2019 Outlook_CIO Roundtable

Richard Edgar: [00:07]

Hello and welcome to Fidelity's outlook 2019 - what we think investors should be watching for in the year ahead.

I'm joined by **James Bateman**, Chief Investment Officer for Multi Asset, **Romain Boscher**, CIO for Equities, **Marty Dropkin**, Head of Research for Fixed Income and **Neil Cable**, Head of Real Estate.

Welcome to you all.

Now before we go into detail, I suppose nobody knows what's going to happen exactly in the year ahead, but what we do know is that it's not going to be like this one, particularly as volatility spikes.

But James, this time last year, you were telling us to be braver for longer. How much braver, and for how much longer, should we be, do you think?

James Bateman: [00:45]

I guess that really is the question, Richard, and to my mind, there's a fine line between bravery and foolishness, as being brave this year has mostly, been rewarding.

Continuing that bravery throughout 2019 probably won't. And therefore the question is, when do we ease off the pedal?

When do we actually say the bull market really has seen its best?

I'm not sure we're there yet, but I do think that moment is coming. Thinking about de-risking and thinking about diversification is more and more important, as we move into the New Year.

Richard Edgar: 01:16

Romain, from an equities point of view, just how bumpy is this road going to be in 2019?

Romain Boscher: 01:22

We are expecting decent returns for next year, but these returns will be associated with a much higher level of volatility, so more risk in the system, because there is nowhere to hide.

We are starting to consider moving away from this unprecedented experiment within the quantitative easing story, but it won't be trivial for any of us here.

		We are facing a unique moment and the only thing we have to consider now is to talk about an unprecedented situation.
Richard Edgar:	01:54	Unique and unprecedented, how exciting.
		Marty, I suppose from a fixed income point of view, what's going on in bond markets is now really affecting everybody, as you've just heard.
Marty Dropkin:	02:03	Yes, it’s all about liquidity for us and what's going on with the central banks, as James and Romain just referred to, a lot of what happens in fixed income markets will feed into the broader arena. Certainly, it has already in 2018 and we're expecting it to do that as well in 2019.
Richard Edgar:	02:23	Okay, and Neil, yields in some of the prime real estate markets have been falling in some of the major markets, how concerned are you with what’s going on in the other asset classes?
Neil Cable:	02:32	If I had any of those buildings I would be quite concerned. But to echo James’ point, 2019 isn't the time to be brave in real estate, it is the time to lock into yields that are higher than what you're seeing in the prime markets.
		The things that worry me are if interest rates or inflation take off more rapidly than everyone's expecting.
		If they don't, everything should be fairly smooth. Growth will go out, but yields should be steady, but there are a few trolls under the bridge.
Richard Edgar:	03:01	Right, well, you've set us up perfectly actually, because I've asked each of you to bring in a chart to illustrate your ideas for the year ahead.
		James, we're going to take a look at yours first of all, which is focusing on inflation in the US, so explain what was going on.
James Bateman:	03:13	So really the base case for us is that inflation is going to exceed target and exceed expectations, and that can be a vicious cycle.
		You can see in the chart this idea that you're well above target, partly from lagged commodity prices, partly from the output gap closing, but, in aggregate, the picture is simple.

Inflation in some developed markets, particularly the US and the UK, is going to be materially above target. And that opens a couple of questions here.

One, is how do central banks respond, and how do they respond correctly, but I think the other one related to that is how do risk assets respond?

And what worries us is an inflationary spiral that gets a bit out of control, which completely changes forecast interest rates in major economies. This changes the discount rate, which changes the valuation perception of stocks and causes a massive rerating - so that worries us.

And as Romain said, this is a unique environment. One of the reasons for this is that we have seen a decade in which returns to workers have effectively been flat (there hasn't been wage inflation) and returns to asset owners (those invested) have been phenomenally strong.

We know just from history that this divergence is likely to converge, and it can converge in one of two ways. One is a major market correction across most assets, the other is substantial wage inflation.

The probability is that we see a bit of both, and therefore inflation is worrying me and worrying our team because it is actually one of the ways you see a reversion to historical norms. And given the concerns over the lack of wage inflation in the last decade, we think central banks will intentionally be behind the curve.

That will initially probably boost risk assets but will be a very painful cliff edge when they finally start to catch up.

Richard Edgar: 04:53 So that's your exposition. What I want to ask, though, is that you are an inflation hawk - you have been for some time. Why are you worried when so many in the market or not?

