Q4 2019

Investment Outlook: Summary

Bending, not breaking

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

Fidelity INTERNATIONAL

Q4 outlook overview

If investors wanted a quiet summer period, they didn't get it. The third quarter saw no resolutions to the many risks weighing on the markets and introduced a few new ones. To the US-China trade war, global recession fears and Brexit we can add yield curve inversion, Hong Kong protests, a higher risk premium on oil as a result of Saudi production facility attacks and the threat of impeachment of the US president.

But no resolution does not mean an absence of progress. Central banks have turned dovish rhetoric into material action in both developed and emerging markets, which, along with lower bond yields that support growth and targeted Chinese fiscal and monetary stimulus, gives us comfort. And economic data is pointing to flatlining, not declining, activity. Crucially, the US consumer is proving resilient, helped by employment levels remaining at record highs.

However, growth is still weak and investors should remain on their guard. Consumer numbers should be watched closely. If consumer data components show signs of fraying it could remove a key support for the economy. Default rates in the most levered areas of the fixed income market have started to rise, albeit from a low base but could be a sign of vulnerability. In equities, the recent rotation into value stocks may prove short-lived without sustained economic recovery.

Fiscal policy is another theme. There are signs that monetary tools are reaching their limits and calls for fiscal stimulus are growing louder. If fiscal levers are pulled, it could have far reaching consequences across asset classes and regions, including the return of inflation, a weaker US dollar and a resurgence in emerging markets. Because of the role governments play in fiscal policy, and now, arguably, on monetary policy, it's prudent to be aware of political developments. However, it's also made central bank policy more unpredictable in both its direction and impact. In this more uncertain paradigm, investors are better served by centering their attention on individual companies and allowing themes to emerge rather than the other way around.

For now, the economy is bending, not breaking. In this environment we suggest portfolios are tilted towards safety but remain exposed to risk assets. That means a quality bias in equities, favouring US government bonds for protection in market sell-offs and being more selective on tenant exposure within real estate. As we enter the fourth quarter, there's plenty in the calendar to keep markets anything but quiet.

Paras Anand
Head of Asset Management, Asia Pacific

Fidelity's Global Asset Allocation

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.

Fidelity's Global Asset Allocation process is led by:

- **Paras Anand**, Head of Asset Management, Asia-Pacific
- **Anna Stupnytska**, Head of Global Macro and Investment Strategy (GMIS)
- **Wen-Wen Lindroth**, Lead Cross-Asset Strategist

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House view

No global recession imminent but visibility poor beyond 2020

Wen-Wen Lindroth
Lead cross-asset strategist

There's been increasing talk of a global recession but we don't see an imminent risk of such an event. The economic data is pointing to slower but positive growth in the US, and there's evidence of some resilience globally through to the end of 2020. However, visibility is low beyond that point. We suggest paying close attention to 2020 earnings estimates, consumer and employment data and private equity flows to understand where the balance of risks could play out.

We are neutral risk at an aggregate level in equities and credit. Signals from key data points are diverging, whether that's weak manufacturing data versus strong consumer and labour data or continuing trade tensions versus easing monetary policy. We express our view through moving up in quality, selectivity and long Yen exposure. We pare back risk in the euro periphery area, emerging market sovereign debt and currency.

Inflation has been a key debate for us, and we have turned bullish. There are signs of rising inflation in the US, and any expectation of eventual fiscal stimulus suggest that inflation breakevens are very cheap at current prices. As a result, we are positive on gold as an inflation play. We have turned less bullish on emerging markets in general. The emerging market recovery has not been as strong as the market had hoped and next year could prove to be even tougher.

In real estate, given the late cycle market conditions, we have reduced our exposure to growth and shifted portfolios to emphasise income liquidity and stability, and are closely monitoring the UK market for opportunities as non-core assets are re-priced.

