in tightening monetary policy without triggering an economic downturn. At present, markets expect lofty increases of 150-250 basis points in benchmark interest rates in the US, Europe, and the UK over the coming 12 months.

The major central banks have talked tough on inflation in recent months having been too casual in their response last year. To ensure their credibility and bring inflation under control they are under considerable pressure to follow through, and this could spell further sell offs in equities and widening of credit spreads.

However, the stress on the economy could be greater than many think. Financial conditions are tightening rapidly, and liquidity is draining out of the system, and this is just as Fed quantitative tightening is starting. There's a real possibility that the major central banks will have to abandon their tightening trajectories prematurely given the fiscal cliff, powerful base effects, a significant loosening of the labour market, and thawing supply chain issues. If that's the case, the narrative in the market could shift abruptly and wrong foot investors.

The risk of further asset price dislocation is skewed to the downside and credit markets are still under-pricing corporate defaults that would quickly rise in a recessionary environment. For example, the 1-year implied default risk for USD high yield is approximately 2.5% - this seems far too optimistic in a rising rate and slowing growth backdrop. As recession risks grow, we're likely to see duration perform well and it could make sense to gradually increase exposure to US Treasuries.

Capital preservation in a climate of heightened uncertainty is essential, however, when monetary policy and the market narrative change eventually, there could be exceptional returns available.

Steve Ellis
Global CIO Fixed Income

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Important Information

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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: Fixed income funds invest in bonds whose price 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: Some fixed income funds may invest in overseas markets. 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: Fund investing in emerging markets can be more volatile than other more developed markets.

Derivatives: Some fixed income funds 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. The fund may be exposed 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.

Other: Fidelity Funds do not offer any guarantee or protection with respect to return, capital preservation, stable net asset value or volatility. 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.

Strategy Summary

The FIXED INCOME MONTHLY provides a forward-looking summary of the medium-term views from the Fidelity 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 within a fund and the views shared below. 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 in a fund.

Rates	– –	–	=	+	++
Duration			→	●	
UST Rates			→	●	
EUR Rates - Core			→	●	
EUR Rates - Periphery		●			
GBP Rates			→	●	

Main views

- Moving to overweight US duration from a flat position with the Fed likely to hike less than currently expected by the market.
- Moving to an overweight position in European core duration. Rhetoric is hawkish, but headwinds to growth mean that the ECB may struggle to raise rates as much as expected. Maintain underweight European peripheral government bonds.
- Moving overweight UK Gilts as market appears to be under-pricing recession risk.

Inflation	– –	–	=	+	++
Breakeven Inflation				●	
IL – USD				●	
IL – EUR			●		
IL – GBP				●	
IL – JPY			●		

- Retaining our overweight overall to breakevens as we believe global inflation expectations will move higher in the short run.
- Overweight US breakevens and moved to an overweight in US real duration given real yields are in positive territory and look attractive.
- Neutral EU breakevens and long real duration on the back of downside real growth risks in Europe.
- Overweight UK breakevens, with energy prices likely to drive UK inflation higher still.

Investment Grade Credit	– –	–	=	+	++
Investment Grade Credit Beta				●	
USD IG			●		
EUR IG					●
GBP IG			→	●	
Asian IG (USD)			●		

- Valuations remain very attractive across EUR IG markets, leading to our strategic bullish view on the asset class.
- We maintain a neutral outlook on US IG.
- We are slightly more positive on Sterling IG due to fiscal stimulus and cheaper valuations.
- We remain constructive on China and expect further policy support while we maintain a neutral stance on Asia IG overall.

Financial and Corporate Hybrids	– –	–	=	+	++
Financial and Corporate Hybrids			→	●	
Contingent Convertibles			→	●	
Investment Grade Corporate Hybrids				●	

- Moving to overweight in contingent convertibles on the back of cheapening valuations and attractive entry points
- Overweight corporate hybrids on the back of more attractive levels and higher incentives to call. New issue premia emerging too.

High Yield	– –	–	=	+	++
High Yield Credit Beta			●		
US High Yield		●			
European High Yield		●			
Asian High Yield				●	

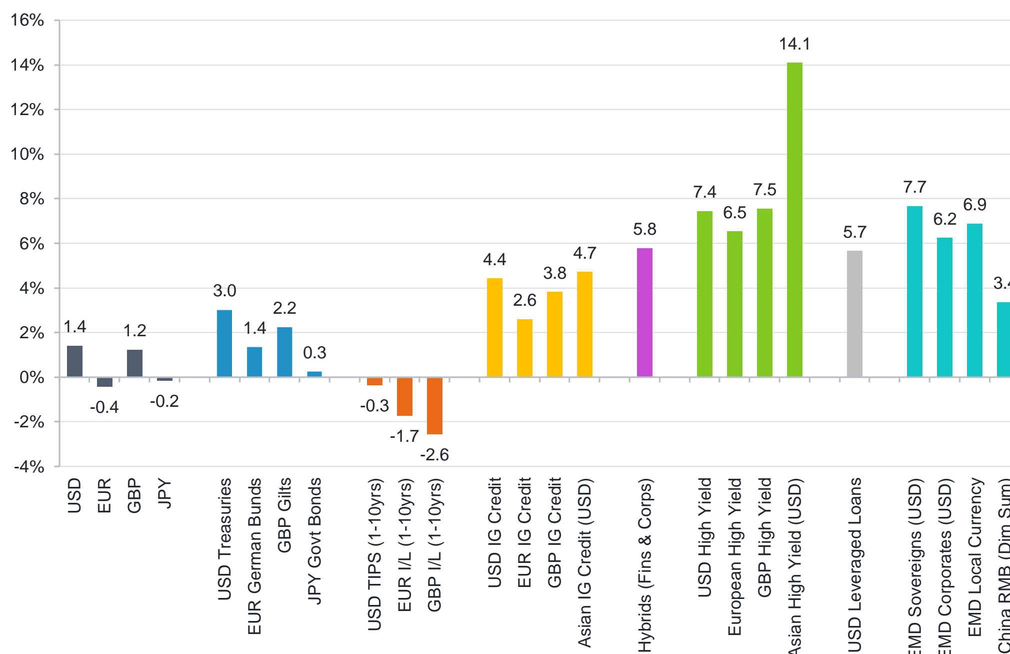
- We maintain a positive stance on Asia HY, on the back of attractive valuations.
- Retain a negative view on US HY, amid a deteriorating macro backdrop, tightening real rates and valuations not pricing recession.
- We remain cautious on geopolitics in Europe, and therefore keep a negative view on European HY.

