

2019



Fidelity
INTERNATIONAL

Market outlook

Changing tracks





Alva Devoy
Managing Director
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The return to normal

Quantitative easing has been the only game in town for years but the game is now changing. Ten years into the longest bull run in history, major dislocations are starting to appear, characterised by bouts of volatility as we return to a more normal investing environment.

The US effect

In this more volatile environment, we expect US corporate earnings growth to slacken in 2019, but remain positive, at around 8 or 9 percent. An unusual set of circumstances boosted year-on-year growth in US earnings per share to an average of around 24 percent in the first three quarters of 2018. The cocktail of lower corporate taxes, a reduced regulatory burden, and a growing economy helped the US market outperform those of other countries. These factors are however one-offs and we expect their impact on earnings growth to fade in 2019. US earnings will grow but at a reduced pace, more in line with the performance of the real economy.

Companies may well start to see headwinds, such as rising cost inflation, intensifying in 2019. Labour-intensive sectors are the ones most exposed, and we will be closely watching the extent to which freight cost inflation and increasing wage costs are borne by consumers. We see a risk that companies will have to absorb some of this, putting pressure on margins.

The debt threat

The biggest threat to equities in 2019 is debt. The 10-year quantitative easing experiment, coupled with a debt-fuelled boom in China, has left the world with a big tab to pay.

Central banks lowered the cost of debt funding in response to the global financial crisis in 2008, and there is a natural limit to how far and how fast they can normalise it. Given the sheer amount of debt in the global economy, a full return within a few years to the aggregate

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interest rate of last cycle (around 4.5 percent) is simply unaffordable. While the global aggregate interest rate increased from 1.2 per cent to 2.2 percent over the last two years, going further than this could risk triggering a new financial crisis, something no central bank is willing to do.

Problems in the debt market have the potential to spread to other parts of the financial system which is why we're paying attention to the Italian bond market and the Chinese corporate bond market. We're more concerned about China than Italy. While the Italian bond market is the biggest in Europe, it's predominately in the hands of domestic investors, who think long term and don't panic in periods of market volatility. The Chinese market is less mature and is experiencing its first ever credit cycle, marked by a first wave of defaults. Chinese policymakers have a lot of tools available to them to stimulate the economy in response but it remains to be seen how investors will react.

A note on volatility

Above all else, financial markets dislike uncertainty. Yet markets are also prone to over-react to events that cloud the short-term outlook. As an investor, it is important to take a step back at these times and keep an open mindset. When we're prepared at the outset for episodes of volatility on the investing journey, we're less likely to be surprised when they happen, and more likely to react rationally. By having an open mindset and a longer-term investment perspective that accepts short-term volatility, investors can begin to take a more dispassionate view. Not only does this help with the job of staying focused on long-term investment goals, it also allows investors to begin to exploit lower prices rather than lock in losses by emotionally selling at lower prices.

Thank you for your support of Fidelity throughout 2018 – we look forward to continuing to create better futures for your clients with you in 2019.



Paul Taylor
Country Head –
Equity Investments

Despite dire predictions, I believe 2019 will be a stronger year for the Australian equity market as much of the uncertainty we've experienced this year will have played out. Interest rates remain low, balance sheets are strong, earnings growth is still mid-single digits, valuations have improved and dividend yields are attractive. I would expect to see earnings growth combined with valuation expansion in 2019 driving solid investment returns for the calendar year.

To date the Australian Equity Market (ASX 200) has delivered a negative 2.5% return for the year following strong returns in both 2016 and 2017.1 Market concerns around higher interest rates, a US/China trade war and declines in the residential property market consumed positive returns from the first half of 2018.

Outlook for Australian Equities

In 2019 I believe we'll see a returned focus to high quality businesses with strong cash flows and high certainty of earnings. Over the last few years low quality businesses have been pushed up by the stock market on higher inflation and growth expectations. I think this is unlikely to continue in 2019 as fundamentals re-exert their dominance.

