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Slowing but going

Investment Outlook

Fidelity Editorial
Q1 2020

January 2020

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Slowing but going

The first year of the new decade is shaping up for a relatively benign economic outlook, with modest deceleration in the US and China, and the potential for re-acceleration in Europe and emerging markets.

On balance, we take a moderately risk-on approach, but a wide range of economic, domestic and geopolitical risks persist. Resumption of nuclear testing by North Korea and the US conflict with Iran are on the radar. There's also the US presidential election to contend with and various flavours of increasingly extreme politics vying to outdo each other.

Overall, 2020 looks to be a story of growth stabilisation rather than big acceleration and it displays the signs of the final stages of a bull market. However, late cycle dynamics appear poised to extend for at least one more year.

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Key highlights

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Equities and credit are now moderate overweights, while government bonds have been downgraded to neutral. European and UK equities should benefit from lower political risk, loose monetary policy and some de-escalation in global trade tensions.

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The US expansion looks set to continue for a little longer, though likely at a slowing rate. This bodes well for risk assets and somewhat poorly for Treasuries. Nevertheless, stark downside risks persist and would most likely emanate from politics.

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Easing trade tensions and stabilising economic data should encourage some reversal of the capital flight from equities we've seen in recent years, setting the path for positive equity performance in 2020.

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We kept an overall neutral US duration exposure until recently when we moved to a small underweight stance as a result of weaker momentum signals in our quant models.

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With markets behaving as if global growth is reflating when the data is merely flatlining, our team is growing increasingly concerned that investors have become complacent. Against this backdrop, we are cautious overall.

Real Estate
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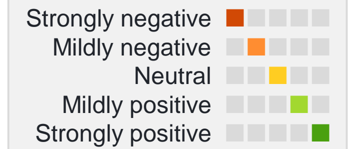
Rental growth will play a bigger role than capital growth in real estate outperformance in 2020, a trend evident in major cities. In such an environment, actively assessing tenant risk will be key to sustaining income returns.

House view

As the final quarter of 2019 progressed, we became more tolerant of risk. Positive news on the economy and geopolitical developments, and synchronised central bank intervention mean that conditions are set for a relatively benign macroeconomic outlook for the start of 2020. We tilt towards a risk-on approach as a result.

House view on asset allocation

December 2019



	Near-term (3-6 months)		Medium-term (12-18 months)		
Asset Class	**Allocation**	**Change**	**Allocation**	**Change**	**Key Views**
EQUITIES		**+1**		**+1**	**Near-term view on equities remains neutral. Medium-term view on equities upgraded to moderately overweight.** Fundamental view assumes slower but plateauing growth, but with a high level of vigilance around 2020 earnings given downward earnings revisions. Focus on 'quality at a reasonable price' and maintain bias to growth over value. Relatively neutral on region.
Growth / Quality		0		0	
Value / Income		0		0	
US		0		0	
Europe		+1		+1	
Japan		0		0	
EM		0		0	
SOVEREIGN BONDS		**-1**		**+1**	**We enter 2020 with a neutral view on government bonds.** The Fed engineered a soft landing and we agree with the market that rates remain on hold through 2020. Negative rates/yields in Europe should begin normalising, and eventually fiscal policy will replace European Central Bank (ECB) monetary action. We expect more aggressive easing from the People's Bank of China (PBOC), once pork-driven inflation subsides.
US		-1		+1	
Europe		0		0	
UK		-1		0	
China		0		0	
CREDIT		**+1**		**+1**	**Medium-term view on credit upgraded to moderately overweight.** The upgrade is driven by our move in European high yield from neutral to moderately overweight, based on improved politics, bottoming European data and the expectation of coupon-like returns. Less positive on US Investment Grade/High Yield (IG/HY) given valuations and fundamentals, but continued high conviction in overweight in China/Asia credit.
Global IG		0		0	
Global HY		+1		+1	
Asia Credit		+1		+1	
EM CREDIT		**0**		**0**	**Maintain moderately overweight.** Valuations still attractive versus other asset classes and central bank easing is supportive. Our soft landing outlook for the global economy combined with the global central bank 'put' is an overall positive for emerging markets.
EM Corp		0		0	
EM Sov. $		0		0	
EM Sov. Local		0		0	
CASH		**0**		**0**	Neutral over the medium-term view.

Source: Fidelity International, December 2019.

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Strong conviction views

December 2019: Medium-Term (12-18 month) view

ASSET CLASS	Long / Overweight	Short / Underweight
EQUITIES	▪ **Value**: Assuming a stable macroeconomic backdrop in 2020, we see a path to higher market levels for value stocks after their long-term underperformance versus growth. Value also provides more late cycle downside risk protection from sectoral and valuation perspectives. ▪ **Europe and UK**: Cheap valuations, lower political risk post-UK election, some de-escalation in global trade tensions and an accommodative ECB are supportive.	▪ **Growth**: Growing regulatory threats to tech and rich valuations. ▪ **Banks**: Lower for longer policy rates are a significant headwind.
FIXED INCOME	▪ **US Breakevens:** Signs of rising US inflation, eventual stimulus and valuations amongst the cheapest in fixed income drive our overweight in US inflation-linked bonds. ▪ **China and Asia high yield:** Attractive yields, higher secular growth rates and ample monetary and fiscal stimulus are supportive.	▪ **Bunds**: Negative rates/yields in Europe should begin normalising assuming we are correct on a cyclical bounce in industrial/manufacturing sectors and temporarily diminished trade tensions. Over the longer-term, fiscal policy will replace the ECB's negative rate policy.
CURRENCIES	▪ **CAD:** We like Cash Available for Distribution (CAD) on valuation, fundamentals and technicals. In the short-term, the oil price should rise due to shale supply disappointment and bottoming demand. Canada 2yr yields are higher than US Treasuries, and signals from a flat curve, carry and momentum support an overweight. We also expect Canada's economic growth to be stronger than the US's in 2020.	▪ **EUR:** Low carry and low economic growth versus the rest of the world, and continued political overhang from Brexit negotiations.
COMMODITIES	▪ **Copper:** Stabilisation in the global economy is supportive. In the longer-term, struggling supply conditions and solid demand are tailwinds.	▪ **Natural gas:** Ramping up US shale oil supply results in more supply of US gas as it is a by-product, putting downward pressure on prices. ▪ **Iron ore:** Recovering supply over the next 12-18 months combines with softening demand to hurt prices.
REAL ESTATE	▪ **EUR mixed use:** Tenants are attracted to assets integrated into the urban fabric, offering live-work-play environments that attract and retain staff. We expect this sector to be resilient in any slowdown. ▪ **Focus on income:** Acquire longer duration (5+ years) assets and extend leases on existing assets to provide liquidity and income stability within portfolios. ▪ **UK ex. retail**: Initiating an overweight based on attractive valuations versus Europe ex retail and the removal of an overhang in political risk.	▪ **Low liquidity markets:** Aggressive repricing is no longer compensating for additional risks. ▪ **UK retail:** Sector has begun to reprice but industry disruption is still affecting the security of income streams.

Source: Fidelity International, December 2019.

Economic outlook

The geopolitical headlines have improved and risk sentiment is back, but it's the data that ultimately underpins the markets and this is largely positive. Many of the trends we started seeing in the second and third quarter of 2019 are now coming to fruition. In Q1 2020, we see that stabilisation becoming more ingrained, though markets remain fragile.

Economic outlook: Overview

Markets betting on 2020 growth rebound: we broadly agree

What's changed

- Economic data is encouraging on the whole, with clear signs of stabilisation. Policymakers have been synchronised in their support. Central banks across the world are easing monetary conditions and there is fiscal expansion under way in Europe and China, and potentially forthcoming in the US and UK.

