A delicate balance

Fidelity International’s outlook for the global economy, equities, fixed income, multi asset and real estate

House view

We have adjusted our house view in equities, government bonds and credit to reflect the increasing risk-off sentiment among our portfolio managers. In the near-term we have downgraded equities and cash, and upgraded US Treasuries.

Economic outlook

While the bond market asserts its gloomy forecast, the US equity market has broken to new highs, banking on an accommodative Fed and positive developments in US-China trade. This latter view is too optimistic in our opinion - the Fed won’t be as accommodative as the market expects and trade tensions will continue.

Equities

Overall valuations are higher than normal but not yet in bubble territory. Positive global growth and Fed dovishness should support valuations in the long term with good opportunities in Japanese stocks and selective tech stocks.

Fixed Income

In the short term, we have marginally increased credit exposure in our portfolios based on the dovish tone from policymakers and some sign of appeasement on the trade front. However, our long-term view of de-risking and seeking quality yield remains in place.

Multi Asset

Despite the risk of disappointing fundamentals, the Fed’s dovishness will support asset prices and so we are neutral on equities. We continue to take a nuanced view at a regional level however, and are keeping a close eye on central bank policy.

Real Estate

While real estate pricing remains attractive in relative terms, the mispricing of risk is becoming a major challenge. Style drift risks are growing and are evident across most markets and sectors, with pricing premiums between prime and secondary assets and geographies also narrowing.
Over the past few quarters we’ve seen some wild swings in sentiment. After ending 2018 in a gloomy mood, markets spent the first half of 2019 finding their animal spirits again, notwithstanding the hiccup in May. Now, as we enter the third quarter, we are in a finely balanced position epitomised by an overly pessimistic bond market on the one hand, and an optimistic equity market on the other. We think we are somewhere in between those views.

The bond market, egged on by dovish central bank rhetoric and US-China trade war concerns, is fearing recession, and the equity market, taking the same themes is hoping for continued dovishness and progress in trade disputes. The US economy is slowing down but we don’t think it will slip into recession, so the extent of dovish Fed expectations may be overdone. And trade talks will rumble on, at least in the short to medium term - this is not a fleeting battle, it’s a drawn-out war. Barring any exogenous shocks, we could find the market in a sort of limbo for some time, albeit with bouts of volatility as investors latch on to the latest event looking for direction.

The good news is that late cycle dynamics and punchy valuations offer areas of the market for investors to exploit, but it requires a nuanced approach. For example, in the short term, equities are richly valued so we are moderately underweight but in the long term it’s still an attractive market supported by global growth. In government bonds, in the short term the market could still go higher but long-term risk-adjusted returns may underwhelm.

Central banks are attempting to extend a cycle that has already gone on for a long time, and this ratchets up the potential volatility we could see as investors weigh up data, policy and political developments. The best defence for investors is maintaining clear-eyed, sober analysis and focussing on the long term.

Paras Anand
Head of Asset Management, Asia Pacific
Market conditions are a potentially combustible mix, and this has driven our shift to more defensive positioning. Macro risks arising from unresolved US-China trade tensions, a still-tentative bottoming in global macro data and exogenous shocks all have the potential to derail the fragile stabilisation in global growth. Despite bullish signals from our proprietary indicators and a fairly rosy corporate earnings outlook from our analysts, we are heeding numerous warning signs. These include late cycle dynamics, nervous bond markets, rich valuations and complacency in some parts of the market.

We have adjusted our house view in equities, government bonds and credit to reflect the increasing risk-off sentiment among our portfolio managers. The key changes are:

- Equities: near-term downgrade to moderate underweight
- US Treasuries: near-term upgrade to moderate overweight; medium-term upgrade to neutral
- Credit: near-term downgrade to neutral; medium-term downgrade to neutral

**Asset class breakdown**

**Equities**
From a bottom up perspective, we see positive, albeit materially lower, corporate earnings growth in 2019. The moderation in growth is due to the roll-off of US tax reform impacts, slower sales and the combined effects of wage growth, cost inflation, higher taxes and higher interest rates. Valuations have been supported by central bank easing, more than offsetting political noise. Capital inflows, particularly purchases by the Bank of Japan and other central banks, and corporate buy-backs have boosted equities.

From a top down view, we are monitoring downside risks from a slowdown in global growth, trade war uncertainty, spiking volatility and/or a relapse in US economic data. The global economy is in late cycle and punchy valuations could be undone by a trade shock.

**Fixed Income (government bonds)**
Despite positive economic growth in the US and stronger data from China since the beginning of the year, the risk of our macroeconomic bear case is rising. Indeed, the rapid change in US Federal Reserve policy from hawkish to dovish since the last quarter of 2018 shows that we are not the only ones with concerns. The market consensus now anticipates four to five rate cuts (103 basis points) over the next 12 months compared with two to three rate hikes last November.

The pivots in Fed policy and US-China trade negotiations have caused our view to shift from underweight duration to a near-term overweight in US Treasuries and neutral positions in Bunds and Treasuries. We think a recession in the US remains highly unlikely over a 12-month horizon, even incorporating the knock-on effects from higher tariffs. As a result, we have moved to neutral in US Treasuries. We are overweight Chinese government bonds.

**Fixed Income (corporate credit)**
In developed markets we have reduced risk and have downgraded both investment grade and high yield credit to neutral. Within each of these we have moved up in quality, global central bank dovishness and lower political risk in emerging markets than last year.

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Fidelity’s Global Asset Allocation process combines the granular, on-the-ground views of our research analysts together with a macroeconomic and quantitative framework driven by our strategists.

Each quarter, we bring together our regional and thematic experts from across the world to participate in the Quarterly Investment Forum (QIF), where we discuss macroeconomic and geopolitical conditions and how they will impact markets. Each asset class division incorporates this shared understanding into their respective investment and asset allocation decisions.

Every month, we hold Global Asset Allocation meetings where divisional Chief Investment Officers (CIOs), global portfolio managers and strategists share and debate views on macro conditions, markets and cross-asset allocation to produce the house view.

Fidelity’s Global Asset Allocation process is led by: Paras Anand, Head of Asset Management, Asia-Pacific, Anna Stupnytska, Head of Global Macro and Investment Strategy (GMIS) and Wen-Wen Lindroth, Lead Cross-Asset Strategist.
### House view on asset allocation

#### June 2019

<table>
<thead>
<tr>
<th>Asset class</th>
<th>Near term (3-6 months)</th>
<th>Medium term (12-18 months)</th>
<th>Long term (2+ years)</th>
<th>Key views</th>
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<tr>
<td>Cash</td>
<td><img src="#" alt="Strongly negative" /></td>
<td><img src="#" alt="Neutral" /></td>
<td><img src="#" alt="Neutral" /></td>
<td><strong>Our position on cash is neutral. In the near-term, this is driven by expected underperformance of cash versus US Treasuries and higher quality credit. Over the medium- and long-term horizons, risk assets should outperform cash.</strong></td>
</tr>
</tbody>
</table>
| Equities    | ![Strongly negative](#) | ![Neutral](#) | ![Neutral](#) | **Near term:** We are downgrading equities to underweight from neutral. Many market segments are overpricing global growth prospects, while trade war tensions could catalyse a sell-off. We continue to take a nuanced view at a regional level, however.  
**Medium term:** We remain neutral on equities. We are cautious due to late cycle dynamics and increasing risks posed by populist policies globally. On the other hand, technicals remain supportive in the form of central bank purchases, corporate buybacks and the ‘Japanification of Europe’. Importantly, central banks appear ready to intervene once again, should the global economy show signs of a recession.  
**Long term:** We remain overweight, as equities should continue to be supported by global growth and valuations. |
| Government bonds | ![Strongly negative](#) | ![Neutral](#) | ![Neutral](#) | **Near term:** We are upgrading US Treasuries to overweight from underweight, as the rapidly escalating US-China trade tensions have tipped the Fed from a hiking to an easing bias. Expect tighter financial conditions to persist amid extended rhetoric. We upgrade Gilts to neutral; remain underweight Bunds and overweight Chinese government bonds.  
**Medium term:** We are upgrading US Treasuries to neutral from underweight. Downside macroeconomic risks related to the trade tensions are growing, this is balanced by uncompelling government bond valuations. We remain underweight in Bunds and Gilts and overweight CGBs in the medium term.  
**Long term:** We remain underweight, as risk assets should provide better risk-adjusted returns in the long run. |
| Credit      | ![Strongly negative](#) | ![Neutral](#) | ![Neutral](#) | **Near term:** We are downgrading both IG and HY credit to neutral from overweight, due to trade tensions, political uncertainty and signals of a global slowdown. We continue our trend of moving up in credit quality and prefer shorter duration in credit.  
**Medium term:** We are downgrading both IG and HY credit to neutral from overweight, for the same reasons as above. We believe these risks are likely to persist over a 12-18 month horizon.  
**Long term:** We remain overweight, as credit risk assets should outperform government bonds and cash over the long term. |
## House view

