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Short Duration: Rising-Rate Resilience

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Within the short-duration[1] sector of the bond market—bonds with maturities of five years or less—favorable supply-and-demand characteristics, and a steep yield curve, are presenting attractive investment opportunities.

KEY TAKEAWAYS

- Demand for short-duration bonds has been strong, driven by a broad base of investors.
- Supply has been well supported, with issuance including a wide variety of sectors, resulting in a balanced market.
- A steep yield curve is favorable for short-duration investing because it provides attractive yield and return opportunities.
- Research and trading can generate specialized investment ideas that fit well into short-duration portfolios.
- The Federal Reserve's actions will continue to influence short-duration markets.

Diversified supply

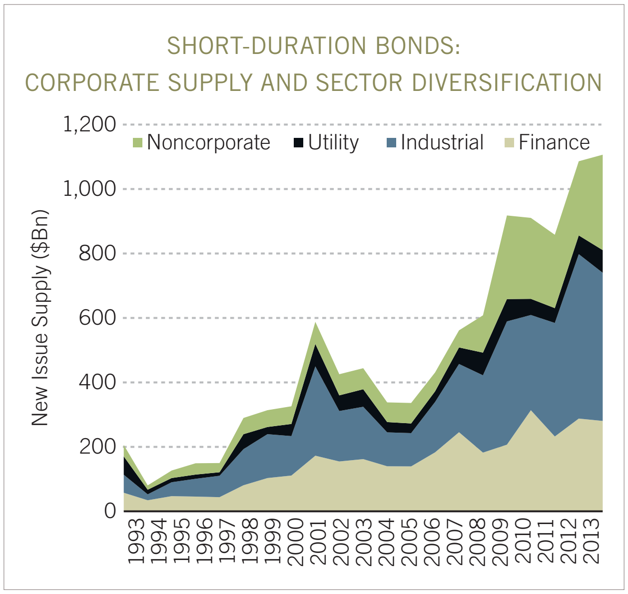
During 2013, the short-duration bond market experienced a robust supply of high-quality bonds across all spread sectors, including corporate, asset-backed, agency-mortgage-backed, and commercial-mortgage-backed securities. A steady supply pipeline has persisted into 2014; companies continue to modestly extend their maturity profiles while simultaneously taking advantage of relatively low interest rates.

The ongoing supply has provided short-duration investors with expanded opportunities to diversify into a widening variety of sectors. Short-duration corporate issuance has broadened to include many industrial and utility issuers, with banks and financial institutions continuing to represent a consistent source of supply (see Exhibit 1, below). In addition to new-issue corporate bonds, issuance in asset-backed and commercial-mortgage-backed securities that are collateralized by automobile, credit card, and commercial-mortgage loans has rebounded from five years ago and continues apace (see *Research Spotlight*, page 3). Short-duration investors with access to experienced research analysts and traders have a large and diversified opportunity set from which to construct a high-quality portfolio.