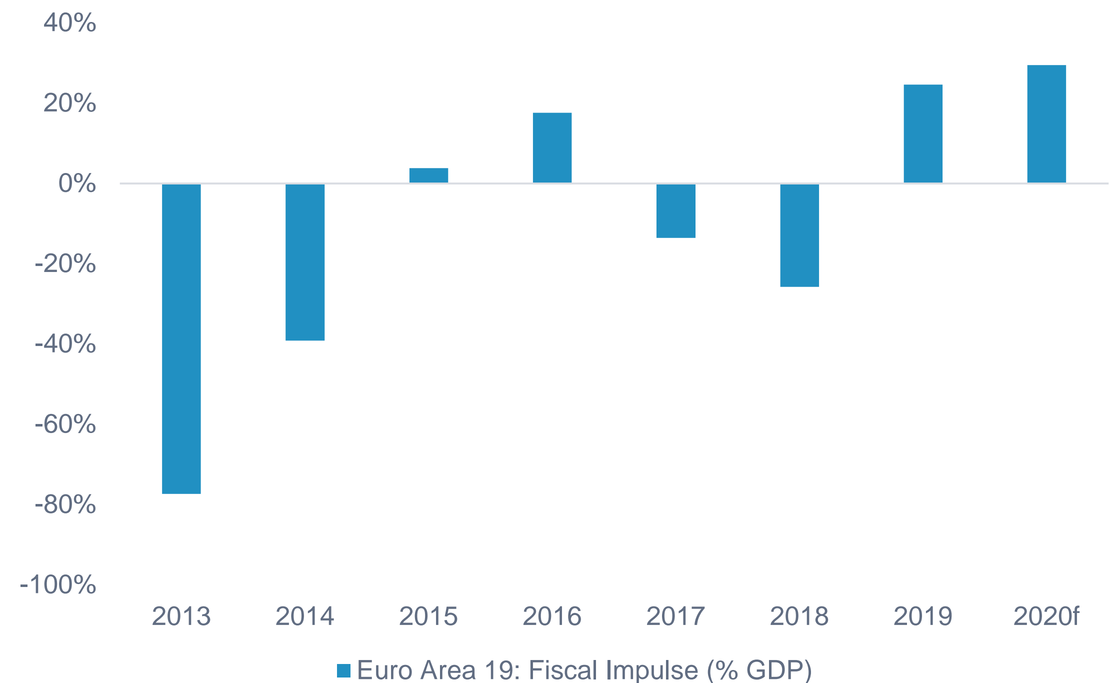
Key takeaway

- Markets are betting on a growth rebound in 2020. Our proprietary indicators have been suggesting this for some time and therefore we broadly agree.

Investment implication

- The US expansion looks set to continue for a little longer, though likely at a slowing rate. This bodes well for risk assets and somewhat poorly for Treasuries. Nevertheless, stark downside risks persist and would most likely emanate from politics.

Easier fiscal conditions to support Eurozone growth



Source: National Sources; Haver Analytics, Fidelity International, July 2019.

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Economic outlook: Data & Policy

"In a good place"

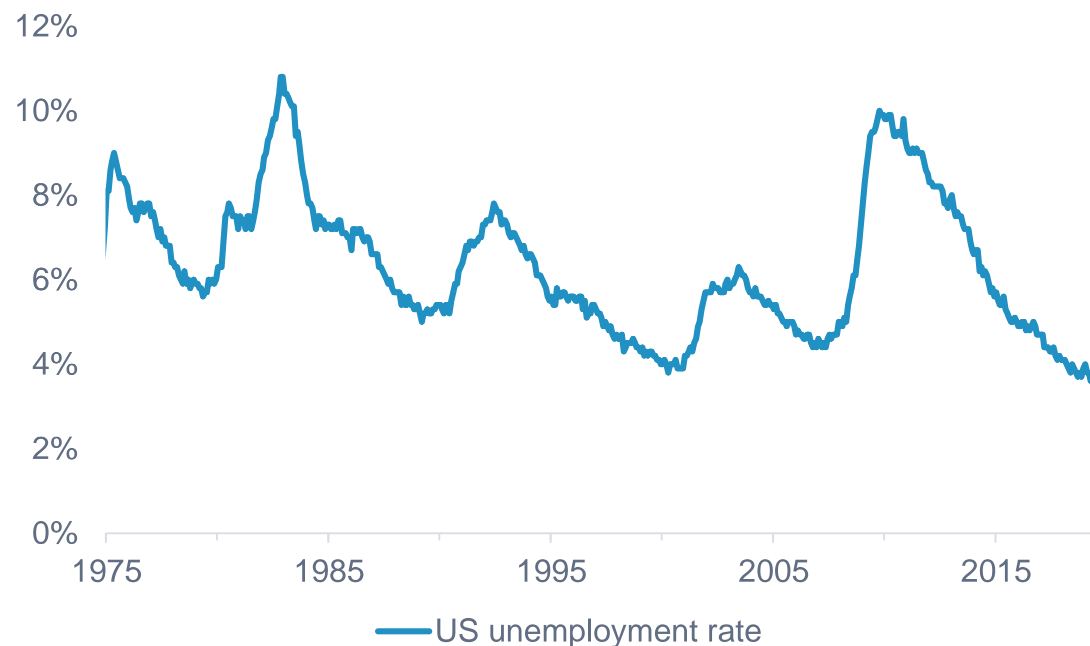
What's changed

- Fed chair Jerome Powell asserted that the US economy is "in a good place" and the data is bearing that claim out to a degree.
- Euro area macro data appears to be stabilising, with the new set of forecasts by ECB staff showing both growth and inflation gradually recovering over the forecast horizon.

Key takeaway

- US rate cuts have re-stimulated the housing market, consumer confidence remains resilient, the US is experiencing the strongest labour market for 50 years, and there are early signs of a stabilisation in manufacturing.
- But US investment is still weak and it will be hard for the economy to maintain above-trend growth.
- The outcome of the ECB strategy review, running over the course of 2020 will be closely watched.

US economy manages a soft landing with positive data and below target inflation



Source: US Department of Labor, December 2019.

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Economic outlook: Gauges of Economic Activity in Real-Time (GEARs)

Steadily grinding higher

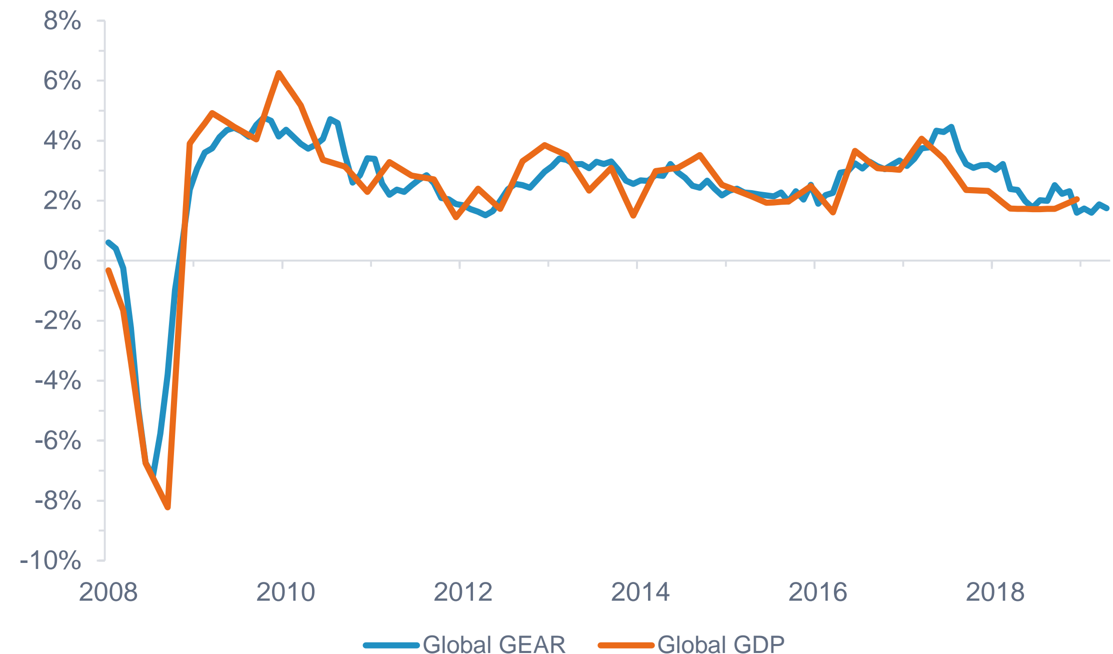
What's changed

- Most developed market countries are grinding higher from their Q3 lows, even Germany.
- Despite the US dipping towards its 2019 lows as consumer spending finally loses steam after an unsustainably strong run, a resurgent real estate sector is keeping the overall GEAR robust.

Key takeaway

- The Emerging Market (EM) aggregate GEAR remains comfortably above its turn-of-the-year lows, continuing to suggest stability. However, the country mix is wildly divergent.
- China has little new to update, with a similar reading to the last quarter. Despite all the headline noise around trade, front-loaded domestic stimulus in the first half could be enough to maintain reasonable growth rates in 2020.

Hinting at stabilisation



Source: Fidelity International, November 2019.

The Fidelity Gauges of Economic Activity in Real-time (GEARs) are monthly 'close-to-real-time' indicators of current activity across several key developed market and emerging market economies. They are a proprietary quantitative input to Fidelity's investment process, providing insight into economic activity that supports tactical decision-making in portfolios.

