



Outlook 2020: Soft landing, earnings returning

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

This is for investment professionals only and should not be relied upon by private investors

Outlook 2020 - Foreword

After a year of renewed monetary policy expansion, we expect the world to avoid a global recession in 2020. However, several of our CIOs raise the issue of negative bond yields, which are now of systemic concern. With central bank rates at their lowest levels and US Treasuries at their richest valuations in 100 years, we appear to be close to bubble territory, but we don't know how or when this bubble might burst. 2020 could see that inflection point, but, as we have already learned, this cycle has not been a typical one and these conditions could persist for some time to come.

Meanwhile, liquidity is under threat from the decline of globalisation. The frictionless flow of capital around the world is subject to increasing barriers, such as those resulting from the recent US/China trade dispute. As capital is confined to smaller pools, it weakens the ability of the financial system to withstand unexpected shocks, such as a counterparty failure. As active managers, we work to stay ahead of these developments and find opportunities amid the uncertainty.

We expect sustainability to remain a core theme across the corporate landscape in 2020. We engage with companies on their environmental, social and governance (ESG) characteristics during the thousands of meetings our analysts conduct every year, and this year, we introduced our proprietary sustainability ratings across equities and fixed income which provide a detailed picture of corporate ESG behaviour. These allow us to pinpoint both those companies which are already leaders and those making significant improvements across a range of areas from transparency and supply chain management to de-carbonisation.

Over the long term, these companies are more likely to thrive, cope better with emerging risks and thus deliver better financial returns.

Wishing you a happy 2020,

Anne Richards

Chief Executive Officer, Fidelity International



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Outlook 2020 - Macro view

Expect a soft landing for global growth



Wen-Wen Lindroth

Lead Cross-asset Strategist & Senior Credit Analyst

Geopolitical risks that dominated headlines in 2019 - such as the trade war - have been subsiding. If this fragile calm can persist throughout 2020, we should see a soft landing for global GDP growth. The synchronised wave of dovish central bank policy in 2019, plus a confident consumer buoyed by strong employment markets, should be enough to prevent a global recession in major economies - for now. However, pockets of weakness remain, most notably in the manufacturing and industrial sectors. We believe inflation will re-emerge in 2020, as wage pressures build amid low levels of unemployment and tariffs add to input costs, or their removal triggers a surge in growth.

US Federal Reserve rate cuts in 2019 are helping the US housing market, adding an important support to the economy. Our expectation is for US GDP to grow at 1.9 per cent, assuming that Presidents Trump and Xi sign the 'Phase 1' agreement and suspend the escalation in tariffs. While Trump will continue to pressure the Fed to cut rates in the run-up to the election, the state of the economy and stock markets at all-time highs point to a pause in easing for now. Late-cycle dynamics appear poised to last for yet another year. We may well see a rebound in risk sentiment in anticipation of better news from manufacturing and export sectors, strengthening the case for inflation to pick up in the US.

European economies meanwhile should escape recession too, with around 1-1.5 per cent GDP growth. Against this backdrop, negative rates will persist in Europe, with bund yields trading in a range of -20 to -60 basis points. Bunds could move closer to zero if trade talks go exceptionally well, but positive yields seem unlikely while the European Central Bank remains in easing mode. If the trade war escalates again, we expect attention to switch to fiscal stimulus within individual countries. An EU-wide fiscal plan looks unlikely in the short term.

We expect Chinese growth to slow in 2020, but in a managed fashion thanks to targeted stimulus. Even with a resolution of the trade war, risks remain for the Chinese economy. Emerging markets (EM), which feel the impact of trade tensions most acutely, will be vulnerable to dollar strength and a more hawkish tone from the Fed. At present, monetary policy throughout EM remains accommodative and, in aggregate, EM economies are likely to generate solid growth in 2020. Even so, investors in emerging markets will need to remain selective and side-step idiosyncratic risks - in particular, populist unrest which has claimed several heads of state across emerging markets in the last 12 months.

Domestic and international political risks remain the most significant tail risk for 2020, in our view. Central banks, having carried the baton almost as far as they can for the last decade, look increasingly spent. How governments now confront questions of growth, inequality and demographics will be key for investors over the next decade.

Table: Fidelity growth and inflation estimates for 2020

	GDP growth	Inflation	Policy rates
Global	3.1%	3.0%	n/a
US	1.9%	2.1%	Hold
Eurozone	1.4%	1.5%	Hold
UK	1.3%	2.1%*	Hold
Japan	0.6%	0.5%	Hold
China	5.9%	2.1%	Continue monetary and fiscal easing

*CPI. Source: Fidelity International, November 2019.