Shape of yield curve favorable for short-duration investors

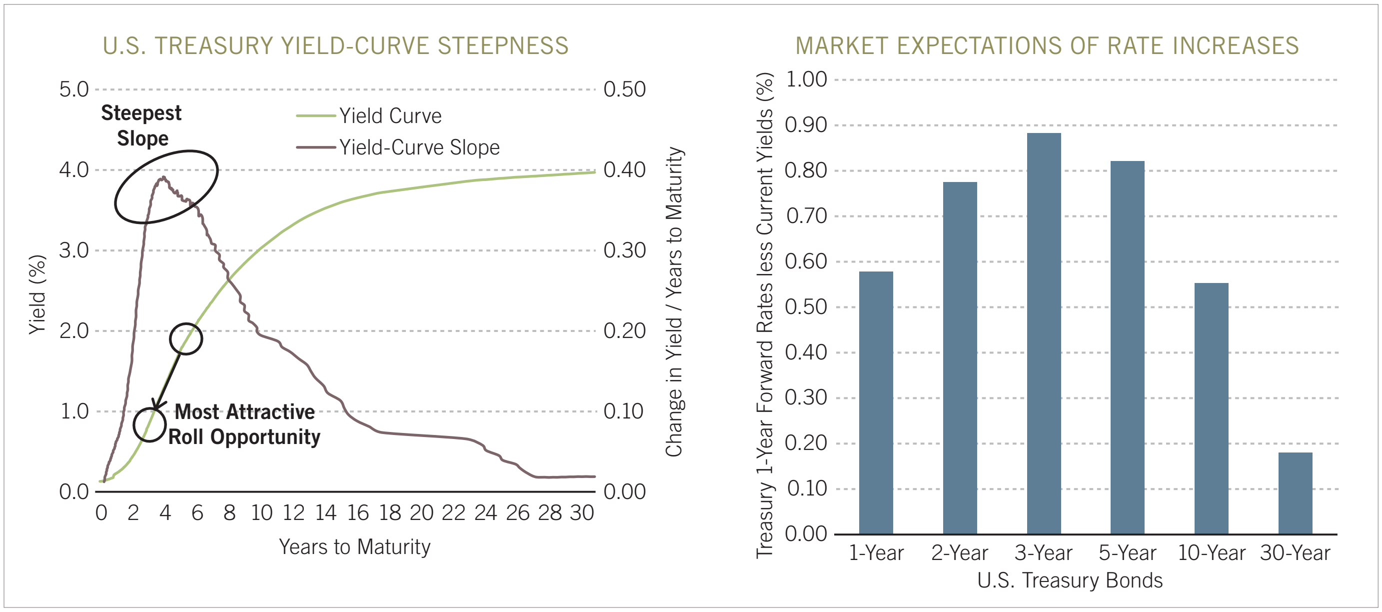
Healthy supply dynamics have been further enhanced by the steep yield curve.[2] Specifically, short-duration investors have the potential to get paid more to invest in moderately longer maturities in the three- to five-year range (see Exhibit 2, page 2, left-hand chart). In fact, the front end is the steepest segment of the overall Treasury yield curve, thus providing short-duration investors with opportunities to add yield and total return, as long as their investment horizons and holding periods are consistent with maturities within this range. However, a rapid increase in short rates in excess of forward rate expectations (see Exhibit 2, page 2, right-hand chart) could reduce the potential returns from extending into these longer maturities.

EXHIBIT 1: Since 2008, corporate supply and sector diversification have grown.



Source: Barclays, as of Dec. 31, 2013.

EXHIBIT 2: Yield curve steepness means short-duration investors have the potential to get paid more in moderately longer maturities.

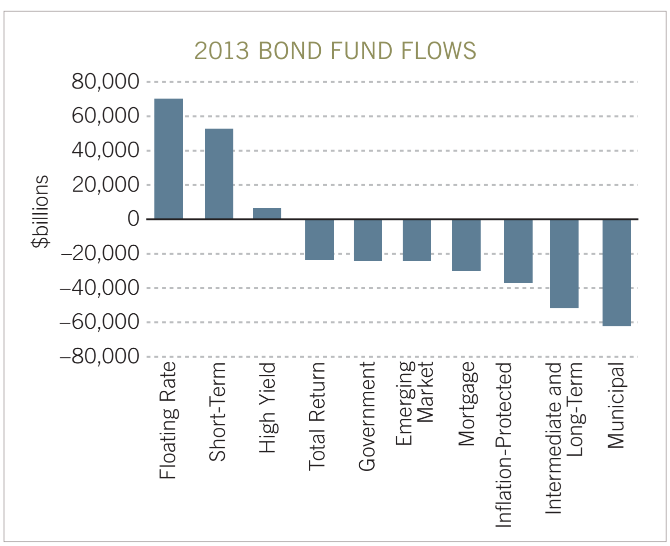


Source: Bloomberg Finance, L.P., Fidelity Investments (AART) as of Dec. 31, 2013. Past performance is no guarantee of future results.

