INVESTMENT OUTLOOK

Fidelity market and investment view

January 2018

"We are in the home stretch of the nine-year bull market but in the absence of recession or inflation the gains can grind on"

By Tom Stevenson, Investment Director

Executive summary

Please note the views in this document should not be seen as investment advice. If you are unsure about the suitability of an investment, you should speak to an authorised financial adviser.

Asset classes	Current View	3 Month Change	
Equities	⊟	▶	A slice of 2018's returns was brought forward into 2017. Some consolidation is to be expected. A good time to be a stock-picker.
Bonds	⊟	▶	The reckoning was postponed again in 2017. The big story was the lack of inflation. High-yielding corporate debt looks most vulnerable.
Property	☑	▶	Real estate remains a source of high and sustainable income. But the end of the cycle is nearer. Parts of the market are frothy; selectivity is key.
Commodities	⊟	▶	Oil has recovered and should trade in its current range. Slowing China limits the outlook for metals. Gold remains an insurance policy.
Cash	☑	▶	With so little volatility in 2017, expect more ups and downs in 2018. In that environment, cash will help investors take advantage of any dips.
Equity regions	**Current View**	**3 Month Change**	
US	⊟	▶	There are reasons to be both positive and negative on the US but the valuation headwinds marginally outweigh the growth tailwinds.
UK	⊟	▲	The UK market has suffered in relative terms as investors focused on Brexit. The bad news is now largely in the price of this defensive market.
Europe	☑	▶	Good growth, a supportive central bank, reasonable valuations. Europe remains our most favoured regional market at the moment.
Asia Pacific ex-Japan	☑	▶	The past year has been profitable for Asia and Emerging Market investors. The long-term growth story remains intact and valuations are reasonable.
Japan	☑	▶	No longer the equity market's big secret, Japan is back on investors' radar. But there is still plenty to go for in this cheap market.

Current View: ☑ Positive ⊟ Neutral ☒ Negative

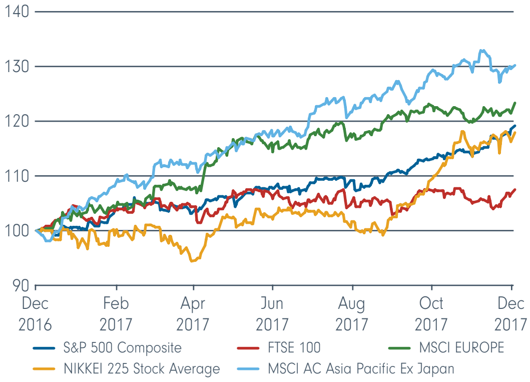
3 Month Change (since the last Investment Outlook): ▲ Upgrade ▶ Unchanged ▼ Downgrade

For more market data including full 5 year performance figures see page 12 ▶

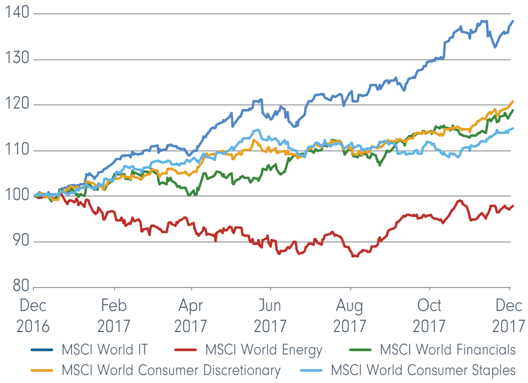
2017: the year in two charts

Regional winners and losers

2017 was a good year for equity investors. The UK was the laggard but even here, given the relatively high yield London-listed shares offer, total returns were acceptable. The other main regional markets got to similar positions to each other but via different routes. The US was the steadiest performer, as real growth picked up the baton after early Trump-related optimism was tempered by political realism. Europe picked up the pace after the relief of the elections in the first half of the year and was supported by good earnings growth thereafter. Japan was going nowhere until the autumn when an easing of North Korean tension and the re-election of Shinzo Abe boosted sentiment. Asia was the stand-out performer. This might raise alarm bells were it not for the low base the region was starting from. Looking back at the executive summary from a year ago, we were positive on the US, Europe and Japan and neutral on Asia and the UK. Not a bad hit rate.



Source: Thomson Reuters Datastream, as at 31.12.17, rebased to 100.



Source: Thomson Reuters Datastream, as at 31.12.17, rebased to 100.