James Bateman: 05:03 So in microcosm, what worries me is that when I was talking with an external quantitative analyst a while ago, they said that they had taken inflation out of their quantitative models because they're 'beyond' inflation.

I think because we haven't actually seen inflation get out of control in developed economies for more than two decades, there is this presumption that central bank independence and that its focus on monetary policy means you will never see material inflation again.

Therefore, an awful lot of investors and an awful lot of people around the world simply just don't think it's a problem. And the biggest problems in markets are always the ones that most people don't think *are* problems. That's why inflation worries me.

Richard Edgar: 05:53 Okay, well, central banks are not immune to inflation and they definitely know that it does matter, and they tend to have longer memories than a lot of people in markets.

But, if we think about the Fed, they traditionally talk tough but tend to see through elevated levels at least for a while. Do you think that'll happen this time?

James Bateman: I think it will. I think there are two things the Fed focuses on. Clearly, they are focused on inflation and we'll come to that. The other thing they're focused on is markets, and one of the things that worry me with the Fed is that, even if it's not in their mandate, if the stock market sees pronounced periods of volatility or start declining heavily, everyone knows a Fed cut is coming.

So they have this kind of bias to reducing rates or keeping them flat in the short term, to avoid or to stave off a major market correction. So that's point one.

The other point, more to what you were saying though, is when you think about Fed activity, they can intellectually justify a long period of above target inflation because they had a long period of below target inflation.

And so if you take a 20-year view on trying to meet your inflation target, you can run it between three and five percent for a decade before you really materially overshoot that target, and that I think is why they might be behind the curve this time.

Richard Edgar: 06:54 Marty, do you agree that central banks are now getting this extraordinarily long time horizon?

That they're happy to allow things to vacillate on a level that we normally would have agreed and ignored?

Marty Dropkin: 07:05 To follow on from what James was saying, I think what's interesting to look at is, over the last three or four months, as the Fed dots have continuously increased, we're now looking ahead and looking at sort of a mid-three and a half percent Fed target range a couple of years out - the markets are nowhere near that.

The markets are dozens of basis points inside of that, thinking that the Fed is going to have to actually start easing off. And so, I think it feeds into exactly what James is saying that, is the Fed, is the market, are they in the same spot?

And I think they aren't. And so, what the Fed does ultimately will be driven by lots of different factors, but it certainly creates this dynamic where the market doesn't necessarily believe it.

Richard Edgar:	[07:54]()	Does that mean that 2019 might be the year when the Fed actually says what it thinks?
Marty Dropkin:	07:57	Well, I don't know if that's ever going to happen, but we can certainly wish for something like that.
Richard Edgar:	08:03	Okay, well, while we are in the United States, let's have a look at the chart that you brought along as well, we can see a huge drain in liquidity. Can you talk us through that?
Marty Dropkin:	08:09	Yes, so it's not just the Fed, it's the G4 and it's really global balance sheets. It's well known that we're exiting a period of quantitative easing and moving into a period of quantitative tightening. The Fed is already reducing its balance sheet, it started about a year ago at about $10 billion of reduction a month, and heading towards $50 billion. We're expecting the European Central Bank to stop injecting liquidity into the system at the end of this year. So the big concern there, as we head into 2019, is with this reduction of liquidity in the system, we're expecting a lot more volatility.
Richard Edgar:	08:47	Is that what we've seen towards the end of 2018 already - is the volatility perhaps expressing that liquidity is being drained?
Marty Dropkin:	08:52	We are. And if anything, the markets have already started to react to that. Clearly equity markets are a lot more volatile, as are fixed income markets, although not that much. And so I think, if one thing has surprised me throughout 2018, it's yes, rates have risen and we're well off of the tights on the 10-year treasury. But it's happened in a fairly smooth fashion.

Richard Edgar: 09:19

So what would you predict for 2019 then? More volatility?

How will that lack of liquidity in fixed income markets play out? It must be concerning?

Marty Dropkin: 09:28

It is concerning and we do predict more volatility, when the liquidity actually starts to drain from the system, and it's already been draining.

When balance sheets start to shrink a little bit, I don't know if that's the tipping point - It's hard for anybody to know that, but it does give us pause, and it does make us think that now's the time to be looking at quality assets.

We want to be positioned relatively conservatively. Valuations aren't cheap and almost all fixed income markets, we're still (compared with long term averages) looking at spreads which are very, very tight.

And so it's really about looking at quality assets right now, not trying to stretch. And I think just as Neil talked about in the real estate market, we're looking at very similar dynamics in fixed income.

