Sunny spells with thundery showers

Investment outlook

Q3 2018

Fidelity Editorial

Sunny spells with thundery showers

- The global economy is broadly in good shape, although we are anticipating a period of higher volatility including fluctuations in sentiment in all asset classes.

- The effects of central bank liquidity removal will be a key theme over the rest of 2018.

- Other potentially disruptive narratives include: weakening macroeconomic data, dollar strength, political risk, trade tariffs and the price of oil.

- We see value in taking some risk off the table, although we are not overly pessimistic.

Contents

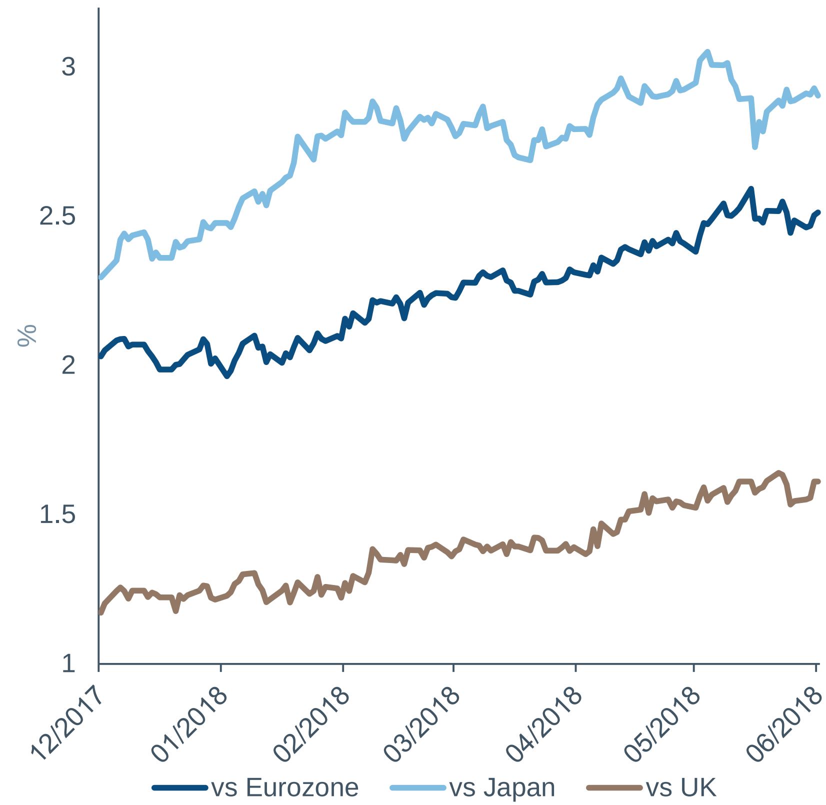
Themes for Q3 2018

1: Central bank liquidity removal

The Fed is diverging from other major central banks

- We are seeing evidence of dollar liquidity tightening in many markets, although liquidity conditions remain relaxed elsewhere.
- Despite the ECB beginning tapering, central bank policy is diverging - two more hikes from the Fed this year are largely priced in, although we believe the Fed will pause in December.
- It remains very difficult to predict the longer term effects of central bank liquidity removal, but we expect the uneven timing of normalisation to add to volatility.
- Tightening dollar liquidity and a strong dollar make us defensive on all fixed income risk assets.
- We think emerging markets will come under particular pressure in a strong dollar environment.

US 10y yields are rising relative to other economies



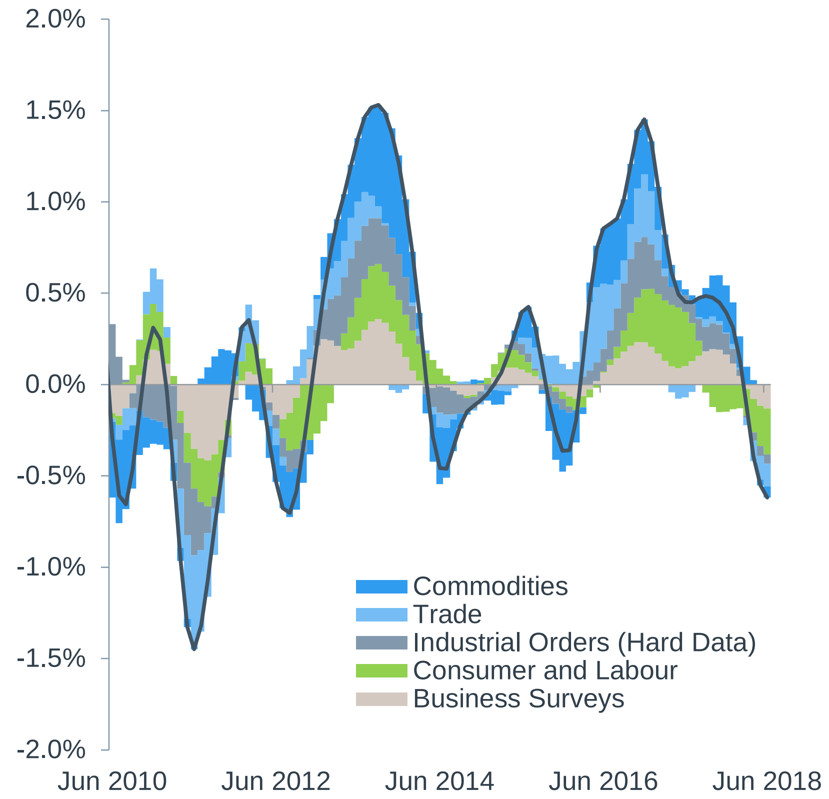
Source: Thomson Reuters, Fidelity International, June 2018

