Commentary

If You Don't Like Bonds Now, Maybe You Just Don't Like Bonds

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Ford O'Neil
Portfolio Manager

Celso Munoz, CFA
Portfolio Manager

Christian Pariseault, CFA
Head of Institutional Portfolio Managers

Beau Coash
Institutional Portfolio Manager

Stacie Ware, PhD, OLY
Quantitative Analyst

KEY TAKEAWAYS

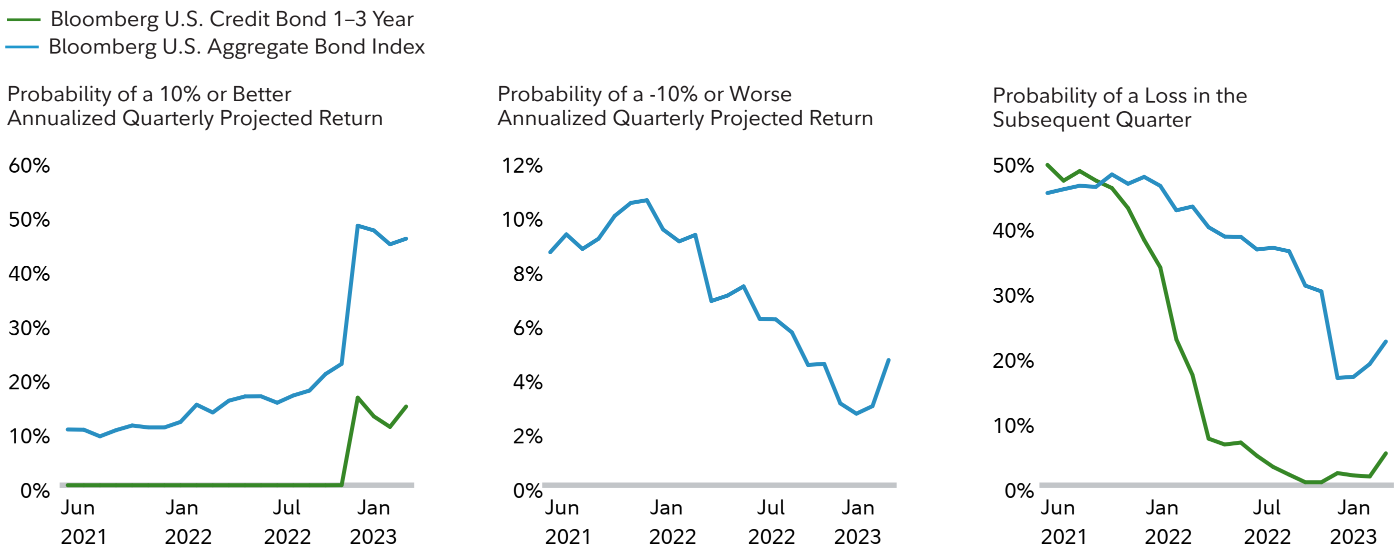
- Our investment team believes the fixed income market has become more attractive, offering the potential for meaningful diversification[1] from stocks and the highest yields in more than a decade.
- Our proprietary risk models, based on 5,000 simulations, suggest the bond market (represented by Bloomberg U.S. Aggregate Bond Index) may offer better than 45% odds for an annualized double-digit return over the next quarter, as opposed to about 5% odds for a quarterly annualized double-digit loss.
- The yields offered by the bond market as of the end of March may help to hedge against the potential for increased spread volatility.
- Participants in the futures market anticipate that the U.S. Federal Reserve will end its cycle of higher policy rates before the summer, which we think could lead to higher bond prices.
- The potential for peak policy rates in 2023 also raises our expectations for positive bond-market returns, based on the historical return for multiple bond categories following peak yields.[3]
- We believe one of the most flexible ways to invest in bonds is using an approach that can adjust for a changing inflation path and allocates across investment-grade and below-investment-grade securities.

See the Methodology explanation on p. 8 for information about the research approach and the inherent limitations of simulated projections.

