Braver for longer…
Investment outlook
Fourth quarter 2017
The bull market is still intact but it’s now in its last phase.

Solid global growth and robust earnings growth are still supporting stocks.

Pockets of rich valuations are becoming a concern in a range of asset classes.

Bond markets will be driven by central bank policy, inflation data and the outlook for China.

The risk of policy mistakes remains elevated.

Braver for longer…
Contents

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2. Equities

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Five themes to follow
1: Keep a close eye on US inflation

Benign conditions in the US, for now…

- Inflation will likely dictate the next Fed move, rather than unemployment. Watch closely for signs of US inflation to indicate if there will be a hike this year.

- Inflation is subdued in the US right now, despite a tight labour market. Markets believe there is wiggle room within the Fed’s projected interest rate outlook.

- But a weak dollar could import goods inflation, medical care prices may rise, and September’s hurricanes have raised the outlook for gasoline prices.

- US breakevens aren’t reflecting all these upside inflation risks.

Source: Fidelity International, DataStream, Sept 2017
2: Growth is stabilising

Fidelity Leading Indicator (FLI) signals stable global growth

- The FLI, designed to lead global industrial production by 1-3 months, points to a stabilising global cycle.
- Is this a genuine and prolonged stabilisation in growth around trend levels or is it a holding pattern before a renewed inflection downwards?
- It's hard to say as there is a lack of dominant headwinds or tailwinds globally.
- Budding headwinds could include Fed tightening and the reigning in of Chinese stimulus.
- Offsetting tailwinds are the weaker US dollar and falling long-end yields. Few countries have actually started tightening and commodity prices are broadly firming up.
- Watch for any of these headwinds or tailwinds starting to dominate.

Source: Fidelity International, September 2017
3: Corporate earnings
Earnings growth is driving equity returns

- 12 month forward earnings growth has been closely correlated to equity returns. We can’t expect multiples to expand much further, so any pull back in earnings growth expectations could hit equity markets.
- For the time being, earnings growth is still supportive - fundamentals are good and volatility is low.
- But there are pockets where valuations are starting to look stretched, particularly in the technology sector.

![Earnings growth vs MSCI World index](sourceDataStream.png)

Source: DataStream, September 2017
4: Defusing China’s debt bubble

19th National Congress kicks off in October

- Beginning 18 October, the fifth generation of Chinese leaders will meet at the 19th National Congress to reshuffle the leadership and decide the agenda for the next five years. Deleveraging could be a major theme.
- We expect the large, incumbent state-owned enterprises (SOEs) to be a key focus, with further innovations in ownership structure likely and privatisation possible.
- Stricter regulation of local government financing vehicles (LGFVs) and local government debt could improve regional indebtedness.
- Reining in residential mortgage growth should help contain fast-rising household debt.

5: Geopolitical risk is rising
North Korea tensions continue to ratchet up

- Any consideration of direct military conflict with North Korea remains unlikely at this point.
- But events are creating some uncertainty which could act as a drag on market performance.
- Outside of North Korea, there are still continuing issues in the Middle East, Russia and Venezuela.
- In Europe, Brexit talks are making slow progress, and the AfD party in Germany could prove a thorn in Merkel’s leadership of the EU.
- Finally, in the US, the debt ceiling deadline will re-emerge in December, and Trump’s isolationist rhetoric hasn’t gone away.

Source: Policyuncertainty.com, September 2017
Equities overview
A case of hanging on

- The drivers of this bull market are beginning to look played out and we are close to the end of this cycle.
- The market-defining themes of multiple expansion & the re-rating of stocks with IP over those with hard assets are running out of fuel.
- It’s a case of hanging on for now, but also thinking about protecting against downside risk.

Comparing bull market returns

Fidelity forecasts

<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
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Earnings growth to support markets

Source: Fidelity Earnings Forecasts, Fidelity Insight, Fidelity International, September 2017

Source: Fidelity International, Thomson Reuters, September 2017
US equities

The punchbowl is still in place

The monetary policy outlook remains supportive

- Markets have reduced their expectations for US rate hikes in this cycle as inflation remains contained, despite tightness in the labour market.

