Fidelity INTERNATIONAL

Q3 Outlook

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Fidelity CIO Outlook - Nearing the limit

July 2020

CIO overview

Andrew McCaffery

The strength of the market rebound from the Covid-19 crash in the second quarter of 2020 will be hard to match in the third. It occurred despite the widespread economic pain caused by lockdowns but as central banks flooded the financial system with liquidity. Even as countries were posting large year-on-year falls in GDP, the S&P 500 had its best quarter since Q4 1998, returning 20 per cent. The Nasdaq rose 31 per cent, its best quarter since Q4 1999 and the heady days of the dot com boom. Fixed income bounced back too. Investment grade debt had its best quarter since Q2 2009, returning 10 per cent, while high yield also returned 10 per cent.

The extraordinary monetary and fiscal measures taken by policymakers to counter the worst economic effects of the virus encouraged an element of animal spirits - particularly among retail investors. But as more bleak economic data emerges, we think markets are nearing their limits without further stimulus and a much stronger recovery. They cannot defy economic gravity indefinitely.

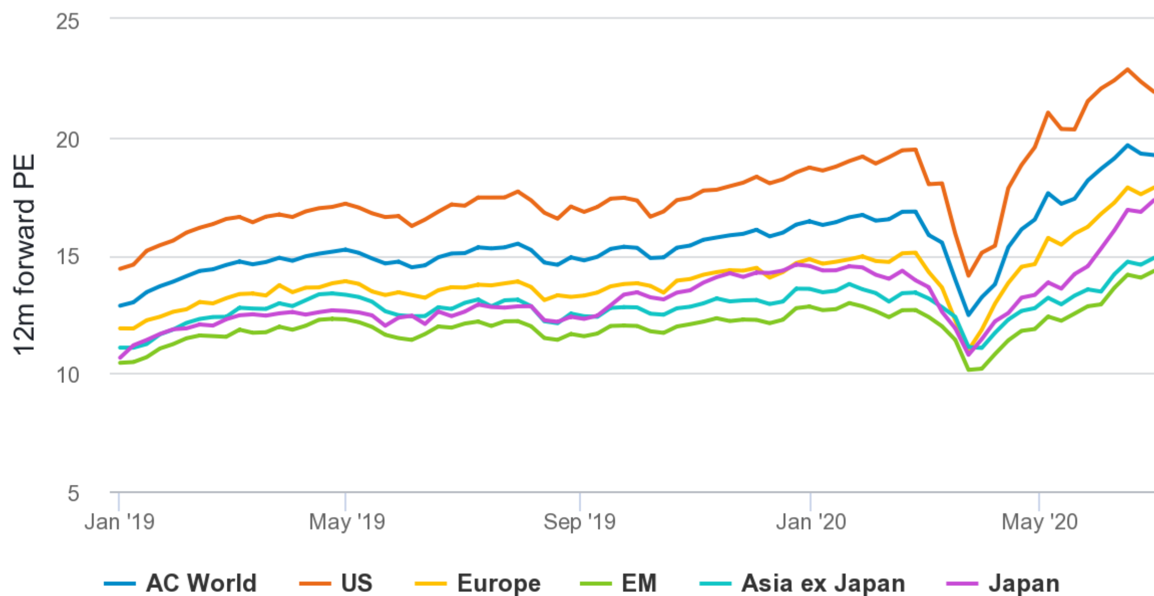
Secondary outbreaks, and failure to get the first outbreak in some countries under control, are forcing more local lockdowns, meaning the reopening of economies is likely to take time and will happen at different rates. Evidence of the real, underlying economic damage is emerging, especially in labour markets. For these reasons, we believe that the third quarter is likely to be much more challenging than the second quarter recovery would imply, and markets could see renewed volatility.