### Strong conviction views

**June 2019**

<table>
<thead>
<tr>
<th>Asset class</th>
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<th>Medium term (12-18 months)</th>
<th>Key views</th>
</tr>
</thead>
</table>
| **Equities** | ■ Tech (bottom-up equity call)  
■ EM Asia  
■ Energy (bottom up equity call) | ■ Europe  
■ Materials (bottom-up equity call) | **Tech**: Highest aggregate stock ratings amongst our analysts and fastest 2020E earnings growth.  
**EM Asia**: Chinese credit growth is a major tailwind for the region, but we are watching closely for any moderation after possible distortions from the New Year. Valuations remain attractive and fundamentals are also holding up.  
**Europe**: Consensus has been bearish on Europe given a sharper than expected growth slowdown since the start of 2018 which has carried over into this year. While recession remains unlikely, it is still too early to call the ‘all clear’, given the challenging external backdrop and domestic risks. |
| **Fixed Income** | ■ UST (near-term)  
■ China Rates  
■ Higher quality IG/HY credit (vs. lower quality)  
■ EM | ■ Lower quality IG/HY credit  
■ Gilts | **UST (near term)**: Rapidly escalating US-China trade tensions have tipped the Fed from a hiking to an easing bias; we are upgrading UST to a near-term overweight and a medium-term neutral view.  
**IG/HY Credit**: We downgraded credit to neutral from overweight and are moving up in credit quality (BBBs to As; Bs and CCCs to BBs). We are being highly selective, given escalating trade tensions, late cycle dynamics and rich valuations; amongst sectors we prefer US IG, China IG and Asia HY.  
**EM hard currency sovereign debt**: We remain overweight based on global central bank dovishness, China stimulus, valuation and lower EM elections risk compared with 2018. |
| **Currencies** | ■ JPY  
■ EUR  
■ RMB | | **USD**: We are negative on USD over the medium-to-long-term on valuation. However, still weak global growth is giving the relatively high yielding USD a ‘risk off’ bid. This should keep USD range-bound for now, leaving us close to neutral on a trade-weighted basis.  
**JPY**: Soft global growth should keep JPY bid as a fundamentally cheap safe haven. Rate differentials are also closing with other economies, given the BoJ’s limited ability to lower rates.  
**RMB**: Rich valuation and the need for an offset to US tariffs, combined with more dovish and less interventionist rhetoric from the PBoC Governor, will allow downside risks to the RMB to play out. |
| **Commodities** | ■ Brent oil  
■ Diesel  
■ Copper  
■ PGMs | ■ Natural Gas (Henry Hub)  
■ Iron ore  
■ High Sulphur fuel oil | **Brent (positive)**: “Saudi First” oil policy, Iran sanctions, Venezuela woes create upside risks in 2H19 possible.  
**Natural Gas (negative)**: Ramping up in US shale oil results in higher US gas supply as a by-product.  
**Copper (positive)**: Short-term copper is equity-like, but in the longer term, supply side is struggling. |
| **Real Estate** | ■ Last mile logistics in major European cities  
■ UK retail assets | | **EUR Logistics**: E-commerce is strong driver of demand growth, combined with supply shortages in major conurbations, it will deliver strong rental growth.  
**UK Retail**: Re-valuation of sector has only just begun – oversupply, disruption and taxation will continue to drag on demand. |
A slow, ambling recovery

It looks like we are moving past the trough of the global economic cycle and into a recovery phase. However, a slow, ambling improvement looks more likely than a sharp bounce back. Headwinds that we faced last year, such as tightening financial conditions, the strengthening US dollar, a slowing China, and surging oil prices, have eased and turned into crosswinds. Still, this picture of subdued growth warns us against complacency.

Despite the unexpectedly positive outcome from the US-China trade talks at the G20 meeting, the trade war is set to rumble on. While it will delay and damage the global recovery, it is not enough to derail it. Ultimately, China’s fiscal and credit policy, and US monetary policy, are more important drivers. China has initiated a stimulus package, and we are yet to see the full effects feed through into activity. When they do, they should support growth not only in China but also in Europe, which relies heavily on Asia for external demand.

The US is slowing steadily, ‘catching down’ after its economic outperformance last year. With the US fiscal boost now fading and unlikely to be renewed in the short to medium-term, US Federal Reserve policy is the only game in town for the world’s biggest economy. The Fed is set on a dovish course, and the market expects three rate cuts in 2019 and four to five in the next 12 months. In our opinion that will prove unnecessary. The US economy is unlikely to slip into recession and two rate cuts this year should suffice to stabilise growth around trend levels.

Data is positive but nuanced

Our proprietary data is more positive than last quarter. The Gauges of Economic Activity in Real-time (GEAR), which measures global growth across countries and regions, has bottomed and moved off recent lows. This global figure masks important divergences between countries and particularly between the US, Eurozone and China. The Chinese economy still looks vulnerable, with its GEAR only slightly above its January trough. If it moves lower from here it would point towards a slowing of global trade, but the strong stimulus we saw in Q1 should provide some support.

The Fidelity Leading Indicator (FLI) is a forward-looking predictor of global industrial production and GDP, with a lead of about three months. It now shows promising global activity ahead, indicating that positive and accelerating growth is likely by the fourth quarter of this year. However, like the GEAR, it is signalling a mixed picture at the granular level. Moreover, we must also be wary of base effects - easy comparisons to a weak start of the year - flattering quarter-on-quarter results.

Market pessimism (and optimism) is overdone

While we preach caution at this time, we are more positive on global prospects than some areas of the market, with US Treasury yields at the lowest levels since November 2016 and Bund yields negative. While the bond market asserts its gloomy forecast, the US equity market has broken to new highs, banking on an accommodative Fed and positive developments in US-China trade. This latter view is too optimistic in our opinion - the Fed won’t be as accommodative as the market expects and trade tensions will continue.
The Fidelity Gauges of Economic Activity in Real-time (GEARs) are monthly ‘close-to-real-time’ indicators of current activity across several key developed market and emerging market economies. They are a proprietary quantitative input to Fidelity’s investment process, providing insight into economic activity that supports tactical decision-making in portfolios.

What’s changed

The global economy has bottomed and moved above the lows seen at the turn of the year. However, the positive headline figures disguise significant country divergence. China, in particular, is still concerning.

Key takeaways

- The US GEAR has picked up since the weakness we saw at the start of the year, but the improvement has been narrowly driven and it is down materially from its highs.
- The Eurozone has stabilised over the past few months, but trade-sensitive European countries are continuing to weaken.
- China is our key concern; it hasn’t been able to build on the nascent recovery we saw in Q1.
- Emerging markets, especially Latin America, could benefit from recent political developments around reforms and trade. Most notably Korea, South Africa and Turkey, have bounced sharply from their lows.

Investment implication

The stabilisation of the global GEAR is a reason to be positive but there are a number of risks that could derail the momentum, including China growth and the trade dispute.
In depth: Pickup in the US, stabilisation in Europe

The latest Global GEAR (Gauges of Economic Activity in Real-time), an unweighted average of all countries, looks stable and comfortably above its recent lows. However, this disguises some significant divergence among economies, with the US rebounding after its recent fall, the Eurozone stabilising, and China slowing again.

After a significant slowdown at the start of the year, the US GEAR has picked up substantially. However, this is narrowly driven by a consumer rebound, with consumer sentiment also remaining buoyant. Instead, the sharp slowdown seen in the US industrial sector and softer labour market data may give us a better signal as to the direction from here.

The Eurozone GEAR has also found a foothold, following 2018’s deceleration. It has been flat at a near-trend rate of 1.3 per cent for a few months. The key contributors to this stabilisation have been trade data and industrial new orders, suggesting a nascent turnaround in the external cycle. That said, some of the more trade-sensitive European economies - Germany, Sweden, Switzerland - are slowing to new lows.

China slows again

More worrying is that the engine of global trade, China, has reversed most of its recent recovery, falling back to the 5 per cent range. The slowdown has been broad based, with a variety of indicators such as truck sales, freight volumes, electricity consumption and investment all turning downwards. However, real estate data have remained surprisingly strong, as credit and policy restrictions are loosened.

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If we were to see China’s activity move another leg lower from here, any bull case for global growth in the second half of 2019 would start to look precarious. Earlier stimulus could still feed through to the real economy - we saw a surprisingly large credit impulse in Q1 and this should provide support in the coming quarters.

Some of the more idiosyncratic stories in emerging markets are also important. South Africa’s large bounce, after contracting in Q1, suggests the country might narrowly avoid entering a technical recession as President Cyril Ramaphosa starts his new term. Turkey remains in a very mild expansion after its 2018 recession, and the major Latin American economies are struggling but not quite in recession territory. The positive political developments over the last month, such as progress in pension reforms in Brazil and a trade truce between Mexico and the US, could have the potential to support growth.