Emerging Markets	– –	–	=	+	++
EM Hard Currency Sovereign Debt				●	
EM Hard Currency Corporate Debt				●	
EM Local Currency Duration				●	
EM FX		●			
China RMB Debt			●		

- Fundamentals are deteriorating and outflows from the asset class have been persistent. But valuations have adjusted significantly; we remain slightly overweight credit risk.
- EM FX may see further downside from a risk-off market and hawkish Fed.
- We are still overweight local currency duration after many EM central banks hiked policy rates last year.

Yields across fixed income asset classes

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



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

Source: Fidelity International, Bloomberg, JPM and ICE BofA Merrill Lynch bond indices. 8 June 2022. Shows 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 other asset classes. The Yield to Maturity (also known as the Redemption Yield) is the anticipated return on a bond / fund expressed as an annual rate based on price / market value as at date shown, coupon rate and time to maturity. The redemption yield is gross of any charges and tax. Yield to Worst: is the lowest potential yield that can be received on a bond considering all potential call dates prior to maturity. Hybrids universe defined as 50% Corporate Hybrids and 50% Financial Hybrids indices.

Summary of returns as at 31 May 2022 (%)

Government	1 Month	YTD	2021	2020	2019	2018
US Treasuries	0.1	-8.5	-2.4	8.2	7.0	0.8
EUR Bunds	-1.7	-9.6	-2.6	3.0	3.1	2.4
UK Gilts	-3.1	-13.1	-5.3	8.8	7.3	0.5
Inflation Linked						
USD	-1.2	-6.3	6.0	11.5	8.8	-1.5
EUR	-3.4	-2.8	6.2	3.1	6.0	-1.4
GBP	-7.9	-18.9	3.9	11.3	6.5	-0.3
Investment Grade Corporate						
USD	0.5	-11.9	-1.0	9.8	14.2	-2.3
EUR	-1.3	-9.1	-1.0	2.6	6.3	-1.1
GBP	-1.6	-11.3	-3.0	8.7	10.8	-2.0
Asian Dollar	0.2	-8.3	0.0	7.6	11.5	-0.1
Financial and Corporate Hybrids						
Contingent Convertibles	0.1	-8.7	4.7	6.8	17.6	-3.7
Investment Grade Corporate Hybrids	-0.5	-8.7	1.4	3.8	14.2	-4.6
High Yield						
US	0.3	-7.8	5.4	6.2	14.4	-2.3
European	-1.1	-11.2	3.3	3.6	13.8	-3.9
Asia	-3.4	-14.7	-6.2	8.4	13.2	-3.3
Emerging Markets						
EM USD Sovereigns	0.0	-15.0	-1.8	5.3	15.0	-4.3
EM USD Corporates	-0.6	-11.2	0.9	7.1	13.1	-1.6
EM Local Currency (USD unhedged)	1.8	-10.5	-8.7	2.7	13.5	-6.2
China RMB	0.6	0.7	3.2	3.7	5.6	5.2

Past performance is not a reliable indicator of future results. The value of investments and the income from them can go down as well as up so you may get back less than the amount originally invested. Source: Fidelity International, ICE, Datastream, 31 May 2022. Total Returns based off JPM and ICE BofA Merrill Lynch bond indices as of 31 May 2022. Custom index used for Asia High Yield (ICE BofA Merrill Lynch Q490 Index).

Macro and Rates Overview

Monthly Review

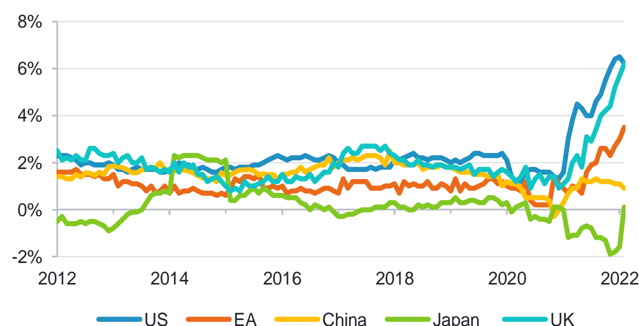
- Quantitative tightening in the US began at the start of June against a background of resurgent volatility, with initial monthly caps of $30bn and $17.5bn for Treasuries and MBS respectively.
- The US economy continues to add jobs at a robust pace, and this will fuel the argument for a 50bp hike at the September FOMC meeting, which is likely to remain the policy hot spot throughout the summer.
- Eurozone inflation reached a record 8.1% in May, some 30bps above consensus, adding to pressure on the ECB to normalise policy.

