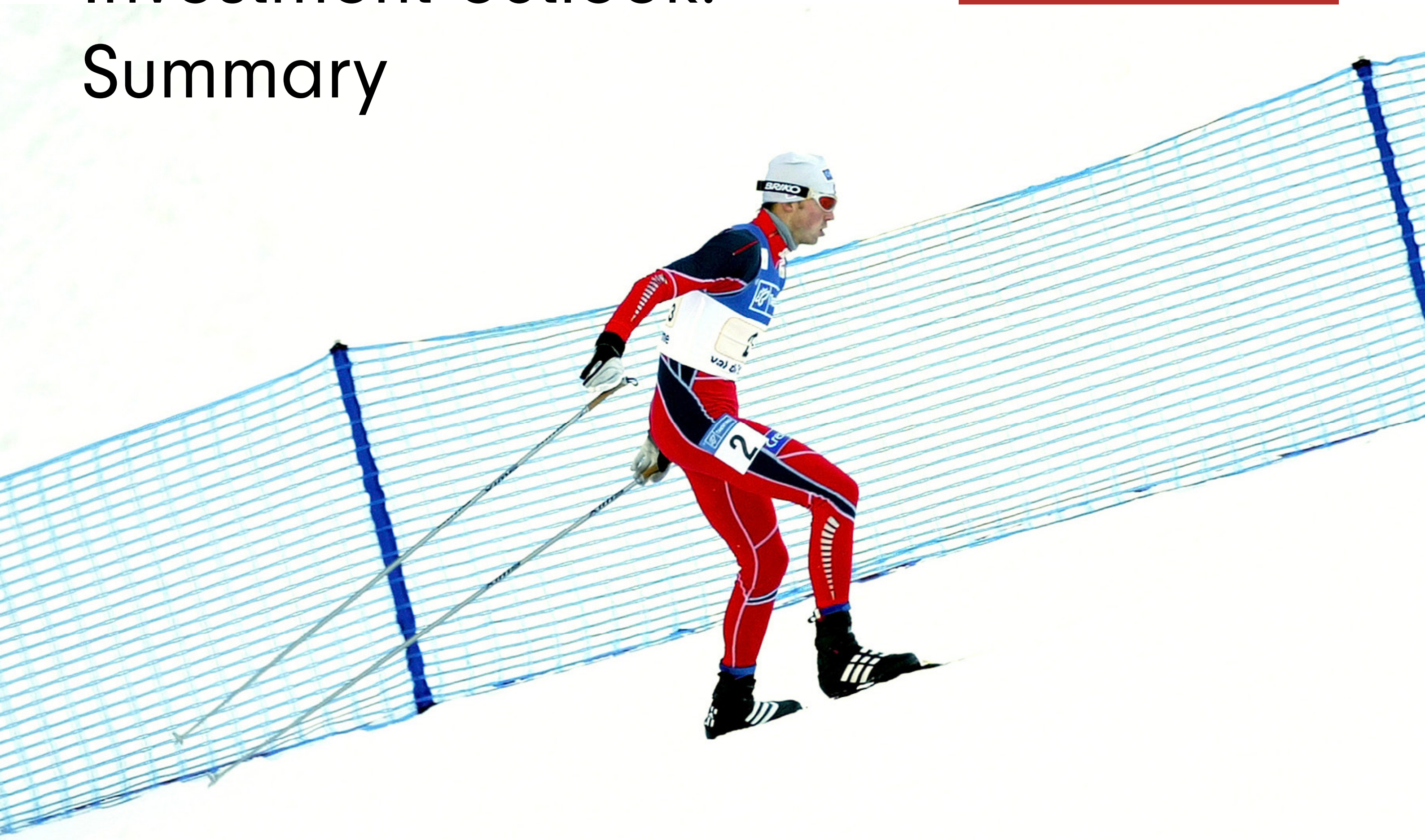
Q1 2020

Investment outlook: Summary



Slowing but going

Fidelity International's outlook for the global economy, equities, fixed income, multi asset and real estate

This is for investment professionals only and should not be relied upon by private investors

Intro Q1 2020

The first year of the new decade is shaping up for a relatively benign economic outlook, but returns in 2020 will depend on a variety of different factors.