GEARS: Regional stabilisation hides country divergence

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Economic outlook

Fidelity Leading Indicator (FLI): Stronger data indicate a recovery

Growth has been reassuringly broad-based

The Fidelity Leading Indicator (FLI) is a proprietary quantitative tool, used in shorter-term asset allocation decisions by portfolio managers. It is a model designed to anticipate the direction and momentum of global growth over the coming months, and - importantly for investors - identify its key drivers.

What’s changed

The FLI cycle tracker moved into the ‘top-right’ quadrant (positive and improving growth), which is a major improvement since the start of the year. In Q2, the FLI signalled acceleration for the first time in two years.

Key takeaways

- There has been a steady improvement in the FLI through Q2, after a poor Q1, although low base effects have flattered results.
- All sectors are now out of the ‘bottom-left’ quadrant, with global trade and consumer/labour in the top-right, while the other three sectors had below-trend but accelerating growth.
- While we are very likely to be past the trough, it is too early to be confident that we are returning to strong growth rates - the FLI disguises divergent global growth trends.

Investment implication

The FLI’s ‘quantitative signal’ is modestly positive, pointing to short duration and long risky assets positioning. The former perhaps feels more comfortable, given the strong run in equities of late.
In depth: Too good to ignore

The improvement in the FLI cycle tracker to the ‘top-right’ quadrant of positive and improving growth is too good to ignore. No sector is in the ‘bottom-left’ any more, compared to all five as recently as February. This partially reflects that the latest recovery has been flattered by quarterly comparisons to the poor start of this year when distortions from US-China tariffs hurt global activity.

Two sectors are in the ‘top-right’ quadrant and, of these, global trade has been the biggest contributor, driven by notable bounces in both hard and soft data. Consumer/labour also moved into the top-right quadrant, albeit marginally. Components remain mixed, with US data weakening, a trend echoed elsewhere in the FLI.

Rebound in growth

The other three sectors are all in the ‘top-left’ quadrant of growth below-trend but accelerating. Business surveys continue to show signs of stabilisation, albeit at soft levels. The global new orders/inventories ratio seems to have stabilised, after more than a year of deceleration.

Bellwether Eurozone surveys are also perking up after a poor run, countering the fall seen in US data. Industrial orders have rebounded, particularly in Germany, reinforcing the business surveys. Japanese data is also finding a foothold but to a lesser extent. Commodity-linked components have also bounced back and are now in the ‘top-left’ quadrant, somewhat at odds with still-weak spot prices. This improvement has, at least in part, been driven by dislocations in global shipping rates after the Brazilian dam disaster.

There are positives - US monetary conditions have now eased, after overtightening with respect to the global economy last year. While the all-important US Dollar has yet to weaken convincingly, emerging market forex has been broadly stable, which is key to global growth. Chinese policy has been surprisingly supportive year-to-date, a complete reversal of 2018’s tightening, which should feed into domestic and global activity with a lag.

But it is not all good news. The US slowdown looks set to continue. Its fiscal boost is turning into a drag, while business confidence has been falling for months, reinforced by elevated US corporate leverage. Renewed US-China tariff escalation is a burden but must not be overemphasised as a driver of growth in either economy, and certainly not in the rest of the world. The short-term disruption on sentiment will delay and dent, but is unlikely to derail, global stabilisation. This is contingent on tariff escalation remaining confined to US-China; the latest US ‘truces’ with Mexico and Europe are positive.

Economic outlook

Headwinds

It is too early to have confidence that we are returning to particularly strong growth rates. Only half of the individual FLI components showed above-trend growth. Moreover, the FLI disguises divergent global growth trends, as the US continues to slow from good levels while other economies look to bottom out.
Economic outlook

Data & Policy: A fragile recovery

US-China trade war is manageable: Fiscal and credit conditions dwarf US trade (US$ bn)

What’s changed
The major central banks have confirmed dovish stances with the both the ECB and Fed likely to start to cutting rates soon. Macro data is more positive than at the start of the year but the overall picture masks divergences between countries.

Key takeaways
- The Fed has opened the door to a July rate cut. The question is whether the cut will be 25 or 50 basis points (bps). Following the G20 meeting, a 25 bps cut looks more likely.
- Markets expect three Fed rate cuts in 2019 while our base case is that two cuts will suffice given that the US will not slip into recession.
- We think there is a good chance that the ECB will deliver some combination of quantitative easing and rate cuts.
- Trade tensions remain but we should be careful of overstating their importance.
- The overall economic recovery is hiding pockets of divergence, so while the US strengthens, the Eurozone is stabilising, and China is sliding. But even within those regions there are nuanced pictures.

Investment implication
The Eurozone economy is more robust than many give it credit for, and Bund yields, which are currently negative on the 10 year, are pricing in too much pessimism. In the near-term, the Fed’s easing bias should keep US Treasury yields tight.
Economic outlook

In depth: Central banks set the tone

In the space of six months the Fed tanker has completed an about-turn from hawkishness to dovishness, confirming its stance at the June FOMC meeting. After raising rates last December, the Fed has firmly opened the door to the first rate cut since December 2008 at the July meeting. The question for markets, which expect three cuts in 2019, is whether the July cut will be 25 or 50 bps. With the resumption of trade talks, the Fed does not need to be as aggressive, so, in our opinion, the possibility of a 50 bps cut at the next meeting is less likely.

We expect the US economy to slow to trend growth rates, but, crucially, not approach recession. Given this outlook, it’s logical for the Fed to cut twice in 2019 and bring rates comfortably below its newly-revised ‘neutral’ estimate of 2.5 per cent.

We expect the US economy to slow to trend growth rates, but, crucially, not approach recession. Given this outlook, it’s logical for the Fed to cut twice in 2019 and bring rates comfortably below its newly-revised ‘neutral’ estimate of 2.5 per cent. Our base case is a 25 bps cut in July and another in September. There are clear parallels to the two rate cutting cycles in the mid-1990s (1995-6 and 1998) where the Fed was able to ease without tipping the US into recession.

The balanced tone at the June ECB meeting quickly gave way to a dovish message at the bank’s annual Sintra conference, where President Mario Draghi said that more stimulus would come if there were no improvement in the economic outlook. This was a surprise to some ECB policymakers, given that changes to bond purchases, interest rates and forward guidance policy were barely discussed in June.

We think some combination of renewed quantitative easing and rate cuts is possible. Draghi probably has the clout to push through a rate cut, despite disagreement among ECB policymakers about whether further negative rates would do banks more harm than good. Bond purchases are easier to agree on but further QE could provide more easing than the economy needs. Our view is that the Eurozone domestic economy is more robust than many realise, and the external drag should turn as emerging markets recover. Financial conditions have also already eased significantly. Negative Bund yields are pricing in too much pessimism; historically long-dated bond yields rise at the onset of QE as investors bet on reflation. In the near-term, ECB QE would suppress yields still further.

Trade tensions remain but shouldn’t be overstated

While there was no immediate further escalation at the G20 meeting between Donald Trump and Xi Jinping, tensions will remain given diametrically opposed views on certain key issues. The US is demanding effective monitoring and enforcement of Chinese promises, while China views implementing changes to its domestic law to allow this monitoring as an unacceptable infringement on its sovereignty. Moreover, despite the US relaxing some of the restrictions on Huawei, many in China view the imposition as proof that the US wants to limit China’s economic development; so why offer substantive concessions if that’s the US’s ultimate goal?

However, while tariffs and related uncertainty are a drag that will slightly dent and delay any global recovery, the magnitude of the impact on US and China growth should not be overstated. Global growth will be even less affected, with other economies benefitting from an acceleration of the re-routing of supply chains out of China, which has been underway for some time.

Mixed picture on data

The macro picture is more positive than it was earlier in the year but still rather hazy. The recovery is hiding pockets of divergence, so while the US strengthens, and the Eurozone stabilises, China is sliding. Even the US, which saw a strong consumer-led rebound in Q2, experienced a slowdown in business surveys and job growth suggesting that the economy is moderating after the temporary ‘sugar high’ of the fiscal boost last year, and inflation has also repeatedly surprised to the downside.

Eurozone data has been robust with GDP expanding above 2 per cent in both Q4 and Q1, and unemployment falling at a steady pace. China growth has continued to weaken through the quarter and infrastructure spending is yet to pick up despite heightened local government bond issuance. China’s credit impulse has turned positive for the first time since 2017, having been deeply negative in 2018; this is a key support to growth. China’s stimulus is big enough to matter, but it has yet to fully feed through.

We think the Fed’s dovishness should boost global growth, particularly helping emerging market countries to ease conditions, which in turn should increase demand for European goods. The trade war is damaging, and delays any improvement, but it shouldn’t have the heft to derail a global recovery.
What’s changed

US Federal Reserve policy and rhetoric around trade tensions both continue to buffer equities. Concerns around global growth and escalating trade tensions in May gave way to Fed dovishness and a mildly positive outcome in the US-China trade talks in June to leave the S&P 500 at a new record high.