Personally, I always love these periods in investments markets as it gives me the opportunity to buy the businesses I've always wanted to own at much more attractive valuations. Warren Buffet once said that as an investor, it is wise to be "Fearful when others are greedy and greedy when others are fearful". It certainly feels like a lot of people are fearful right now. Is it time to get greedy?

2019 is also looking like another important year for the banks and financial services with the Royal Commission releasing their findings on 1 February. While the report is unlikely to be pleasant reading it could also, interestingly, bring more certainty to the sector as companies start to put poor behaviour and bad press behind them. With more attractive valuations, low expectations and high dividend yields, banks could end up having a much improved 2019.

The resource sector looks to have more mixed prospects ahead. In general, balance sheets are strong and management teams are taking a disciplined approach to the cycle. In the past, the majority of blow-ups were caused by poor balance sheets so the sector's disciplined approach to capital is certainly positive. On the negative side, China is slowing with the potential US /China trade war further subduing

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demand and weakening commodity prices. So, strong balance sheets but vulnerable commodity prices translate to more mixed prospects for the sector and the need for investors to have a more selective approach. I remain focused on quality, strong cash flow businesses that have greater certainty in their earnings outlook.

The sectors I believe to be best positioned in 2019 are consumer staples and healthcare. Strong cash flows and greater certainty around earnings are attributes that will be in demand as the market's higher expectations on interest rates and inflation begins to moderate. In addition, companies and sectors that can deliver growth in this environment are also likely to be chased by the market as earnings growth is proving a rare attribute in these market conditions. I firmly believe that in strong economic conditions a rising tide is likely to lift all ships, in tougher conditions you really need to back the best management teams to deliver a strong strategy and execution.

The residential property market is also likely to continue its soft landing in 2019. Residential property prices in Sydney and Melbourne are fundamentally over-valued however there isn't a catalyst for major declines but rather a soft deflating of prices. I would expect residential property prices in Sydney and Melbourne to be flat to slightly down in 2019 which points to a more subdued year for residential property services and construction related companies.

The other key event for markets in 2019 will be the Federal election. While there are concerns around some possible policy changes like Capital Gains Tax (CGT) discount, negative gearing and franking credit refunds, it is likely that the election results will bring more certainty. Australia has had considerable political instability over the last decade and the 2019 Federal election result has the potential to bring more stability. Political stability allows companies to make decisions and better invest for the future.

2019 is shaping up as a better year for investment returns in the Australian share market. More attractive valuations, solid dividend yields, strong balance sheets and a returned focus to quality, cash flows and fundamentals should provide investors the potential to reap good rewards.

Finally, I would like to take this opportunity to wish you all a wonderful holiday season and a fantastic 2019.



Amit Lodha
Portfolio Manager
Fidelity Global Equities Fund

Late cycle: time for caution or opportunity?

We believe that we are in the throes of a late-cycle bull market, often accompanied by bouts of volatility and recession fears. As we move towards 2019, investors must guard against the market rotation, as the sectoral distribution of returns tends to change during such periods.

2019 investment outlook for global equities

Going into 2019, I remain cautious on the outlook for global equities, in view of the risks in the current late-cycle environment. Tightening US monetary conditions, global trade frictions, slowing Chinese growth, Italy's debt problems and rising interest rates at a time of higher corporate indebtedness, present headwinds to the global economy and equity markets.

So far, the trade tensions and rhetoric around US-China relations have disproportionately impacted emerging market equities. However, the inter-linked global value chains mean that bilateral trade tensions between the world's two largest economies could have global ramifications. Add to this rising crude oil prices, which are primarily driven by supply distortions in Iran and Venezuela, are also weighing on oil-importing economies, and this calls for additional caution.