Equities

Earnings returning in 2020



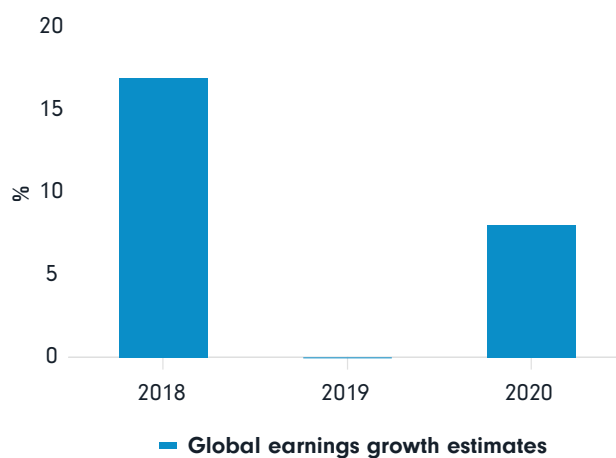
Romain Boscher
Global CIO, Equities

Quick take

- Earnings returning in 2020, thanks to dovish monetary policy and a resilient US consumer
- Recession should be avoided despite industrial weakness, but fiscal action may be needed
- Value stocks may enjoy a renaissance, but banks remain constrained by low rates
- Watch China's property market in case the bubble bursts

Equity markets rebounded in 2019 once an uncomfortable period of Fed tightening and slower earnings growth passed. Despite a mid-year escalation in the trade war and European political upheaval, the Federal Reserve's policy U-turn - cutting rates three times and resuming balance sheet expansion - helped calm recession fears. While the industrial sector has gone into recession, its diminished importance to overall GDP and the continued resilience of the US consumer means we expect a soft landing for the global economy in 2020. Earnings are likely to bottom out and then recover: after a flat year in 2019, earnings growth is projected to be around 8 per cent in 2020.

Chart 1: Earnings growth to pick up in 2020



Source: Fidelity International, October 2019.

Income hunt to drive return to equities

Markets are beginning to reflect this potential improvement. Any signs of over-exuberance, however, could make us more cautious. Amid all the political noise, we remain focussed on earnings as they account for the majority of stock price movement over the medium term and 80-90 per cent of price movement over a decade. Of course, you have to pay attention to interest rates and fund flows too. We expect interest rates to remain low, and perhaps go even lower. Given sizeable outflows from equities in 2019, we expect a recovery in 2020 precisely because interest rates will stay low and investors starved of income will be attracted by returns.

Value comeback possible, but financials remain constrained

Nonetheless, we remain wary of the increasing Japanification of major economies. Keeping rates very low for a long period leads to low economic growth and volatility. The latter prevents defaults rising in the short term, but over the long term increases the number of zombie companies kept alive by cheap credit rather than by solid earnings growth. To avoid these value traps, we maintain a quality bias with a preference for companies with strong balance sheets. If, however, growth begins to recover in

2020, there could be a shift back to the value and cyclical stocks that have previously been overlooked.

Banks are the exception. The pricing of their raw material - namely interest rates - will remain extremely low and perhaps go even more negative. In my view, there is no such thing as a negative rate. In fact, it is a levy on banks and savers such as pension funds. Negative rates introduce a kind of insidious default on assets. Ordinarily, central banks try to inflate away unsustainable debt levels after a financial crisis, but this time - despite ultra-low rates and quantitative easing - they have failed.

Motto for 2020 is: It's mostly fiscal

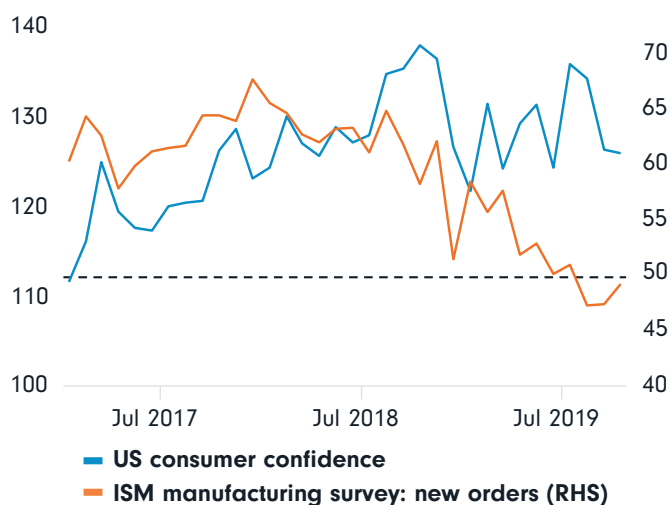
As central banks run out of ammunition to stimulate growth, we expect attention to shift to fiscal policy. My motto for 2020 would be: it's mostly fiscal (or 'IMF' in tribute to the International Monetary Fund former head Christine Lagarde who has called for fiscal expansion). We are probably underestimating the fiscal room for manoeuvre in China and the US, while central bankers in Japan and Europe are both telling their states to spend more. US and Japan could benefit the most from any switch in spending towards new industries such as electric cars and robotics, while more traditional German industries risk being left behind.