Asset class breakdown

Equities

Near-term we remain neutral on equities. Our fundamental view assumes slower but plateauing growth, but we are vigilant around 2020 earnings, given recent downward earnings revisions. We are focusing on 'quality at a reasonable price' and maintaining a bias to growth over value in a soft economic environment.

Fixed Income (government bonds)

We are moderately overweight in the near-term on government bonds, reflecting our preference to buy US Treasuries and Gilts on price weakness. We have moved to tactically neutral on Bunds and Chinese government bonds. The European Central Bank underwhelmed in its latest quantitative easing package and valuations are unattractive assuming a recession in Europe is not imminent. CGBs face technical headwinds in supply, causing us to take profits.

Fixed Income (corporate credit)

There's no change to our near-term overall neutral view. The outlook is highly uncertain. Investors are weighing the conflicting forces of late cycle dynamics, trade and geopolitical risks, a global manufacturing recession and a historic year-to-date rally on the one hand and still resilient labour and consumer data and central bank dovishness on the other.

House view

Changes to positioning

September 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	□□■□□	0	□□■□□	0	**Near-term view on equities remains neutral.** Fundamental view assumes slower but plateauing growth, but with high level of vigilance around 2020 earnings, given downward earnings revisions. Focusing on 'quality at a reasonable price' and maintain bias to growth over value. Relatively neutral on region.
US	□■□□□		□■□□□		
Europe	□□□■□		□□□■□		
Japan	□□■□□		□□■□□		
EM	□□■□□		□□■□□		
EM debt	□□□■□	-1	□□□■□	-1	**Downgrading to moderate overweight.** Lower return expectations on failure of stronger growth to materialise over the summer against a backdrop of lingering trade tensions and rising geopolitical risk. Valuations still attractive versus other asset classes but largely at 1-year tights.
EM Corp	□□□□■		□□□□■		
EM Sov $	□□□■□		□□□■□		
EM Sov local	□□□■□		□□□■□		
Credit	□□■□□	0	□□■□□	0	**No change to near-term overall neutral view.** An uncertain picture stemming from the conflicting forces of late cycle dynamics, trade and geopolitical risks, a global manufacturing recession and a historic year-to-date rally; countered by still resilient labour and consumer data and central bank efforts to prolong the expansion by any means necessary.
Global IG	□□■□□		□□■□□		
Global HY	□□■□□		□□■□□		
Asia Credit	□□□■□		□□□■□		
Soveriegn bonds	□□□■□	0	□■□□□	0	**No change to near-term moderate overweight.** This reflects our preference to buy US Treasuries and Gilts on weakness. We moved to a tactical neutral on Bunds and Chinese government bonds. The ECB underwhelmed on QE and valuations are uncompelling assuming a recession in Europe is not imminent. We've taken profits on CGBs, which face technical headwinds in supply.
US	□□□■□		□■□□□		
Europe	□□■□□		□■□□□		
UK	□□□■□		□□■□□		
China	□□■□□		□□□■□		
Cash	□□■□□	0	□□■□□	0	Neutral over the near-term view.