Technology leading the pack: sector returns

At the risk of sounding like a cracked record, it is hard to overstate the importance of diversification in an investment portfolio. Even in a relatively calm year in the markets, with low volatility and supportive growth and policy, the gap between the best and worst performers has been significant. There's no doubt which sector led the pack in 2017. Technology was the stand-out performer but comparisons with the dot.com bubble are wide of the mark. Despite the fact that technology is finally delivering what it promised two decades ago, valuations are notably more realistic thanks to the sector's remarkable profitability and growth. Energy had a disappointing year despite the more recent rally in the oil price. Financials had a good second half, buoyed by the prospect of rising interest rates and deregulation. Consumer staples went sideways in the second half as the sector was less favoured as a safe haven in a recovering global economy.

Acknowledgements

I would like to thank the many knowledgeable and experienced people within the wider Fidelity organisation who have helped me develop the ideas in this *Investment Outlook*. Although the views expressed here do not represent the shared opinion, or house view, of Fidelity's investment team, the combined expertise of over 380 investment professionals in 13 countries is a very significant resource on which I have been able to lean. In particular, I would like to thank Adnan Siddique, Senior Investment Writer; Paras Anand, Head of European Equities; Richard Lewis, Head of Global Equities; Toby Gibb, Investment Director, European Equities; Jeremy Osborne, Investment Director in Tokyo; Tim Orchard, Head of Asian Equities in Hong Kong; Natalie Briggs, Investment Director, Emerging Market Equities; Matthew Jennings, UK Investment Director;

Front of mind: four themes

Investing in an age of technological disruption

Is your portfolio Amazon-proof? Twenty years on from the stock market flotation of the online-bookseller-turned-disrupter-in-chief, this is a question that many investors will be asking in 2018. Amazon is not the only corporate revolutionary, of course, but it is the poster child of the seismic changes that have every chief executive looking nervously over their shoulder.

Technological disruption is moving well beyond retail. It is up-ending sectors such as energy and automotive manufacturing, too, as technology companies grab an ever-bigger part of the value chain. For the laggards in this process, the risk is that disruption is terminal. Some companies will simply never bounce back.

This matters to investors because it changes the rules. Simply waiting for the right point in the cycle to pick up underperforming companies on the cheap – classic contrarian value investing – just doesn't work anymore. Successful investors now need to ask serious questions of the companies they invest in – like do they have a future at all? There are more value traps around today – companies that look cheap but will probably get cheaper still.

Then there is the challenge of valuing the winners. For a handful of the top companies, there really may be no price that is too high. For some, it really is 'different this time'. The promise of the dot.com bubble is finally being delivered nearly two decades on. But watch out; different this time was the thinking behind the Nifty 50 stocks in the 1970s and it was an approach that ended badly then. Valuation clearly matters still and companies that let their investors down will pay a heavy price – investors are shooting first and asking questions later if the share price falls after profits warnings in the past year are any guide.

So, investing is more exciting than ever but also riskier. The potential gains from this technological revolution are enormous. The need to protect your portfolio against failure has never been greater.

Amazon: the rewards of disruption

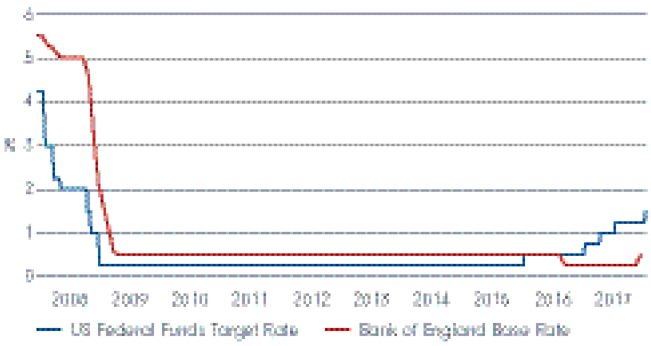
Source: Thomson Reuters Datastream, 31.12.17, total returns in local currency.

Past performance is not a reliable indicator of future returns. When investing in overseas markets, changes in currency exchange rates may also affect the value of an investment.

Central banks: getting back to normal

The biggest driver of stock and bond markets since the credit crunch has been central bank policy. The emergency measures implemented in the aftermath of the crisis succeeded in their principal objective – preventing a repeat of the Great Depression. Since then, however, the main achievement of rock-bottom interest rates and quantitative easing has been to boost the value of financial assets. For those of us lucky enough to have kept our jobs and owned bonds, shares and property, it has been a case of 'Crisis, What Crisis?'

Interest rates: starting to diverge



Source: Thomson Reuters Datastream, 31.12.17

Past performance is not a reliable indicator of future returns.

The era of abundant liquidity and cheap borrowing is slowly but surely coming to an end. Janet Yellen has been a safe pair of hands at the Federal Reserve and has preferred to fly with the doves, along with her counterparts in the UK, Europe and Japan. However, despite failing to restore inflation to the Fed's target (the unfinished business of her four-year term), Ms Yellen has clearly set the US central bank on a path to monetary normalisation.

