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Q2 2019

Investment Outlook

Summary

Braver for longer… with caution

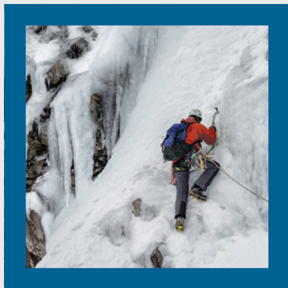
Q2 outlook overview

The contrast between the first quarter of 2019 and the final quarter of 2018 could not be starker. The speedy shift in market sentiment from gloominess to cheerfulness around US Federal Reserve policy and the US-China trade dispute has lifted all boats. As we look forward to Q2, we caution that the same fundamental issues around slowing economic growth remain, although this is more a return to trend late-cycle conditions rather than a recession. Still, in the short term, excitable markets may have got ahead of themselves resulting in a disconnect between fundamentals and price performance, and investors adopting an indiscriminate risk-on approach could be exposed to swings in sentiment.

Eighteen months ago, in our Q4 2017 Outlook, we suggested the bull market was still intact but entering its last phase and we advocated a *Braver for longer* approach. Since then, the cycle has ground onwards with two periods of correction and the bull market continues. There are risks aplenty, but there are also attractive opportunities if you look hard enough - there is still some life left in this old cycle yet.

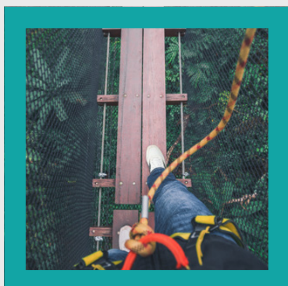
Anna Stupnytska
Head of Global Macro and Investment Strategy

Outlook: At a glance



Economic outlook

Greater clarity on the economic cycle will only emerge towards the middle of the year, but in the meantime the overall picture suggests the global industrial slowdown is continuing. As a result, markets are back into a 'bad is good' mindset. Investors should consider a defensive approach to navigate markets where conventional interpretations of data may not necessarily have the expected impact.

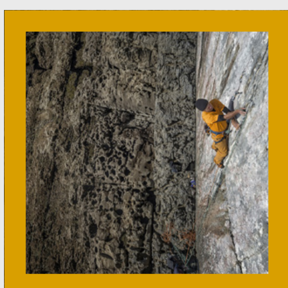


Equity

While corporate earnings growth forecasts remain too optimistic, our analysts continue to find opportunities on a regional and sectoral level. Japan has been sold off aggressively with much of the bad news priced in. Similarly, investors seem overly pessimistic towards cyclical stocks with Chinese exposure.

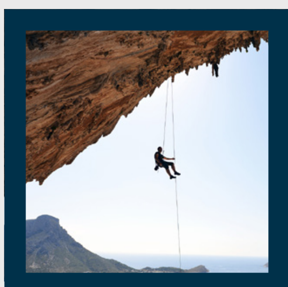
Fixed Income

With US yields at around 2.5 per cent, and the market pricing in some chance of cuts this year, US treasuries have limited room to rally further. We favour a tactical short position, expecting US rates catch up to the equity bounce. Investors should be cautious of risks around a still unresolved trade dispute between the US and China, and late cycle dynamics.



Multi Asset

Given the heightened volatility in markets and the uncertain direction of the global economy, we believe that now is the time to be active in every sense of the word. We are overweight equities but are highly selective in regional allocations given discrepancies in attractiveness. We prefer value stocks in the US, defensive assets like US treasuries and are biased to high quality in credit.



Real Estate

New capital deployment faces style-drift risks. It will be vital to recognise unintended strategy drifts early enough to adjust course and, therefore, to avoid an escalation of risk as the European real estate investment cycle unwinds. Specific to the UK, valuation markdowns in the retail sector were the main reason behind weak MSCI UK All Property performance in 2018, and with further corrections expected, we expect UK-focused funds with the lowest retail allocations to continue outperforming.

Economic outlook

Back at trend levels
What a difference a few months make in the market. Risk assets have posted one of their strongest starts to the year for over a quarter of a century based on a few choice words from the US Federal Reserve. But the underlying problems from a fundamental perspective remain. Economic activity is slowing, and a real concern is that the market has got ahead of itself leaving it vulnerable to a sudden pull back. Recession doesn't feature as a headline worry for us at this point. On the contrary we can see more of a threat as the year progresses from overly pessimistic views on the US economy and what that means for Fed action.