2: Fundamentals are still broadly robust…

…but sentiment is cooling

- Many markets are still supported by solid fundamentals and we expect continued strength along the themes of US tax reform and digitisation.
- The US economy remains particularly strong, in contrast to increasing weakness in Europe. It remains to be seen if the US can continue its growth if major economies elsewhere slow further.
- The Fidelity Leading Indicator is in the lowest decile of its backtested history, signalling a broad based slowdown rather than an imminent slump.
- While we have not seen the sort of irrational exuberance in equity markets that would cause us to be seriously worried, we do expect markets to enter a period of consolidation in Q3.

Fidelity Leading Indicator points to a slowdown



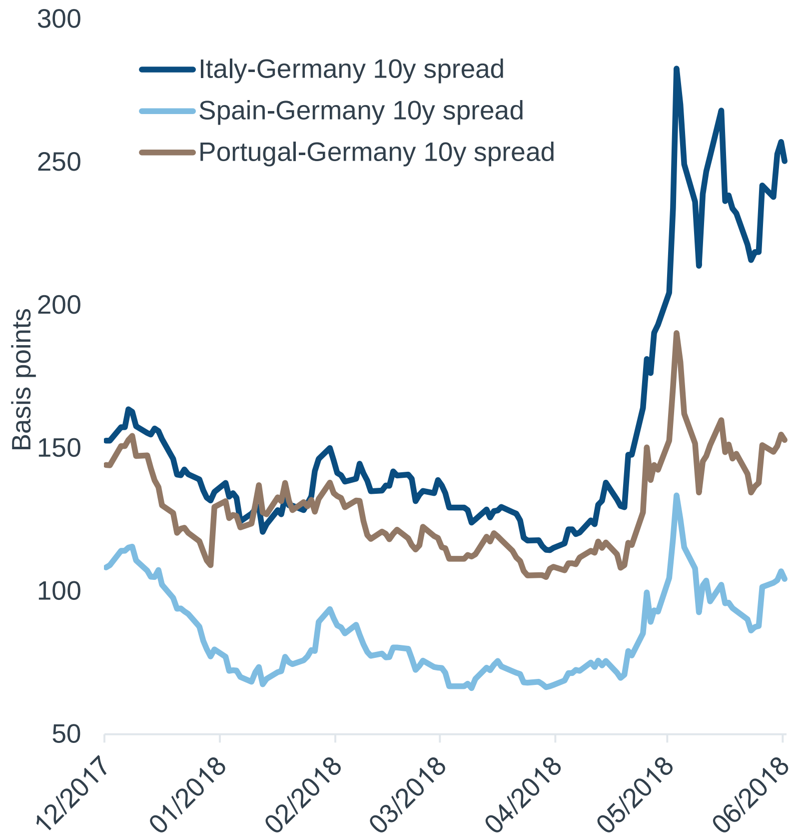
Source: Fidelity International, July 2018.

3: There are a number of other potential headwinds

We expect volatility to increase

- **Trade wars** – While we believe the impact of continuing escalation of tariffs will be economically small, the added uncertainty will push volatility up in the short term.
- **Political risk** – we think there is potential for politics to have a large impact on markets for the rest of the year. Italy is still a worry and Merkel's position is looking weaker.
- **High oil price** – Inflation is already close to target in the US and Europe and moves higher from here could force the Fed and the ECB into hiking faster than they would like. Unlike market consensus, we doubt US shale production can increase quickly enough to mitigate any short-term oil price spikes, which could fuel inflationary pressures.