Key takeaways

- Despite flat corporate earnings, global equities have performed strongly this year due to a re-rating.
- Disconnects are appearing, examples being energy stocks decoupling from the oil price and fixed income and equities in seeming contradiction.
- Quality stocks are still valued above long-term averages, signalling that fear is influencing the market.
- Chinese data looks promising, but we caution against assuming a full China recovery in the second half of the year.

Investment implication

Overall valuations are higher than normal but not yet in bubble territory. Positive global growth and Fed dovishness should support valuations in the long term with good opportunities in Japanese stocks and selective tech stocks.

“Despite US stocks reaching new record highs, this remains a challenging environment for equity investors. Disconnects are appearing amid quick, sharp bouts of volatility. This uncertainty creates opportunities, but it requires discipline to profit from them.”

Romain Boscher Global CIO, Equities
In depth: Déjà vu

May and June were mini re-runs of last December and January, and for the same reasons. Recession fears and US-China trade tensions caused the sell-offs in December and May and dovish central bank rhetoric and positive newsflow on trade talks led to recoveries in the following months respectively. Investors should hold to fundamentals in these ‘topsy-turvy’ market gyrations - and take quiet confidence from them.

When it comes to earnings, flat is the new up. Global equities have performed strongly year-to-date with the MSCI AC World Index up nearly 15 per cent. This is due to a re-rating from 13x price-to-earnings to 15x, more than enough to offset earnings downgrades in an environment of high base effects and fading US fiscal stimulus. Information technology stocks have enjoyed significantly better earnings revisions than other sectors, which partly explains their leadership of the market.

Equities versus bonds: Both can’t be right

A disconnect is appearing in the energy sector

Fidelity aggregate analyst forecasts

<table>
<thead>
<tr>
<th>Global equity forecasts</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
</tr>
</thead>
<tbody>
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<td>Return on equity</td>
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<td>P/E valuation</td>
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<tr>
<td>P/B valuation</td>
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<table>
<thead>
<tr>
<th>Capital market assumptions</th>
<th>3 years</th>
<th>5 years</th>
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<tr>
<td>US equities</td>
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<tr>
<td>European equities</td>
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<td>Japanese equities</td>
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<tr>
<td>Developed market equities (US$)</td>
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<tr>
<td>Emerging market equities (US$)</td>
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These are estimates of return per year in USD, based on our proprietary modelling, for illustrative purposes only. They reflect the views of investment professionals at Fidelity International. Indices used for calculation: US equities - S&P 500, European equities - MSCI EMU, Japanese equities - TOPIX, DM equities - MSCI World, EM equities - MSCI EM.

Source: Fidelity International, March 2019
Equity

Disconnects widening

This is a difficult environment for stock-pickers. A number of long-held correlations have been breaking down over the past several months. Investors that correctly identified wider trends could still have ended up holding the wrong stocks.

For example, there’s been a growing disconnect between the relative performance of the energy sector versus the oil price. US energy has closely followed oil prices over the past two decades but started diverging in 2016 when energy started to underperform despite a stable to rising oil price. In the year-to-date, a 30 per cent rise in the oil price hasn’t changed the underperformance of energy companies which lag the global index by 3.9 per cent. The outlook for oil remains broadly positive, but we are questioning whether there are more structural drivers at play - investors could be giving up on fossil fuels.

Another disconnect is occurring between fixed income and equities. US bond markets are now pricing in four Fed rate cuts over the next 12 months - historically a bearish indicator, yet at the same time US high yield spreads have tightened significantly year-to-date. In equities, the consensus forecasts double-digit earnings per share (EPS) growth for the S&P 500 in 2020. These measures seem to contradict one another.

Fear still in the market

Fear is still playing an influential role in equities. Quality stocks are trading above their long-term average against the market indicating that investors are still too scared to move into value for concerns about a macro slowdown. While quality valuations may look extended considering the last five years, they are still not at the excessive levels that we saw in previous bubbles and we could see this quality dominance running for much longer. Overall market valuations are above normal levels but far from bubble territory.

Despite the US and China reopening trade negotiations at the G20 meeting, the dispute is far from over and this has the potential to cause continuing volatility in equities. Similarly, the Fed’s dovishness is supporting markets, but rhetoric is likely to contribute to market swings. Chinese data looks promising, but we caution against assuming a recovery in the second half of 2019 at this stage.

With valuations not overly demanding and global growth remaining positive, the market should be supported in the long-term. We see compelling opportunities in the Japanese market, which continues to be undervalued. From a bottom up perspective, we like the tech sector, which is benefitting from earnings revisions.
**Equity**

**Regions**

Some regions looking slightly expensive

![Graph showing price to book for different regions](image)

- **Global**
- **US**
- **Europe**
- **Asia ex Japan**
- **Emerging markets**
- **Japan**
- **EMEA/Latam**

**Fidelity aggregate analyst forecasts**

<table>
<thead>
<tr>
<th>Earnings growth forecasts</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
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</thead>
<tbody>
<tr>
<td>Global</td>
<td>1.1%</td>
<td>9.0%</td>
<td>7.8%</td>
</tr>
<tr>
<td>US</td>
<td>1.2%</td>
<td>10.6%</td>
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<tr>
<td>Europe</td>
<td>1.0%</td>
<td>7.2%</td>
<td>6.4%</td>
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<tr>
<td>Asia ex Japan</td>
<td>1.9%</td>
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<td>10.5%</td>
</tr>
<tr>
<td>Japan</td>
<td>-2.7%</td>
<td>6.5%</td>
<td>6.0%</td>
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<tr>
<td>Emerging markets</td>
<td>2.3%</td>
<td>10.0%</td>
<td>11.7%</td>
</tr>
<tr>
<td>EMEA/Latam</td>
<td>4.1%</td>
<td>8.0%</td>
<td>9.6%</td>
</tr>
</tbody>
</table>

**Source:** Fidelity International, 1 July 2019

**Investment implication**

Corporate earnings growth is expected to be flat to slightly positive in 2019 after a strong 2018, rising to high single digits in most regions in 2020. Consensus expectations remain on the high side.

Valuations are rising in most regions and are above long-term averages but haven’t reached bubble territory as macro concerns remain at the centre of investors’ attention.

**US: Fed and trade still the drivers**

New highs in US equities posted at the start and end of the quarter were punctuated by the month of May, which saw the S&P 500 lose nearly 6 per cent. Fed policy and trade talks dominated performance in both directions. The trade dispute could limit business spending and lead to a modest industrial slowdown but it doesn’t have the power to stop the US economic expansion. Although macroeconomic data is mixed, the economy is still growing and recession fears are overdone - however that economic growth is slowing. Fed support in the form of two potential rate cuts this year should act as a tailwind to the economy and equities.
The recent announcement by the US House Judiciary Committee to investigate the competition of multiple technology companies could slow the progress of US tech stocks. This is not the first time FAANG companies have been targeted by regulators. These investigations will drain time and resources from these companies and increase scrutiny on their corporate activities.

**Europe inc UK: ECB could provide support**

Geopolitical risk was a key feature for European stocks. The region was not immune from market gyrations caused by the trade dispute between the US and China and it has its own trade battle with the US. Talks over US threats of tariffs against European automakers stalled in May and an additional list of goods that could be affected by tariffs was drawn up by the US on 1 July. Brexit also continues to be a burden with the outcome still very unpredictable. These uncertain but lingering events have the potential to continue to cause volatility.

Although economic growth in the region is stabilising, it is still fragile, so stimulus would help equities. Any recovery in China would also benefit stocks as European external demand relies heavily on Asia.

On the more positive side, political risk from the European Parliament elections eased as populist and Eurosceptic parties underwhelmed at the polls and centrists remained dominant. A lift for equities also came from the ECB President Mario Draghi, who indicated the central bank was considering monetary support in the form of more asset purchases and/or rate cuts. Although economic growth in the region is stabilising, it is still fragile, so stimulus would help equities. Any recovery in China would also benefit stocks as European external demand relies heavily on Asia.

**Asia-Pac ex Japan: Reforms and stimulus in the pipeline**

The trade war is causing demand shifts and this can be most clearly seen in shipping. US import data is showing that Chinese imports are down but this is being offset by higher imports from Vietnam, Malaysia and China. The problem is that Vietnamese ports are reaching capacity so any increase from here is unlikely.

Year-to-date total social financial growth has been 10.6 per cent, which is slightly higher year-on-year, driven by looser monetary policy, front loading of bank loan issuance and early issuance of a government special bond this year. We think there is considerable government support for infrastructure spending. Following the tidy up of public-private partnership projects last year, delayed projects are now being pushed through with local governments given the means to raise cash to finance them. The government appears to be adopting a highly flexible series of mini-stimuli rather than an ‘old school’ type stimulus. We think that this will translate into supportive physical demand from Q3, however a lasting recovery into H2 is not yet guaranteed.