- Fed chair Yellen will start to normalise policy by beginning to shrink the Fed’s balance sheet in October. If markets react badly, the policy is likely to be reversed.

Everyone is now buying tech

- A low-growth, low-inflation environment is still a ‘goldilocks’ one for tech stocks.

- The FAAMG stocks have actually shown lower implied volatility than the market and even consumer staples stocks.

- Any acceleration in the economy would see tech stocks cede leadership to cyclical value/rate-sensitive stocks.

### Fidelity forecasts

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### FAAMG – growth stocks and safe stocks?

European (incl. UK) equities
Sweet spot: fading politics and improving macro

Political worries have faded dramatically in recent months
- We have moved to a position where economic and corporate factors have assumed greater importance.

Easy gains are past and stock-picking matters more now
- While there is scope for stocks to deliver earnings into their valuations, there is more limited room for stock multiples to expand further.
- This may make European stocks more vulnerable to short-term events and geopolitical anxieties.

More positive on UK banks
- We are more positive on the outlook for UK banks. While the financial crisis still looms large in the memory of investors, banks are now a very different beast, operating in a much-changed environment.

Fidelity forecasts

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UK banks have much stronger capital positions

Regional earnings optimism

- Concerns over a Chinese economic slowdown have faded and market sentiment has improved.
- Reforms are improving the profitability of state-owned enterprises (SOEs), and supply-side reforms introduced in coal and steel sectors are being extended to other industries.

Rich valuations in the Chinese internet giants

- The market rally in China has been dominated by internet stocks, particularly Alibaba, Tencent and Baidu.
- These are high-quality companies with huge first-mover advantages and dominant market positions but there is limited margin of safety now.

Indian growth story intact but caution advised

- While India’s growth story remains intact, the Goods & Services Tax (GST) reforms could mean we see a little disruption to consumption and GDP numbers for a few quarters.

Fidelity forecasts

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Chinese IT sector leading the way

Source: FactSet, 31 August 2017, based on MSCI China Index in USD terms for period 31/08/14 – 31/08/17.
Japanese equities

Growth is good, but inflation is lagging

Monetary policy likely to remain unchanged

- Real GDP came in at 2.5% annualised in Q2, the sixth straight quarter of growth and the longest streak for 11 years. However, CPI languished at 0.4% in May and June, and 0.5% in July.

- Given the disappointing pick-up in inflation, monetary policy is likely to remain unchanged.

Positive outlook for consumption and corporate earnings

- Healthy employment and gradually improving wages are encouraging for consumption.

- A new replacement cycle is starting in consumer goods like cars and electronics. Corporate earnings continue to grow strongly and exports rose for the eighth consecutive month in July.

Small caps or large caps?

- Japanese small caps are outperforming large caps, but this isn’t creating valuation opportunities in sectors like cars and banks because US consumers are extended, price competition is intense and there is little scope for acceleration in loan growth.

Fidelity forecasts

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Small caps outperforming large caps

EMEA and Latin American equities
A benign backdrop for emerging markets

Relatively benign conditions

- Global growth has been solid and the dollar has weakened as expectations for US rate hikes were diminished.

Russia remains tied to oil, but there are bright spots

- When the oil price struggles, Russian equities usually do too. US shale producers’ ability to respond quickly to prices means that the oil price is essentially capped. As a result, we continue to avoid energy stocks.

- Instead, we favour domestic companies with strong market positions like Sberbank and mail.ru.

Materials sector benefits from Chinese capacity withdrawals

- Our analysis indicates copper will move into supply deficit in the next few years, which is supportive for Grupo Mexico, which benefits from a low cost of production via Southern Copper (SCCO on the chart).

- The outlook for steel and aluminium producers is also more positive given capacity rationalisation among Chinese SOEs.