Strategy	– –	–	=	+	++
Duration			→	●	
UST Rates			→	●	
EUR Core			→	●	
EUR Periphery		●			
GBP Rates			→	●	

Outlook

The war in Ukraine and China's zero Covid policy (ZCP) are sending shockwaves to the rest of the world through commodity markets, supply chains, confidence and financial channels, further amplifying the stagflationary dynamics (rising inflation and slowing growth) that have gripped the world for the last few months. The probability of a recession in Europe is rising and a European recession is our base case. Despite severe supply side issues, major central banks are determined to bring inflation down by aggressively tightening policy. This is bound to cause further damage to an already shaky growth outlook, including in the US.

Global inflation still elevated - core CPI rates (yoy)

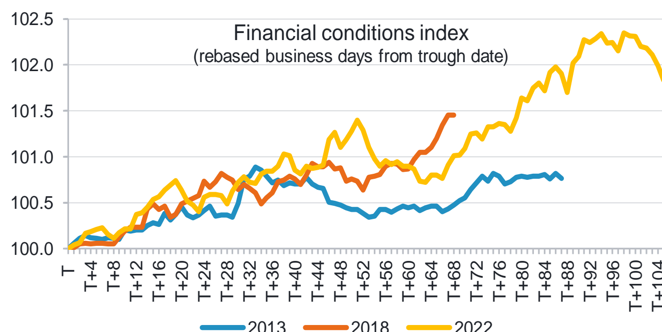


Source: Fidelity International, Haver Analytics, June 2022.

While some moderation of growth is desirable for inflation-targeting central banks, achieving the right mix of growth and inflation – tightening policy just enough to bring inflation back to target while keeping growth around potential – is a tricky balancing act. Even US Treasury Secretary and former Fed chair Janet Yellen recently noted that the Fed will need to be "skilful" and "also lucky" to guide the economy to a soft landing. Ultimately, the Fed underestimated the inflationary forces in the system and has had to change gears aggressively to ensure that inflation expectations do not become dangerously de-anchored.

Following the start of the war in Ukraine and its deeply inflationary nature, particularly for Europe, central banks have been aggressive and financial conditions have tightened substantially. As a result, we believe the stagflationary dynamics in the economy are peaking. We are therefore shifting our attention to the transition out of stagflation and into the next phase of the cycle where recession risks intensify. For the US, we see a higher probability of a hard landing compared to a soft one at this stage.

Financial conditions have tightened considerably more than recent cycles



Source: Fidelity international, Bloomberg, June 2022. Note: Time T is the FCI trough date in tightening cycle for 2013 and 2018, for 2022 time T is the 31/12/2021. The X axis represents the number of business days from time T.

Analysts in the market have a range of views about whether inflation has peaked, indicating the pervading level of uncertainty. The market is also increasingly focussing on growth concerns and, in this environment of pessimism, if there are further elevated inflation prints, we could test the recent highs in treasury yields. However, given the moves higher in 10-year US treasury yields this year, it is difficult to see them rise materially from here and break into new highs. As a result, we are gradually starting to favour a long position having been flat on US rates.

In May, Eurozone inflation reached a record 8.1%, some 30 basis points above expectations, and commentary around the ECB is now very hawkish with the central bank echoing the rhetoric of its US counterpart. If inflation proves persistent, the ECB may feel compelled to force a recession to curb price increases. However, given the headwinds to growth already in view, the central bank could struggle to raise rates by any substantial degree above 50 basis points - the market's pricing of the ECB's terminal rate of around 1.9%, which is in the upper end of the 1-2% range discussed by ECB officials, appears very ambitious. A U-turn in central bank tone wouldn't be unusual, and we note that the Bank of England, which was one of the more hawkish major central banks at the turn of the year, has turned somewhat more dovish recently following concerns around growth.

In core Euro we are overweight but we remain underweight peripheral debt for the time being because of diminishing central bank support and more fiscal spending as a result of Russia's invasion of Ukraine, which both act as headwinds to government spreads. In UK rates we move overweight as the genuine risk of recession seems to be under-priced.

Inflation-Linked Bonds

Monthly Review

- Global 10-year breakevens narrowed over the month, weighing down the asset class from an inflation risk perspective.
- The eurozone's inflation rose to 8.1% in May, driven by a persistent surge in food and energy prices.
- The inflation rate in the US slowed to 8.3% in April from 8.5% in March, while the Personal Consumption Expenditures (PCE) price index rose by 6.3% in April. The ease in inflation level was prompted by a fall in gasoline and used cars prices.

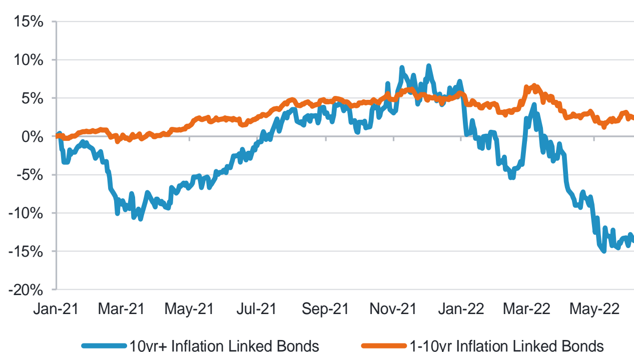
Strategy	– –	–	=	+	++
Breakeven Inflation				●	
IL – USD				●	
IL – EUR			●		
IL – GBP				●	
IL – JPY			●		

Outlook

Breakeven rates across developed market fell during May. Risk assets came under pressure as the market narrative shifted slightly from inflation to lower growth, thus weighing on inflation expectations. Nominal and real yields rose over the period, but real yields rose more than nominals yields. Inflation levels remain elevated with headline rates in US, UK and Euro Area reaching +8.3%, +11.1% and +8.1% year-on-year (YoY) respectively.