Imagine a world in which bonds offered about 46% odds of generating a double-digit annualized quarterly return, roughly 22% odds of a negative return over the next quarter, and about 5% odds that the historically poor results of 2022 would be repeated.

These are among the potential scenarios we see, based on our fundamental analysis and the 5,000 proprietary model simulations we've run, conditioned on market volatility at the end of March, to gauge potential market outcomes, accounting for a range of possible decisions by the U.S. Federal Reserve and both hard and soft economic landings (Exhibit 1).[4] These simulations took into account our view of current and expected market conditions over the next three months.

EXHIBIT 1: Historical Return Scenario Analysis



Past performance is no guarantee of future results. For illustrative purposes only to depict the probability and range of models based on our historical analysis and research and the level of market volatility as of 3/31/23. This is not meant to be exhaustive of all possible options or models an advisor may wish to consider, and will not necessarily come to pass. Source: Fidelity Investments proprietary risk model, most recent data, as of 3/31/23. The risk model simulations are consistent with the implied volatility regime (a measure of the degree of expected asset-price fluctuations) on the dates shown and the portfolio benchmark holdings (the Bloomberg U.S. Aggregate Bond Index), along with a dependency structure (the dependency of individual portions of the bond market on other entities of the same market) across the risk factors that has been estimated from historical relationships and conditioned on the level of volatility present in the market at that time. The impact on indices uses the sample space of 5,000 simulated factor changes and coincident exposures to project contributions to price return for each factor. Probability of return scenario analysis has inherent limitations, due to the prospective application of a model designed using predicted and historical data trends and may not reflect the effect that any future material market or economic factors could have on performance. The probability of an annualized quarterly projection of 10% or worse return for the Bloomberg US Credit Bond 1–3 Year Index was negligible and, therefore, not included in the exhibit. See the Methodology explanation on p. 8 for information about the research approach and the inherent limitations of simulated projections.

We believe the fixed income market has become more attractive, offering the potential for meaningful diversification from stocks, and the highest yields in more than a decade.

Moreover, we've received feedback about the potential peak for interest rates from all three of our analyst teams, covering quantitative, macro, and sector perspectives.

Our optimism is based on the data in our quant models. We believe:

- Upside potential has increased across fixed income markets.
- The overall market, as measured by the Bloomberg U.S. Aggregate Bond Index, shows about a 5% quarterly annualized probability of a large drawdown (10%+) for 2023, compared with a peak probability of about 10% in 2022.
- As of March 31, 2023, the probability of an absolute loss over the next quarter in short-duration credit is less than 5%, down from 50% in mid-2022.
- We see the strongest potential for upside among high-quality U.S. long credit rated A+, although our analysis suggests these bonds also have the highest probability of a loss over the next quarter (28%).

Higher Yields Provide a Cushion

It's mainly the market's attractive yield cushion that has led us to believe that the market could see a positive return the next 12 months. As of March 31, 2023, the yield to worst[5] for the Bloomberg Aggregate Bond Index was 4.39%, and 30-day SEC yield for the Fidelity Total Bond Fund, which has the flexibility to invest across bond asset classes and a range of credit qualities, stood at 5.29% (Exhibit 2).