The data is pointing downwards
Our proprietary data is pointing to an unmistakable broad-based weakening in global economic activity. The Gauges of Economic Activity in Real-time (GEARs), which measures global growth across countries and regions, highlights faltering developed market economies; Japan is in contraction, Europe is close to it, and, although the US is comfortably in positive territory, its economy has rolled over. Emerging markets paint a more positive picture after a poor end to 2018, but it's too early to tell whether this can last; a pessimistic scenario is that emerging markets could be dragged down by the weakness of developed markets.

The Fidelity Leading Indicator (FLI) provides guidance as to where the global economy is heading. Intended as a predicator of the future direction of global industrial production, the FLI is deep in negative territory, suggesting we are not going to escape the slowdown in the near-term. Global activity could continue to soften through the first half of 2019.

Late-cycle, not end of cycle
While the probability of a US recession has risen according to a number of market-based models, the hard data clearly points to late-cycle dynamics, not the end of the cycle. Some major economies face very uncertain prospects, particularly the Eurozone and potentially the UK, but the US is performing back at trend growth levels, while it was above-trend previously. China has the potential to brighten the outlook with stimulus, but the magnitude of announced measures so far hasn't delivered the punch needed to turn China around or lift the global economy.

Late-cycle dynamics take time to play out and despite the plethora of risks - central bank policy mistakes, geopolitical events, economic slowdown, wage push inflation, corporate leverage, the list goes on - it is too early to worry about the end of the cycle.

Bad is good and good is bad
For investors, the volte-face of central banks is helpful to a degree. It initiated a wave of risk-on market activity and lifted all boats, but dovish policy by itself is not sufficient to push global growth back into above-trend territory. This stop/start in policy normalisation amid a slowing economy has jerked markets back into a 'bad is good' mindset, where, in the market's thinking, softer data improves the chances of loose monetary policy continuing. But, in our view, markets are too gloomy on US economic growth and, despite the Fed's reiteration of its dovish stance, underestimate the potential for the Fed to switch back into normalisation mode beyond this current soft patch. If that happens, markets could be in for a sudden jolt.

> "The disconnect between economic fundamentals and markets is unlikely to be sustainable in the short term. Markets are poised for big swings in risk sentiment over coming weeks and possibly months."
>
> - **Anna Stupnytska**, Head of Global Macro and Investment Strategy

About the views
This investment outlook provides a representative summary of the views of Fidelity International's investment teams. At Fidelity, individual portfolio managers have considerable flexibility and ultimately fiduciary responsibility for all investment decisions within their portfolios. Given this portfolio manager discretion, there may be differences between the broad, representative views shared here and the strategies applied within specific Fidelity funds.

Equity

Overview

What's changed

Equity markets have rallied year to date. Driven by the US Federal Reserve's dovish turn and positive news flow around the US and China trade dispute, equities rebounded from oversold and bearish levels in late December to more sensible valuations as the first quarter progressed.

Key takeaways

- From the worst December since 1931 for S&P 500 returns to the best January since 1987, equity sentiment has switched from considerably pessimistic to fairly optimistic over the past quarter, as trade tensions somewhat abated.
- Political uncertainty remains. This is a long process of geopolitical competition, where China is challenging the US for political and economic status. The recent conciliatory signs may well be mere highlights in a battle, which itself is part of a multi-year, perhaps multi-decade, trade war.
- After very strong corporate earnings growth in 2018, expectations are more moderate for 2019. Although we have reasons to be positive, we think the consensus estimate of 6 per cent earnings growth in the US may still be too high.

Investment implication

While corporate earnings growth forecasts remain too optimistic, our analysts continue to find opportunities on a regional and sectoral level. Japan has been sold off aggressively with much of the bad news priced in. Similarly, investors seem overly pessimistic towards cyclical stocks with Chinese exposure.

> "Over the past two quarters, equities have experienced significant changes in sentiment. This volatility is unlikely to fade through 2019 and investors will need to be on guard. This will no doubt create opportunities for the long-term investor and we should not be afraid to embrace them."
>
> - **Romain Boscher** Global CIO, Equities

Fixed Income

Overview

What's changed

The US Federal Reserve's December pivot towards dovishness was unexpected and the March meeting reinforced this new direction. Having stuck to a hawkish stance and raised benchmark interest rates nine times since December 2015, this was a significant shift for the central bank.