In both India and Indonesia, incumbent governments have been elected to another term, with India’s Narendra Modi receiving an even larger majority than in 2014. This bodes well for the continuation of reforms but it’s important to keep a close watch on the direction of the changes as both economies require a much-needed boost.

**Japan: Exposed but attractive**

We continue to be positive on Japan. It’s still priced cheaply compared to other developed markets while corporate balance sheets are strong and companies are increasingly pursuing shareholder-friendly policies. Economically, the country delivered a positive surprise by growing 2.1 per cent in Q1. However, Japan is buffeted by the US-China trade spat due to its exposure to global trade flows and its perception as a safe haven, which leads to a stronger currency and less competitive exports in times of global uncertainty. This could lead to some price volatility but cheap valuations make Japanese stocks a source of attractive long-term investments at this time.

**Emerging markets: Pockets of high risk**

Saudi Arabia and Argentina joined the MSCI Emerging Markets index with the former following a two-step process due to complete in August. Passive capital flows of $11 billion and $1 billion respectively are expected to flow into the countries as a result. Saudi Arabia still requires much-needed reforms, particularly around job creation to address its youthful demographic. We have been frequently engaging with local Saudi companies since first visiting the country in 2015, but, despite some interesting industries, the market continues to look expensive on a risk-adjusted basis.

Argentina’s macroeconomic picture shows tentative signs of recovery. It’s made significant progress in reducing the fiscal deficit, improving external balances and building up currency reserves. However, as the country approaches a general election in October, the deep recession and stubbornly high inflation could give an advantage to populists. Argentina is also reliant on agricultural exports, particularly soybeans, which are facing softer prices as a result of falling demand from China, itself dealing with an African swine fever epidemic. Economic uncertainty and political noise will continue to drive sentiment in the upcoming months.

Brazil made some progress on social security and tax reforms, which supported sentiment. Russian stocks also rallied as investors scoured the market for cheap and relatively trade war-insulated pockets. But, overall, emerging markets have now underperformed their developed market counterparts for five consecutive months.
**Equity**

**Sector views**

**Tech stocks get the most positive ratings from Fidelity analyst**

<table>
<thead>
<tr>
<th>Sector</th>
<th>Cap weighted average rating (1=strongly positive 5=strongly negative)</th>
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<td>Communication Services</td>
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<td>Financials</td>
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<td>Energy</td>
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<td>Industrials</td>
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<td>Utilities</td>
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<tr>
<td>Health Care</td>
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<tr>
<td>Materials</td>
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</tbody>
</table>

Based on FY19 results. Source: Fidelity International Insight, 30 April 2019

**Top three sectors**

**Information Technology: Semiconductors leading the way**

Tech stocks were hurt by the trade conflict but bounced back strongly in June led by semiconductors - an industry with deep supply chains and demand from China. The trade truce around Huawei is positive for US companies and we’ve improved the outlook for chipmaker Broadcom as a result. But it’s not yet clear exactly how far the restrictions will be lifted. Any clarification could lead to further gains for semiconductors, particularly given that a number of negative events have occurred in the past year so any positive newsflow could be a tailwind.

China cloud computing is also an opportunity. Companies are investing heavily in cloud capacity and overall digitisation is at an earlier stage compared to other countries. Companies such as Alibaba are well placed to become dominant players. 5G adoption is a multi-year trend for the sector. China is continuing its development and, in the US, monetisation beyond the consumer and Internet of Things, in areas such as cloud gaming, is a nascent but significant source of revenue growth.

**Investment implication**

The sectors where our analysts are most constructive are Technology, Communication Services and Financials, while they are least constructive in Materials, Health Care and Utilities.
Communication Services: Special situations developing

Media and Entertainment leads this sector with a number of special situations developing. WPP looks close to selling its Kantar unit to a private equity buyer. Yahoo Japan was a standout performer after an ownership swap in the company indicated it could eventually be a takeover candidate for Softbank Corp. South Africa’s Naspers is taking action to close its price discount over the longer term by listing its international internet assets in Amsterdam. Tencent’s momentum is expected to improve materially over the rest of the year as the 2019 games releases start to have a bigger impact and US games maker, Activision Blizzard, has a growing pipeline and an ambitious management team.

Yahoo Japan was a standout performer after an ownership swap in the company indicated it could eventually be a takeover candidate for Softbank Corp.

In Telecommunications we are more cautious. European companies are facing negative revisions. There are pressures from rising leverage, competitive intensity in most markets including Spain, Belgium, France and Switzerland and expensive spectrum auctions in Italy and Germany. Our view could be revised later this year when a new European Commissioner is appointed who could potentially change telecom industrial policy and trigger industry consolidation.

Financials: Upside still available

Falling yields are negative for banks as they reduce their interest income, and we have cut earnings forecasts as a result. However, there is still substantial upside available following significant sell-offs recently. The sector is now at multi-decade price-to-earnings troughs and there are tentative signs that European macro conditions could exceed expectations over the coming quarters.

US Fed stress test results were improved across the board which provide confidence in US banks. JP Morgan looks particularly strong given its industry leading earnings and dominance in multiple business lines. Financial exchanges have performed very well over the last 12-18 months and we see no reason for that to change. Companies such as Deutsche Boerse, London Stock Exchange and Euronext are long-term holds. UK asset managers look gloomy however, after being badly affected by market volatility and outflows. They continue, along with other European asset managers, to have market share taken by ETFs.

Bottom three sectors

Materials: Stubborn challenges remain

We have been negative on Materials for some time and continue to be so. The challenges facing the sector remain stubbornly in place. Headwinds to global growth, weak construction demand, a strong US dollar, unresolved trade war concerns and cooling property demand and infrastructure development in China are all contributing to pessimism in the sector. Global steel is also facing a margin squeeze. However, there are pockets where we see the very early signs of value brewing.

In Metals & Mining, while demand is increasing for lithium, driven by increasing battery use, many projects are underfunded, which could herald good investment opportunities in the future. Gold could also benefit from investor fear and falling real interest rates. And targeted stimulus from the Chinese government may provide support to materials demand in China over the next year.

Health Care: Regulation rhetoric remains in focus

The sector has some positives. Valuations aren’t demanding, innovation is improving and China is a growth area. But these are dominated by US pricing headwinds, most acutely affecting the managed care industry. International pricing benchmarks are difficult to implement and ‘medicare for all’ is unworkable in practice but still caused a major correction in April. As the US election cycle ramps up we expect healthcare to be a contentious topic and rhetoric around regulations will burden the sector.

European Medtech performed well and offers structural growth from ageing populations and increasing disease incidence. There is considerable dispersion in the industry, however, so selecting attractive idiosyncratic growth stories at reasonable prices is key. We like Grifols, Qiagen and Livanova.

Utilities: High valuations

Declining bond yields have helped boost utilities but valuations are now above historical averages relative to the index. The sector has few growth opportunities despite steady cash flows.

In the US, gas utilities are facing ongoing speculation around regulatory caps. In Europe, utility companies are vulnerable to an increase in historically low German bond yields. In the UK, any general election would heighten fears around nationalisation in the case of a Labour government. There are also nationalisation themes developing in French airports and German assets. Our favourite name is Ferrovial, which is a very defensive company with no European exposure and could unlock value by completing its divestment programme.
Fixed Income

Overview

What’s changed

The US Federal Reserve and European Central Bank are seeking to extend this cycle with further monetary easing. Both central banks are indicating rate cuts, which has led to a resurgence in the search for yield. The G20 meeting brought more conciliatory tones between the US and China. However, trade-related uncertainty is unlikely to completely subside, amid slowing US growth that is converging towards global levels. In Europe, signs of macro stabilisation could be a false dawn against trade headwinds and the political impasse around Brexit.

Key takeaways

- US Treasury yields edged to their lowest levels since November 2016 due to Fed dovishness, concerns about global growth and a deterioration in trade talks between the US and China.
- While the market is pricing in three rate cuts in the US in 2019, our base case is for only two given our expectation that the slowing US economy will avoid recession.
- In Europe, the scramble for safe haven assets and ECB dovishness pushed Bund yields to new lows and a worsening of the outlook drove us to revise our European duration exposure.
- In the UK, growing worries that Theresa May’s successor, after her resignation, will pursue a no-deal Brexit further hampered risk sentiment.

Investment implication

In the short term, we have marginally increased credit exposure in our portfolios based on the dovish tone from policymakers, and some sign of appeasement on the trade front. However, our long-term view of de-risking and seeking quality yield remains in place. In Europe, we pared back our duration exposure and are back to neutral given low inflation, renewed ECB dovishness, and the strong correlation between European core government bonds and US Treasuries.

“Central banks are back in the driving seat, driving yields lower across the board. While the search for income has resumed, investors should not be complacent, and focus on quality income rather than yield at all cost.”