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Economic outlook: Fidelity Leading Indicator (FLI)

Indicates we're past the worst

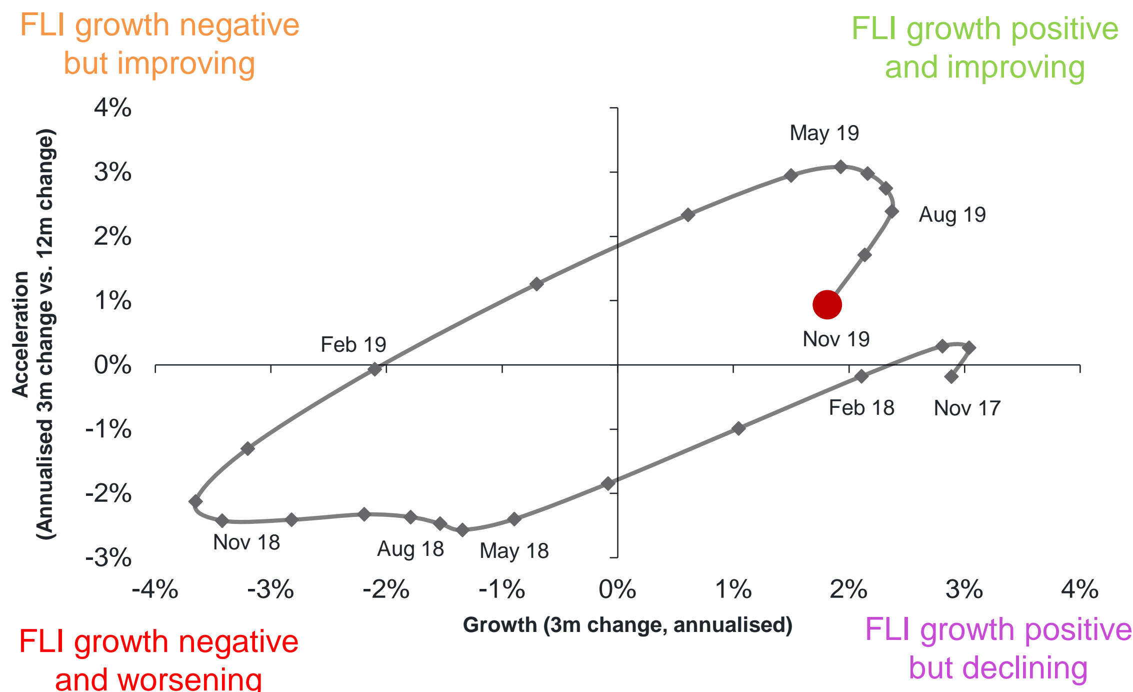
What's changed

- The FLI continued to stay in positive territory, but there are some signs of cooling - pointing to an acceleration in the global economy in the first quarter of 2020, but at subdued growth levels.
- Only two sectors were in the top-right quadrant that indicates above-trend and accelerating growth, while two were in the bottom-left of below-trend and decelerating growth.

Key takeaway

- Worryingly, global trade moved out of the top-right and into bottom-left quadrant, with both hard and soft data weakening. Global trade levels have been flatlining for the past six months, with mini-cycles around this trend.
- A bright spot is in Europe, where Germany's foreign orders look to be consolidating their rebound despite a weak domestic picture.

Marginal cooling but still positive



Source: Source: Fidelity International, December 2019.

The Fidelity Leading Indicator (FLI) is a proprietary quantitative tool, used as an input into shorter -term asset allocation decisions by portfolio managers. It is a model designed to anticipate the direction and momentum of global growth over the coming months, and - importantly for investors - identify its key drivers.

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Equities

The re-rating of equities we saw in 2019 was largely driven by the promise of future earnings growth, and, as we enter 2020, investors will be watching corporate profits closely. Earnings expectations are broadly fair and valuations still reasonable despite the double-digit returns in the past year. If those earnings forecasts bear out, we could see some of the investor capital that flowed out of equities in recent years start to trickle back in and support markets in 2020.

Equities: Overview

The promise of earnings growth

What's changed

- The first phase of a US-China trade deal looks to be in hand, as does a replacement for North American Free Trade Agreement (NAFTA). The Fed has moved to a hold stance after three rate cuts, and economic data is generally more positive. All these factors have helped equities reach new highs in the final quarter of 2019.

Key takeaway

- 2019 equity gains were mostly driven by multiple expansion, and earnings need to come through in 2020 to maintain market levels.

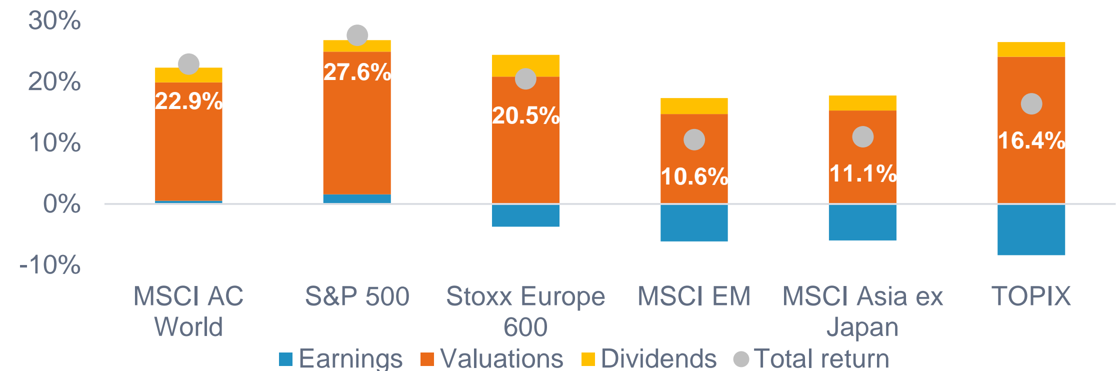
Investment implication

- Easing trade tensions and stabilised economic data should encourage some reversal of the capital flight from equities we've seen in recent years, setting the path for positive performance in 2020. However, domestic politics, particularly the US election cycle, may lead to continued volatility.

Fidelity global forecasts

	2020	2021
Earnings growth	9.0%	9.5%
Return on equity	14.1%	14.5%
Dividend yield	2.5%	2.7%
P/E valuation	15.9x	14.5x
P/B valuation	2.2x	2.1x

Multiple expansion has driven returns in 2019



Top - Source: Fidelity International, 7 January 2020.
Bottom - Source: Refinitiv DataStream, Fidelity International, November 2019.

Equities: Regions

Policymakers will be key

US: Domestic politics moving to centre stage

- Markets are awaiting the Democratic nominee in the US Presidential election. The big risk for investors is if Elizabeth Warren moves decisively into the lead.
- Warren's policies of higher taxes, increased regulation and restrictions on private capital could encourage companies to hold more cash, causing liquidity conditions to deteriorate and triggering market sell offs.
- Despite being in the later stages of the cycle, US markets should continue to rise if economic data remains supportive.

Europe: Crying out for a fiscal boost

- The European Central Bank announced a broad-based monetary policy stimulus package in September 2019, but we believe these measures will have to be supplemented by fiscal policy moves in order to aid economic growth.

Fidelity earnings growth forecasts

	2020	2021
US	9.3%	10.1%
Europe	8.4%	6.3%
Asia ex Japan	9.8%	12.4%
Japan	6.5%	9.4%
Emerging markets	10.8%	12.7%

Fidelity capital market assumptions

	3 years	5 years	10 years
US equities	5.2%	6.0%	6.3%
European equities	5.7%	7.3%	6.9%
Japanese equities	6.4%	7.3%	7.4%
Developed market equities	5.3%	6.5%	6.7%
Emerging market equities	6.5%	7.7%	7.9%

Top - Source: Fidelity International, 7 January 2020.
Bottom - Source: Fidelity International, June 2019. These are estimates of return per year in nominal USD, based on our proprietary modelling, for illustrative purposes only. They reflect the views of investment professionals at Fidelity International. Indices used for calculation: US equities - S&P 500, European equities - MSCI EMU, Japanese equities - TOPIX, DM equities - MSCI World, EM equities - MSCI EM.

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Equities: Regions

Unrest impacts regions

Asia-Pac ex JP: Trade and HK protests dominate the region

- The Chinese market has clawed back a significant chunk of losses on optimism around trade talks, but the Hong Kong protests are having an impact. On the ground, we sense a moderately cautious tone from companies, consultants and government entities.