Richard Edgar: 10:13

I just want to bring you in briefly, Neil, because you were nodding along with what most of what Marty was saying. How does it affect your markets, in particular in 2019, as we look at the changes going on?

Neil Cable: 10:22

Well, I quite often use the phrase a ‘bond with a roof’, and there's a logic to that, investors invest in real estate because they've got duration, we've got lease contracts underpinning a consistency of income, but we're impacted by exactly the same headwinds and tailwinds.

So quantitative easing has been effectively the German government underwriting the value of real estate assets for the last four or five years within Europe. It's been quite a phenomenon we can tell our grandkids about this.

So the reversal of that does give you pause and we talked a little bit at the start about how ‘heady’ the valuations are in some prime markets.

People shouldn't worry too much about that because prime markets really are quite thin, they're just a few streets in any given city and there they make the headline news.

		But the pricing has broken records, so yields are now two and a half percent. Two and a half percent is about the premium you need for illiquidity, depreciation, obsolescence and the nature of the asset class. So effectively people are doing what they did with sovereign bonds, they're just pricing them more or less zero - and that's why we're doing the same thing. We are looking for investment grade, we're looking for duration of income, we're sticking like glue to our tenants, making sure they keep paying the rent and I think that's what investors want from us. They want that consistency and indeed a premium on the yield.
Richard Edgar:	11:44	So Marty, let me just come back to you to ask about the volatility that you were talking about. Presumably that then starts to offer some opportunity as well - that, if you know where to look, there is some positive news as well?
Marty Dropkin:	11:56	The animal spirits are still very much alive in the US, so we're looking at an M&A environment that's intense. LBO markets are still very much the flavour of the month. And so as we look at that dynamic, those are clearly very negative for our fixed income world if you're invested in companies that are experiencing that dynamic. We just want to make sure that we're really hunkering down and focusing on those companies that have rock solid balance sheets, good management, that is committed to a capital structure that makes sense.
Richard Edgar:	12:31	So there's a quality thing there as well. I know you talked about picking the winners. Normally, in fixed income you talk about avoiding the losers. Romain, I want to come to you because I knew that you're concerned about corporates being exposed to interest rates. Why is that?
Romain Boscher:	12:46	We are paying more attention than ever to our fixed income colleagues, for a couple of reasons. So, the first one is that I have to be humble and I must confess that, over time, they have frequently been the first one to wave the white flag. So, it's always interesting to see if there is a warning within either the interest rate or spread level. But this time it is more relevant than ever because we are facing that everywhere, in the developed world, in the emerging world, in the sovereign world, in the corporate world.

And coming back to your questions related to corporate bonds, it’s true that as of today, in some categories like small and mid-caps in the US, now we're reaching historical highs. So, we are four times EBITDA. It is not that comfortable.

And last but not least, we also have to confess that, it’s probably partially true for real estate-related assets too, we were enjoying or benefiting from this famous TINA (There Is No Alternative) world. So, there is no alternative. So when rates were at zero, in the fixed income world, by definition, people were still starving for yield.

Their only option was either to pick real estate or illiquid assets, alternative assets generically speaking, or to consider equities as a source of yield. Because in the equities world, surprisingly, the average dividend worldwide has been extremely stable, around 3% - which is still true today. We are still at around 3%, 5% in Europe, even in Japan it is around 2.3%.

But the problem I have is that I have to put things in context, into perspective. It's true that when a global aggregate, typical yield was at 1.2% / 1.3% only a year ago, and that now this average global aggregate, it is much closer to 2.2% / 2.3%. Fortunately, it is still attractive to consider equities as a source of yield, but it's less attractive in relative terms.

Richard Edgar: 15:05 The chart that you've brought along, I think is one way of explaining this as well. If we look at the comparison of US stocks to the rest of the world, they've had a kick, and everybody thinks that's the fiscal boost that Donald Trump gave shares, but do you agree with that entirely?

Romain Boscher: 15:11 It’s true the fiscal boost played a key role, but more generally speaking, the striking thing is that there was nowhere to hide, and traditionally when you are facing or anticipating tough times, bonds were the place to hide.

And, as of today, year-to-date returns are more or less negative for any asset class except US equities. So surprisingly, perhaps US equities were the place to hide?

The story now is to understand how long can it last and is there a link between this massive outperformance of US equities with a Trump policy, or is there another explanation?

Richard Edgar: 15:56 James, do you agree, or do you have another explanation?