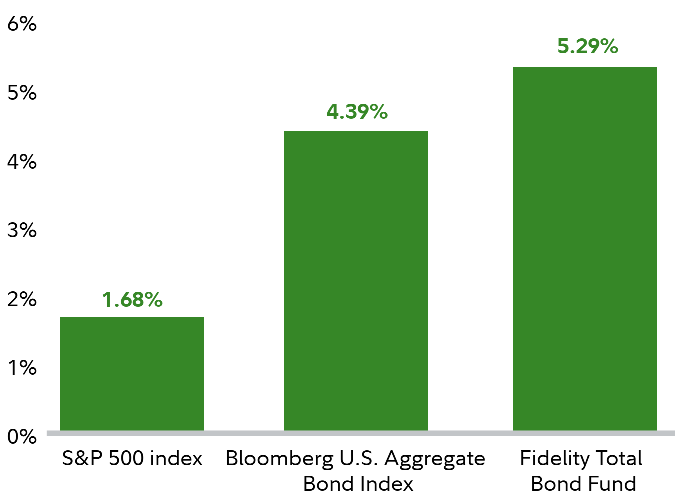
We typically consider the yield the fund generates to be a quarterly performance advantage. Thus, we believe the yields offered by the fund as of the end of March may help to hedge against the potential for increased spread volatility. At the end of the first quarter of 2023, the annualized yield for the Bloomberg U.S. Aggregate Bond Index more than doubled that of the S&P 500 index, and the fund's yield more than tripled that of S&P 500. Therefore, we see greater potential for stocks to deplete their yield cushion, compared with bonds.

If we see price gains for bonds in 2023, we would expect total market returns to exceed the return generated from just yields. We believe the overall market could benefit from the power of compounding, limited bond supply, and real rates that have moved into positive territory as core inflation continues to recede from its 2022 high.

The latter is particularly important because it means that investors have potential to surpass the rate of inflation without taking on excessive risk. As of the end of March, the 10-year Treasury yield at roughly 3.5% was more than a full percentage point above the 10-year breakeven inflation rate[6] of about 2.3%. Keep in mind that, depending on market conditions, a mix of Treasuries, high-grade corporate bonds, asset-backed securities, and similar risk assets could earn a healthy premium over Treasuries, and exposure to certain plus sectors—including high-yield bonds—could generate an even larger spread premium, although these securities introduce greater default risk.[3]

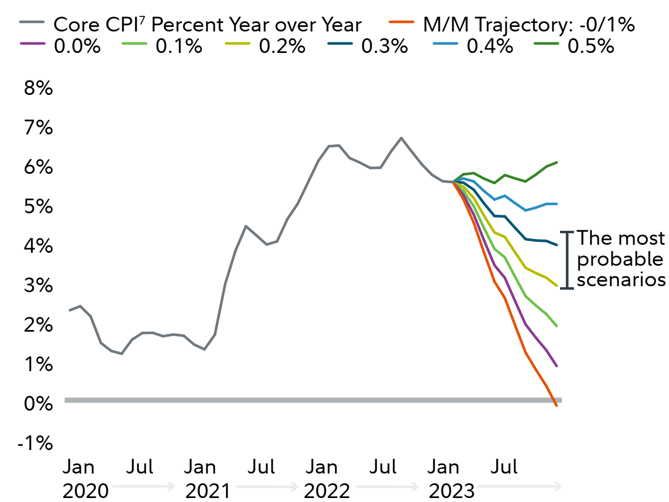
EXHIBIT 2: The Yield Cushion

Annualized Yields for Bonds versus Stocks



Source: Bloomberg Finance L.P. and Fidelity Investments. Yields for the S&P 500 index and the Bloomberg U.S. Aggregate Bond Index reflect current annualized yields as of 3/31/23. The yields stated are no guarantee of future results. It is not possible to invest directly in an index. The S&P 500 yield is the dividend yield as of the date indicated. Yield for the Bloomberg U.S. Aggregate Bond Index is the yield-to-worst[5] figure as of 3/31/23. The yield for Fidelity Total Bond Fund is the 30-day SEC yield as of 3/31/23 (see endnote 2 for a definition). As of 3/31/23, it was 5.29%.