House view

Strong conviction longs and shorts

September 2019: Medium term (12-18 month) view

Asset class	Long/Overweight	Short/Underweight
Equities	■ **'Quality at a reasonable price':** Reflecting the reach for yield, central bank support and share buybacks. A hedge against late cycle risks. ■ **Small cap equities:** Size factor, related to cyclicality, less liquidity and higher leverage, has been very detrimental to small caps over the last two quarters. These fears are now more than discounted in the price. ■ **EM Asia:** While vulnerable to trade tensions, the overall picture remains positive, given central bank easing and Fed cuts leading to a lower USD.	■ **Banks:** Lower for longer policy rates a significant headwind. ■ **Value:** We do not see the rotation from momentum into value as sustainable; recent surge more likely a dead cat bounce.
Fixed Income	■ **Breakevens:** Signs of rising US inflation, eventual stimulus and valuations amongst the cheapest in fixed income drive our overweight position. ■ **EM corporates:** Slightly less risk-on due to sluggish growth, but stimulus, monetary easing and valuation remain tailwinds in our view. ■ **Chinese govt bonds:** Continued PBOC easing and expectation of eventual convergence to US Treasury yields.	■ **US Treasuries and Bunds:** Although downside risks are growing, our base case is that the global economy will bend but not break over the course of 2020. We also see some upside risk to US inflation. US Treasuries and Bunds price in more recession risk and rate cuts than we currently
Currencies	■ **JPY:** Expect soft global growth to keep JPY well-bid as a fundamentally cheap safe haven. Rate differentials are also closing with other economies, given the BoJ's limited ability to lower rates.	■ **USD:** We are negative on USD over the medium-to-long-term on valuation. An accommodative Fed and slower growth should also contribute to a lower USD.
Commodities	■ **Copper:** Near-term, global growth will override fundamentals. Longer-term, struggling supply conditions and solid demand should provide support for copper price. ■ **Gold:** In a depressed real yields environment, gold should outperform; similarly, it will do well in the context of an inflationary policy response.	■ **Natural gas:** Ramping US shale oil results in US gas as a by-product. ■ **Iron ore:** Recovering supply over 12-18 months and softening demand.
Real Estate	■ **EUR mixed use:** Tenants attracted to assets integrated into the urban fabric, offering attractive live-work-play environments in order to attract and retain staff. Expected to be resilient in any slowdown. ■ **Focus on income:** Acquire longer duration (5+ years) and extend leases on existing assets to provide liquidity and income stability within portfolios.	■ **Low liquidity markets:** Aggressive repricing no longer compensating for additional risks. ■ **UK retail:** Sector has begun to reprice, but disruption still impacting on security of income.

Economic outlook

Overview

What's changed

Data continues to be mixed with the US showing clear signs of slowing down, Germany in recessionary territory, but signs of tentative stabilisation in the Eurozone, emerging markets and China. Both major and emerging market central banks are taking dovish action.

Key takeaways

- Key headwinds from 2018 are reversing this year. We expect a recovery from the lows of Q4 2018, but still-subdued growth acts as a warning against complacency. We don't subscribe to the view that we are facing an imminent global recession.
- Easier US Federal Reserve policy is a boost to growth, and China stimulus is big enough to matter. Emerging market countries are slashing interest rates, which will also eventually feed through to bolster Europe.
- The US-China trade war delays and damages the global recovery, but it has not derailed it so far. The direct impact is limited in size and scope, and its disruption and volatility will fade.
- In our view, the US economy will slow, while the rest of world will stabilise. The US faces drags from fading fiscal stimulus, corporate debt overhang, falling business confidence, and a more mature economic cycle.

Investment implication

With key headwinds from last year reversing, even in the face of ongoing US-China uncertainty, there is a basis for expecting continued recovery and global growth compared with Q4 2018. Overall, the Fidelity Leading Indicator (FLI) suggests that global bond yields should rise from their current depressed levels and risk assets should be modestly supported.

Equities

Overview

What's changed

The themes of central bank dovishness, growth and recession worries, yield curve inversion and the US-China trade war continue to dominate. Corporate earnings have been somewhat side-lined this quarter, as global geopolitics has become the driving force determining the push and pull factors in regional markets.

Key takeaways

- Global equities faced a torrid first half of the quarter as numerous geopolitical and economic headwinds dampened sentiment. Sentiment improved in the second half of the quarter as positive political developments and a dovish bias from central banks took hold.
- Relatively placid markets in September belied a sharp switch in the momentum versus value trade. But given the economic backdrop we think this may be short-lived.
- Renewed calls for fiscal policy could start to sway policymakers. With diminishing gains from monetary policy and lows bond yields, the argument for fiscal stimulus becomes more convincing.