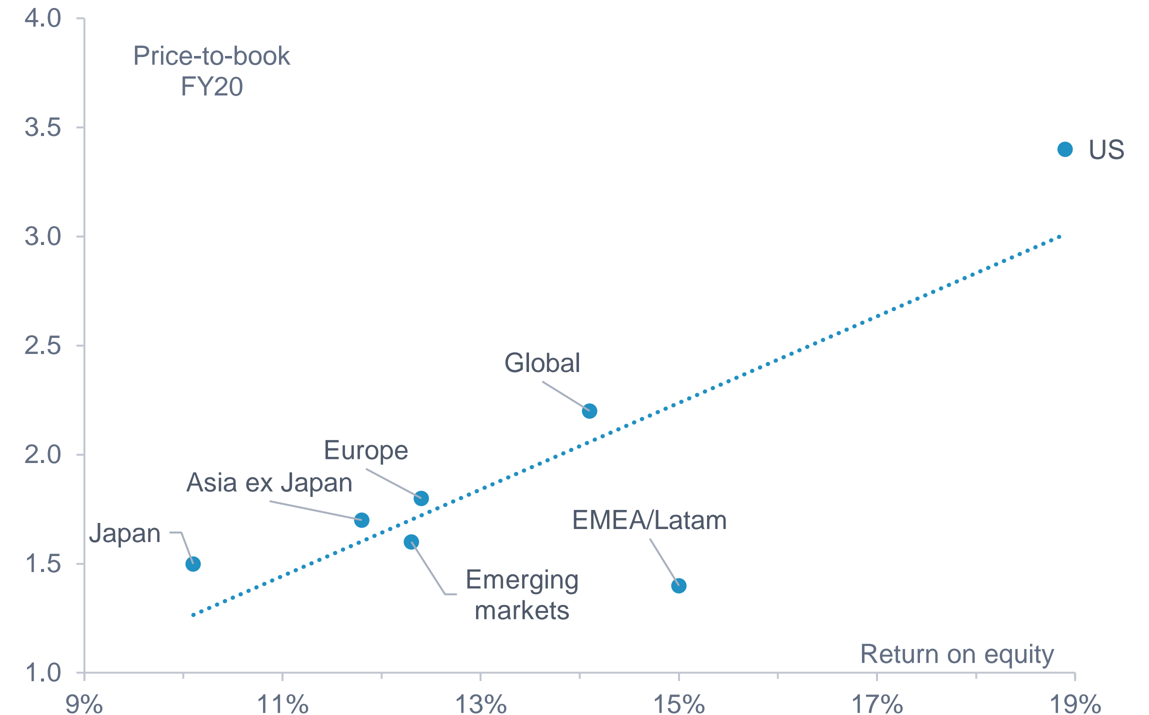
Japan: Trade optimism provides supportive backdrop

- Japan's relatively open economy is a key beneficiary as global markets feel more confident and trade tensions ease.

EM: Generally positive quarter

- EM ended the quarter brightly after a strong start, punctuated by a mid-quarter lull. Across countries performance has been mixed.
- Central banks across emerging markets continued to ease their monetary policies and introduced fresh stimulus measures to support growth.

Fidelity earnings growth forecasts



Source: Fidelity International, 7 January 2020.

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Equities: Sectors

The energy sector could see a large swing in earnings growth in 2020

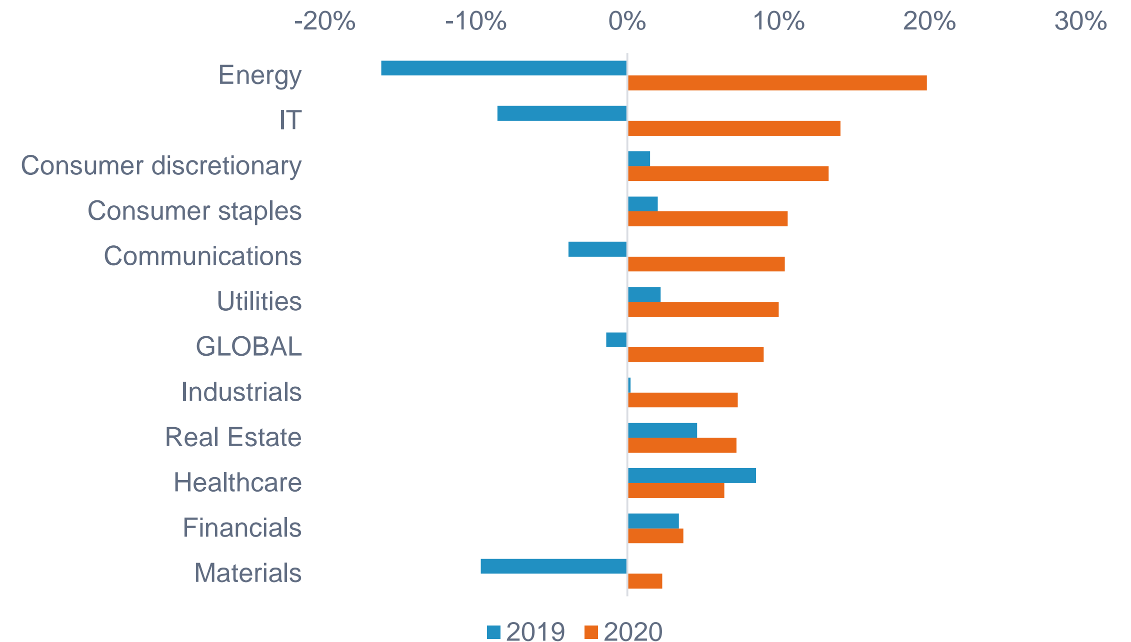
Top: Refining margins to drive earnings growth in energy

- While we estimate energy earnings fell by more than any other sector in 2019, we think they will rebound the most in 2020.
- Refining margins, helped by increasing demand for lower sulphur fuels as a result of the International Maritime Organisation (IMO) rules to be introduced in January 2020, should experience double-digit percentage growth.

Bottom: Out of favour materials

- Materials is at the bottom of the list for expected earnings growth in 2020 and that largely comes down to macro headwinds.
- The materials sector is highly dependent on Chinese growth for marginal demand and with GDP growth slowing over the last seven quarters, it has limited materials sales. But some of the market commentary about the extent of the Chinese slowdown, and, by extension, materials, is overdone.

Fidelity International's year-on-year net income growth forecasts for 2020



Source: Fidelity International, 7 January 2020.

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Equities: Sectors

Sector to watch: Semiconductors moving into upswing

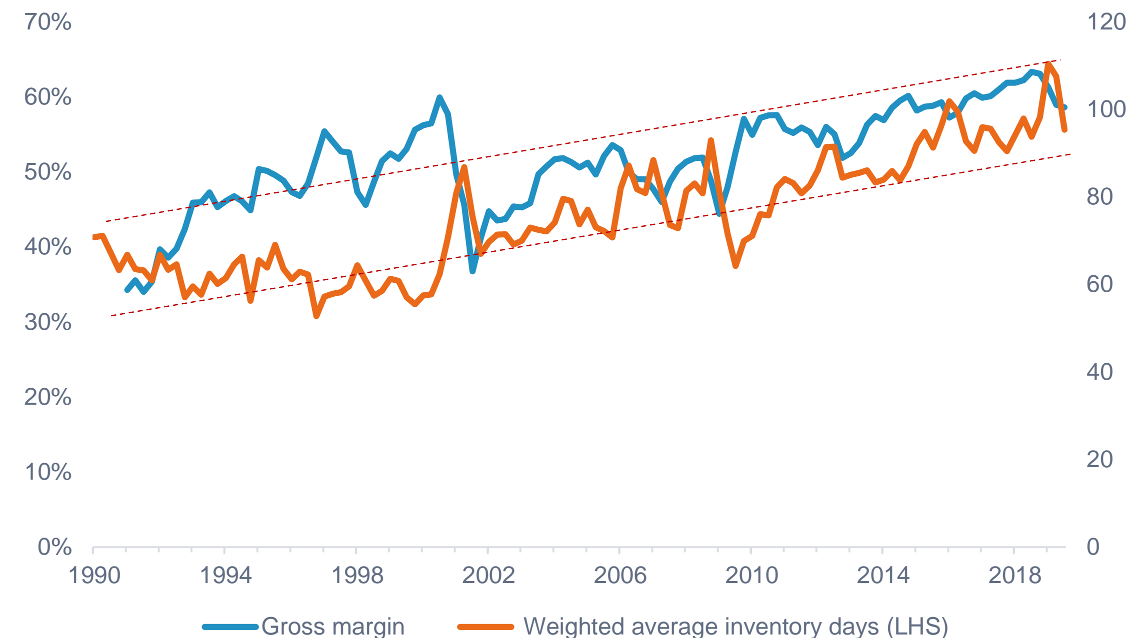
Restocking inventories could drive revenues

- A number of inventory channels are lean, at multi-year lows or below target levels, and the weighted average number of inventory days sits at the bottom of its trend range.
- A potential rebound in demand for semiconductors, particularly memory chips, could also benefit semiconductor capital equipment companies, which manufacturer machines used to produce electronic devices.