She delivered the promised three quarter-point rate hikes in 2017 and it is likely that her successor, Jay Powell, will deliver another three this year and two in 2019.

This will see America diverging from the rest of the developed world. Mark Carney has undone last year's panicky post-Brexit cut but is under no pressure to deliver any more tightening at the Bank of England. The outlook is too uncertain in the UK to take the risk and inflation will fall back as the currency settles into its current band. In Frankfurt, Mario Draghi at the ECB is even more cautious and will not raise rates until this year's tapering of QE is done. Policy remains super easy in Japan.

So, interest rates will be less helpful in 2018 than they have been, but only marginally so. The new normal in America will see rates of only about 3% and for the rest of the world even that hurdle remains a long way off. Seeking an income will remain a priority for investors.

Tales of the unexpected: putting politics into perspective

It feels like politics should matter more than it does. The past couple of years has seen profound changes in the political landscape on either side of the Atlantic and an escalation of geo-political risks further afield. But the impact of all the dramatic headlines – from Trump to Brexit, North Korea to the Middle East – has been short-lived and largely inconsequential.

Politics does affect market sentiment, however, and so it cannot be ignored. Take the European stock markets, for example. At the beginning of last year, many were worried about a swing towards populism and protectionism. When mainstream candidates gained the upper hand across the region, investors were able to focus on improving fundamentals. Nothing really changed other than investors' perceptions.

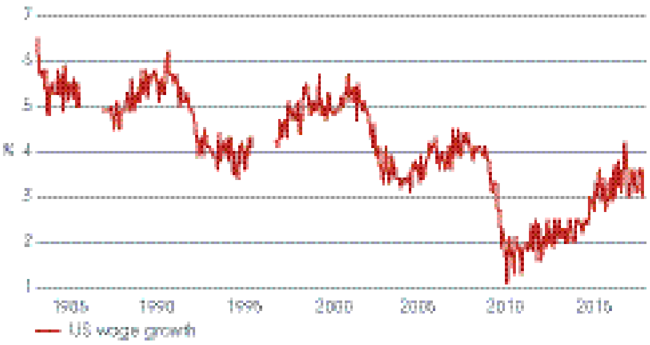
Something similar has happened in the UK, where anxiety about Brexit has had an impact on both the real economy and market sentiment. As with Europe at the beginning of last year, there is a danger that investors have overdone the gloom. Weak sentiment means that the UK is starting to look like an interesting contrarian play. It would not take much progress towards a trade deal (or even just the prospect of an extended transition period) for investors to start seeing the glass as half full again.

As for geo-political risk, history shows that markets can take even the most dangerous situations in their stride. While conflict in Korea or an escalation of the rivalry between Saudi Arabia and Iran would be catastrophic, it would be wrong for investors to treat either as their base case. Investment is a game of probabilities and both remain relative long-shots. It feels like 2017 was the year when we started to put politics into perspective after the upheavals of 2016.

Risks: what keeps us up at night

So, if politics is not the major risk as we move into 2018 what is keeping us awake at night? The biggest concern is that the lower for longer interest rate thesis is wrong. Bull markets do not die of old age, they tend instead to be 'murdered' by central banks. So why might interest rates rise faster than investors currently expect?

Wages: bouncing back



Source: Thomson Reuters Datastream, 15.10.17, US Atlanta Wage Growth Tracker (3 month moving average)

The most likely cause is a pick-up in wage inflation. Wages are a major driver of the overall inflation rate and it would not take much of a rise in labour costs to put pressure on the Fed to raise rates faster than the currently-expected trajectory. Rising wages are, in fact a double negative for share prices because if workers regain some of the bargaining power they have lost over the past 40 or so years today's high profit margins will be unsustainable. The mismatch between historically low unemployment and a lack of wage inflation is a puzzle but history has shown that bull markets tend to peak as the jobs market approaches full employment.

A second reason why rates might rise more quickly than expected is if central banks decide they are stoking a bubble in asset prices and worry about the impact of market excesses on financial stability.

The third reason to fear higher interest rates is if the Fed starts to worry about the impact of excessive fiscal easing thanks to President Trump's tax reforms. Tax cuts are a great way of stimulating a depressed economy (as Ronald Reagan knew) but they might be a reckless measure when the jobs market is already tight and debts are at record levels.

One knock-on impact of higher rates could be an increase in the default rate on corporate bonds (already rising). Problems in the high yield bond market tend to prefigure trouble in the equity market, so this is something to watch closely in 2018.

Asset classes

EQUITIES

Bull markets compared: how much longer?

Source: Thomson Reuters Datastream, 31.12.17

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It's been a vintage year for equity investors. Outside the UK, which has had other things on its mind, stock markets have delivered fantastic returns. Buoyed by reasonable earnings growth as the world enjoyed a synchronised recovery, investors were happy to bring forward 2018's returns into last year.