Within Europe, the market has punished Italian equities and government bonds for the country's debt-laden budget, and we could expect more volatility as negotiations with the European Commission continue. All of these issues are interdependent, as the path of the oil price in some cases drives the path for bond yields and emerging market currencies. What is making things more complex is that price signals are increasingly spurious, as they are driven by algorithms and ETF trading.

Nonetheless, a late cycle is still positive for risk assets, and increased market volatility can create interesting dislocations and offer interesting buying opportunities to add value.

What could most surprise investors next year?

The super bearish case for global equity markets would be the further acceleration of ongoing trade wars – and it seems to me that trade and defence are two sides of the same coin. Trade uncertainty lasting for longer could become a drag for investment, and would be very negative for investors. But I also believe that this would force Chinese authorities to push even more aggressively towards a stimulus scenario to counter the effects of a slowdown in its economy.

The current market scenario seems to be where one needs to tread cautiously in terms of portfolio construction, with greater emphasis on finding stocks that lose less, rather than gain more.

How China's stimulus plan would translate into actual impact is unclear, as it depends on the monetary and fiscal stimulus size, given the constraints of moving from surplus to deficit on the current account.

On a positive note, the bullish case for global markets involves oil prices coming down and the US Federal Reserve suggesting that it would take a pause and watch data due to uncertainty from trade-related disputes. With rising raw material costs and wage pressures, the Fed needs to start cutting rates or suggest that it is done. This would be an extremely Goldilocks-positive scenario (good for growth stocks and bad for value stocks). It could also be the time to buy defensives.

Capturing the best opportunities

The flattening yield curve and extended debt levels are giving us reason to be careful, however the strong corporate earnings growth and still tight credit spreads suggest room to run for equity markets. Although absolute valuations don't give you a sufficient margin of safety, on a relative basis compared to fixed income markets, equities remain attractively valued.

The current market scenario seems to be where one needs to tread cautiously in terms of portfolio construction, with greater emphasis on finding stocks that lose less, rather than gain more.

Our global equities portfolio is well-diversified across a range of industries and sectors, with no regional and sector bias. Our focus remains on bottom-up stock picking, so the regional weightings of the portfolio are not necessarily a reflection of our top-down view of the markets.

US and Japan continue to provide interesting bottom-up investment opportunities. The US growth outlook remains strong, due to robust macroeconomic data, tax cuts and fiscal spending stimulus, while overseas cash repatriation is encouraging buyback activity.

At a sector level, the focus is on information technology stocks – less on FANGS and more on old tech names like ORACLE and Microsoft, which have solid business fundamentals. I have a more positive view on the direction of oil prices, and continue to invest in long-term ideas in the healthcare space.

Overall, I believe that stock-specific fundamentals will remain the key driver of equity returns. Consequently, the portfolio continues to focus on companies that demonstrate strong pricing power, are led by talented management teams and are available at reasonable valuations.



Alex Duffy
Portfolio Manager
Fidelity Global Emerging
Markets Fund

Positive returns, despite ongoing volatility

Investment risks in 2019 are finely balanced within global emerging markets. Although we see volatility continuing, we expect a positive return for emerging market equities next year, with potentially greater dispersion of returns across regions than we have seen in the last 3-5 years.

2019 investment outlook for global emerging markets

Investment risks in 2019 are finely balanced within global emerging markets (EM). The overarching downside risk to the asset class remains that of a sustained softening of Chinese economic activity or worse, a substantial devaluation of the RMB, and a rise in Chinese funding costs leading to pressures on asset quality within the banking system and tightening liquidity conditions. The authorities are well aware of these risk factors and there are multiple ways in which they can mitigate them – the recent trade truce with the US is a step in the right direction.

On the positive side, EM equities are finishing a difficult year at relatively-attractive valuations, and while earnings estimates in EM Asia in particular are likely to see further downward revisions, expectations are being reset for a much healthier entry point than that which we experienced in December 2017.

On the balance of probabilities, my base case is for a choppy but absolute return for EM equities, but with potentially greater dispersion of returns across regions than we have witnessed in the last 3-5 years.

