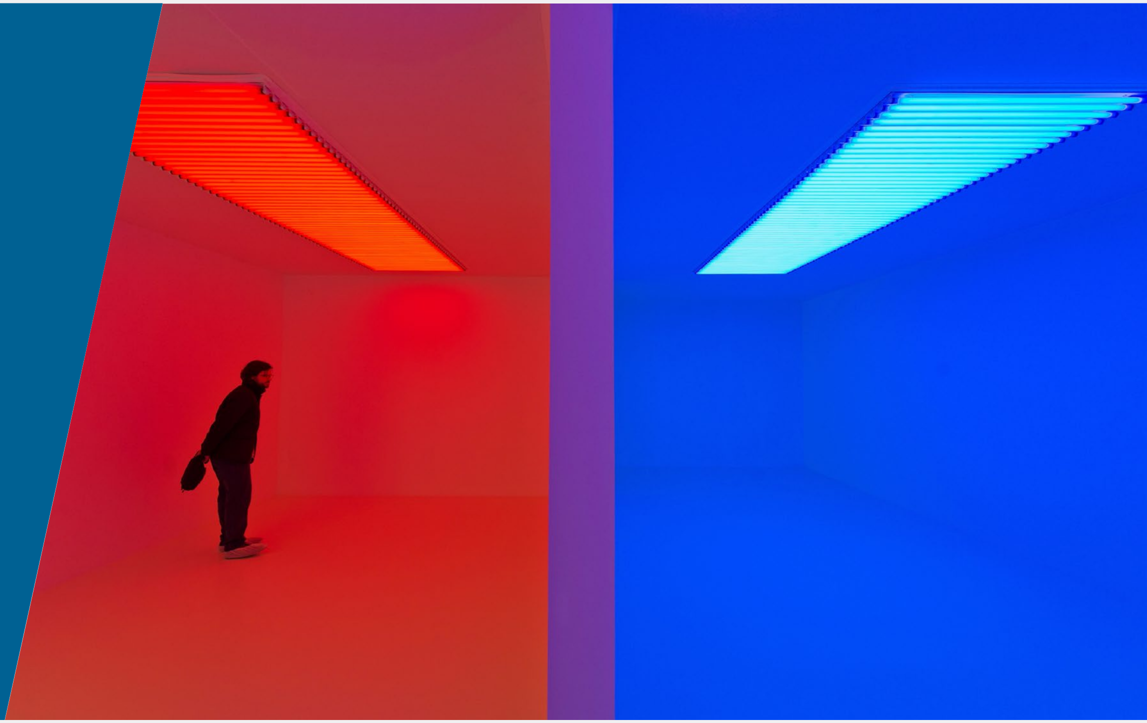
Q3 2023 Investment Outlook

Between resilience and fragility

FIL Investment Management

July 2023



Between resilience and fragility

Three themes for Q3 2023

Resilience now, fragility later

The markets continue to oscillate between resilience and fragility, driven by four ‘Ls’: liquidity, labour, lags, and lending. Abundant liquidity and tight labour markets have supported consumer and corporate sector resilience, pushed out maturity walls, and delayed the impact of aggressive rate hikes. Yet we remain wary of lagged policy effects and tightening lending standards, which underscore our continued expectation for a hard landing in developed markets (DM).

On a cross asset basis, our conviction in DM “resilience now, fragility later” is expressed through conservative positioning and up-in-quality rotation in equities and credit, and an overweight in US Treasuries. Areas where we see opportunity include higher quality investment grade (IG) bonds given current coupons, and sub-sectors in real estate and private credit that benefit from sustainability trends, robust cross-border capital flows, and muted default rates.

The long game in China

Although the shine on the post-Covid recovery quickly faded, our conviction is growing that a selective and patient approach in China will be rewarded. Our recent research trips to 1st and 2nd tier cities revealed pockets of strength, e.g. in “green” and high tech sectors, and in well-managed local cities like Hefei. We expect continued fiscal and monetary stimulus to support the 5 per cent growth target, supported by a low inflation backdrop.

Our investment teams turn more sanguine, based on this better fundamental outlook and highly attractive China equity valuations. We believe that playing the long game with patient deployment of capital will ultimately yield desired returns. From a tactical multi-asset perspective, our risk-on stance is articulated as a double overweight in China equities, single overweight in credit, and a double underweight in China government bonds (CGBs).

Corporate sentiment stabilising

Our research analysts noted a lull in corporate sentiment last quarter. But an uptick in June suggests sentiment was simply resting rather than stalling, with fears of a banking sector meltdown abating and Japanese equities roaring. Sentiment in China remained flat as questions linger over the strength of the recovery. Bullishness has returned among consumer staples companies, though is yet to shared by investors and consumers themselves.

Nevertheless, we view improving corporate management sentiment as a possible sign of complacency given the policy lags, withdrawal of Covid-era liquidity, and fragilities below a calm surface. On the positive side, non-labour costs continue to trend downwards, and are likely to turn deflationary this quarter. But persistently high wage cost pressures throughout DM suggest that central banks are far from done, while the majority of our analysts still anticipate recession over the next 12 months.

Source: Fidelity International, July 2023.

Key themes and their investment implications for Q3 2023

	Asset Allocation	Equities	Fixed income	Private credit	Real estate
Resilience now, fragility later	▪ We are positioned cautiously, underweight (UW) equities and credit. Economic activity remains relatively robust in DMs, but leading indicators of earnings are falling, while tightening credit conditions remain a headwind to the medium-term outlook. ▪ We are moving up in quality across asset classes. In equities, this means allocating to minimum volatility equities and defensive sectors over cyclical sectors. In fixed income, we prefer government bonds and investment grade (IG) over riskier high yield (HY).	▪ We are increasingly cautious and favour a quality and defensive bias as risks mount. ▪ Strong US performance led by mega cap tech stocks has created concentration risk, which could falter if artificial intelligence (AI) hype fails to meet expectations and/or the US Federal Reserve (Fed) keeps rates higher for longer. ▪ In Europe, the macro backdrop is deteriorating, but valuations, particularly in cyclicals, have been slow to react, which could spell a period of weak price performance.	▪ US inflation is well placed to continue its decline given the sharp contraction we have seen in Fed money supply growth (a leading inflation indicator). ▪ IG credit markets are relatively well priced for a recession, especially in Europe - but high yield and European equity markets are not.	▪ Now is a time to be defensive and seek certainty of returns. ▪ Given the current instability of the current economic environment, the predictable returns offered by an all-weather asset class like private credit may prove beneficial.	▪ Unusually tight demand/supply balance in Europe is providing short term resilience. ▪ Fragility later would come primarily from greater-than-expected interest rate rises which would have a negative effect for both investment and occupier markets. ▪ As is typical in real estate cycles, individual property re-pricing moves long before wider market indices, and so H2 represents a good buying opportunity in European real estate markets.
The long game in China	▪ Recent data from China has indicated the initial momentum of the re-opening recovery is waning. However, we believe that China and many emerging markets (EM) more broadly are facing fewer headwinds than many DMs, and China in particular could represent a good diversifier for portfolios. ▪ Global luxury equities are a beneficiary of increased spending and tourism related to China's re-opening. The sector should also offer some downside protection.	▪ Although the China recovery and policy stimulus have underwhelmed, we believe there are positive signals from the region. Regulatory uncertainty may have peaked, earnings are trending up and valuations are attractive both historically and relatively.	▪ We believe that China's recovery is not over, but the path will be slower and bumpier, and the net growth impulse will not reach previous cycle levels. The property sector may not be close to a turnaround yet given the underwhelming sales recovery. ▪ The weakness in business and household investments will be the key signs to monitor for policy support. However, barring a crisis, it is unlikely to reach the previous all-out easing cycle levels. The bearish views have been reflected in China HY valuations.		
Corporate health	▪ The inflation and growth outlook looks better in select EMs. For example, there are opportunities in Indonesian and Brazilian equities and Brazil and South Africa local government bonds. ▪ We have tilted away from US equities given the tighter lending standards following the banking crisis. We believe Europe small caps represent an opportunity as they are at a large discount to those in the US.	▪ We expect 2023 to be a year of earnings contraction with pressure particularly acute in the US and Europe as companies continue to contend with inflation and tight monetary policy. Defensive sectors such as consumer staples and healthcare are better placed. ▪ There are bright spots in Japan, with its trend of shareholder friendly action, and China's more responsible capital allocation.	▪ Falling liquidity and tightening credit conditions are concerning. In the US HY market, our calculations show the implied one year forward default rate is just 2.6 per cent. If we incorporate adjustments, we can say investors expect, at most, a 4.6 per cent default rate. But this is still only half the default rate that we have seen in previous recessions.	▪ The higher cost of debt will make it harder for companies to invest in growth. Firms will look to control costs, and falling interest rate coverage ratios will drive a (limited) increase in defaults. ▪ Industries are broadly sanguine heading into H2 but credit specific challenges may rise. Some weakness in the chemicals sector could be the canary in the coal mine, but more likely a symptom of some destocking across the market.	▪ Structural move to sustainable offices and hybrid working, providing opportunity for green building strategies and bifurcating the market. ▪ Weak demand for 'unsustainable buildings' / strong demand for more sustainable buildings.

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Global Macro

Macro scenario analysis

Our base case remains a cyclical recession over the next 12 months, but if policy remains highly restrictive into 2024, the risk of a balance sheet recession will increase, as persistently high funding costs will damage growth and raise default risks

Global Macro Scenario Grid (0-12 months horizon)

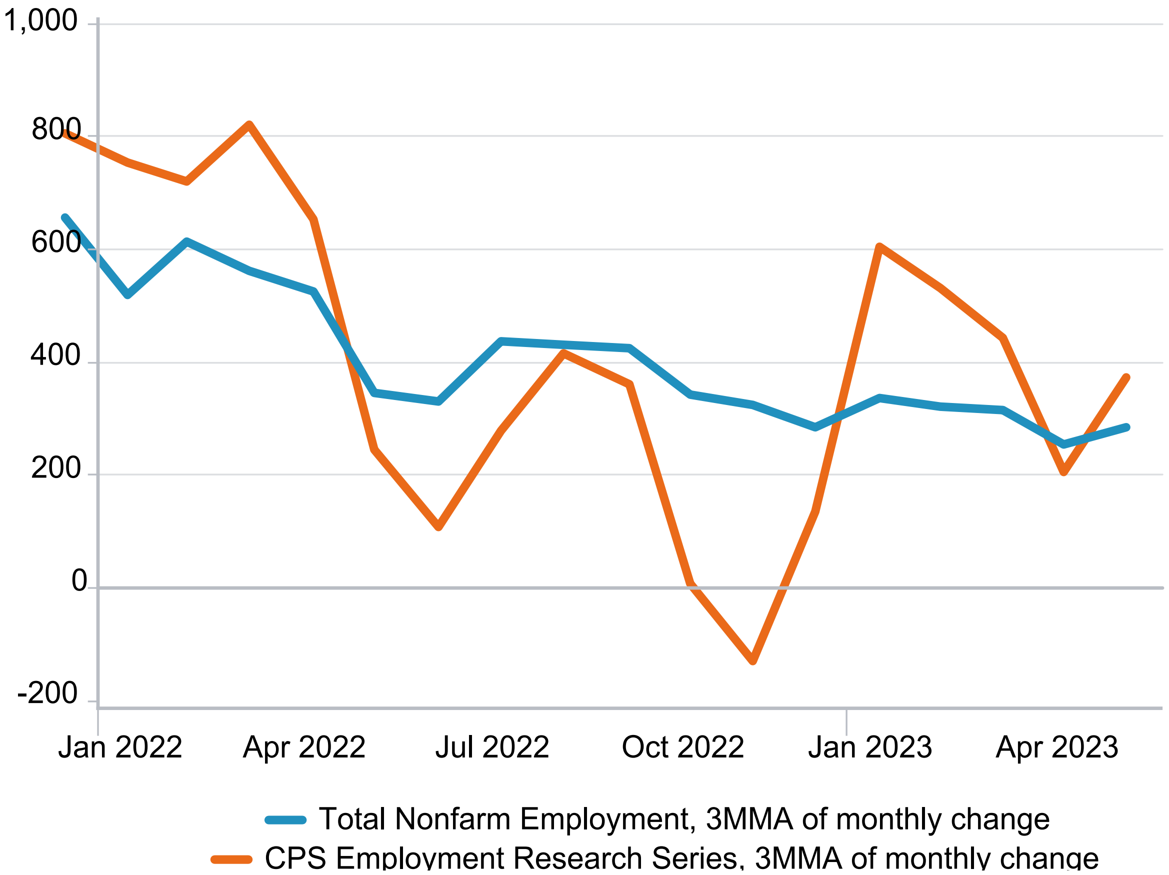
	Balance Sheet Recession	Cyclical Recession	Soft Landing
Time horizon	0-6m 6-12m	0-6m 6-12m	0-6m 6-12m
Growth/Inflation dynamics (delta)*	Growth: ↔ ↓ Inflation: ↔ ↓	Growth: ↓ ↓ Inflation: ↓ ↓	Growth: ↓ ↔ Inflation: ↓ ↔
Scenario narrative	US Fed overtightening results in a more severe shock to demand and triggers a wave of defaults, leading to a deeper recession, with potential implications for financial stability. However, this scenario is only likely to materialise in the 12-18 month horizon.	US Fed tightening pushes the economy into a cyclical recession. However, an eventual pivot by central banks combined with stronger balance sheet positions in DM economies cushion the shock, preventing a severe downturn.	A combination of easing supply disruptions and a resilient consumer leads to avoidance of recession. Central banks manage to successfully control inflation, with the economy remaining at near-trend growth.
UR implications**	>6.5%	4.4% – 6.5%	3.5% – 4.4%
Probability	15%	80%	5%

Note: Brackets show last month's probabilities. *Growth/inflation arrows indicate deltas from current levels. **This row denotes where we think the unemployment rate may land in each scenario

Source: Fidelity International, June 2023.

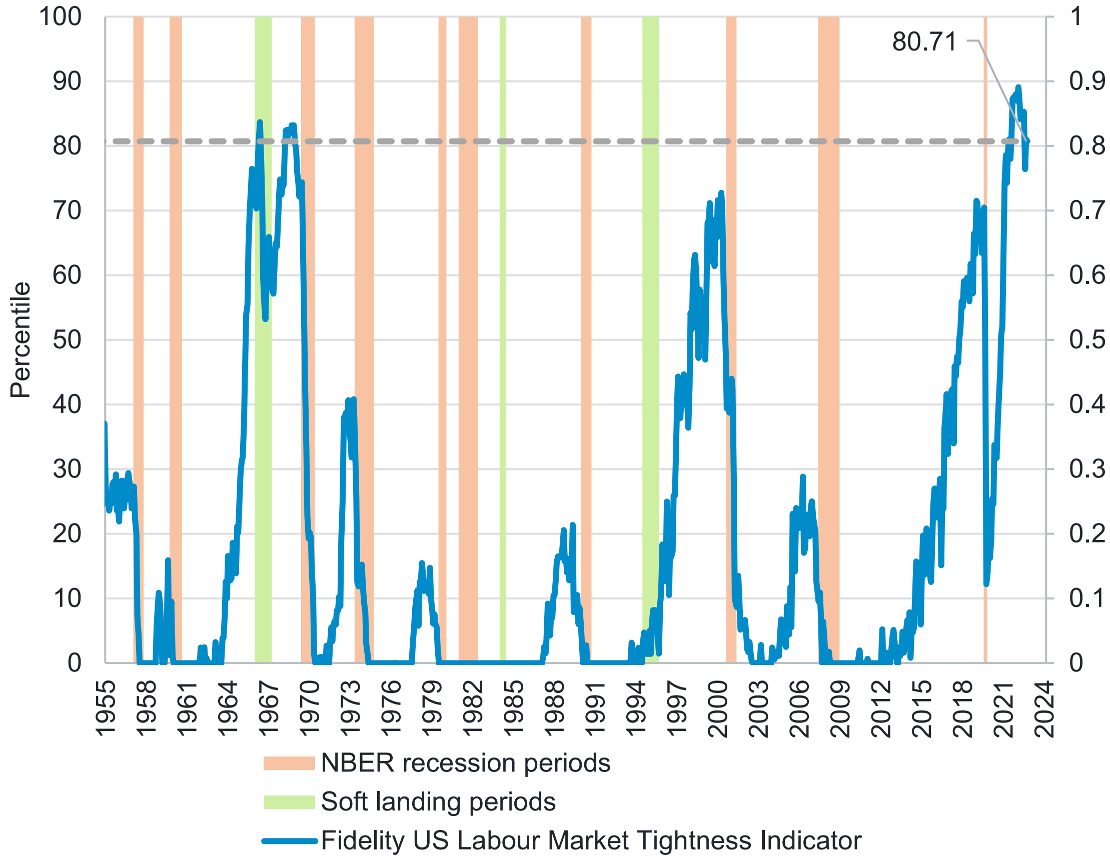
US labour market remains extremely tight compared to historical standards

US Labour market still strong…



Source: Fidelity International, Haver, June 2023.

…and tight

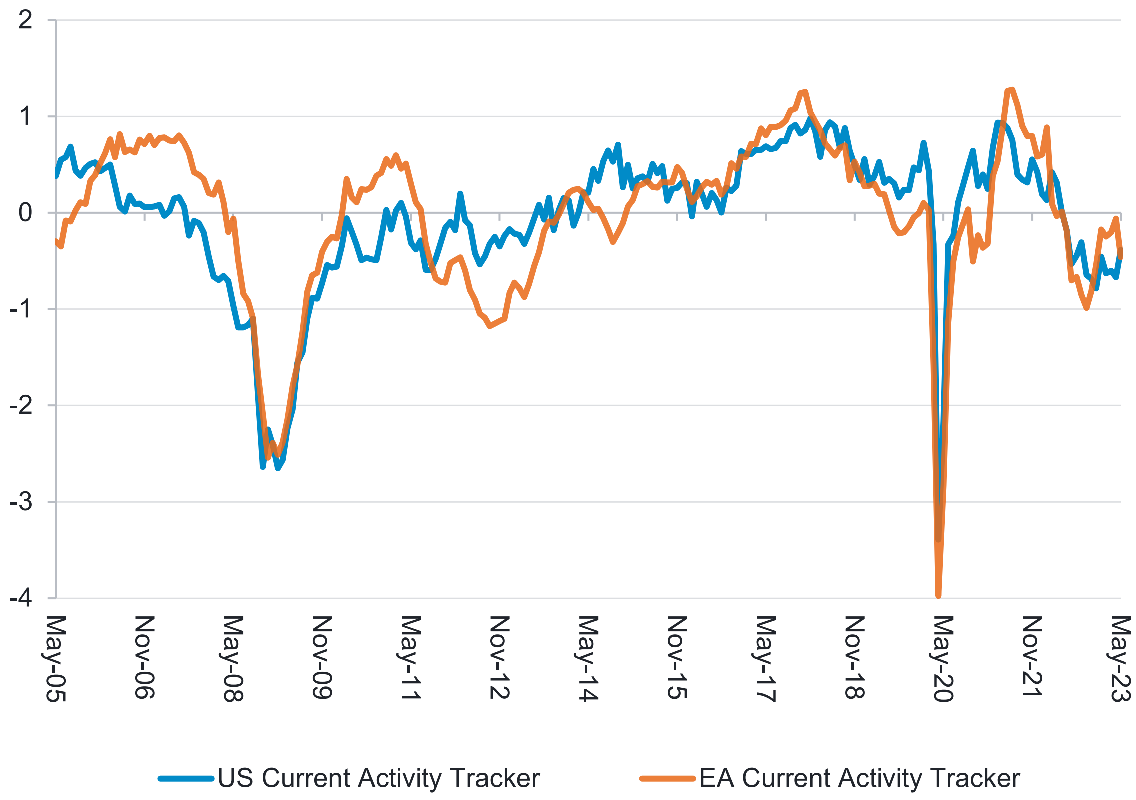


Source: Fidelity International, Haver Analytics, June 2023.