EXHIBIT 3: Core Inflation Assuming Different Monthly Trajectories

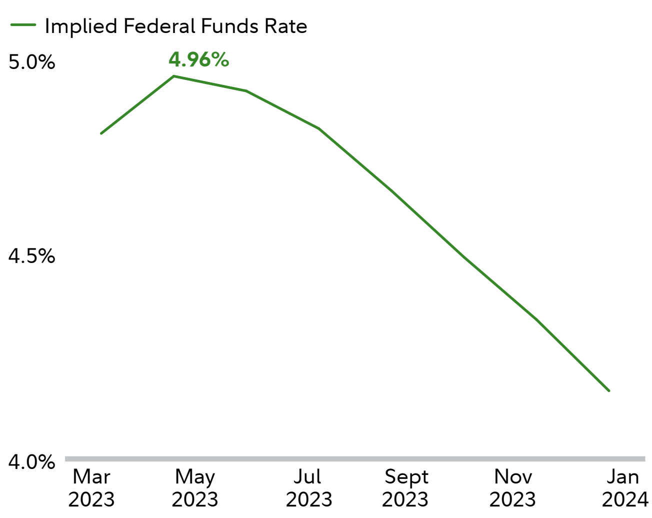


M/M is month over month. Source: U.S. Bureau of Labor Statistics, Haver Analytics, and Fidelity Investments, as of 3/14/23. Data calculated monthly. Core inflation estimates are derived from historical relationships and conditioned on the level of volatility present in the market at that time. Projected core inflation is not reflective of actual results, given that market conditions may vary.

From a macro perspective, we believe the rate of inflation could continue to decline in the coming months. According to our scenario analysis, the inflation rate through mid-2023 is likely to recede from the 2022 peak for the core consumer price index (Exhibit 3). The two most likely scenarios, in our view, would bring core CPI[7] below 4%. We believe the strength of labor markets largely will determine where core CPI ultimately lands.

Lower inflation could make it far more likely that the Fed will stop hiking rates in 2023, thus improving the prospects for longer-term bonds. Participants in the fed funds futures market anticipate that the Fed will end its cycle of higher policy rates before the summer, which could lead to higher long-term bond prices. The market has been discounting small rate hikes, with the fed funds rate possibly peaking in May at about 4.96% (Exhibit 4). Thereafter, it's possible the yield curve could move lower.

EXHIBIT 4: Fed Funds Implied Rate



Fed funds implied rate measures the current fed funds rate relative to the forward rate, as reflected in the futures market. Source: Bloomberg Finance L.P. as of 3/31/23. Fed funds futures are not a guarantee of future results for the fed funds rate.

Returns from Peak Yields

The potential for market yields peaking in 2023 is another factor that raises our expectations for positive bond-market returns. Exhibit 5 shows three- and five-year returns for proxies representing corporate bonds, high-yield bonds, and U.S. credit. Following the past five peaks for market yields, all three bond segments averaged double-digit returns in the three and five years following peak yields for the bond market.[3]

What If We're Wrong?

We believe the Fed would likely have to "lose its battle" with inflation in order to see a strongly negative return for the overall bond market in the coming months. In our view, a strongly negative return could occur, for example, if we saw an unforeseen surge in fuel prices, or if a resurgent economy in China after the easing of COVID-19 lockdowns led to a spike in labor costs and global materials prices.

We caution that there are still many possible inflation paths, which means that every month over the next 12 months, the bond market will need to "check in" with the monthly inflation data. The process of a check-in may at times induce volatility. We repeat our research monthly and recalibrate our proprietary risk model following these market check-ins to adjust for the changing levels of market volatility. That said, our teams believe it would take a radically different inflation course and/or significant spread widening to result in a very pessimistic outcome for the bond market.

EXHIBIT 5: Returns Following Peak Yields

Starting from:	2/29/2000		4/30/2002		7/31/2006		1/31/2014		11/30/2018	
Index	**3-Year**	**5-Year**	**3-Year**	**5-Year**	**3-Year**	**5-Year**	**3-Year**	**5-Year**	**3-Year**	**5-Year ***
S&P500	-36.0%	-8.6%	8.5%	35.5%	-22.7%	15.6%	29.0%	50.3%	79.3%	63.7%
US Credit	34.4%	53.0%	24.3%	35.5%	15.3%	40.1%	12.7%	17.1%	24.9%	9.5%
US Corp	33.5%	52.9%	24.7%	35.7%	14.1%	40.5%	13.3%	17.5%	26.2%	10.0%
US HY	1.4%	40.5%	36.7%	63.9%	6.4%	56.0%	14.6%	20.7%	24.0%	15.0%
LL	11.9%	28.4%	17.7%	33.0%	-0.9%	28.5%	11.1%	16.2%	13.3%	16.6%

