

A delicate balance

Investment outlook

Q3 2019

Fidelity Editorial

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A delicate balance



As we enter the third quarter, we are in a finely balanced position epitomised by an overly pessimistic bond market on the one hand, and an optimistic equity market on the other. We think we are somewhere in between those views.

The bond market, egged on by dovish central bank rhetoric and US-China trade war concerns, is fearing recession, and the equity market is hoping for continued dovishness and progress in trade disputes. The US economy is slowing down but we don't think it will slip into recession, so the extent of dovish Fed expectations may be overdone. And trade talks will rumble on - this is not a fleeting battle, it's a drawn-out war. Central banks are attempting to extend a cycle that has already gone on for a long time, and this ratchets up the potential volatility we could see as investors weigh up data, policy and political developments. The best defence for investors is maintaining clear-eyed, sober analysis and focussing on the long term.

Key highlights

House view

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We have adjusted allocations to reflect the increasing risk-off sentiment among our portfolio managers. In the near-term, we have downgraded equities and cash, and upgraded US Treasuries.

Economic outlook

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While the bond market is gloomy about the economy, US equities are banking on an accommodative Fed and positive news in US-China trade. We think this is too optimistic on both counts.

Equities

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Overall valuations are higher than normal but not yet in bubble territory. Positive global growth and Fed dovishness should support valuations in the long term.

Fixed Income

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In the short term, we have marginally increased credit exposure based on the dovish tone from policymakers. However, our long-term view of de-risking and seeking quality yield remains in place.

Multi Asset

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Despite the risk of disappointing fundamentals, the Fed's dovishness will support asset prices so we are neutral on equities. We continue to take a nuanced view at the regional level however.

Real Estate

27

While real estate remains attractive in relative terms, mispricing is becoming a major challenge. Style drifts are growing and pricing premiums are narrowing.

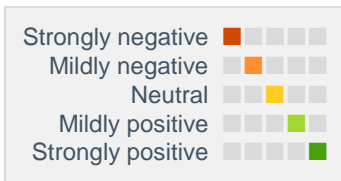
House view

“Market conditions are a potentially combustible mix, and this has driven our shift to more defensive positioning. Macro risks arising from unresolved US-China trade tensions, a still-tentative bottoming in global macro data and exogenous shocks all have the potential to derail the fragile stabilisation in global growth.”

Wen-Wen Lindroth, Lead Cross-Asset Strategist

House view on asset allocation

June 2019



Asset Class	Near term (3-6 months)	Medium term (12-18 months)	Long term (2+ years)	Key views
CASH	Change: 0	Change: 0	Change: 0	<ul style="list-style-type: none"> Our position on cash is neutral. In the near-term, this is driven by expected underperformance of cash versus UST and higher quality credit. Over the medium- and long-term horizons, risk assets should outperform cash.
EQUITIES	Change: ▼ 1	Change: 0	Change: 0	<ul style="list-style-type: none"> NEAR TERM: We are downgrading equities to underweight from neutral. Many market segments are overpricing global growth prospects, while trade war tensions could catalyse a sell off. We continue to take a nuanced view at a regional level, however. MEDIUM TERM: We remain neutral on equities. We are cautious due to late cycle dynamics and increasing risks posed by populist policies globally. On the other hand, technicals remain supportive in the form of central bank purchases, corporate buybacks and the 'Japanification of Europe'. Importantly, central banks appear ready to intervene once again, should the global economy show signs of a recession. LONG TERM: We remain overweight, as equities should remain supported by global growth and valuations.
GOVERNMENT BONDS	Change: ▲ 2	Change: ▲ 1	Change: 0	<ul style="list-style-type: none"> NEAR TERM: We are upgrading US Treasuries to overweight from underweight, as the rapidly escalating US-China trade tensions have tipped the Fed from a hiking to an easing bias. Expect tighter financial conditions to persist amid extended rhetoric. We upgraded Gilts to neutral; remain underweight Bunds and overweight Chinese government bonds. MEDIUM TERM: We are upgrading US Treasuries to neutral from underweight. Downside macroeconomic risks related to the trade tensions are growing; this is balanced by un compelling government bond valuations. We remain underweight in Bunds and Gilts; overweight CGBs in the medium term. LONG TERM: We remain underweight, as risk assets should provide better risk-adjusted returns in the long run.
CREDIT	Change: ▼ 1	Change: 0	Change: 0	<ul style="list-style-type: none"> NEAR TERM: We are downgrading both IG and HY credit to neutral from overweight, due to escalating trade tensions, rising political uncertainty and growing signals of a global slowdown. We continue our trend of moving up in credit quality and prefer shorter versus longer duration in credit. MEDIUM TERM: We are downgrading both IG and HY credit to neutral from overweight, for the same reasons as above. We believe these risks are likely to persist over a 12-18 month horizon. LONG TERM: We remain overweight, as credit risk assets should outperform government bonds and cash over the long term.

