Q4 2018

Investment Outlook

The uncharted path

- Although the pace of growth is slowing, global economic expansion still has further to run, especially while the US continues to benefit from the recent fiscal stimulus package.
- Tighter dollar liquidity, a stronger dollar and protectionism should continue to be the key themes driving sentiment in the coming quarter.
- All eyes will be on the Fed for clues about the speed and size of US monetary tightening. The Fed may have a tough choice to make next year if its current path of a hike each quarter becomes too much for the US economy or the rest of the world to handle.
- The magnitude of the slowdown in China will also be crucial for global markets in the next few months. The policy response so far has been small and larger measures to stimulate growth seem at odds with the desire to deleverage.
- The difficulties of emerging markets look set to continue for the time being.

Fidelity's outlook for equities, bonds and alternatives

Q4 outlook overview

How much further can this run? Ten years after the global financial crisis, almost a decade of economic growth alongside an unprecedented market rally has left that question consuming investors.

The stresses in some emerging market countries this summer have revived memories of previous crisis, with analysts seizing on differences and similarities.

As we consider how the rest of 2018 will play out, our main focus is on the growth and policy trajectories of the US and China. The US Federal Reserve is gradually normalising policy to prevent the economy from overheating after years of unconventional easing, with fiscal stimulus bringing additional challenges. At the same time, Chinese policymakers are looking to stop their economy slowing down after largely exhausting their fiscal and monetary arsenal – and all this without compromising reform momentum. To add to the uncertainty, the trade war with the US shows no sign of easing. The global economy is charting new territory.

We do not believe the end of this global economic expansion is imminent but it is certainly the case that this cycle is mature. And at this stage of the cycle investor resilience will continue to be tested, not just within the more vulnerable emerging markets, but also within some asset classes and sectors. While the global backdrop remains moderately positive for risky assets – and our investment views broadly reflect this stance - further bouts of market volatility are likely as we approach the end of 2018.

Bart Grenier
Global Head of Asset Management

Outlook: At a glance

Equity 5

US: We expect the recent outperformance of the US to continue for now, driven by strong earnings, robust economic growth and a pickup in capex. We don't expect a dramatic change in the narrow market leadership by the tech giants.

Europe: Although slowing, economic momentum remains robust and we expect the corporate environment to remain supportive.

Asia Pacific: The overall outlook has turned more negative but this means valuations look more attractive especially compared to the US. Developments in China will be critical.

Japan: We expect above-trend growth to continue for the time being, supported by rising capex and consumption, and think valuations are attractive at current levels.

Emerging markets: We expect sentiment to continue to be hindered by tightening dollar liquidity and dollar strength, although there are a few notable areas of strong performance, such as India.

Global sectors: Our most favoured sectors are technology, healthcare and financials, while our least favoured sector is materials.

Fixed Income 13

Government: We expect the US yield curve to flatten from here but there are technical reasons for this and we're not thinking about a recession.

Inflation-linked: Inflation-linked debt in the US, the UK and Europe broadly looks in line with our fair value estimates. We have a structurally positive view on US breakevens but momentum will be a headwind over the coming quarter.

Investment grade: Investment grade debt looks attractive on the basis of momentum, liquidity and mean reversion factors. However, spreads below historical averages and corporate fundamentals showing late-cycle characteristics warrant caution in some areas of the market.

High yield: High yield continues to benefit from good earnings momentum, but it will be difficult for credit spreads to tighten further in Q4. Coupon-like returns are therefore our base case scenario.

Emerging markets: Valuations in some parts of the market have adjusted to account for the macro challenges that emerging markets face. However, one last leg lower could come in Q4.

Alternatives 19

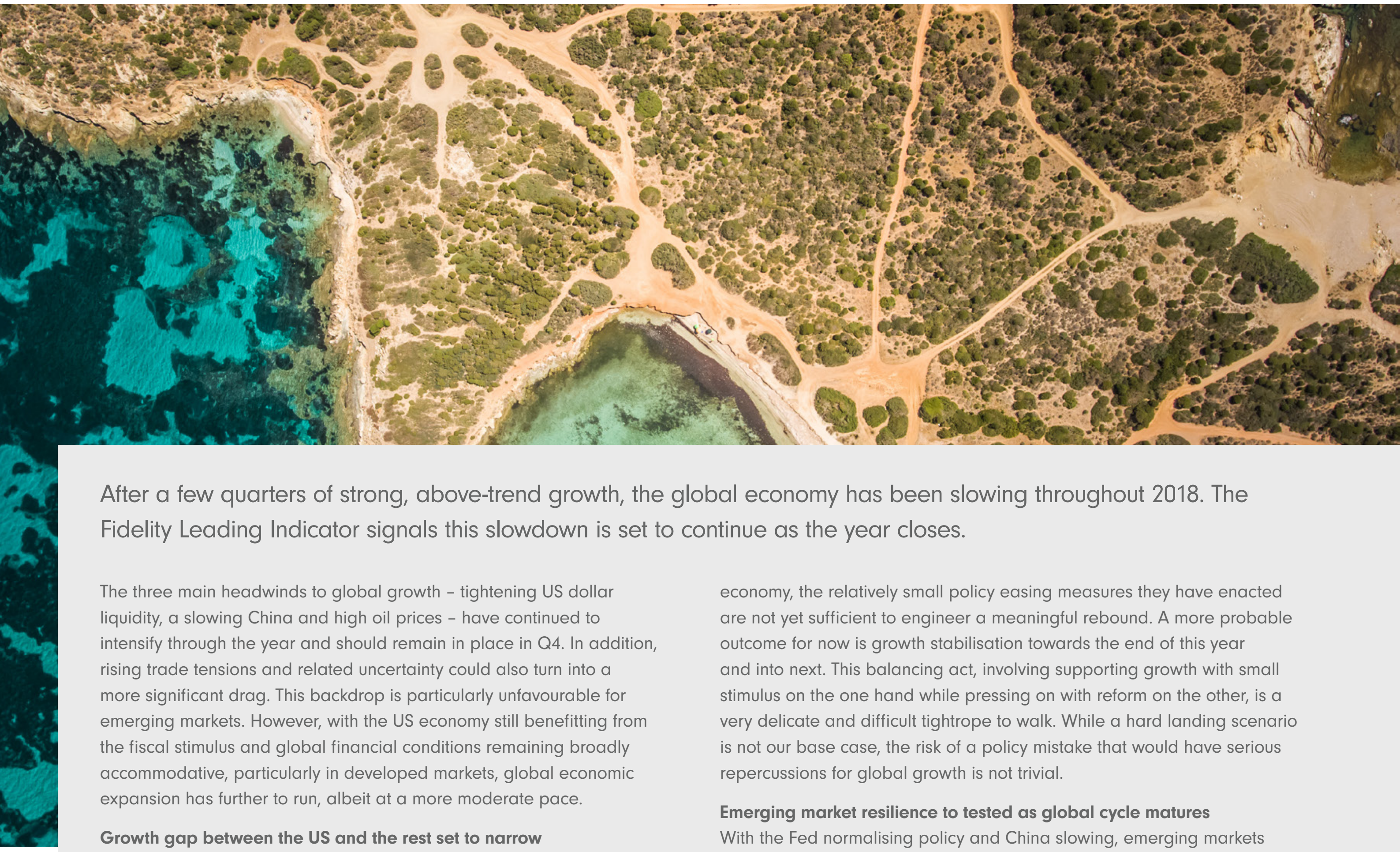
European commercial real estate: The lagged monetary cycle in Europe – compared with the US and the UK – continues to support the real estate market on the continent, bolstered by strong domestic demand and labour markets.

UK commercial real estate: We expect Q4 2018 to be fairly quiet for UK commercial real estate as market participants await clarity on the terms of Britain's departure from the European Union.

Commodities: The outlook for commodities is mixed. Solid global growth and late-cycle dynamics should boost demand while the continued slowdown in China's industrial sector will weigh on sentiment.

Alternative strategies: We expect long/short equity and global macro hedge funds to perform well in the coming months, although we note that the large spread in performance makes it important to choose wisely.

Q4 macro outlook



After a few quarters of strong, above-trend growth, the global economy has been slowing throughout 2018. The Fidelity Leading Indicator signals this slowdown is set to continue as the year closes.

The three main headwinds to global growth – tightening US dollar liquidity, a slowing China and high oil prices – have continued to intensify through the year and should remain in place in Q4. In addition, rising trade tensions and related uncertainty could also turn into a more significant drag. This backdrop is particularly unfavourable for emerging markets. However, with the US economy still benefitting from the fiscal stimulus and global financial conditions remaining broadly accommodative, particularly in developed markets, global economic expansion has further to run, albeit at a more moderate pace.

Growth gap between the US and the rest set to narrow

The growth differential that opened up this year between the US and the rest of the world is likely to start narrowing in Q4 as the sugar rush from the fiscal stimulus diminishes. Some US indicators are pointing to late cycle dynamics as the economy is clearly hitting its capacity constraints, especially in the labour market. Concerns of overheating should see the US Federal Reserve stick to its current plan of quarterly hiking, at least to the end of this year. However, Governor Jay Powell may have a tough choice to make if the impact of further rate hikes, combined with quantitative tightening and increased Treasury issuance, becomes too much for the US economy and the rest of the world-- especially for emerging markets--to handle. This is one theme markets will focus on in 2019.

China caught between growth and reform

Broadly speaking, while the US determines global financial conditions, it is China that shapes global growth. As the stimulus of 2015-2016 has been withdrawn over the past year, China's growth has slowed, mainly driven by a sharp deceleration in infrastructure investment and the negative credit impulse as the squeeze on shadow financing continued. While the authorities have clearly been concerned about the overall direction of the economy, the relatively small policy easing measures they have enacted are not yet sufficient to engineer a meaningful rebound. A more probable outcome for now is growth stabilisation towards the end of this year and into next. This balancing act, involving supporting growth with small stimulus on the one hand while pressing on with reform on the other, is a very delicate and difficult tightrope to walk. While a hard landing scenario is not our base case, the risk of a policy mistake that would have serious repercussions for global growth is not trivial.