In the short-duration sector, strong supply and favorable yield-curve technicals have been met with equally strong demand, resulting in a healthy, balanced market. Evidence of demand can be found in cash-flow data. According to EPFR Global, short-duration and floating-rate fixed income funds received $119 billion in inflows in 2013 (see Exhibit 3, below).

Strong demand is also demonstrated by the popularity of short maturities within new bond offerings, no matter how large the issuance. Many new, investment-grade corporate issues offer multiple maturities, including short-duration tranches. For example, Verizon Communications issued $49 billion of bonds in September 2013—the largest corporate issue in the history of the investment-grade segment (see Exhibit 4, below). The deal included fixed- and floating-rate coupons, all of which experienced exceedingly strong demand. So far in 2014, the multitude of investors seeking short-duration investments has continued to contribute to a well-subscribed and well-balanced short-duration market.

EXHIBIT 3: Demand for short-duration bond funds was strong in 2013.



Source: EPFR Global.

Multiple sources of demand for short-duration bonds

One source of demand for short-duration bonds has been cash managers seeking yields in excess of those earned on cash

EXHIBIT 4: New issues incorporate meaningful short-duration supply.

Largest Ever Investment-grade Issue: Verizon Communications, $49 billion bond issuance, Sep. 2013		
Maturity	**Coupon**	**Amount**
Three year	3 month LIBOR + 1.53% (Floating rate)	$2.25 billion
Three year	2.50%	$4.25 billion
Five year	3 month LIBOR + 1.75% (Floating rate)	$1.75 billion
Five year	3.65%	$4.75 billion
Seven year	4.50%	$4 billion
Ten year	5.15%	$11 billion
Twenty year	6.40%	$6 billion
Thirty year	6.55%	$15 billion

Source: Fidelity Investments. LIBOR (London Interbank Offered Rate). Information presented is for information purposes only and is not investment advice or an offer of any particular security.

investments. This cohort continues to invest in moderately longer maturities in an effort to take advantage of the steep yield curve, as described earlier. In addition, the strategy of rolling down a steep yield curve has the potential to be a highly effective source of returns on an absolute basis and relative to a benchmark.[3] Another source of demand has been investors with defined maturity horizons that are consistent with the five-year (or shorter) maturity profile of short-duration bonds.

Other short-duration investors include asset managers and target-date fund managers who have strategically allocated portfolio assets to short-duration fixed income because of its relatively lower interest-rate sensitivity. Some investors are shifting from long-duration to short-duration bonds to prepare for higher interest rates while maintaining their allocations to fixed income. These participants include individuals, overseas institutions, sovereign wealth funds, state treasuries, insurance companies, and a variety of other mandates. Finally, long-term population demographics continue to support fixed-income allocations in general, and short-duration bonds provide an attractive fixed-income choice, accompanied by moderate levels of interest-rate risk and price volatility.

Outlook

The positive balance of supply and demand, as well as favorable return characteristics in the short-duration segment, continues to provide support for the short-duration area of the bond market. With respect to rising interest rates, the Federal Reserve continues to articulate a commitment to steady, gradual policy normalization. In her inaugural report to Congress, Fed Chair Janet Yellen emphasized continuity, which thus far has meant a measured reduction in Treasury and mortgage-backed security purchases well in advance of anticipated increases to the federal funds target rate.