Fidelity forecasts

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Gruppo Mexico: at the right end of the copper cost curve (owns Southern Copper – SCCO)

Global equity sector views
We still favour technology and telecoms

Positive on technology and telecom stocks

- We remain positive on technology, where companies are successfully attacking the profit pools of other industries by re-imagining and transforming their business models.

- We like telecoms in national markets like Korea, US and Japan, where there is strong pricing power.

Negative on consumer discretionary

- We remain negative on consumer discretionary, where stocks face a range of headwinds including the shift to online and the shift towards consumer experiences rather than consumer goods.

More negative on energy

- The swiftness of US shale supply responses has been greater than expected – notwithstanding extended cuts by OPEC.

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Table: Fidelity Insight, Global Aggregate Forecasts in USD, September 2017.
Fixed income overview

Relentless yield search continues...

- The unrelenting search for yield continues to drive bond markets.

- As a result, credit spreads are near historic lows and valuations warrant caution. Fundamental analysis and discrimination between securities and covenants is vital.

- The key question for central bankers is whether we are seeing a sustainable recovery or a cyclical pick-up within a secularly stagnant regime.

- We believe a range of structural factors (debt, demographics, low productivity) could keep growth and inflation low for some time yet.

Current and forecast government bond yields

<table>
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<tr>
<th>10 year yield</th>
<th>Current</th>
<th>Sept-18</th>
<th>Sept-20</th>
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<tr>
<td>US</td>
<td>2.24%</td>
<td>2.44%</td>
<td>2.74%</td>
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<tr>
<td>Germany</td>
<td>0.42%</td>
<td>0.68%</td>
<td>1.14%</td>
</tr>
<tr>
<td>UK</td>
<td>1.34%</td>
<td>1.58%</td>
<td>1.98%</td>
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Fixed income outlook

The central bank dilemma: cyclical or structural?

Sustainable recovery or cyclical pick-up in a secular stagnation environment?

- In our view, the current cyclical uplift is not enough to justify meaningfully higher yields, with structural issues such as debt overhang, ageing populations and low productivity giving reasons to expect low growth and inflation for some time.

The Fed sets a date for balance sheet reduction

- The Fed will start shrinking the balance sheet in October by reducing treasuries and MBS reinvestment by up to $10bn each month.

- Interestingly, the Fed reduced its mid-term interest rate trajectory and the long-term terminal rate (2.75%), but this wasn’t reflected in near-term projections.

ECB pushes the hard decisions down the tracks

- September’s ECB meeting was a non-event – no changes in rates or asset purchases, and no indication of when tapering could be expected.

- The path to normalisation remains broadly on track and is expected to start in 2018, but in the meantime the focus is on inflation and the level of the euro.
Inflation linked bonds
US inflation bull case is stronger than market pricing suggests

US breakevens not entirely reflecting upside risks
- Softening inflation expectations in recent months have led to scepticism over the strength of the US economy.
- But August data reminded us there is some pressure in the system with both headline and core inflation posting above expectations.
- The labour market remains tight, dollar weakness should support goods inflation, medical prices could rise, and September’s hurricanes have raised the outlook for gasoline prices.
- We project headline inflation around 2% in H1 2018, and 2.5% by middle of next year.

Few opportunities in Europe as inflation slides towards year-end
- The ECB’s 2% target will slip further from reach in the winter months. Ongoing euro strength may shave 60 bps from CPI this year and commodity price base effects are still feeding through. We remain neutral.

UK breakevens appear overvalued
- It’s possible that hedging is causing UK importers to delay raising prices until Q4. But we think the pass-through from cheaper sterling into inflation data has peaked.

Fidelity inflation forecasts

Investment grade bonds
Rich valuations warrant a cautious approach

The hunt for yield, combined with central bank purchases, has put a cap on yields and volatility

- Investors looking for income yet afraid of taking excessive credit risk have found IG to be a welcome alternative to low-yielding government bonds.
- As central banks now prepare to unwind the policies that have driven IG bonds, caution is warranted.
- That said, the demand and supply backdrop is unlikely to suddenly worsen.