The impact of political risk can spread



Source: Thomson Reuters, Fidelity International, June 2018

Equities

Equities overview

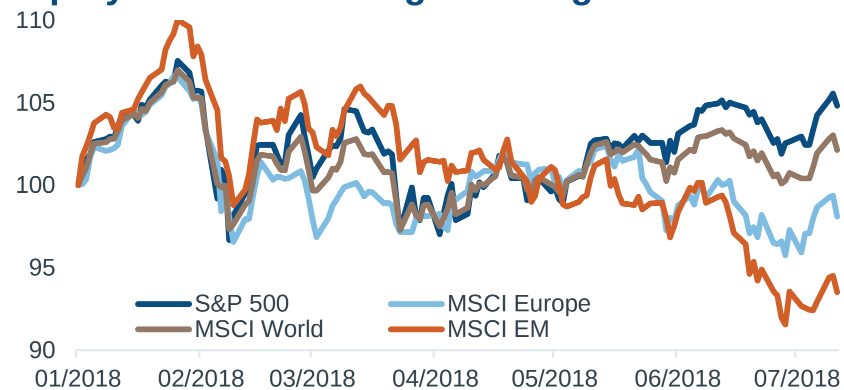
Solid fundamentals but significant risks on the horizon

- Global fundamentals remain relatively robust with the US looking particularly strong. Our earnings growth forecasts point to a bumper 2018 before falling back to trend in 2019 and 2020.
- However, there are a number of risks that we think have the potential to weigh on sentiment: a strong dollar, rising US yields, weakening economic data outside the US, trade wars, political risk, and surprise inflation.
- We believe the market is in a consolidation phase where sentiment swings and increased volatility are to be expected, especially given the thin volumes traditionally seen during summer.
- Our Multi Asset team moved to 'neutral' from 'overweight' on equities for the first time since 2009, although we feel a dramatic revaluation is unlikely and we are not overly pessimistic.

Fidelity global forecasts

	2018	2019
Earnings growth	**17.3%**	**7.3%**
Return on equity	**14.3%**	**14.6%**
Dividend yield	**2.6%**	**2.8%**
P/E valuation	**15.5x**	**14.2**
P/B valuation	**2.2x**	**2.0x**

Equity markets starting to diverge



Price return, 12 months to:	30/06/2014	30/06/2015	30/06/2016	30/06/2017	30/06/2018
S&P 500	18.0%	10.0%	0.0%	15.0%	12.0%
MSCI Europe $	19.9%	-7.2%	-12.5%	13.8%	1.9%
MSCI World $	16.5%	3.7%	-5.9%	14.2%	9.5%
MSCi EM $	1.9%	-2.3%	-19.6%	24.5%	11.5%

Past performance is not a reliable indicator of future results.

Top - Source: Fidelity International, June 2018.
Middle/bottom - All indices USD total return. Source: Thomson Reuters, Fidelity International, July 2018.

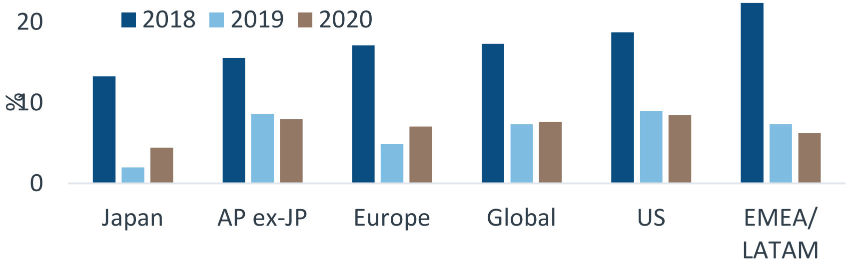
Equities regions

Expect divergence

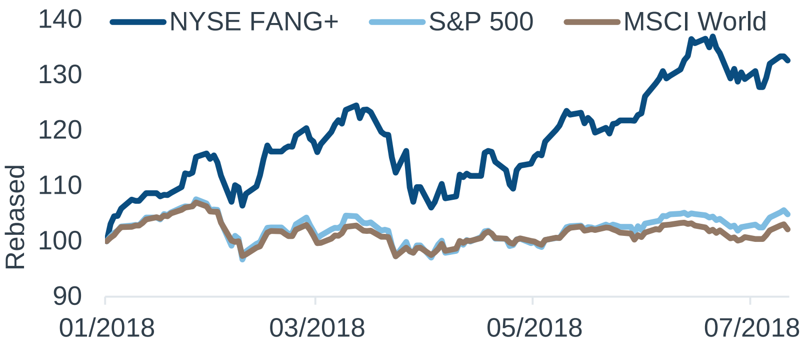
- The mid-term outlook for the US remains robust due to a favourable macro environment, strong jobs data and rising capex.
- Data is softening in Europe in addition to elevated political risks. We are watching developments in Germany particularly closely for signs of weakness.
- We see the sharp sell-off in China equities more related to economic slowdown than trade dispute. We see mounting risks although we are not overly concerned over the medium term.
- We are more positive on Japan's outlook than market consensus. Our outlook for Asia ex-Japan is optimistic despite rising US yields, although politics remains a concern in the long term.