On the economic front, the US and China, are slowing down, but their monetary and fiscal policy stimulus in 2019 has been sufficient to engineer soft landings. Meanwhile, Europe and emerging markets are showing signs of recovery from the industrial/manufacturing recession of the past 18 months. All this could mean a relatively forgiving 2020, with modest deceleration in the US and China, and the potential for re-acceleration in Europe and emerging markets.

But investors will have to grapple with a variety of trends. Inflation, so far muted following the global financial crisis, could reassert itself if there is fiscal largesse in an easy monetary environment. The danger here is not a high probability of this happening per se, but the lack of awareness of the risk, particularly in the bond markets.

We should also not be complacent about continued US dollar strength. We could be reaching a tipping point when investors collectively recognise just how fundamentally overvalued the world's reserve currency is. If that happens a different group of assets will gain market leadership. But investors are cautious, and in a world that feels unstable, the dollar gets top marks as a safe haven.

Another crucial but often underplayed component to asset returns is market structure. The enduring rise of passive instruments and low volatility strategies mean that new sets of investors are entering the market and old ones are changing their behaviours. Fundamental investors must be aware that a segment of the market is excluding valuation as a consideration in their investing decisions.

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 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.

Paras Anand
Head of Asset Management, Asia Pacific

Fidelity's Global Asset Allocation Process

Fidelity's Global Asset Allocation process combines the granular, on-the-ground views of our research analysts together with a macroeconomic and quantitative framework driven by our strategists.

Each quarter, we bring together our regional and thematic experts from across the world to participate in the Quarterly Investment Forum (QIF), where we discuss macroeconomic and geopolitical conditions and how they will impact markets. Each asset class division incorporates this shared understanding into their respective investment and asset allocation decisions.

Every month, we hold Global Asset Allocation meetings where divisional chief investment officers (CIOs), global portfolio managers and strategists share and debate views on macro conditions, markets and cross-asset allocation to produce the House View.

Contents

House View

Tilting to risk-on

Wen-Wen Lindroth

Lead cross-asset strategist

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. In this environment, corporate earnings growth could rebound to high single digits, off a low 2019 base, amid an upswing in the global inventory cycle and moderate top line growth. We tilt towards a risk-on approach as a result.

Equities and credit are now moderately overweight, while government bonds in the near term 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. In credit, China and Asia high yield offer attractive value and the underlying countries benefit from higher growth rates and more monetary and fiscal firepower than other regions.

We also favour asset classes that have been overlooked or are undervalued. US inflation-linked bonds fall into the latter category as markets continue to under-price the potential for sustainably higher US inflation. UK real estate (excluding retail) could also be attractive as there is now some stability following the UK general election and the sector is cheap compared to similar European property.

Asset class breakdown

Equities:

We are moderately overweight on equites. Value stocks are particularly attractive following long-term underperformance versus growth stocks. Value could also be the defensive play at this stage of the cycle as it provides some downside risk protection.

Fixed Income (government bonds):

We downgraded sovereign bonds to neutral. The stronger macroeconomic backdrop, a more risk-on approach, and the Fed staying on hold means still-low government bond yields will struggle to creep lower from here. We are neutral on Treasuries and Gilts while Bunds look particularly unattractive.

Fixed Income (corporate credit):

In fixed income credit we are moderately overweight. China and Asia high yield offer value, while European high yield could benefit from less political risk and bottoming economic data.

Changes to positioning

December 2019: Near and medium term views

Strongly negative ■■■■■ Strongly positive

Asset class	Near term (3-6 months)	Change	Medium term (12-18 months)	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	□■□□□		□■□□□		
Value/Income	□□□■□		□□□■□		
US	□■□□□		□■□□□		
Europe	□□□□■		□□□□■		
Japan	□□□■□		□□□■□		
EM	□□■□□		□□■□□		
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	□□□□■		□□□□■		
EM Sov. $	□□□■□		□□□■□		
EM Sov. local	□□□■□		□□□■□		
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 given valuations and fundamentals, but continued high conviction in overweight in China/Asia credit.
Global IG	□□■□□		□□■□□		
Global HY	□□□■□		□□□■□		
Asia Credit	□□□□■		□□□□■		
Soveriegn 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 monetary action. We expect more aggressive easing from the People's Bank Of China, once pork-driven inflation subsides.
US	□□■□□		□□■□□		
Europe	□□■□□		□■□□□		
UK	□□■□□		□□■□□		
China	□□■□□		□□□■□		
Cash	□□■□□	0	□□■□□	0	Neutral over the medium-term view.