Emerging market resilience to tested as global cycle matures

With the Fed normalising policy and China slowing, emerging markets are facing a double blow. The most vulnerable countries are already being punished for irresponsible policies of the past decade. But while ongoing crises in Argentina and Turkey might seem idiosyncratic, these are all symptoms of the post crisis search-for-yield-exuberance created by the global low rate environment. Turkey's stress has the potential to become systemic, spilling over to other emerging markets. It is certainly true that emerging economies are broadly in a better shape than in late 1990s or even relative to five years ago. However, given the unfavourable headwinds, their resilience will continue to be tested as the global cycle matures.

Predicting the end of the cycle in real time is inherently difficult. It is reasonable to suggest, however, that the global economy is now in the later stages of the post-crisis economic expansion. Despite the ticking clock implications of being 'late cycle', market dynamics in this period tend to still be positive for risky assets. But differentiation across asset classes, regions and sectors is ever more important.

Anna Stupnytska
Global Economist

About the views

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

Equity

Overview

Key takeaways

- We expect the themes of tightening dollar liquidity and dollar strength to continue to impact equity markets over the coming quarter, especially in emerging regions, with all eyes on the Fed for clues on the pace of interest rate hikes and balance sheet reduction.
- US equities look set to continue their outperformance for the time being thanks to strong earnings and economic activity. However, we expect the pace of US growth to moderate and the performance gap between other regions to narrow from here.
- The slowdown in the Chinese economy is a concern for global equity markets, particularly in Asia and emerging economies. It is difficult to forecast how profound or prolonged the deceleration will be, or what policy response the situation might provoke.
- Uncertainty around global trade will also continue to weigh on sentiment, as will the unpredictability of US policy in general.

Fidelity forecasts

Global equity forecasts:	2018	2019	2020
Earnings growth	16.1%	5.4%	7.5%
Return on equity	14.3%	14.6%	14.4%
Dividend yield	2.5%	2.7%	3.0%
P/E valuation	15.4x	14.2x	13.1x
P/B valuation	2.1x	2.0x	1.8x

Source: Fidelity International, August 2018.

Capital market assumptions:	3 years	5 years	10 years
US equities	6.2%	5.7%	4.8%
European equities	7.2%	7.5%	6.8%
Japanese equities	7.2%	7.0%	6.3%
Developed market equities	6.8%	6.6%	5.8%
EM equities	8.0%	7.8%	7.1%

These are estimates of return per year in 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. Source: Fidelity International, September 2018.

Equity

Outlook

Lone star

The standout theme in equity markets at the moment is the divergence in the prospects of the US versus the rest of the world. America has left other equity markets behind since June this year and it is difficult to see this dynamic changing any time soon. Tightening dollar liquidity as a result of Fed rate hikes and corporate profit repatriation are sucking money back in to the US and away from other markets, and we expect this theme to continue to hurt other regions, especially emerging markets. These factors coupled with strong corporate earnings and macroeconomic readings make the outlook for the US attractive both on absolute and relative terms.

The narrow leadership of the US market has become a little broader recently, but we don't expect a meaningful rotation away from the FAANGs in the near term. This isn't an echo of the dot com bubble – there is no euphoria now and the mega-cap tech stocks have huge positive cash flows thanks to their dominant market positions, suggesting there would be buyers in the case of a revaluation.

However, US economic growth appears to be slowing somewhat and earnings have probably peaked. We believe the US market is most likely to enter a Goldilocks phase rather than another period of rampant growth. A softer patch for the economy could, in fact, be positive for risk assets and might also take some of the steam out of the dollar, which could give equities in other regions some positive news.

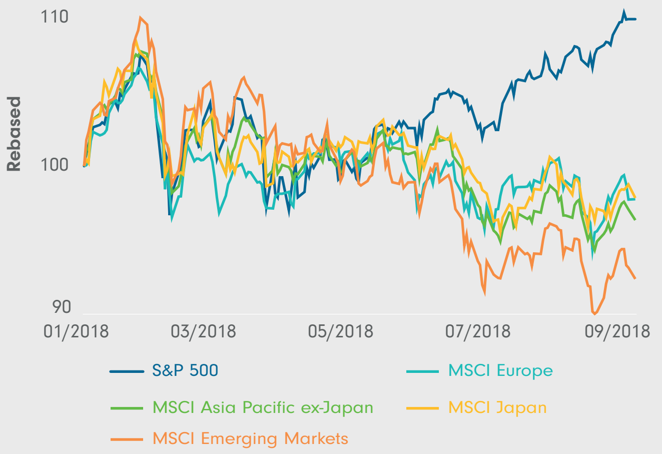
Cracks are appearing in China

Contrasting with the fortunes of the US is China, which is such an important driver of sentiment in Asian and emerging markets equities. On the positive side, PMIs are stable, imports are surprisingly strong and house prices are robust. However, investment, especially infrastructure, is very weak, and real estate construction is negative. Plunging retail sales volumes stand in contrast with second quarter GDP that was supported by a huge boost from consumption; this suggests that growth is materially weaker than the official number. All these factors indicate that the direction of travel has undoubtedly been downward. Policy reaction has been minor to date and it remains to be seen how far the government will let growth slow before taking meaningful action. Chinese equities have revalued dramatically this year, but we think a good deal of the slowdown story could already be priced in.

It has felt like the last phase of arguably the longest bull market in history for quite some time now. But the cycle looks set to continue for the time being and we doubt the FAANGs story will prove to be the last leg of this bull market by the time it does finally roll over. The corporate environment is still good, especially in the US, while cash flows are robust and buybacks and M&A are high. There are plenty of sectors and regions that have not been involved in the recent rally and it's entirely possible that something else will pick up the mantle if the current leadership changes.

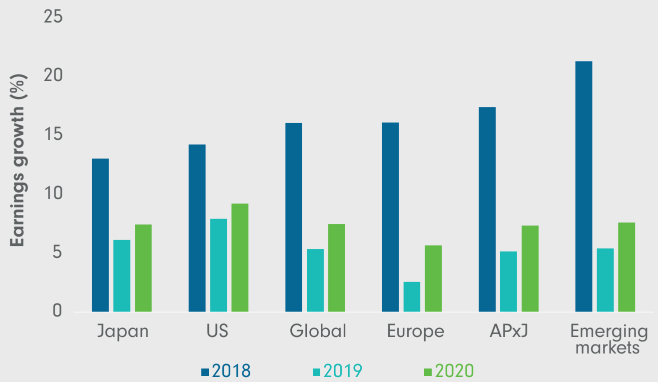
[1]Facebook, Apple, Amazon, Netflix and Google.

The US has left other regions behind in recent months



Total return indices in USD.
Source: Thomson Reuters, Fidelity International, September 2018.

Fidelity earnings growth forecasts by region

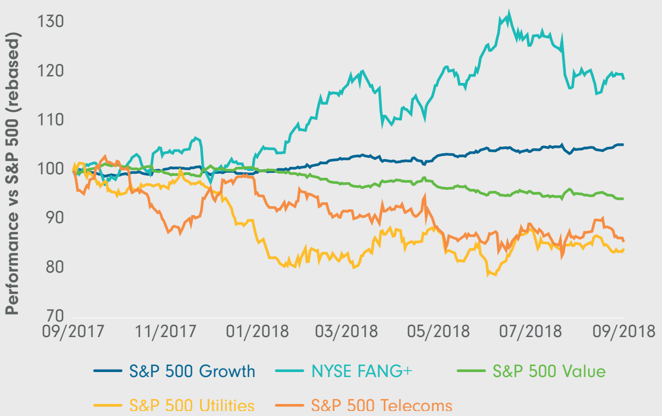


Source: Fidelity International, August 2018.

Equity

US equities

Tech should keep leading but with some rotation into defensive sectors



Monthly total return verses S&P 500.
Source: Thomson Reuters, Fidelity International, September 2018.

Fidelity forecasts

US aggregate forecasts	2018	2019	2020
Earnings growth	14.2%	7.9%	9.2%
Return on equity	18.3%	19.0%	18.4%
Dividend yield	1.7%	1.9%	2.1%
P/E valuation	18.5x	16.9x	15.4x
P/B valuation	3.3x	3.1x	2.8x

Source: Fidelity International, August 2018.

Outlook

The impact of tax reforms has plenty more room to run
Our outlook for the US hasn't changed a great deal from the start of the year: all things being equal, we are still very positive about the prospects for equities. Earnings and GDP readings have been very strong so far this year and while some of this is due to the one-time effect of corporate tax cuts, we believe the broader tax reforms will continue to exert a positive effect until the end of next year. Repatriations are expected to hit $700 billion this calendar year. Some of this will be returned to shareholders but we are also starting to see a pickup in capex thanks to companies' new ability to fully expense capital spending. Eventually wage costs will rise from their current benign level and productivity-boosting investment now will help offset those effects.

It is difficult to see what will stop the current cycle in the near term, with the US looking strong in absolute and relative terms. The labour market is tight but there's no real threat from inflation at present. While the US is the most expensive market in the world on valuation terms, this has been the case throughout much of history and there are structural reasons for higher valuations in the US, due to its lower proportion of cyclicals and higher proportion of tech stocks. There is some worry that a global slowdown, especially in China, could hamper the positive US story. But the US is generally a defensive market and a slowdown in other regions coupled with a strong dollar could well prove to be a boost for US shares.