For investors concerned about stagflation risks we think inflation linked bonds offer attractive properties from here offering an inflation hedge and a hedge against a drop in real growth. We continue to prefer a lower duration approach to accessing the asset class focusing on the 1-10yr segment of the market. Valuations have also improved for developed market linkers and we see upside potential in breakevens with real duration looking attractive as real yields have marched ever higher.

We retain a preference for 1-10yr inflation linked bonds over longer dated linkers

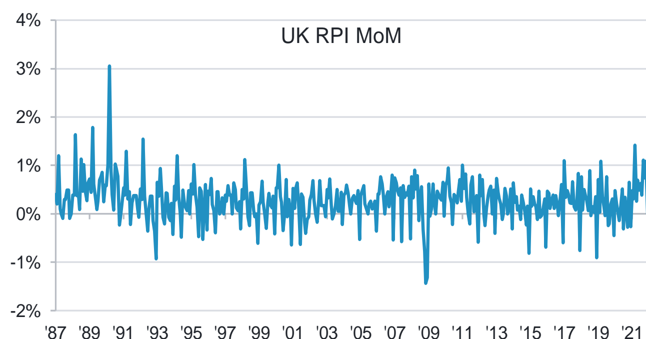


Source: Fidelity International, Bloomberg, June 2022.

In the US, headline CPI saw an increase of +0.3% month-on-month (MoM) in April, while core inflation rose +0.6% MoM, taking the YoY rate to +8.3%. As we suspected, March seems to be the peak for YoY US inflation in 2022 (+8.5% YoY) as base effects started to weigh down on the index (such as via the impact from used cars and trucks). Shelter, food, airline fares and new vehicles contributed the most to the MoM increase. Food prices rose by +10.8% which was their largest YoY gain since November 1980. We expect US inflation to continue moderating from current elevated levels as the negative base impacts from large positive MoM gains in 2021 roll out of the 12-month rate. The key questions remain twofold: "how fast will this moderation be?" and "where will inflation settle in the long term?". Through base impacts we know US inflation will likely settle around 5% by year end 2022, but the move from 5% down to the Fed's 2% target (albeit that target being core PCE, and we're discussing CPI) is more difficult to predict. Ultimately, there are a few factors that make us think that the second move could take longer than expected and we think US inflation will settle at a level higher than pre-Covid. Firstly, the shelter component of CPI continues to show strength and wages remain robust which should continue to support housing. Medium to longer-term factors such as deglobalisation (exacerbated by Russia's war in Ukraine), ageing populations and the need to de-carbonise the economy also support a slightly higher inflation outlook ahead.

In terms of positioning, we maintain a constructive stance on US breakevens but given we expect the inflation data to continue moderating through to year end, our view is becoming less bullish. We moved to a long position in US real yields over the month as 10yr US TIPS yields look attractive at current levels (+0.2%) and given some of the downside risks to real growth.

UK prices rise at fast monthly pace in April



Source: Fidelity International, Bloomberg, June 2022.

In the UK, headline RPI (which is what index linked Gilts are referenced to for inflation uplift purposes) marched higher to +11.1% YoY while CPIH (the ONS's preferred measured) also rose to +7.8% YoY. The MoM increase in RPI of +3.4% was the largest monthly increase since the index began tracking MoM gain in 1987. As we highlighted last month, Ofgem increased the cap energy suppliers can charge UK households and this increase came into effect in April thus impacting positively impacting the inflation release. Unsurprisingly, the largest positive contributors to the YoY increase in the inflation rate for April came from housing and household services (predominantly from electricity, gas and other fuels, and owner occupiers' housing costs). We expect UK inflation to remain elevated for 2022 with another cap increase from Ofgem due in October. Accordingly, we maintain an overweight stance in UK breakevens despite valuations looking somewhat stretched.

Euro Area inflation also marched higher and hit a new all-time high in May to +8.1% YoY (up from +7.5% in April). Energy price pressures were a major contributor to the MoM rate given higher oil prices and the on-going pass through from the electricity and gas while food prices also contributed positively. Despite weakening demand due to real incomes being squeezed from high inflation over wages, non-energy industrial goods' prices rose as input cost driven momentum continued. We maintain a long position in Euro real duration. Europe is quite heavily impacted from the energy crisis sparked by the war in Ukraine and real growth could be significantly impacted should the EU place an embargo on Russian energy.

Investment Grade Credit

Monthly Review

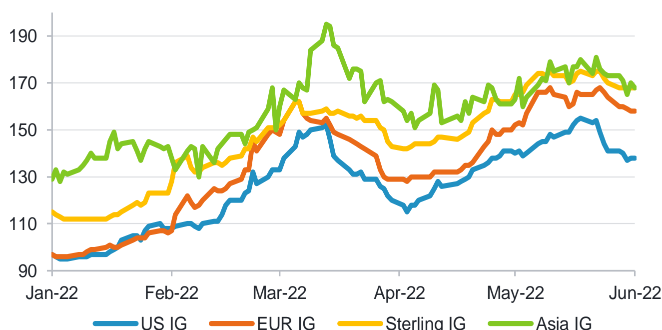
- Investment Grade (IG) credit spreads widened in May as the market began to price global recession and growth risks.
- Returns were mixed across markets with US and Asia IG posting absolute positive returns and Euro and Sterling IG continuing drawdowns.
- Euro IG valuations are at their cheapest level across the IG asset class on a relative basis, offering a sufficient spread cushion and room for outperformance compared to other regions.