Strong conviction views

September 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:** (Cash available for distribution) We like 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.

Economic Outlook

Overview

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 takeaways

- Markets are betting on a growth rebound in 2020. Our proprietary indicators have been suggesting this for some time and therefore we broadly agree.
- US growth is softening but should remain in expansion. The slowdown should not be enough to de-rail global growth which is moderately positive but stable. In Europe, we do not see German weakness as a sign of broader concern.
- The direction of the US dollar is key for asset class performance in 2020. The fundamentals suggest the US dollar should weaken, but market sentiment may not let it for some time yet.

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.

Equities

Overview

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 US Federal Reserve has moved to a hold stance after it cut rates for a third time. Economic data is generally more positive and fears of a recession look to have passed for the time being. All these factors have helped equities reach new highs in the final quarter of 2019.

Key takeaways

- 2019 equity gains were mostly driven by multiple expansion, and earnings need to come through in 2020 to maintain market levels.
- Central banks could take a back seat to government fiscal plans in both the US and Europe as monetary policy appears increasingly less effective.
- The landslide Conservative party win in the UK election could motivate international investors to moderate underweight allocations to the UK.
- A major risk in 2020 is the Democratic primaries in the US, which, particularly if Elizabeth Warren is nominated, could trigger equity sell offs.

Investment implications

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, should feature more prominently and lead to continued volatility. The less cyclically exposed parts of the US economy appear fairly robust and could continue to perform if the general economic backdrop remains supportive.

Fixed Income

Overview

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 US Federal Reserve delivered a third rate cut and then signalled that its "mid-cycle adjustment" was over, switching to a hold stance. Economic data has shown resilience in the face of headwinds.

Key takeaways

- Many macro and geopolitical risks faced in 2019 have receded, but there are plenty of events that could still bring volatility to the market.
- The US and Iran confrontation has been quickly shrugged off by the market, which has focused instead on the prospect of a US-China trade agreement that would partially roll back tariffs.
- Beyond geopolitics, the macro backdrop is on track to deliver a reasonable level of growth in 2020.
- We expect both the Fed and European Central Bank (ECB)to stick to their current biases towards easing and cautiousness.

Investment implications

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.

Multi Asset

Overview

What's changed

Risk asset strength continued unabated towards the end of 2019, with the US equity market hitting new highs throughout the fourth quarter. Government bond yields have broken their previous 2019 pattern of plunging when equity markets rallied, indicating that the 'reluctant rally' we saw through much of last year has turned to one of investors accepting at least a near-term continuation of strong performance.

Key takeaways

- 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.
- Given the mismatch between the market and underlying data, it's important to closely monitor manufacturing and services indicators, as well as unemployment and inflation numbers.
- Inflation could be the flipside of growth if global growth does surprise to the upside and could potentially spike. This would be especially negative for fixed income assets.

Investment implications

With markets behaving as if global growth is reflating when the data is merely flatlining, we are growing increasingly concerned that investors have become complacent. Against this backdrop, we are cautious overall but poised to take advantage of shorter-term opportunities as they present themselves. We are hedging possible inflation risk by allocating to gold, inflation-linked bonds and financials.

Real Estate

Overview

What's changed

Economic growth in both the UK and Eurozone remains slow, dragged down by a manufacturing sector struggling with global trade disputes and automotive sector regulation. Nevertheless, demand for high-quality offices and industrial real estate remains strong. A combination of supply constraints and a positive macro outlook for employment, business investment and household expenditure should support a gradual increase in rents.

Key takeaways

- Real estate investment shows no sign of slowing despite weak Eurozone growth.
- Vacancy rates in most European markets remain low despite accelerating levels of development completions. Rising construction costs may start to feed through into increased rents.
- Eurozone real estate offers an attractive yield premium over other asset classes. But in some cases the liquidity, depreciation and obsolescence risks of direct real estate are not being adequately priced.
- UK open-ended real estate funds have suffered outflows due to anxieties about Brexit and falling values in the retail sector. But the clear majority won by the Conservative party in the election may give sufficient clarity to entice cross-border yield-seekers back into the UK real estate market.

Investment implications

Rental growth will play a bigger role than capital growth in real estate outperformance in 2020, a trend evident in major centres such as Paris, Berlin, Munich and Amsterdam. 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. We are no exception and will be monitoring the UK market closely over the next six months for distressed sales.

Important Information

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