US industrial and consumer strength diverges

Another first is that the US consumer sector has been flourishing even as the country's industrial companies suffer a recession, posting declines similar to those in 2008. Usually, consumer and manufacturing areas move in concert. But despite the trade war, the US consumer remains strong, supported by monetary and fiscal policy. US citizens are taking advantage of lower rates to refinance their mortgages. Meanwhile, industrials now account for a much smaller part of the economy than they did 10 years ago, so their weakness has less impact. We therefore anticipate a soft landing at the GDP level in 2020, with perhaps not even a single quarter of negative growth. The same is true for the European consumer, who is also holding up relatively well, despite the low-growth environment and German industrial weakness.

Chart 2: US industry and consumer strength diverges



Source: Refinitiv, Fidelity International, October 2019.

Chinese property is a risk

We continue to monitor headline risks such as the trade conflict, Brexit fallout, Italian debt and US electoral

uncertainty. However, we focus more on the risks we can't fully price yet, such as where the borrowing limit is in a state-run economy like China. The total debt to GDP figure in China is questionable because it depends on how you aggregate national, corporate and financial debt. But, roughly speaking, total-debt-to-GDP in China has grown substantially over the last decade from 140 per cent to around 300 per cent, while high debt-to-GDP levels in economies such as the US and Japan have risen only slightly in comparison.¹

We therefore anticipate a soft landing at the GDP level in 2020, with perhaps not even a single quarter of negative growth. The same is true for the European consumer who is also holding up relatively well, despite the low-growth environment and German industrial weakness.

The property market is also a concern. China, along with Canada and Australia, avoided the worst of the debt-driven financial crisis a decade ago, but each has since experienced a property bubble. Informal estimates suggest that around 50 million flats in China are empty, with investors banking more on further capital growth than rental income.² (Real estate accounts for a fifth of China's GDP).³ But pinpointing when the bubble may burst is difficult. Prices have declined twice over the last five years in China without prompting a formal property recession. In Canada and Australia, price declines are already visible.

Conclusion

We expect a modest improvement for equities in 2020 as earnings bottom out and start to pick up, aided by dovish policy in the US, Europe and China and a still strong consumer. As monetary policy runs out of road, however, and negative rates start to penalise bondholders, fiscal stimulus will be needed to boost growth.

¹Reuters 2019 <https://www.reuters.com/article/us-china-economy-debt/chinas-debt-tops-300-of-gdp-now-15-of-global-total-hifidUSKCN1UD0KDD>

²CICC 2019

³FT 2019 <https://www.ft.com/content/bbc8e656-2491-4c76-860f-3f0ca60cb289>

Fixed Income

No recession in 2020, but watch out for inflation



Steve Ellis
Global CIO, Fixed Income

Quick take

- Synchronised central bank easing could persist in 2020
- Amid low core bond yields, expect further inflows into higher-yielding areas such as emerging markets; but be wary of EM currencies
- Market pessimism on inflation is overdone, meaning now might be the time to consider inflation-linked bonds

In 2019, central banks returned to synchronised policy easing for the first time since the financial crisis. We believe this will continue in 2020 as central banks deploy whatever tools they can to stimulate growth and avoid a full-blown recession. With core bond yields likely to remain low - 10-year Treasuries below 2 per cent - we expect further inflows into areas of fixed income that offer more attractive yields. Yields in defensive investment grade are already tight, so we expect investors to diversify into higher-yielding areas such as emerging market debt. Inflation pressures continue to build in the US, which could present an opportunity for inflation-linked bonds.