Strategy	– –	–	=	+	++
IG Credit Beta				●	
USD IG			●		
EUR IG					●
GBP IG			→	●	
Asian IG (USD)			●		

Outlook

The month of May affected Investment Grade (IG) credit spreads differently across the regions as the market began to shift more towards fundamental concerns around global recession and growth risks. This was particularly evident in the decline of long end US Treasury yields as well as the underperformance of High Yield in comparison to Investment Grade, which was a reversal of the trend we could observe earlier in the year. The change in positioning and the demand in safer assets was also evident in the wide gap between AAA-A and BBB credit spreads which continued to widen across all asset classes this month. Nevertheless, absolute returns have been very different across all asset classes within IG, despite the continuous global widening of IG credit spreads.

Global IG credit spreads

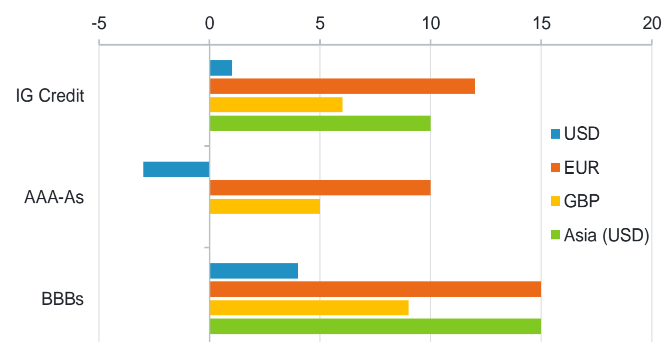


Source: Fidelity International, Bloomberg. 3 June 2022.

Sentiment worsened in Europe over May as markets further priced in high inflation prints and hawkish ECB rhetoric, both leading towards an increased risk of a recession in the region. Euro IG spreads widened by 12bps over May, taking the index level to 160bps at month end. Absolute returns were negative at -1.3% for the month, prolonging the continued drawdown seen in Euro IG credit markets. Despite the recent performance, yields in Euro IG have now risen to levels not seen since 2019, therefore, we continue to consider this as a good buying opportunity for credit. However, we put a strong emphasis on high-quality credit, such as A-rated companies, Banks and Industrials as well as German corporates, all which have features that should be able to withstand the effects of a potential recession.

In the US, IG spreads widened only marginally, and the asset class posted an absolute positive return of +0.5% in May. US labour market data surprised to the upside, however, the current market sentiment remains mixed as inflation continuous to stay persistently high (8.3% YoY in April vs its highest point in 2022 of 8.5% in March). We acknowledge that the inflation second derivative is slowing, but as of now, there are no clear signs of the required sustained slowdown. US IG valuations remain relatively attractive from a fundamental perspective as leverage for high quality issuers has come down. However, assessing the bigger picture of the US IG credit market and its aforementioned risks on a relative basis, warrants a cautious approach for now, therefore, our view remains unchanged in US IG credit for now.

IG Credit Spread changes over May



Source: Fidelity International, Bloomberg. 31 May 2022.

Meanwhile Sterling IG posted the highest absolute negative return of -1.6% on a relative basis this month as credit spreads widened by 6bps. Despite the fall in Gilt yields at the front end of the curve following the much weaker than expected PMI print, the longer dated yields rose over most of the month leading to an underperformance of the asset class. The weak PMI print also affected Sterling IG credit spreads negatively as uncertainty around economic growth further materialised. This was particularly observable as BBB credit spreads widened by 9bps while AAA-A rated credit spreads widened by 5bps. A positive counter to the recent market move could be the £15bn in fiscal support announced by the chancellor last week which should boost economic growth over the coming quarters. On the back of the recent announcement of the fiscal stimulus as well as current valuations and attractive yield levels, we have changed our outlook to positive for now.

Asia IG finished the month of May in marginal positive territory in absolute terms of +0.1%, despite the +10bps widening in IG credit spreads. Supply chain disruptions remain a key factor of concern across the region, with labour shortage adding further to the increased complexity of global supply chains. On a positive note, China lifted lockdowns and shifted towards mass testing to ensure less disruptions to economic activity. We also acknowledge that Asia remains in a better position to defend itself against the economic impact of the Russia-Ukraine war, nevertheless, we consider it unlikely that Asia will be able to fully able to escape the effects of rates differentials, weakening demand and concerns around liquidity. Hence, our view on Asia IG remains unchanged for now, and we maintain a neutral stance.

High Yield

Monthly Review

- High Yield (HY) bonds posted negative returns as spreads widened over the period, in the face of recessionary fears and tightening liquidity conditions by central banks.
- It was further impacted by soaring inflation, firming the case for the ECB to hike its interest rates.
- Asian HY markets faced yet another volatile month driven by China's zero Covid policy leading to weaker external demands and continued downward pressure on the property sector.