RESEARCH SPOTLIGHT

Short-Duration Commercial Mortgage–Backed Securities

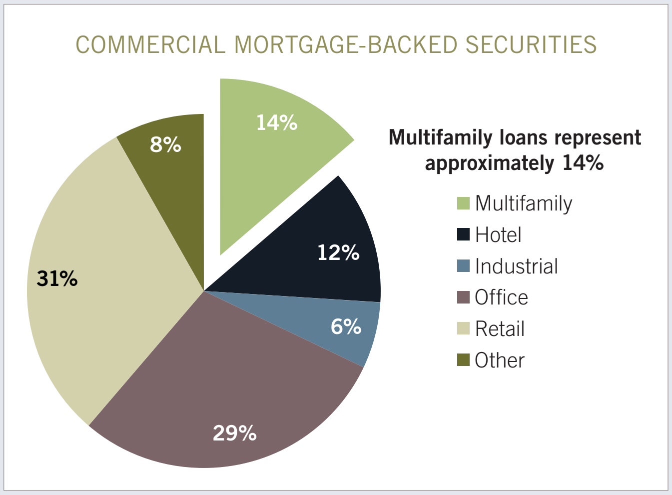
The short-duration bond market is composed of many spread sectors, including corporate securities, asset-backed securities (ABS), and mortgage-backed securities (MBS). Although some areas of MBS experienced difficulties from 2007 to 2009, many rebounded, and these sectors remain an integral part of the investment-grade market today.[4] From an asset management perspective, within these markets the cross fertilization of ideas among credit, macroeconomic, and quantitative research can generate investment ideas that are well suited to the short-duration bond market. A recent example is a segment within commercial mortgage-backed securities (CMBS)—multifamily-directed classes—that has the potential to provide attractive, risk-adjusted returns.

CMBS are packages, or “securitizations,” of many underlying commercial mortgage loans. These securitizations are subdivided into classes, or “tranches,” with different maturities and credit quality profiles; various tranches may appeal to investors with differing risk tolerances and time horizons. Large CMBS issuances contain loans on a variety of property types, including retail, office, and multifamily (see Exhibit 5, right).

Appropriate CMBS analysis relies on extensive resources. The bonds’ long-term performance is typically affected by the overall health of the commercial real estate market; therefore, a robust macroeconomic view with respect to real estate can provide a portfolio manager with the groundwork from which to build a CMBS allocation in a portfolio. In addition, the credit quality of various property types within CMBS offerings can vary both across deals and over a market cycle. Unlike “plain-vanilla” bonds with defined maturity dates, CMBS are not homogeneous securities. Detailed research at the property-type level and at the underlying-loan level is critical to identifying the ability of a bondholder to be paid. Finally, cash-flow modeling and scenario analysis of the underlying loans, in conjunction with analysis of the various tranches within a securitization, are necessary in order to assess the timing and value of principal-and-interest payments.

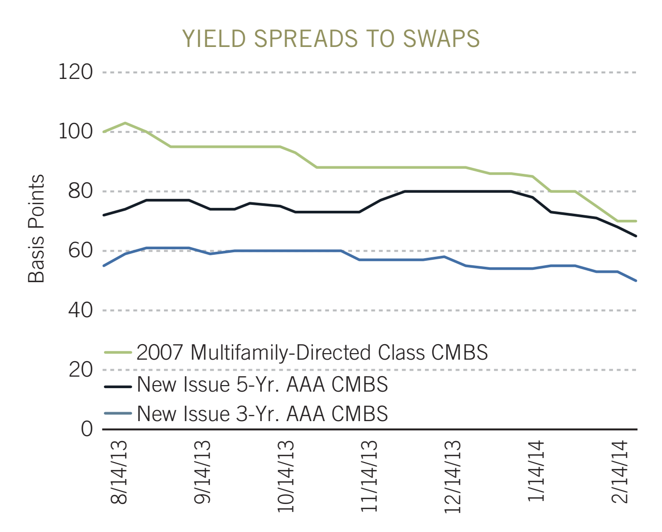
From 2000 through 2007, government-sponsored entities (GSEs) such as Fannie Mae and Freddie Mac invested in CMBS tranches that received principal and interest payments specifically from underlying multifamily-mortgage loans. Multifamily mortgages, unlike other property exposures such as retail or office loans, were considered to be consistent with the GSEs’ housing mandate.