Source: Fidelity International, June 2019

Strong conviction views

June 2019

Asset Class	Strong POSITIVE conviction	Strong NEGATIVE conviction	Key views
EQUITIES	<ul style="list-style-type: none"> Tech (bottom up equity call) EM Asia Energy (bottom up equity call) 	<ul style="list-style-type: none"> Europe Materials (bottom up equity call) 	<ul style="list-style-type: none"> Tech: Highest aggregate stock ratings amongst our analysts and fastest 2020E earnings growth. EM Asia: Chinese credit growth is a major tailwind for the region, but we are watching closely for any moderation after possible distortions from the New Year. Valuations remain attractive and fundamentals are also holding up. Europe: Consensus has been bearish on Europe given a sharper-than-expected growth slowdown since the start of 2018 which has carried over into this year. While recession remains unlikely, it is still too early to call the 'all clear', given the challenging external backdrop and domestic risks.
FIXED INCOME	<ul style="list-style-type: none"> UST (near-term) China rates Higher quality IG/HY credit (vs. lower quality) EM 	<ul style="list-style-type: none"> Lower quality IG/HY credit Gilts 	<ul style="list-style-type: none"> US Treasuries (near term): Rapidly escalating US-China trade tensions have tipped the Fed from a hiking to an easing bias; we are upgrading US Treasuries to a near-term overweight and a medium-term neutral view. IG/HY credit: We downgraded credit to neutral from overweight and are moving up in credit quality (BBBs to As; Bs and CCCs to BBs). We are being highly selective, given escalating trade tensions, late cycle dynamics and rich valuations; within sectors we prefer US IG, China IG and Asia HY. EM hard currency sovereign debt: We remain overweight based on global central bank dovishness, China stimulus, valuation and lower EM elections risk compared with 2018.
CURRENCIES	<ul style="list-style-type: none"> JPY 	<ul style="list-style-type: none"> EUR RMB 	<ul style="list-style-type: none"> USD: We are negative on USD over the medium-to-long-term on valuation. However, still weak global growth is giving the relatively high yielding USD a 'risk off' bid. This should keep USD range-bound for now, leaving us close to neutral on a trade-weighted basis. JPY: Soft global growth should keep JPY bid as a fundamentally cheap safe haven. Rate differentials are also closing with other economies, given the BoJ's limited ability to lower rates. RMB: Rich valuation and the need for an offset to US tariffs, combined with more dovish and less interventionist rhetoric from the PBoC Governor, will allow downside risks to the RMB to play out.
COMMODITIES	<ul style="list-style-type: none"> Brent oil Diesel Copper PGMs 	<ul style="list-style-type: none"> Natural Gas (Henry Hub) Iron ore High Sulphur fuel oil 	<ul style="list-style-type: none"> Brent (positive): 'Saudi First' oil policy, Iran sanctions, Venezuela woes create upside risks in 2H19. Natural Gas (negative): Ramping US shale oil results in US gas as a by-product. Copper (positive): Short-term copper is equity-like, but in the longer term, supply is struggling. Iron ore (negative): Recovering supply over 12-18 months meets softening demand.
REAL ESTATE	<ul style="list-style-type: none"> Last mile logistics in major European cities 	<ul style="list-style-type: none"> UK retail assets 	<ul style="list-style-type: none"> EUR Logistics: E-commerce is a strong driver of demand growth, combined with supply shortages in major conurbations, and delivering strong rental growth. UK Retail: Re-valuation of sector has only just begun – oversupply, disruption and taxation will continue to drag on demand.

Source: Fidelity International, June 2019

Economic outlook

“The global economy has turned a corner - but it’s heading into the slow lane. The good US GDP figure for the first quarter was deceptive, and the US economy will continue its slowdown in the second half of 2019. However, this won’t be enough to stop a recovery emerging in the rest of the world.”

Ian Samson, Markets Research Analyst

GEARs: Central bank fears and calmer GEARs

Pickup in the US, stabilisation in Europe, slowing China

What's changed

- The global economy has bottomed and moved above the lows seen at the turn of the year. However, the positive headline figures disguise significant country divergence. China, in particular, is still concerning.

Key takeaway

- The US GEAR has picked up since the weakness we saw at the start of the year, but the improvement has been narrowly driven and it is down materially from its highs.

Investment implication

- The stabilisation of the global GEAR is a reason to be positive but there are a number of risks that could derail the momentum, including China growth and the trade dispute.

Global GEAR looks stable



Source: Fidelity International, June 2019

The Fidelity Gauges of Economic Activity in Real-time (GEARs) are monthly 'close-to-real-time' indicators of current activity across several key developed market and emerging market economies. They are a proprietary quantitative input to Fidelity's investment process, providing insight into economic activity that supports tactical decision-making in portfolios.

FLI: Stronger data indicate a recovery

Too good to ignore

What's changed

- The FLI cycle tracker moved into the 'top-right' quadrant (positive and improving growth), which is a major improvement since the start of the year. In Q2, the FLI signalled acceleration for the first time in two years.

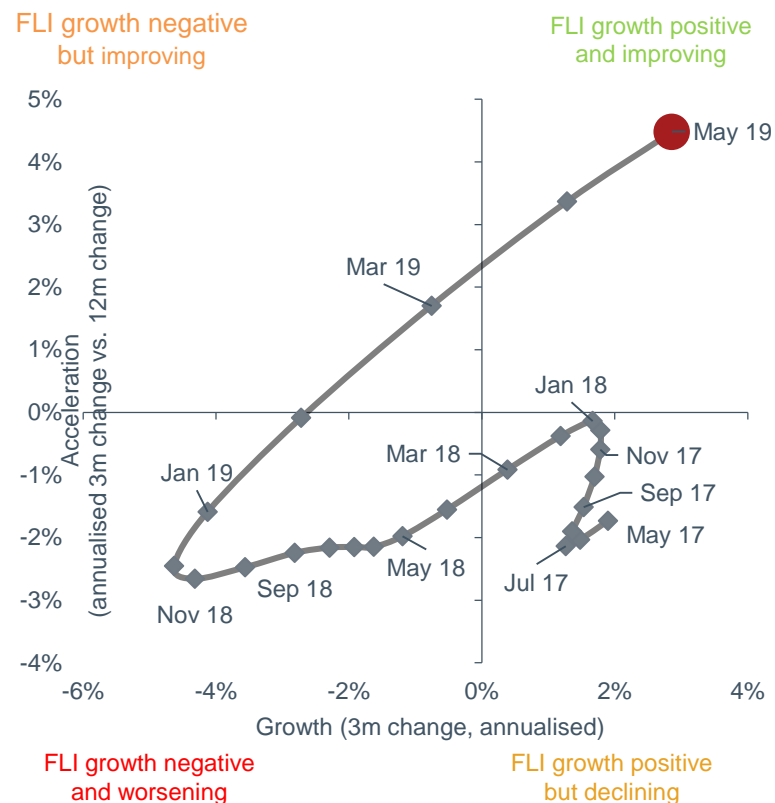
Key takeaway

- All sectors are now out of the 'bottom-left' quadrant, with global trade and consumer/labour in the top-right, while the other three sectors had below-trend but accelerating growth.

Investment implication

- The FLI's 'quantitative signal' is modestly positive, pointing to short duration and long risky assets positioning. The former perhaps feels more comfortable, given the strong run in equities of late.

Growth has been reassuringly broad-based



Source: Fidelity International, June 2019

The Fidelity Leading Indicator (FLI) is a proprietary quantitative tool, used as an input into shorter-term asset allocation decisions by Portfolio Managers. It is a model designed to anticipate the direction and momentum of global growth over the coming months, and - importantly for investors - identify its key drivers.

Data & Policy: A fragile recovery

Central banks set the tone

What's changed

- The major central banks have confirmed dovish stances with the both the ECB and Fed likely to start to cutting rates soon. Macro data is more positive than at the start of the year but the overall picture masks divergences between countries.