James Bateman:	15:58	I definitely agree with Romain. Clearly Trump's tax cuts benefited US stocks and the fact that most other asset clauses looked pretty unattractive drove people even further into US equities. What I would add to that, though, is when we think about what's driven the US, a large part of the upside has been driven by just a few stocks. And the lack of breadth or the decreasing nature of breadth over 2018 is one of the phenomena we can't forget - US tech and the FAANGs were a large part of what drove that market up. That is a global sentiment trait, it is investors globally saying that these are the future, we're going to invest in them. Had we not had a TMT bubble in living memory, we'd probably be saying, is this a bubble? I'm unconvinced it's a bubble, and actually I think what you do look at in the US is a very bifurcated market, with some stocks that you can't really value - the complexity of valuing a stock that might dominate the global market in distribution or business services (or might not) makes it almost impossible. But if you look at the broader market, there are still areas of value. So what's interesting about the US is, typically it's the lowest beta equity market when markets fall, so when markets fall it's the best place to be. And actually a large part of the US market, in particular the large-cap traditional value stocks, is an area that could be a nice two-way position, with the potential to maybe go further up, but equally should protect on the downside. So maybe there's more money to come into the US, whatever people's overall view is.
Richard Edgar:	17:25	And what about the rest of the world?
Romain Boscher:	17:27	I couldn't agree more because it's a fact. Even if it is a fact to say is that every day we had narrower leadership in the US market, when you are paying attention to the aggregated level of earnings, earnings per share are going at 20, 24, 25 percent pace for three quarters in a row now. So this is a reality that cannot be denied because earnings are remaining in the driving seat. So this is why we are remaining extremely focused on earnings and why we have to consider very seriously any type of inflation.

Cost inflation, freight costs, or consequences related to new types of tariffs - because if cost inflation is moving up, margins could be under pressure.

We have to make a distinction between the US, the American world, where we still believe that there is room for a value call, and the rest of the 'sluggish' world, where we are still very much favouring a growth call.

Richard Edgar:	18:40	And, underpinning all of this are quality business models that are going to be driving the yield for those companies.
Romain Boscher:	18:40	When I was stressing that I'm particularly worried about debt, I'm going through a cycle and I don't know if we are at the end or middle of the cycle which is about the economy. But when it's about the bond market, we are definitely at the end of the cycle and at this moment, you should stand closer to the exit door when you are investing in a low investment grade or junk bond.
Marty Dropkin:	19:12	I want to pick up on Romain's point because it's so important, especially even thinking about James' point about where inflation might end up. It's clearly something we're watching, as well as wage cost increases, and transportation increases. Let's not forget refinancing risk. So what's ended up happening in the debt markets more recently is the leverage loan market has really taken off and companies are often looking to refinance where they need to in the loan market. Now that's generally linked to a rates environment, and so if rates start to rise because of some inflationary pressure, then you end up with this refinancing risks that could clearly cause some problems for those companies with weaker balance sheets.
Richard Edgar:	19:51	Okay, well Neil, you try to avoid that type of a tenant like the plague. So tell us about the chart that you've brought along as well.
Neil Cable:	20:01	A fairly simple reminder of the consistency of income through a cycle. So this is from MSCI, they get their information from real buildings that are owned and managed by institutions all over Europe. So it's a big sample of actual data. And if you look at the chart, it's pretty boring if you just look at the income bit, as year in, year out, you tend to get somewhere

between four and five percent income. And what's quite interesting is that this is the average. So at one extreme, a bunch of vacancies in a downturn because people have gone for the wrong tenants; at the other end of the extreme, you'll get very safe, secure income and very steady.

So what you want to try and achieve is that steadiness, but try and capture some of the growth if you can. And that's why it's great having colleagues like Marty, Romain and James, because getting the intelligence that we can learn from them, not just on individual companies but on sectors worldwide, means that, although we're less able to jump in tactically, we can think tactically more long term.

We're signing up companies for five and 10-year leases. So we're taking the right bets on the right kind of companies to try and get that consistency of income through the cycle.

And that's why I keep going back to, make sure you've got a bit of a cushion, so the investment grade buildings that offer four percent yields are much more attractive and much less likely to be damaged if we get a surprise uptick in interest rates, than if you've already paid two, two and a half percent.

Richard Edgar:	21:29	So an almost impossible question, but it's never stopped me asking them in the past - how different do you think things will be a year from now then, when you look at the pattern of how you think about markets now, and how you might think in 12 months' time?
Neil Cable:	21:40	Yes, it is almost impossible.