Europe remains our preferred market

- Low inflation will force the ECB to taper QE purchases only very gradually, keeping support in bond markets in place.
- Corporate fundamentals are solid, with low leverage and good coverage ratios.

More cautious on US and UK

- US IG continues to attract foreign flows thanks to a still attractive headline YTM. But hedging costs have risen substantially in the last two years for European and Asian investors, so value is less compelling.
- UK IG investors cannot ignore political hurdles around Brexit.

High yield bonds
Keep your powder dry at these valuations

Plenty of risks
- Investor belief in central bank ‘puts’ remains deeply entrenched and restrained inflation provides ongoing support to high yield credit markets.
- At current levels, the scope for further spread tightening appears limited, leaving coupon income as the main source of returns.
- Keeping some powder dry seems a sensible approach, particularly given the low opportunity cost at current spread levels.

Focus on Europe
- Fading political risk, improving economic momentum, and a dovish ECB have provided a supportive backdrop.
- We don’t see ECB potential tapering as a catalyst for a sharp repricing – they will still be a very large buyer, while net supply of European HY is negative.

Still cautious on US and Asian High Yield
- Fundamentals are strong in both regions but the possibility of a slowdown in the near term must be acknowledged.

Emerging market debt
Strong investor demand reflected in tight valuations

Risks ahead
- EM has been one of the best-performing fixed income asset classes this year, thanks to the strongest inflows in five years. But there are risks ahead.
- Performance will depend on three key factors: global central bank policy, China and commodities.
- The Fed and China are especially relevant, as the former sets the global cost of capital and the latter the global rate of growth, and both of these help to drive capital flows in or out of emerging markets.

Prefer corporates to sovereigns in hard currency
- We prefer EM hard currency corporates over sovereigns, as the former benefits from cleaner positioning and higher credit quality.

Duration opportunities in local currency
- Local Currency duration offers high real interest rates, at a time when EM inflation is falling and local central banks remain firmly in easing mode.

Cautious on EM currencies
- There could be scope for retracement of the USD selloff as Fed policy normalisation progresses.

China’s credit impulse is falling after credit creation in 2016

Real yield differential between EM and DM is at a decade high

Top: Fidelity International, Haver, UBS, August 2017. Credit impulse is defined as the Y/Y change in the ratio of new net credit to GDP.
Alternatives
Commercial real estate overview
Economy and monetary policy still supportive, but watch valuations

- The unexpectedly strong economic upturn, coupled with unchanged monetary policy will support the market.
- The opposite is true in the UK, where a subdued economic outlook due to Brexit remains the key headwind. Strong returns from UK commercial real estate in 2017 are unlikely to be sustained in 2018 as the rate of yield compression slows.
- There are risks and opportunities in both the European and UK markets. Stretched valuations in prime real estate are a common risk.
- A focus on core plus/value add is our strategy of choice on the continent, while a focus on the security of lease and tenure ought to offer outperformance in the UK.

Fidelity forecasts

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<tr>
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<th>5-year</th>
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<td>Europe market level total return*</td>
<td>11.7% ± 2%</td>
<td>4.9% ± 3%</td>
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<tr>
<td>UK market level total return**</td>
<td>8.2% ± 3%</td>
<td>6.9% ± 3.5%</td>
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Source: Fidelity International, Jones Lang LaSalle, RealFor, MSCI IPD, August 2017.
*Synthetic prime all property return forecasts Western Europe (excl UK) and expected variation from the base case scenario.
** MSCI IPD UK All Property Index return forecasts and expected variation from the base case scenario.
Commercial real estate: Continental Europe
Fundamentals are strong, but be wary of ‘excess capital’

A healthy economic upturn
- Robust economic sentiment has turned into a stronger than expected upturn.
- Across the continent, 2018-2019 forecasts are 20-30 bps stronger. This should provide further comfort for investors seeking European exposure and boost confidence in real estate’s ability to deliver robust and sustainable income returns.
- Our ‘extended real estate cycle’ view is unchanged, and we expect it will run into early 2019.