The bull market since 2009 has been long and strong. In duration, it has only been exceeded by the 1990s in the post-war period. The drivers of the nine-year bull market – particularly higher valuation multiples – are, however, largely played out.

That is the bad news. Offsetting this is the fact that there is little reason to expect a bear market in 2018. To believe that will happen, you have to think we are on the brink of a recession or that inflation is poised to return with a vengeance, pushing interest rates up much faster than either investors or the Fed currently forecast. Neither of these looks particularly likely although inflation, as I discuss elsewhere, is a genuine tail risk.

Putting money to work in the stock market makes sense only if you think the potential reward outweighs the possible risks. With the S&P 500 having reached the 2,700 mark that has looked like a sensible target for some time, the market as a whole may go up a little from here. But, having risen four-fold in ten years, there's a real chance that it retreats by rather more. The risk and reward is, therefore, asymmetrical.

If volatility remains low then another few percentage points of capital plus dividend income might look alright in a context where cash and bonds offer such paltry returns. If, as I expect, volatility comes back next year, as investors respond to central banks delivering on their promised tightening of policy, then the rewards may look a bit more marginal.

This, of course, is at the aggregate market level. It is a good reason to be suspicious of the siren call of low-cost market trackers that guarantee to deliver you market returns minus fees. It is an equally good reason to roll up your sleeves and go to the effort of identifying that minority of fund managers who have the ability to deliver market-beating returns.

The 30-year collapse in real interest rates has provided a tailwind for equities. The rising tide has taken away the need to pick winners and avoid losers. Just turning up has been enough. This won't be the case next year and probably for many years to come. In more ways than one, the New Year is a good time to get active again.

COMMODITIES

Oil continues to be the most widely-watched and important commodity. As we move into 2018, the outlook is balanced and the base case must be for crude to stay within its current trading band between \$60 and \$70 a barrel.

The reasons to expect further rises in the price this year include the continuing discipline of OPEC and its partners, notably Russia. They have extended production curbs until the end of 2018, albeit with a review in the middle of the year. This confirms Saudi Arabia's new-found desire to put a floor under the oil price while it pushes through far-reaching reforms at home and faces off against its regional rival Iran. The days when it thought it could quickly price US Shale out of the market are long gone. On the supply front, it's worth bearing in mind that disruptions due to war and weather are unusually low at the moment. There is a view that the rate at which output falls away in Shale wells in North America may have been underestimated too.

The other main driver of the oil price is end-user demand. Here, too, the pressure looks like being to the upside as the global synchronised recovery remains on track. Half of oil demand comes from the developed countries in the OECD and growth here is firm.

Offsetting these positive factors is the ever-present risk that a much higher price of oil will encourage more Shale production. This source of new potential supply will continue to put a ceiling on the oil price. The days of \$100 oil are long gone and the market looks in reasonable balance.

Oil in focus

Source: Thomson Reuters Datastream, 31.12.17

Past performance is not a reliable indicator of future returns.

BONDS

Returns for fixed income investors were good again as yields across the bond spectrum ended the year a bit lower than they started. While markets were braced for a year of tightening, the real story was the unexpected failure of inflation to respond to the synchronised pick up in global growth.

Economists are having to re-assess the models which have served them well in the past, rules of thumb like the Phillips Curve which illustrates the trade-off between inflation and employment. With unemployment at historically very low levels, inflation should really be picking up faster than it is. This is a real conundrum for policy-makers, but maybe it shouldn't be. It simply reflects the ongoing headwinds for growth and inflation of too much debt and an ageing population that's dropping out of the workforce and into retirement.

The danger posed by the inflation puzzle is that central banks keep policy looser for longer and tolerate above-target inflation, even at the risk of stoking up imbalances in the system. We are already seeing debt at historically high levels and risk-taking by companies is increasing.

Whether this is a problem further down the track or not, it probably means that 2018 will be another year of low interest rates. This is particularly likely in Europe, where inflation is notably absent, and the UK, where Brexit continues to cast a shadow. Only in the US are we likely to see a sustained tightening.

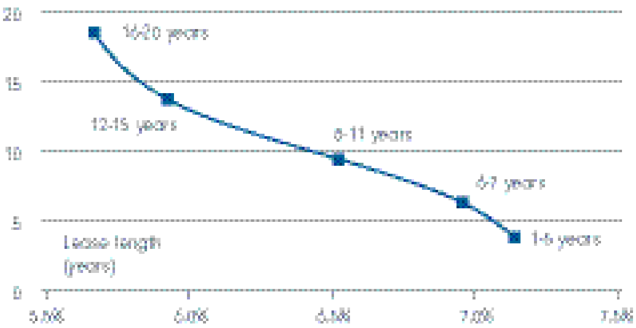
The bigger worry for fixed-income investors is in corporate debt where valuations have become stretched as the difference between the yields on company and government bonds has narrowed. High-yield bonds look particularly vulnerable because the reward for rising default risks is uncomfortably low.