Crowded trades present a key risk. While the tech sector has benefited from lockdowns as more activity has moved online, and maintained market leadership, the concentration of investment within these companies is at a record high in the US. The five largest stocks in the S&P 500 - Microsoft, Apple, Amazon, Alphabet and Facebook - accounted for almost 23 per cent of the entire index market cap at the mid-year point, up from 17 per cent less than a year ago, and well above the previous high of just below 19 per cent. Meanwhile, correlations between asset classes have narrowed, meaning it is important to think carefully how to diversify portfolios than can withstand future market evolution.

In terms of opportunities, Europe generally seems to have got the virus under control more effectively than the US, despite further localised outbreaks, enabling it to open up more confidently and without the political backdrop of a major election. The landmark agreement to launch the EU Recovery Fund should boost recovery in the region. Asia, meanwhile, continues to show leadership in terms of coming out of this crisis, with swifter responses to further outbreaks. However, it too remains subject

to concerns about weaker global demand due to the pandemic and more stimulus may be required to maintain its position.

Chart 1: Markets continue the recovery trend, but are starting to look expensive



Source: Refinitiv, June 2020.

Macro outlook

Anna Stupnytska

While the extent of economic disruption remains uncertain, we have constructed a range of scenarios for 2020 and beyond. Moving into the third quarter, the balance of probabilities across the scenarios remains the same as when we first created them in April. Our base case is at 60 per cent, our downside case at 30 per cent and our upside at 10 per cent.

However, we have revised down our GDP growth predictions. We now expect global growth at around -3 per cent in 2020 and 4 per cent in 2021 in our base case scenario. While this is still below consensus, street forecasts have trended lower towards our view over the past few weeks. It’s also worth noting that there is a wide range of forecasts out there, underlying the uncertainty around growth outcomes.

Chart 2: Economic scenarios for global GDP growth 2020/2021

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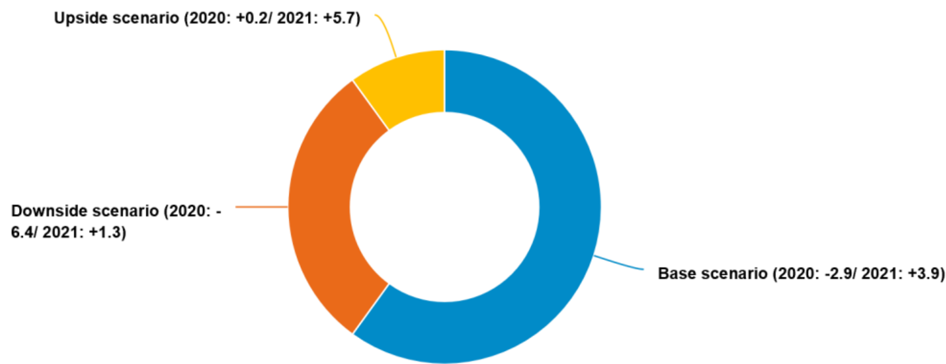


Source: Fidelity International, July 2020.

The enormous intervention by policymakers has helped to stabilise household incomes through the worst of the crisis. However, the outlook for the second half of 2020 depends not only on how policy initiatives continue to develop, but also on changes in the behaviour of households and corporates.

We will continue to adjust our scenarios as more evidence of the magnitude of these changes emerges, but we continue to expect GDP growth at the end of 2021 to be below pre-crisis levels (see chart). This is based on the view that the sharp contraction in the first half of 2020 will be followed by only a modest rebound in the second half of this year and through 2021. We expect the output gap may persist for several years to come, particularly in developed economies, implying limited inflationary pressures for the time being.

Chart 3: Global GDP will take time to recover from the virus impact

Source: Fidelity International, July 2020.

We believe that we are past the trough of this crisis and into the rebound phase. We have seen numerous upside surprises in terms of activity in some countries, with mobility and pent-up demand boosting growth in some indicators into double digits. In Europe, where the virus appears to be under greater control, mobility has continued to improve, despite localised lockdowns in Germany, Italy and Spain.

