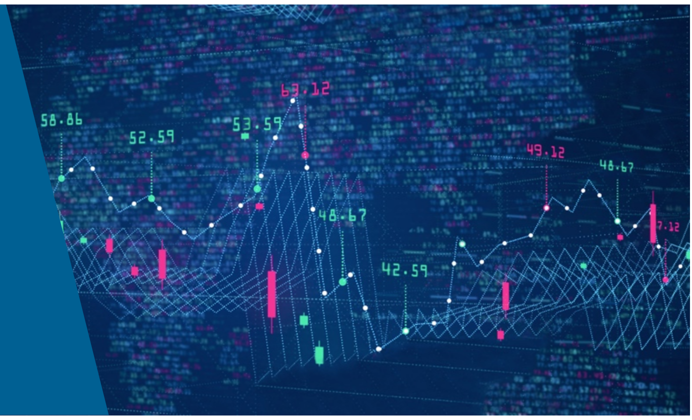
Fidelity INTERNATIONAL

Global Market Outlook 2022

Catch-2022

Fidelity Asia Fund

Anthony Srom



Waiting for opportunities to emerge

Amid market uncertainty, we remain cautious moving into 2022. While new investment ideas are harder to find, we will still look for opportunities in situations where sentiment is negative to the point that fundamentals are ignored.

Key points

- Given current risk-reward levels, we remain cautious of Asian equity markets. Uncertainties range from currencies to politics.
- In an inflationary environment, companies with genuine pricing power and capital expenditure-light business models are preferred.
- The primary way to generate performance is with careful stock picking and short-term sentiment swings, especially in China A-shares. For example, the semiconductor space could present relatively attractive opportunities.

What is your investment outlook in 2022?

We remain cautious of Asian equity markets. The market is relatively expensive with a high degree of risk, be it macro or political. At the time of writing, the regional benchmark has fallen and is down by more than 10 per cent from the peak this year[1]. Essentially, investors are already in a bear market, which no one seems to be mentioning. This is despite massive monetary and fiscal stimulus and the gradually re-opening of economies. Although it is difficult to predict a return one year out, our expectations are for low-single-digit total returns on an annualised basis over the medium-term of 5–10 years.

That said, we will wait for opportunities to emerge and believe that careful and focused stock picking is the primary way to generate alpha.

What do you think could surprise the market in 2022, either positively or negatively?

The prospect of renminbi devaluation is the biggest ‘X factor’ in our minds. It’s something the market is not entirely focussed on and, over the short-term, would be taken negatively. In China, gross domestic product (GDP) growth has been slowing for years. And the deleveraging campaign has simply resulted in leverage rising at a slower rate. At the same time, China’s foreign-exchange reserves have not been growing strongly, which constrains money creation and, therefore, economic growth. It’s a question of how much more pain the government can take. Not much more, we suspect.

In terms of portfolio exposure, we are looking at whether companies are either domestically or more internationally exposed. China’s exporters would benefit from a devaluation, and it is relevant to understand if they have US-dollar or local-currency debt.

[1] As of 16 November 2021, for MSCI AC Asia Pacific ex Japan Index (Net).

Which themes, sectors, or regions offer opportunities or potential risks

Given our conservative view of the market, the primary way to generate performance is with careful stock picking, and there are still many interesting opportunities. Select China A-shares continue to offer a good balance of risk and reward, plus large sentiment swings can present mispriced opportunities.

Regulation in China is another hot topic for investors. The positive news is that the market increasingly factors in regulation, and valuations have started to reflect this. In some cases, we have seen overcorrections, leading to investment opportunities. In the Fund, for example, we've used negative sentiment towards the property sector and linked industries to buy Chinese paint company SKSHU Paint. Its stock price had moved significantly lower, but we took the view that even if new building developments slow, the demand for paint remains robust due to renovation and maintenance needs. Plus, the industry structure is favourable.

There is also a chance to benefit from dips in the semiconductor cycle. The long-term structural drivers of technology are material and unlikely to dissipate in the near term. Key beneficiaries of this include leading Asian companies like TSMC, SK Hynix and Mediatek. Opportunities are likely to present themselves when market sentiment turns negative. This will be based on a short-term view of inventory or demand.

Within your portfolio, where do you have the highest levels of conviction, and which areas are you avoiding?

The market is focussed on the transitory nature of inflation. We think that inflation is likely to be higher for longer and continue to focus on stock-by-stock selection. Companies with genuine pricing power and capital expenditure-light business models are preferred.

We have a relatively high conviction in some of the leading global technology firms based in Asia. The portfolio is exposed to the hardware value chain through equipment supply, foundry, and memory names, where there is a clear structural supply-demand gap. It is essential to look at both the cyclical and the structural factors in these industries, and it appears we are in a shallow cyclical downturn. Share prices have reacted quite severely, particularly in the memory space. The negative sentiment has depressed stock prices in the short term; however, the long-term opportunity hasn't changed. Structural demand for servers, artificial intelligence, and machine learning remains intact.

Do you expect sustainability factors to influence returns, and how is this reflected in your portfolios?

Sustainability is becoming a greater focus for the market overall, and we consider this within the holistic fundamental analysis of a business. Environmental, social, and governance (ESG) issues are a risk factor, but they're also an opportunity given they involve regulatory change and policy support. We are also aware that this trend has a good deal of positive sentiment behind it. Thus, valuations may be rich for certain companies linked to ESG themes.

Waterproofing and insulation materials company Beijing Oriental Yuhong exemplifies how sustainability is integrated into our investment process. While the industry environment is favourable for this business, as the government's regulation of waterproofing quality becomes tighter, the company's insulation business also stands to benefit from China's carbon neutral commitment by 2060. Properties are among the largest carbon emitters, so good insulation will go a long way towards cutting emissions.