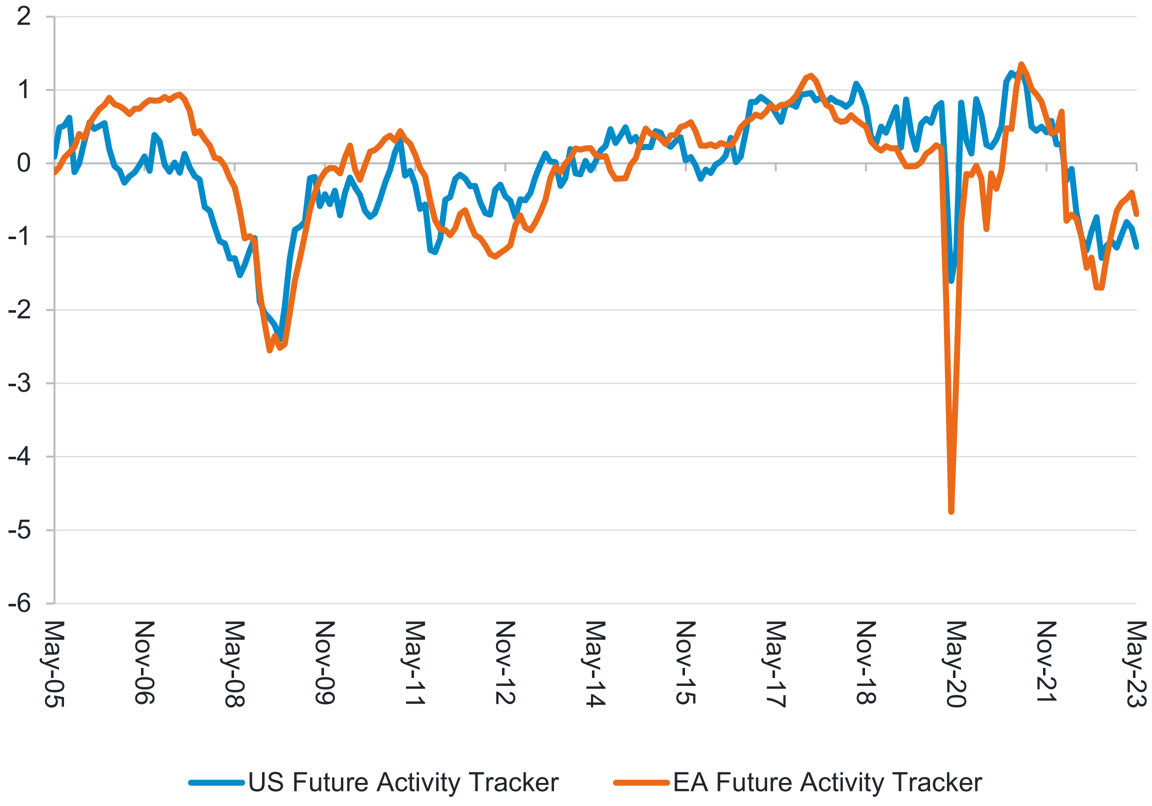
US and Euro Area trackers signal slowing activity in May

Both US and Euro area activity tracker slows in May barring current activity in the US buoyed by improving housing data

Current Activity Trackers – US and EA (Z scores)



Future Activity Trackers – US and EA (Z scores)

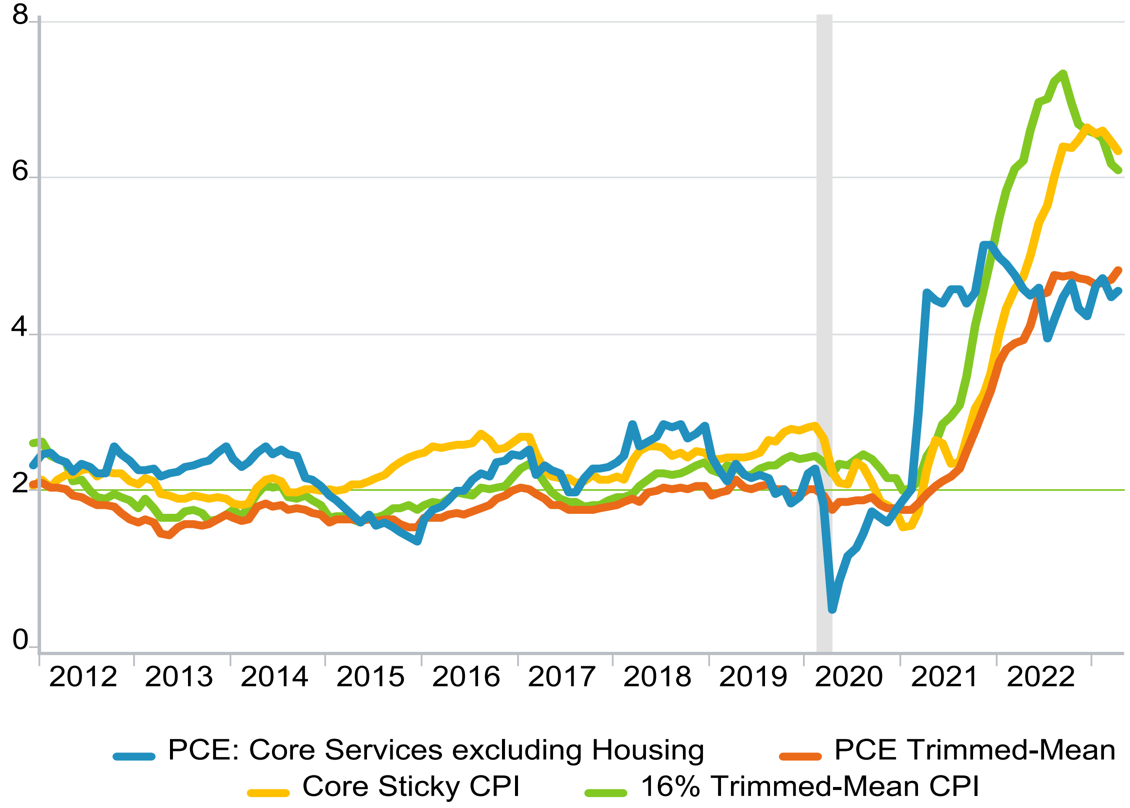


Source: Fidelity International, Fidelity Global Macro Team calculations, June 2023.

US and Euro area (EA) measures of underlying inflation

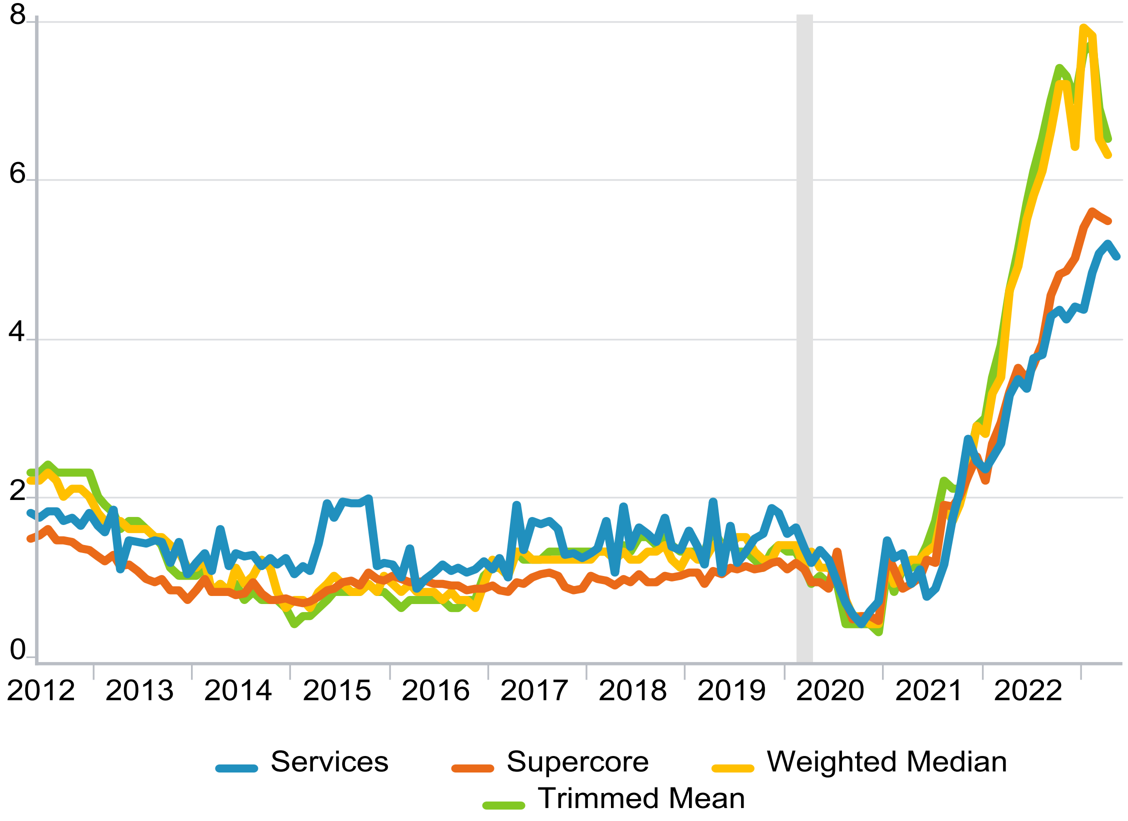
High and sticky core inflation means the bar for a central bank pivot will remain high through the year

Alternative measures of US personal consumption expenditures (PCE) and consumer price index (CPI) (% year on year (YoY))



Source: Fidelity International, Haver Analytics, June 2023.

Alternative measures of EA Harmonized Index of Consumer Prices (HICP) (% YoY)

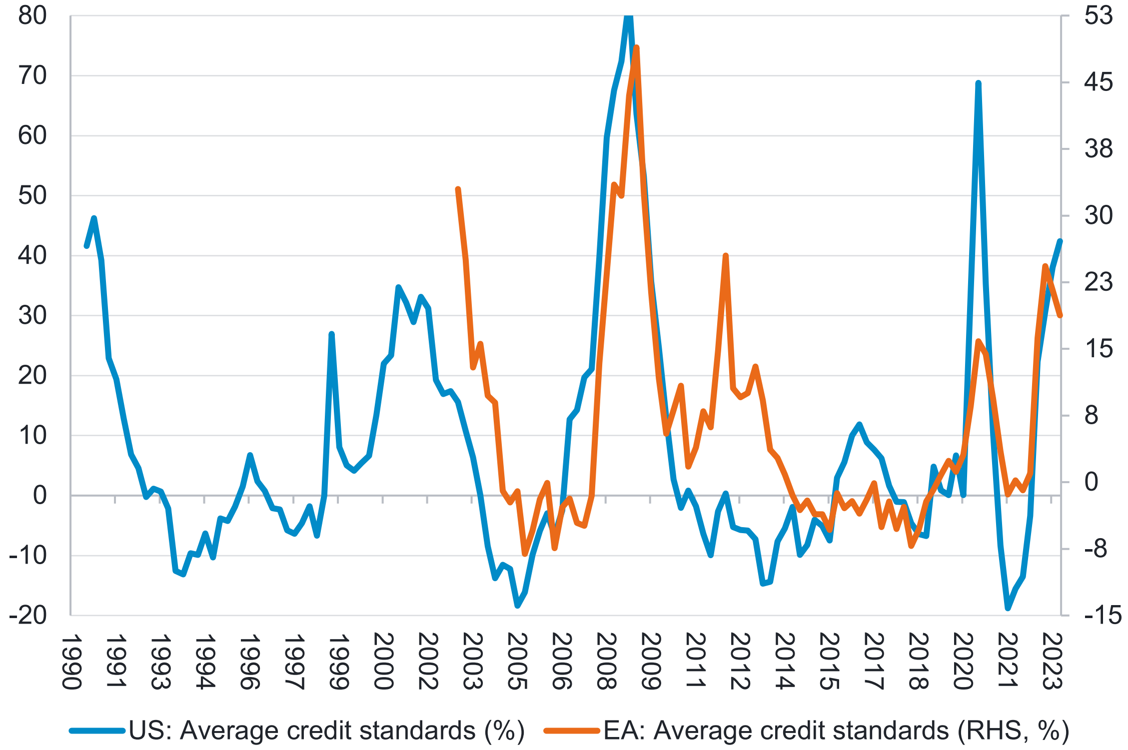


Source: Fidelity International, Haver Analytics, June 2023.

DM credit conditions on both the demand and supply side continue to deteriorate, setting up the possibility of things suddenly breaking from Q4 2023 onwards

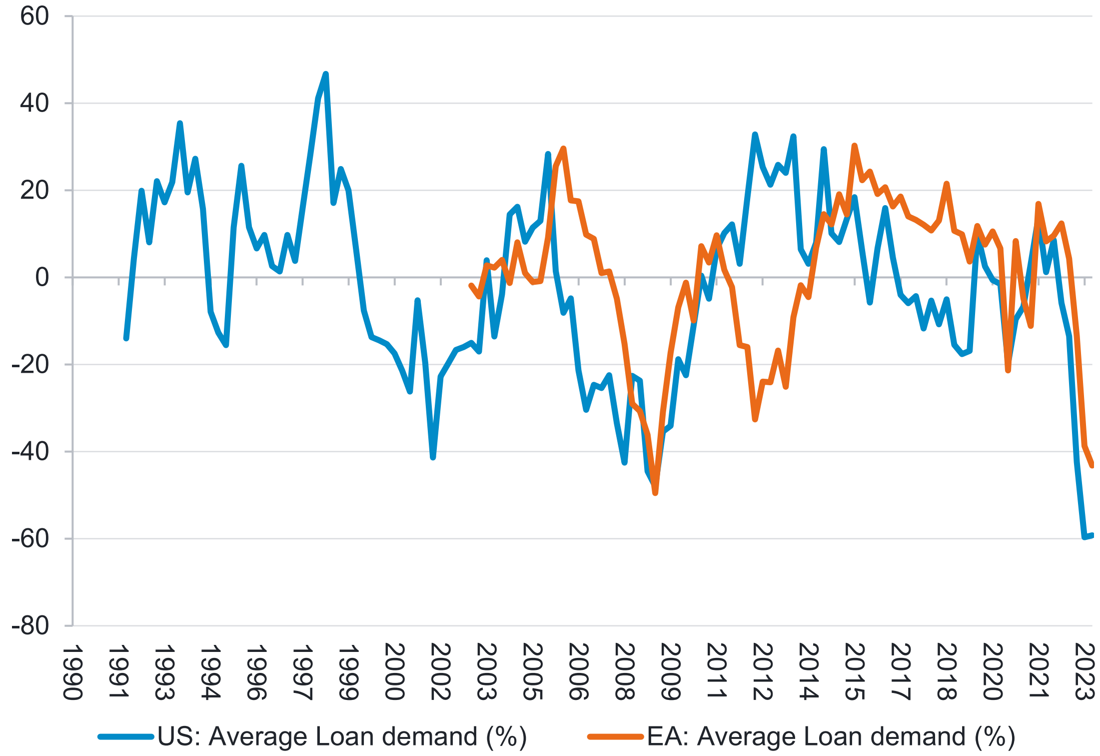
DM credit standards continue to tighten…

Economy-wide bank credit standards



… whilst indicators of loan demand are seeing significant falls.

Economy-wide bank loan demand

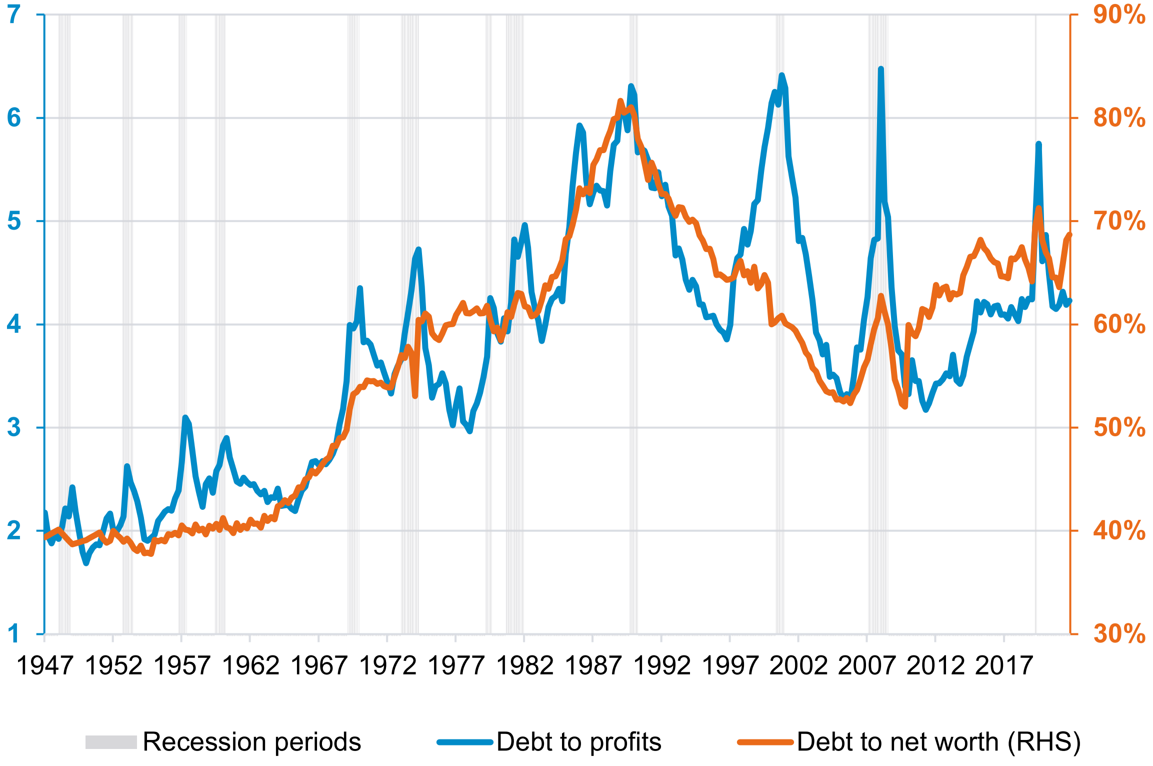


Note: For US average, sub-components include: C&I loans, residential mortgages, and commercial real estate. For Euro area average, sub-components include: business loans, residential mortgages, and 'consumer credit & other lending'.

Source: Fidelity International, Haver Analytics, June 2023.

Corporate maturity wall poses balance sheet risks if the US Fed is forced to keep rates elevated in the face of high and sticky inflation

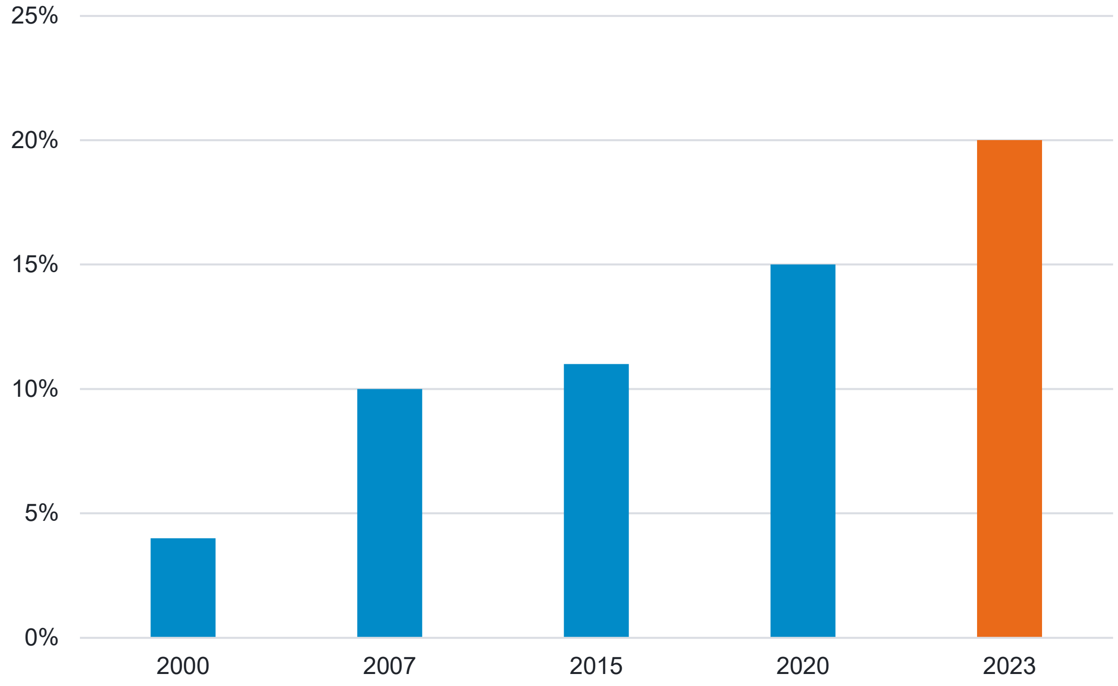
US corporate balance sheets stretched compared to prior recession levels



Source: Fidelity International, Haver Analytics, April 2023.

Significant amount of corporate debt comes due in 2025

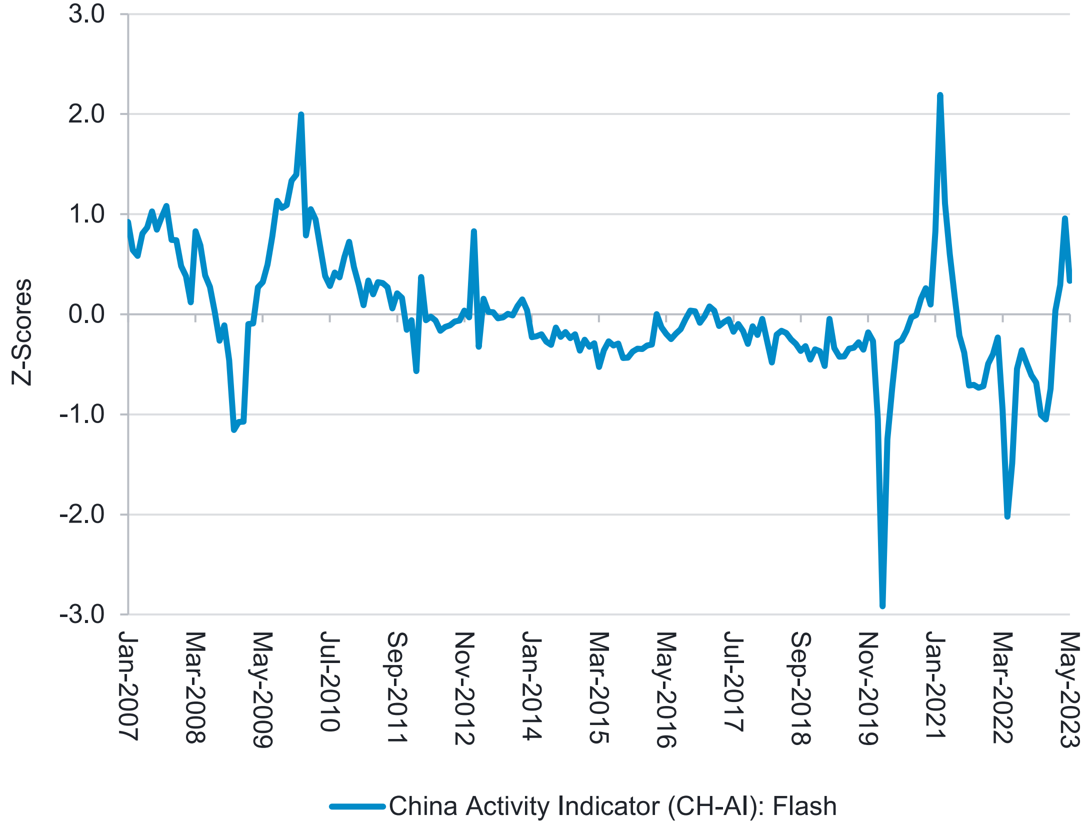
Percent HY debt due within 3 years



Source: Fidelity International, MS, ICE, April 2023.