Key takeaways

- Government bonds posted positive returns so far this year amid equity market strength, driven by central bank policy shifts, political risk and weak data out of Europe.
- The Fed's turnaround from a hawkish tone to a decidedly dovish one surprised the market, but the shift may come back to haunt the Fed later in the year when an overheating economy could warrant hikes, not cuts.
- Economic data from the US remains largely in positive territory and, while the external picture has somewhat weakened, it is not dramatically different.
- We see the Fed resuming its hiking path either later this year or in 2020, which compares with rate cuts currently expected by the market as early as Q1 next year.

Investment implication

With US yields at around 2.5 per cent, and the market pricing in some chance of cuts this year, US treasuries have limited room to rally further. We favour a tactical short position, expecting US rates catch up to the equity bounce. Investors should be cautious of risks around a still unresolved trade dispute between the US and China, and late cycle dynamics.

"The Fed's dovish turn has helped risk assets. As we get closer to the end of the credit cycle, however, investors should keep a watchful eye and prefer quality over income at any cost."

- **Steve Ellis**, CIO Fixed Income

Multi Asset

Overview

What's changed

The policy shifts of the US Federal Reserve and China towards pausing tightening and starting fiscal stimulus respectively, have reinforced our shift to overweight equities. Being selective is key to avoid missing out on the gains at this late stage of the market cycle without taking excessive risk.

Key takeaways

- Having bought the excessive sell-off in equities, we are now reassured by China stimulus and the Fed 'pause' but are selective given regional disparities in attractiveness.
- We balance our increased weight to equities with high-quality fixed income. Interest rate exposure can perform well in certain regions if the global economy surprises to the downside but diverging credit fundamentals warrant being selective.
- We are underweight cash as opportunities are arising out of market volatility. The negative after-inflation returns from cash and lack of duration 'hedge' have led us to overweight fixed income to balance our equity position.

Investment implication

Given the heightened volatility in markets and the uncertain direction of the global economy, we believe that now is the time to be active in every sense of the word. We are overweight equities but are highly selective in regional allocations given discrepancies in attractiveness. We prefer value stocks in the US, defensive assets like US treasuries and are biased to high quality in credit.

"This late-cycle environment means multi asset managers will have to live up to their name."

\- James Bateman, CIO Multi Asset

Real Estate

Overview

What's changed

The end of 2018 saw a number of disruptions to the Eurozone economy, such as Germany narrowly avoiding technical recession in the second half of the year and the French Gilets Jaunes protests. While the near-term Eurozone economic outlook is underwhelming, it is stable and supported by robust domestic fundamentals. In the UK, retail real estate valuations are starting to reflect the weak fundamentals of the sector, playing catch-up with the poor performance of listed retailers and operators.

Key takeaways

- The macro slowdown is clashing with market optimism. The mismatch between weak economic fundamentals and unabated real estate market strength is expected to be especially pronounced this time.
- Target allocations to real estate in EMEA institutional portfolios continue to rise, reaching 11.1 per cent in 2018[1]. A need to deploy capital late in the cycle tends to push investors to so-called style drift and take on more risk than planned to find suitable investment products.
- The lack of consensus over Theresa May's Brexit Withdrawal Agreement has further increased the overall uncertainty and continues to negatively impact the UK's economic activity and its real estate market.
- The UK retail sector will continue to be particularly challenging.

Investment implication

New capital deployment faces style-drift risks. It will be vital to recognise unintended strategy drifts early enough to be able to change course and, therefore, to avoid escalation of risk as the European real estate investment cycle unwinds. Specific to the UK, notable valuation markdowns in the retail sector were the main reason behind weak MSCI UK All Property performance in 2018, and with further corrections expected, we expect UK-focused funds with the lowest retail allocations to continue outperforming.

> "The continuing low interest rates and weight of capital into the real estate market point to an extended cycle, but investors should not be complacent. Now is the time to ensure portfolios take on less risk and focus on defensive characteristics such as quality of income as well as quality of physical real estate."
>
> \- **Neil Cable** Head of European Real Estate

[1]The 2018 Allocations Monitor' by Cornell University's Baker Program in Real Estate and Hodes Weill & Associates, LP.

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