Recession is a risk, but will be avoided in 2020

The key risk for 2020 is that central bank policy fails to generate growth, governments shrink from fiscal stimulus and the global economy plunges into recession. We think recession will be avoided and the global economy will have a soft landing. However, if there is a recession in the US, default risk would rise, and balance sheet strength would become even more important. While spreads would widen in this scenario, this should be offset by core yields remaining very low. So on a total return basis, having duration or interest rate exposure should be positive. Another key risk for markets is the outcome of the US election. If Elizabeth Warren is chosen as the Democratic frontrunner and the impeachment process overwhelms Donald Trump, the share prices of US corporates could take a hit.

Negative rates indicate policy limits

While we expect rates to remain low in the US and perhaps go even more negative in Europe, we are concerned about nearing the limits of what monetary policy can achieve. There are now over \$16 trillion of bonds with negative yields, mostly in European sovereign debt. In October, Greece - which a few years ago required the biggest ever bailout - sold a three-month government bond with a yield of -0.02 per cent, according to reports.¹ If the economy, especially in Europe, drifts further towards recession-like territory, more rates could go negative. The European Central Bank rate is currently -0.5 per cent and expected to fall by another 10 basis points between now and the end of next year. This may or may not aid growth in the short term, but economies are unlikely to make real headway without the introduction of widespread fiscal stimulus.

Hunt for yield favours Asia, but beware EM currencies

In this climate of low and negative rates, hard currency emerging market debt, especially Asian high yield, looks attractive. Even if our base case scenario that a recession is avoided proves incorrect, any contraction is unlikely to be very deep or to restrict refinancing on a global scale as seen during the financial crisis. We would not expect defaults to rise sharply, though it could make sense to remain defensive.

We like Chinese debt, which offers a decent yield. Overall debt is rising in China, but it is manageable for now. If the trade war ramps up and conditions worsen, Chinese policy makers are likely to step in and provide fiscal reflation or monetary easing, albeit in a targeted fashion as they are doing currently. The central bank has been reducing reserve requirement ratios and overnight rates, while the fiscal deficit in China is about 6.5 per cent of GDP. Our proprietary indicators suggest the current stimulus is already having an impact.

We also think there is a case for buying Chinese government bonds: 10-year bonds are yielding around 3.5 per cent and could go lower. China is largely financed internally by very large savings. Levels of external debt

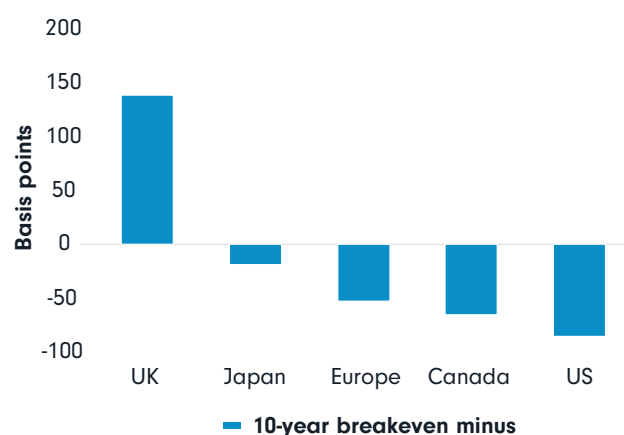
financing are quite low compared to other countries - but follow a similar pattern to Japan.

On the other hand, we are more cautious about EM currencies. The asset class suffered from a strong US dollar in 2019, and although the Fed is cutting rates, other countries around the world are also easing, reducing the opportunity for dollar weakness. Finally, EM currencies are also sensitive to any growth slowdown, which is what we expect in 2020 even if we stay out of recession.

Pessimism around inflation is overdone

Inflation has been below target in recent years, but could re-emerge to some degree in 2020 and beyond. The market is overly pessimistic about inflation, in our view, with global breakevens trading at a discount to core inflation. The exception is the UK, where inflation expectations have oscillated alongside sterling and Brexit headlines. While consensus estimates of US inflation in 2020 are 2.1 per cent, our estimate is closer to 2.5 per cent, driven by building wage pressures amid historically low unemployment and a strong US consumer.

Chart 1: Market's inflation expectations look overly pessimistic



Source: Fidelity International, Bloomberg, October 2019. Chart shows 10-year breakeven rate minus core year-on-year inflation.