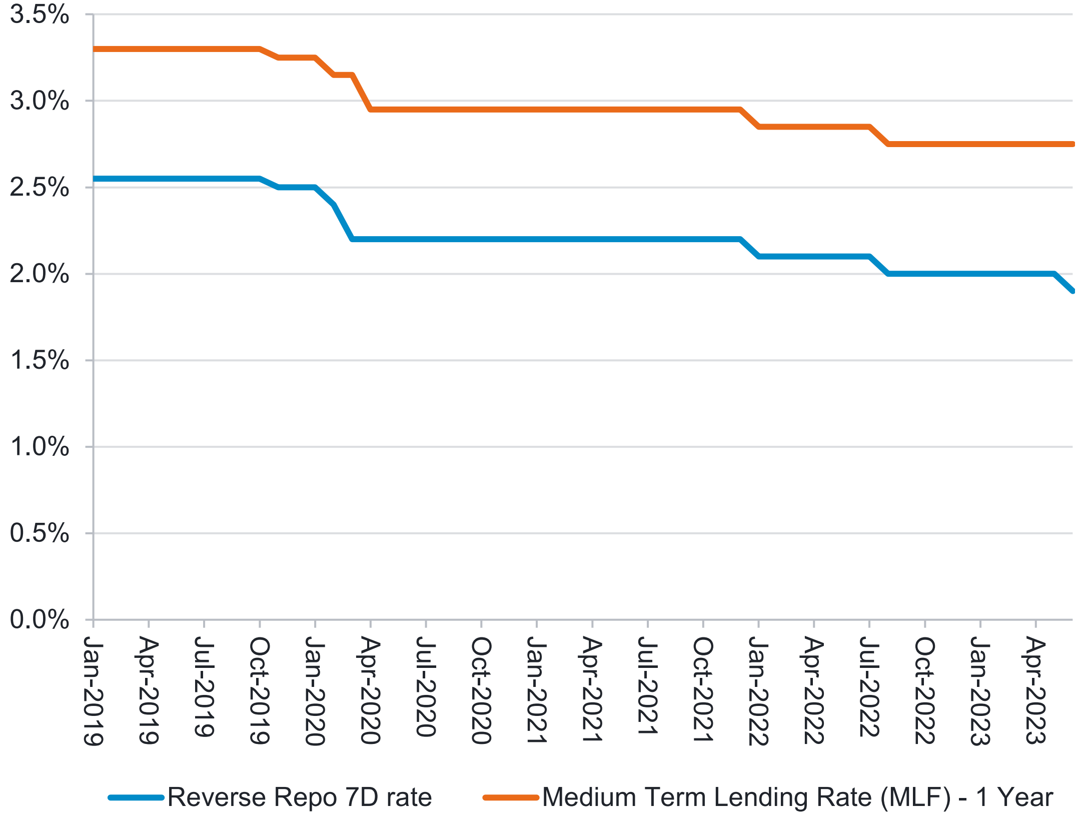
China Outlook: A gradual recovery which hits the official growth target is our base case, but risks are tilted to the downside

Activity has begun to moderate on a year-on-year basis as re-opening effects fade



Source: Fidelity International, Fidelity Global Macro Team calculations, June 2023.

Latest rate cut is fuelling expectations of more policy stimulus ahead, but changed reaction function makes this unlikely

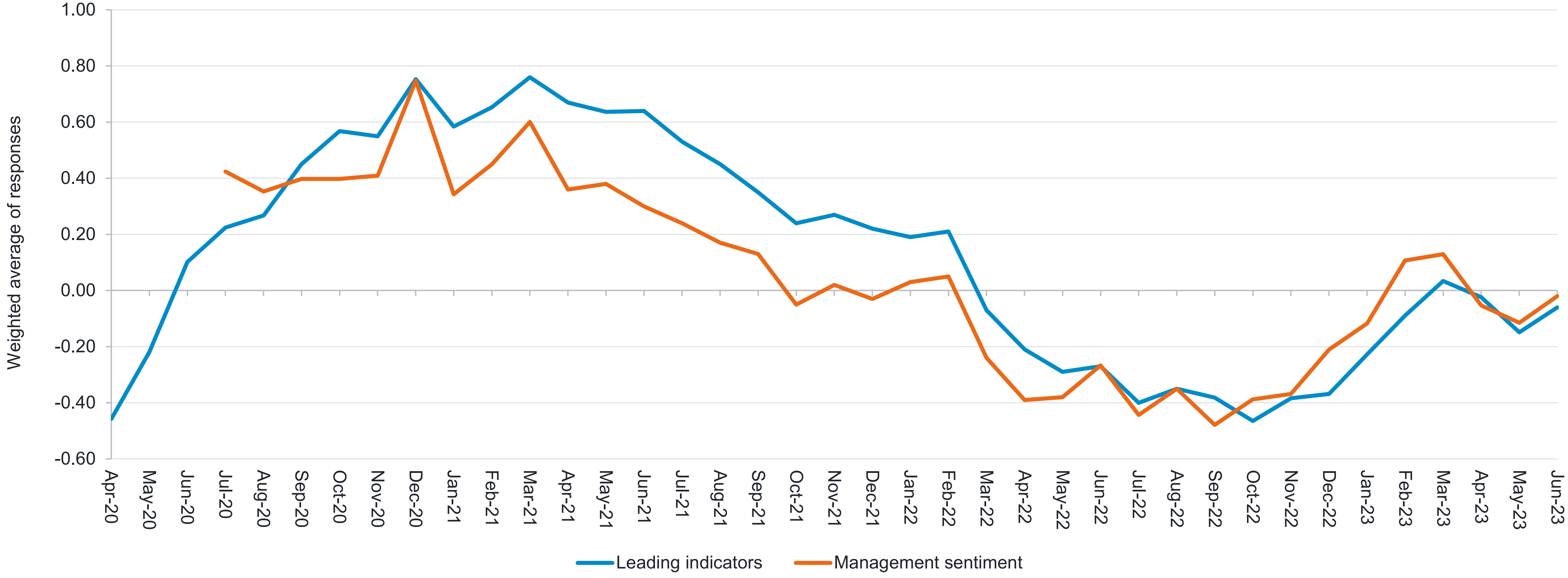


Source: Fidelity International, Bloomberg, June 2023.

Global Investment Research

Was management sentiment resting or stalling earlier this year? An uptick last month suggests the former, even if the regional picture is mixed

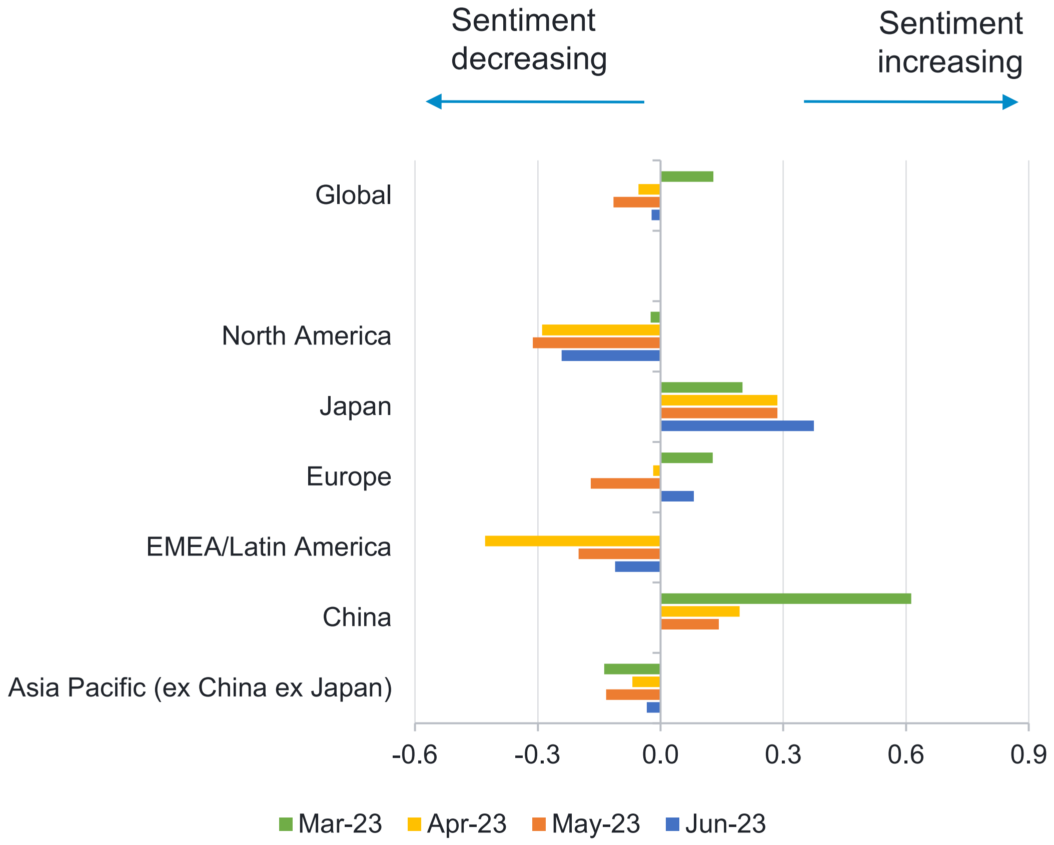
Fidelity analyst survey corporate leading indicators and management sentiment, June 2023



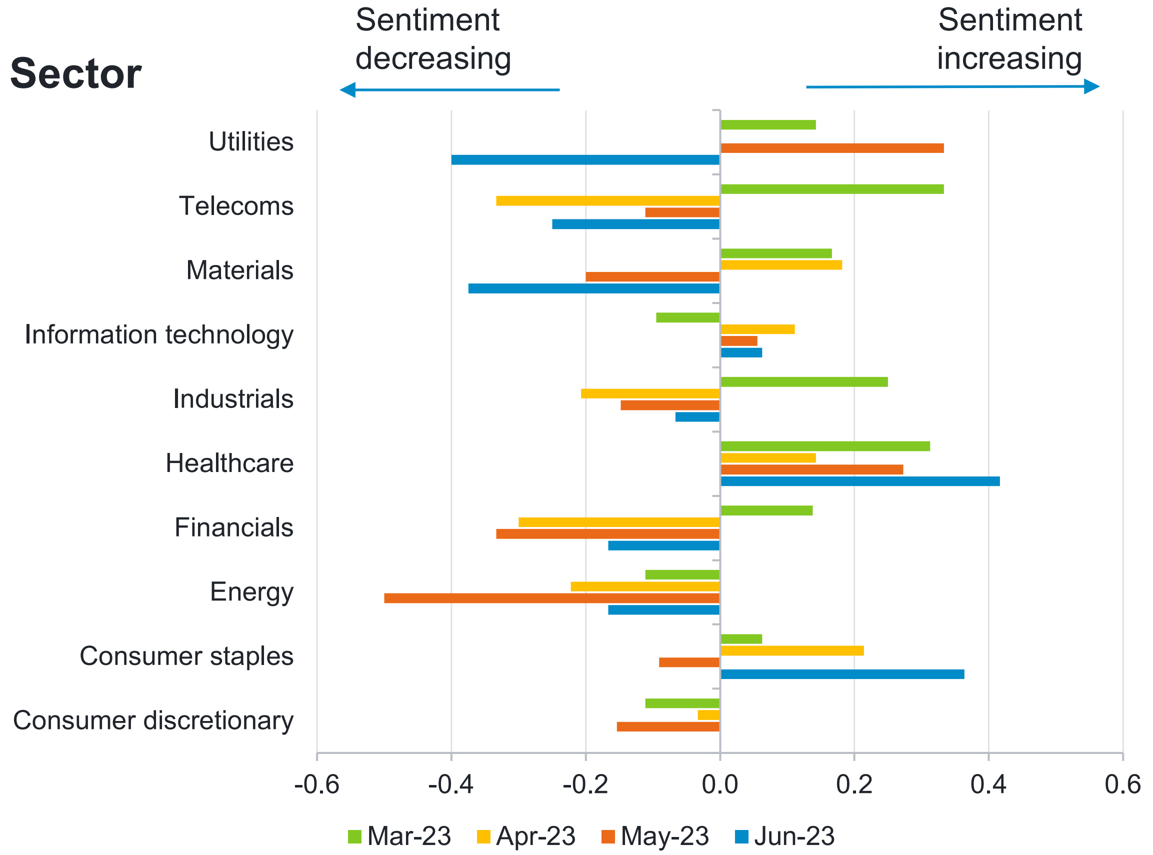
Source: Fidelity International Global Investment Research, June 2023

Fears in the US and Europe ease as financial sector concerns abate, while sentiment in China remains flat; consumer staples take off

Management sentiment by region

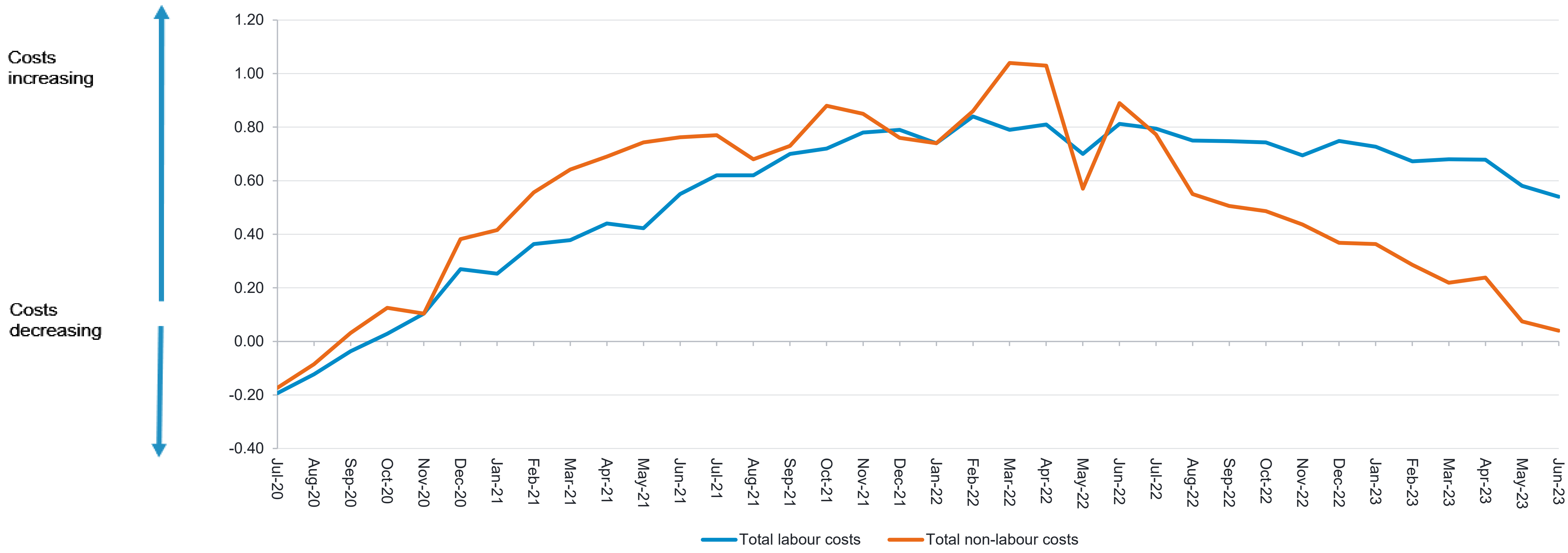


Management sentiment by sector



Source: Fidelity International Global Investment Research, June 2023. Charts show proportion of responses reporting management sentiment is positive minus those reporting management sentiment is negative; strong negative and strong positive receive a higher weighting. Question: "Based on your recent research and interactions with companies, to what extent, if at all, has your perception of management sentiment over the next 6 months changed?"

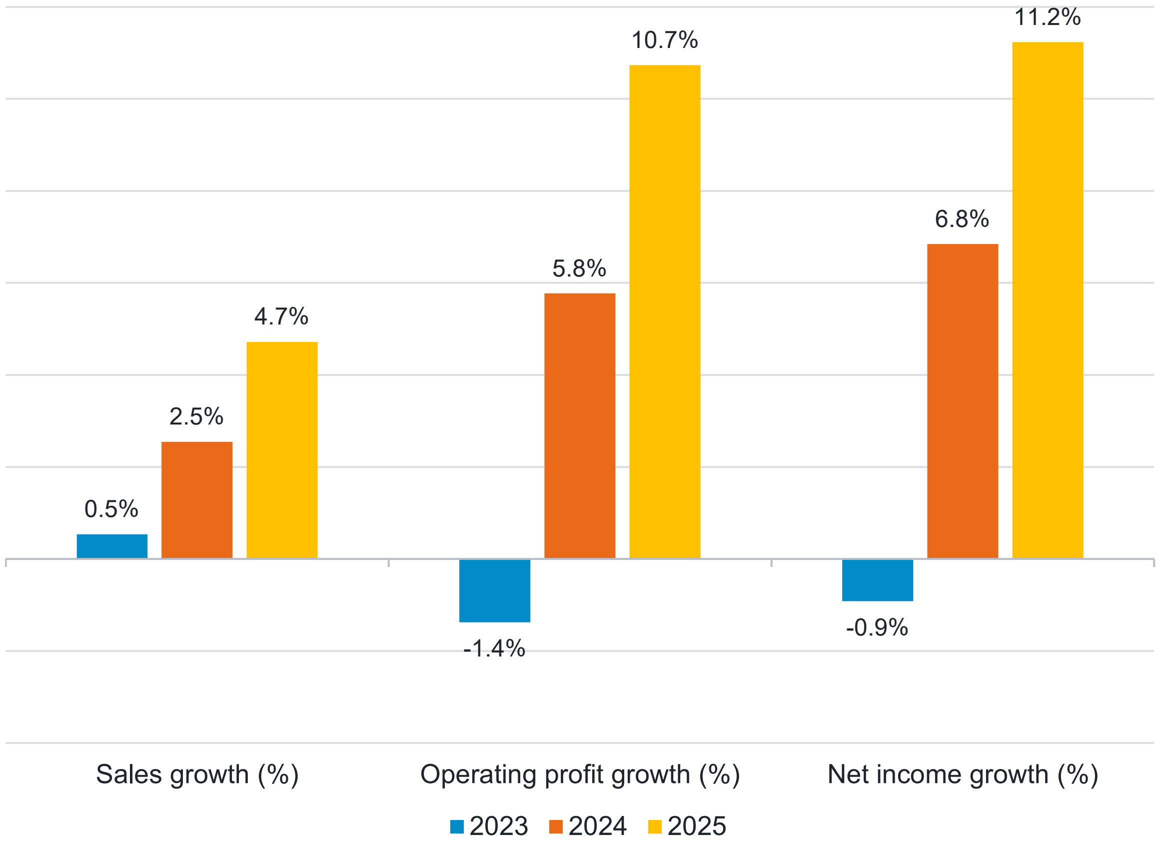
Global cost increases continue to trend downwards; non-labour costs likely to turn deflationary this quarter