As in the equity market, the late stage of the economic cycle is a time to focus on picking the right securities. This is more important than trying to squeeze a little more income out of your bond portfolio.

Important information: Please be aware that the price of bonds is influenced by movements in interest rates, changes in the credit rating of bond issuers, and other factors such as inflation and market dynamics. In general, as interest rates rise the price of a bond will fall. The risk of default is based on the issuer's ability to make interest payments and to repay the loan at maturity. Default risk may therefore vary between different government issuers as well as between corporate issuers

PROPERTY

Shorter leases offer higher yields



Source: Fidelity. Real Estate data is based on Fidelity International's proprietary deals database, over the 12 months to 19.10.17

The commercial property cycle has, like its bond counterpart, gone on for longer than the sceptics feared. Real estate is still a source of attractive and high-quality yields and so property has a place in any well-diversified multi-asset portfolio. However, while 2018 will see many of the tailwinds for the asset class continue, we are, by definition, one year closer to the end of the cycle than we were a year ago. This is not a time to throw caution to the wind, as some real estate investors seem to be. This is rather a time to lock into sustainable income and to de-risk a portfolio.

There are a few ways to do this. First, it is worth noting a key difference between bonds and property. With bonds, an investor gets paid for taking the risk of holding bonds for longer. With real estate, it is the opposite. Short leases are considered riskier (because of the potential for an empty building) and so investors pay less (and get a higher yield).

The frothiest part of the property market is high quality and long leases. Here yields are now as low as 3% or less. There is no room for error at this level, or even much income to pay for depreciation, obsolescence and other ongoing costs. So, counter-intuitive as it may sound, shorter leases with higher yields are worth focusing on today.

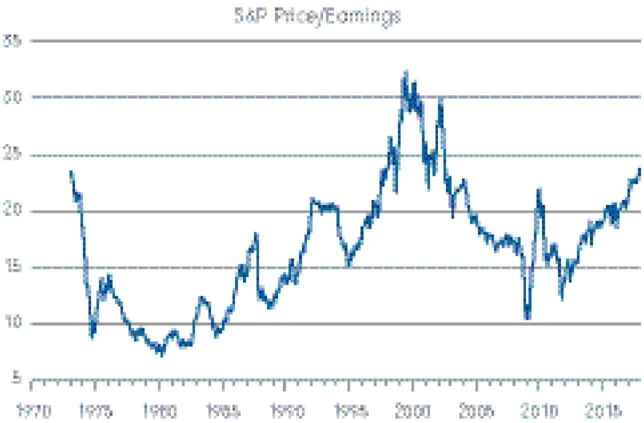
Another way to de-risk a portfolio is to shun leverage. Debts are cheap but late in the cycle is a good time to reduce not increase borrowings. Finally, look for contrarian ideas. The UK is out of favour with real estate investors because of Brexit fears. Arguably, this is now in the price.

Important information: Some funds in the property sector invest in property and land. These can be difficult to sell so you may not be able to cash in this investment when you want to. There may be long delays in acting on your instructions to sell your investment. The value of property is generally a matter of a valuer's opinion rather than fact.

Equities – a regional perspective

US

Valuations: rising steadily



Source: Thomson Reuters Datastream, 28.9.17

Past performance is not a reliable indicator of future returns. When investing in overseas markets, changes in currency exchange rates may also affect the value of an investment.

There are reasons to be both positive and negative on the US market. On balance, the headwinds are likely to outweigh the tailwinds, however, and we think there are better opportunities elsewhere in the world.

The first reason to be positive about the US is its relative defensiveness. The high quality of American companies, their high margins and the speed with which they can protect profits by cutting costs, make America a safe haven if you think that the recovery might falter this year.

Secondly, the US dominates technology, which continues to look like a market leader in 2018 as the promise of the internet revolution is finally delivered. Partly thanks to technology, earnings revisions in the US are positive.

Thirdly, tax reforms have the potential to lift profits at US companies and to encourage those who have parked profits overseas to repatriate them and probably return them to shareholders via dividends and share buybacks.

That is the good news – and it is worth adding that betting against the US market would have been an expensive mistake throughout the nine-year bull market since 2009. The bad news is that there are also a number of reasons to be negative about US shares.

The first of these is valuation. As we have pointed out here many times in recent quarters, the US is the world's most expensive major market. Indeed compared to the rest of the world, it has exceeded the peak it reached in the late 1990s. Whether you look at valuations as a multiple of earnings or assets or relative to the dividend income paid by US companies, the alarm bells are beginning to ring.