Past performance is no guarantee of future results. Source: Bloomberg Finance L.P., based on historical data, with the most recent data collected as of 3/31/23. *Five-year returns starting 11/30/18 are only through 3/31/23. Index returns calculated using monthly data. US Credit returns calculated using the Bloomberg U.S. Credit Total Return Value Unhedged USD Index. U.S. Corporate Bonds calculated using the Bloomberg U.S. Corporate Total Return Value Unhedged USD Index. U.S. High Yield calculated using the Bloomberg Barclays U.S. Corporate HY Total Return Value Unhedged USD Index. Leveraged Loans calculated using the S&P/LSTA Leveraged Loan Total Return Index. It is not possible to invest directly in an index.

A Diversified Bond Approach

In our view, one of the most flexible ways to invest in bonds is using an approach that can adjust for a changing inflation path and allocates across investment-grade and below-investment-grade securities.[1] We believe this strategy, which utilizes sector rotation, asset allocation, and security selection to help manage the fund's overall risk and interest rate risk, can capitalize on wide total-return dispersions. Our managers have the freedom to dial up and dial down risk based on changing market and economic conditions.

Part of the appeal of this approach for some investors is that the ability to access higher-yielding bond segments within a diversified portfolio may help to buffer drawdowns, thereby attempting to enhance return potential while managing risk.[3] The compounding of these higher yields also may help to insulate against price shocks.

Fidelity Total Bond Fund Positioning as of February 28, 2023:

Duration View: Favoring intermediate-term and longer durations, which could benefit if inflation declines faster than current market expectations.

Leveraged Loans: Overweight: Floating rate coupons continue to reset higher with Fed hikes. Spreads are still attractive, given our expectations of relatively low defaults in the coming year.

High Yield: Overweight: Within this market, the focus is on idiosyncratic BB-rated credit ideas, as opposed to generic beta to the sector.

U.S. Investment-Grade (IG) Corporates: Overweight: Within this segment, we are underweight long credit, in favor of intermediate and short credit with stories that our credit analysts think can improve on a relative basis through this market cycle.

Inflation-Protected Debt: The fund has no TIPS[8] exposure. The TIPS market either believes the Fed will win the inflation fight or the illiquidity of the sector is driving down prices.

Structured Product: Overweight: The fund holds AAA-rated collateralized loan obligations for floating rate income and relative defensiveness. We've added to some asset-backed securities holdings, including in the aircraft industry. Spreads in traditional auto and credit card asset-backed securities are too tight. We also see some single-asset, single-borrower opportunities among commercial mortgage-backed securities.

Agency Mortgage-Backed Securities: Underweight: Sector spreads have snapped back after significant underperformance but are not offering compelling risk-reward.

Non-Dollar: There is effectively no non-dollar exposure in the fund, as all non-dollar holdings are hedged back to the U.S. dollar.

Average Annual Total Return

(As of 3/31/23) Fund inception 10/15/2002. Gross expense ratio as of the most recent prospectus is 0.45%.

Index	1-Year	3-Year	5-Year	10-Year	Life
Fidelity® Total Bond Fund (Retail Class) FTBFX	-4.90%	-0.41%	1.64%	2.07%	4.02%
BBg US Agg Bond	-4.78%	-2.77%	0.91%	1.36%	3.32%
BBg US Universal	-4.61%	-2.02%	1.05%	1.62%	3.67%

The performance data featured represents past performance, which is no guarantee of future results. Investment return and principal value of an investment will fluctuate; therefore, you may have a gain or loss when you sell your shares. Current performance may be higher or lower than the performance data quoted. To learn more or to obtain the most recent month-end or other share-class performance, visit fidelity.com/performance, institutional.fidelity.com, or 401k.com.