EXHIBIT 5: Commercial-mortgage-backed securities include several property types.



Source: Intex as of 12/31/13.

EXHIBIT 6: Multifamily-directed bonds have provided attractive yield spreads relative to other CMBS.



Source: Wells Fargo Securities, LLC, as of Feb. 2014. Yield Spreads to Swaps are based on CMBS yields relative to the yields for conventional fixed-rate, similar-maturity interest rate swaps. One basis point equals 0.01%. Past performance is no guarantee of future results.

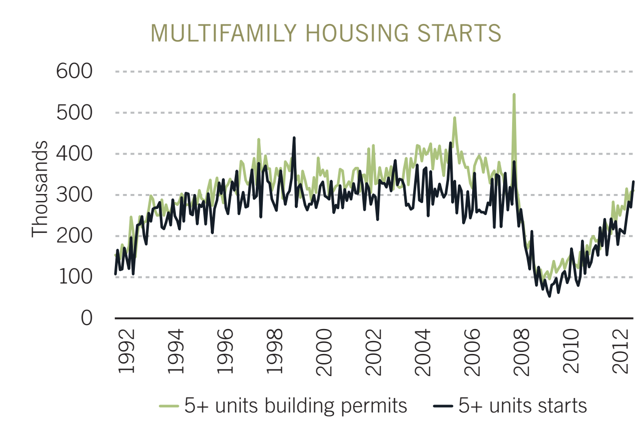
Now, although these multifamily-directed bonds have continued to perform as expected, regulatory pressures incentivized the GSEs to sell them, which they began to do in early 2013. Short-duration investors who purchased seasoned[5] bonds at that time were able to purchase them at prices that were attractive when compared with other similarly rated short-duration bonds. Some in the investment community were put off by the depth of analysis required and the potential for overwhelming supply from Fannie Mae and Freddie Mac. However, those investors able to commit resources to generate detailed analysis of underlying loans, realistic valuations, and insightful trade executions, were able to identify certain bonds with the potential as stable and attractive sources of yield, liquidity, and total return for diversified, short-duration portfolios.

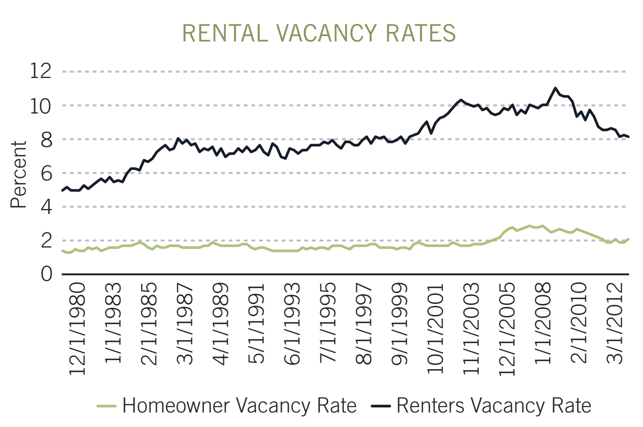
Since August 2013, multifamily-directed CMBS performance has benefited from the overall improvement in housing fundamentals (see Exhibit 6, left). Loan delinquencies and multifamily vacancies have fallen, and demand for rentals has been supported by people who may still face credit challenges in the residential mortgage market (see Exhibit 7, below).

In addition, increasing acceptance of multifamily-directed CMBS by investors, as well as the measured pace of supply from Fannie Mae and Freddie Mac, have supported prices in the segment. Many of the bonds provide short-duration portfolios with additional diversification beyond corporate, Treasury, and other investment-grade sectors. Finally, their cash-flow profiles fit short-duration investment strategies extremely well; most principal and interest is typically received in five years or less, which is consistent with the ongoing reinvestment profile of a short-duration bond portfolio.