Past performance is not a reliable indicator of future results

Earnings growth set to return to trend from 2019



Tech stock outperformance is creating valuation mismatch opportunities



Price return, 12 months to:	30/06/2014	30/06/2015	30/06/2016	30/06/2017	30/06/2018
NYSE FANG+	NA	NA	13.0%	53.0%	48.0%
S&P 500	18.0%	10.0%	0.0%	15.0%	12.0%
MSCI World $	16.5%	3.7%	-5.9%	14.2%	9.5%

Top - Source: Fidelity International, June 2018.
Middle/bottom - Source: Thomson Reuters, Fidelity International, July 2018

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Equity sectors

Positive on telecoms, financials, energy and tech

Positive outlook

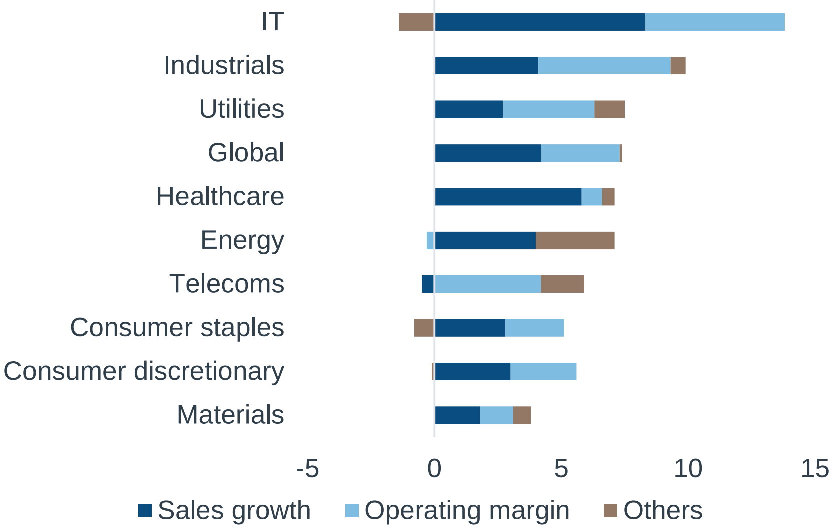
- **Telecoms** – Particularly in the US, where good subscriber growth is combined with reasonable valuations. More cautious about EMEA/LATAM telcos.
- **Financials** – Banks in the US should benefit from relaxed regulations and positive operating leverage, while US insurers should be supported by rising yields and M&A activity.
- **Energy** – Especially in Europe and Asia Pacific ex-Japan, where cash conversion and distribution policies are improving. However, valuations are rich in EMEA and LATAM.
- **Technology** - The internet of things, AI cloud computing and robotics should drive innovations and growth in the industry.

Negative outlook

- **Consumer discretionary** – extended cold weather hit retailers' sales in the US, while retailers in Asia Pacific are facing pricing pressure from supermarkets and discounters. The media industry is the bright spot in the sector.

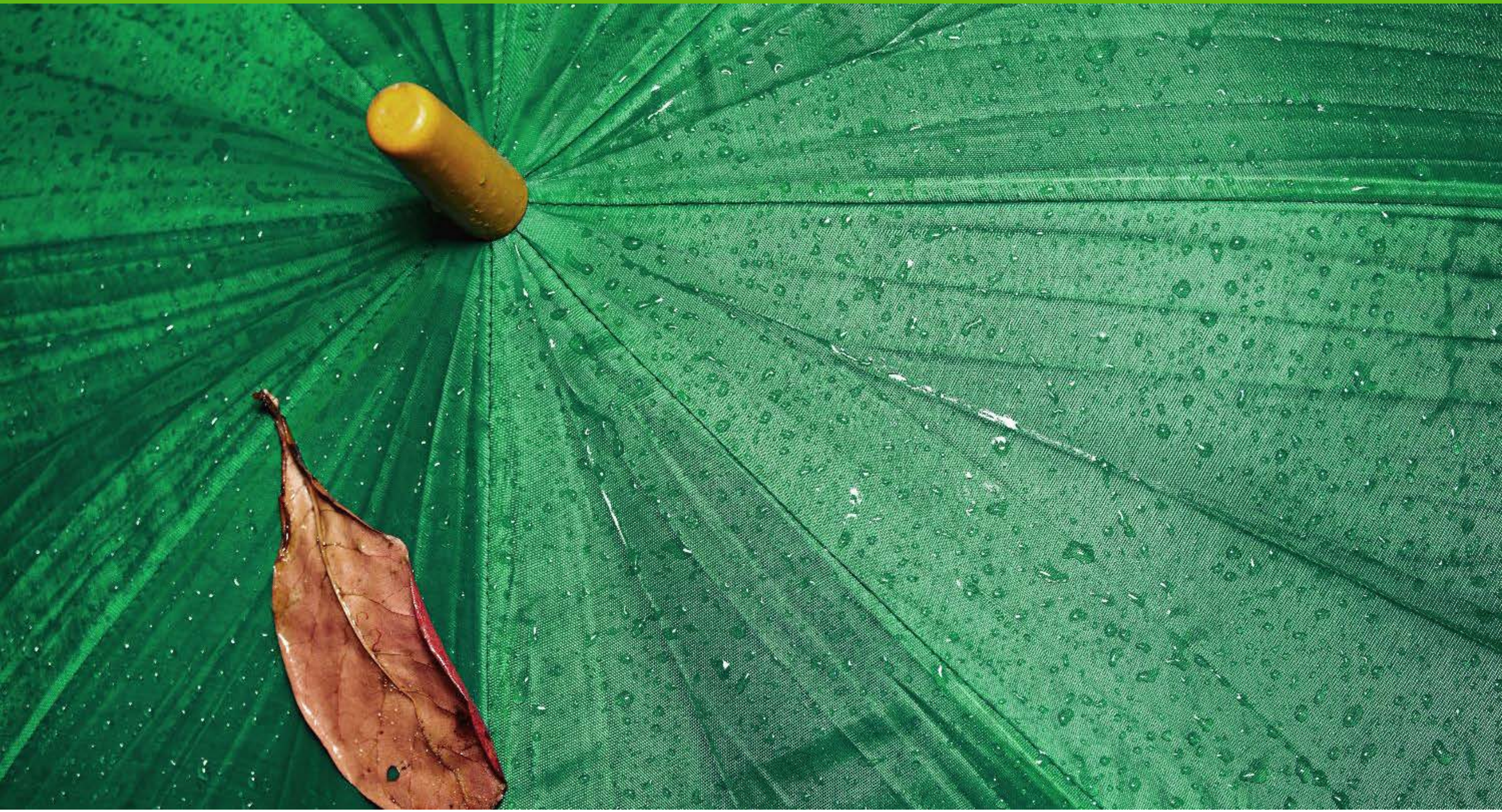
Favoured sectors	Less favoured sectors
Telecommunications	Consumer discretionary
Financials	Real estate
Energy	Materials