Despite concerns about consumer caution, services sectors have shown greater signs of recovery than manufacturers still wrestling with weaker external demand.
In the US, early signs of job recovery (mostly temporary employment) and some optimism among consumers have given way to greater caution as new cases appeared, creating a second wave of the initial outbreak even as states try to open up their economies. Indeed, evidence across a range of developed markets (for example, data on mobility, consumer confidence and labour markets) shows some of the initial reopening bounce has peaked earlier than expected and is levelling off.

As economies move from the re-opening to the recovery phase, we will be assessing how far the impact of the virus has permanently damaged the economy, by focusing on four main areas:
1. The trajectory of the virus and the level of restrictions, as these have implications for the engines of economic growth
2. The demand side of the economy and the impact on the labour market
3. Higher corporate indebtedness: will a liquidity crisis morph into a solvency crisis?
4. Policy support and how that evolves to focus more on growth and less on emergency funding

Some early evidence suggests that the long-term damage to the labour market may be significant. In the US, for example, estimates suggest that 30 per cent of lost jobs may turn into permanent layoffs, especially as policy support winds down from current levels. This runs the risk of creating a vicious cycle in which consumers are more worried about their jobs, save more and spend less, further depleting corporate revenue and pushing more companies to lay off workers.

While interest rates remain low, companies wishing to access capital should be able to do so relatively cheaply. However, to prevent widespread insolvencies, policymakers will have to move further towards pro-growth measures, and away from the unprecedented action taken to fight the crisis. This may prove difficult, and could cause reactions like the “taper tantrum” in markets.
Returning to any kind of normal in the current situation is going to be tough in the absence of a vaccine and we expect confidence to take time to build, especially as countries gear up for further waves of Covid-19 in the winter months.

Equities

Romain Boscher

Despite the market falls in the first quarter, outflows from mutual funds were pretty modest and markets have since recovered much of the lost ground thanks to the size of central bank intervention. While the number of share buybacks has reduced and, in some sectors, dividends are at risk or have been cut, equities continue to offer higher yields than most government bonds in developed and, increasingly, in developing, markets.

It is possible that in due course more central banks will follow Japan's example and buy equities, as well as bonds, through their quantitative easing programmes as they seek other ways to support markets. If we do move towards a Japan-like scenario over the next few years, we expect this to generate a decent appetite for equities. Corporates tend to become cash rich in this scenario and investors can find sustainable income rather than go all out for risk.

Shorter-term, however, we think markets are complacent. They are pricing in a seamless V-shaped recovery at a time when the global economy is under huge strain and the global health crisis remains unresolved. In our view, earnings for the second quarter are likely to be -45 per cent, and -25 per cent for the whole year, with considerable variation between sectors. In this environment, we are maintaining a quality bias, with a preference for larger companies over smaller ones. This is not the time to put more risk on the table.