While multifamily-directed CMBS bonds are more expensive than they were only a few years ago, the segment can still offer competitive sources of income and sector diversification. Ongoing research and analysis with respect to macroeconomic housing fundamentals, GSE reform, commercial real estate, and structured product valuation remain critical to finding value in this segment of the CMBS sector.

EXHIBIT 7: Multifamily-directed CMBS have benefited from improved housing fundamentals and lower rental vacancy rates.





Source: Credit Suisse, U.S. Census Bureau, as of Dec. 2013.

MACRO INSIGHTS

Forward Guidance: Conveying the Fed's Intention to Keep Policy Rates Low Well into the Future

Since the financial crisis struck in 2008, the Federal Reserve (Fed) has provided an extraordinary amount of monetary stimulus to the U.S. economy, first to arrest the downturn and then to support the subsequent recovery. However, the federal funds rate, the standard tool of monetary policy, was lowered to near zero very early in this process. Confronted with the "zero lower bound," the Fed has needed to rely on other, less conventional tools to provide accommodation. Large-scale purchases of Treasury and agency securities, commonly known as quantitative easing, were the most prominent unconventional policy, but equally important in the Fed's eyes was the policy of providing "forward guidance" as to the future path of the federal funds rate. In general, forward guidance is intended to convey the Fed's intention to keep short-term interest rates low, well into the future. Since longer-term interest rates reflect, in part, the bond market's expectation of future short-term interest rates, forward guidance exerts downward pressure across the yield curve, encouraging consumption, investment, and economic growth.

The Fed's forward guidance policies have evolved significantly throughout the post-2008 recovery. Guidance was initially qualitative in nature, suggesting short-term rates would remain low for "an extended period." In 2011, it evolved to a "time-contingent" policy—an intention to keep rates low until a fixed future calendar date. By late 2012, the policy had changed again, this time to a "state-contingent" format; suggesting rates would stay low until certain economic thresholds had been achieved. Specifically, the policy stated that rates would remain near zero at least until the unemployment rate declined to 6.5%, subject to the condition that forward inflation remained below 2.5%. Since then, the economic recovery has continued, and the unemployment rate has declined faster than the Fed expected, hitting 6.7% in February 2014. However, the decline has been driven in large part by people dropping out of the labor market, some due to retirement as the workforce ages, others because they could not find jobs. Further, inflation has actually fallen and now sits just over 1%, well below the Fed's 2% target. This backdrop drove the Fed to tweak the policy again at its March 2014 meeting. The forward guidance no longer specifically references the unemployment rate, but rather points to an assessment of a broad range of labor market, inflation, and financial indicators. Based on its economic forecasts, the Fed is currently expected to begin raising rates in the middle of 2015, and to then raise them only gradually even as the economy approaches full employment. While the Fed's forward guidance policies have evolved meaningfully over the past few years, the core purpose has been and will remain the same: conveying a strong intention to keep policy rates low, well into the future. Economic conditions, including low inflation, signs of ongoing labor market slack despite the falling unemployment rate, and modest GDP growth suggest that the Fed will likely make good on this intention.

This policy has important implications for the yield curve. In December 2013, the Fed announced plans to gradually wind down its asset purchase program in 2014 (a process commonly known as "tapering"). Asset purchases lowered long-term bond yields by reducing the supply of such instruments in the marketplace. Expectations of an imminent "taper" announcement therefore drove long-term yields meaningfully higher during 2013. However, short-term yields remained protected from the backup by the Fed's forward guidance policies, and accordingly the yield curve steepened notably. A steep yield curve and the Fed's intention to keep rates low well into 2015 may provide investors in short-duration bond funds with modest exposure to rising rates and the opportunity to benefit from rolling down the yield curve, an attractive combination of risk and return potential.