Steve Ellis, CIO, Fixed Income
In depth: Major central banks confirm easing mode

Despite several opportunities to adjust market expectations for rate cuts in the months and quarters ahead, the Fed stuck to a cautious tone, almost certainly confirming action at the July meeting. Meanwhile, ECB President Mario Draghi indicated rate cuts and asset purchases could be in the pipeline. Central banks are attempting to extend the cycle and the market has responded, reigniting the search for yield.

US Treasury yields dropped by over 30 bps in May and, following the June FOMC meeting, dipped below 2 per cent. Four rate cuts are now priced in over the next 12 months by the market. From a macro standpoint, we are more optimistic than the market expects. Our base case scenario is that the Fed will make two cuts in 2019, less than what is currently priced in, as the US economy will slow but escape recession.

With support from fiscal stimulus looking unlikely, monetary policy may prove an important tool to counter the effects of the trade war. US Treasuries, in turn, should remain well supported as the US macro story plays out. We are closely watching labour force data, the key pillar of macro strength that has yet to crack.

In our portfolios, we are trimming risk at the edges and de-risking overall but have slightly increased credit beta in the short term in response to central bank dovishness. However, our longer-term view remains the same: cautiously balancing credit risks with yield and moving towards quality yield rather than the market’s sentiment of ‘yield at all costs’.

Expectations of Fed hikes have disappeared

These are estimates of return per year in USD, based on our proprietary modelling, for illustrative purposes only. They reflect the views of investment professionals at Fidelity International. Indices used for valuation: US Treasuries - 10 year US Treasury from ICE BofAML par yield curve, German government bonds - 10 year German government bond from ICE BofAML par yield curve, US investment grade - ICE BofAML US Corporate Index, European investment grade - ICE BofAML Euro Corporate Index, US high yield - ICE BofAML US High Yield Index, Euro high yield - ICE BofAML Euro High Yield Index.

Source: Fidelity International, June 2019

Forecast tables

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<th>Jun-2021</th>
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<td>UK</td>
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Source: Bloomberg, US Federal Reserve, Fidelity International. 5 June 2019

Capital market assumptions

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<td>US Treasuries</td>
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<td>German government bonds</td>
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<td>US high yield</td>
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<td>European high yield</td>
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Source: Refinitiv, July 2019
Case for higher Bund yields in jeopardy

In Europe, core rates tracked US Treasuries and the safe heaven bid pushed Bund yields into negative territory and to record lows. The case made earlier in the year for higher Bund yields following stabilisation in the European macro picture is in jeopardy by the recent turn in trade events and dovish rhetoric from the ECB president. The worsening of the outlook pushed us to revise our European duration exposure. We pared back our core European duration exposure and hedged against further bouts of risk aversion.

The macro picture remains clouded by the ongoing trade row, which remains a key risk despite the positive messages out of the G20.

In the UK, focus has turned to the race to replace Prime Minister Theresa May. Conservative MPs have selected two candidates to put to a party membership vote in July. Both, on the face of it, appear willing to consider a hard Brexit. The UK macro backdrop remains challenging and Gilts will continue to be heavily influenced by other rates markets. On balance, however, we keep an underweight stance, mostly because of the flatness of the curve and expensive valuations.
Fidelity International

Investment Outlook

Sub-asset classes

**Inflation-linked**

Global inflation markets sold off during the quarter as inflation expectations fell on economic slowdown fears and technical factors. May alone saw futures on Brent Crude fall over 10 per cent dragging US breakevens lower with global inflation expectations following. Year-on-year US CPI and core CPI for April came in lower than expected but rose from the previous month. The headline figure continued to see upward pressure from the gasoline component driven by the oil price increases earlier in 2019 feeding through to prices.

UK breakevens were a notable exception to global breaken trends, as domestic political issues continued to be the dominant driver. Speculation and news flow around Brexit and a potential general election is reflected in Sterling volatility. As Sterling depreciates, it puts upward pressure on import costs and inflation expectations.

Volatility in Eurozone inflation remains elevated due to seasonal factors, where package holiday discounts and subsequent price rises tend to drive fluctuations in the headline figure. However, the volatility in these components has been exacerbated by a change in methodology announced at the turn of the year. Interestingly, measures of ‘super core’ Eurozone inflation continue to tick upwards.

**Investment implication**

We moved tactically underweight US inflation expectations early in May as the month is typically seasonally weak. Now that the decline in US breakevens has materialised, we are back to neutral. The FOMC is in the midst of a monetary policy strategy review and given recent rhetoric over alternative objectives, such as targeting nominal GDP or inflation ‘averaging’, we expect some important developments that could have major implications for inflation markets in the longer term.

We have moved neutral in Eurozone breakevens, which had traded cheaply relative to core measures of inflation earlier in the year. However, the latest fall in core inflation has brought this fundamental picture back to fair value.
Investment grade

The rise in risk aversion did not spare investment grade (IG) credit, with spreads in all regional markets widening during the quarter, only to recover as central banks boosted demand for income yet again. The longer duration profile of the asset class also played in its favour, as the fall in government bond yields contributed to positive total returns. The strong rally in US Treasuries benefitted US and Asia IG credit in particular. Both delivered a positive total return of 7-9 per cent year-to-date, outperforming other markets, in spite of wider spreads.

Looking under the surface, spreads may face further upward pressures given the still-challenging macro backdrop, and lingering trade-related concerns. At the margin however, IG credit should remain better insulated from the slowing growth environment compared to other higher beta areas of the market. The decompression theme of tightening spreads between IG and HY has been put temporarily on hold by the latest round of central bank dovish rhetoric. Overall, we continue to favour higher quality credit.

At the regional level, our preference remains for Europe and Asia. In European IG, our positive stance is based on better valuations and corporate fundamentals. Adjusting for quality, the asset class has underperformed the US market on a spread basis over the past year, despite lower leverage. Both sector and single country exposure remain an important driver of returns for EUR IG investors. The spectre of tariffs lingers on the automotive sector, and while the deadline for their implementation has been postponed to Autumn, bonds in the sector will continue to face downside risks. More recently, the prospect of another Corporate Sector Purchase Programme (CSPP) by the ECB has supported EUR IG spreads, perhaps a little too soon given the political hurdles that need to be overcome for a new round of stimulus to materialise. At country level, we keep a cautious stance on Italian names where we see rising political risks and volatility ahead. Our preference remains for selected utilities and the largest financials in the country.

Investment implication

Expectations of a supportive Fed and more stimulus from China to offset the impact of the ongoing trade war keep us positive towards Asia IG. Spreads on the asset class have been relatively resilient year to date, and only recently started to react to the developments in trade negotiations. Domestic central banks meanwhile, will use the opportunity offered by a Fed that is in easing mode, and could potentially cut rates, to ease policy further. The technical backdrop, as a result, should remain supportive as yield-hungry local investors continue to add to high quality, USD-denominated paper.

For US IG, the market remains sensitive to the ongoing news flow on the tariffs front. Dispersion at sector level has increased sharply, with energy and automotive names lagging the more defensive in the second part of the quarter. It’s not just about tariffs however. Looking beyond credit, global stock markets also indicate concerns in the industrial, chemical and retail sectors, and combined with ongoing small cap stock weakness suggest a slowing macro story. Given the challenges that still lie ahead, we keep a neutral to cautious stance towards US IG credit and prefer EUR IG credit.
High yield

High yield credit spreads resumed tightening in June

Limited refinancing needs are favourable for high yield assets

Demand for high yield (HY) bonds fell in May, making it the first month of negative total returns in 2019 for global high yield credit. The drawdown was short lived however, rebounding in June thanks to more accommodative signals from global central banks. The escalation in trade rhetoric between the US and China, volatility around the EU elections, Brexit developments and continued Italian political risk, were enough to turn markets into risk-off mode before central bank dovishness spurred demand from yield-hungry investors. Year-to-date returns remain strong at nearly 10 per cent and spreads are 120 bps tighter from year end.

Looking ahead, spreads will trade on the back of political headlines and central bank policy, keeping volatility elevated. The cautious messages from the rates market will probably see dispersion rise. The need for yield, however, remains extremely strong, driven by dovish central banks and a surge in the volume of negative yielding assets. At the same time, despite investor flows turning marginally negative in May, limited refinancing needs should keep supply in check for the remainder of the year, providing a positive technical dynamic for spreads.

European HY was not immune to the tough month risk assets experienced in May, with the index posting -1.5 per cent of total return and spreads widening by 67 bps. This was led by Brexit, sectoral headwinds and fears of an upcoming global recession dampening risk sentiment. However, most of the drawdown and spread widening was recouped in June. Asian HY was relatively resilient versus the wider asset class and equities in May and spreads narrowed less than other regions in June. Weak sentiment along with buyer preference skewed towards shorter tenors and higher quality, has led to steeper curves and an underperformance of B-rated bonds.