Earnings forecasts by sector for 2019



Source: Fidelity International, June 2018.

Fixed Income



Fixed income overview

Defensive on all risk assets

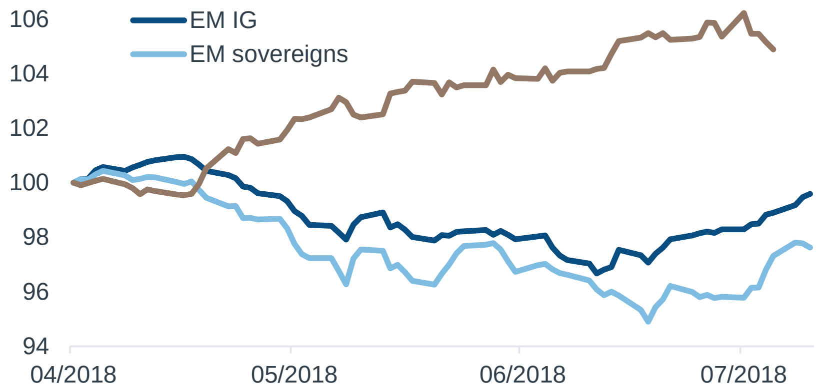
- Tightening dollar liquidity and a stronger dollar make us defensive on all risk assets, a trend we see impacting emerging market debt particularly hard.
- We continue to believe the structural reasons for lower yields – ageing populations and the debt overhang – are still intact and will curb central banks' hawkishness as they remove stimulus.
- We are increasingly concerned about the lack of liquidity, especially in EMD, which is exacerbating volatility and making trading difficult and more costly.
- We remain cautious on high yield debt while political uncertainties linger and dollar liquidity conditions continue to tighten.

Past performance is not a reliable indicator of future results

Current and implied government bond yields

10 year yield	Current	Dec-18	Dec-19
US	2.83%	3.16%	3.49%
Germany	0.30%	0.86%	1.43%
UK	1.25%	1.67%	2.14%

We think a strong dollar will be a headwind for emerging market debt



Price return, 12 months to:	30/06/2014	30/06/2015	30/06/2016	30/06/2017	30/06/2018
Merrill Lynch USD Investment Grade Emerging Market Corporates	6.4%	-0.5%	15.6%	7.5%	2.3%
Merrill Lynch USD Emerging Market Sovereigns	11.5%	-0.7%	9.9%	5.4%	-2.8%

Top – Source: Bloomberg, Fidelity International, July 2018.
Middle/bottom – Indices: BofA Merrill Lynch USD Emerging Market Sovereigns, BofA Merrill Lynch USD Investment Grade Emerging Market Corporates, US Nominal Broad Dollar Index. Source: Thomson Reuters, Fidelity International, July 2018.

Fixed income regions

Central bank policy divergence

US

- Attention has turned to the flattening yield curve. Even though two more hikes are priced in this year, we expect the Fed to pause in December.
- Data remains on a strong footing although we see scope for data to disappoint in H2 2018 due to dollar strength, higher rates and wider spreads.