Supply and demand imbalance
- The supply and demand imbalance that developed after the financial crisis is expected to continue, with below-average long-term new completion levels yet robust demand expectations.
- This imbalance is likely to be a feature over the next five years.

Extended window for core plus / value add strategies
- ‘Excess capital’ (a growing pool of very competitive cross-border investors) is pushing prime real estate yields down in many markets, but investors with detailed micro-market knowledge still have opportunities.

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<td>Market level capital growth</td>
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<td>1.2% ± 3%</td>
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Office take-up in western Europe (ex. UK)

Forecast source: Fidelity International Real Estate, JLL, August 2017. Synthetic prime all property return forecasts Western Europe (excl. UK) and expected variation from the base case scenario.

Commerical real estate: UK
Buoyant market but choppiness ahead

Subdued economic outlook
- Political and economic risks remain the key challenges with little progress apparent thus far in Brexit discussions.
- This is impacting business investment, which has remained flat since the start of 2016, as businesses continue to postpone capital expenditure due to Brexit uncertainty, despite strong corporate performance.

Broader investor mix with local buyers active again
- Despite the uncertainty, the UK real estate market continued to behave in line with long-term trends.
- Encouragingly, local investors accounted for about half of H1 2017 transactions by value, with property companies, REITs and investment funds being most active.

Heading into choppy waters
- In contrast to economic projections, commercial real estate forecasts suggest a very strong end to the year.
- The most important aspect to watch out for as the UK heads into choppier waters would be tenant strength and lease structures.

Fidelity forecasts*

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UK real estate investment activity by source of capital

H1 2017 = £18.2bn

Commodities

Solid commodity performance, however outlook calls for caution

Surging metals driven by supply cuts
- Metals have performed strongly mainly driven by cutbacks in production - most notably in Australia and Brazil, where cuts in response to the initial fall in commodity prices in 2011 have begun to feed through.
- Demand is robust. While China tightened policy over H1, this has not yet had a significant impact on the economy. However, we expect it to feed through into slower growth, weakening the outlook for industrial metals.

Energy fundamentals positive in the short term, but shale mitigates the medium term outlook
- With inventories falling more than seasonal patterns, and the US rig count stalling, the short term outlook is positive.
- In medium to long term, higher oil prices will ultimately incentivise US shale production.

Real yields could take the shine off of gold
- Real yields are a strong predictor of moves in the gold price, and are likely to rise in the coming months, indicating caution on precious metals like gold.
Infrastructure

Renewables powers wider opportunities

Increasing number of operational assets are coming to market

- Significant project pipeline built under old regime of generous government subsidies are coming to market
- Renewables M&A is already 40% higher in H1 2017 versus all of 2016.
- New opportunities emerging as societal needs develop e.g. offshore wind farms require new offshore transmission cables (OFTOs) to connect generated power to the existing onshore networks.
- New assets often offer above normal returns, as investors use higher discount rate in ‘novelty’ premium. As the asset class generates more data points, these risks are priced more efficiently and asset values are revised upwards.

Sector poised for evolution

- Battery storage is becoming increasingly important to the UK grid following £246m UK government investment programme announcement.
- Renewables tend to be higher yielding, involve less leverage and have greater revenue variability than the rest of the infrastructure sector.

Renewables M&A is picking up strongly

More capital targeted at Offshore Transmission (OFTOs)

The bull market is still intact but it’s now in its last phase

Solid global growth and robust earnings growth are supporting stocks

Pockets of rich valuations are becoming a concern in a range of asset classes

Bond markets will be driven by central bank policy, inflation data and the outlook for China

The risk of policy mistakes remains elevated
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