Moreover, the Chinese recovery is likely to be bumpier than previously forecast, and we expect more targeted easing from Chinese authorities in the next two quarters, which should support the asset class.

Investment implication

We are neutral US HY, with spreads now 100 bps from the recent lows. These levels would be considered attractive in a non-recessionary environment, but the trade war warrants a cautious and nimble approach. At the same time, we have empirically observed that when the Fed is in an aggressive easing mode, lower rated HY names suffer more as this represents a recessionary signal to the market. We expect returns in the asset class to primarily originate from coupon accumulation rather than capital appreciation for the remainder of 2019.

We have taken risk closer to a neutral stance in the past few weeks, as we believe that valuations became ‘fairer’ after their relative cheapness in the first quarter. Multiple fronts of volatility have begun to resurface on both a regional and global scale, but solid fundamentals, a dovish ECB, and a steady, if below trend, European macro environment should continue to provide support.
Emerging markets

Investment implication

In sovereign debt, we took the opportunity from wider spreads in May to add risk in recognition of better valuation, increasing the credit beta on the portfolio. Key overweights are largely unchanged, with positions in Chinese corporate debt, Saudi Arabia, Turkey and Argentina. We also added some exposure in Dominican Republic, Oman and Sri Lanka over the month.

Russia remains our largest underweight position as well as names in Latin and Central America where valuations appear tight despite relatively stable fundamentals.

Our constructive view on local duration is unchanged. Real policy rates are high in many EM countries after central banks were forced to hike rates last year to defend against currency weakness. Now we see EM inflation falling sharply which gives central banks some room to stay dovish this year. Our main overweights are Israel, South Africa and Serbia. We stay underweight in Hungary, Czech Republic and Poland, which are experiencing inflationary pressures from robust domestic growth and tight labour markets.

All three areas of emerging market debt (EMD) delivered a strong performance over the quarter. Sovereign and corporate hard currency indices posted positive returns, driven by US dollar duration as US yields pushed lower. Both asset classes saw spreads widen in May, but eventually recovered in June, on the back of the central bank-led turnaround in risk sentiment.

Local markets returned 3.7 per cent over the quarter, with gains driven by local duration and carry, and small positive returns from FX. Total EMD fund flows in May were negative; around $1 billion came out of local currency funds which was only partly offset by a modest $300 million of inflows into hard currency funds. Nevertheless, we expect strategic flows into the asset class to continue. The hunt for yield remains an important driver of demand and developed market yields are at fresh lows for the year.

Our outlook for hard currency debt remains positive, backed by expectations of further stimulus from China and a persistently dovish tone from the Fed both in terms of rate hikes and the plan for balance sheet reduction. Against this backdrop we see further near-term downside risks for US Treasury yields which could protect against the negative impact of more spread widening in hard currency markets.

Local currency debt continues to underperform hard currency with EM FX struggling against a strong US dollar. In a world of persistently dovish developed market central banks, the US dollar still offers yield, stability, liquidity and more resilient domestic growth than other advanced economies.
What’s changed

The falling volatility seen in 2019 has reversed in the latter part of Q2 as trade tensions again came to the fore. The macro data in places looks reassuring but market valuations are high and vulnerable to exogenous events.

Key takeaways

- While the Fidelity Leading Indicator is showing modest acceleration, caution is warranted as trade tensions have again resurfaced.
- After a weak 2018, China stimulus is expected to feed through as we move into the second half of the year. While the trade dispute is affecting sentiment, this could result in more supportive policy. This would be a tailwind for China and emerging Asia more broadly.
- We have returned to a neutral view on equities due to central banks’ willingness to support asset prices once again, but do not believe it is prudent to move to overweight given markets’ stretched optimism and a slowing US economy.
- With an underweight duration view we maintain our positive view on cash. We do not see this as a structural overweight, but rather a tactical view to allow us to buy into opportunities as they present themselves.

“When valuations are stretched, the downside risk is high, and we are in that position today. There are clear, binary downside risks which could have a significant impact on markets given valuations.”

Multi Asset team

Investment implication

Despite the risk of fundamentals disappointing on the downside, the Fed’s dovishness will support asset prices and so we are neutral on equities. We continue to take a nuanced view at a regional level, however, and are keeping a close eye on central bank policy.
**In depth: Calm markets punctuated by volatility**

The first four months of 2019 saw a steady upward trajectory in risk assets and the longest consecutive period of falling volatility since 2014, which had investors puzzling over what could derail equity market momentum. The resurgence of trade tensions temporarily answered that conundrum in May, as equity markets gave back some of their still impressive year-to-date gains, before recovering in June after central bank dovishness became further entrenched and incremental headway was made in the trade dispute. At the same time, the risks of recession have receded rather than increased.

Given this backdrop, our team sees a market ripe for shorter-term positioning, and this is reflected in our views. We have updated our view on equities to neutral after a brief period of being underweight, and while this overall perspective is nuanced - underweight US and overweight emerging markets, for example - we still see many markets overpricing global growth prospects, and if trade wars or fundamental data deteriorate, we could see a sell-off.

Conversely, fixed income markets are pricing in bearishness, and given low carry and poor valuation support, we maintain our underweight duration view, especially in non-US sovereigns. We also have a positive view on cash, as having ‘dry powder’ to deploy when markets produce dislocations will be important in the coming months, especially amid the continuing ‘tit-for-tat’ trade dispute between the US and China. This situation has the potential to trigger over- or underreaction from markets. We are also closely watching the impact of the trade conflict on prices paid by consumers, as this will clearly impact how long President Donald Trump is willing to continue down the path of brinkmanship, particularly as we build towards the 2020 US election.

**Uncertain Europe**

Political uncertainty has not receded in the UK, and the European elections did not throw up any signs of a national consensus on Brexit. As the governing Conservative Party fights it out to see who their next leader will be, it’s clear that the next Prime Minister will be dealing with the same intractable political situation as their predecessor - an ongoing headwind for an already weak Eurozone.

In this uncertain environment, the full breadth of Fidelity’s Multi Asset investment team is working hard to uncover opportunities.
Sub-asset classes

Equities

- **US** - We maintain our neutral view on equities as the markets again touched all-time highs, but without the attendant economic signals that would be expected. Trade war sentiment is another headwind that hasn’t receded.

- **Canada** - We remain neutral on Canadian equities given their heavy reliance on their southern neighbour. Housing market softness, above-target inflation, and pipeline capacity are concerns despite a higher oil price acting as a tailwind.

- **UK** - Brexit headwinds remain. With the next PM likely to pursue a hard-line Brexit strategy, the outlook remains precariously unclear. Valuations are attractive, but we do not believe in taking a strong view given this backdrop.

- **Europe ex UK** - Italy may have moved out of recession, but budget tensions with the EU are back. The Eurozone is dependent on Chinese growth, so we would need to see more solid signs of improvement there to move back to neutral.

- **Japan** - Our view on Japan remains neutral. We have not seen signs of improvement in the domestic economy and earnings revisions remain negative. Fallout from trade tensions between the US and China may hit Japan as well.

- **Asia Pacific ex Japan** - While markets in Hong Kong are vulnerable to trade tensions, the overall picture remains generally positive and liquidity remains abundant. Australia’s housing market leaves us cautious, however.

- **Global emerging markets** - We remain positive on emerging markets, albeit with a nuanced view. While still vulnerable to trade tensions, they are set to benefit from a dovish Fed cutting rates and weakening the dollar.

- **EM Asia** - We are still positive on the prospect of China stimulus feeding through in the second half of the year. While trade wars remain in play, positive signs out of the G20 meetings are at least a near term tailwind.

- **EM EMEA** - Turkey is emerging from a cleansing recession, with industrial production and turnover positive, but political risks remain. Russia remains vulnerable to sanctions, but this has receded somewhat due to the US focus on China.

- **EM LatAm** - Hard data in Brazil remains poor, but developments on pension reform seem cautiously positive. Mexico looks likely to see at least a short-term bounce after US tariffs were avoided.

Fixed income

- **US Treasuries** - Moving back to neutral after a period of strong performance due to Fed dovishness and demand for defensive assets. We see US Treasuries as an important defensive position in many of our portfolios.

- **Euro core** - Given further signals of dovishness by outgoing ECB President Mario Draghi, and yields remaining negative, we maintain our underweight view. For many European investors Bunds will still have a defensive role.

- **Euro periphery** - Italy has moved out of recession, but budget tensions with the EU are back in play. Our Income range has maintained its short position in Italian government bonds to reflect this negative outlook.

- **Inflation-linked bonds** - Inflation is still low, but we believe that US TIPS are an important asset as a hedge against the risk of inflation surprising on the upside. We remain positive on this defensive asset.

- **Investment grade** - We take a neutral view on IG bonds. This is a nuanced view, however, and we remain focused on high-quality, short-duration, US dollar denominated issues, especially given the historically large percentage of BBB ratings.