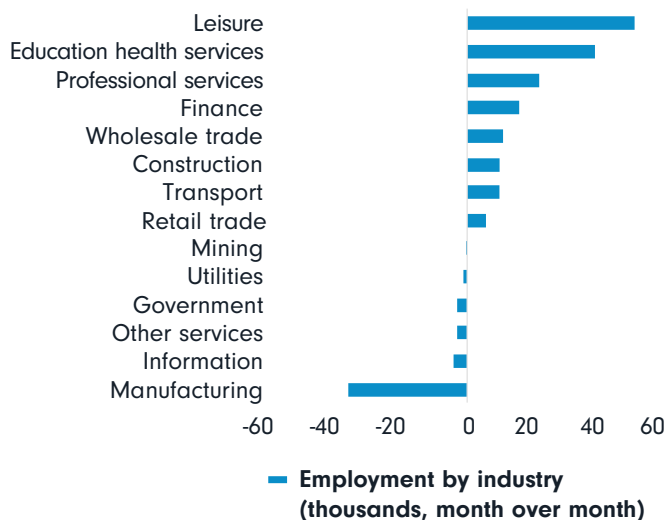
The other potential fillip for inflation is a de-escalation of the US-China trade war. While the removal of tariffs could reduce upward pressure on prices, the ensuing rebound in growth should more than offset this, leading to higher inflation overall.

¹FT.com <https://www.ft.com/content/5dde46c4-ea83-11e9-a240-3b065ef5fc55>



As central banks keep monetary policy loose and the global economy stabilises, inflation is increasingly likely to reappear. Consumer sectors already account for most of the employment increase in the US, allowing the country to avoid a full GDP recession even as manufacturing remains very weak. We think this presents an opportunity for inflation-linked bonds over the medium term.

Chart 2: Strong US consumer translates into higher employment in leisure and health
Change in non-farm payrolls in October 2019



Source: Haver Analytics, November 2019.

Conclusion

We think the outlook for fixed income in 2020 is positive, driven by the dovish policy environment and the potential de-escalation in the US-China trade conflict. We may not see the levels of return that occurred in 2019, as spreads have already narrowed significantly, but absent a recession or an inflation shock, we expect solid returns from higher-yielding areas of the global debt markets. Now may be the time to consider inflation protection while markets are so pessimistic about future price rises.

Multi Asset and Alternatives

A moment of reckoning



Andrew McCaffery
Global CIO, Alternatives and Solutions

Quick take

- 2020 could bring more of the same - dovish monetary policy and US pre-eminence - or mark a distinct shift of capital to other areas of the world
- US companies are less confident than consumers and could reduce borrowing and investment
- Elizabeth Warren becoming the Democrat nominee may exacerbate this caution, as companies and consumers anticipate higher taxes and more regulation, and job openings decline
- Tactical allocations to non-US assets such as emerging markets, alongside alternative investments and income-generating assets, could help navigate the switch

In recent years, the US has led the global economy and capital markets, buoyed by supportive monetary and fiscal policy. In 2020, we may have more of the same or there could be a moment of reckoning, with a distinct capital shift away from the US towards areas such as emerging markets. I believe the latter is more likely, driven by US electoral concerns. Much depends on US corporate and consumer confidence and the direction of the dollar, but non-US assets, alternatives and income-generating plays could provide a useful way to navigate this environment.

US corporates are less confident than consumers

The US consumer is still strong even though the industrials sector is in recession. But as chart 1 shows, US companies do not share consumers' confidence. Following a period of high debt issuance to buy back shares amid little real revenue growth, companies - bar a few sectors such as technology - are losing their willingness to borrow. They could even start to reduce issuance and take liquidity from the market. While this may strengthen the balance sheet at a single company level, at a market level, it could create a liquidity squeeze that tightens conditions for more highly-levered firms.

Chart 1: US companies don't share consumers' optimism



Source: Haver Analytics, November 2019.

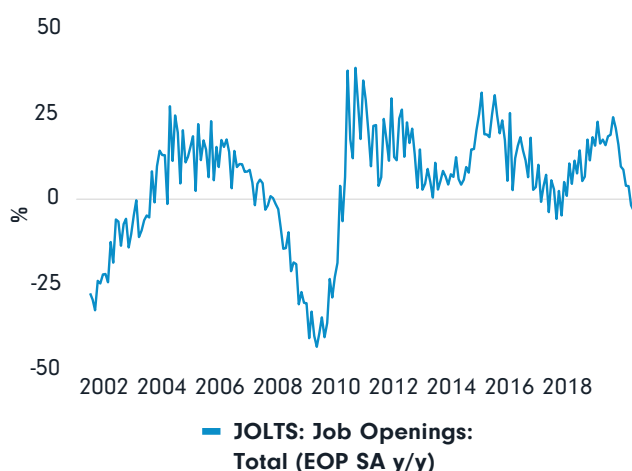
Leveraged loan issuance is significantly down in 2019, while the initial public offering market has struggled with the misallocation of capital into some of the newer, disruptive companies with only speculative potential to generate profits. This could further depress corporate appetite for raising new capital. If issuance falls away more broadly, concerns about the default cycle and recession will percolate through from high yield to investment grade, putting yield spreads at risk.