Secondly, the US economy is in the late stages of the cycle. This is a time when risks increase because companies become more relaxed about raising borrowings and animal spirits re-emerge. We are seeing a deterioration in the health of US balance sheets. Expect this to show up first in the high yield debt market as defaults increase and then to spill over into the stock market.

The third reason to be nervous about US equities is the Federal Reserve. Bull markets tend to be killed off by central banks and there is no doubt that the Fed is further into its tightening cycle and more determined to restore monetary normalisation. With US workers likely to regain some of their lost pricing power as unemployment falls to historically low levels, we should expect rates to rise steadily through 2018.

The final reason to be cautious is that the US is starting 2018 from a higher base than other markets. More Americans already own shares than elsewhere so there is less money on the side-lines. And the US market is close to a share of global market capitalisation at which it has peaked in the past.

So, we have a balanced view of the US equity market, but definitely at the negative end of neutral.

UK

Inflation: well above target

Source: Thomson Reuters Datastream, 15.11.17

Past performance is not a reliable indicator of future returns.

I have been negative on the UK equity market for some quarters now since the post-referendum honeymoon ended and investors focused on slowing growth, declining real earnings and Brexit uncertainty. While none of those factors has really changed that much, the underperformance of the London market means the bad news is much more in the price. We're upgrading the UK to neutral.

To start with the negatives, the UK market's dependence on commodities now looks less appealing, with oil having settled in a new trading range and demand for base metals limited by slowing growth in China.

Secondly, economic growth is slowing for a number of reasons. Consumer confidence is weak as the sterling-fuelled inflation rate remains stubbornly higher than average household earnings growth. Business investment is weak. Perhaps most importantly productivity is poor.

Thirdly, the political backdrop remains unhelpful. The next year or so of Brexit negotiations will be tough and they will highlight the deep-seated divisions between and within political parties.

All this is known, however, and arguably factored into share prices in the UK, which anyway are less driven by domestic factors than most major stock markets.

The first of the positives is the valuation of the UK stock market, which on a number of measures looks compelling. First, measured against earnings, the UK equity market stands on a price-earnings ratio of just 14.4 compared with 14.8 in Japan, 15.5 in Europe and 18.3 in the US. Against companies' assets, the price to book value is less than half that in the US and as cheap or cheaper than in every other major market.

The area in which the UK looks most attractively-valued is income. The yield on the UK stock market is about 3.5%. That is twice the yield available in Japan and the US and significantly higher than in emerging markets and Europe. Only in emerging markets are valuations as attractive when compared with expected earnings growth.

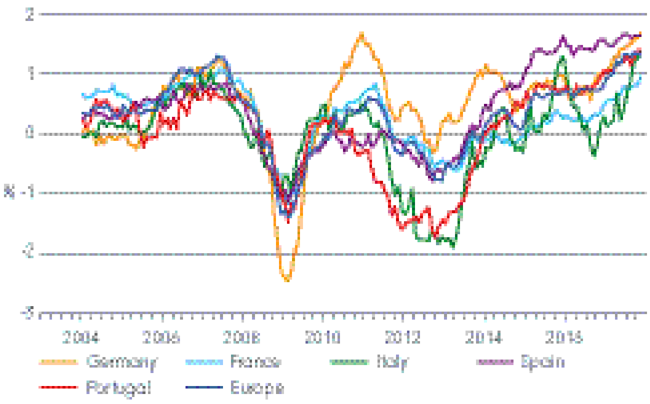
Other positives include sterling, which looks more likely to depreciate a bit from its current level than to appreciate by a great deal. The exposure of British companies to faster-growing emerging markets looks like a positive. Sentiment looks as negative as it is likely to get.

Finally, the prospect of a softer Brexit, with an extended transition period in which nothing much changes and businesses have the time to adapt to any new relationship with Europe, is looking more likely.

So, while things will remain tough in Britain for the foreseeable future, it feels that more of the bad news is now in the price.

EUROPE

Economic sentiment improving



Source: Thomson Reuters Datastream, 15.11.17, quarterly percentage changes

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Europe remains our preferred regional equity market for a long list of reasons. The first of these is the strength and sustainability of the economic recovery. The region still has a lot of catching up to do after losing significant ground during the sovereign debt crisis. Europe's economy is only just bigger than it was before the financial crisis, whereas the US and UK economies are 15% and 10% bigger respectively.

Markets have also lagged so there is a second string to the catch-up story. The failure of markets to keep pace has resulted in European valuations being significantly lower than those in the US. For stock-pickers there are a few sectors which look even more undervalued than the market as a whole – these include mining, industrials, insurance and car-makers.