No immediate change is expected in market leaders
Recently the market has been driven by FAANG momentum. The lateness of the cycle and the fact that the US is already at full employment leads us to believe that another significant leg up in US growth is not on the cards, which explains why investors are willing to pay a premium for companies that are growing. While we have observed small pockets of rotation over the past few months, we are not expecting the market leadership to change significantly in the next quarter, although we might see some moves into defensive sectors such as utilities and telecoms. We expect some extra volatility around healthcare names, especially large pharmaceutical firms, as President Donald Trump has made no secret of his desire to reduce their power and may take steps to follow up his rhetoric after the mid-term elections.

Trump emboldened in trade wars but he may have his wings clipped in the mid-terms
The Republican Party must navigate the November elections. There is a real chance the Democrats will take the House and a slimmer chance they will take the Senate as well. We don't anticipate either would jeopardise the positive growth outlook but it would significantly hinder President Trump from putting any new major policies in place during the remaining two years of the current presidential term. In any case, Democrats broadly agree with Republican plans for increased infrastructure and defence spending so we expect these to proceed whichever way the elections pan out. The recent strength of the US relative to other regions has emboldened President Donald Trump to stick to his uncompromising approach to trade negotiations. While there is an obvious short-term downside to tariffs, this is far outweighed by the positive impact of the recent tax reforms, and longer-term scenarios could see supply chain reconfiguration that would boost US jobs and manufacturing.

Equity

European (incl. UK) equities

Cyclical sectors are looking historically expensive compared to defensive sectors

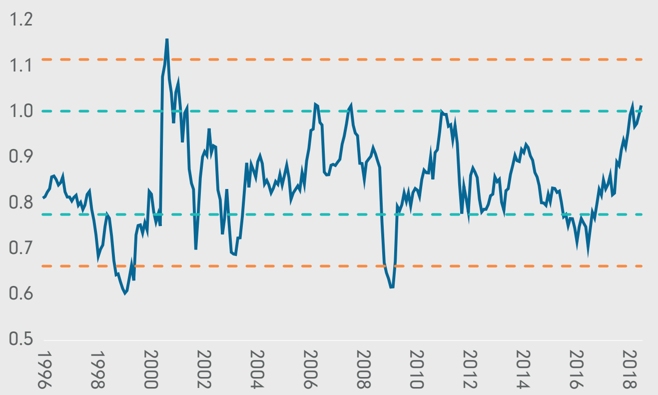


Chart shows European cyclical sectors' price-to-book valuation relative to that of European defensive sectors. Light blue lines show +/- 1 standard deviation, orange lines show +/- 2 standard deviations. Source: Morgan Stanley, Fidelity International, September 2018.

Fidelity forecasts

Europe aggregate forecasts	2018	2019	2020
Earnings growth	16.1%	2.6%	5.7%
Return on equity	12.8%	13.1%	13.2%
Dividend yield	3.5%	3.8%	4.1%
P/E valuation	15.0x	13.8x	12.7x
P/B valuation	1.9x	1.8x	1.6x

Source: Fidelity International, August 2018.

Outlook

Tariffs threaten a stable growth outlook

Economic momentum in Europe remains relatively strong although the rate of growth is slowing. Consumers in Europe haven't had it this good for some time – monetary policy is accommodative, the eurozone has now posted 20 consecutive quarters of growth, unemployment is at eight-year lows and wages are rising. We also see the corporate environment as supportive and expect good companies to find cost savings elsewhere to mitigate rising labour costs. The ECB has signalled no rate rises until September 2019 at the earliest, by which time the interest rate differential with the US could be as much as 3 per cent. Any euro weakness as a result of this would be a boost for exporters and overseas earners.

One of the main threats to this outlook is trade war escalation. News flow around tariffs is already increasing volatility and sentiment swings in equity markets.

One of the main threats to this outlook is trade war escalation. News flow around tariffs is already increasing volatility and sentiment swings in equity markets. Car makers and semi-conductor manufacturers have already been knocked in anticipation of disruption to their supply-chains. Our research shows manufacturers enjoyed a permanent margin increase of around 7 percentage points shortly after a flurry of free trade deals was signed in the 1990s and early 2000s. Any reversal of those margin gains due to increased tariffs would obviously be very negative for the sector.

Brexit impact remains difficult to predict, even at this late stage

There is little clarity on the state of play in Brexit negotiations and it remains difficult to predict the outcome, with only months to go. However, UK domestic investment is already being stifled by uncertainty and even a 'soft' Brexit will probably be negative for UK growth. UK stocks are not yet cheap enough even for our value managers. A no-deal Brexit would cause significant headwinds for the whole of Europe as well as more localised impacts. For example, the UK is Spain's fourth largest trading partner and any UK slowdown would hurt many exporters there.

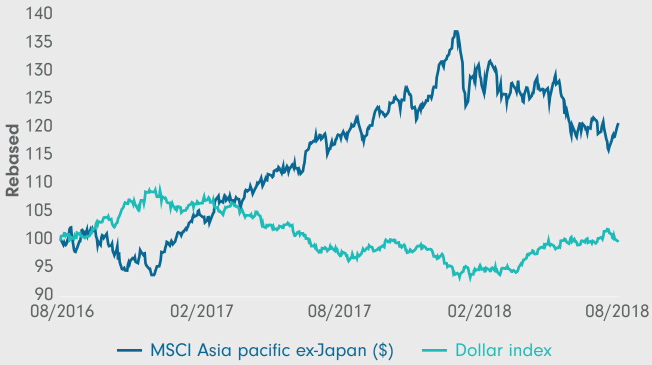
Cyclicals look expensive

Cyclical sectors in Europe are at their highest valuations compared to defensive sectors since 2010. As such, we expect outperformance in cyclical sectors to prove harder to come by, although attractive companies with structural growth drivers on the cheaper end of the valuation scale can still be found.

Equity

Asia Pacific (ex.Japan) equities

Asia Pacific equity market fortunes are closely tied to the dollar



Source: Thomson Reuters, Fidelity International, August 2018.

Fidelity forecasts

Asia Pacific (ex.Japan) aggregate forecasts	2018	2019	2020
Earnings growth	17.4%	5.2%	7.4%
Return on equity	12.5%	12.5%	12.4%
Dividend yield	3.2%	3.3%	3.5%
P/E valuation	13.1x	12.2x	11.3x
P/B valuation	1.6x	1.5x	1.4x

Source: Fidelity International, August 2018.

Outlook

Uncertainty is driving volatility

Asia Pacific ex-Japan equity markets have seen increased volatility recently and we see no reason for that picture to change significantly in the coming months. The unpredictability of US policy in general, not just trade tariffs, has led to a sense of uncertainty that has weighed on sentiment. This has been compounded by the strength of the dollar which has a significant impact on the region, especially countries that have borrowed heavily in dollars such as Indonesia. The overall outlook has turned slightly more negative but this has made valuations look healthier, especially in comparison to the US.

China is the most important market in the region. The negative sentiment around global trade is starting to make itself felt on the ground in the form of slowing retail sales.

China is driving the bus, but in which direction?

China is the most important market in the region. The negative sentiment around global trade is starting to make itself felt on the ground in the form of slowing retail sales. The recent stock market sell-off has further dented consumer confidence given the unusually high proportion of Chinese personal savings invested in stocks. Tech-darling Tencent reported its first ever drop in earnings last quarter and released downbeat guidance around some of its new games. This negative sentiment is filtering through into cheaper valuations and we see plenty of opportunities at the margin in China. We still believe in the long-term growth story despite the current slowdown, and think US mid-term elections should keep President Trump from dialling up the protectionism rhetoric for the time being. And despite the gloomier macro outlook, there are still plenty of things that Beijing could do to give the economy a short-term boost should they want, such as infrastructure spending, reducing de-leveraging trends, loosening housing regulations or even devaluing the yuan (although this would be quite a surprise).

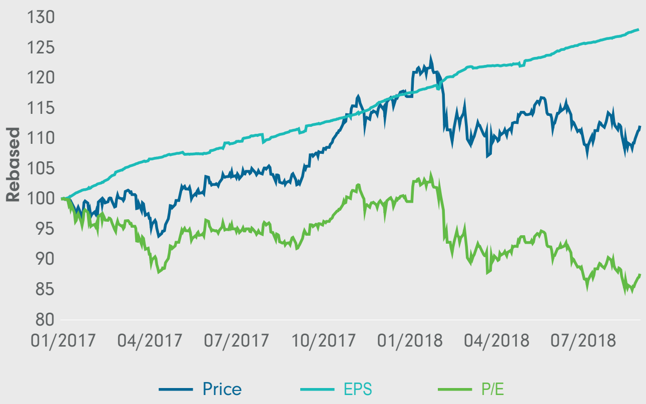
Australia could be hurt by China slowdown

Australia has been the leader of the APAC region in relative terms during the past few months of uncertainty, offering a flight to safety and attractive yields. However, we think some of this excitement will wane – GDP growth looks set to remain moderate and the Chinese slowdown is not good news for Australian commodity producers and property markets – although the safety factor could continue to be a positive if volatility in the region continues. In Korea, the recent relaxation of Chinese restrictions on travel to the country has helped boost consumption there as Chinese tourist numbers return to normal levels.

Equity

Japanese equities

TOPIX valuations have declined despite earnings growth



Source: Thomson Reuters, Fidelity International, August 2018.

Fidelity forecasts

Japan aggregate forecasts	2018	2019	2020
Earnings growth	13.0%	6.1%	7.4%
Return on equity	11.9%	11.3%	11.1%
Dividend yield	2.2%	2.3%	2.5%
P/E valuation	12.8x	12.5x	11.7x
P/B valuation	1.5x	1.4x	1.3x

Source: Fidelity International, August 2018.