Index returns include reinvestment of capital gains and dividends, if any, but do not reflect any fees or expenses. It is not possible to invest in an index.

Before investing in any mutual fund, please carefully consider the investment objectives, risks, charges, and expenses. For this and other information, call or write Fidelity for a free prospectus or, if available, a summary prospectus. Read it carefully before you invest.

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Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk. Nothing in this content should be considered to be legal or tax advice, and you are encouraged to consult your own lawyer, accountant, or other advisor before making any financial decision.

Stock markets are volatile and can fluctuate significantly in response to company, industry, political, regulatory, market, or economic developments. Foreign markets can be more volatile than U.S. markets due to increased risks of adverse issuer, political, market, or economic developments, all of which are magnified in emerging markets. These risks are particularly significant for investments that focus on a single country or region.

Risks for Fidelity Total Bond Fund

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.) Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Unlike individual bonds, most bond funds do not have a maturity date, so avoiding losses caused by price volatility by holding them until maturity is not possible. Lower-quality bonds can be more volatile and have greater risk of default than higher-quality bonds. Foreign securities are subject to interest rate, currency exchange rate, economic, and political risks, all of which are magnified in emerging markets. Leverage can increase market exposure and magnify investment risk.

Investing involves risk, including risk of loss.

Past performance and dividend rates are historical and do not guarantee future results.

Credit ratings for a rated issuer or security are categorized using the highest credit rating among the following three Nationally Recognized Statistical Rating Organizations ("NRSRO"): Moody's Investors Service (Moody's); Standard & Poor's Rating Services (S&P); or Fitch, Inc.

Diversification and asset allocation do not ensure a profit or guarantee against loss.

All indices are unmanaged. You cannot invest directly in an index.

Index Definitions:

The Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage-back securities (agency fixed-rate pass-throughs), asset-backed securities, and collateralized mortgage-backed securities (agency and non-agency).

Bloomberg U.S. Credit Bond 1–3 Year Index is a market value–weighted index of investment-grade corporate fixed-rate debt issues with maturities in the range of one to three years.

S&P 500 index is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.

Bloomberg U.S. Credit Total Return Value Unhedged USD Index is a total return, unhedged index of investment-grade corporate fixed-rate debt issues with maturities of one year or more.

Bloomberg U.S. Corporate Total Return Value Unhedged USD Index is a total return, unhedged index of the investment-grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by U.S. and non-U.S. industrial, utility, and financial issuers.

Bloomberg Barclays U.S. Corporate HY Total Return Value Unhedged USD Index is a total return, unhedged index of U.S. dollar-denominated, high-yield, fixed-rate corporate bonds.

S&P/LSTA Leveraged Loan Total Return Index is a total return index designed to represent the performance of U.S. dollar-denominated institutional leveraged loan portfolios using current market weightings, spreads, and interest payments.

Bloomberg U.S. Universal Bond Index represents the union of the Bloomberg US Aggregate Bond Index, the Bloomberg U.S. Corporate High Yield Bond Index, the Bloomberg 144A Bond Index, the Bloomberg Eurodollar Bond Index, the Bloomberg Emerging Markets Aggregate USD Bond Index, and the non-ERISA portion of the Bloomberg U.S. CMBS Index. Municipal debt, private placements, and non-dollar-denominated issues are excluded from the index. The only constituent of the index that includes floating-rate debt is the Bloomberg Emerging Markets Aggregate USD Bond Index.

Fidelity Institutional® provides investment products through Fidelity Distributors Company LLC; clearing, custody, or other brokerage services through National Financial Services LLC or Fidelity Brokerage Services LLC (Members NYSE, SIPC); and institutional advisory services through Fidelity Institutional Wealth Adviser LLC.

Institutional asset management is provided by FIAM LLC and Fidelity Institutional Asset Management Trust Company.