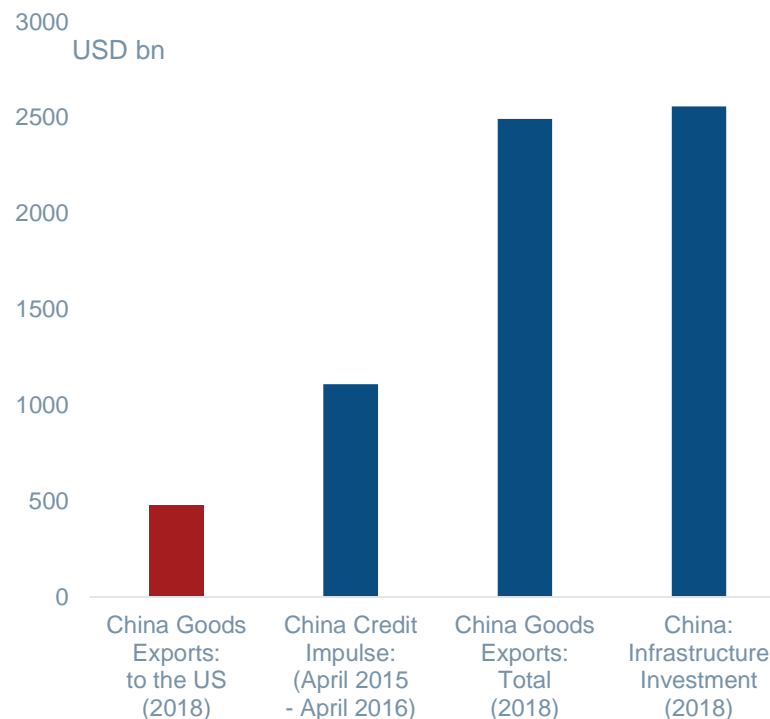
Key takeaway

- Markets expect three Fed rate cuts in 2019 while our base case is that two cuts will suffice given that the US will not slip into recession.

Investment implication

- The Eurozone economy is more robust than many give it credit for, and Bund yields, which are currently negative on the 10 year, are pricing in too much pessimism. In the near-term, the Fed's easing bias should keep US Treasury yields tight.

US-China trade war is manageable: Fiscal and credit conditions dwarf US trade (US\$ bn)



Source: National Sources; Haver Analytics, Fidelity International, March 2019

Equities

“Despite US stocks reaching new record highs, this remains a challenging environment for equity investors. Disconnects are appearing amid quick, sharp bouts of volatility. This uncertainty creates opportunities, but it requires discipline to profit from them.”

Romain Boscher, Global CIO, Equities

Equities: Overview

Disconnects are widening

What's changed

- US Federal Reserve policy and rhetoric around trade tensions both continue to buffer equities. Concerns around global growth and escalating trade tensions in May gave way to Fed dovishness and a mildly positive outcome in the US-China trade talks in June to leave the S&P 500 at a new record high.

Key takeaway

- Disconnects are appearing, examples being energy stocks decoupling from the oil price and fixed income and equities in seeming contradiction.

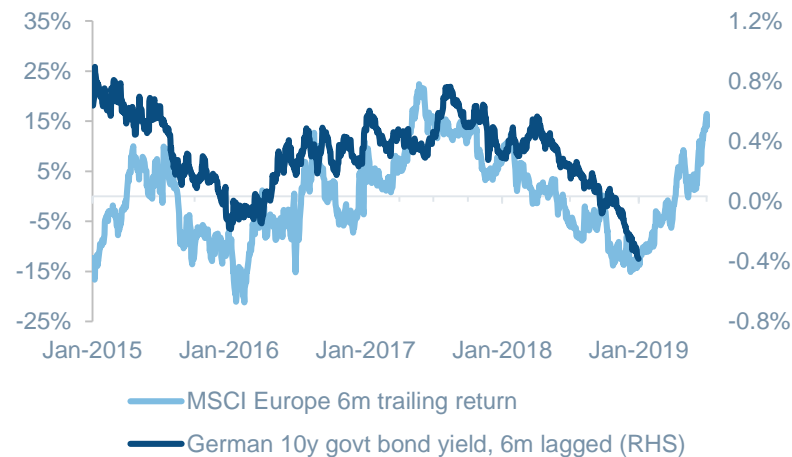
Investment implication

- Overall valuations are higher than normal but not yet in bubble territory. Positive global growth and Fed dovishness should support valuations in the long term with good opportunities in Japanese stocks and selective tech stocks.

Fidelity global forecasts

	2019	2020
Earnings growth	1.1%	9.0%
Return on equity	13.8%	14.2%
Dividend yield	2.6%	2.8%
P/E valuation	15.4x	14.1x
P/B valuation	2.1x	1.9x

Equities versus bonds: Both can't be right



Top - Source: Fidelity International, 1 July 2019
 Bottom - Source: Fidelity International, Refinitiv, July 2019

Equities: Regions

Central banks topping the agenda

US: Fed and trade still the drivers

- Fed policy and trade talks dominated performance in both directions. The trade dispute could limit business spending and lead to a modest industrial slowdown but it doesn't have the power to stop the US economic expansion.
- Although macroeconomic data is mixed, the economy is still growing and recession fears are overdone, however economic growth is slowing. Fed support in the form of two potential rate cuts this year should act as a tailwind to the economy and equities.

Europe: ECB could provide support

- A lift for equities came from the ECB President Mario Draghi, who indicated the central bank was considering monetary support in the form of more asset purchases and/or rate cuts. Stimulus would help equities

Fidelity earnings growth forecasts

	2019	2020
US	1.2%	10.6%
Europe	1.0%	7.2%
Asia ex Japan	1.9%	9.4%
Japan	-2.7%	6.5%
Emerging markets	2.3%	10.0%

Fidelity capital market assumptions

	3 years	5 years	10 years
US equities	6.0%	6.1%	6.4%
European equities	3.7%	4.4%	4.5%
Japanese equities	3.5%	4.1%	4.2%
Developed market equities (US\$)	6.3%	6.6%	6.8%
Emerging market equities (US\$)	7.0%	7.4%	7.5%

Top - Source: Fidelity International, 1 July 2019

Bottom - Source: Fidelity International, March 2019

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.

Equities: Regions

Opportunities require some digging

Asia ex Japan: Reforms and stimulus in the pipeline

- The Chinese government appears to be adopting a flexible series of mini-stimuli rather than an 'old school' type stimulus. This could support physical demand from Q3, however a lasting recovery into H2 is not yet guaranteed.
- Both India and Indonesia's incumbent governments have been elected to another term. This bodes well for continuing reforms.