Valuations give us pause for thought

- Earnings multiples are near mid-cycle levels, so further performance from here will depend more on earnings upgrades than multiple expansion.
- Those earnings upgrades have a good chance of coming through, but the stock price upside is more limited when valuations are relatively high.

Semiconductor companies' inventories sit at bottom of trend range



Source: Fidelity International, company data, December 2019.

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Fixed Income

After most fixed income asset returns ended 2019 on a high note, we enter 2020 acknowledging that it will be difficult to replicate last year's performance given the low starting point for yields.

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Fixed Income: Overview

Expectations must be moderated

What's changed

- The announcement of a phase one trade deal between the US and China caused government bond yields to rise significantly in Q4 2019. The Fed delivered a third rate cut and then signalled it was switching to a hold stance. Economic data has shown resilience in the face of headwinds.

Key takeaway

- Many macro and geopolitical risks faced in 2019 have receded, but there are plenty of events that could still bring volatility.

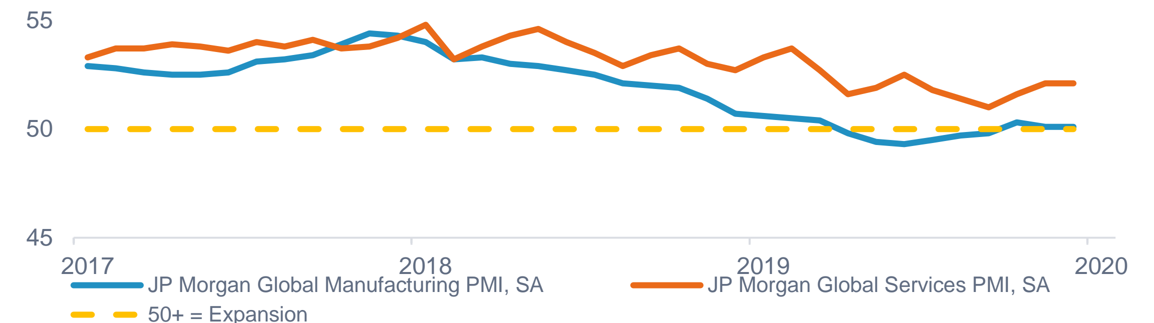
Investment implication

- We keep an overall positive long-term view on US duration and will look to add on any weakness given its resilience during bouts of volatility. We added back to our core European duration exposure and are positioned for some widening in spreads between core and both semi core and peripheral markets.

Fidelity capital market assumptions

	3 years	5 years	10 years
US Treasuries	1.2%	0.8%	1.3%
German government bonds	-1.8%	-1.0%	-1.5%
US investment grade	2.0%	2.4%	2.8%
European investment grade	-0.3%	0.1%	0.3%
US high yield	4.1%	4.3%	4.7%
European high yield	2.0%	2.1%	2.2%

Global manufacturing remains weak



Top - Source: Fidelity International, June 2019. These are estimates of return per year in USD and EUR, based on our proprietary modelling, for illustrative purposes only. They reflect the views of investment professionals at Fidelity International.
Bottom - Source: Bloomberg, December 2019.

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Fixed Income: Inflation-linked

Attractive backdrop ahead

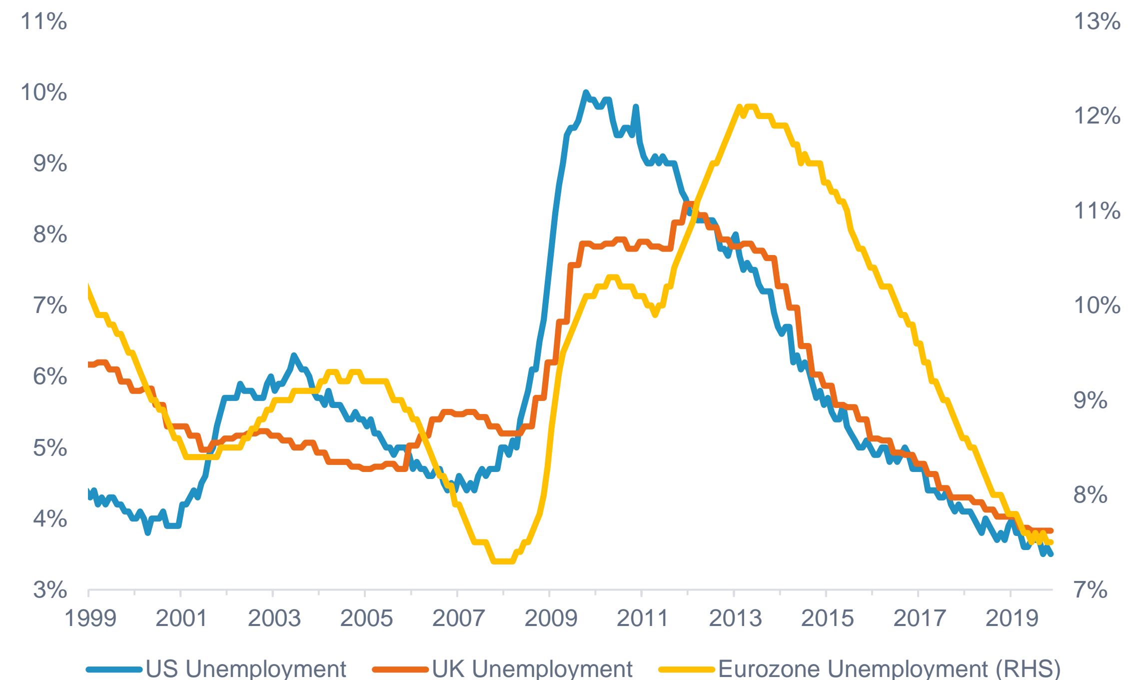
Returning volatility

- 2019 saw a mixed picture for global breakevens. While the asset class was relatively unchanged overall for the year, it hides the fact that volatility in global inflation expectations has returned.
- The US labour market is tight with wage increases continuing to outstrip inflation and unemployment at cycle lows. We think US breakevens continue to show fundamental value at 1.8 per cent versus core Consumer Price Index (CPI) at 2.3 per cent. We forecast US core CPI to reach 2.5 per cent by mid-2020 before falling back.

Italian breakevens attractive

- The strong UK labour market is offset by expensive valuations, making us comfortable with being neutral UK breakevens.
- Eurozone breakevens look cheap relative to fundamentals, such as versus super core inflation for example, and BTPei breakevens look even cheaper relative to their European counterparts in Germany and Spain.

Unemployment remains at the cycle-lows



Source: Fidelity International, Bloomberg, December 2019.

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Fixed Income: Investment grade

Leverage is a concern in the US

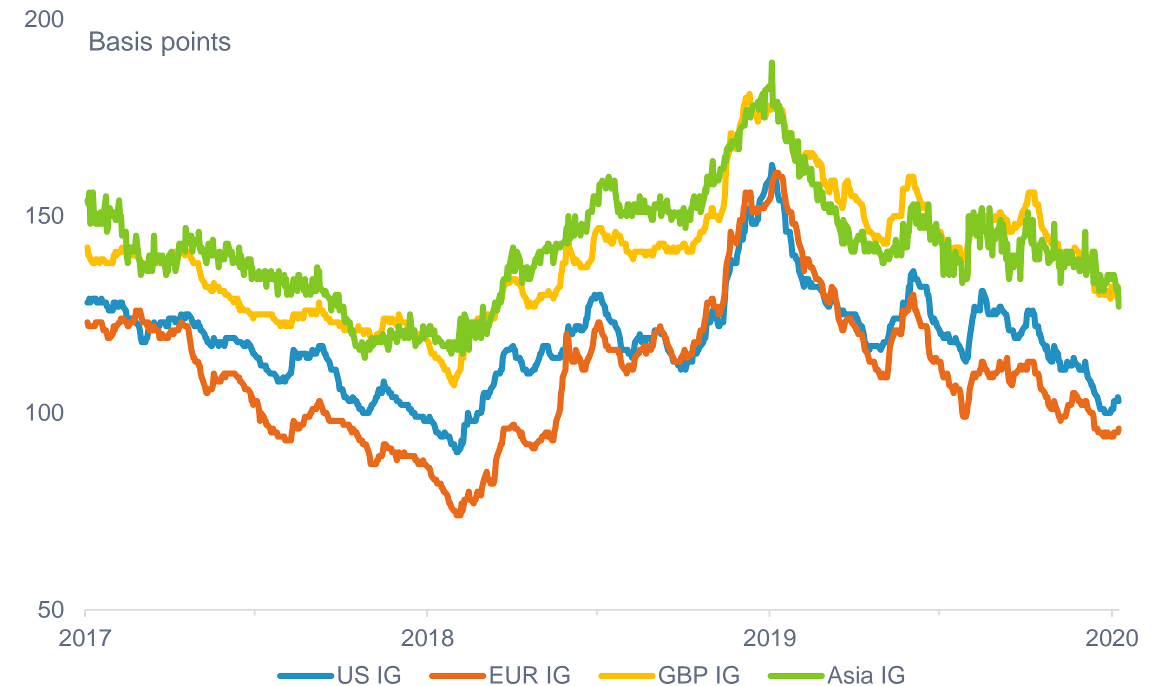
Pricing in benign outlook

- US credit rode a wave of renewed tailwinds in 2019. Spreads tightened across all sectors, and now price in a benign outlook, while largely ignoring the ongoing weakness in manufacturing.
- With leverage on an upward trend in the US, spreads look expensive, and given the potential for further escalation on the geopolitical side, we stay underweight.