Outlook

Growth back on track after Q1 wobble

The broadly positive macro outlook for Japan looks to be back on track after GDP shrank by 0.6 per cent (annualised) in Q1 this year. We expect above trend growth to continue for the time being, supported by capex and consumer spending. Corporate investment is being driven by capacity expansion in manufacturing sectors, ongoing labour-saving investment and the upgrading of older facilities, as well as investment related to the Tokyo 2020 Olympics. Consumption is being supported by a tight labour market putting upward pressure on wages. The risks to this view primarily come from an escalation of global trade wars, as well as late-cycle pressures and a slowdown of growth in emerging markets, particularly China. On balance, Japan's economy is in relatively good shape, although we are seeing an accumulation of downside risks and we expect growth to slow in line with broader global trends (ex-US).

On balance, Japan's economy is in relatively good shape, although we are seeing an accumulation of downside risks and we expect growth to slow in line with broader global trends (ex-US).

Recent sentiment has driven valuations to attractive levels

Japan's equity markets have underperformed global averages so far this year. Sentiment has worsened and defensive sectors have outperformed. Overseas investors have withdrawn money at a remarkable rate - 2018 is currently on course to be the largest year of net selling since 1987. However, underlying fundamentals have broadly stayed the same. Corporate earnings have grown despite the strength of the yen and earnings revisions have been positive. As a result, valuation multiples have contracted to levels below that of Europe and the rest of Asia, levels that we think look attractive.

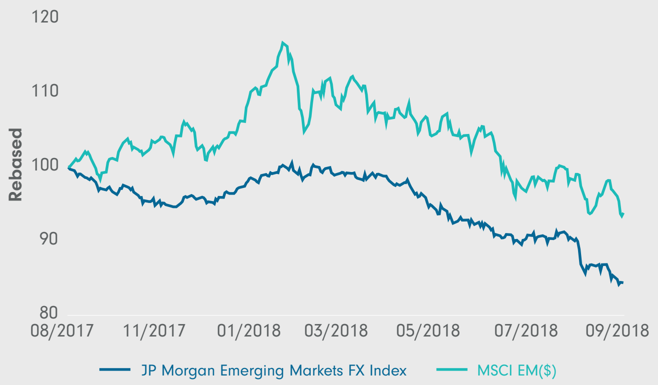
Conditions in place for a strong Q4

Assuming Prime Minister Shinzo Abe is re-elected in September, as is widely expected, and the global trade environment does not deteriorate further, conditions should be in place for capital to return in Q4 and equity markets to post solid performance. We expect earnings guidance to be revised upwards in the last quarter of this year. Japanese companies typically have a substantial amount of cash on their balance sheets and we believe there is significant scope for further ROE improvement due to better capital management. In addition, despite a recent tweak, the BOJ has signalled that the market should expect policy to remain loose for some time.

Equity

Emerging markets equities

The strength of the dollar will continue to be one of the key drivers of EM equities



Source: Thomson Reuters, Fidelity International, September 2018.

Fidelity forecasts

Emerging market aggregate forecasts	2018	2019	2020
Earnings growth	21.3%	5.4%	7.6%
Return on equity	12.6%	12.7%	12.7%
Dividend yield	3.0%	3.3%	3.5%
P/E valuation	12.2x	11.2x	10.4x
P/B valuation	1.5x	1.4x	1.3x

Source: Fidelity International, August 2018.

Outlook

Dollar strength and liquidity tightness should continue to drive EM assets

Equities in emerging markets have had a tough time of it in recent months. Tightening dollar liquidity, a strong dollar and heightened trade tensions have all weighed on sentiment and reduced valuations. We expect these themes to continue to shape the near-term sentiment for emerging market assets. Currencies have come under considerable pressure, initially Argentina and Turkey but now spreading to India and South Africa, and this too has had knock-on effects on equity markets. However, we believe that risks stemming from the reduction in offshore dollar liquidity will be more apparent in the balance sheets of companies than governments. While there are a few notable exceptions (we're looking at you Turkey), many emerging market countries are less reliant on external funding than they were before the Asian currency crisis in the '90s.

Although the broad macro picture in China is one of slowing growth, we continue to see many opportunities to invest in good quality businesses that are exposed to consumption, particularly in areas like autos and e-commerce.

Consumers in China are still spending despite broader softness

Although the broad macro picture in China is one of slowing growth, we continue to see many opportunities to invest in good quality businesses that are exposed to consumption, particularly in areas like autos and e-commerce. Beyond the consumer, China's willingness to liberalise industries such as financial services is encouraging. The environment across China's old economy is more nuanced. The government has been successful in executing a significant capacity reduction in areas such as steel and coal and there is scope for this to continue. However, investment in infrastructure is weak and real estate construction is negative.

Russia resilient, while India's outperformance is tempered by currency weakness

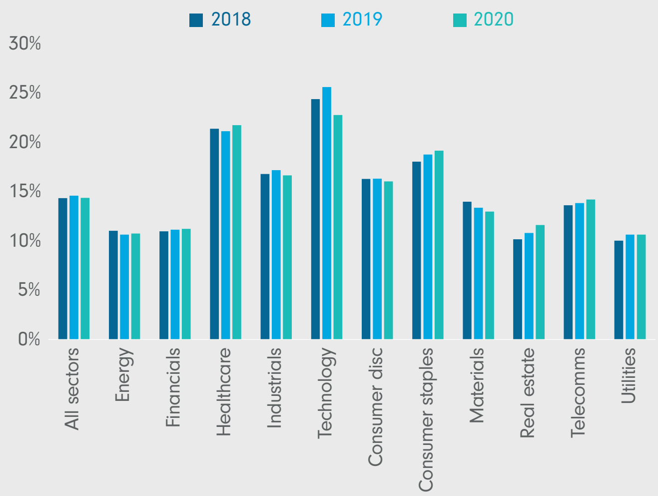
Investors will demand significant discounts for holding Russian assets while the prospect of further US sanctions hangs over the country. From a macro perspective, the Russian economy has proven remarkably robust, thanks in part to the oil price.

Prime Minister Narendra Modi has made notable advances to his reform agenda in India in the form of a goods and services tax, demonetisation and a bank recapitalisation programme. Each one weighed on the economy to differing degrees, but the prospect of an improved fiscal base, a modernised (and less corrupt) monetary system and a more fundamentally sound banking system could benefit the country for years. We see real opportunities in the banking sector, where demand for services is still nascent. However, while the long-term outlook for India remains very positive, recent dollar strength and rupee weakness, as well as higher oil prices, have the potential to stoke inflationary pressure and hasten interest rate rises which would temper the optimism to some degree, and we feel that finding opportunities at reasonable valuations is becoming more difficult.

Equity

Global equity sector views

Fidelity global return-on-equity forecasts by sector



Source: Fidelity International, August 2018.

Analyst sector ratings

Most favoured sectors	Less favoured sectors
Information technology	Materials
Healthcare	Real estate
Financials	Consumer Discretionary

Outlook

Innovation is still driving tech forwards

Industry innovation continues to drive our positive view of the technology sector. We remain positive on Apple given its revenue stability, however we have downgraded some Asian tech hardware names because we have a negative outlook for the dynamic-random-access-memory cycle; server demand fell in the first half of the year and mobile content growth is slowing. We have a positive outlook on European IT services and software following a recent correction that we felt went too far. We have a negative outlook on the Asia telecommunications equipment sector because the 4G capex cycle is winding down while spending on 5G has not yet begun.

Valuations for US and European pharmas look attractive

We have a positive outlook for the healthcare sector across all regions except EMEA/LATAM. In the pharma and biotech subsector, we expect product pipeline to offset downside risks across a range of pharma stocks in Europe and the US, and valuations remain at reasonable levels. However we still have a negative outlook on Japanese companies due to the adverse pricing environment for generic and off-patent drugs. Within the healthcare equipment services subsector, we maintain our positive stance on the US due to healthy organic sales growth expectations, on Japan due to robust demand and on the Asia Pacific region due to positive Australian hospitals and equipment providers.

US financials set to benefit from higher rates

Our outlook for financials remains positive, led by companies in the US across all subsectors. US banks should benefit from a less onerous regulatory regime, higher spread income on better volumes, benign credit and positive operating leverage. US insurers should be supported by rising yields and increasing M&A activity in the reinsurance space. We are getting incrementally more positive about Asia Pac ex Japan insurance companies, mainly due to overall embedded value growth for Chinese insurers, backed by strong in-force business growth.

Commodity price declines take their toll on the materials sector outlook

Our outlook on the materials sector remains negative, driven by European and Asia Pacific ex Japan metals and mining firms, because of weakening Chinese credit and money supply growth and unfavourable international macro supply dynamics, including a strong dollar, US monetary policy tightening and the trade war. However we see the potential for US steel producers to do well thanks to domestic import tariffs.

Fixed income

Overview

Key takeaways

- The actions of the Fed and dollar liquidity conditions are the all-important factors in fixed income markets at the moment. US treasuries now have an attractive yield and money has flooded back to the US in search of a safe home at the expense of foreign assets.
- With the ECB on hold, European investors will turn their attention to the upcoming Italian budget. We think the market is pricing in too high a risk of Italexit or redenomination.
- While we feel events in Turkey and Argentina do not herald the start of a wider emerging market crisis, we think emerging market bonds will continue to struggle against significant headwinds in the coming months.