—Julian Potenza, Macro/Asset Allocation Analyst

A potential offset to the supportive dynamics in the short-duration sector would be a sudden and unexpected increase in inflation. Such an increase would likely cause market participants to accelerate their expectations of Federal Open Market Committee interest rate increases, which could place unexpected, upward pressure on short-term rates and downward pressure on bond prices. In addition, yield-curve flattening that tends to occur in anticipation of higher policy rates could lessen or remove the potential yield advantage of investing in moderately longer maturities. However, if higher inflation were accompanied by stronger economic growth, then riskier assets could continue to perform. In this scenario, the potential yield advantage of short-duration spread sectors could offset the impact of higher short-term Treasury rates. In the meantime, although short-term rates may eventually increase, the long window for policy firming should be supportive of continued opportunities to construct a diversified, short-duration portfolio that will provide attractive risk-adjusted returns over time.

Bond market update

For the one year ended January 2014, bond-market performance reflected a period of significant transition for fixed income investors as they anticipated, and then reacted to, a gradual shift in Federal Reserve monetary policy away from quantitative easing (QE). During the period, less interest-rate-sensitive sectors, such as high-yield bonds and leveraged loans, were bid higher while higher-quality and more rate-sensitive sectors came under selling pressure (see Exhibit 8, right).

After a benign beginning to 2013 in terms of performance and volatility, bond investors recoiled in June in response to then-Fed-Chairman Bernanke's indication that the Fed *could* begin tapering in 2013. Bond market volatility spiked and yields rose. While market expectations for scaled back purchases to begin in 2013 were not met, the Fed did announce in December its plan to begin decreasing its asset purchases in early 2014. By then, some amount of tapering had already largely been priced into the bond market and was reflected in the yield curve, which had shifted up and steepened—but remained anchored at zero. With the advent of 2014, the potentially negative implications of reduced Fed buying for certain emerging-market-countries' current-account balances gained attention and contributed to market volatility, bond investors turned to higher-quality fixed income assets, which sent yields lower.

EXHIBIT 8: Fixed income performance summary.

	% Yield	Years Duration	% YTD	% 1 Year	% Ann. 5 Year
Barclays U.S. Aggregate Index	2.31	5.52	1.48	0.12	4.94
Barclays Interm. Gov/Cr Index	1.48	3.85	0.92	0.42	4.23
Barclays 1-5 Year Gov/Cr Index	0.89	2.65	0.45	0.81	2.92
Barclays U.S. Corp. Index	3.09	6.90	1.81	1.15	8.92
Barclays U.S. Corp. High Yield Index	5.64	4.08	0.70	6.77	17.72
Barclays U.S. High Yield Loans Index	N/A	N/A	0.61	4.84	13.13
Barclays Emerging Market USD Aggregate Bond Index	5.41	5.75	–0.28	–3.76	12.33
Barclays U.S. Treasury Index	1.30	5.08	1.36	–0.63	3.03
Barclays U.S. Mortgage-Backed Securities Index	3.02	5.31	1.56	0.63	3.98
Barclays U.S. TIPS Index	2.20	6.84	1.98	–6.17	5.69

Source: Barclays, as of Jan. 31, 2014. Past performance is no guarantee of future results. The index returns reflect the reinvestment of dividends and other earnings. This chart is for illustrative purposes only and does not represent actual or future performance of any investment option. It is not possible to invest directly in a market index. Securities indices are not subject to fees and expenses typically associated with managed accounts or investment funds.

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Views expressed are as of the date indicated, based on the information available at that time, and may change based on market and other conditions. Unless otherwise noted, the opinions provided are those of the authors and not necessarily those of Fidelity Investments or its affiliates. Fidelity does not assume any duty to update any of the information.

Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

Past performance is no guarantee of future results.
Diversification/asset allocation does not ensure a profit or guarantee against loss.

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.

High yield/non-investment grade bonds involve greater price volatility and risk of default than investment grade bonds.

Increases in real interest rates can cause the price of inflation-protected debt securities to decrease.

Floating-rate loans generally are subject to restrictions on resale and they sometimes trade infrequently in the secondary market, and as a result may be more difficult to value, buy, or sell. A floating-rate loan might not be fully collateralized, which may cause the floating-rate loan to decline significantly in value.