Source: Fidelity International Global Investment Research, June 2023

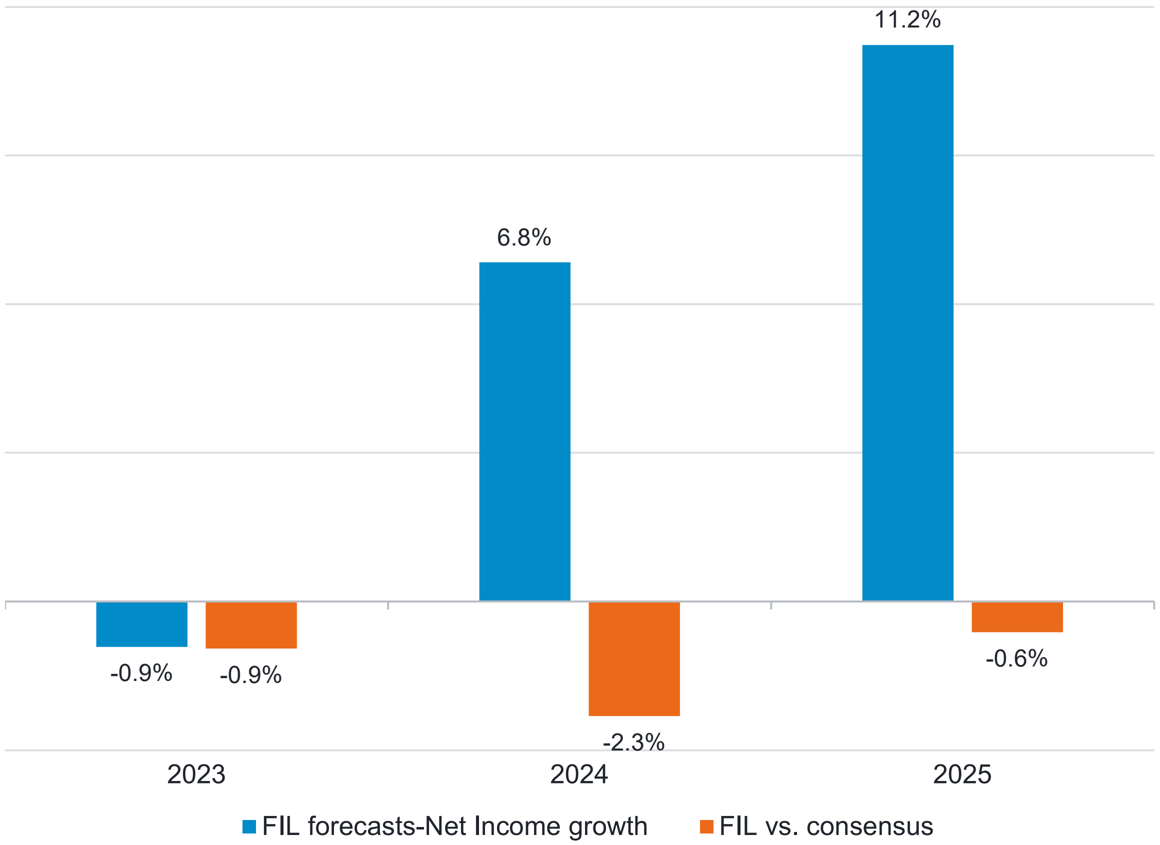
Expect a squeeze in operating and net income growth this year, with a bounce back to come in 2024

Global Growth forecast



Source: Fidelity International, IBES, 31 May 2023

Fidelity vs Consensus YoY Growth %



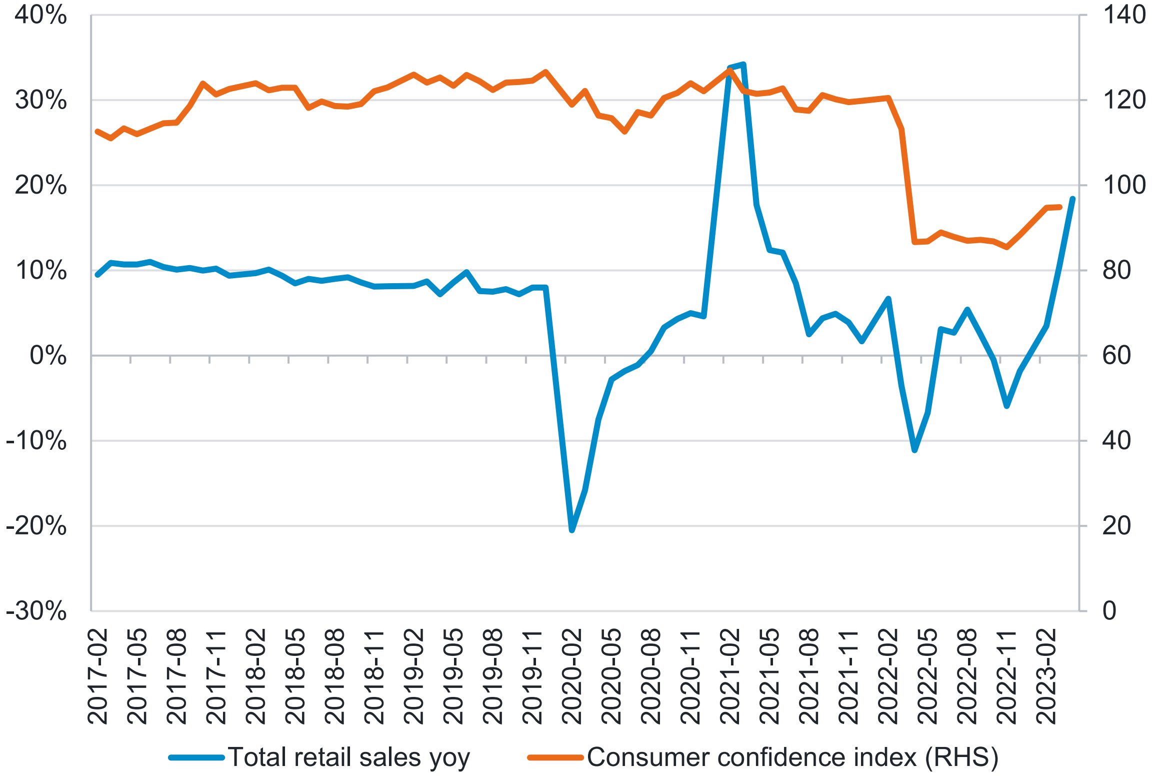
Source: Fidelity International, 31 May 2023

China Flagship Trip: Recovery so far is underwhelming and uneven

Consumers hesitate to spend and focus on value-for-money amid economic uncertainties

Retail sales rise but low consumer confidence hinders a full recovery

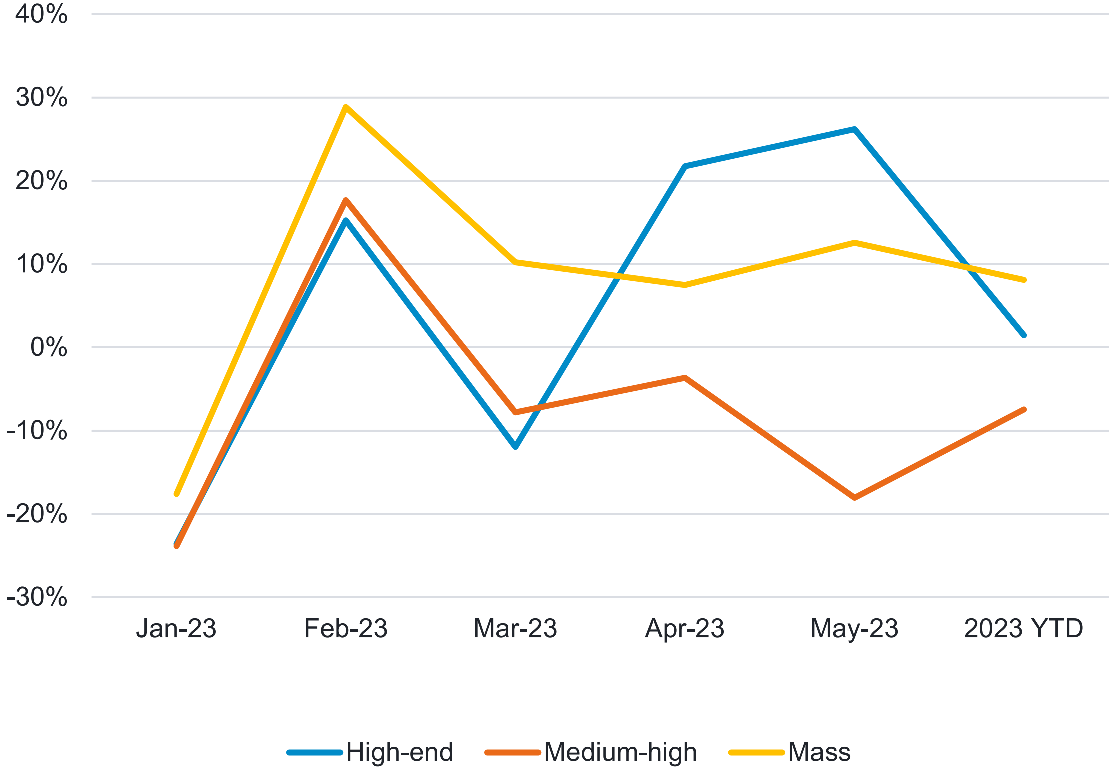
Total retail sales growth and consumer confidence index



Source: National Bureau of Statistics, April 2023

Bifurcated sales trend among different product segments

China online cosmetics sales growth



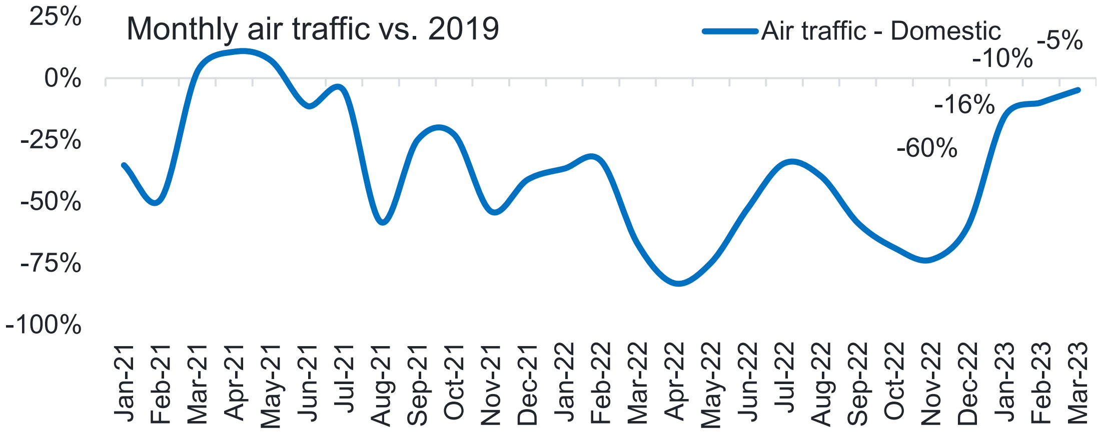
Source: Tmall, Taobao, TikTok, JD, May 2023

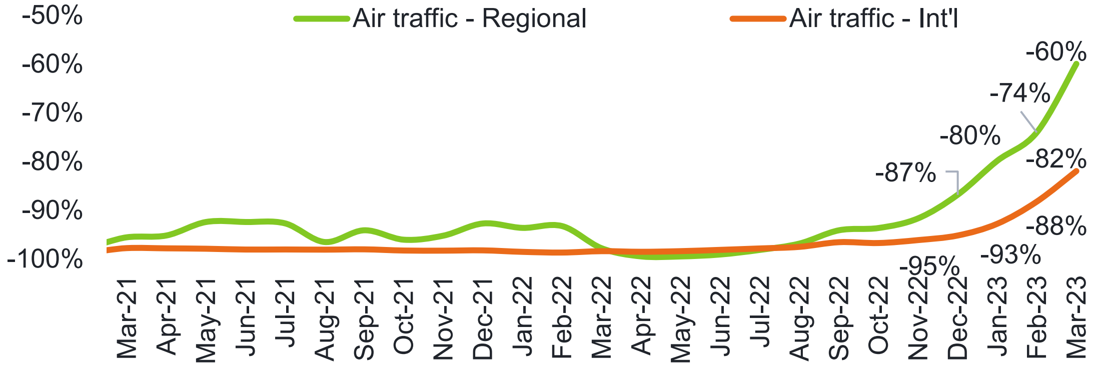
Good news is that the China recovery is still in early innings

Plenty of opportunities from market penetration, consolidation of smaller players and localisation

Air traffic yet to return to pre-COVID level

Domestic and overseas air traffic vs. 2019

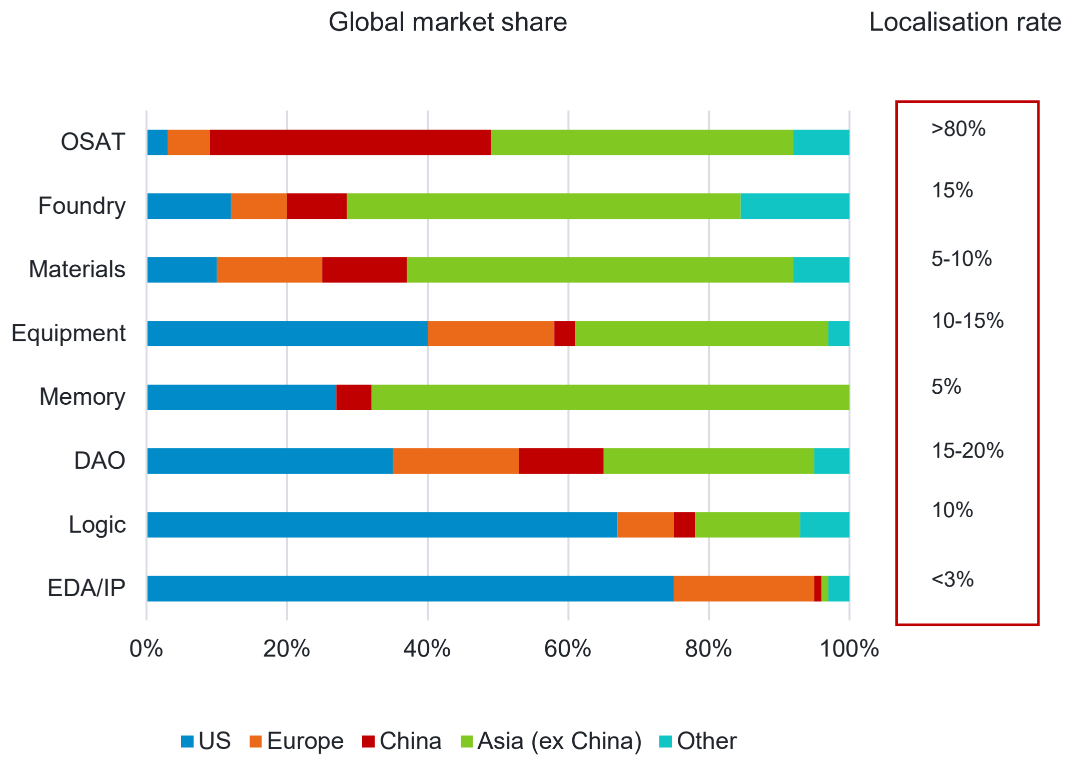




Source: CEIC, March 2023

Low localisation across semiconductor value chain

Chinese players' global market share and localization rate



Source: Fidelity International, 2022

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Real Estate

Real Estate: Key takeaways

Tight demand and supply balance in Europe

- Unusually tight demand / supply balance in Europe which is providing short term resilience in the market.
- Fragility later would come primarily from greater interest rate rises than anticipated which would have a negative knock-on effect for both the investment and occupier market.

Sustainability provides opportunities

- Structural move to sustainable offices and hybrid working, providing opportunity for green building strategies and bifurcating the market.
- Weak demand for ‘unsustainable buildings’ / strong demand for more sustainable buildings.

European office & logistics vacancy rates remain low

- European market structures (planning regimes, availability of finance for speculative development) have restricted new development, resulting in low levels of vacancy, and shortages of best-in-class space.
- In contrast, US markets have seen significant speculative development activity, leaving the market oversupplied.

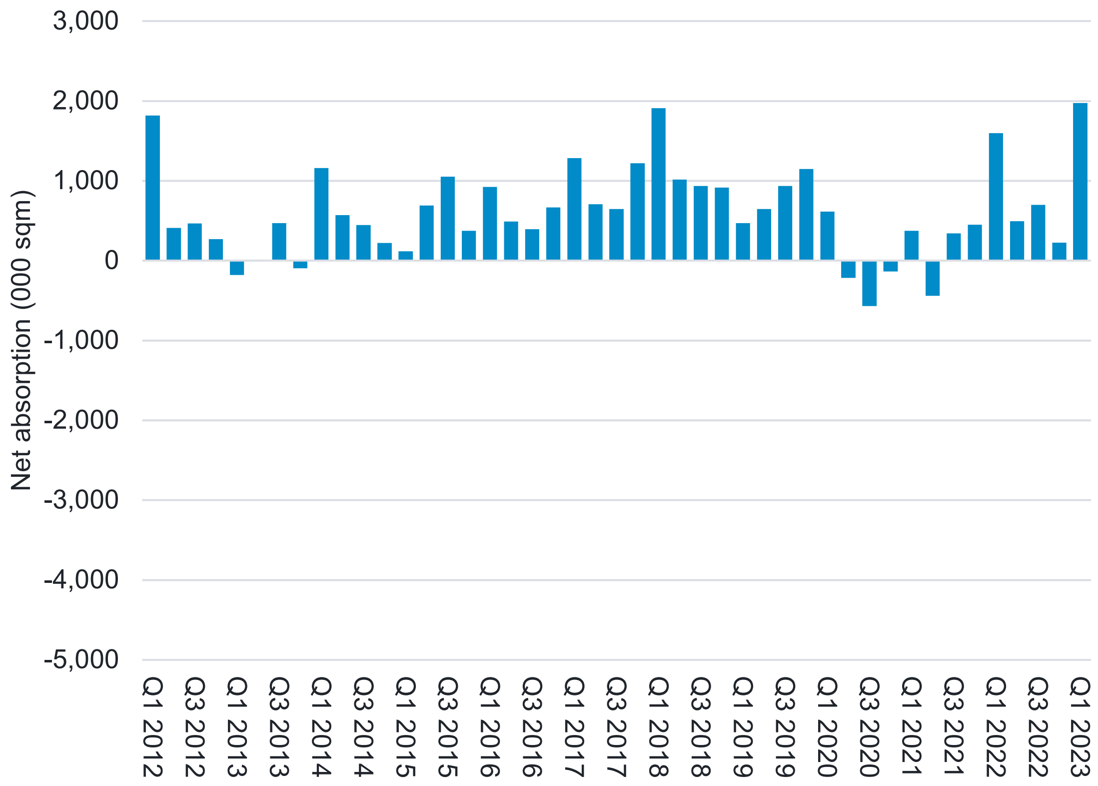
Valuations indicate markets are stabilising

- Prices have fallen by 15-25 per cent in past year, driven by change in interest rates. Speed of adjustment has been unprecedented.
- Short term indicators suggest values are now stabilising, but a higher for longer scenario for interest rates could put yields under further pressure.

Unusually tight demand and supply balance in Europe providing short-term resilience

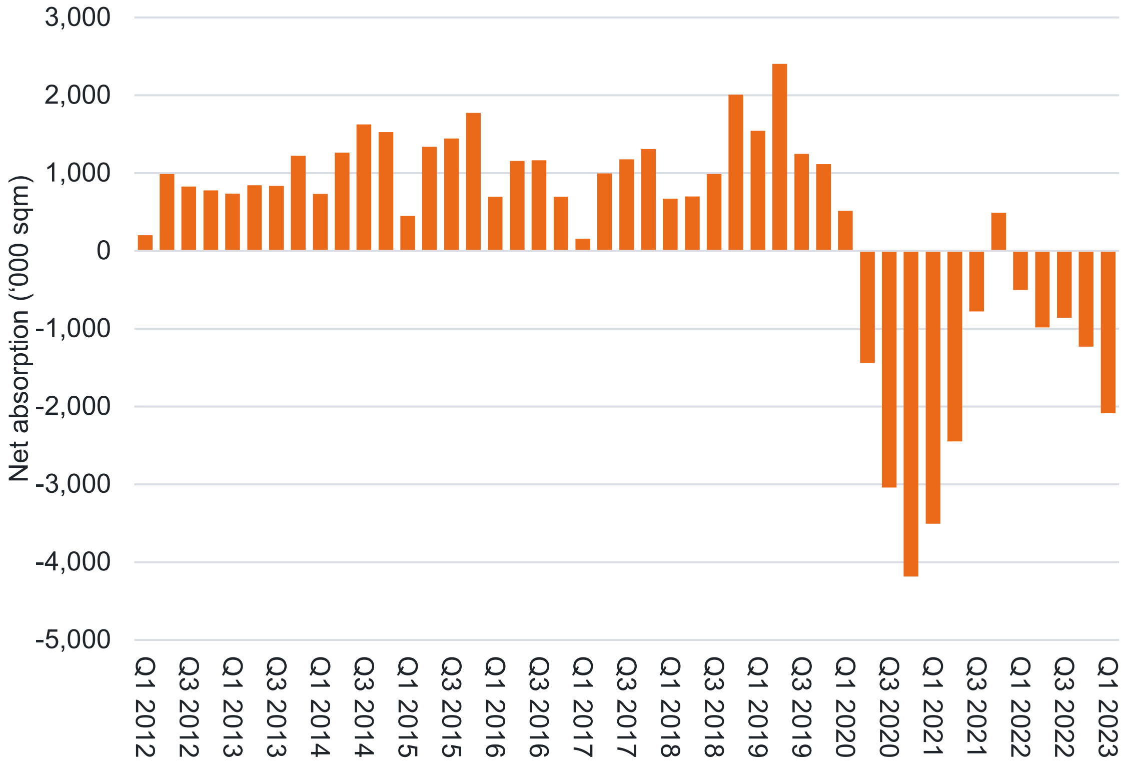
But US market suffering from excess supply and weak demand as companies reassess space requirements

Europe office market net absorption



Source: JLL, May 2023.