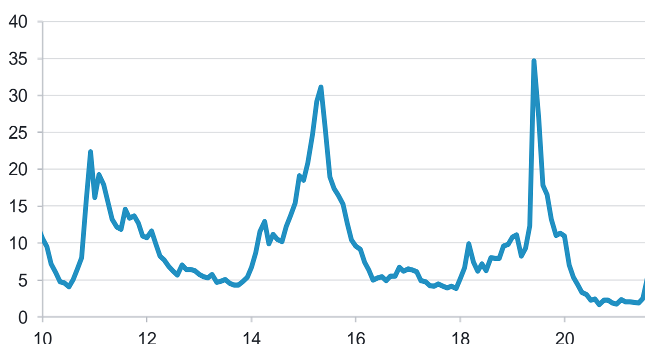
Strategy	– –	–	=	+	++
High Yield Credit Beta			●		
US High Yield		●			
European High Yield		●			
Asian High Yield				●	

Outlook

Global HY returned -0.4% in May (in local currency terms), continuing the total negative return trend for a fifth consecutive month, with spreads widening by 28bps on the month. HY performance over May was V-shaped, with initial underperformance leading to a fast bear market rally. The first half of the month was dominated by the same drivers that have moved markets YTD, panic around aggressive central bank hiking and recessionary fears which finally led to some pick up in dispersion measures which have been subdued for months. That quickly reversed, due to prevailing bearish sentiment, reduction in rate volatility and more attractive valuations luring investors back into the asset class. Even though the risk-reward proposition of the asset class has improved materially for intermediate horizon investors in the face of improved valuations, we maintain a neutral stance as we believe spreads have room to widen from here in order to appropriately discount a recessionary macro environment.

Turning to US HY, we saw a total return figure of 0.3% for the month of May, the only regional HY market to post positive returns, after selling off significantly in the first half of the month. This was mainly led by the rally in US Treasuries, as the latest Fed meeting minutes proved to be less hawkish than expected, even hinting that rate hikes could pause after the summer. This coincided with economic data on the US suggesting that fears around recession might be overdone, which led to a relentless credit spread rally and improved investor sentiment. BB paper rallied a lot more than lower quality names, and as a result we saw an uptick in distressed credits, which doubled over May (see below), something we have been expecting for a while given the state of the credit cycle. This was not enough to significantly move the new issue market however, which is having one of its most disappointing years, with total supply equalling ~$55bn YTD and a lot of deals performing poorly. We maintain an underweight stance given growth concerns, and potential negative technical market dynamics in June, especially post the squeeze we experienced over May.

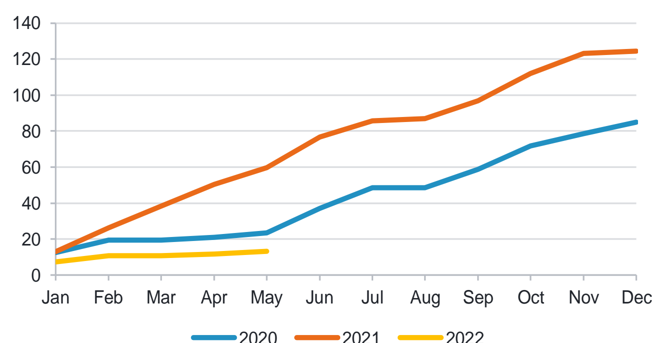
US HY distress picking up after a long time



Source: Fidelity International, ICE BofA Indices, May 2022.

EHY returned -1.2% over May, with spreads widening by 20 bps. European macro and geopolitical vulnerabilities continue to affect the asset class, which posted its 5th consecutive negative return month, something we have only experienced twice in this decade. Fundamentals are not showing any signs of concern, yet, with default rates remaining low and earnings not been hit for most companies. Technicals remain balanced, with flows for the asset class remaining muted while the new issuance market continuing to disappoint (see below). On the valuation front things are a bit more upbeat, with more attractive yield levels and quality (default-remote) names promising decent returns over the medium term. Even though European HY has sold off significantly more relative to US HY, we remain underweight as Europe is particularly vulnerable due to its geographic proximity to Russia and therefore a much more certain recession, while tightening financial conditions and draining liquidity in the system are unlikely to provide a cushion to HY spreads in the near-term future.

Supply has been almost non-existent in 2022



Source: Fidelity International, Credit Suisse, May 2022. HY issuance EUR & GBP (in EUR bn)

Asia HY saw -3.7% in total returns for the month of May, whilst spreads widening by 47bps on the month. The market has experienced severe correction and price drawdown since last May, and whether that continues heavily depends on how seamless the development of multiple restructurings on the property sector in China turns out to be. Economic policies by the Chinese government are being watched closely, as Covid cases seem to be coming down, and zero Covid approach is being refined. Technicals for the asset class remain poor with liquidity fragmented. That said we remain constructive on Asian High Yield on improved valuations across ex-China space with the timeline still very much being focused on longer-term horizon. This is further reinforced by fundamentals from the largest constituent bottoming out, as well as the extremely poor technical backdrop that could set things up for a rebound when inflationary pressures subside down meaningfully, and general macro backdrop improves.

Emerging Markets

Monthly Review

- Emerging market debt posted mixed returns with local currency bonds outperforming hard currency bonds.
- While credit spreads widened over the month, lowering of US treasury yields supported returns.
- Emerging market local currency bonds posted positive returns supported by currency returns.