Investment implication

Despite favourable news on US-China trade and global monetary policy easing, the economic backdrop remains uncertain. Such an environment favours more defensive, growth companies. However, if the macro outlook does become more supportive, and if we see a shift from monetary to fiscal stimulus, we could see the momentum trade evolve from defensive-growth to more cyclical areas. Such a shift could pose risks as the defensive-growth trade has become crowded.

Fixed Income

Overview

What's changed

The US Federal Reserve cut rates for the first time since the global financial crisis, implementing two 25 basis point cuts. The US Treasury curve flattened, with the 2-year and 10-year yields inverting for the first time since 2007. Many sovereign bond yields in Europe reached all-time lows in August. The European Central Bank announced a new round of quantitative easing having only finished its previous programme nine months ago.

Key takeaways

- The ongoing trade war and weak economic data spurred investors to seek out safe-havens such as government bonds and gold, a reflection of mounting concerns of an upcoming recession.
- The ECB's package of a 10 basis point reduction in the deposit rate and 20 billion euros of monthly asset purchases for an indefinite period should reduce average volatility over the medium term, but is probably not enough to reduce short-term volatility.
- Brexit continues to dominate in the UK. Beyond that, the UK economy is weak and there is an argument for monetary easing from the Bank of England.

Investment implication

We are positive on US government bonds to guard against sell offs in risk markets. The underwhelming quantitative easing package from the European Central Bank should mean that spreads widen between semi-core countries and Germany.

Multi Asset

Overview

What's changed

Following the rally through the first half of the summer, US equities reversed all-time highs at the end of July just as the US Federal Reserve cut rates for the first time in a decade. While prices bounced back in early August, markets did not react as positively to the 25 basis point rate cut as many investors predicted. Trade news continues to exert an outsized influence.

Key takeaways

- Markets have been wobbly despite the Fed rate cuts. President Donald Trump's tariff escalation, and the US Treasury Department's accusation of China currency manipulation, has weighed on sentiment.
- Over 2019 so far, risk assets have performed strongly but demand for safe-haven assets continues to be resilient. This seeming contradiction is sending a mixed message to investors.
- We see two possible scenarios emerging: either flatlining but not declining growth or a further slowdown feeding through to impact consumer and service sectors forcing a rerating downwards. At this point, we are leaning towards the first scenario.

Investment implication

In some of our portfolios, managers are choosing to hold 'taper tantrum insurance' in the form of exposure to financials that should outperform in the event of monetary tightening. Despite the flat yield curve - typically a bad sign for banks - this position hedges against the risk of central banks surprising markets with a hawkish move or inflation coming in higher than expected.

Real Estate

Overview

What's changed

The economic outlook for both the UK and the Eurozone is more subdued, with growing concerns over weakness in the manufacturing sector and a build-up of external risks, such as trade tensions and Brexit. Reflecting the weaker growth, inflation expectations have been revised downwards. If inflation does turn out to be lower in the short to medium term, this will reduce the levels of income growth that real estate investors will be able to capture through lease indexations.

Key takeaways

- Brexit-related uncertainty has shoved many investors in UK real estate to the sidelines. However, the weakness of sterling and expected falls in property prices, especially in the retail segment, could see investors move back into the market relatively quickly, in the event of a moderate Brexit scenario.
- The manufacturing sector will remain weak whichever economic scenario prevails, and real estate investors should focus on understanding their tenant exposure to the sector.
- In the Eurozone, investor competition remains high, sustaining expensive pricing.
- Strong income characteristics, urbanisation, land values and growing liquidity across several alternative sectors will be some of the key near-term investment themes in both the UK and the Eurozone.

Investment implication

Real estate will continue to be favourably viewed in a multi-asset portfolio for its attractive pricing and income, but the recent softening of economic growth and the escalation of external downside risks call for a more tailored approach to late-cycle investing. Being selective and actively assessing tenant exposure to optimise and sustain high income returns, while limiting allocations to markets and sectors that historically have been illiquid during downturns, is key.

Important information

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