What most surprise investors next year?

Latin American and EMEA (Europe, the Middle East and Africa) equities outperformed EM Asia, on account of the underperformance of technology stocks. In many instances, we believe that technology and internet stocks are relatively expensive, with high expectations built into consensus forecasts. The leaders of the next bull market are very rarely the same as the leaders of the prior one.

On the balance of probabilities, my base case is for a choppy but absolute return for EM equities, but with potentially greater dispersion of returns across regions than we have witnessed in the last 3-5 years.

On the negative side, without a reasonably timely resolution to the US-China trade dispute, I see the likelihood of a devaluation of the renminbi as being quite high. Chinese equities are already discounting a reasonable part of this, however, and so I think that investors could be surprised by positive returns in Chinese stocks, despite currency devaluation.

Capturing the best opportunities

The focus remains on owning well-managed business with attractive return profiles, an accretive reinvestment opportunity and a valuation that offers an adequate margin of safety on a free-cash-flow basis.

There are numerous examples of such opportunities across EM and I have been concentrating the portfolio in the higher conviction names, as valuations have become more attractive

I view the financial sector as being one of the most interesting areas of the market, given the balance sheet quality of dominant, retail-facing banking models. These businesses look to be well-positioned to serve the pent up demand for finance and consumption across emerging markets.

The materials sector also looks to have a number of businesses offering attractive dividends and yields. Such stocks will likely deliver adequate returns in the current environment and should benefit from any effort by the Chinese government to stimulate its economy.



Anthony Srom
Portfolio Manager
Fidelity Asia Fund

Stay selective on Asian equities

We expect Asian equity markets to remain challenging, given continued volatility and muted global growth. While we remain cautiously positioned, we are ready to act on opportunities as they arise.

Three take aways

- 1 We expect 2019 to be a challenging year for equities, with the key for the Asian region being how China addresses its structural risks.
- 2 The US back-tracking on its Quantitative Tightening program and cutting interest rates could surprise markets.
- 3 We remain focused on companies with strong balance sheets and resilient demand, as these should see relatively better earnings than those more cyclical parts of the market.

2019 investment outlook for Asian equities

I think 2019 will be a challenging year for equities, as some of the excesses from the past decade come to a halt.

Many investors point towards increasingly cheaper valuations, however I don't see a huge amount of value, given earnings revisions are likely to trend down as global economic growth remains muted.

China is the key for the Asian region, as it faces increasing structural risks, such as addressing excessive debt, which are unlikely to be resolved without having an impact on external financial markets. Quantitative Tightening (QT) and deleveraging policies globally should mean a continued tightening of liquidity, which is likely to increase volatility.

China is the key for the Asian region, as it faces increasing structural risks, such as addressing excessive debt, which are unlikely to be resolved without having an impact on external financial markets.

Investors will need to be very selective about the companies in which they invest, with an extra focus on companies with strong balance sheets being necessary to weather this storm.

What could most surprise investors next year?

Two things come to mind.

First, some large 'stimulus' from China that it can ill afford, whether it's infrastructure-led, or personal consumption-led via tax cuts or subsidies. Second, the US Federal Reserve begins cutting rates as it back-tracks on its Quantitative Tightening.

Either of these is possible should markets fall materially. If this occurs, we will look to deploy some of the portfolio's cash into existing or new ideas.

Capturing the best opportunities

With tougher markets and heightened volatility ahead, the portfolio remains conservatively positioned, however we are ready to act on opportunities as they arise, such as our recent buying of selective China A-shares.

The China A-share market was one of the worst performing regional markets in 2018, with an indiscriminate sell-off across almost the entire market providing some interesting stock-specific investment ideas.

I remain focused on companies with strong balance sheets and resilient demand, as these should see relatively better earnings than some of the more cyclical parts of the market. Most of the portfolio's India holdings have been sold, however we'll be ready to buy back into this market should valuations become more attractive.

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