North America office market net absorption

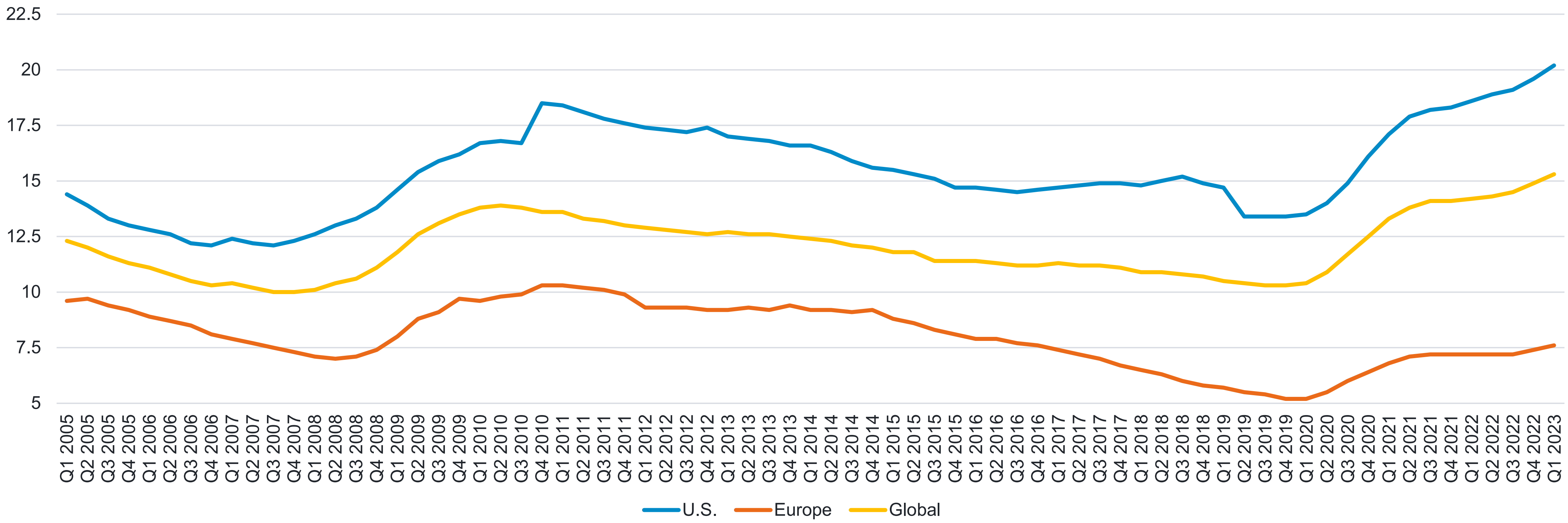


Source: JLL, May 2023.

European office vacancy rates remain low, supporting rental growth

Supply of ‘sustainable’ buildings is even more limited, supporting ‘green’ premium.

Office vacancy rates (%)



Source: JLL, May 2023.

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Private Credit

Private Credit: Key Takeaways

Debt servicing costs add pressure

- Amidst rising rates and high inflation, leveraged firms' debt servicing costs have risen to account for around 36 per cent of their cash flow. This has not yet been fully felt in companies' performance, but may soon begin to impact capex and growth.
- Companies from the most stable sectors tend to be carrying the larger amounts of debt. These are the firms most impacted by this dynamic but are also those that are able to withstand increased costs.

Credit selection remains key

- While the rise in debt costs offers opportunities for investors, the decline in interest coverage ratios is likely to drive an increase in defaults going forward.
- Any weaknesses are likely to be company specific rather than sector wide, with dispersion felt across industries, so a prudent review of credit is paramount.
- The default rate likely to be more restrained in Europe than in the US.

Liquidity runs deep

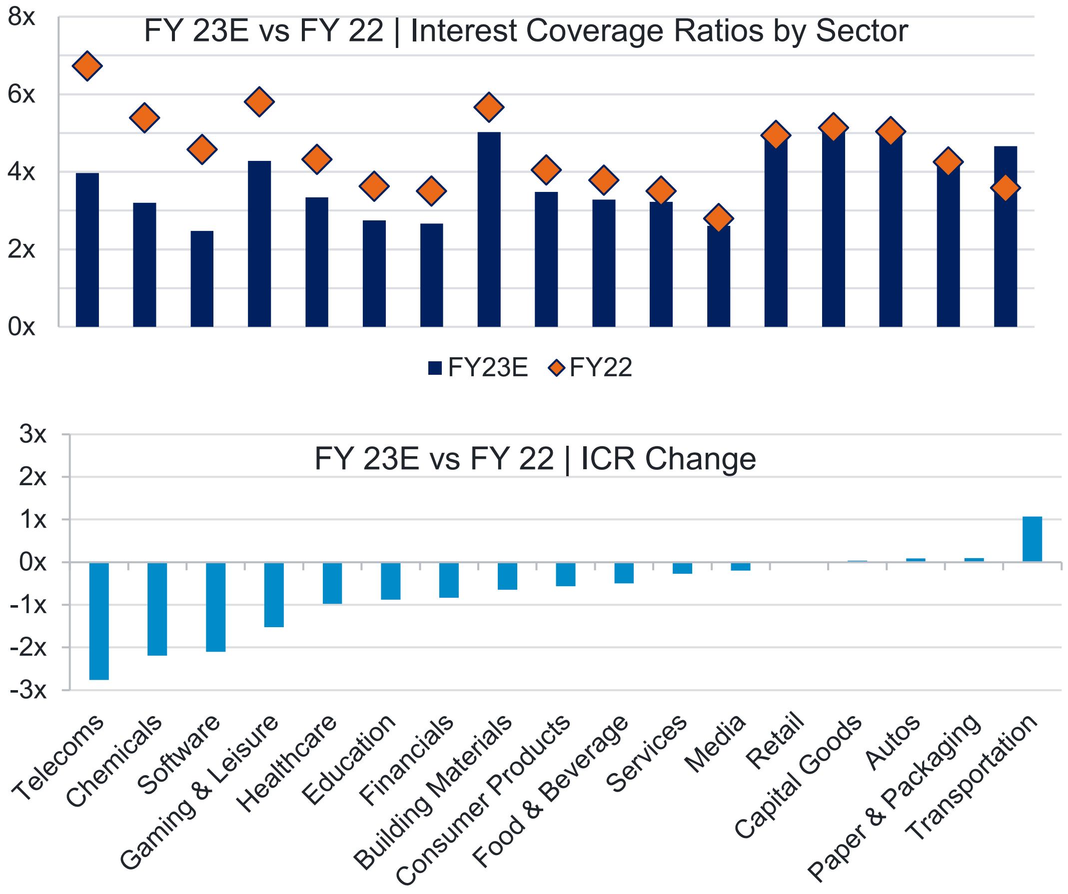
- The volume of dry powder available in both private credit and private equity funds is running at some of the highest levels ever reported. Amendments and extensions of existing deals are getting done across Europe even for borrowers with tricky capital structures.
- Issuers have only drawn on around 15 per cent of their revolving credit facilities, suggesting a level of flexibility is still available to issuers.

Stability through the volatility

- There is little clarity on the economic outlook. But whether sticky inflation means rates remain higher for longer, or whether deteriorating economic fundamentals prompt a pivot, we believe high quality carry in private credit has strong benefits.
- Should a repricing event occur in the second half of the year, we anticipate private credit will experience lower volatility while still offering a meaningful rate of return.

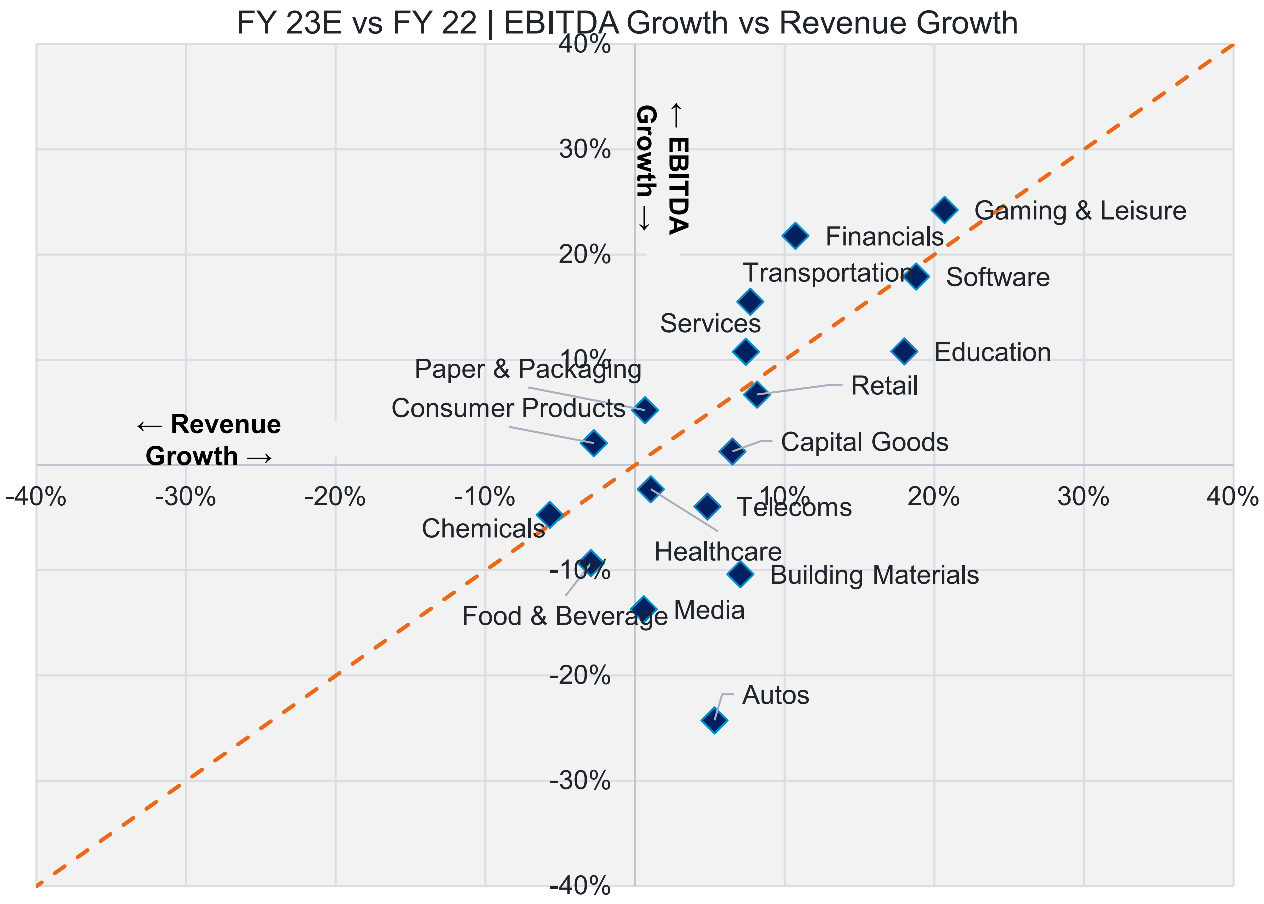
Climbing debt servicing costs starting to bite on back of rising rates

Interest coverage ratios broadly falling year on year as debt costs rise –it is the names in strongest sectors that have most leverage and so facing the most pressure



Source: Fidelity International, June 2023.

The inflationary backdrop continues to support revenue growth in most sectors, but EBITDA growth weakening in some industries



Source: Fidelity International, June 2023.

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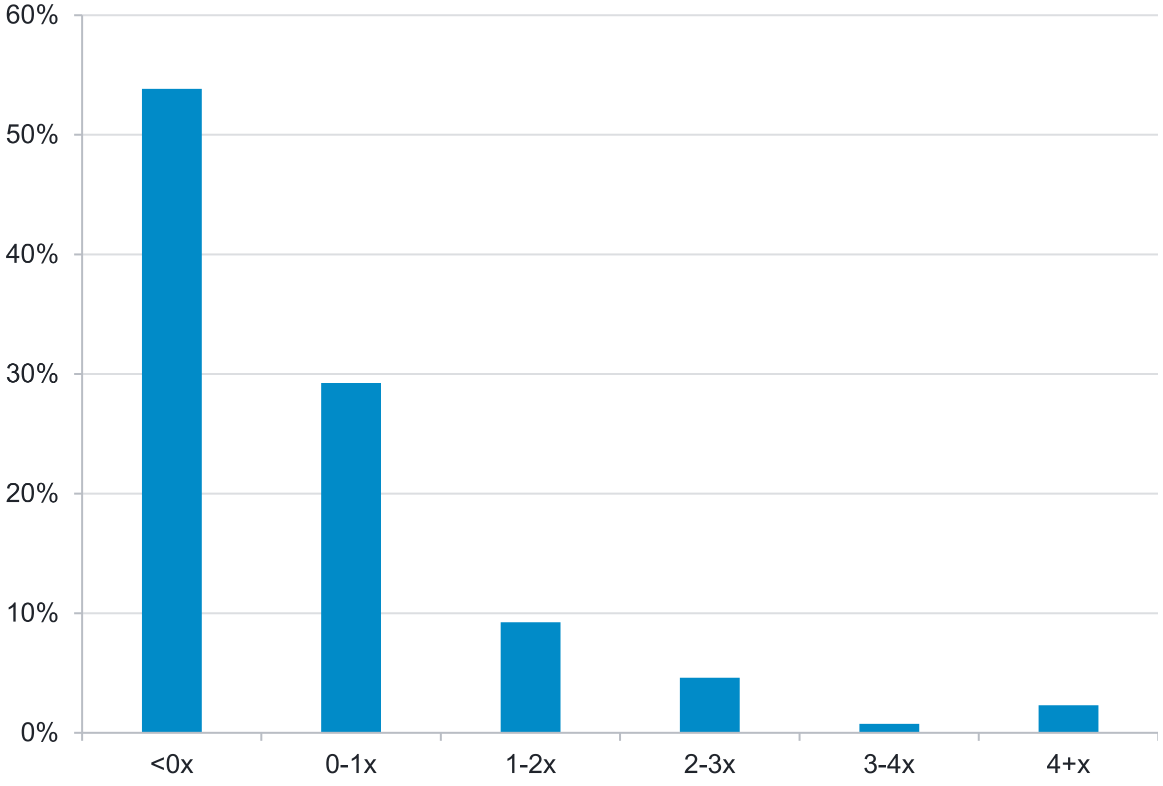
Majority of companies not yet pressured to refinance in higher spread environment although some pressure points exist

Sponsors and issuers have been proactive in managing their capital structures, with plenty of capacity to draw funding from revolving credit facilities remaining.

More than half of the names in our coverage are deleveraging by the end of the year…

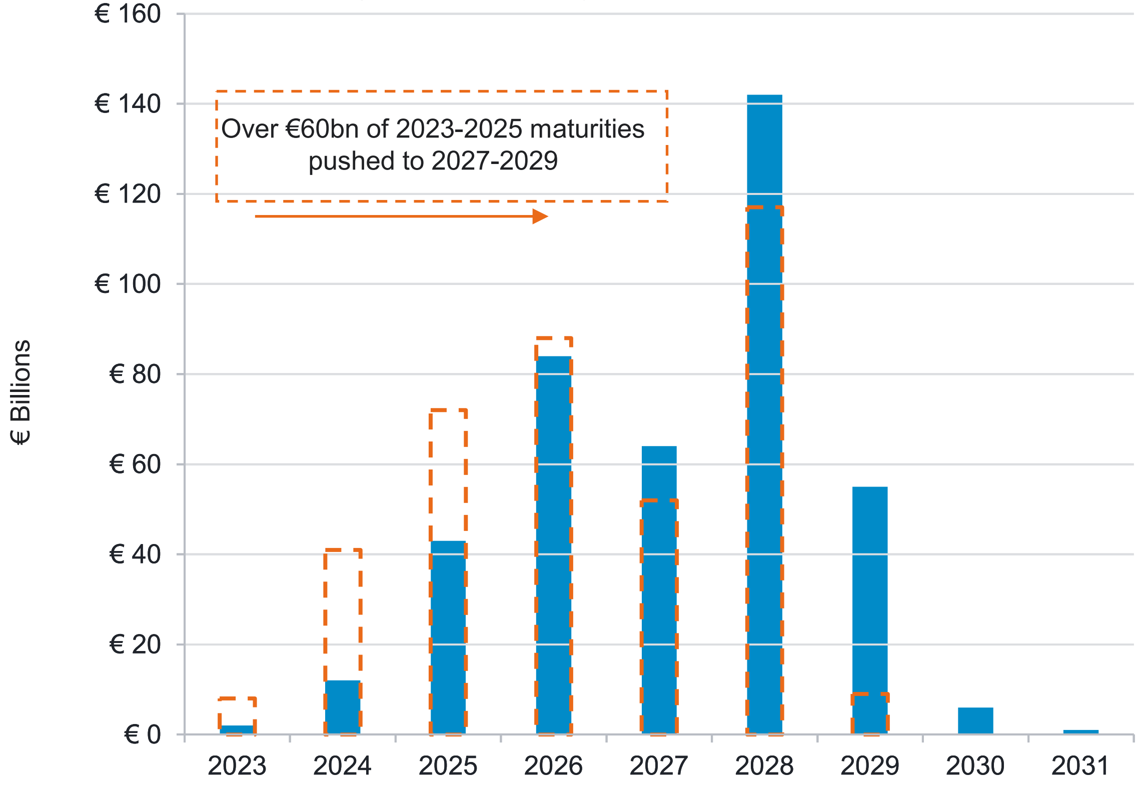
FY 23E vs FY 22 | NTL Change



Source: Fidelity International, June 2023.

…while the maturity wall in the leveraged loan market is being chipped away

Leveraged loans – maturity wall as it stood in Jan 22 vs June 23



Source: Credit Suisse Western European Leveraged Loan Index, June 2023.

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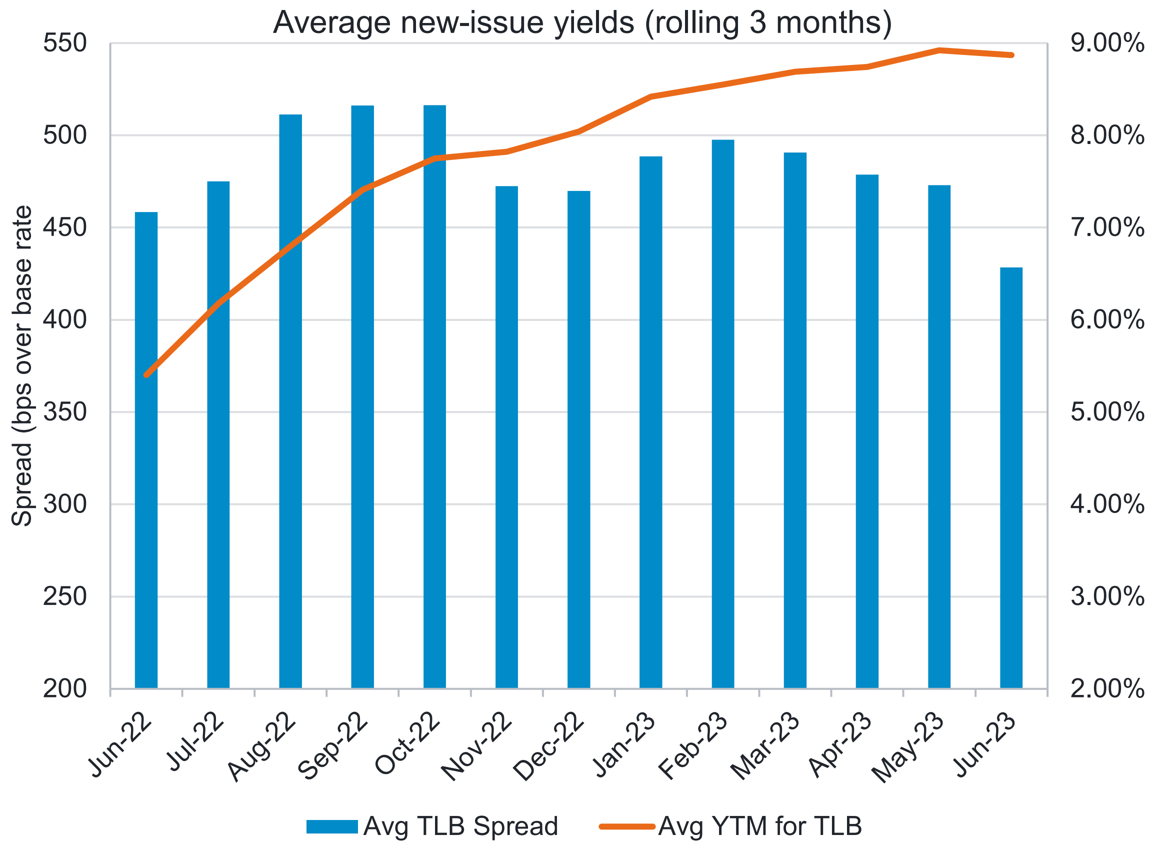
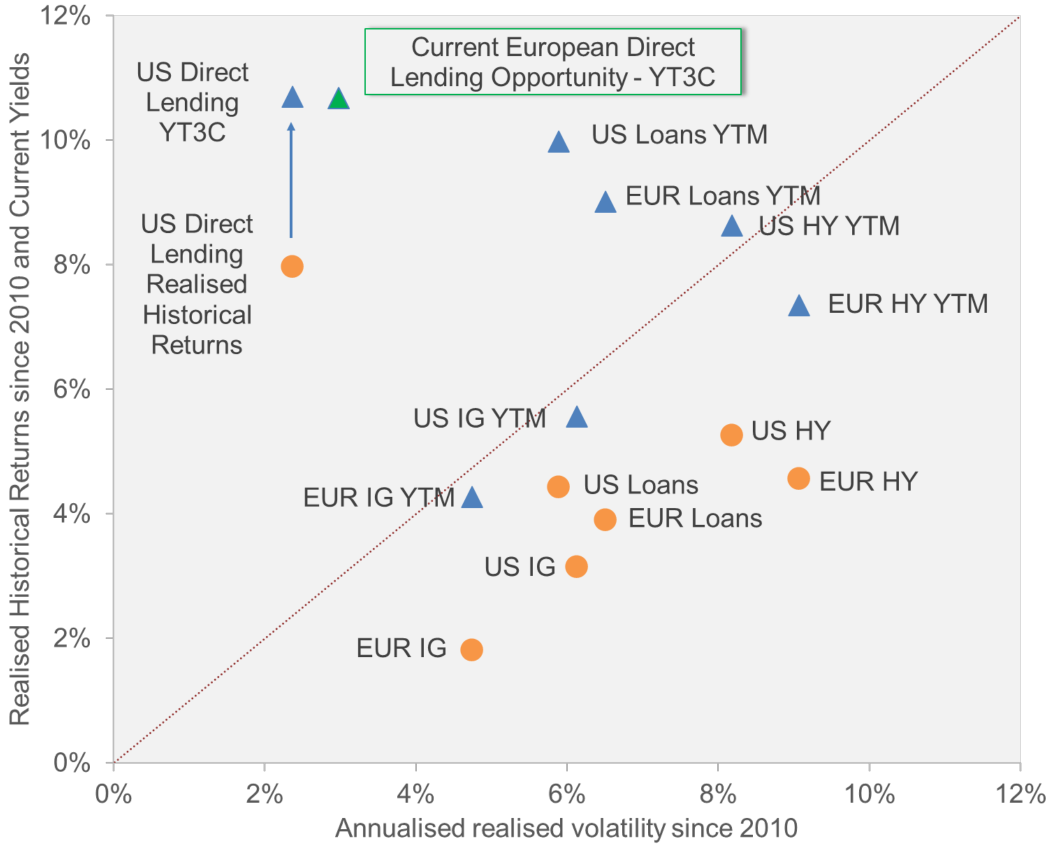
Returns and terms remain compelling as investors take upper hand

In the European senior secured primary market yields have risen to almost 9 per cent



Source: PitchBook | LCD, June 2023

Current market yields remain promising, but even including previous losses realised returns



Source: Cliffwater Direct Lending Index, Credit Suisse Leveraged Loan Index, Credit Suisse US High Yield Index, Credit Suisse Western European Leveraged Loan Index, ICE BofA Euro High Yield Index, June 2023

Fixed Income

Fixed Income: Key takeaways

Recessionary risks persist

- It has been an unusual cycle in that a slowdown is taking longer than usual to appear because of the preceding tsunami of fiscal and monetary easing due to Covid.
- Central banks have raised rates aggressively and are reaching breaking point. Policy rates at current levels could create a credit event and negative growth shock.