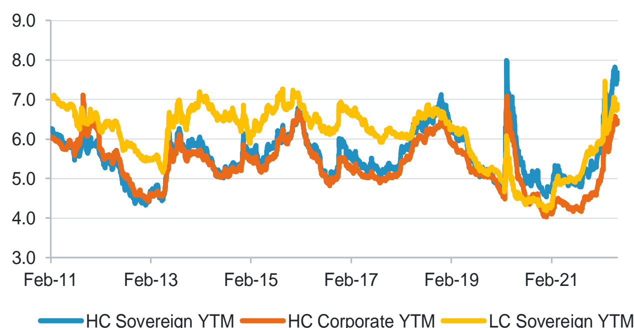
Strategy	– –	–	=	+	++
Hard Currency Sovereign				●	
Hard Currency Corporates				●	
Local Currency Duration				→	●
EM FX			→	●	
China RMB			●		

Outlook

Emerging market debt posted mixed returns in May with local currency bonds outperforming hard currency bonds. While credit spreads widened over the month, falling US treasury yields supported hard currency bond returns. Negative sentiment around the ongoing war in Ukraine coupled with fears over the growth and inflation outlook continued to weigh on spreads. But US yields fell as the market shifted from focusing on high inflation prints to the prospect for lower growth and possible recession - this provided some tailwind for a long duration asset class like emerging market credit. Local currency bonds posted positive returns supported by currency returns and some stabilisation of yields. While fundamentals are still challenged, the technical and valuation picture has improved significantly over the last two months with yields near the top end of the long-term range.

In hard currency debt, we still maintain an overweight stance, but are likely to use any rallies over the summer to take down credit risk in some areas. Fundamental risks include tightening US dollar liquidity, slowing growth and a weak Chinese economy after lockdowns in Shanghai and Beijing. But yields on hard currency bonds reflect a lot of this risk which has undoubtedly brought some value back into the asset class. On the technical side, we've just seen the first week of inflows into hard currency bond funds across the industry after a long period of persistent outflows. Taking all this together, we still prefer to be overweight, as the valuation and technicals are more supportive despite some fundamental challenges. Within the strategy, our positioning remains concentrated in high yield names with some exposure to distressed credits as well. We maintain our conviction in Chinese property names where we expect stimulus to be targeted for the rest of the year. Other key names like Colombia and Egypt are held given high political risk premia and IMF support respectively.

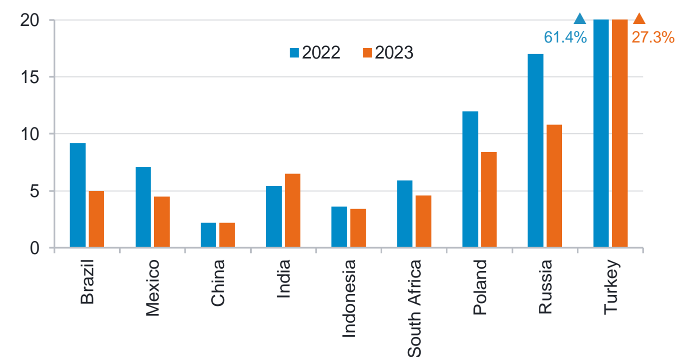
Yields are at multi-year highs setting aside the short lived Covid spike



Source: Fidelity International, Bloomberg, JP Morgan. As of May 2022.

We are now slightly overweight in EM currencies, having taken our EMFX beta up during the last few weeks, mostly through reducing underweights and also adding some overweights like the Brazilian real and Hungarian forint. This position is tactical, as our conviction on being long EM FX risk remains much lower than EM rates as the environment for global growth remains extremely challenging. Most EM currencies have been hit very hard since the end of March despite many of them experiencing hugely positive terms of trade shocks lately, along with improvements in their Balance of Payment dynamics from the commodities boom. Equally, the US dollar has soared to multi year highs while survey evidence suggests that long positioning is at record highs on the greenback. All of this comes at a time when US yields, US growth expectations and the US data surprise indices appear to be peaking relative to the rest of the world. With the market narrative shifting from "Fed fears" to "growth fears" we think this opens a window for some near-term relief from the US dollar strength, which often helps to stabilise EM sentiment. Our longer-term outlook for EM currencies remains more cautious.

EM CPI forecasts (%)



Source: Fidelity International, Bloomberg. As of 6 June 2022.

On local rates markets, we are now overweight duration with a large curve flattening bias. Our risk is concentrated mostly in three particularly markets, namely the long-end of Brazil, Mexico and Uganda along with some smaller exposures to other countries. Brazil and Mexico are at quite advanced stages of the tightening cycle, have sizable ex-ante real yields and we think we are close to the peak of inflation. Uganda is quite different, as it is an uncorrelated market which offers very high nominal and real yields, light offshore positioning and some FX stability for now.

Quant Appendix

Fidelity Fixed Income Quantitative Scorecard

6th May 2022

Credit Beta & Asset Allocation

Credit Beta	TOTAL	Macro-economics	Sentiment	Valuation	Seasonality
USD Investment Grade Credit	0.00	0.4	-0.7	0.6	-1.0
EUR Investment Grade Credit	0.06	0.4	-0.5	0.6	-1.0
USD High Yield	0.00	0.4	-0.7	0.6	-1.0
EUR High Yield	0.00	0.4	-0.7	0.6	-1.0
EMD Sovereigns (USD)	-0.13	-1.0	-0.5	0.6	-1.0

Comments:

The model turned marginally more bullish this month. The main themes are improved sentiment in IG and improved seasonality in EUR credit. The macro backtdrop remains unfavourable for EMD sovereigns so the model retains its small short position in that asset class.