Current & implied government bond yields

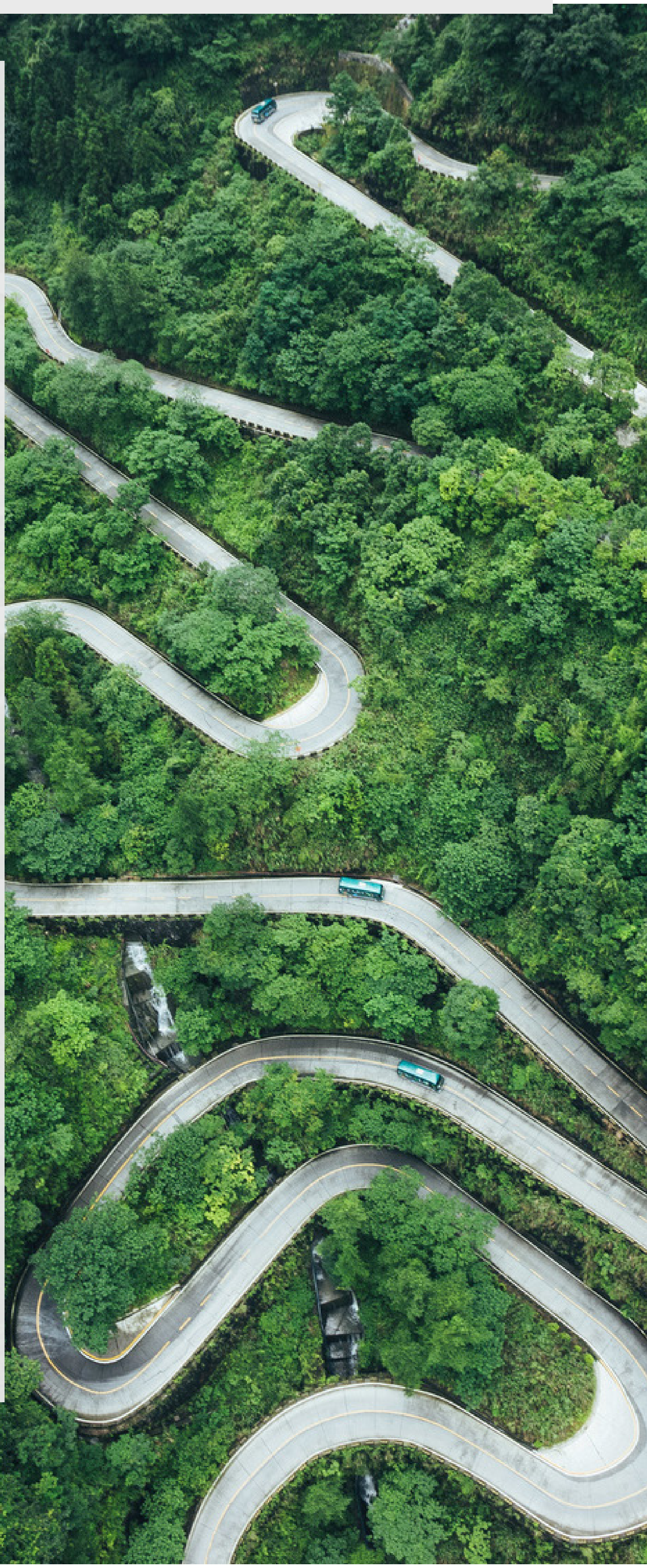
10 year yield	Current (%)	Sep-19 (%)	Sep-20 (%)
US	2.86%	2.94%	3.04%
GER	0.33%	0.53%	1.04%
UK	1.41%	1.53%	1.91%

Source: Bloomberg, 3 September 2018.

Fidelity forecasts

Capital market assumptions:	3 years	5 years	10 years
US treasuries	2.8%	2.7%	2.6%
German government bonds	2.1%	1.9%	1.8%
US investment grade	3.5%	3.7%	3.9%
European investment grade	2.2%	2.5%	2.8%
US high yield	3.9%	4.4%	5.0%
European high yield	3.6%	3.9%	4.2%

These are estimates of return per year in 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 Treasuries - 10 year US treasury from ICE BofAML par yield curve, German government bonds - 10 year German government bond from ICE BofAML par yield curve, US investment grade - ICE BofAML US Corporate Index, European investment grade - ICE BofAML Euro Corporate Index, US high yield - ICE BofAML US High Yield Index, Euro high yield - ICE BofAML Euro High Yield Index. Source: Fidelity International, September 2018.



Fixed income

Outlook

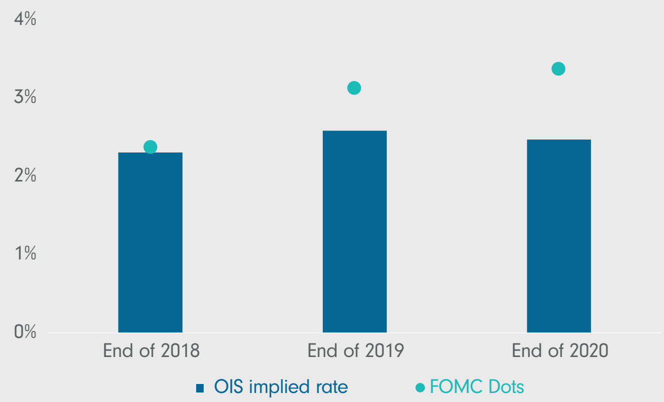
The Fed may have a tough decision to make next year
While the latest US data has come in softer than expected, the broad picture still points to a growth rate of around 3–3.5 per cent for the rest of the year. The Fed should have ample room to hike twice more this year and both hikes are priced in by the market. Looking ahead to 2019, we expect US growth to slow, but remain higher than the rest of the world, thanks to monetary conditions that are still easy and the continuing tailwinds from the fiscal stimulus earlier this year.

However the Fed will have to balance further rate hikes with quantitative tightening and rising US Treasury issuance, and may not be able to deliver on its planned three additional hikes in 2019. The challenges ahead for US growth and for the Fed are being priced in by the market, with the US Treasuries yield curve now at its flattest level since 2007. We expect the curve to flatten further from here, however we would not rush to conclude that a flat or inverted yield curve is necessarily a predictor of a recession, as the long end of the curve is being influenced by other, more technical factors, such as liability-driven investing (LDI)-related demand for US duration that is helping to keep yields low. Trade-related concerns and volatility may provide a flight-to-safety bid to US Treasuries, but the medium-term path for yields is still higher in absence of a sudden macro shock, which we see as unlikely in the near term. We expect US 10-year yields to break to the upside of the recent range, driven by tighter monetary policy and a still supportive macro backdrop.

With the ECB dormant until Q4 2019, attention will turn to Italy
In Europe, the ECB is no longer the focus of market participants after it committed to leaving rates unchanged until at least the second half of 2019. Investors have little expectation that rates will be hiked at all, with only 7 basis points priced in by September next year. In the absence of monetary policy activity for the time being, attention will turn to politics. The Italian budget at the end of September is the next hurdle on the horizon, with headlines that have driven Italian government debt (BTPs) spreads wider and kept volatility elevated in all Italian assets. After the latest moves, a non-negligible probability of Italexit or redenomination is in the price – yields on 3-year BTPs suggest that the market is pricing circa 20 per cent probability of redenomination with a 30 per cent haircut. This is a lot. We ultimately think the government will deliver a budget in line with the 3 per cent EU limit, but the pressure on BTPs might intensify between now and the end of September. By the same token, German government debt should continue to trade in line with market sentiment towards Italy until we get more clarity.

Bond markets are now pricing in a greater probability of no-deal Brexit
Brexit remains the main driver for Gilts and other UK assets. It remains hard to predict the outcome at this juncture, although the latest news flow has led the market to assign a greater probability to a no-deal Brexit outcome. Following the most recent hike by the Bank of England, we now expect one more hike over the next 12 months but not much more after that. Given the uncertain political outlook, it is difficult to see the BoE being anything but cautious in the months ahead. The outlook for Gilts will remain binary as we approach the March deadline, with reward not high enough to compensate for the risk at this juncture. A neutral stance is therefore warranted.

Markets are sceptical that the Fed will hike as much as it has indicated



Source: Bloomberg, Fidelity International, September 2018.

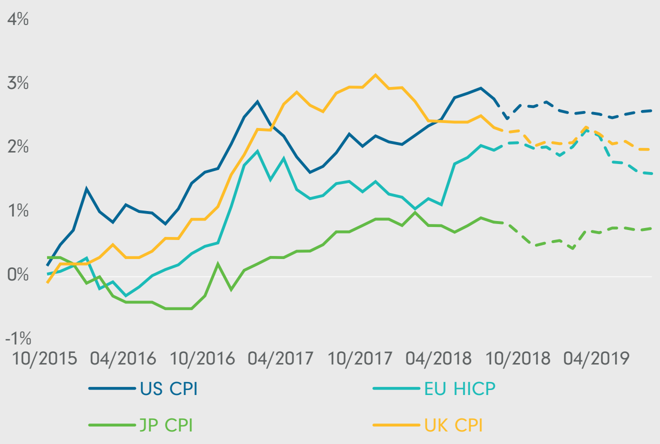
Investors are pricing in too high a probability of Italexit or redenomination

Source: Bloomberg, Fidelity International, September 2018.

Fixed income

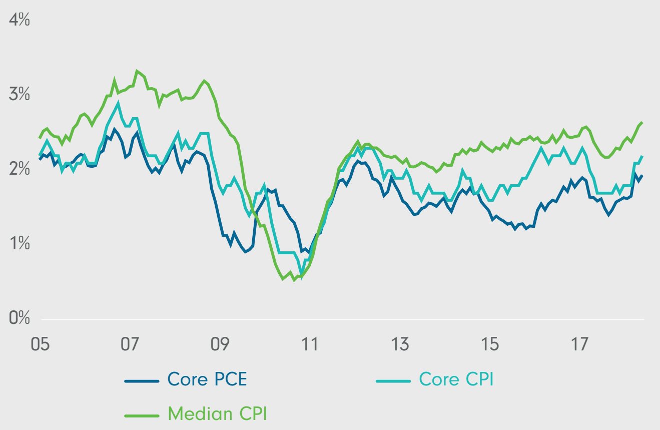
Inflation linked bonds

Fidelity inflation forecasts point to the stabilisation of price growth



Source: Fidelity International, August 2018.

