Fidelity INTERNATIONAL

From the desk of

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A lot has taken place since we wrote our last edition of 'From the desk of', the vast majority of which related to the macro environment. The sell-off that commenced at the start of the year continued through to June, wiping over 20% off the major global equity markets. Then, in textbook fashion, a bear market rally retraced back around half of the losses over the next two months, before another wave of selling pressure triggered new cyclical lows in recent days.

Irrespective of the direction of the market, one thing has been constant all year, and that is heightened volatility. We warned about this in our 2022 outlook, reaffirmed it again in our last FTDO, and we continue to think this will remain a key feature of equity markets, for at least the remainder of the year.

This all stems back to the fierce war on inflation currently being waged by central banks around the world. High inflation is a problem that needs to be tackled, there's no doubt about this. However, the stubborn persistence of high inflation coupled with the resolve of central banks to bring it under control bring us to an interesting juncture – what's the price that will be paid for winning this war? It is this question that markets are grappling with, and there are now elevated fears that the price may end up being a painful recession. What started off as a valuation adjustment to higher interest rates is now morphing into a growth scare, as evidenced by the price declines over the past month in cyclical sectors such as energy and home builders.

The next few months will be extremely tricky to navigate. The 'Goldilocks' scenario will be one where we are on a clear path to bringing inflation back under control, but one where economic growth will remain positive, albeit slowing. The odds of achieving this, however, are worryingly becoming slimmer as time goes on.

In addition, whilst substantially down year to date, equity markets are not yet pricing in a genuine recession, as we are yet to see any meaningful earnings downgrades coming through. So if we fail to achieve the ideal outcome, it is likely that stock prices may continue to feel some pressure.

We continue to favour high-quality companies that can exhibit pricing power, have sustainable and durable business models, and trade at undemanding valuation multiples. However, we also think now is the time to prioritise businesses with resilient and sticky revenue streams, as well as those with very strong balance sheets. These are key factors needed to survive any recession, should that outcome eventuate. Stock picking, as ever, will be key. The disparity in shareholder returns between quality companies that successfully navigate the volatile macro environment and those that succumb to it can be quite large. Success over the next six months may well be defined by dodging bullets, as opposed to striving to hit home runs.