The big risk for investors in 2020 is that Elizabeth Warren gets the Democratic nomination and markets retreat as liquidity conditions begin to deteriorate. Private capital too is likely to be a target for Warren, given her focus on corporate taxes.

US election risk could further inhibit confidence

While Federal Reserve policy will probably remain dovish, it cannot prolong the cycle indefinitely. In this climate, fears of post-election tax hikes (and regulation) could encourage even more companies to run for cash.

Chart 2: Marked deceleration in job creation in 2019



Source: Haver Analytics, November 2019.

So the big risk for investors in 2020 is that Elizabeth Warren gets the Democratic nomination and markets retreat as liquidity conditions begin to deteriorate. Private capital too is likely to be a target for Warren, given her focus on corporate taxes.

While the US consumer kept the economy out of recession in 2019, there are indications that employment may be nearing a peak. New job offerings turned negative in 2019 and may remain so in 2020. If consumers, like corporates, begin to believe their taxes will increase, consumer activity could grind to a shuddering halt.

Non-US assets could outperform

This may appear a somewhat pessimistic view. But from a multi-asset perspective, it offers a chance to generate returns via tactical allocations and to guard against risks. It also demonstrates the benefits of diversification. If a capital rotation occurs, there will be more opportunities outside the US, particularly in emerging markets and Europe. Japan's improvements in corporate governance are also interesting. The recent tax hike there may, for the first time in 20 years, create better conditions for investors. If people start to believe that prices aren't going down any more, Japan will be on a different path to almost every other large economy.

Chinese influence is not going away

The direction of the dollar remains key for emerging markets. Any dollar weakness on the back of US uncertainty could spark relative outperformance across a range of economies. For me, the dynamics in places like Indonesia look more attractive than, say, Singapore. Countries such as Vietnam and Cambodia that have benefited from shifts in supply chains should also not be overlooked.

China is going through a natural progression from a developing to a developed economy. There are risks in terms of the asset/debt profile and the amount of zombie businesses. But the authorities still have scope to use currency and capital reserves to offset debt issues. I remain unconvinced that they want anything other than a purely manufacturing deal with the US as the consumer part of the economy matures. Over the next decade, wealth generation in China and Asia is set to continue and the broader China influence is not going away.

Alternatives: renewables and royalties

Another means of navigating a more challenging environment in 2020 is through more defensive positioning, via hedging, long-volatility strategies and income-generating alternatives. Examples include sustainable infrastructure such as renewables and potentially investments that offer income from high quality royalties. Cash levels may rise but only in order to rebalance and reallocate at better entry levels.

Conclusion

We are approaching a moment of reckoning. Either the cycle turns or rolls on until the US election. While 2019 was about the US-China trade talks, Brexit and renewed monetary stimulus, 2020 could be an inflection point for profits and liquidity. Corporate concerns about borrowing will only increase if the Democrats appear likely to win the US election and central banks may have little left in the tank to combat these late-cycle dynamics. If the dollar weakens as a result, this could be an opportunity for non-US assets.



Value hiding in plain sight



Paras Anand
Head of Asset Management, Asia Pacific

Quick take

- Asian markets offer good relative earnings growth at modest valuations
- Expect some rotation between and within markets
- Corporate reform and restructuring can drive underlying earnings growth

As we enter 2020, a rotation in markets seems possible. While central bank policy remains accommodative across the world, there is a risk that the returns to those strategies that have been the greatest beneficiaries have largely played out. In recognition of this, investors may already be considering where capital will move to and how a change in market leadership will affect their portfolios. As ever, valuations and yields will be important. In this context, we believe Asian markets, overall, offer good earnings growth at lower valuations, relative to many developed markets.

These modest valuations set investors up for reasonable returns from the region in 2020, while developed markets outside the US struggle to boost growth. But it remains important to be selective as we expect some rotation within markets. In China, in particular, there could be weaker returns from the popular technology and consumer names and stronger performance from other sectors.