Now is the time for duration

- US inflation is well placed to continue its decline given the sharp contraction we have seen in Fed money supply growth (a leading inflation indicator).
- IG credit markets are relatively well priced for a recession, especially in Europe - but high yield and European equity markets are not.

Money market funds continue to reap the benefits of higher rates

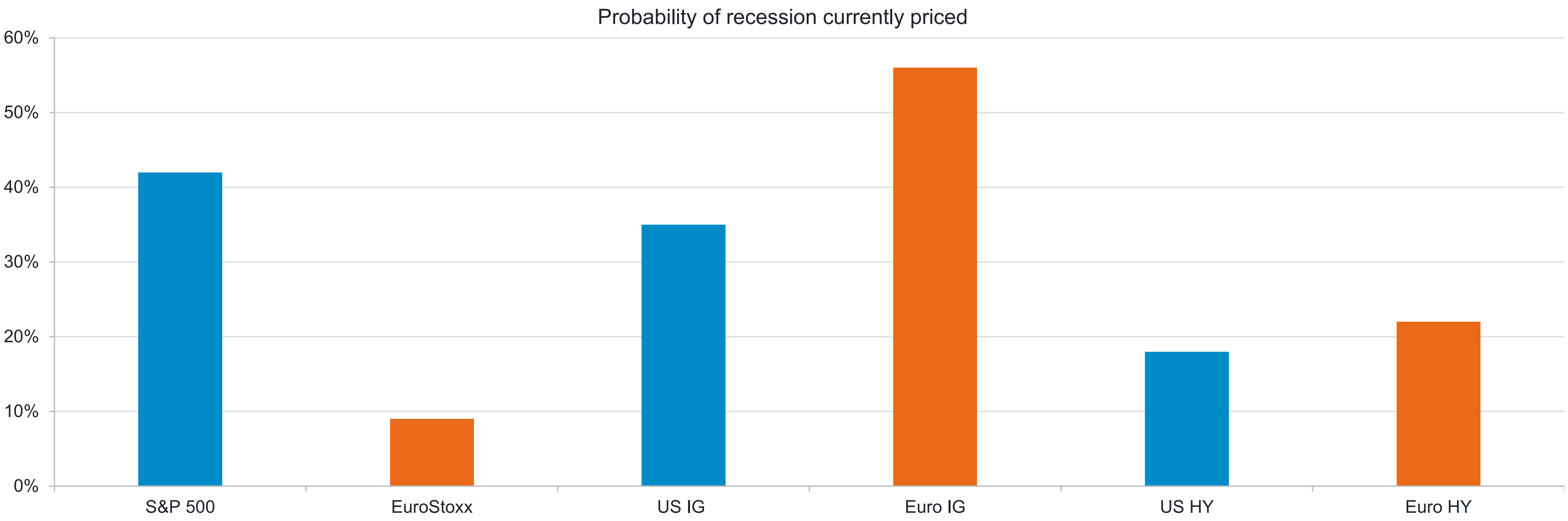
- With debt ceiling negotiations behind us we are going to see a large amount of issuance, coupled alongside quantitative tightening, as the treasury rebuilds its cash buffer in coming months. This is likely to drain dollar liquidity, as market participants reallocate further to money market funds to absorb this additional issuance.
- The magnitude of impact will depend on whether issuance comes from reserves or the reverse repurchase agreement (RRP). The former would be more painful for markets.

Source: Fidelity International, 2023.

The ‘best flagged recession in history’ still isn’t upon us

Excess savings as a result of Covid mean it’s taking longer for tighter financial conditions to bite

Higher quality credit markets are relatively well priced for a recession, especially in Europe - but HY markets are not

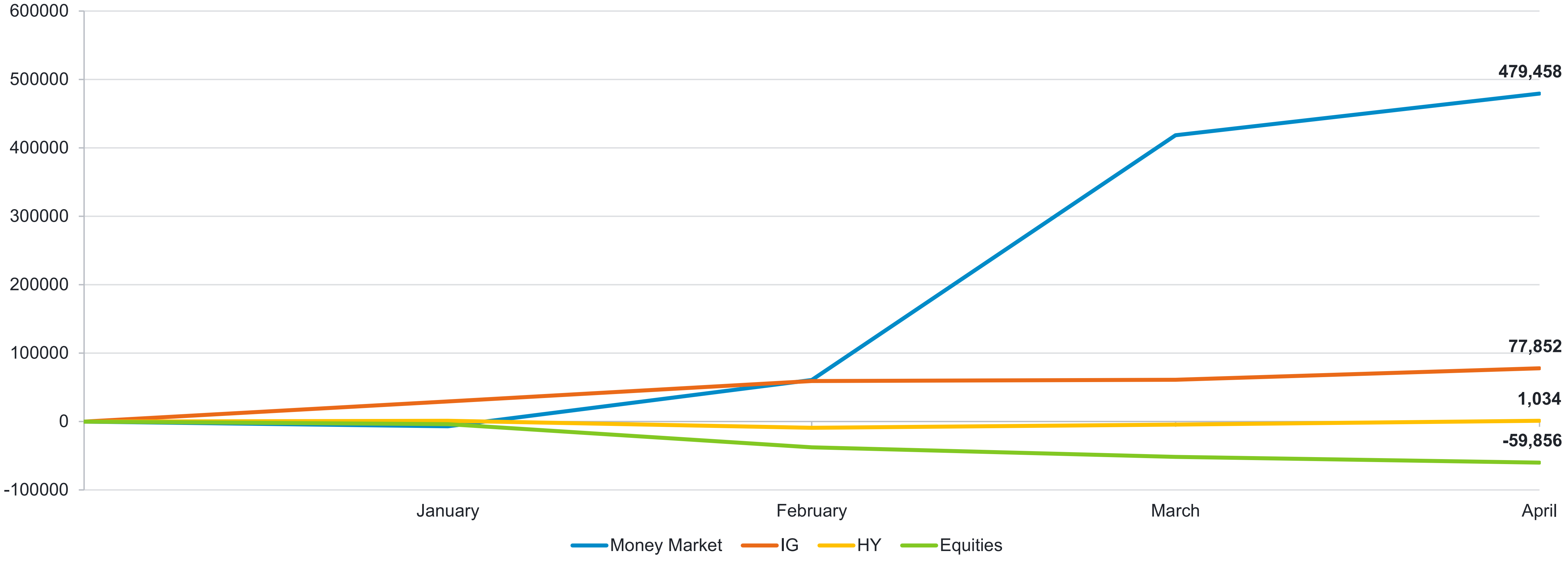


Source: Fidelity International, JP Morgan Research, 8 June 2023.

Money market funds continue to reap the benefits of higher rates

Huge issuance of US$1trn in coming months is likely to drain dollar liquidity, but the magnitude depends on whether it comes from reserves or the RRP. The former would be more painful for markets.

Cumulative US Fund Flows YTD (USD$m)

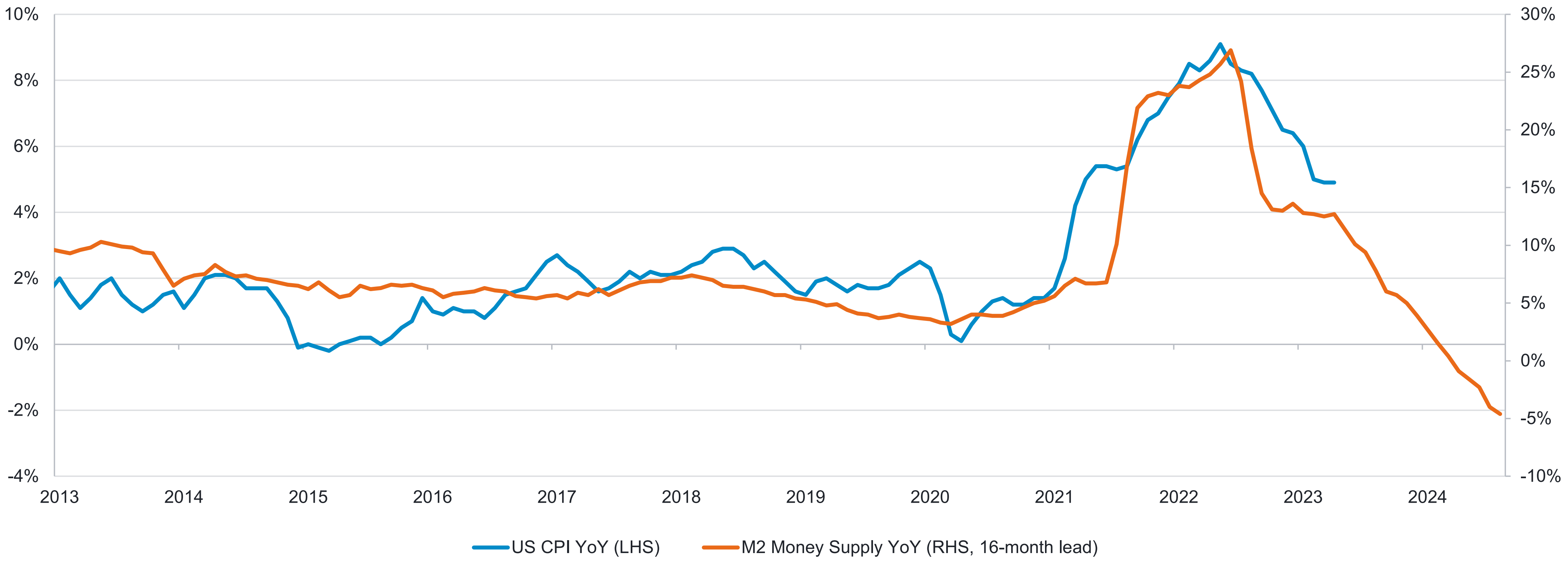


Source: Fidelity International, JP Morgan Research, 9 June 2023.

Disinflationary forces are at play

Inflation is always and everywhere a monetary phenomenon

A slowdown in money supply growth might indicate slowdown in inflation



Source: Fidelity International, Bloomberg, 30 April 2023.

Equities

Equities: Key takeaways

Increasingly cautious on global equities

- Concentration risk in US equities is becoming very pronounced with the market hyped about AI and sanguine about potentially more Fed rate hikes.
- Equity volatility remains low, diverging from bond market volatility, indicating some complacency over the risks of recession.
- In Europe, despite deteriorating fundamentals, cyclical valuations versus defensives are extended.

Asia bucking the trend

- Japanese market reforms are having an impact. Companies are pursuing positive strategies including greater board diversity, better governance and increasing shareholder returns.
- In China, despite the slow recovery, weak policy stimulus and ongoing US-China tensions, companies are allocating capital better and valuations are both historically and relatively attractive.

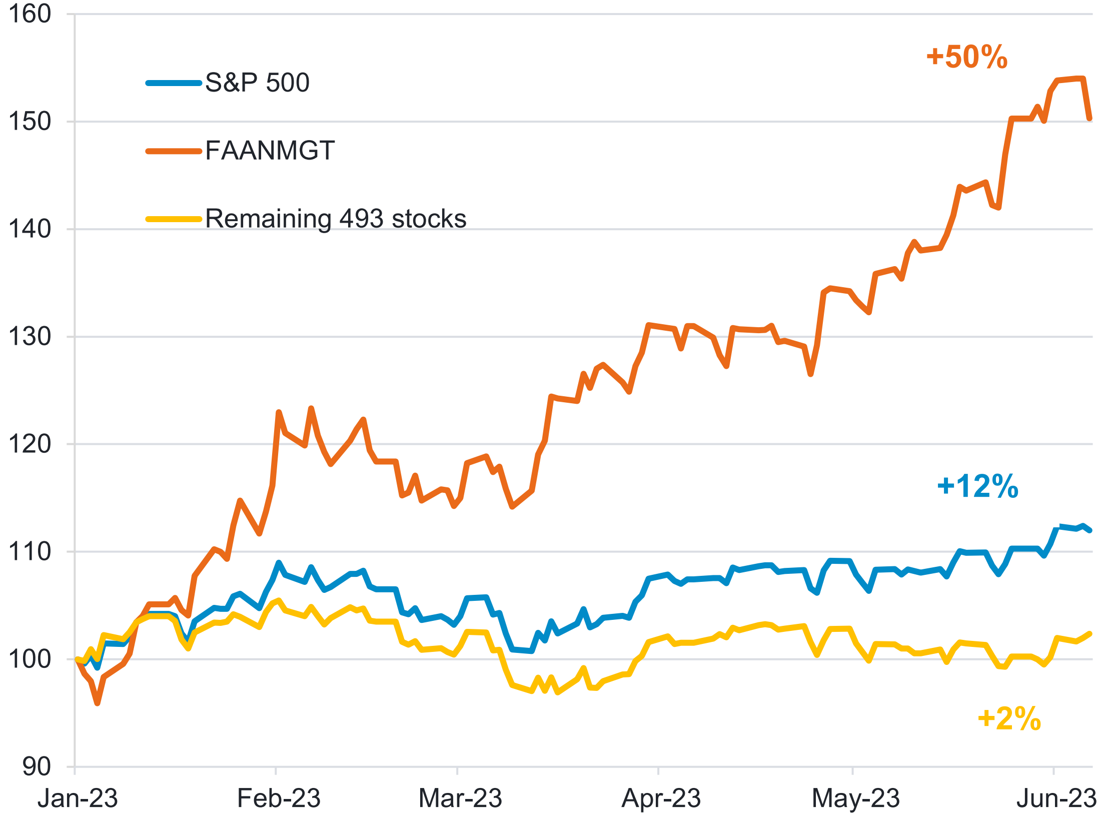
Margin pressure globally

- In all regions, margins are falling, but this is from relatively high 2022 levels.
- Earnings revisions ticking down in the US and Europe, but up in Asia.
- From a bottom-up perspective, we expect global earnings growth to be slightly negative this year, but bounce back to mid-to-high single digits next year.

US equities showing signs of complacency

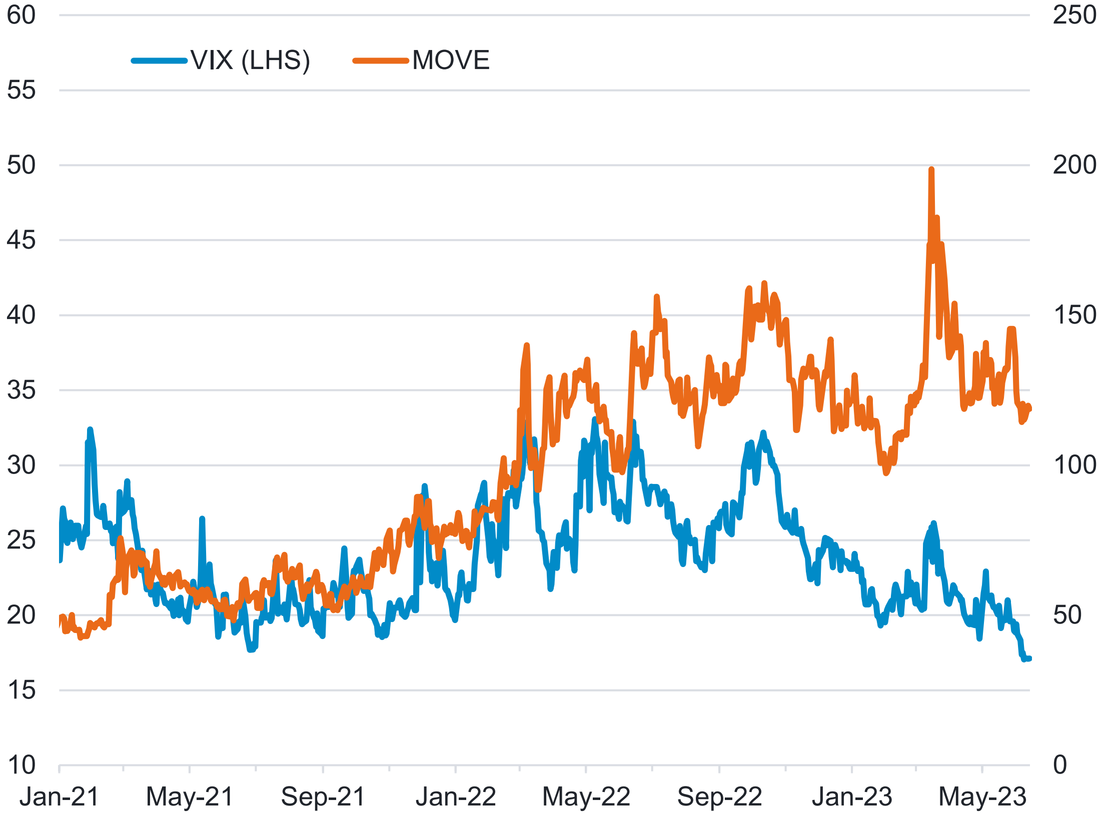
Highly concentrated and calm market, despite the risks

Mega cap tech driving US performance in 2023



Rebased to 100 as of Jan 23. Source: Fidelity International, Goldman Sachs, 7 June 2023. Note: FAANMGT (Meta, Apple, Amazon, Nvidia, Microsoft, Alphabet, Tesla).