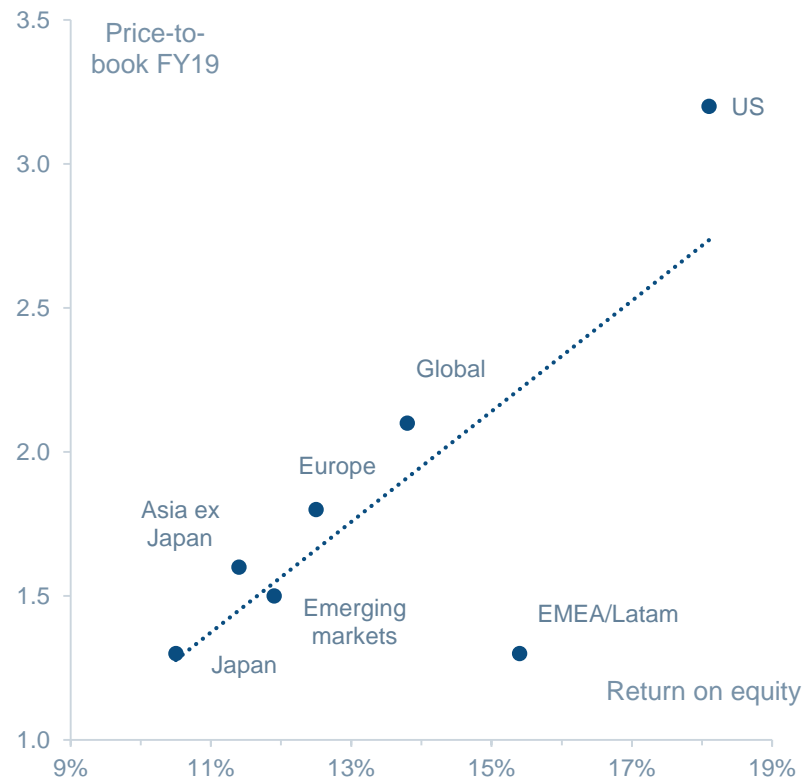
Japan: Exposed but attractive

- We continue to be positive on Japan, however, it is buffeted by the US-China trade spat due to its exposure to global trade flows and its perception as a safe haven.

EM: Pockets of high risk

- Overall, emerging markets have now underperformed their developed market counterparts for five consecutive months.

Some regions starting to look expensive



Based on FY19 results. Source: Fidelity International Insight, 1 July 2019

Equities: Sectors

'Trade truce' lifts IT stocks

Top three sectors

Information Technology: Semiconductors leading the way

- The truce around Huawei is positive for US companies and we've improved the outlook for chipmaker Broadcom as a result. But it's not yet clear exactly how far the restrictions will be lifted. Any clarification could lead to further gains for semiconductors.

Communication Services: Special situations developing

- Media and Entertainment leads this sector with a number of special situations developing.

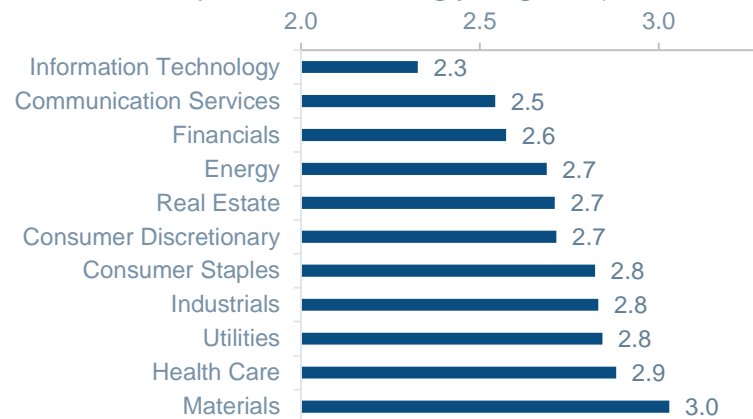
Financials: Upside still available

- Falling yields are negative for banks as they reduce their interest income, and we have cut earnings forecasts as a result. However, there is still substantial upside available following significant sell offs recently.

Most favoured sectors	Least favoured sectors
Information Technology	Materials
Communication Services	Health Care
Financials	Utilities

Tech stocks get the most positive ratings from Fidelity analyst

Cap weighted average rating (1=strongly positive, 5=strongly negative)



Reference to specific securities should not be taken as recommendations

Source: Fidelity International, 30 April 2019

Equities: Sectors

Macro stories driving valuations

Bottom three sectors

Materials: Stubborn challenges remain

- Pessimism in the sector is being driven by headwinds to global growth, weak construction demand, a strong US dollar, unresolved trade war concerns, and cooling property demand and infrastructure development in China.

Health Care: Regulation rhetoric remains in focus

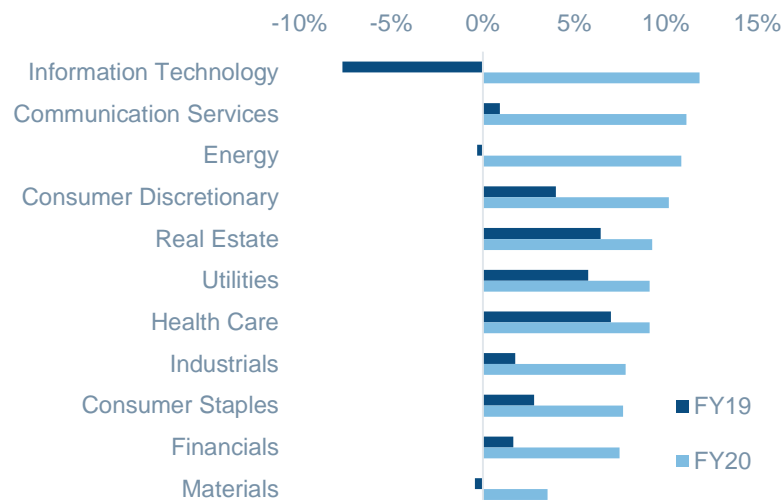
- Valuations aren't demanding, innovation is improving and China is a growth area. But these are dominated by US pricing headwinds, most acutely affecting the managed care industry.

Utilities: High valuations

- Declining bond yields have helped boost utilities but valuations are now above historical averages relative to the index.

Most favoured sectors	Least favoured sectors
Information Technology	Materials
Communication Services	Health Care
Financials	Utilities

Fidelity earnings growth forecasts on two-year view



Source: Fidelity International, 1 July 2019

Fixed Income

“Central banks are back in the driving seat, pushing yields lower across the board. While the search for income has resumed, investors should not be complacent, and focus on quality income rather than yield at all costs.”