Table: Asia earnings outlook appears strong relative to many developed markets

Earnings growth	2019	2020	2021
Global	0.0%	8.0%	9.1%
Asia-Pacific ex-Japan	2.8%	9.3%	13.0%
Emerging markets	3.4%	9.9%	13.0%
Europe	-3.6%	6.0%	6.2%
Japan	1.0%	4.6%	7.5%
US	0.0%	9.5%	9.4%
China	13.5%	6.2%	11.4%

Source: Fidelity International, 12 November 2019.

Corporate reform and self-help can drive growth

Other themes are emerging. After being re-elected, India's Prime Minister Modi appears to be driving a concerted effort to continue reforming the economy, including the recent move to cut corporation tax rates. These measures demonstrate his desire to create a more business-friendly environment.

Japan is also seeing a step change in corporate restructuring and capital reallocation. While headline growth may seem uninspiring, Japanese companies are becoming classic self-help stories, restructuring their portfolios, divesting uneconomic businesses and actively managing their balance sheets. However, concerns about the overall demand environment and lack of inflation continue to weigh on valuations.

Similarly, corporate governance is evolving in China, alongside the opening up of capital markets. The consumption story in China remains strong, although it is interesting to note how local brands are now growing at a faster rate than international brands across a range of categories including food and luxury goods. In fact, Chinese luxury brands could soon infiltrate western markets just as Japanese ones did back in the 1980s, reflecting a shift in global influence. South East Asian economies, meanwhile, should benefit from underlying economic development, as well as international investment such as the China 'belt and road' initiative.

Global slowdown is a bigger risk for China than debt

Chinese indebtedness remains a theme for global investors, but it is important to contextualise the risk. While China's current account has moved from surplus to deficit, this reflects in part the changing shape of the Chinese economy from a heavy reliance on exports to a more balanced economy. There is more debt at the household level as people have rushed to buy property, but state-owned enterprises have been de-leveraging and policy measures have limited overall lending growth.

Dollar weakness could support returns

A weaker US dollar in 2020 would help support not only underlying growth and liquidity conditions, but also returns for global investors. There has been a belief that cuts in reserve rates represent an attempt by China to devalue its currency to increase competitiveness. However, the country's ambition to develop the renminbi as an international currency suggests that stability is a greater long-term priority. Meanwhile, sovereign debt markets in Asia and Asian high yield look attractive on a relative basis because of the combination of yield, growth and some de-leveraging.

Conclusion

We are incrementally more bearish on the dollar thanks to more accommodative policy in the US. There is a recognition that the US-China trade war has stopped escalating, even if a deal is hard to achieve. Because Asia has transitioned to a more consumption-based economy, the trade tensions should have less of an impact on underlying growth than many had feared. There is still potential for companies, due to balance sheet management and underlying demand, to deliver strong earnings growth.

Finally, as some of the tailwinds supporting the market leaders of recent years run out of steam, we may see a rotation towards asset classes and areas of the market with more attractive valuations. Being aware of liquidity levels may also become more important if the benign conditions that investors have enjoyed over recent times begin to change. Those chasing returns in less liquid assets may suddenly find that they miss the value inherent in large, listed Asian securities that has been hiding in plain sight.

Real Estate

More of the same or a possible shock?



Neil Cable
Head of European Real Estate Investments

Quick take

- Financial markets are gearing up for the next phase of the economic cycle. Real estate valuations are generally expensive, with some Continental Europe markets at all-time highs
- The lower for longer, or 'lower forever', environment of low rates and inflation may continue or an 'unknown unknown' could shock the system
- In this uncertain environment, focus on property assets with a sustainable income

As we head into 2020, we see one of two scenarios playing out. One is a continuation of the current cycle in which property yields - despite seeming low to real estate investors - should still offer a premium over other asset classes, particularly bonds where yields have plummeted. In such a scenario, economic growth will be muted due to the advanced nature of the cycle, and rental incomes will be harder to increase.

There is a strong consensus in the market for this scenario, as we have seen authorities trying and failing to raise interest rates. The Federal Reserve has had to reverse course and cut rates three times in 2019.

The second scenario is a bigger concern. If an unknown factor shocks the markets, values could fall rapidly. For instance, if inflation spikes, all asset classes will be hit as yields rise and capital earnings decline. The inflation genie, once out of the bottle, cannot be controlled by quantitative easing or interest rate cuts. Rising inflation could cause a structural shift in the markets and investors will struggle to deal with the fallout.