- **US high yield** - We maintain our underweight view on US high yield, and see the market as vulnerable to any change in course from the Fed or risk off sentiment rising. Our Income range prefers other regional high yield markets.

- **European high yield** - Our view remains neutral on Euro high yield. We upgraded our view on the asset class earlier this year based on improving valuations, and, while this thesis is intact, we are not prepared to move to an overweight view.

- **Asia high yield** - In our Income portfolios, Asia high yield remains a key area of conviction. The market is relatively protected from trade war tensions given its domestic focus, and fundamentals remain attractive.

- **Hard currency emerging market debt** - We remain positive on hard currency emerging market debt given increased Fed dovishness, a positive for EM central banks. Our view is that USD strength is likely to recede, and this would be another boost.

- **Local currency emerging market debt** - We maintain our positive view on local currency debt, and further dovishness by the US Fed could be a tailwind. Given the likelihood of USD weakening our Income range has not added back to currency hedges.

- ** Emerging market corporate debt** - Our view on emerging markets corporate debt remains negative given the asset class is vulnerable to the global late cycle environment, and we prefer to access emerging market debt via government bonds.

Currency

- **US dollar** - The Fed’s abrupt end to rate hikes and ‘QT’, significantly slowing US growth, falling core inflation, ‘twin deficit’ headwinds, and very expensive fundamental valuations has us bearish on the USD against select currencies.

- **Euro** - While the Eurozone remains challenged and the ECB is trapped at negative interest rates, the Euro now prices a lot of investor pessimism. An upturn in the external cycle could catch consensus off-guard, boosting EUR.

- **Japanese Yen** - Despite its strong run, JPY remains attractive as a cheap ‘defensive’ asset. There is upside potential on falling interest rate differentials as markets increasingly price in the next US downturn, or on broad USD weakness.
Real Estate

Overview

What’s changed

Style drifts tend to be exacerbated by the weight of capital, and this time around is no exception. As we move through the year, there is a growing evidence that investors in European real estate are venturing into secondary markets and geographies, and towards more specialist sectors in search of yield.

In the UK, the lack of progress on Brexit and weak economic fundamentals have extended the quiet period of investment activity, which started in Q4 2018, well into Q2 2019, although there are signs that more assets have been coming to the market in recent weeks. The build-up of pressures in the UK retail sector continues, and the recent signs of price softening in other sectors mean that 2019 will see lower returns across the board.

Key takeaways

■ Deployment of capital has become a major challenge. Only around 50 per cent of equity raised for real estate investment in 2018 has so far been deployed as investor competition intensified. An absence of willing sellers has led to a reduced supply of properties. This was a key factor behind slower investment activity across the globe, and in Europe in particular.

■ The lack of progress on Brexit is extending uncertainty, leaving most UK real estate market participants unable or unwilling to make decisions. Adverse conditions in the UK retail sector continue, leading us to expect significant capital declines in the sector as the year unfolds.

“Macro factors - persistently low interest rates, currency volatility, politics - continue to be the tail that wags the real estate dog, drawing investors to property for its yield premium and perceived safe haven status. But fundamental real estate factors are starting to reassert themselves again - most notably in retail property in the UK, which is falling in value in some locations both quickly and significantly. Successful investors will be those who have already re-positioned portfolios over the past year.”

Neil Cable, Head of European Real Estate

Investment implication

While real estate pricing remains attractive in relative terms, the mispricing of risk is becoming a major challenge. Style drift risks are growing and are evident across most markets and sectors, with pricing premiums between prime and secondary assets and geographies also narrowing.

In the UK, investors with an already-low retail sector allocation should have a strong advantage, but the benefits of being overweight to the industrial sector appear to be fading. Specific asset characteristics irrespective of sector, such as lease length, tenant covenant, as well as active asset management, are likely to be key factors in delivering outperformance in what is likely to be a year of low total returns.
Outlook

Strong domestic demand should drive Eurozone economic growth in 2019 to 1.3 per cent, an unchanged outlook from the previous reporting period. The divergence between the weakness in the export-focused manufacturing sector and the strength of domestic economies has been a prominent feature since H2 2018 and is set to continue into H2 2019. Strong domestic fundamentals are reflected in:

■ A robust service sector, which should continue to support corporate balance sheets and expansions, and, in turn, occupational real estate market fundamentals.

■ On-going labour market strength, with unemployment rates expected to fall further, leading to an even tighter job market and further upward pressure on wage growth. This should set the scene for stronger consumer spending in 2019.

The downside risks remain and include external shocks such as escalating trade tensions and political risks. In combination with a weaker economic outlook, these may prolong the current Eurozone real estate cycle further, but equally, an external or economic shock could well result in property yields increasing and triggering the end of a cycle.

The European Central Bank has indicated that interest rates will not rise during 2019. Supported by further indications that the ‘lower for longer’ interest rate environment will be prolonged, we expect pricing for good quality, income-producing real estate investments to be maintained at current high levels, with room for moderate increases in selective core Eurozone markets, such as Germany and the Netherlands. However, late-cycle price overshoots, particularly the mispricing of risk, underestimation of new supply and speed of the current development cycle, can threaten a successful investment strategy.

In the UK, the negative sentiment generated by Brexit will continue to dampen the real estate market, with weak investment activity now extending into Q3. That said, there are signs that more assets have been coming to the market in recent weeks.

Given that we are late cycle, we believe that investors should be focusing on delivering strong and stable income, secured where possible with long leases on good quality assets in core, established markets. At the same time, some carefully selected asset management opportunities should assist in capturing capital growth, especially considering the unabated occupier demand and investment market strength for quality industrial and office assets. This thinking is uniform and should hold true almost regardless of geography.
Real Estate

Regional breakdown

Eurozone pricing: Evidence of late-cycle pricing overshoots in secondary offices

Continental Europe

Robust labour market conditions and a strong consumer spending outlook should continue to prop up the European economy, amid risks of becoming unbalanced due to ongoing trade and political tensions. As in the recent past, healthy letting demand, low supply and growing real estate allocations will continue to support the core Eurozone commercial real estate markets. The challenge is to find suitable properties to invest in as pricing competition intensifies. With persistent high demand for income boosting prices, either investors need to accept more risk when deploying new capital, or, as is increasingly the case, investors need to materially lower their return expectations.

With the exception of retail, yield spreads between prime and secondary real estate continued to narrow in Q2 2019 to around 200 basis points (bps) at a pan-European level - a level last seen in 2012. The evidence that investors are venturing into more secondary markets in search of yield is growing, especially in the office sector where pricing shifts have been particularly sharp. Spreads between prime and secondary office yields narrowed to 150 bps or less in most Western European markets, and in many cases are now below 100 bps. Such low spreads highlight areas of risk we have been growing more concerned about over the last few quarters, such as the late-cycle tendencies of price overshoots and the mispricing of risk, both likely to have been exacerbated by the weight of capital.

Investment implication

With prime office yields in most European markets now somewhere between 3 and 4 per cent, the risk of style drift is significant. A focus on sustainable income and an acceptance of lower returns will be key to prudent decision-making.

Some specialist retail segments may deliver attractive returns given a promising consumer spending outlook. The key factors to assess here will be tenant affordability and the sustainability of consumer demand towards the relevant retail segment.

Source: Fidelity International, CBRE, June 2019
Real Estate

Regional breakdown

UK

With Prime Minister Theresa May’s resignation, no substantive progress on Brexit, and the UK economy forecast to contract in Q2 2019, we expect the UK real estate market to remain quiet.

The MSCI UK Monthly Property Index reflects the caution shown in the investment market. Total returns for the three months to the end of March were 0.5 per cent, a significant slowdown from the 1.1 per cent recorded in the three months to December 2018. The retail sector remained the biggest drag on performance, but capital growth also turned negative in the office sector as rental growth proved insufficient to offset a modest softening of yields, and even the industrial sector saw a very slight widening of yields. The latest 2019 UK All Property total return forecast has been revised down to only 2.1 per cent.

The latest series of retail insolvencies triggered wide concern about the sector. Keen to avoid situations of default, lenders are keeping a careful watch on potential loan-to-value (LTV) breaches and are starting to question whether some retail properties should continue to be categorised as institutional-grade products.

Overall, there has been a general shift in sentiment, with four-year UK All Property performance forecasts now in the 4.0-5.8 per cent per annum range for the stronger-performing segments. With that in mind, a focus on longevity and quality of income should provide some cushion to further softening in pricing.

Investment implication

The retail sector will continue to drag on performance as the risk of significant valuation write-downs continues to build. The market is preparing for a much deeper correction, given the implied pricing in the REITs market.

That said, recent price softening in other sectors means that 2019 will see lower returns across the board. Equally, as this unfolds, the UK market will offer a window of opportunity for timely, tactical investing as attractively priced, or even ‘mispriced assets’ are likely to come onto the market from distressed sellers at a time when most investors will not be in position to acquire. Cash-rich UK investors stand to benefit the most.
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