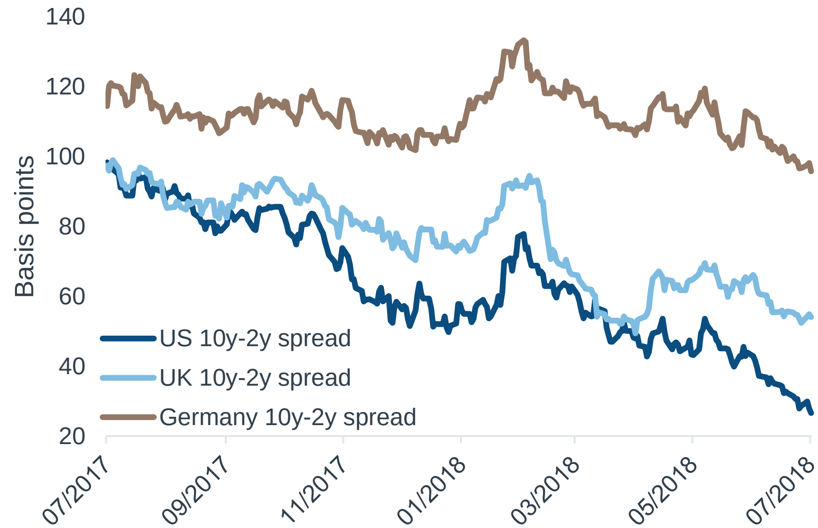
Europe

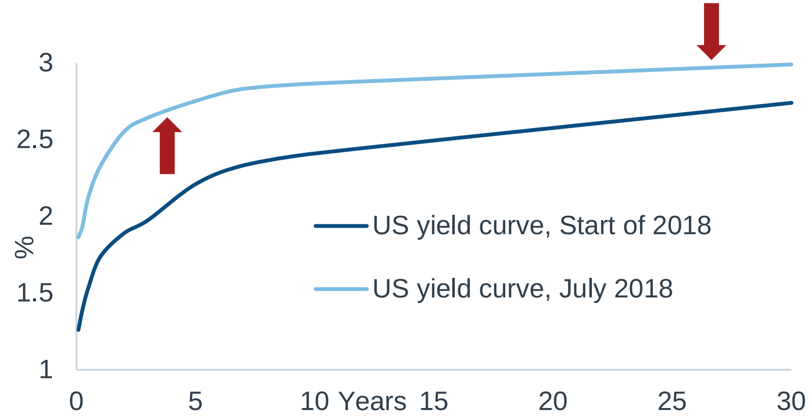
- Weakening economic data and ongoing political uncertainty have kept Bunds well supported recently. We see a risk of higher yields ahead, however, and advocate a short duration stance.
- We think the risk of early elections in Italy is underestimated by the market, although fiscal deterioration is largely reflected in the price of BTPs. The situation will continue to impact other European periphery spreads.

UK

- We expect Gilts to stay supported due to Brexit uncertainty and low UK growth forecasts, despite hawkish signals from the BoE.

Yield curves are flattening, especially in the US





Both - Source: Thomson Reuters, Fidelity International, July 2018.

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Fixed income sectors

Cautious on risk assets

Investment grade

- Spreads of investment grade corporate debt have continued to widen in recent months. We are conscious that poor liquidity over the summer could exacerbate any negative moves and therefore think defensive positioning is prudent.

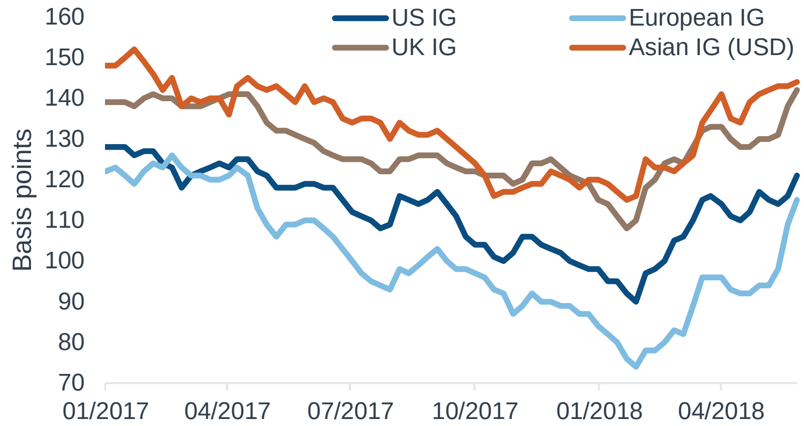
High yield

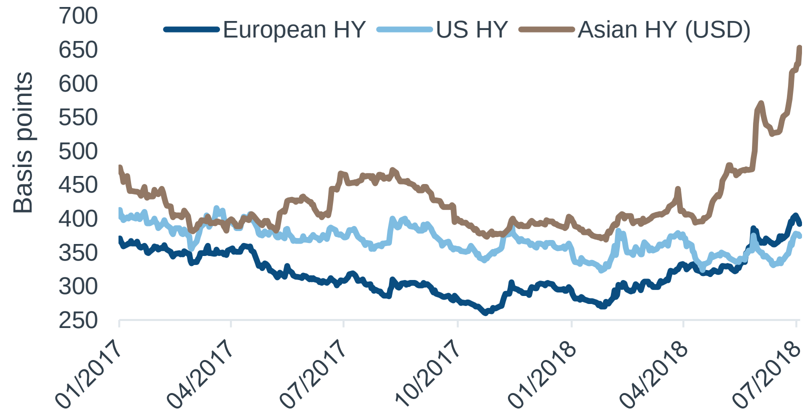
- We remain cautious on high yield debt in all regions while political uncertainty and volatility linger, and see scope for further spread widening in Q3.
- US fundamentals remain strong, however an expected supply glut from downgraded issuers will weigh on prices.