Asset Allocation	TOTAL	Macro-economics	Fundamentals	Sentiment and Liquidity	Valuation and Reversion
Investment Grade Credit	0.25	0.3	-0.3	0.3	0.3
High Yield	-0.14	0.3	-0.3	0.0	-0.3
US Loans	0.10	0.3	0.3	0.1	0.0
EM Sovereign Debt (USD)	0.42	1.0	0.0	0.3	0.5
EM Local Currency Debt	-0.19	1.0	0.0	0.3	-1.0
EM Corporate Debt (USD)	0.40	1.0	1.0	0.2	0.3

Comments:

The model has added a bit of risk over the last month, except for in high yield where it has moved to a small short. Generally sentiment and liquidity signals have improved, while the macro backdrop has deteriorated in developed markets.

Interest Rates

Duration	TOTAL	Global Growth	CFTC	CBAI HY	Commodity	Cyc vs. Def	Reversion (Return)	Reversion (Yield)	Global Momentum	Slope	Seasonality
EUR	0.15	0.46	1.42	0.43	-0.10	0.17	2.00	1.79	-1.84	-0.95	0.51
USD	0.12	0.46	1.42	0.43	-0.10	0.17	2.00	1.28	-1.84	-0.69	0.14
GBP	0.21	0.46	1.42	0.43	-0.10	0.17	2.00	1.67	-1.84	0.09	0.07

Comments:

The model rotated into long positioning across the board this month. The common positive driver being a combination of a more bullish global growth signal, strengthened CFTC institutional investor reported holdings and narrowed bid-ask dispersion (reflecting a less stressed credit market). The slope signal is now positive for GBP after a steepening seen towards the end of the month. Global momentum remains near max short as the rates market sell-off continues. Note: Going forward the reversion signal will be separated into its two underlying components, reversion on return and on yield.

Cross-Market Duration	TOTAL (beta-neutral)	TOTAL	Slope	Real yield	Fair Value	Growth	Inflation	Unemployment
AUD	-0.06	-0.30	-0.62	0.34	0.13	-0.73	-0.53	-0.39
CAD	0.13	-0.05	-0.15	0.09	-0.24	-0.22	0.43	-0.23
CHF	0.65	0.57	0.33	2.64	0.75	0.00	-0.08	-0.21
EUR	-0.24	-0.14	-0.44	-0.46	0.42	0.33	-0.41	-0.30
GBP	-0.20	-0.17	-0.44	-0.77	-0.46	0.46	0.16	0.01
JPY	0.63	0.44	2.80	-0.59	-0.23	0.14	0.06	0.47
NZD	0.00	0.00	-0.28	0.33	-0.18	-0.31	0.53	-0.09
SEK	-0.44	-0.33	-0.85	-1.36	0.35	0.18	-0.86	0.59
USD	0.00	-0.02	-0.35	-0.21	-0.55	0.16	0.70	0.15

Comments:

The model remains short SEK and EUR and long CHF and JPY. The model is increasing its short on SEK as the real yield signal is driving the CHF vs SEK trade, along with the hike delivered by Riksbank that led to flattening of the SEK curve. The real yield signal continues to be bullish on CHF on the basis of relatively low inflation forecast in the country.

Quant Appendix explained

Fidelity Fixed Income Quantitative Scorecard

Credit Beta & Asset Allocation

Credit beta:
1. Macroeconomics: global macroeconomic surprises compared to consensus expectations
2. Sentiment: trends in credit spreads and bond market bid-offer spreads
3. Valuation: deviation of spreads from recent averages, expecting reversion to the mean
4. Seasonality: technical indicator driven by historic returns in the corresponding period

TOTAL	1 Macro-economics	2 Sentiment	3 Valuation	4 Seasonality
0.00	0.4	-0.7	0.6	-1.0
0.06	0.4	-0.5	0.6	-1.0
0.00	0.4	-0.7	0.6	-1.0
0.00	0.4	-0.7	0.6	-1.0
-0.13	-1.0	-0.5	0.6	-1.0

Credit Asset Allocation:
1. Macro: Global leading indicators plus qualitative growth and rates/inflation assessment
2. Fundamentals: Aggregated trend of single-company forecasts for leverage, margins and indebtedness
3. Sentiment and Liquidity: trend in bid-offer-spreads, cross-asset-class volatility and spread volatility
4. Valuation and Reversion: deviation of spreads from their historic averages, and risk premium above expected losses given long term average default rates

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

Directional Duration:
1. Growth forecast momentum: lower forecasts are dovish, lead to lower rates.
2. CFTC: signal tracking the Treasury futures contract holdings of institutional investors.
3. CBAI HY: indicator of stress in the HY credit market by evaluating bid-ask spread dispersion in the index
4. Commodities momentum: a proxy for state of the economic cycle
5. Cyclical stocks outperformance: a proxy for economic optimism
6. Reversion (Return): deviation of price from their average historic value, expecting reversion to the mean
7. Reversion (Yield): deviation of yield from their average historic value, expecting reversion to the mean
8. Momentum: measures large moves in a single direction, taking advantage of autocorrelation of flows and returns
9. Slope of the yield curve: steep curves earn a higher risk premium
10. Seasonality: technical indicator driven by historic returns in the corresponding period

1 Global Growth	2 CFT C	3 CBAI HY	4 Commodity	5 Cyc vs. Def	6 Reversion (Return)	7 Reversion (Yield)	8 Global Momentum	9 Slope	10 Seasonality
0.46	1.42	0.43	-0.10	0.17	2.00	1.79	-1.84	-0.95	0.51
0.46	1.42	0.43	-0.10	0.17	2.00	1.28	-1.84	-0.69	0.14
0.46	1.42	0.43	-0.10	0.17	2.00	1.67	-1.84	0.09	0.07

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

1 Slope	2 Real yield	3 Forward yield	4 Growth	5 Inflation	6 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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