In Europe, fundamentals still matter

- The ECB's bond buying activity did not prevent dispersion in performance within the eligible universe. This is a sign that even with the ECB active again, fundamentals and creditworthiness still matter rather than beta exposure alone.
- On a historical basis, European IG spreads and all-in yields are marginally expensive but we are unlikely to see a meaningful widening any time soon. We keep a neutral stance.

Investment grade credit spreads tightened in 2019



Source: Fidelity International, Bloomberg, ICE BofA Merrill Lynch bond indices, shows option-adjusted spreads, January 2020.

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Fixed Income: High yield

Sentiment is upbeat

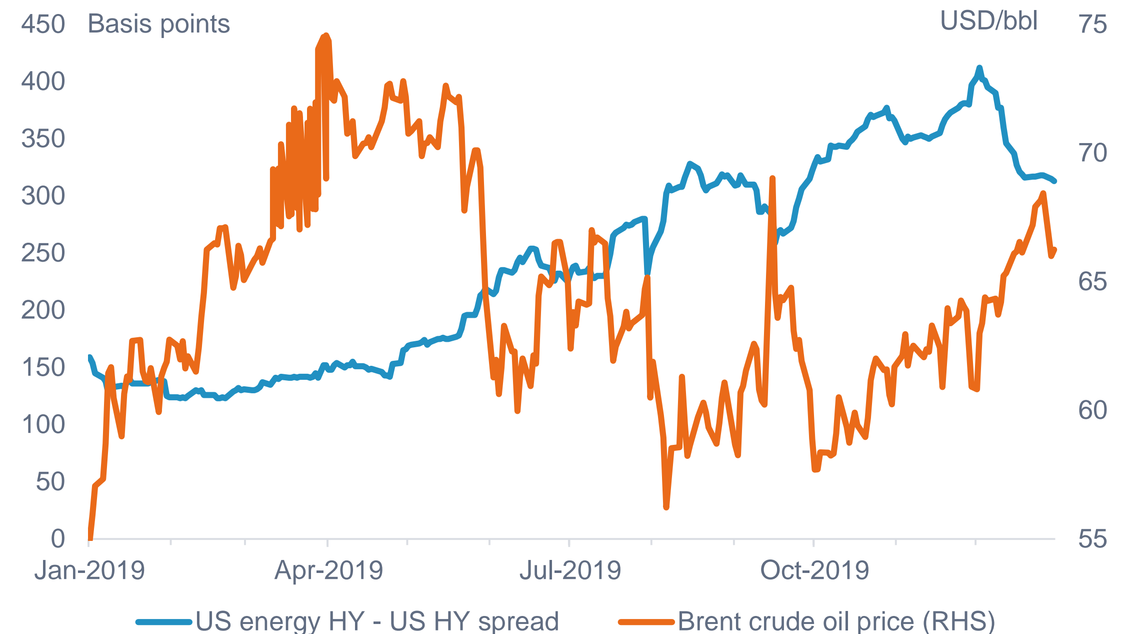
Supportive conditions

- A set of market friendly improvements on politics and technical dynamics helped risk assets finish the year strongly.
- In Europe, we saw a more favourable stance towards lower rated names, as investors showed willingness to embrace more risk.
- In the US, demand for yield is alive. With the Fed expected to stay on hold for 2020 and manageable levels of expected net issuance, the market has organic support.

Positive on Europe, neutral on US

- We maintain a positive credit beta stance in Europe despite tight valuations, mainly due to the lack of any obvious catalysts that would put pressure on spreads.
- We are comfortable with our neutral positioning in the US, but we are prepared to move underweight if geopolitical risks or corporate debt ratios rise.

Oil prices, well off the lows, leave room for a rebound in US HY energy



Source: Fidelity International, ICE BofAML Indices, December 2019.

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Fixed Income: Emerging markets

Entering 2020 on a solid footing

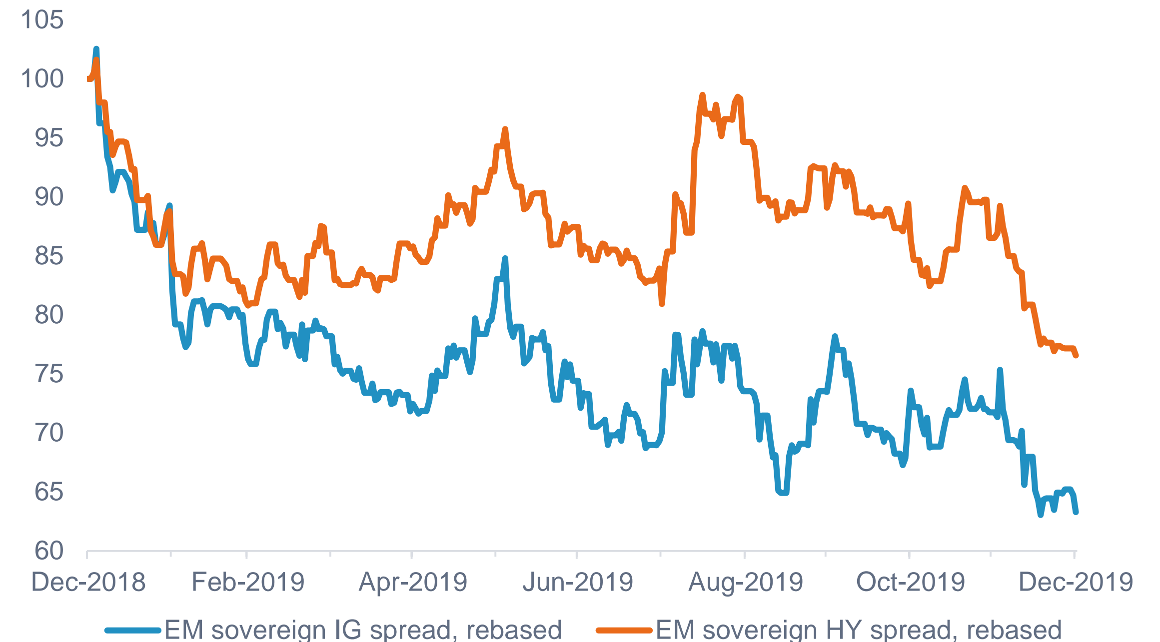
Constructive on hard currency

- Local markets impressively outperformed hard currency in December, ending 2019 up 13.5 per cent, ahead of hard currency corporate debt up 13.1 per cent.
- While valuations in some areas of hard currency debt are now less appealing, we maintain a constructive view given we expect further monetary and fiscal stimulus, and global growth and inflation to remain subdued.

EM Foreign Exchange (FX) spreads attractive

- EM hard currency spreads still offer an attractive risk premium, especially in high yield. We expect EMD to continue to benefit from positive technical tailwinds and capital inflows in a low yield, low inflation world.
- Key overweights are now in South Africa, China, Serbia and Romania while we are underweight rates in Thailand.

EM HY offers value after the underperformance in 2019



Source: Fidelity International, Bloomberg, December 2019.

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Multi Asset

With economic data stalling, or at least not strengthening meaningfully, the ‘Fed put’ remains in place, slightly tempering our concern about the disparity between markets and economic fundamentals. We believe that fighting a money-printing Fed is too bold a call, but so is blithely accepting the reflation story.

Multi Asset: Overview

Don’t fight the Fed, but reflation looks shaky

What’s changed

- Risk asset strength continued unabated towards the end of 2019. Government bond yields have broken their pattern of plunging when equity markets rallied, indicating that the ‘reluctant rally’ has turned to investors accepting near-term continuation of strong performance.