Steve Ellis, CIO, Fixed Income

Fixed Income: Overview

Major central banks confirm easing mode

What's changed

- The Fed and ECB are seeking to extend this cycle with further monetary easing. Both are indicating rate cuts, which has led to a resurgence in the search for yield.

Key takeaway

- US Treasury yields edged to their lowest levels since November 2016 due to Fed dovishness, concerns about global growth and a deterioration in trade talks between the US and China.

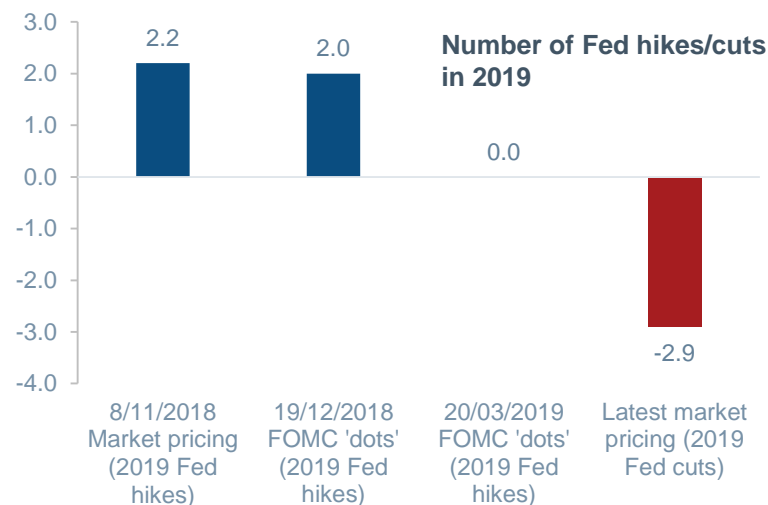
Investment implication

- In the short term, we have marginally increased credit exposure in our portfolios based on the dovish tone. However, our long-term view of de-risking and seeking quality yield remains in place

Current and implied government bond yields

10 year implied yield	Current	Jun-2020	Jun-2021
US	2.04%	2.17%	2.30%
Germany	-0.31%	-0.14%	-0.02%
UK	0.84%	0.99%	1.13%

Expectations of Fed hikes have disappeared



Top – Source: Bloomberg, June 2019

Bottom – Source: Bloomberg, US Federal Reserve, Fidelity International. 5 June 2019

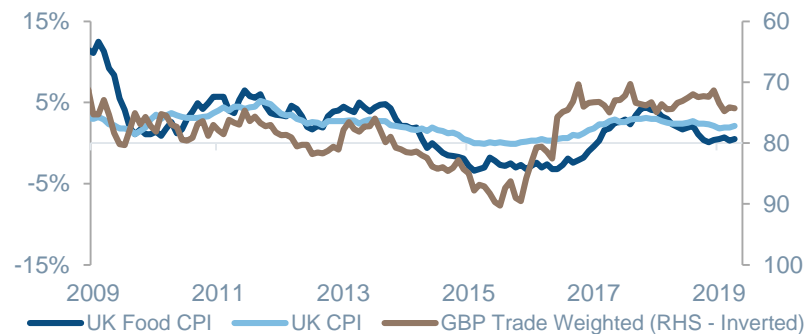
Fixed Income: Inflation-linked

Global inflation market sell off

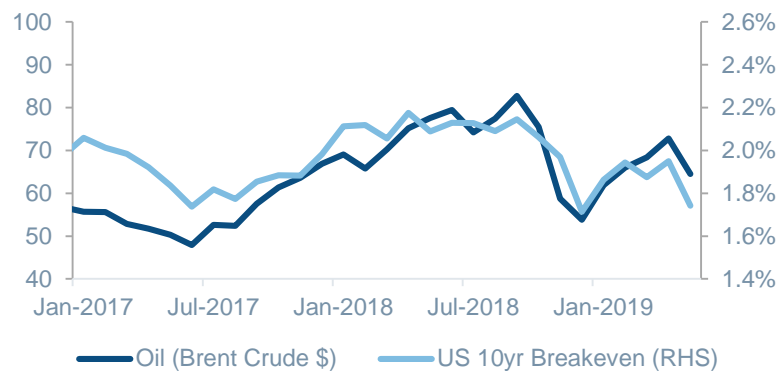
Inflation expectations fall on slowdown fears and technicals

- May alone saw futures on Brent Crude fall over 10 per cent dragging US breakevens and global inflation expectations lower.
- UK breakevens were a notable exception to global breakeven trends, as domestic political issues continued to be the dominant driver.
- Volatility in Eurozone inflation remains elevated due to seasonal factors, where package holiday discounts and subsequent price rises tend to drive fluctuations in the headline figure.
- We moved tactically underweight US inflation expectations early in May as the month is typically seasonally weak. Now that the decline in US breakevens has materialised, we are back to neutral.

Sterling impact on UK inflation is swift and meaningful



Oil prices led the drop in breakevens



Top – Source: Fidelity International, Bloomberg, as at 31 May 2019

Bottom - Source: Fidelity International, Bloomberg, 31 May 2019

Fixed Income: Investment grade

Rise in risk aversion did not spare IG

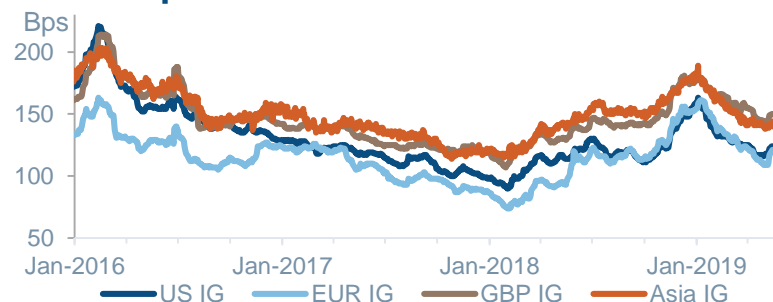
Widening spreads

- Spreads in all regions widening during the quarter, only to recover as central banks boosted demand for income yet again.
- Spreads may face further upward pressures given the challenging macro backdrop, and lingering trade-related concerns.
- At the margin however, IG credit should remain better insulated from the slowing growth environment compared to other higher beta areas of the market.