Tariffs pose a greater risk to US inflation than we previously thought



Source: Bloomberg, Fidelity International, August 2018.

Outlook

The rising risk of US import tariffs is meaningfully increasing domestic inflation

We expect US inflation to run at 2.3–2.4 per cent in the second half of the year, but with several upside risk factors on the horizon. We now see the upward inflationary pressure from import tariffs as a larger factor than before – while the original tariffs on $30 billion of steel and aluminium barely impact consumer prices, the likelihood of tariffs on most or all imports from China, including categories like consumer electronics, has increased substantially. Raising tariffs from 10 to 25 per cent on a comprehensive range of products totalling $200 billion or more could raise CPI by 0.5 per cent by some rough estimates, still a small effect for breakevens and likely to be eclipsed by the ensuing growth slowdown, but a rather significant change for the 6–12-month outlook.

While we have a structurally positive view on US inflation and US breakevens, momentum in both breakeven inflation and TIPS flows is looking increasingly negative on a 3–4-month view. We have a more cautious outlook towards the asset class on a tactical basis as negative flows and deteriorating global sentiment counteract the undeniably positive CPI fundamentals coming from robust core inflation wages, low unemployment and upside risks from politics.

UK breakevens are at fair value but there are risks on both sides

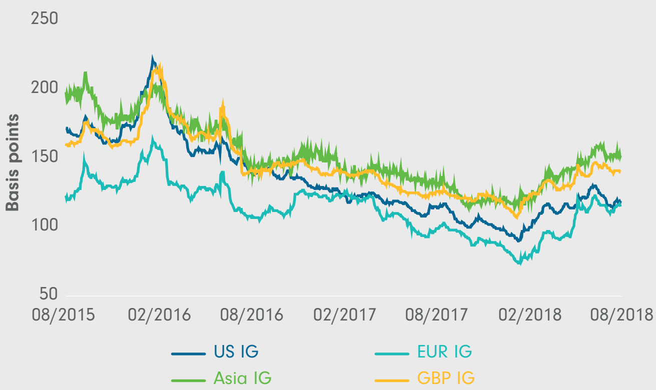
Over in the UK, we expect headline UK CPI to fall to around 2.3 per cent in the next three months, and around 2 per cent during the first quarter of next year, as the contribution of the oil/petrol price increase that we saw in late-2017 fades and even second round effects of the 2016 FX shock fades out. Core CPI should hold steady at the current range of 1.8–2.0 per cent though August core inflation might be a weak outlier at 1.6 per cent due to base effects. Looking at UK breakevens, at 3.05 per cent they now look close to our fair value estimates, but with large uncertainty on both sides – upside risks from strengthening demand and possible FX depreciation from a cliff-edge Brexit, offset by downside risk from weakening house prices and the tail risk of another RPI formula reform. On a short-term basis, the case for an overweight position has now decreased. UK breakevens, like their US counterparts, are unlikely to be immune to the deterioration in global risk sentiment, weak flows into the asset class and a more challenging outlook for commodities and risky assets.

Lastly, European breakevens are broadly in line with fair value at present. There are however some opportunities across the curve, with the front-end of most inflation-linked curves in Europe looking attractive at current levels.

Fixed income

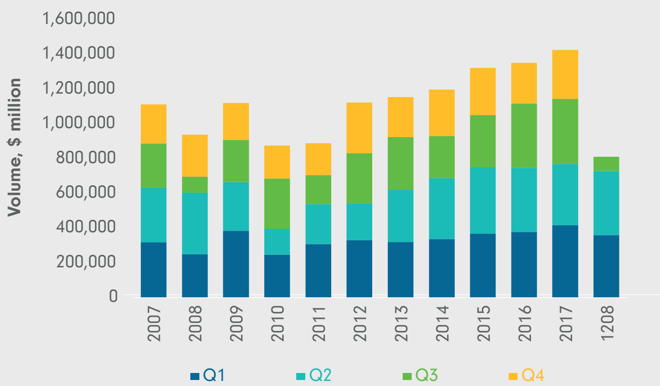
Investment grade bonds

Despite widening this year, IG spreads are still below historical averages



ICE BofA Merrill Lynch bond indices used.
Source: Thomson Reuters, Fidelity International, September 2018.

US supply has been light this year but Q4 is set to see a large increase



US investment grade corporate universe.
Source: Bloomberg, Fidelity International, August 2018.

Outlook

The US market gears up for a record supply dump
While the pace of growth might be slowing, economic data out of the US is still very healthy and the recent deceleration has not yet affected markets in any substantial way. We highlight that, following anecdotes in numerous Q3 US corporate earnings calls, especially in the mid-cap industrial sectors, there has been a large (but unquantifiable) degree of pull-forward demand ahead of import tariffs that are now being applied, as firms look to build inventories ahead of price increases to come. It is reasonable to assume that this will be somewhat reversed later in the year. In the near term, all eyes are on the well-flagged increase in supply in September, after the summer lull, and ahead of the US mid-term elections. Latest estimates range between $120–150 billion of new US investment grade supply. Anything at the high end of this range or above would make the month the largest in history. Market consensus is that new issues will be well absorbed, although investors are likely to demand a large new issue premium, pushing spreads wider.

Fundamentals are strong in Asia
The latest round of corporate results in Asia has been good although there was variability across sectors. Property, metals and mining names have been particularly positive whereas tech has come under some pressure, with industrials mixed. Our expectation is for fundamentals to stabilise from here. The new issue pipeline for Asian corporates is very busy but it should be absorbed well by the market, with inflows that continue to trickle into high quality Asian credit.

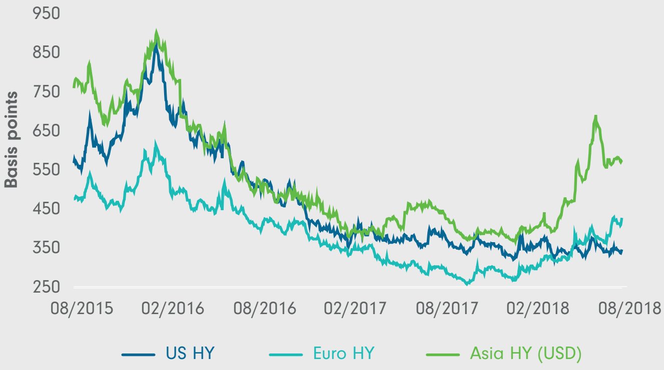
The sterling market has been supported by risk-off flows
Sterling investment grade has been eerily quiet during the summer months and largely ignored the consistent stream of Brexit-related headlines. Anecdotal evidence suggests most of the support to the asset class has been driven by institutional investors de-risking away from equities into fixed income as Brexit concerns mount, valuations in riskier asset classes appear on the expensive side and volatility is likely to remain elevated. Our expectation is for this trend to continue. However, the market remains very fragile and it won't take a lot for there to be a reasonable sell-off, particularly after the recent outperformance of sterling investment grade versus high-rated credit denominated in other currencies.

Volatility looks set to continue in euro investment grade
Euro investment grade bonds experienced a volatile summer, courtesy of plenty of headlines about Italy and trade-related spats with the US. Spreads are now at their widest levels for the last 18 months, due to a combination of trade wars and Italian political risk. We do not believe that either will ultimately severely impair the global growth outlook, with market-friendly outcomes expected on both fronts. Volatility, however, will remain elevated in European credit in the short term, keeping us neutral for the time being.

Fixed income

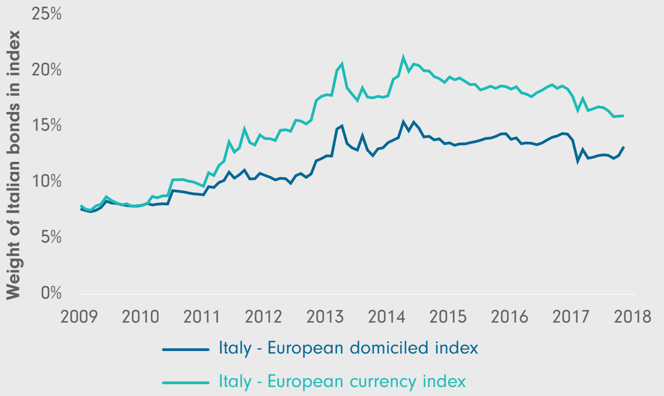
High yield bonds

High yield spreads' grind tighter has run its course



ICE BofA Merrill Lynch indices used.
Source: Thomson Reuters, Fidelity International, September 2018.

Italy makes up a significant proportion of European high yield indices



ICE BofA Merrill Lynch indices used.
Source: Bloomberg, Fidelity International, July 2018.

Outlook

High yield spreads are unlikely to tighten further this year
The positive earnings news out of the US, where over 80 per cent of companies beat analysts' earnings estimates, supported risk sentiment in high yield bonds and partially insulated the asset class from the Turkey-induced volatility that weighed heavily instead on emerging market debt. However, valuations have become more expensive. While the asset class continues to benefit from good earnings momentum, it will be difficult for credit spreads to tighten further between now and the end of the year. Coupon-like returns are therefore our base case scenario, particularly in US and Asian high yield.

The main risks for both asset classes are an escalation of the trade spats between the US and the rest of the world and a deterioration in corporate margins and earnings growth. US companies in particular face tighter labour markets, rising wage bills and higher financing costs. For now, we don't see an immediate threat to returns for US high yield credit, but corporate fundamentals will require close monitoring as we approach the end of the credit cycle and spreads offer little protection to investors. Over the longer term, with central bank support fading and funding costs rising, the more leveraged capital structures will no doubt come under pressure. In the near term we value the better liquidity, diversification and still-supportive domestic growth trends that the US market offers, particularly in comparison to Europe.