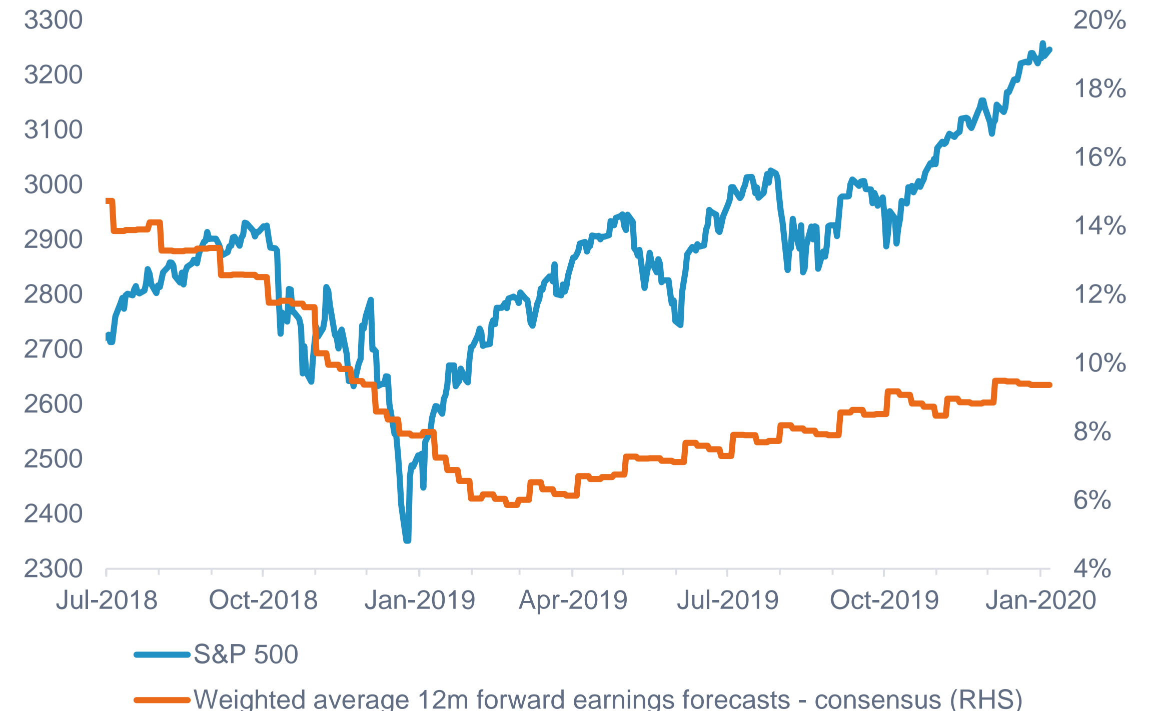
Key takeaway

- Economic growth is flattening, but the market is implicitly expecting it to rise. This is pointing to a gap between market prices and fundamentals. However, the Federal Reserve’s policy stance somewhat moderates our concern.

Investment implication

- We are cautious overall but poised to take advantage of shorter-term opportunities. We are hedging possible inflation risk by allocating to gold, inflation-linked bonds and financials.

Equity prices outpacing earnings growth expectations



Source: Refinitiv, January 2020.

Multi Asset: Equities

Maintaining neutral

What's changed

- We maintain a neutral view on equities but with nuance around regions. In the US we are now moderately underweight but maintain a bias towards emerging markets, particularly Asia.

Investment implications for selected markets

- **US** - We have moved to a modestly negative view. The market continues to hit all-time highs but there are still questions on how long current valuations can hold up given slowing growth. The labour market and consumer remain lynchpins for the direction of travel into 2020.
- **Europe** - Recent Purchasing Managers' Indexes (PMIs) have shown some improvement from weak levels, but Europe's largest economy still has a long way to go to recover. Global trade disputes have yet to dissipate, and we maintain our negative view.
- **Japan** - We remain neutral on Japan. Valuations are attractive, but our view is tempered by trade wars, including Japan's dispute with South Korea. The recent Value-added Tax (VAT) hike is a headwind, but Japan's defensiveness is attractive for many investors.
- **Asia Pacific ex Japan** - The Reserve Bank of Australia (RBA) kept rates on hold at its last meeting, but the Q3 rate cuts spurred equities and house prices higher, and in turn the household debt to income ratio as well. We remain neutral and watchful for signs of trade war spill over.
- **Global emerging markets** - We maintain our positive view on emerging markets, but the outlook is nuanced. Fed dovishness and conditions for a flat or weakening USD are tailwinds. Our bias is towards Asia.

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Multi Asset: Fixed Income

Moderately underweight

What's changed

- We maintain a negative view given high valuations, particularly in the US and Europe. There are opportunities in inflation-linked bonds and Asian high yield.

Investment implications for selected markets

- **US Treasuries** - US government bonds remain an important safe haven asset, and offer relatively attractive yields. After strong performance in 2019, we maintain a neutral view as yields are unlikely to fall in the near term.
- **Euro** - We remain negative on core and peripheral bonds. Yields continue to inch higher after reaching all-time lows in early September. Italian yields have marched higher but we don't think markets are pricing in sufficient political risk or economic headwinds.
- **Inflation-linked bonds** - Our view is still positive. If global growth stabilises, the flipside could be a spike in inflation. Given a decade of easy monetary policy, we believe it is prudent to maintain inflation protection and US Treasury Inflation-Protected Securities (TIPS) are one way of achieving this.
- **High yield** - We remain negative on the US given stretched valuations and dovish policy, rather than fundamentals, are driving returns. Asian HY has had a strong run, causing us to moderate our outlook somewhat, but there is attractive carry to be earned.
- **Emerging market debt** - We are neutral on hard currency EMD after reducing our conviction in early Q4 2019. The asset is still attractive and technicals are strong, but with yields near 3-year lows and continued US dollar strength, we have moderated our outlook.

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Multi Asset: Currency

Negative USD, positive EUR and JPY

Investment implications for selected markets

- **US dollar** - The dollar has receded since October, and we think there could be more to come. Rate cuts have continued, growth continues to fall, 'twin deficits' are in play and we see the currency as overvalued. Our view is negative.
- **Euro** - The euro's downward march has continued, but it still looks to be pricing in too much pessimism. The euro is cheap, in conflict with a current account surplus, and we see rates unlikely to fall further. We remain positive.
- **Japanese Yen** - Our view is still positive. We see upside potential on a valuation basis as a 'cheap defensive'. The Bank of Japan (BoJ) is more likely to stay on the sidelines than their developed markets counterparts, which should provide support for JPY.

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Real Estate

The slowdown in economic growth across Europe is still with us, driven by the manufacturing sector facing strong headwinds from global trade tensions and increased regulation of the automotive sector. Nevertheless, occupier markets across European have remained robust. Macro drivers of tenant demand have improved, supporting steady take up and modest rental growth.

Real Estate: Overview

Pent-up demand keeps yields low

What's changed

- Economic growth in both the UK and Eurozone remains slow, dragged down by the manufacturing sector. Nevertheless, demand for high-quality offices and industrial real estate remains strong.

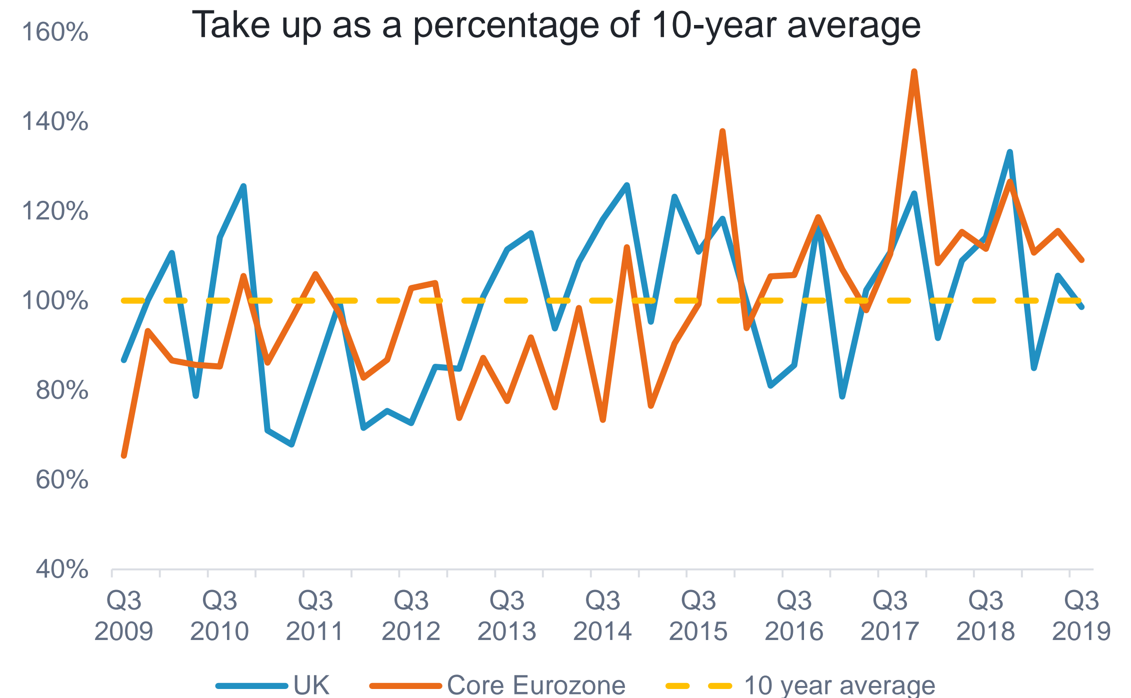
Key takeaway

- Real estate investment shows no sign of slowing despite weak Eurozone growth, but rising construction costs may start to feed through into increased rents.