Equities volatility trending down in contrast to bond market volatility



Source: Refinitiv, June 2023

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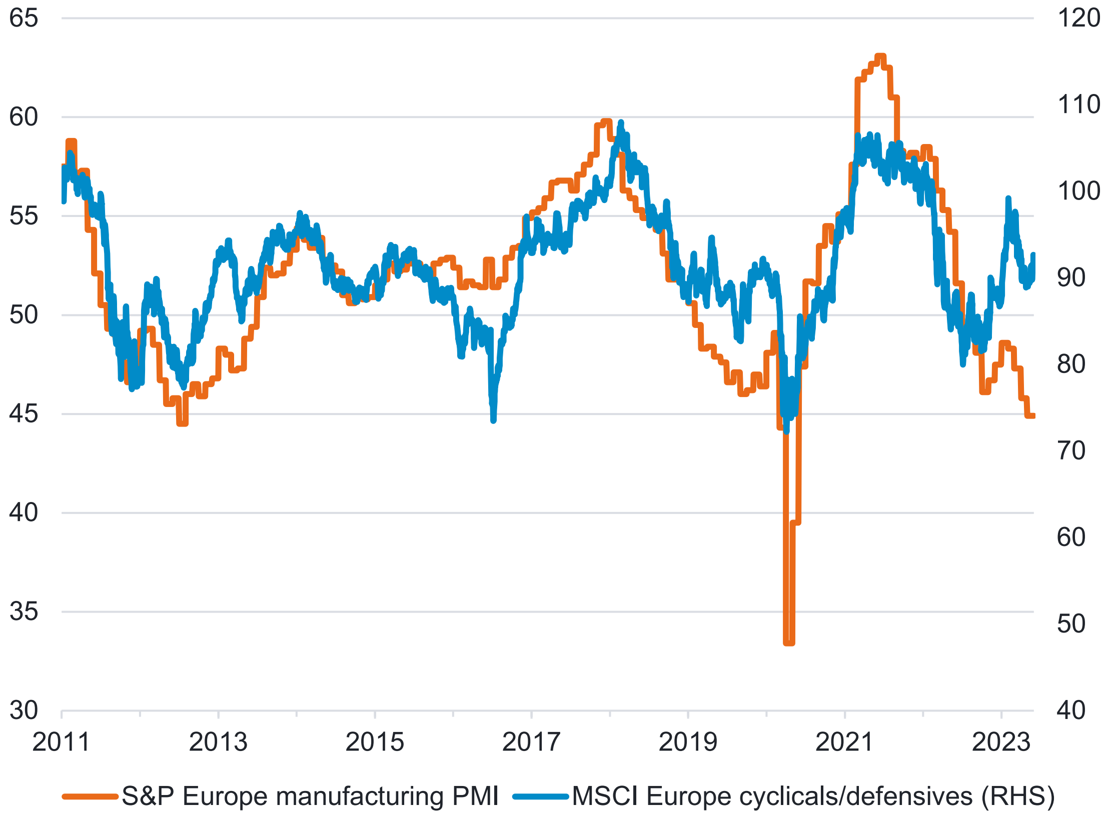
Europe waning, Japan waxing

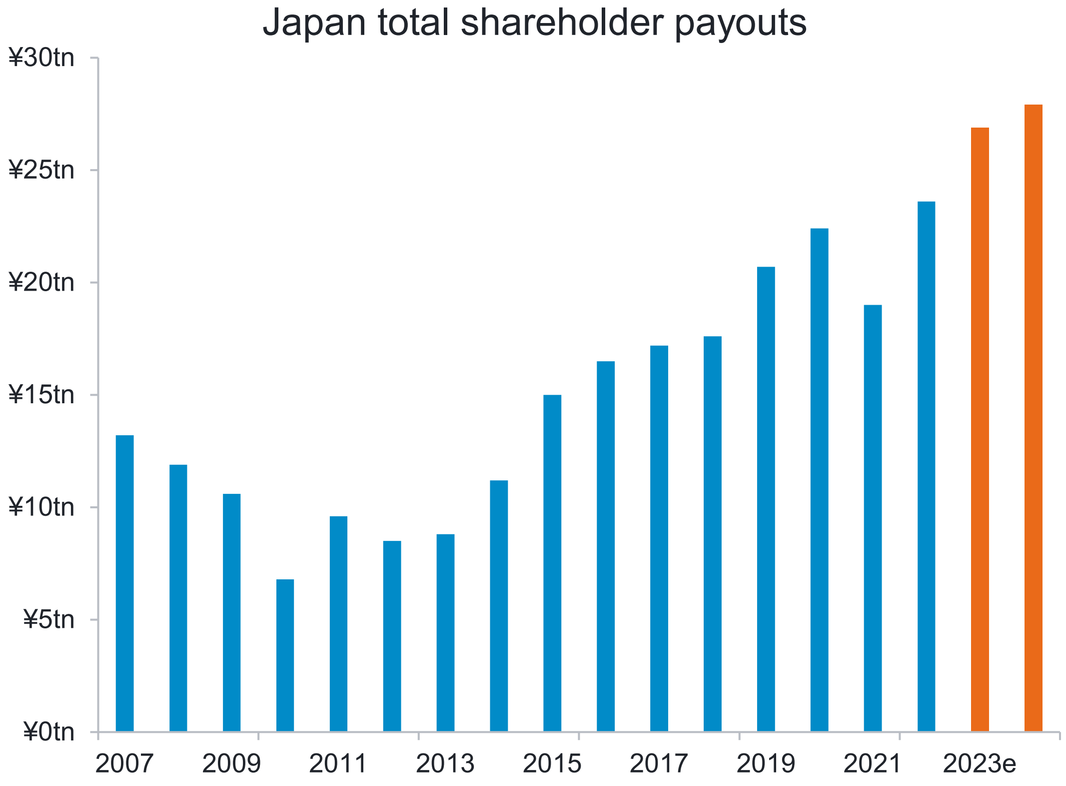
Europe fundamentals are deteriorating; Japan reforms making waves

Europe cyclical valuations lagging deteriorating fundamentals



MSCI Europe cyclicals/defensives ratio is rebased to 100 as of end-2010. Source: Fidelity International, Refinitiv, June 2023

Japan total payouts at a record high

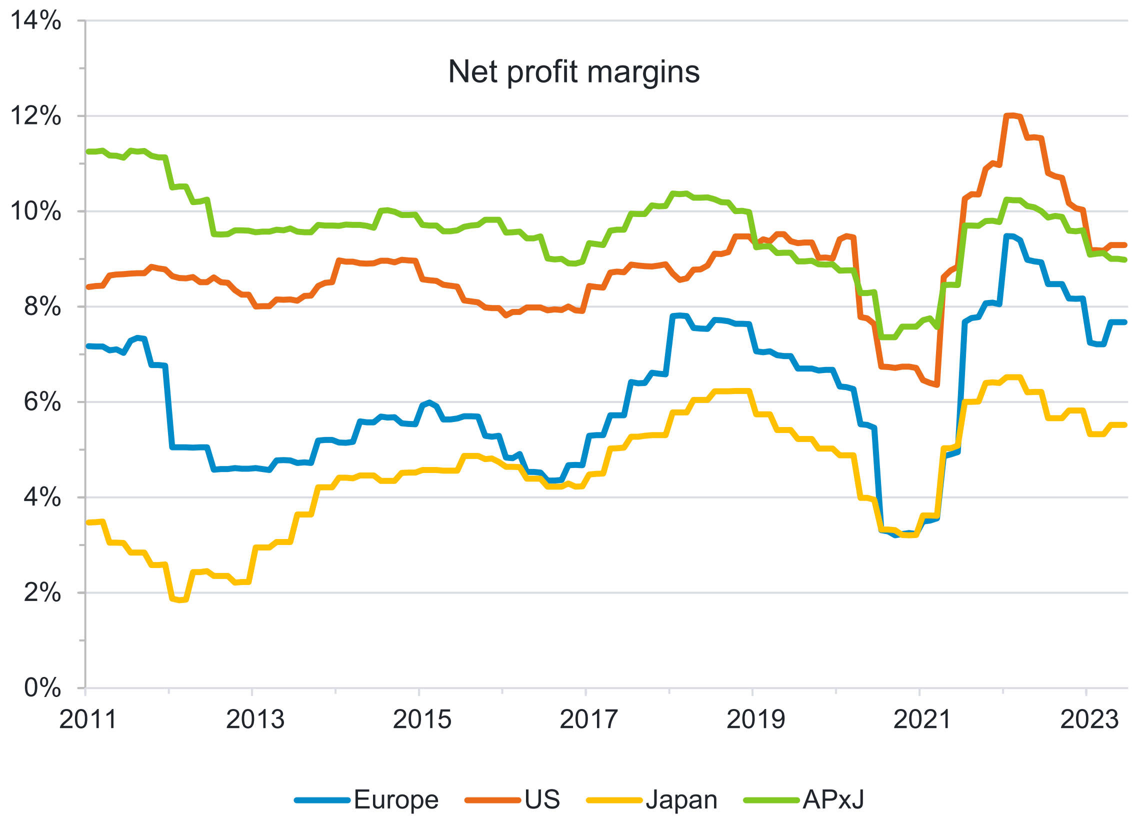


Source: Fidelity International, Jeffries, April 2023.

Inflation biting, but Asia looking better placed

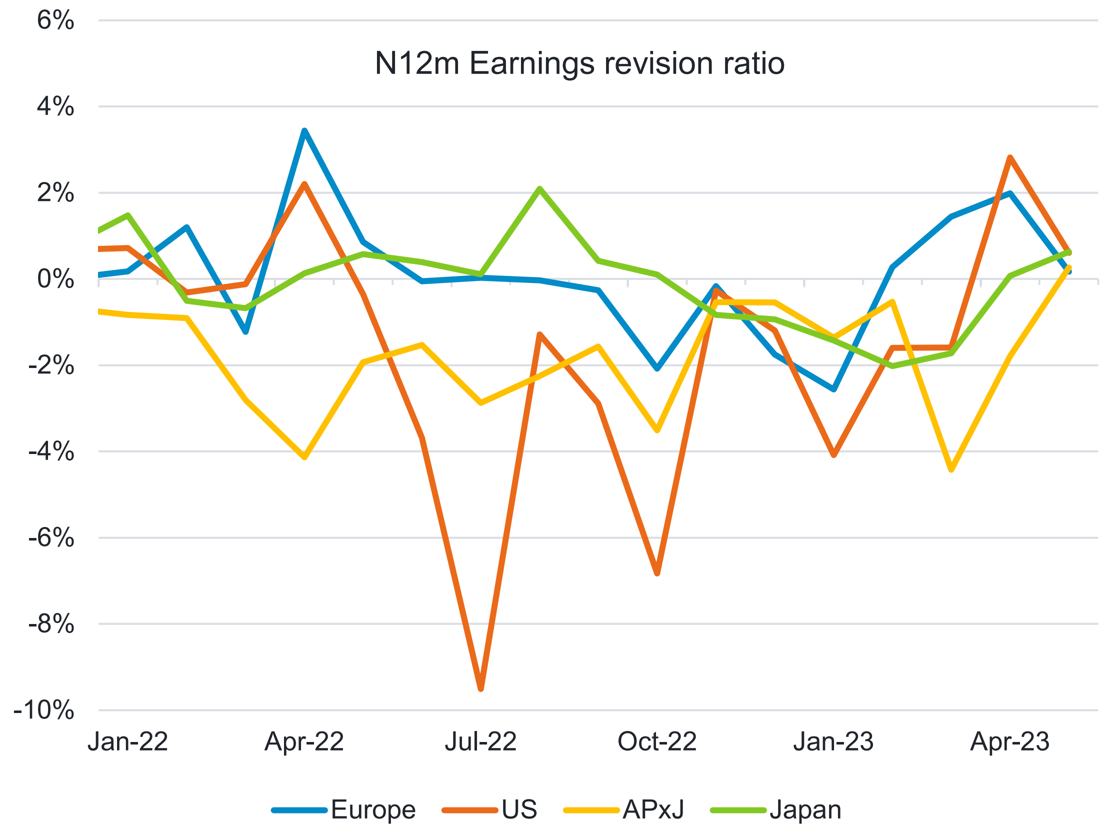
Margin pressure globally, but more positive earnings revisions signals from Asia

Margins weakening globally, but from high 2022 levels



Source: Refinitiv, June 2023.

Earnings revisions ticking down in US and EU, but up in Asia

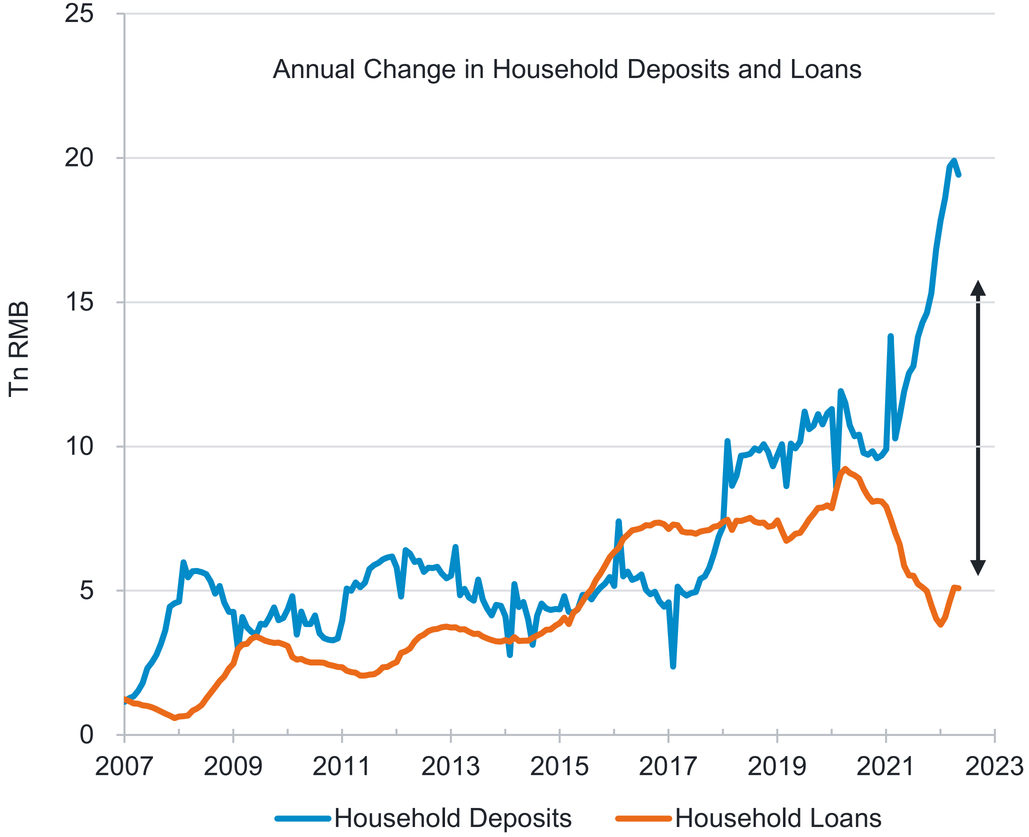


Source: Refinitiv, May 2023.

Weaker-than-expected recovery and lower-than-expected policy stimulus

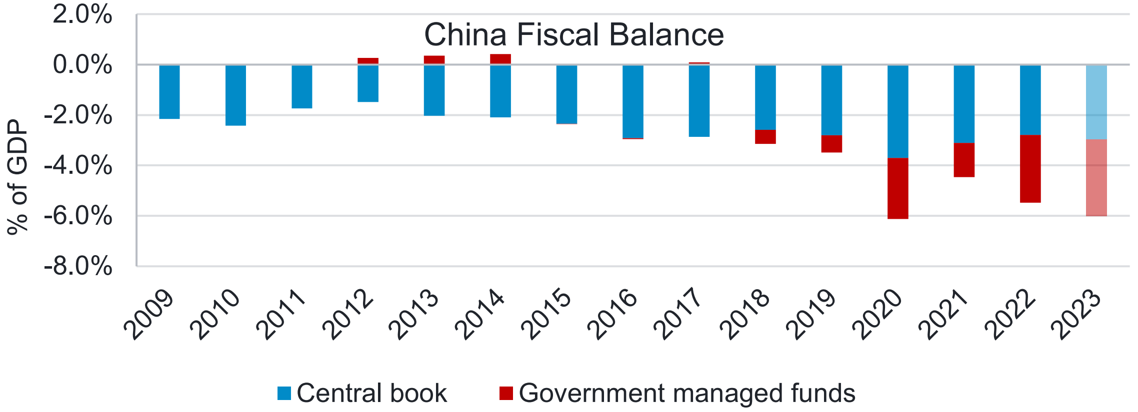
China households are generating excessive savings. Market expects accommodative policy to boost demand

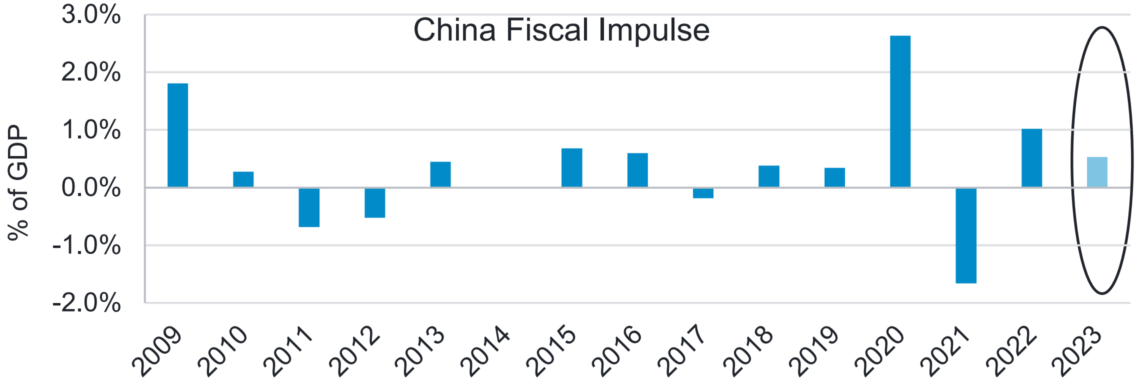
Consumers are recovering from the post-Covid "scarring effect" slowly. China households still generate excessive savings with weak demand



Source: Fidelity International, Bloomberg, June 2023.

Limited fiscal impulse to support growth



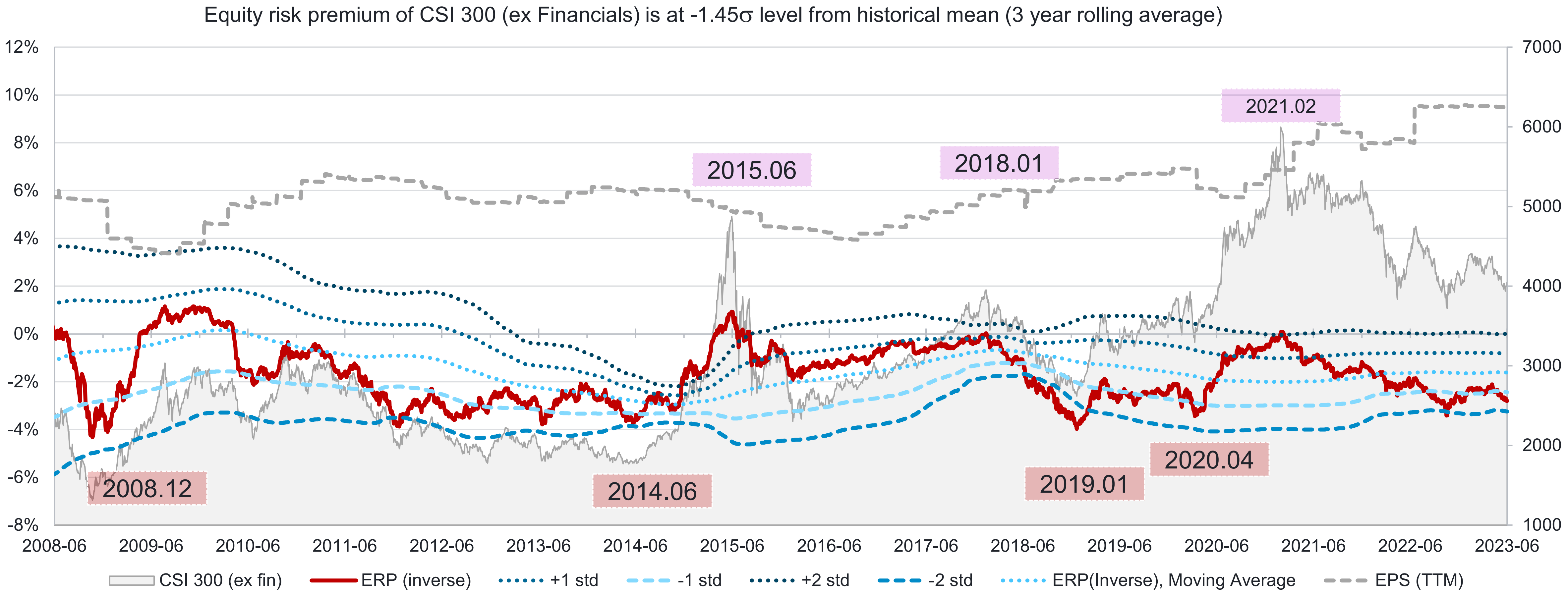


Fiscal impulse is calculated as the annual change of fiscal balance, as % of GDP

Source: State Council of PRC, 2023 data is based on government budget, June 2023.