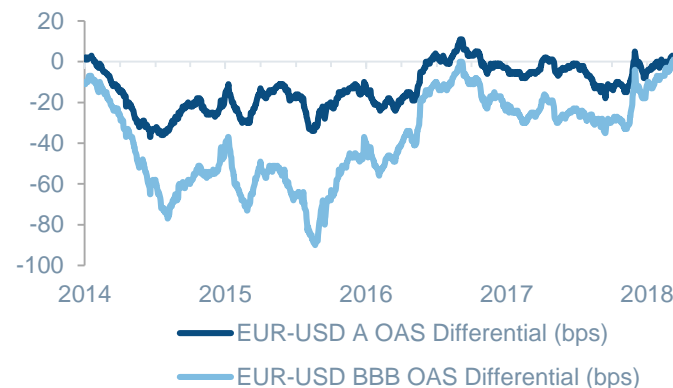
Positive on Asia

- Expectations of a supportive Fed and more stimulus from China to offset the impact of the ongoing trade war keep us positive towards Asia IG.

Investment grade credit spreads widened in the last quarter



EUR IG spreads have underperformed USD IG spreads



Top – Source: Fidelity International, Bloomberg, ICE BofA Merrill Lynch bond indices, shows option-adjusted spreads to May 2019

Bottom - Source: Fidelity International, May 2019

Fixed Income: High yield

Yield-hungry investors back in

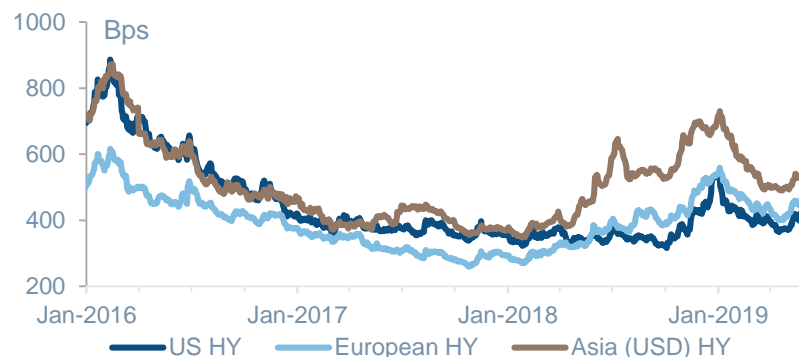
Poor May offset by strong June

- Markets were turned off risk-off mode by the escalation in trade rhetoric between the US and China, volatility around the EU elections, Brexit developments and continued Italian political risk, before central bank dovishness spurred demand from yield-hungry investors.
- Looking ahead, spreads will trade on the back of political headlines and central bank policy, keeping volatility elevated.

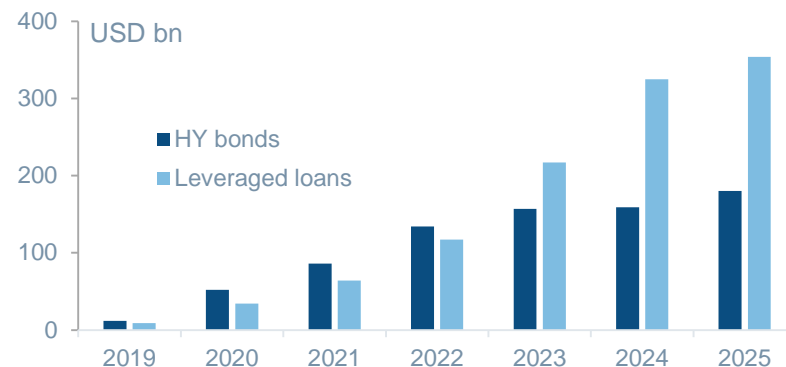
Caution warranted

- We are neutral US HY, with spreads now 100 bps from the recent lows. These levels would be considered attractive in a non-recessionary environment, but the trade war warrants a cautious and nimble approach.

HY spreads resumed tightening in June



Limited refinancing needs are favourable for high yield assets



Top – Source: Refinitiv, Global ICE BofA Merrill Lynch bond indices, shows option-adjusted spreads, to June 2019

Bottom - Source: Fidelity International, Bloomberg, May 2019

Fixed Income: Emerging markets

Strong performance over the quarter

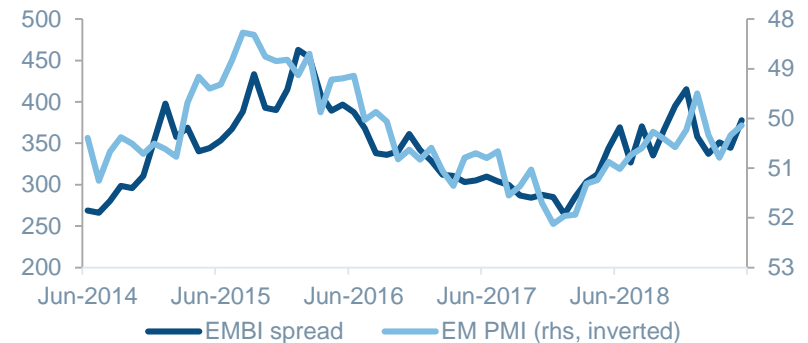
Central bank-led sentiment shift

- Sovereign and corporate hard currency indices posted positive returns, driven by US dollar duration as US yields pushed lower on the back of the central bank-led turnaround in risk sentiment.
- The hunt for yield remains an important driver of demand and developed market yields are at fresh lows for the year. We expect strategic flows into the asset class to continue.

Overweight largely unchanged

- Key overweights are positions in Chinese corporate debt, Saudi Arabia, Turkey and Argentina.
- We added some exposure in Dominican Republic, Oman and Sri Lanka.

EM spreads versus EM PMIs



EM FX continues to struggle against a strong US dollar



Top – Source: Fidelity International, June 2019

Bottom - Source: Fidelity International, Bloomberg, as of 31 May 2019

Multi Asset

“When valuations are stretched, the downside risk is high, and we are in that position today. There are clear, binary downside risks which could have a significant impact on markets given current valuations.”

Multi Asset team

Multi Asset: Overview

Calm markets punctuated by volatility

What's changed

- The falling volatility seen in 2019 has reversed in the latter part of Q2 as trade tensions again came to the fore. The macro data in places looks reassuring but market valuations are high and vulnerable to exogenous events.

Key takeaway

- After a weak 2018, China stimulus is expected to feed through as we move into the second half of the year. While the trade dispute is affecting sentiment, this could result in more supportive policy. This would be a tailwind for China and emerging Asia more broadly.

Investment implication

- Despite the risk of fundamentals disappointing on the downside, the Fed's dovishness will support asset prices and so we are neutral on equities.