Emerging markets

- EMD has had a difficult start to the year and we expect a continuation of headwinds from trade fears, dollar strength and the ongoing removal of monetary stimulus.
- Despite headline yields looking attractive at over 6%, the short to medium term outlook remains fragile.
- We have a more positive outlook for EM corporates than sovereigns.

Investment grade and high yield spreads continue to widen in 2018

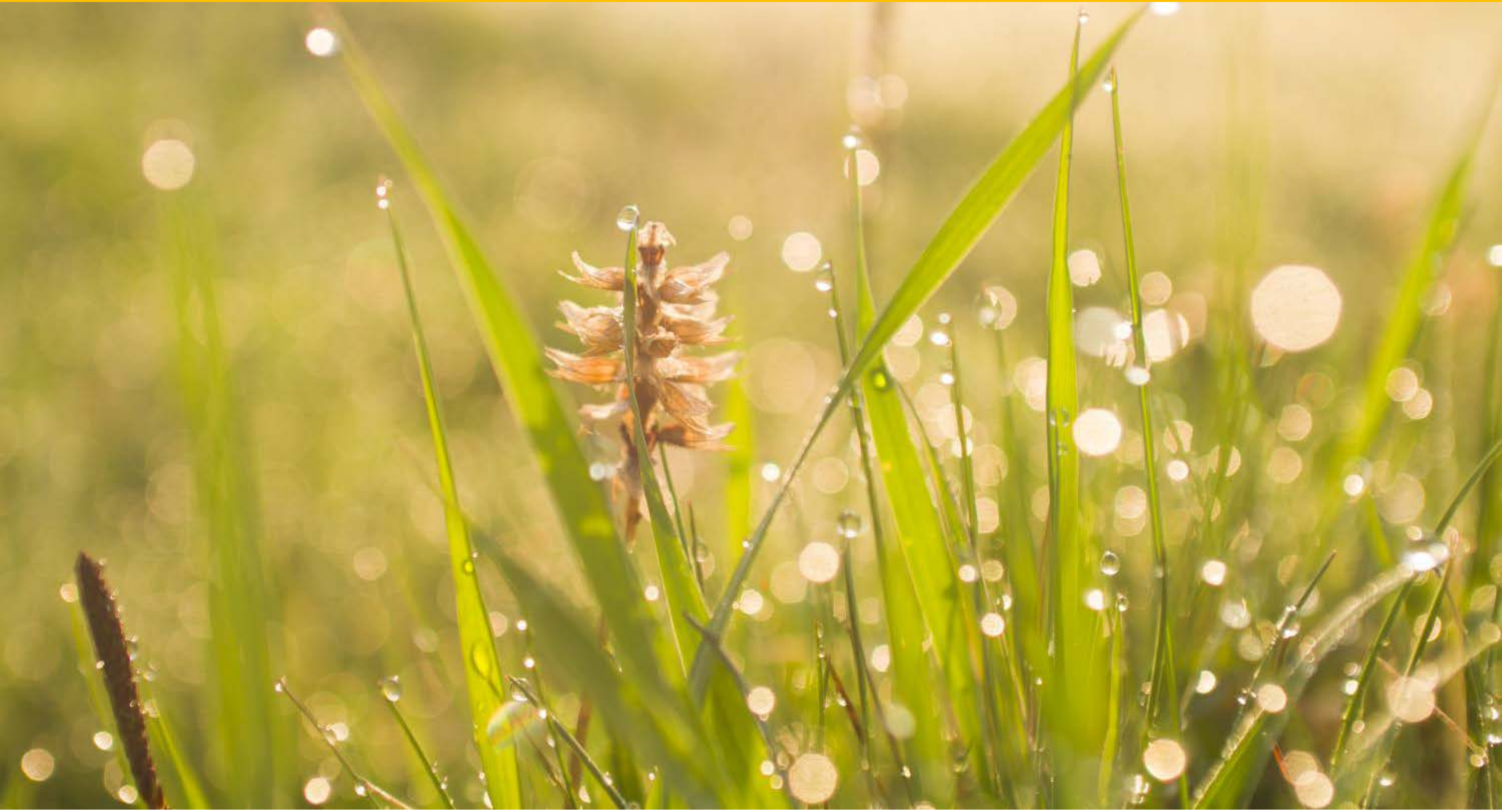




Both – BofA Merrill Lynch indices used. Source: Bloomberg, Fidelity International, June 2018.