Recession and election in the US

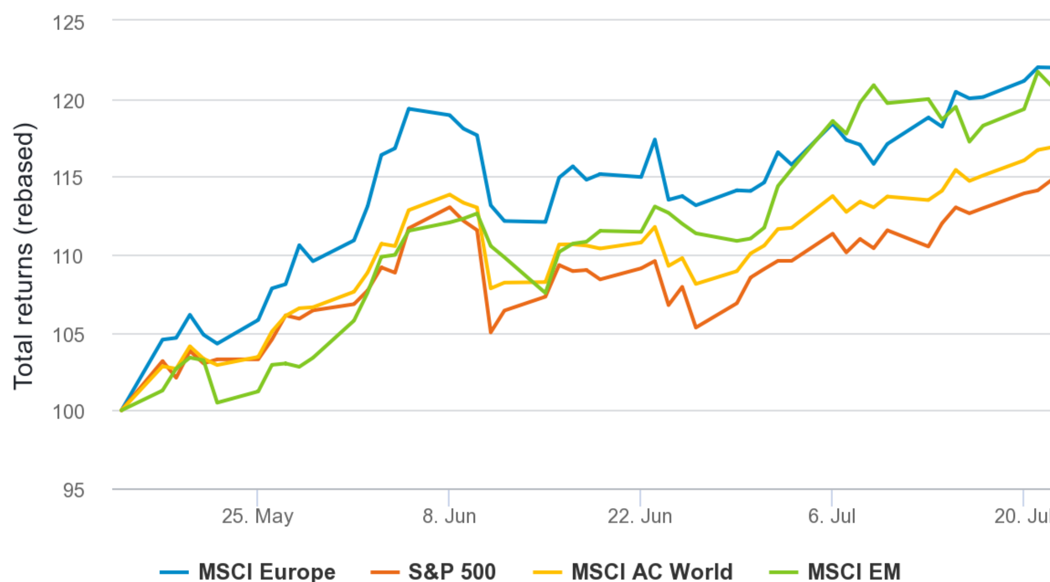
Investors weighing the outlook for US markets are grappling with two diametrically opposed forces: the recession brought on by the Covid-19 outbreak and the presidential election cycle. A second wave of coronavirus cases is undoubtedly a prominent risk factor, but other headwinds to prices include the growing probability of a Democratic sweep of Congress and the potential rise in corporate tax and regulation that would follow. Both are particularly important because they could hinder capital expenditure and cause upward pressure on the unemployment rate.

Meanwhile, corporate earnings are expected to decline sharply in the second quarter and, in the coming months, investors will be closely monitoring company guidance on performance. The Fed's restrictions on bank shareholder pay-outs were largely expected. US banks cannot pay out more than their average quarterly profit over the past four quarters. Relative safe havens have been long-term, secular growth stories such as mega cap technology and 'work from home' stocks, which have generated exceptional momentum, but have become overcrowded trades. Despite temporary rebounds, value statistically remains very cheap compared to growth on every valuation metric and the opportunity to outperform in the short to medium term persists. However, a longer structural shift to value will depend on economic growth, inflation and interest rate changes, which are difficult to gauge with confidence at this point.

Europe appears more positive, but sentiment is priced in

Sentiment towards Europe turned more positive in the second quarter. The MSCI Europe index has outperformed its global peers, particularly the S&P 500, since mid-May (see chart). One key factor in the region's performance is Europe's relative success in gradually reopening the economy, aided by its strong fiscal and monetary policy support via the EU Recovery Fund and the European Central Bank's operations. Positive readings on Purchasing Managers indices (PMIs) have reflected some of this success, with figures for May beating forecasts and even France returning to expansion.

Chart 4: Europe has outperformed global peers since mid-May



All indices in USD. Source: Refinitiv, July 2020.

With these factors now priced in, further signs of recovery may be needed for stocks to rise from current levels. That could come from continued easing of lockdown measures in countries such as the UK, which reopened pubs, restaurants and cinemas in July. However, there are some headwinds that could weaken the outlook for European equities, particularly if there are second waves of Covid-19 in countries that have re-opened their economies; this could trigger more downward revisions to growth forecasts. Beyond that, Brexit negotiations and trade tensions continue to linger.

Cautious on real estate and oil

In terms of sectors, we remain cautious on real estate and energy. Until recently, real estate was seen almost as a risk-free investment that offered solid production of income. However, as the need for office and retail space now looks set to diminish, it will be crucial for investors to find areas where cashflows are reliable and sustainable. Oil is a cyclical sector but even it has rarely seen such dramatic price volatility. When energy consumption declined as people stopped travelling due to Covid, renewables plateaued while oil lost 40 per cent of its value. More and more companies in the sector are taking advantage of the crisis to reallocate capital away from legacy businesses and into renewables.