Volatility no longer falling in 2019



Source: Refinitiv, June 2019

Multi Asset: Equities

Moving back to neutral

What's changed

- We have returned to a neutral view on equities due to central banks' willingness to support asset prices once again, but do not believe it is prudent to move to overweight given markets' stretched optimism and a slowing US economy.

Investment implications for selected markets

- **US** – We maintain our neutral view on equities as the markets again touched all-time highs, but without the attendant economic signals that would be expected. Trade war sentiment is another headwind that hasn't receded.
- **Europe ex UK** - Italy may have moved out of recession, but budget tensions with the EU are back. The Eurozone is dependent on Chinese growth, so we would need to see more solid signs of improvement there to move back to neutral.
- **Asia Pacific ex Japan** - While markets in Hong Kong are vulnerable to trade tensions, the overall picture remains generally positive and liquidity remains abundant. Australia's housing market leaves us cautious, however.
- **Global emerging markets** - We remain positive on emerging markets, albeit with a nuanced view. While still vulnerable to trade tensions, they are set to benefit from a dovish Fed cutting rates and weakening the dollar.

Multi Asset: Fixed Income

Maintain negative view given cautiously constructive outlook on global recovery

What's changed

- We continue to be negative on fixed income and see little upside given record quantities of negative yielding non-US sovereign assets and minimal carry support.

Investment implications for selected markets

- **US Treasuries** - Moving back to neutral after a period of strong performance due to Fed dovishness and demand for defensive assets. We see US Treasuries as an important defensive position in many of our portfolios.
- **Euro core** - Given dovish signals by outgoing ECB President Mario Draghi, and yields remaining negative, we maintain our underweight view. For many European investors, Bunds will still have a defensive role.
- **Investment grade** - We take a neutral view on IG bonds. This is a nuanced view, however, and we remain focused on high-quality, short-duration, US dollar denominated issues, especially given the historically large percentage of BBB ratings.
- **US high yield** - We maintain our underweight view on US high yield, and see the market as vulnerable to any change in course from the Fed or risk off sentiment rising. Our Income range prefers other regional high yield markets.
- **Emerging market corporate debt** - Our view on emerging markets corporate debt remains negative given the asset class is vulnerable to the global late cycle environment, and we prefer to access emerging market debt via government bonds.

Multi Asset: Currency

Short USD, long EUR, long JPY

Investment implications for selected markets

- **US dollar** – Given the Fed’s abrupt end to rate hikes and ‘QT’, significantly slowing US growth, falling core inflation, ‘twin deficit’ headwinds, and very expensive fundamental valuations, we are bearish on the USD against select currencies.
- **Euro** - While the Eurozone remains challenged and the ECB is trapped at negative interest rates, the Euro now prices a lot of investor pessimism. An upturn in the external cycle could catch consensus off-guard, boosting EUR.
- **Japanese Yen** - Despite its strong run, JPY remains attractive as a cheap ‘defensive’ asset. There is upside potential on falling interest rate differentials as markets increasingly price in the next US downturn, or on broad USD weakness.

Real Estate

“Macro factors - persistently low interest rates, currency volatility, politics - continue to be the tail that wags the real estate dog, drawing investors to property for its yield premium and perceived safe haven status. But fundamental real estate factors are starting to reassert themselves again - most notably in retail property in the UK, which is falling in value in some locations both quickly and significantly. Successful investors will be those who have already re-positioned portfolios over the past year.”

Neil Cable, Head of European Real Estate

Real Estate: Overview

Mismatch between price and fundamentals

What's changed

- Style drifts tend to be exacerbated by the weight of capital, and this time around is no exception. As we move through the year, there is a growing evidence that investors in European assets are venturing into secondary markets and geographies, and towards more specialist sectors in search of yield.

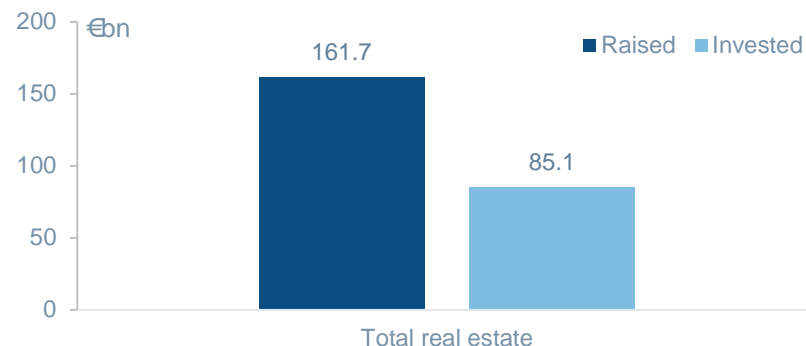
Key takeaway

- Deployment of capital has become a major challenge. Only around 50 per cent of equity raised for real estate investment in 2018 has so far been deployed as investor competition intensified.

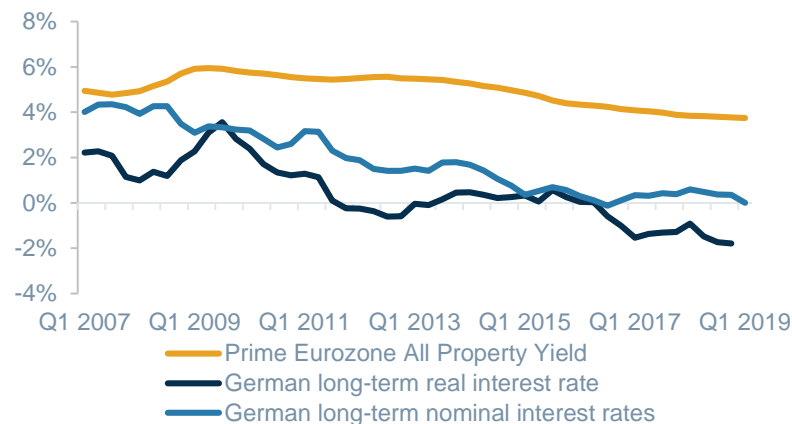
Investment implication

- While real estate pricing remains attractive in relative terms, the mispricing of risk is becoming a major challenge.