Valuations look particularly low in Europe when you consider that company profit margins in the region are much more exposed to a pick-up in activity because the higher fixed-costs caused by Europe's less flexible labour markets mean profits rise more as sales improve.

A further positive factor for Europe is its exposure to the financial sector. This has been a serious headwind in the past as the balance sheets of banks have been under pressure. But in an environment of slowly rising interest rates and higher bond yields, the profitability of financials is likely to improve.

Next in the list of positives is the European Central Bank which has been very supportive under the leadership of Mario Draghi and will most likely continue to be so thanks to the ECB's single mandate to manage European inflation. With no sign of prices in the region rising there is little imperative for the Bank to do anything other than continue to stimulate the economy.

Finally, the political situation in Europe looks much less of a concern than it did this time last year. Having seen off the far-right threat in Holland and France, the chance of a populist upsurge in Europe is much diminished, albeit there is unfinished business in Austria and an election to come in Italy.

The one shadow that hangs over European equities is a further strengthening of the Euro which would make European exports less competitive. While the long-term outlook for the Euro is probably still positive, it has run a long way already so in the shorter term the currency looks less of a headwind than it has.

ASIA-PACIFIC EX-JAPAN/EMERGING MARKETS

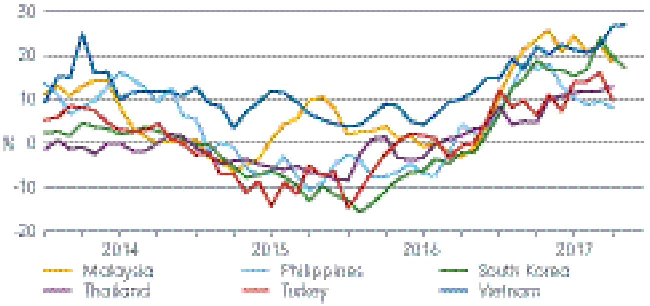
Investors in emerging markets enjoyed 2017. Returns were spectacular and it would be too much to expect them to continue at that level in 2018 as well. The combination of reasonable global growth and a weaker dollar has been a positive one for emerging markets and may be worse on both fronts this year. That said, there are plenty of positives in this asset class with valuations undemanding and the long-term growth story still intact.

China is the big unknown, of course. It accounted for more than 40% of emerging market returns in 2017, largely thanks to the performance of its tech giants, Tencent and Alibaba. Valuations are no longer as cheap as they were. And the government is squeezing monetary policy.

Much more interesting is India, which still has a great deal going for it despite being one of the most popular destinations for emerging market investors. In particular, demographics continue to look compelling and India is way behind China in terms of urbanisation and the growth of its manufacturing base. India should benefit from technology, with internet penetration still a long way behind China's. Some of the headwinds affecting India are also weakening; it is little exposed to China at a time when that country's economy is slowing and the oil price should not rise much further from here, a big help to a major oil importer.

Outside Asia, it is, as usual, impossible to generalise. Russia remains dependent on the oil price. Brazil's economy is improving but politics remains uncertain. Mexico is a play on US growth. Because of these variations, we would always suggest a well-diversified exposure to emerging markets that does not put too many eggs in one country or regional basket.

Emerging market exports: rising tide

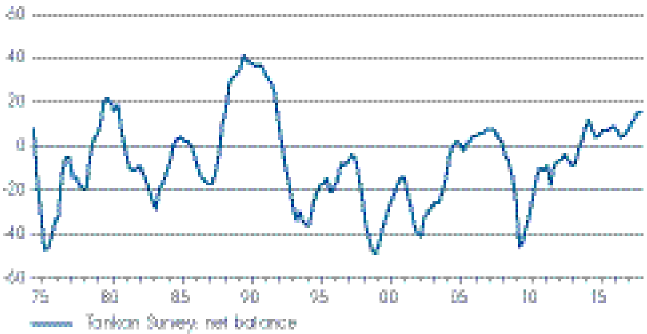


Source: Thomson Reuters Datastream, 15.10.17, 12 month percentage changes (3 months moving average)

Past performance is not a reliable indicator of future returns. When investing in overseas markets, changes in currency exchange rates may also affect the value of an investment. Investments in small and emerging markets can be more volatile than those in other overseas markets.

JAPAN

Japanese economy: fundamentals strong



Source: Thomson Reuters Datastream, Q4, 2017

Past performance is not a reliable indicator of future returns. When investing in overseas markets, changes in currency exchange rates may also affect the value of an investment.

The combination of reasonable valuations and strong earnings growth continues to be the principal reason to stick with Japan. There are plenty of reasons to expect profits to keep rising in Japan. A key one is the diminishing drag of wages as better-paid older workers retire. The seniority system for determining salaries in Japan has lumbered companies with uncompetitive cost structures. Like many things in Japan's slow-moving corporate world, that is beginning to change.