Thematic
Equities
Fixed Income
Alternatives

Alternatives

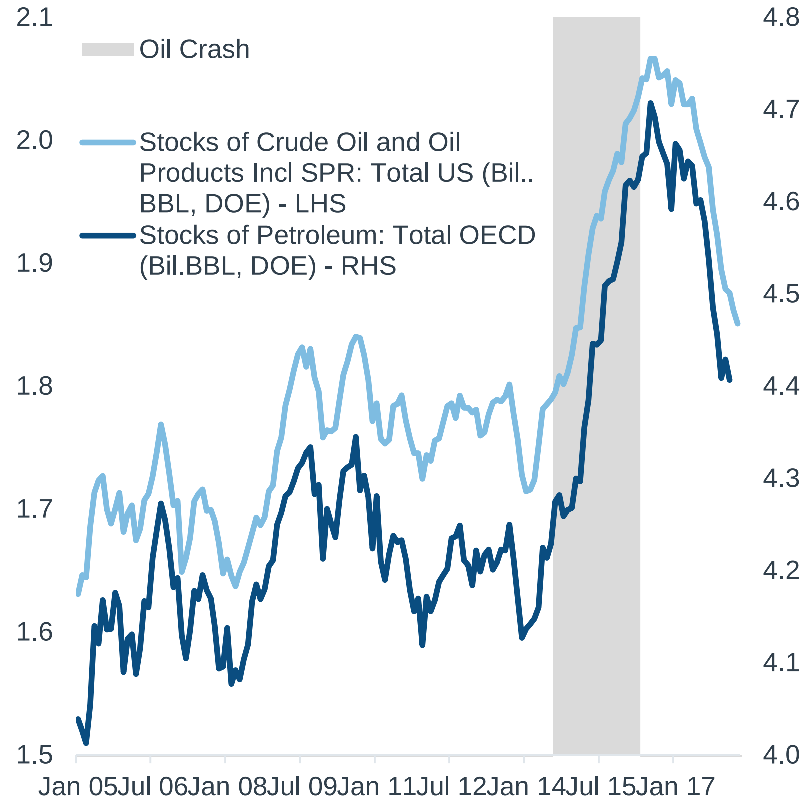


Commodities

Slowdown in global growth

- Commodities continue to experience mixed performance, illustrating the elevated level of differentiation across the asset class.
- Oil remains centre-stage. We think fundamentals are supportive of rising prices thanks to tight inventories and geopolitical risks.
- The primary downside risk for oil prices remains the global trade dispute. The biggest hit to oil prices from this would come from a reduction in global GDP.
- One of the key decisions for investors in the coming months will be how to access commodity exposure.

Falling inventories implies upside pressure to oil prices



Source: EIA, Haver Analytics, Fidelity International, May 2018.

Infrastructure and alternative strategies

Listed infrastructure and hedge funds offer opportunities

- We are positive on the outlook for infrastructure and alternative strategies given our expectation of increased volatility in Q3 due to the low correlation with traditional risk assets.
- Infrastructure has experienced mixed fortunes over the past year, particularly in the UK. However many listed infrastructure strategies look attractive on a NAV basis and we believe downside risks are manageable.
- Aircraft leasing is a maturing area of this asset class. We expect some price volatility for these vehicles in the coming months, but investors should be able to capture some upside here.
- We think alternative investment strategies are attractive at this stage of the cycle for the opportunity to provide uncorrelated alpha, although we note that elevated levels of dispersion will broaden the range of expected outcomes.

The impact of increased volatility in 2018 on alternative investment strategies

Negative impact	Strategies with structural long bias to equities and other risk-assets	Long bias L/S equity Commodity-related strategies
	Strategies with structural bias to trend or momentum factors	CTAs/managed futures Certain risk premia quant Certain quant equity
Limited or mixed impact	Assets / strategies insulated from broader financial markets	Catastrophe bonds Trade finance
	Strategies which are structurally neutral to broad market direction	Market neutral equity Merger arbitrage Relative value
	Less liquid strategies and assets	Private equity Land / direct property Private debt
Positive Impact	Explicitly down-side focused strategies	Tail risk hedging strategies

Source: Fidelity International, July 2018. Reflects Fidelity Multi Asset's assessment of strategies within the alternatives universe, and not an exhaustive list.

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Summary…

- The global economy is broadly in good shape, although we expect a period of higher volatility with fluctuations in sentiment in all assets classes.
- The effects of central bank liquidity removal will be a key theme over the rest of 2018.
- Other potentially disruptive narratives include weakening macroeconomic data, dollar strength, political risk, trade tariffs and the price of oil.
- We see value in taking some risk off the table, although we are not overly pessimistic.

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