Deployment of capital has become a major challenge



Eurozone real estate pricing remains attractive



Top - Source: INREV Capital Raising Survey, April 2019
Bottom - Source: Fidelity International, CBRE, Thompson Reuters, June 2019

Real Estate: Continental Europe

Pricing competition intensifies

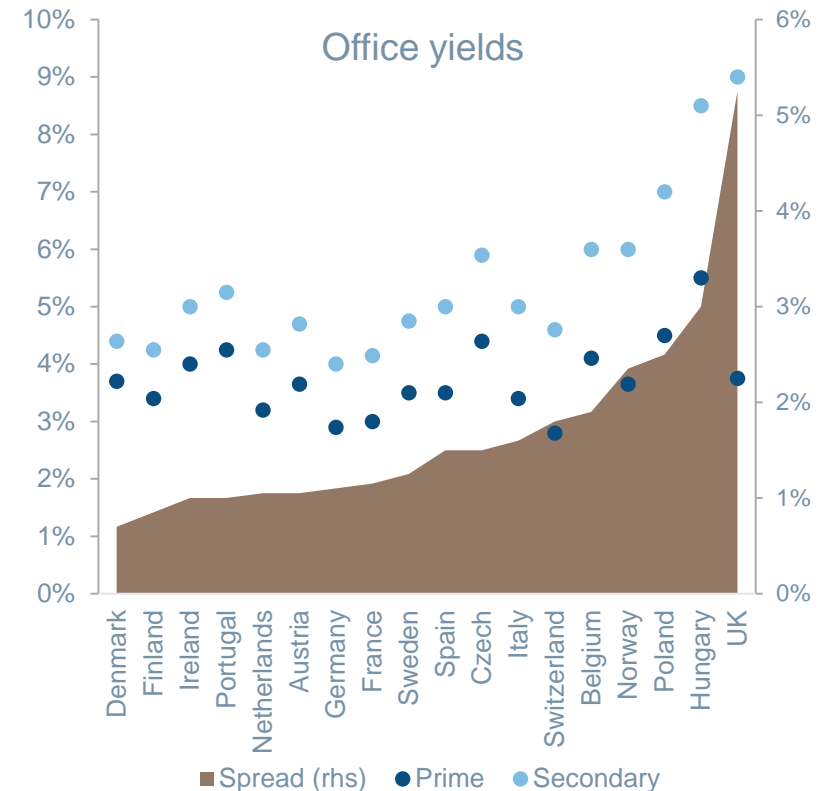
Supportive conditions

- With the exception of retail, yield spreads between prime and secondary pan-European real estate continued to narrow in Q2 2019 to around 200 basis points (bps) - a level last seen in 2012.
- Robust labour market conditions and a strong consumer spending outlook should continue to prop up the European economy, amid risks of becoming unbalanced due to ongoing trade and political tensions.

Expectations need to change

- With prime office yields in most European markets now somewhere between 3 and 4 per cent, the risk of style drift is significant. A focus on sustainable income and an acceptance of lower returns will be key.
- Some specialist retail segments may deliver attractive returns given a promising consumer spending outlook.

Eurozone pricing: Evidence of late-cycle pricing overshoots in secondary offices



Source: Fidelity International, CBRE, June 2019

Real Estate: UK

Pressure building, but also potential opportunities

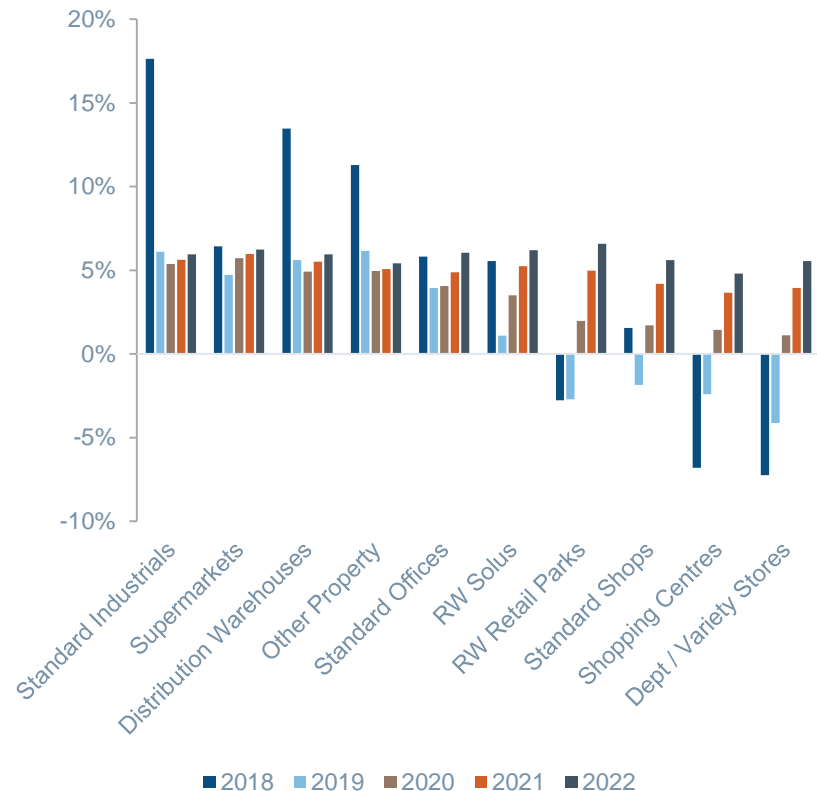
Macro headwinds

- With Prime Minister Theresa May's resignation, no substantive progress on Brexit, and the UK economy forecast to contract in Q2 2019, we expect the UK real estate market to remain restricted.

Correction coming

- The retail sector will continue to drag on performance as the risk of significant valuation write-downs continues to build. The market is preparing for a much deeper correction, given the implied pricing in the REITs market.
- The UK market will offer a window of opportunity for timely, tactical investing as attractively priced, or even 'mispriced assets' are likely to come onto the market from distressed sellers at a time when most investors will not be in position to acquire.

UK real estate: Lower returns across most sectors



Source: Fidelity International, RealFor, MSCI, May 2019

Summary...



House view: We have adjusted allocations to reflect the increasing risk-off sentiment among our portfolio managers. In the near-term, we have downgraded equities and cash, and upgraded US Treasuries.

Equities: Overall valuations are higher than normal but not yet in bubble territory. Positive global growth and Fed dovishness should support valuations in the long term.

Multi Asset: Despite the risk of disappointing fundamentals, the Fed's dovishness will support asset prices so we are neutral on equities. We continue to take a nuanced view at the regional level however.

Economic outlook: While the bond market is gloomy about the economy, US equities are banking on an accommodative Fed and positive news in US-China trade. We think this is too optimistic on both counts.

Fixed Income: In the short term, we have marginally increased credit exposure based on the dovish tone from policymakers. However, our long-term view of de-risking and seeking quality yield remains in place.

Real Estate: While real estate remains attractive in relative terms, mispricing is becoming a major challenge. Style drifts are growing and pricing premiums are narrowing.

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