Governance factors remain crucial

While environmental concerns remain high on the agenda and the crisis has shone a light on how companies treat employees, governance is still crucial to corporate survival. German payments processor Wirecard sold off sharply in June after it emerged that its financial statements were inaccurate. While the company’s missing €1.9 billion in cash only recently captured the headlines, warning signs of financial misreporting had been there for some time. As a result, Fidelity had a negative rating on the stock and our portfolio managers were significantly underexposed to the company.

Fixed income

Steve Ellis

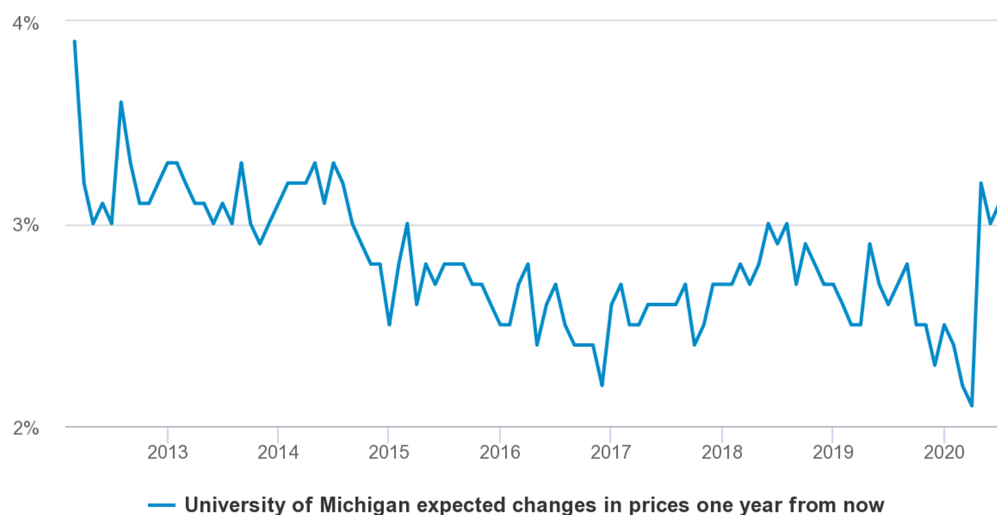
In the wake of the Covid-19 crisis, bond yields have fallen precipitously. Ten-year yields in the US have fallen to just 60bp and real yields have fallen sharply to -90bp, and we expect central banks to continue to keep yields low to ensure that corporations and governments can continue to service high levels of debt outstanding (around 280 per cent of GDP). This may keep bond prices high, but it increases the threat to nominal values of any sign of inflation.

If we take Japan as an historic example, we find that when rates went very low, the savings ratio remained high and credit markets actually performed quite well. So very low rates are likely to be positive for fixed income assets for some time, but incomes will come under pressure. Investors may therefore wish to consider investment grade bonds from a defensive standpoint, and perhaps even select areas of the high yield market for income. While the Fed has said it will consider buying corporate bonds, pessimism persists in some areas of the high yield market, where spreads are implying a 20 per cent default rate over the next five years.

Inflation must appear eventually

Given the scale of economic destruction caused by the pandemic, we are likely to see deflationary forces prevail in the short term. But the immensity of the policy response - $6.2 trillion in fiscal pledges - and a vast increase in monetary stimulus, has driven a sharp rise in monetary growth. This could become a key determinant of asset price inflation, and in due course consumer inflation. During the last crisis, the US financial system was suffering from insolvency problems, so the vast quantitative easing programmes were neutralised as banks did not expand deposit liabilities, which meant money supply was extremely muted. This time, banks are in better shape and therefore the stimulus is likely to creep into higher risk areas, pushing up prices.

Chart 5: Consumer expectations of price increases one year from now have risen



Source: Fidelity International, July 2020.