Endnotes

[1] Diversification does not ensure a profit or guarantee against a loss.

[2] The 30-day yield is a standard yield calculation developed by the Securities and Exchange Commission for bond funds. The yield is calculated by dividing the net investment income per share earned during the 30-day period by the maximum offering price per share on the last day of the period. The yield figure reflects the dividends and interest earned during the 30-day period, after the deduction of the fund's expenses. It is sometimes referred to as "SEC 30-Day Yield" or "standardized yield."

[3] Past performance is no guarantee of future results.

[4] Hard economic landing refers to a marked economic slowdown following a period of rapid growth. Soft economic landing refers to a cyclical economic slowdown that avoids a recession.

[5] Yield to worst measures the lowest possible yield on a bond or bond index, not taking into account potential defaults.

[6] Breakeven inflation rate measures the difference between nominal (stated) yields and real (inflation-adjusted) yields.

[7] Core CPI is the core consumer price index, which measures the change in the cost of goods and services over time, excluding volatile factors, such as food and energy.

[8] TIPS are Treasury Inflation-Protected Securities, a type of U.S. Treasury bond that is indexed to a gauge of inflation.

Author

Ford O'Neil

Portfolio Manager

Ford is a portfolio manager in the Fixed Income division at Fidelity Investments, and is co-lead manager of Fidelity and Fidelity Advisor Total Bond Funds.

Celso Munoz, CFA

Portfolio Manager

Celso is a portfolio manager in the Fixed Income division at Fidelity Investments, and is co-lead manager of Fidelity and Fidelity Advisor Total Bond Funds.

Christian Pariseault, CFA

Head of Institutional Portfolio Managers

Christian heads Institutional Portfolio Management at Fidelity Investments. The institutional portfolio management team is a group within Fidelity's Asset Management Solutions division, an integrated investment, distribution, and client service organization dedicated to meeting the unique needs of the institutional marketplace.

Beau Coash

Institutional Portfolio Manager

Beau is an institutional portfolio manager for fixed income strategies at Fidelity Investments. In this role, he is an active part of the portfolio management team and represents the team's capabilities, thought processes, and views to clients and consultants.

Stacie Ware, PhD, OLY

Senior Quantitative Analyst

Stacie works as part of the investment team and employs mathematical and statistical models that support Fidelity's core, core plus, and tactical bond strategies.

Fidelity Thought Leadership Vice President Michael Tarsala provided editorial direction for this article.

Methodology

Simulated projections have certain inherent limitations since they do not reflect the impact that material economic and market factors might have. Since the activity in a simulation has not actually occurred, the results of the simulation may under- or overcompensate for the impact, if any, of certain market factors and may underestimate the impact of market extreme and the related risk of loss. It is important to remember that this process is based on assumptions that may not reflect the behavior of actual events. A different set of assumptions would create a different probability distribution. Expert opinion regarding expected returns, volatility, and market trends vary widely. **The simulations are not representative of the performance of any client account. All of the graphs and other information are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results.**

For this study, we ran 5,000 risk factor and return simulations from our proprietary risk model for each date from June 2021 through January 2023. We chose these dates because they coincided with the trend of a rising probability of a higher bond market return and lower probability of a negative return. Based on this, we calculated the probabilities that the total index return would be above 250 basis points and below -250 basis points over the next three months on a rolling basis, then annualized these results. As a baseline, we assumed 250 basis points would be on pace for a +10% return and -250 basis points would be on pace for a -10% return over the course of a year. When modeling the distribution of expected returns, we simulated risk factors, including rates and spreads, in a correlated manner and with forward-looking (consistent with the Chicago Board Options Exchange's CBOE Volatility Index and the Merrill Lynch Option Volatility Estimate) estimates of volatility. We then computed fund returns using sensitivities (spread betas, durations, and spread durations) in each simulation, which resulted in the distribution of the expected returns. Using this methodology, we simulated the distribution of returns for each date in the exhibit on a rolling monthly basis.

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