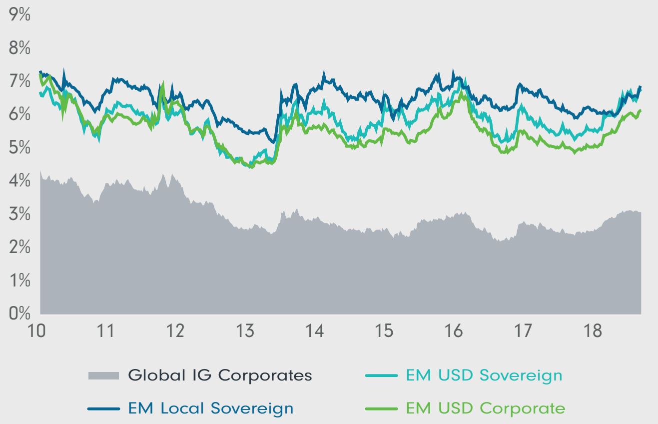
Asian defaults are rising but fundamentals remain stable
Defaults are increasing in the Asian high yield market. While higher defaults ultimately allow for better allocation of capital, they will also encourage further easing by Chinese authorities, although we do not expect stimulus to reach 2016 levels. In terms of risks, a trade war is still the biggest threat to corporate earnings and to the asset class' returns. In the months ahead, we expect Asian high yield (like US high yield) to generate coupon-like returns with bouts of volatility coming from news flow. However, fundamentals should remain stable as long as the Chinese authorities remain in easing mode.

Italy and Turkey weigh on European high yield bonds
Macro factors have been the main driver of European high yield markets of late. The asset class remains exposed to the uncertainty surrounding Italy and its upcoming budget announcement at the end of September. Volatility in Italian assets is likely to remain elevated and continue to influence the broader market (not least because Italian issuers make up such a large share of European high yield). Moreover trouble in Turkey, on Europe's border, and the ties between European and Turkish banks was a further headwind for the asset class. The country finds itself in a full blown financial crisis and the Turkish authorities are struggling to take unpopular but badly-needed decisions to put the economy back on track. In terms of valuations, the relative attractiveness of European high yield has diminished as yields on BTPs have risen in the past few weeks. We still have a cautious stance in light of the challenges ahead and expect other areas of the high yield market to be more attractive in the coming quarter.

Fixed income

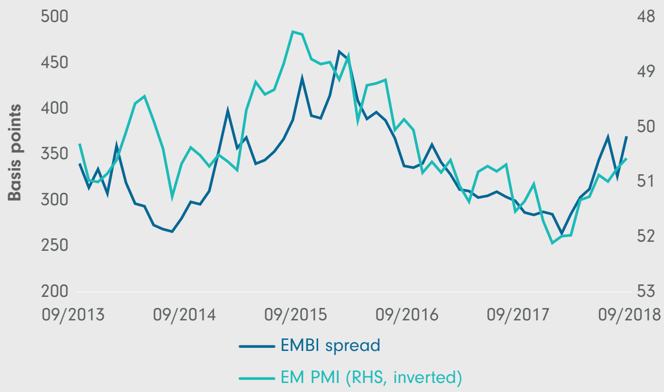
Emerging market debt

EMD yields climb above 6 per cent as pressure rises



ICE BofA Merrill Lynch indices used.
Source: Bloomberg, Fidelity International, August 2018.

EM spreads are closely tied to economic activity



JP Morgan bond indices used.
Source: Bloomberg, Fidelity International, August 2018.

Outlook

Turkey's woes look set to continue without decisive intervention

The rebound witnessed in emerging market assets that we saw in July did not last long. Despite a mixed performance by the dollar against G10 currencies, emerging market assets came back under pressure in August, driven by idiosyncratic stories. Turkey remained firmly under the spotlight as authorities delivered only muted responses to the financial crisis that is engulfing the country. The selloff in Turkish assets has seen little respite and the Turkish lira is down 40 per cent against the dollar so far this year. In our opinion there are plenty of textbook solutions to Turkey's problems which, if implemented, could halt the downward spiral in investor confidence and asset prices. They include an aggressive interest rate hike, installing pragmatic technocrats into key positions in the government, and encouraging the expansion of the manufacturing and export sectors to diversify the country away from consumption and construction. So far, however, there's been very little acknowledgement by Turkish authorities of the gravity of the situation and it seems unlikely that any of these measures will be implemented in a timely manner, if at all.

Problems are related but unlikely to trigger contagion

It may be tempting to take Turkey or Argentina's woes in isolation. However, we do not see them as the cause of broader EM stress or as standalone events. Rather they are a consequence of tightening global liquidity conditions, a stronger dollar and global geopolitical tensions.

Turkey and Argentina share quite unique and acute vulnerabilities, both having hefty current account deficits, high inflation, loose fiscal policy, low foreign exchange reserves, and large external financing requirements. It is therefore reasonable that they have come under most pressure to date. More broadly, however, the exogenous environment remains challenging for all emerging markets. Global liquidity withdrawal is picking up speed as the Fed raises interest rates and shrinks its balance sheet. The dollar should keep appreciating due to favourable growth and interest rate differentials between the US and the rest of the world, while global trade tensions remain a headwind for emerging economies given their sensitivity to global trade. Finally, a combination of cooling growth momentum, higher price pressures and tighter monetary policy in emerging markets will further add to headwinds in the months ahead.

Valuations in some parts of the market, particularly in hard currency sovereign debt, have adjusted to price in the macro challenges that emerging markets face. However, we feel that one last leg lower in the asset class could happen in the coming quarter. Emerging market currencies, meanwhile, continue to act as the main escape valve for imbalances and should remain under pressure until the Fed blinks and pauses its hiking cycle.

Alternatives

Commercial real estate

Key takeaways

- The lagged monetary cycle in Europe compared to the US and the UK continues to support the real estate market in the eurozone, bolstered by strong domestic demand and labour markets.
- Brexit headwinds are starting to impact the UK economy and investor sentiment more than has been the case to date. Sterling weakness and sluggish consumer spending look set to continue in the short term.
- In Europe we favour a defensive strategy focused on core markets, with Germany well positioned to mitigate late-cycle risks due to stable income, affordable rents and resilient capital markets.
- While we expect the coming quarter to be relatively quiet for the UK commercial real estate market, we see opportunities in regional office markets that have little exposure to the services and financials sectors.

Commercial real estate – Continental Europe

Outlook

There are supportive macro and real estate market conditions
European commercial real estate remains in high demand amongst investors as fears around trade wars start to distort capital flows, particularly those from Asia into the US. The supportive interest rate environment should act as an additional tailwind - the Fed and the Bank of England are further down the path to monetary normalisation than the ECB, which is not expected to start increasing interest rates until late 2019. The near term economic outlook is equally positive, with the economy on-track to expand by a healthy 2.1 per cent in 2018, before slowing to a still-above-trend 1.7 per cent in 2019.[2] The GDP data so far this year confirms robust domestic demand aided by continuing improvements in labour markets, helping to offset weaker external demand as tariff tensions slow global trade.

We expect the combination of strong corporate earnings and the relatively healthy economic outlook to continue to support modest rental growth and a healthy occupational landscape. Even though new development completions have been increasing across most markets, with vacancy rates close to (and in many cases below) their structural levels, the supply risk should remain relatively limited.

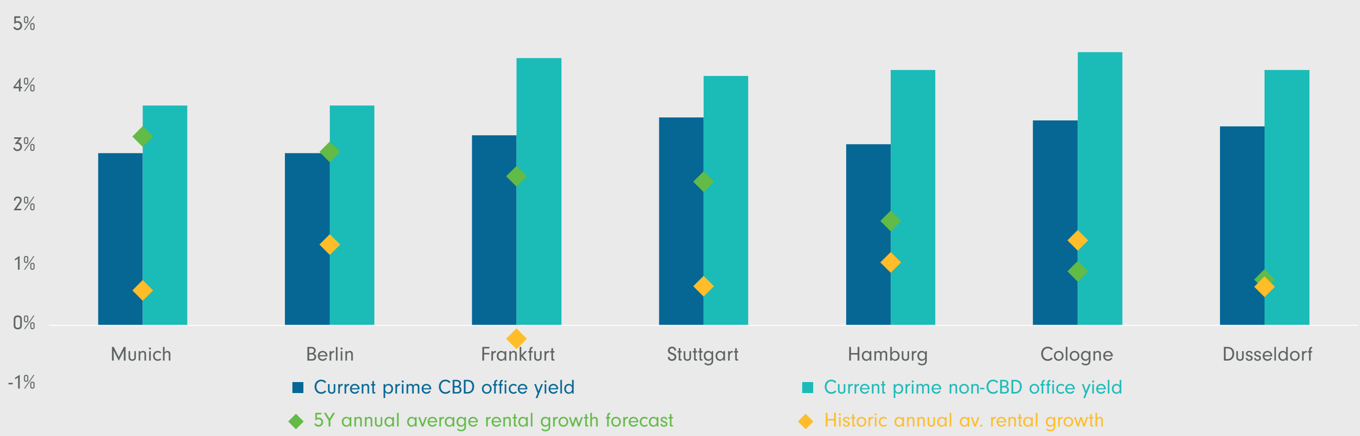
We favour defensive strategies in core eurozone markets
Given we are now late in the investment cycle, having passed the inflection point in terms of yield-driven capital value growth, we expect a slightly lower level of return in the eurozone from 2019 onwards. We believe an investment strategy focused on the core euro denominated markets will be best suited to provide protection from the ongoing political uncertainty and reduce negative impacts on performance from the currency volatility that has reduced international capital returns recently in markets such as Sweden.