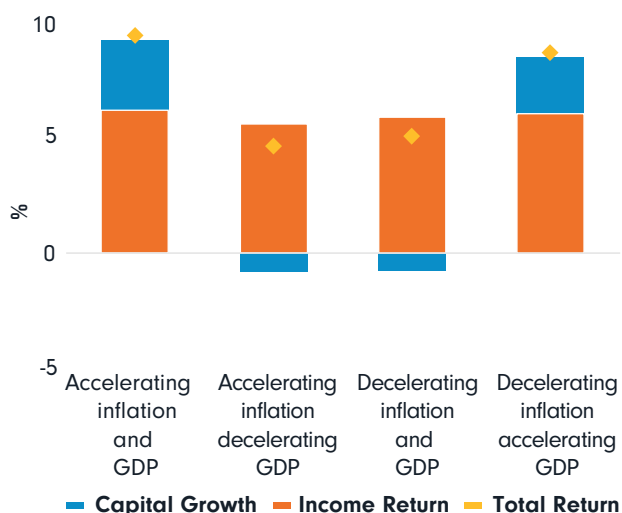
Real estate as a hedge

In such a scenario, investors would need to adjust their portfolios to cope with inflation. A rise of only a few percentage points would still be a shock. But in a gentle reflationary environment, rental income could be sustained or even rise. Companies could increase the prices of their products (as long as it is reflation, not the more damaging 'stagflation') but would also face increased costs, making it important to secure tenants with strong balance sheets who can absorb those costs and afford higher rents - and even better if they have signed a long lease.

In this reflationary environment, landlords should be able to press for higher rents due to lack of oversupply, as we have not seen the excessive speculative development that has characterised previous cycles. Real estate assets therefore typically provide a hedge against a modest rise in inflation, particularly in Continental Europe where contracts are indexed against consumer price inflation.

Chart 1: Real estate can offer hedge against inflation

Annualised performance under different economic conditions Q2 2004 - Q2 2019



Source: MSCI Pan-European Property Fund Index, Q2 2019.

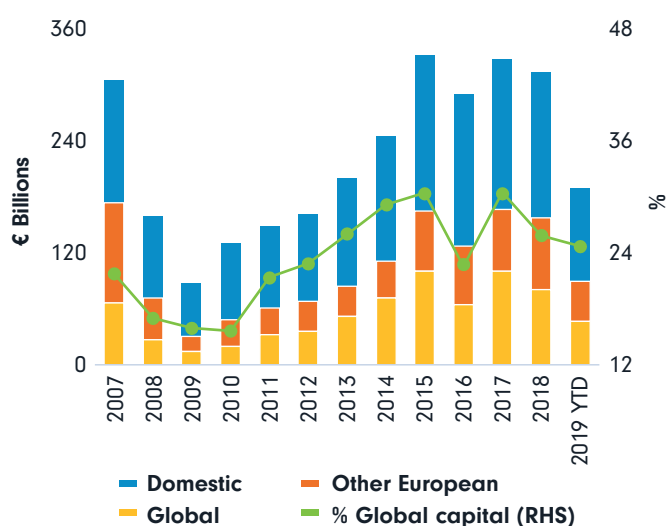
Brexit risk priced in, but Asian capital could flee

Other risks could include the drying up of the diverse pool of investors in European real estate. One of the main factors supporting the market thus far has been the volume and diversity of capital, particularly from Asia. While the number of Chinese investors has dwindled in recent years due to

rule changes, this has been offset by investors from other countries such as South Korea. But if this theme were to reverse or if international flows were to subside, current high valuations would not be supported, and yields would rise. Markets with high participation from domestic investors, such as Germany, would be less vulnerable.

The Brexit saga continues to dominate the UK. But we are seeing opportunities in this market as most of the uncertainty has already been priced in.

Chart 2: Capital from outside Europe has become increasingly important for liquidity European investment volumes



Source: Real Capital Analytics, Q3 2019.

Improving sustainability improves value

Finally, environmental, social and governance factors form part of a continuing major initiative for us in 2020 as we aim to improve our Global Real Estate Sustainability Benchmark (GRESB) score by 40 per cent over the next three years. Real estate is at the heart of our sustainability initiative as buildings contribute some 40 per cent of global carbon emissions. Companies are placing an increasingly high monetary value on properties offering reduced energy use, and we are working with our tenants to improve their energy efficiency and building sustainability.

Conclusion

Real estate assets can offer diversified protection, and, against the coming year's uncertain backdrop, a stable yield. Being selective and actively assessing tenant exposure will help optimise and sustain income returns into 2020.

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