Investments in mortgage securities are subject to the risk that principal will be repaid prior to maturity. As a result, when interest rates decline, gains may be reduced, and when interest rates rise, losses may be greater.

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.

Real Estate is a cyclical industry that is sensitive to interest rates, economic conditions (both nationally and locally), property tax rates, and other factors.

Stock markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments.

Indices are unmanaged. It is not possible to invest directly in an index.

Endnotes
[1] Duration is a measure of a security's price sensitivity to changes in interest rates. Duration differs from maturity in that it considers a security's interest payments in addition to the amount of time until the security reaches maturity, and also takes into account certain maturity shortening features (e.g., demand features, interest rate resets, and call options) when applicable. Securities with longer durations generally tend to be more sensitive to interest rate changes than securities with shorter durations. A fund with a longer average duration generally can be expected to be more sensitive to interest rate changes than a fund with a shorter average duration.

[2] A yield curve is a graphical representation of the yields available for bonds of equal credit quality and different maturity dates. Typically, the universe of bonds represented by a particular yield curve is limited by bond type. The most often cited yield curve represents the short, intermediate, and long-term rates of U.S. Treasury securities.

[3] Rolling down the yield curve refers to the effect of bonds drawing closer to maturity, all else being equal. A simple roll down example: assume the current five-year Treasury bond has a coupon and yield of 5%, while a four-year Treasury has a coupon and yield of 4%. In one year's time, if the yield curve is unchanged, new four-year bonds will still be issued at 4%. However, the five-year bond now has only four years until maturity while it continues to pay 5%—an above-market rate. Investors drawn by the yield will likely bid up the bond price generating a roll-down return for an existing bondholder. Roll-down return is based on an unchanged yield curve assumption.

[4] As of Jan. 31, 2014, agency mortgage-backed securities and commercial mortgage-backed securities represented 30% and 2%, respectively of the Barclays Aggregate Bond Index.

[5] "Seasoning" refers to the length of time since a bond's original issuance date. Seasoning can often be desirable if the issuance period is associated with a strong period of credit quality and stronger-than-recent loan underwriting standards.

Definitions
Barclays U.S. Aggregate Bond Index is an unmanaged, market value-weighted performance benchmark for investment-grade fixed-rate debt issues, including government, corporate, asset-backed, and mortgage-backed securities with maturities of at least one year. Barclays Intermediate Government/Credit Index is designed to cover U.S. Treasury and U.S. government agency debt issues, as well as publicly issued U.S. corporate and foreign debentures and secured notes with intermediate range maturities. Barclays 1-5 Year Government/Credit Index is designed to cover U.S. Treasury and U.S. government agency debt issues, as well as publicly issued U.S. corporate and foreign debentures and secured notes with maturities ranging from one to five years. Barclays U.S. Corporate Bond Index measures the investment grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market. Barclays Corporate High Yield Index measures the market of USD-denominated, non-investment-grade, fixed-rate, taxable corporate bonds. Barclays U.S. High Yield Loans Index is designed to cover the universe of dollar-denominated syndicated term loans with a minimum term of one year. Barclays Emerging Market U.S. Dollar (USD) Aggregate Bond Index is a hard-currency emerging-markets debt benchmark that includes USD-denominated debt from sovereign, quasi-sovereign, and corporate emerging-market issuers. Barclays U.S. Treasury Index is designed to cover the U.S. Treasury market. The index includes issues with at least $250 million outstanding, and one year until final maturity. Barclays U.S. Mortgage Backed Securities Index is designed to cover agency mortgage-backed pass-through securities (both fixed-rate and hybrid ARM) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). Barclays U.S. Treasury Inflation-Linked Index measures the performance of the US Treasury Inflation Protected Securities ("TIPS") market. The index includes TIPS with one or more years remaining maturity with total outstanding issue size of $500 million or more.

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