Other positives for Japan include fund flows, with Japanese pension schemes very heavily weighted to bonds and households to cash. The potential for at least some of that to move into equities as the market starts to move higher augurs well for the stock market.

It's worth remembering, too, that the Japanese central bank will by the end of this year be the only one still expanding its balance sheet. Also, a positive for Japanese shares is the likely downward pressure on the yen from rising US bond yields. A falling currency is always good for the Tokyo market. Finally, Japan continues to have a lead in a number of industries of the future like manufacturing automation.

There are still negatives for Japanese investors. For one thing, Japan is no longer the great hidden secret of the global stock market. An overweight position in Tokyo is now more mainstream and so more priced-in than it was. Japan's demographics remain unfavourable; the country has high debts; and the shadow of China and North Korea hangs over the region. All of that said, though, there is enough going for Japan to keep it on our buy list.

Market data

Please be aware that past performance is not a reliable indicator of what might happen in the future. When investing in overseas markets, changes in currency exchange rates may affect the value of your investment. Investments in small and emerging markets can be more volatile than those in other overseas markets.

INVESTMENT VALUATION AT A GLANCE

	Price-earnings ratio 2018E	Dividend yield 2017
Equities		%
US	18.8	1.8
Europe	14.8	3.4
UK	14.3	4.1
Japan	14.7	1.9
Asia Pac ex Japan	13.2	2.7
Emerging Market Asia	12.4	2.2
Latin America	13.7	2.8
Central East Europe, Middle East & Africa	10.5	3.6

	Redemption Yield
Bonds	%
ML Global High Yield	5.6
German 10-Year Bunds	0.4
ML Global Corporates	2.6
UK 10-Year Gilts	1.6
US 10-Year Treasuries	2.4

INVESTMENT PERFORMANCE AT A GLANCE

% (as at 31st December)	3 m	2012-2013	2013-2014	2014-2015	2015-2016	2016-2017
Equities						
S&P 500	7.9	27.6	14.7	-0.1	15.3	22.4
FTSE All Share	3.9	16.9	1.1	-1.0	20.2	12.6
FTSE 100	3.8	14.6	0.7	-3.4	22.8	11.3
FTSE 250	4.5	29.5	2.9	9.4	9.0	17.9
MSCI Europe	3.9	21.9	-5.2	-4.4	3.7	27.9
Shanghai SE	1.1	-8.6	55.5	1.8	-4.1	7.2
Shenzhen	-0.7	16.6	19.6	20.4	-8.2	4.5
MSCI Emerging Markets	8.6	-6.5	0.2	-17.2	16.7	40.3
MSCI Asia Pacific	9.7	9.2	1.1	-4.1	9.3	33.4
Nikkei 225	14.2	55.0	9.0	7.6	8.3	22.2
MSCI World	7.0	23.3	6.2	-1.9	11.7	23.8
MSCI World IT	11.4	25.2	18.0	3.6	15.3	41.3
MSCI World Energy	10.8	13.8	-9.6	-22.7	29.6	8.5
MSCI World Financials	7.3	23.6	4.1	-5.0	18.4	22.8
MSCI World Consumer Discretionary	9.0	35.4	4.3	4.4	7.6	25.0
MSCI World Consumer Staples	5.2	18.5	8.4	6.0	4.2	17.6
Amazon	25.3	53.0	-22.2	106.5	18.9	59.7
Bonds						
US 10-Year Treasuries	-0.5	-6.1	11.3	0.7	0.5	1.9
UK 10-Year Gilts	1.4	-3.5	15.8	1.2	7.6	3.1
German 10-Year Bunds	0.3	-0.6	17.1	0.5	3.9	0.7
JPM Emerging Markets Bond Index	0.6	-6.9	5.4	1.2	10.8	9.0
ML Global High Yield	1.5	7.3	-0.2	-4.3	15.7	10.5
ML Global Corporates	1.5	0.8	3.3	-3.7	4.1	9.4
Commodities						
CRB Commodities Index	8.1	-5.9	-17.4	-23.6	11.0	2.2
Crude Oil (Brent)	22.7	-5.3	-48.6	-32.3	47.1	25.9
Gold Spot	3.8	-25.4	-3.8	-9.6	8.3	13.7
LME Copper	10.4	-9.0	-13.8	-27.0	22.1	26.9
GSCI Soft Commodities	7.5	-10.9	-15.7	-7.3	16.8	-16.2

Source: DataStream, 31.12.17 in local currency terms. Valuations: Source Citigroup Global Equity Strategist – Citi Research, MSCI, Worldscope, FactSet Consensus estimates as at 31.12.17. Bond Yields: Source DataStream as at 31.12.17.

Have questions?

For more information contact your financial planner or call us on 1800 044 922.

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