We continue to believe the recovery will be protracted. Exiting from various monetary and fiscal programmes is unlikely to be smooth, if it is even possible. Some policies will have to be extended - both fiscal and monetary. While we are not fighting central banks, we are focusing our efforts on finding longer-term winners with high quality ESG characteristics that appear more able to withstand future shocks. This may mean sacrificing a short-term pick up in yield for the sake of a better long-term return profile.

Risky assets have rebounded strongly, perhaps more than justified by fundamentals. Sovereign yields, however, have been stable, pegged by central bank purchases and by expectations of structurally lower growth ahead. We expect this to continue, keeping sovereign yields at current or lower levels. Our latest positioning, largely driven by our macro and quant models, shows an ongoing positive bias towards US and core European government bonds in particular which, while low yielding, offer a welcome "insurance policy" against drawdowns in risky assets after what has been a record recovery since mid-March. On the other hand, we have reduced our exposure to European peripheral bonds, which have rallied back to, or through, their fair value. With volatility still likely ahead, we are now tactically underweight. Finally, an allocation to inflation-linked bonds should offer some protection against any rise in inflation.

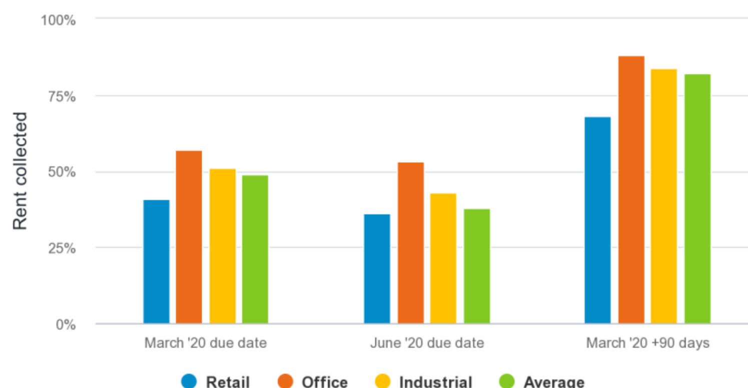
Real estate

Neil Cable

The big lesson of the Covid-19 crisis for direct real estate investment has been to understand the risks to income and the tenants who provide that income, given the instances of non-payment of rents. In the UK, where data is available, 18 per cent of Q2 rents remained unpaid at the end of June. This equates to a rental shortfall of c.£1.5bn. Rent collection for Q3 looks to be equally, if not more, challenging.

Rates of non-payment have differed across sectors, with non-payment highest in the retail sector, which was hurt badly by the lockdown, and lowest in the office sector, despite low levels of occupancy. The picture in continental Europe does not appear to be as challenging as that in the UK, but the themes are very similar and collection levels lag well behind 2019 levels.

Chart 6: Rent collection challenges in the UK have brought income security to the fore



Source: Remit Consulting, July 2020.

However, even within sectors, the drivers of payment or non-payment of rent have differed. Within the industrials sector, widely seen as a beneficiary of the disruption in the retail sector, payment levels varied considerably. Businesses linked to consumer staples and e-commerce saw little disruption during the worst of the Covid crisis and have continued to pay rents promptly, while companies in the manufacturing sector saw significant disruption from both the lockdown and supply chain problems and, as a result, some have struggled to pay rent.

Security of income will therefore be a key aspect of defining 'prime' real estate assets going forward. We expect to spend more time on tenant due diligence in the third quarter to gain further understanding of income risk both at an asset and portfolio level, using an evolving set of quantitative tools and in close collaboration with the rest of the Fidelity investment team. Given weak economic fundamentals and occupier demand, we remain relatively defensively positioned, seeking assets with good quality, sustainable income streams.

As we look for signs of recovery in the investment market, we believe that government policy will play an important role in underpinning investor confidence. The German government has received strong approval ratings for its handling of the crisis; from a real estate perspective, it has been very clear in upholding landlords' rights to rental payment, particularly when compared with the French and UK governments. German real estate is therefore expected to cement its status further as a 'safe haven' market.

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