Late cycle risk mitigation
We expect the market dynamics of the Netherlands and Luxembourg to offer strong performance differentiation. In addition, stable income, affordable rents and resilient capital markets should mean the German market can mitigate late-cycle risks. The strong pockets of rental growth in German offices make the sector particularly attractive. High demand elasticity, supported by strong and diverse occupier demand, at a time when vacancy rates are close or below structural lows, make Berlin, Frankfurt and Munich offices our preferred markets. In addition, constrained supply boosts five-year rental growth projections for Stuttgart offices although the city's high dependency on global trade (trade and industry tenants account for almost a half of letting activity) leave this market exposed to a slowdown in global trade.

Overall, we prefer a long-term approach of avoiding the significantly more volatile (in terms of capital values) prime market segments. We believe this is crucial to a successful late cycle strategy, as even a relatively small upward shift in prime yields would result in a significant erosion of values.

[2]Oxford Economics, July 2018.

Munich, Berlin and Frankfurt office rental growth expectations look attractive



Source: Fidelity International, Bulwiengesa, CBRE, Colliers, RealFor, August 2018.

Commercial Real Estate: UK

We are broadly more positive on UK commercial real estate than the market consensus

2018-2022 IPF Consensus Average Annual Total Return Range vs Fidelity / RealFor.
Source: Fidelity International, IPF UK Consensus Forecasts, RealFor, MSCI, July 2018.

Outlook

Brexit uncertainty impacts economic growth

The latest UK economic growth projections reveal the impact of Brexit-related uncertainty, with 2018 and 2019 forecasts cut to 1.3 per cent and 1.4 per cent respectively.[3] This is well below the long-term annual growth trend of circa 2.0 per cent,[4] and down on the 1.7-1.8 per cent per annum reported in 2016 and 2017.[3] As it stands, most economists expect the UK and EU to reach a withdrawal agreement, but the risk of the UK parliament rejecting it is high. Oxford Economics' latest analysis highlights either a 'Brexit in Name Only' scenario or trading with the EU on the World Trade Organization (WTO) rules as the two most likely eventual outcomes, each having a 31 per cent probability.

Quiet Q4 in tandem with muted trading volumes

We expect Q4 2018 to be a fairly quiet quarter for the UK commercial real estate market as participants await more clarity on Brexit. Aside from Brexit, the key to forming a clear mid-term view on the UK market lies in assessing the longer-term interest rate environment. After a 25-basis-point hike in August, the Bank of England clearly re-iterated that any future rate hikes are likely to occur at a "gradual pace and to a limited extent," meaning UK commercial real estate should continue to maintain a healthy premium over government bond yields, affirming it as a relatively attractive proposition in a broad investment portfolio. Despite this relative attractiveness, the central expectation is for some degree of Brexit-related market correction. In absence of any real clarity on the outcome of Brexit negotiations, any decline in investor sentiment and the extent to which it will affect pricing will be difficult to assess in the short-term, certainly in the non-listed real estate space.

Retail 'in the red' but quality industrial and logistics and selective UK regional offices remain resilient

In the first half of 2018, UK commercial real estate investment activity slowed to £20.1 billion, the lowest reading since the first half of 2013.[5] The sharpest decline has been in the retail sector, which has fallen 25 per cent below its long-term six-month average.[5] Retailers are under tremendous pressure to cut costs and store rationalisation should remain a major theme in the near future. We expect a steady flow of assets for sale as investors try to reduce their UK retail sector exposure.

Healthy letting demand, combined with a scarcity of grade-A office space, in part due to on-going residential conversions, leave many UK regional office markets in rude health. With little exposure to exports of services and financial sector exports, cities like Leeds, Sheffield and Bristol should avoid the worst of any Brexit-related negative impact.

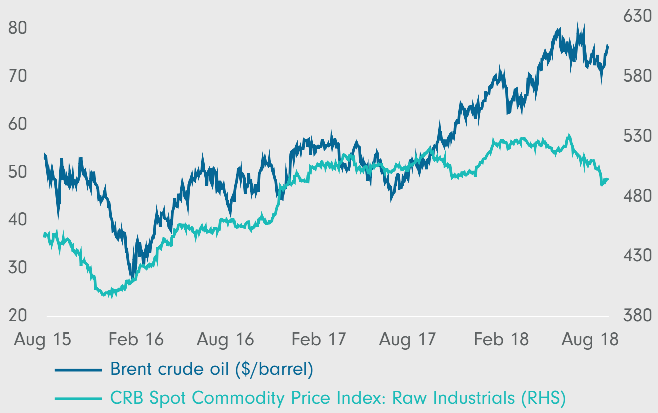
The industrial and logistics sector remains the best performer, with the five-year average annual total return forecast at 8.2 per cent per annum.[6] However, divergence in performance is starting to emerge between the last mile and multi-tenanted assets servicing the Greater London area and the South East, and the rest of the sector, especially the single-tenanted stock.

[3] Oxford Economics, July 2018.
[4] Oxford Economics, long-term average annual GDP growth over the 1990-2017 period.
[5] Source: Fidelity International, Real Capital Analytics, July 2018.
[6] Source: Fidelity International, RealFor, July 2018.

Alternatives

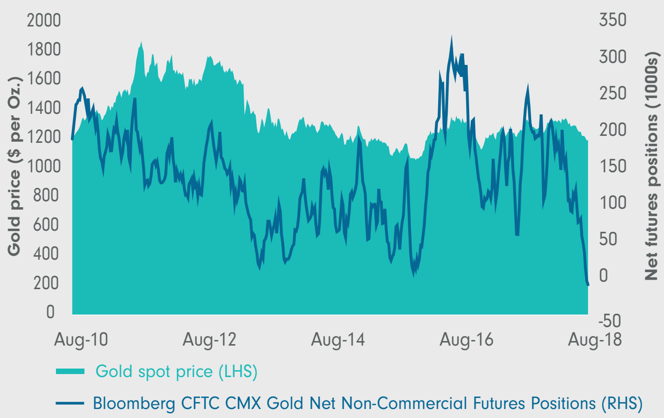
Commodities

The oil price has remained strong in the face of slowing global growth



Source: Bloomberg, Fidelity International, August 2018.

Large short positions in gold futures imply technical factors will impact the price



Source: Bloomberg. Fidelity International, August 2018.

Outlook

The slowdown in China will weigh on commodity markets

The outlook for commodities is mixed. The late stages of the economic cycle tend to be positive for commodity prices while growth remains robust and output gaps are closed. However, the continued slowdown in China's industrial sector will continue to weigh heavily on many commodities. On the demand side, the Chinese economy's previously unquenchable demand for infrastructure and real estate consumed almost half the global supply of many key metals and industrial commodities, but this driver is receding on the back of policy-driven financial tightening. Other emerging markets are also coming under stress, worsening the outlook for incremental demand in many raw materials in the near-term. The supply-side dynamics are more of a mixed bag and provide support for some commodities - especially after the price falls seen so far this year. One particularly notable beneficiary of a restricted supply picture is the oil price.

OPEC supply increases look set to cap oil price gains

Multiple demand and supply side uncertainties have muddied the oil outlook. The fundamental picture looks slightly more bullish in Q4 thanks to low levels of OECD inventories, strong oil demand growth, falling spare capacity and supply disruptions in key markets. The IEA recently increased its oil demand forecast for 2019 by 1 million barrels per day, while supply risks from Iran and Venezuela will continue to add a level of risk premium to the price. Yet we expect OPEC's decision to increase oil production to put a cap on any oil price rises in the near term. Over a longer time horizon, we believe the key drivers will be the risk of a reduction in Iranian supply and the fallout from the ongoing trade disputes.

Gold is being short sold in record amounts

Gold has continued its weak performance so far this year, driven by the strength of the dollar, rate hikes by the Fed, and lack of any serious upward surprises in US inflation. Speculators have even gone net short gold for the first time since 2001, an incredibly rare occurrence and a dramatic turnaround from the start of the year. However, profit taking from short positions could put a temporary floor underneath the price in the event of further declines. In addition to the technical factors, gold's status as a safe haven in times of market stress could make it attractive in the event of weakness in the stock market or additional geopolitical uncertainty, while another potential tailwind could materialise if the Fed were to signal a moderation of the pace of its rate hikes next year.

Alternatives

Alternative investments and strategies

The continued narrow US rally has hurt equity hedge funds in the last few months

Source: Thomson Reuters, Fidelity International, August 2018.

Outlook

- Selectively chosen listed infrastructure vehicles and hedge funds look attractive in absolute terms and particularly attractive relative to traditional markets in this current late-cycle environment.
- There has been a great deal of controversy over the use of PFIs (private finance initiatives) in the UK, and we expect additional volatility over the political conference season.
- Given the wide range of strategies available, from infrastructure to asset leasing to long/short equity or macro/event-driven strategies, we remain acutely aware of the importance of diversification across the very broad alternatives asset class.

Infrastructure assets have experienced mixed fortunes in the past year. Sentiment has been knocked in the UK in particular, as the exposure of poor management practices at certain high-profile contracting companies has combined with Brexit related uncertainty. While the picture has stabilised somewhat in recent months, public finance initiatives (PFI) in the UK are a highly sensitive topic politically at the moment and we expect additional volatility this quarter as the political conference season gets underway.

Long/short equity and Macro strategies:
There has been continued talk of peaks in the stock market, but despite weakness in many regions there is little sign of abatement in the upward trajectory in the United States. This has harmed hedge funds set on capturing value equities relative to their growth counterparts, and managers who are underweight or even shorting growth stocks have been hurt severely by being cautious too early. But in this late cycle environment, we expect well-chosen long/short equity funds and global macro funds to become increasingly important to investors, especially as dispersion and volatility increase and monetary policy tapering continues. However, it is worth noting that hedge funds as an asset-class are quite poorly represented by industry indices, while the wide spread between strong and weak performers increases risks and highlights the need to be selective in identifying differentiated opportunities.

Important Information

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