Highly attractive China equity valuation

Playing the long game with patient deployment of capital will ultimately yield desired returns



Source: Wind, Fidelity International. June 2023

Multi Asset

Multi Asset: Key takeaways

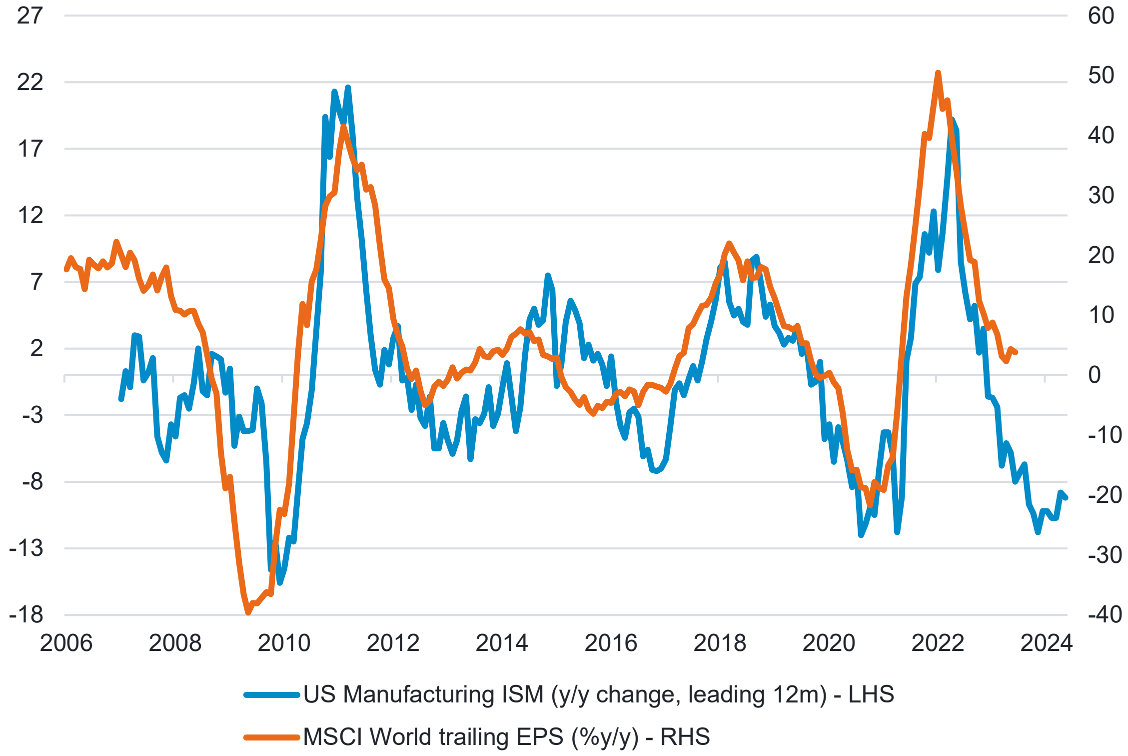
	S&MA key view	Thesis	Investment implications	
1	**Equity headwinds are building**	Leading indicators of earnings – such as new orders, credit availability, money supply – point to weakness in coming quarters. Moreover, we are entering a seasonally weak period for markets.	▪ Move underweight equity, with a 3-6 month view ▪ Move up in quality across asset classes – e.g. 'min vol' US equities	▪ Tilt to defensive sector positioning – staples and healthcare out of cyclicals
2	**The inflation battle will continue, weakening growth - but with growing divergence**	Inflation remains stubborn and far too high in developed markets. This leaves central banks with a tough problem, unable to fully support the slowing economy and also at risk of worsening the medium-term inflation problem. Conversely, several Emerging Markets have subdued inflation.	▪ Allocate to US inflation-linked debt; avoid German Bunds and Italian BTPs (Italian government bods) ▪ Allocate to select EM foreign exchange (FX), and buy EM local currency debt, e.g. Brazil and South Africa local rates	▪ Tilt to Indonesian and Brazilian equities ▪ Neutral duration overall, preferring to 'trade the range'
3	**Banking stress: global contagion averted, but tighter credit conditions to hurt**	The stress seen in US regional banks further accelerates the tightening in credit conditions we saw throughout 2022. While this is unlikely to develop into a full-blown financial crisis, it clearly increases the risk of a 'hard landing' – and particularly blunts economic momentum in the US.	▪ Underweight corporate credit, while preferring investment grade risk over high yield	▪ Tilt away from US equities, e.g. preferring European small caps over US small caps
4	**China's recovery continues**	Although recent data shows the re-opening recovery is uneven, China is much earlier in its economic cycle than most economies, with credit expanding quickly and pent-up demand remaining. Many other emerging markets are benefitting from falling inflation, peak monetary tightening, and attractive valuations.	▪ Allocate to EM and China equities over DM equities ▪ Allocate to global luxury equities	▪ Buy Singapore dollar vs. basket

Source: Fidelity International, as of May 2023. Views reflect a typical time horizon of 12 –18 months and provide a broad starting point for asset allocation decisions. However, they do not reflect current positions for investment strategies, which will be implemented according to specific objectives and parameters.

Equity headwinds are building

Leading indicators of earnings and seasonality are negative, credit conditions are also a headwind

Too early to call for a soft landing: the global earnings cycle is set to deteriorate further



Source: Fidelity International, Refinitiv, June 2023.

Defensive sectors protect portfolios in large slowdowns, without sacrificing market upside

Source: Fidelity International, Refinitiv, June 2023.

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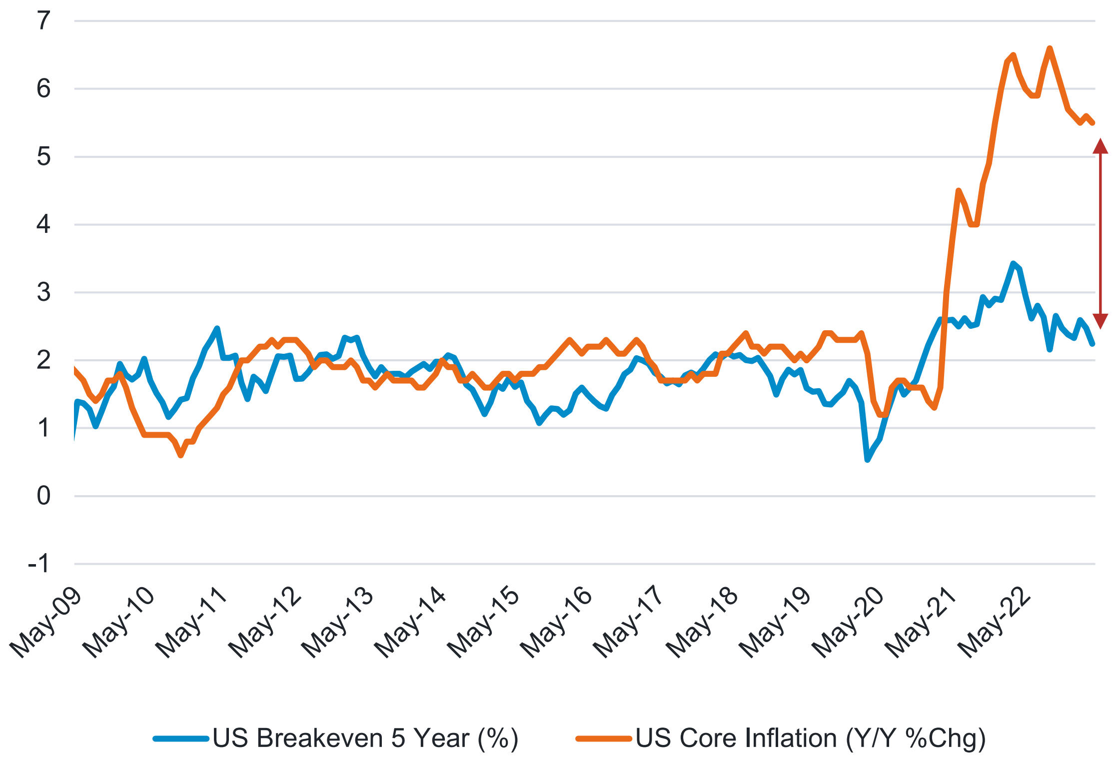
The inflation battle will continue, weakening growth

But divergence is growing, especially between DM and EM

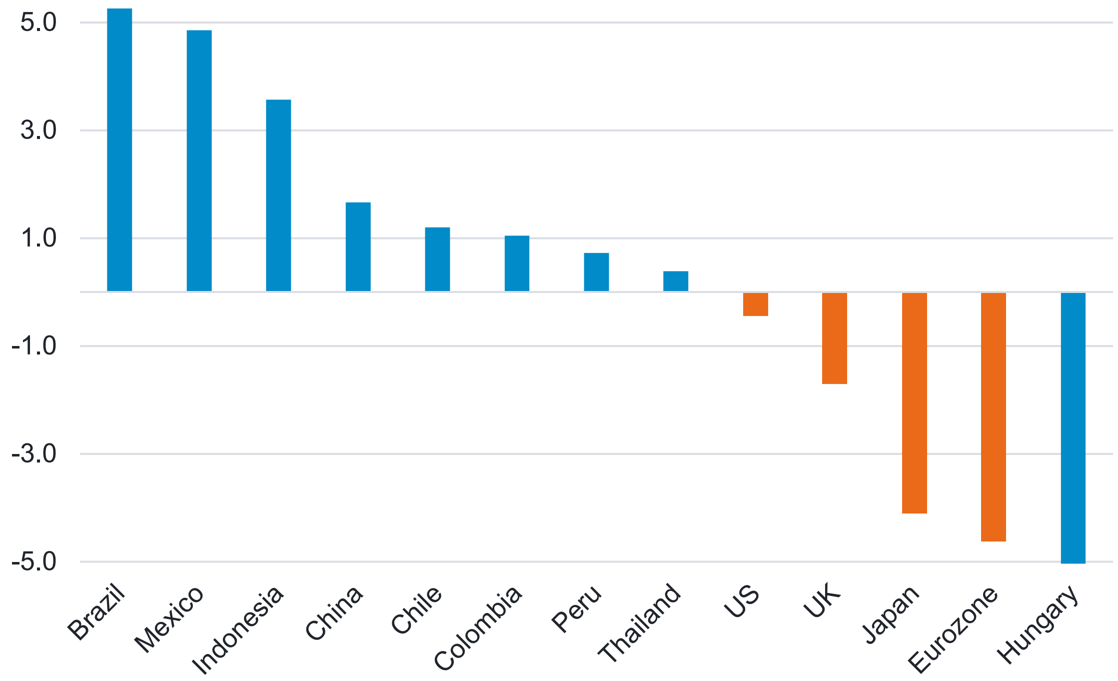
Inflation breakevens do not seem particularly good value given the tail risk of structurally higher inflation: consider treasury inflation-protected securities (TIPS)



Source: Fidelity International, Bloomberg, May 2023.

Prefer select EM FX: Real yields remain a key driver of our FX outlook

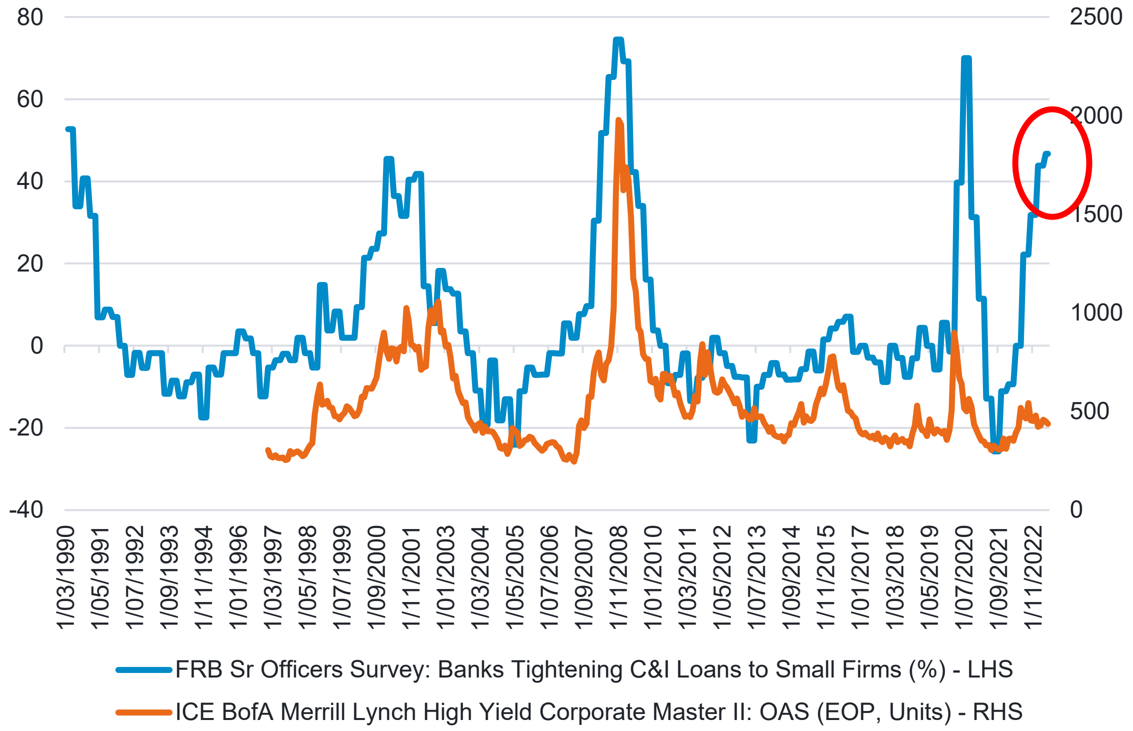
'Real' 3-month interest rate (deflated by core CPI)



Source: Fidelity International, Bloomberg, May 2023.

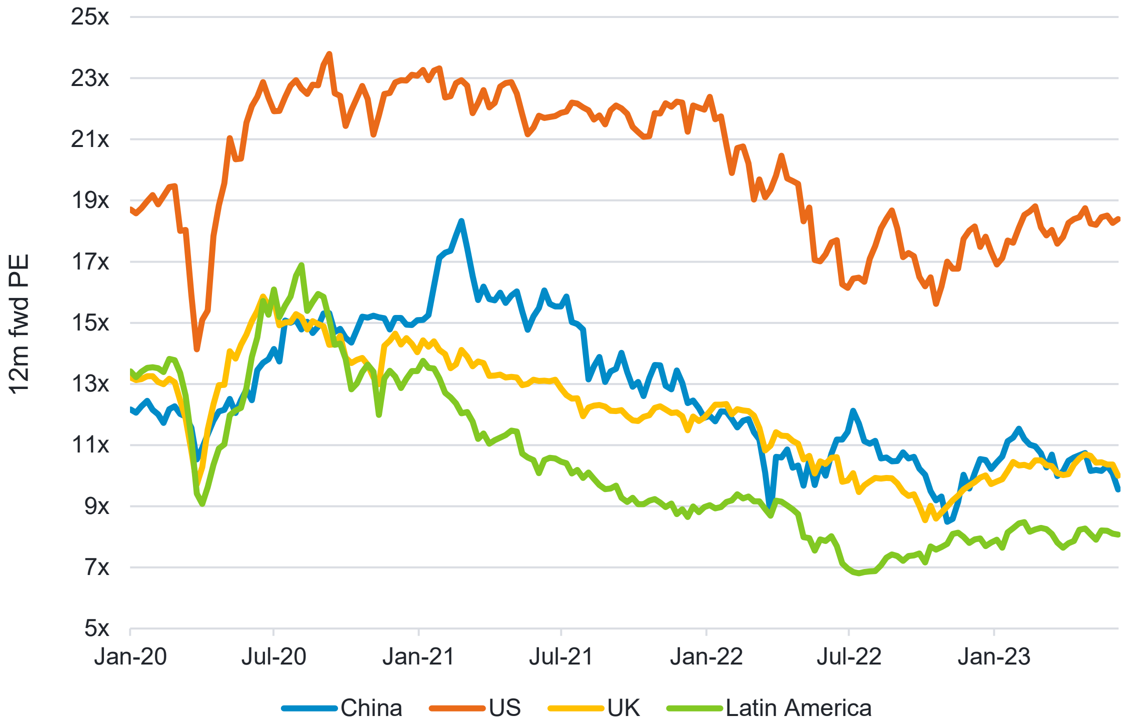
Banking stress: Contagion averted but tighter credit conditions will hurt

Bank lending conditions are deteriorating at a historic rate, leaving broader credit markets vulnerable



Source: Fidelity International, Haver Analytics, June 2023.

Tilt away from US equities: Despite higher for longer bond yields, US equities remain expensive



MSCI Indices. Source: Fidelity International, Refinitiv, June 2023.

China's recovery continues

The recovery is uneven, but there is room for consumption and cross-border mobility to help

China's economic recovery is uneven, but the relative momentum compared to the US is undeniable

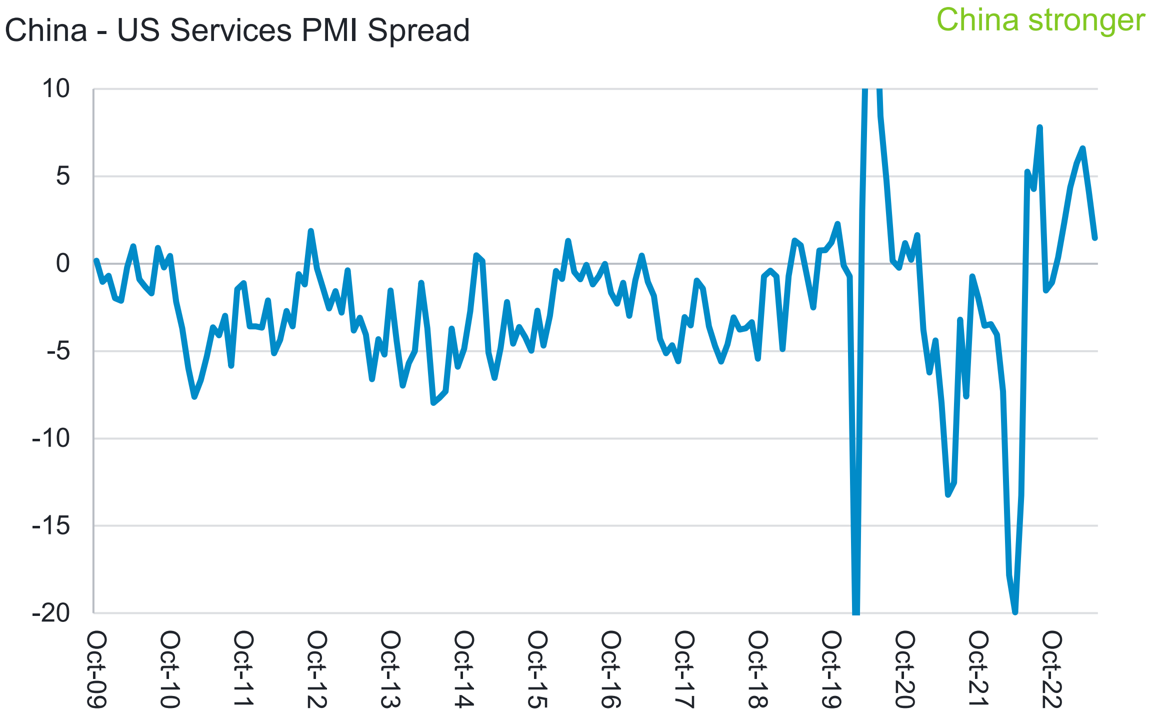


Chart source: Haver Analytics, Fidelity International, June 2023.

Elevated household deposits could support further consumption recovery

Source: Fidelity International, Bloomberg, June 2023.

Key asset allocation views at a glance

Cautious in the near term as equity headwinds build

Equity region

	View	Change	Rationale
US	o●ooo	-	We remain underweight but with lower conviction – current activities are resilient and some cautiousness has already been reflected in sentiment.
Europe ex. UK	oo●oo	-	Activity is recovering but economic surprises have moderated as expectations have caught up.
UK	ooo●o	-	The UK economy is doing better than feared, lowering the chances of an imminent recession. Valuations are still attractive.
Japan	oo●oo	-	Earnings breadth remains relatively weak compared to other markets. Companies are cash rich and sentiment is a positive.
Emerging markets	ooo●o	-	Our conviction is diminishing because recent data from China has been poor and the recovery is uneven. Other EMs still have positive fundamentals though.
Pacific ex. Japan	oo●oo	-	Services activity is rebounding although manufacturing is still weak. Improving relations with China could provide a boost.

Credit

	View	Change	Rationale
Investment grade (IG) bonds	ooo●o	-	We still prefer a cautious positioning in credit via our IG overweight given economic headwinds and higher funding costs.
Global high yield	o●ooo	-	Developed market credit fundamentals are deteriorating and HY issuers are closer to their maturity walls in late 23/early 24.
Emerging market debt (EMD, hard currency)	oo●oo	▼	Recent EMD outperformance makes this a good time to move back to neutral. We still prefer local currency EM debt.

Government bonds

	View	Change	Rationale
US Treasuries	oo●oo	-	Core inflation looks to be finally turning a corner, however the labour market is still strong. Inflation is too high to justify the cuts the market is pricing in.
Euro core (Bund)	o●ooo	-	The European Central Bank (ECB) remains the most hawkish of the major central banks due to persistent inflation.
UK Gilts	oo●oo	▼	The UK economy is proving more resilient than feared and inflation has been helped by a sharp fall in energy prices. We remain concerned about the UK's prospects though.
Japan govt bonds	o●ooo	-	We believe that the yield curve control (YCC) policy has caused financial distortions and will be phased out.
Inflation linked bonds (US TIPS)	ooo●o	-	Inflation pricing to the end of this year looks attractive and the banking crises looks unlikely to precipitate an imminent disinflationary recession.

Currency

	View	Change	Rationale
USD	o●ooo	-	The dollar is expensive on valuations metrics, the skew of risks is negative, and the risks to US growth are more tangible.
EUR	oo●oo	▼	Economic surprises in Europe have become weaker and the euro still has negative real carry.
JPY	oo●oo	▼	Underlying data is supportive of tighter policy, but indications are that the BoJ would rather let higher inflation bed in than try to snuff it out.
GBP	o●ooo	-	Near-term data has been surprisingly positive, but medium-term risks to the UK economy remain.
EM FX	ooo●o	-	EM FX is supported by the Fed pausing, the US underperforming, and falling bond market volatility.

Source: Fidelity International, as of May 2023. Change reflects directional difference in view versus previous month. Views reflect a typical time horizon of 12–18 months and provide a broad starting point for asset allocation decisions. However, they do not reflect current positions for investment strategies, which will be implemented according to specific objectives and parameters.

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