I mean, it's very easy if you do the analysis, you look at the data, you look at the trends to convince yourself that actually all that's going to happen is that things are going to be relatively flat. Yields will be fairly stable. There just won't be so much growth.

There's not an oversupply of buildings generally speaking, we haven't had a single tenant going bust and actually we're increasing the rents quite often in our portfolio across Europe, with quite strong demand from corporates. It's the trolls under the bridge that might jump out and shock you.

I guess the guilty secret from the real estate perspective is a little bit of inflation is usually quite a good thing, a lot is a bad thing. So if we get a little bit, that's okay because generally rents in that kind of environment tend to capture that inflation and go up, and you get a bit of growth on top of that steady yield.

My central bet would be that things will just be fairly boring and we'll be looking at income and not much growth next year. But I'm a little bit more worried about the storm surrounding that nice calm outlook.

Richard Edgar: 27:46

Okay Neil, while you're talking about a sustainable income, you're also interested in, I know in another form of sustainability: environmental, social and governance issues.

So particularly the 'E', I imagine, so tell us a bit more about that, and how important that is going to be in 2019.

Neil Cable: 23:00

Yes. Well I did cheekily put that on the chart alongside the chart I was supposed to bring, so I am glad you asked me.

I think this has been a real tipping point and that's why I wanted to call it out, as it is now becoming as important as performance for clients. So up until now everyone wanted to tick the ESG box and make sure you're investing responsibly - that for instance, if 40 percent of carbon emissions are coming from buildings, they'd want to know that you had an environmental attitude to sustainability, in terms of not using hardwoods in construction and energy use reduction and all that sort of stuff.

But up until this year, I think it was a 'nice to have' and a 'tick box', but really what was more important was - are you a good fund manager and whether you are outperforming your competitors. I think that's the real tipping point now.

The lines between investments, responsible investing, good stewardship, looking after the environment, are all becoming quite blurred because there are some real performance implications.

So take for example, tobacco stocks, which, as you know, there's a debate that's been raging on ESG investing about exclusion lists. Now we don't exclude tobacco stocks, but we'd be very reluctant to buy a building with a tobacco company as a tenant, not because it's moralizing, or the right thing or wrong thing to do, but because actually the market generally is going a bit against that.

So the liquidity of the asset would be less. Perhaps the yield might be impacted, so that the lines are getting very blurred and ESG is really becoming a genuinely important factor.

Richard Edgar: [24:31]

The lines are becoming blurred, but actually it's becoming much clearer, in a sense.

And that's across the board. I mean, I know Marty that you're picking up a lot of that from your clients, and Romain as well.

Marty Dropkin: 24:42

Yes, there's no doubt it's becoming one of the key issues that, certainly equity clients, but undoubtedly fixed income clients, are focused on right now.

But for the right reasons, because we've done some work ourselves to look at whether ESG factors can actually drive better performance in funds, and our view is that they can.

And interestingly enough, it's split fairly well across corporate governance, the social dynamics and the environmental dynamics, as it leads to some linkage with spreads, but very importantly in fixed income - and you mentioned this earlier, Richard - protecting against the downside.

So corporate governance is just tantamount to making sure that we're in the names that don’t default.

Richard Edgar: [25:22]

So it does matter in fixed income in a way that we perhaps didn't think before.

It's been very clearly a theme in in equities, Romain, what's going to be the most important driver in the coming year?

Romain Boscher: 25:34

Yes, in the coming year, and it is already partially true. What is pleasant with ESG is that we are experiencing a new type of issue, which we are sharing across asset classes.

So, instead of being obsessed by what is an issue for equities, what is an issue for bonds, what is an issue for real estate assets?

Now, when we talk about ESG, it is a cross asset, cross region vision.

Nevertheless, there are some nuances. It's true that in the equity world, the entry door was probably much more the ‘G’, so the corporate governance, rather than the ‘E’, like with real estate, It is because we are convinced that in order to precisely to be sustainable, returns have to be associated with a ‘best in class’ corporate governance.

So this is not just a way to capture the attention at a ‘G’ level, because we feel that over time that a good ‘G’ will have a contamination effect on ‘E’ and ‘S’.

We are deploying more and more analysts in this field and we are engaging with corporates - instead of excluding stocks, we are making a choice to make this constructive.

Richard Edgar: 26:56 It's not just here to stay ESG, but you're getting very actively involved as well.

We're out of time, but thank you all very much indeed for your insights.

And if you're right, 2019 is going to be a year to watch for inflation, debt, liquidity and sustainability.

We will be back in a year to see how you've all done. But for now, thank you very much for watching and goodbye.