Investment implication

- Rental growth will play a bigger role than capital growth in real estate outperformance in 2020. In such an environment, actively assessing tenant risk will be key to sustaining income returns. In the UK, the retail market is struggling, but a more realistic pricing of assets is tempting opportunistic investors to look at the sector.

Occupier demand remains robust across Europe, despite political uncertainty



Source: CBRE, December 2019.

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Real Estate: Continental Europe

Eurozone rents set to rise amid increasing construction costs

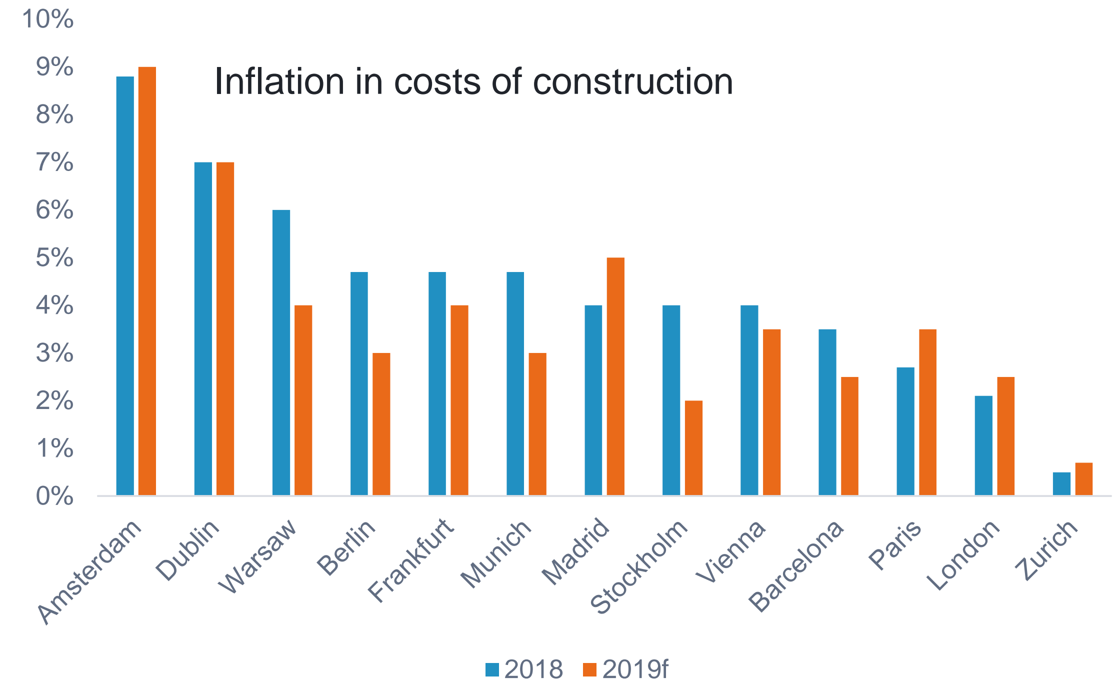
Yields not yet found a floor

- Yields for good quality office and logistics assets remain under pressure given strong demand from European funds and Asia Pacific investors.
- The Eurozone offers an attractive yield premium but we believe that in some cases the liquidity, depreciation and obsolescence risks of direct real estate are not being adequately priced.

Retail yields an exception

- Retail sector yields have started to climb but this may be over-reacting to the fallout seen in the UK market.
- European retail markets face similar e-commerce headwinds to the UK, but the impact of costs, such as rent and tax, on retailer profitability are more modest. Therefore European retail could see a more gradual adjustment to the structural changes in the sector.

European construction costs keep rising



Source: Turner & Townsend, International Construction Market Survey 2019.

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Real Estate: UK

Brexit anxieties lead to outflows and opportunities

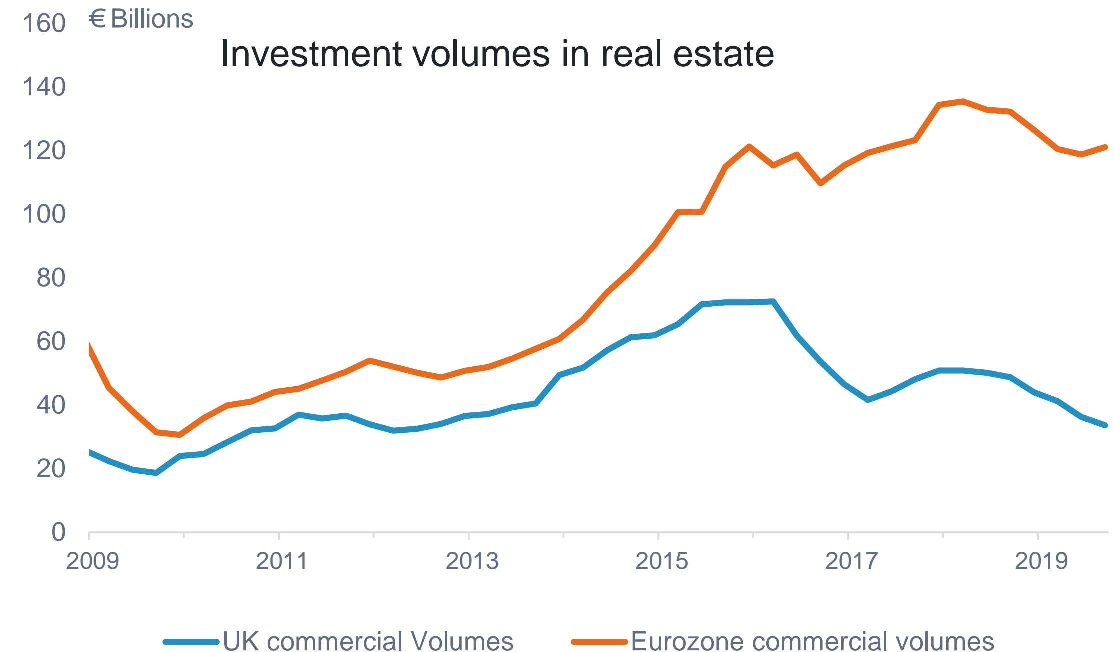
Brexit and election drag

- Political uncertainty around Brexit and the general election has been a drag, opening up a yield spread of around 75-100 basis points in the past 18 months between UK and Europe.
- There have also been outflows from UK open-ended real estate funds due to these anxieties and falling values in the retail.

Still cautious

- While some of the uncertainty has gone, UK domestic investors, particularly the UK funds, are likely to remain cautious.
- The government has ruled out an extension to trade negotiations with the EU beyond the end of 2020. This raises the possibility of another cliff-edge situation. UK funds are unlikely to begin winding down their relatively high cash positions until there is clear evidence that capital outflows have ebbed.

Confidence drained from UK property funds in 2019



Includes property or portfolio sales $10 million or greater. Constant Proportion Portfolio Investment (CPPI) at $2.5 million or greater. Price floor selections do not apply to Hedonic data.
Source: Real Capital Analytics, December 2019.

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Slowing but going

House view: Equities and credit are now moderate overweights, while government bonds have been downgraded to neutral. European and UK equities should benefit from lower political risk, loose monetary policy and some de-escalation in global trade tensions.

Equities: Easing trade tensions and stabilising economic data should encourage some reversal of the capital flight from equities we've seen in recent years, setting the path for positive equity performance in 2020.

Multi Asset: With markets behaving as if global growth is reflating when the data is merely flatlining, our team is growing increasingly concerned that investors have become complacent. Against this backdrop, we are cautious overall.

Economic outlook: The US expansion looks set to continue for a little longer, though likely at a slowing rate. This bodes well for risk assets and somewhat poorly for Treasuries. Nevertheless, stark downside risks persist and would most likely emanate from politics.

Fixed Income: We keep an overall neutral US duration exposure until recently when we moved to a small underweight stance as a result of weaker momentum signals in our quant models.

Real Estate: Rental growth will play a bigger role than capital growth in real estate outperformance in 2020, a trend evident in major cities. In such an environment, actively assessing tenant risk will be key to sustaining income returns.

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