Q4 2019

Investment Outlook

Bending, not breaking

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

Q4 outlook overview

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

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

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

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

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

Paras Anand
Head of Asset Management, Asia Pacific

Fidelity's Global Asset Allocation

Fidelity's Global Asset Allocation process combines the granular, on-the-ground views of our research analysts together with a macroeconomic and quantitative framework driven by our strategists.

Each quarter, we bring together our regional and thematic experts from across the world to participate in the Quarterly Investment Forum (QIF), where we discuss macroeconomic and geopolitical conditions and how they will impact markets. Each asset class division incorporates this shared understanding into their respective investment and asset allocation decisions.

Every month, we hold Global Asset Allocation meetings where divisional Chief Investment Officers (CIOs), global portfolio managers and strategists share and debate views on macro conditions, markets and cross-asset allocation to produce the House View.

Fidelity's Global Asset Allocation process is led by:

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

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House view

No global recession imminent but visibility poor beyond 2020

Wen-Wen Lindroth
Lead cross-asset strategist

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

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

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

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

Asset class breakdown

Equities

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

Fixed Income (government bonds)

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

Fixed Income (corporate credit)

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

House view

Changes to positioning

September 2019: Near and medium term views

Strongly negative ■■■■■ Strongly positive

Asset class	Near term (3-6 months)	Change	Medium term (12-18 months)	Change	Key views
Equities	□□■□□	0	□□■□□	0	**Near-term view on equities remains neutral.** Fundamental view assumes slower but plateauing growth, but with high level of vigilance around 2020 earnings, given downward earnings revisions. Focusing on 'quality at a reasonable price' and maintain bias to growth over value. Relatively neutral on region.
US	□■□□□		□■□□□		
Europe	□□□■□		□□□■□		
Japan	□□■□□		□□■□□		
EM	□□■□□		□□■□□		
EM debt	□□□■□	-1	□□□■□	-1	**Downgrading to moderate overweight.** Lower return expectations on failure of stronger growth to materialise over the summer against a backdrop of lingering trade tensions and rising geopolitical risk. Valuations still attractive versus other asset classes but largely at 1-year tights.
EM Corp	□□□□■		□□□□■		
EM Sov $	□□□■□		□□□■□		
EM Sov local	□□□■□		□□□■□		
Credit	□□■□□	0	□□■□□	0	**No change to near-term overall neutral view.** An uncertain picture stemming from the conflicting forces of late cycle dynamics, trade and geopolitical risks, a global manufacturing recession and a historic year-to-date rally; countered by still resilient labour and consumer data and central bank efforts to prolong the expansion by any means necessary.
Global IG	□□■□□		□□■□□		
Global HY	□□■□□		□□■□□		
Asia Credit	□□□■□		□□□■□		
Soveriegn bonds	□□□■□	0	□■□□□	0	**No change to near-term moderate overweight.** This reflects our preference to buy US Treasuries and Gilts on weakness. We moved to a tactical neutral on Bunds and Chinese government bonds. The ECB underwhelmed on QE and valuations are uncompelling assuming a recession in Europe is not imminent. We've taken profits on CGBs, which face technical headwinds in supply.
US	□□□■□		□■□□□		
Europe	□□■□□		□■□□□		
UK	□□□■□		□□■□□		
China	□□■□□		□□□■□		
Cash	□□■□□	0	□□■□□	0	Neutral over the near-term view.

House view

Strong conviction longs and shorts

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

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

Economic outlook

Overview

What's changed

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

Key takeaways

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

Investment implication

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

Turning a corner, into the slow lane

The third quarter asked a lot of questions of the global economy. Data proved mixed, with manufacturing and trade figures fragile across the board. The US economy is slowing and China's woes have attracted considerable attention. This battery of weak data points has led to some calling an imminent recession. This is too hasty in our opinion. On the contrary, we can see a path from here to growth, albeit slow growth.

Many of the key headwinds global growth faced last year are reversing. One of the most powerful is bond yields, which have swung from rising moderately to falling considerably. Other than Japan, 10-year government bond yields have fallen at least 100 basis points (bps) in the G7 countries over the last year. The magnitude of that impact should not be underestimated with some economists estimating that a 150-200 bps swing in 10-year yields can boost GDP growth by as much as 1.6 per cent. In addition, major central banks are overwhelmingly in easing mode, with emerging market countries using the cover offered by the Fed's dovishness to cut their own rates without too much of a penalty to exchange rates.

Earlier in the year we reserved judgement on the likely effectiveness of Chinese stimulus, which increasingly appears significant enough to provide material support to the Chinese economy and beyond. Fiscal and credit support has expanded as the previous 'deleveraging' policy was put on hold. Moreover, a further reserve requirement ratio (RRR) cut was announced in September, which should spur more lending. Global manufacturing data has closely followed Chinese stimulus in recent years, and expansionary policies in China should boost domestic demand and act as a tailwind to the global economy. Importantly, Europe could be a key beneficiary of recovering Chinese and emerging market demand.

Finally, despite a sudden rise in the oil price after the attack on a Saudi oil facility, it remains below levels seen during most of last year, when consumers had to cope with high and rising energy costs. This also makes it cheaper for a whole host of companies to finance production.

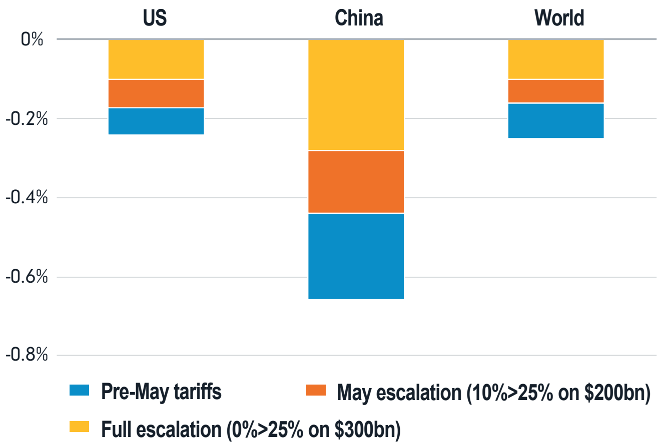
This scenario of easier economic conditions driven by lower yields, Chinese stimulus and lower energy prices chimes with the reading from the Fidelity Leading Indicator (FLI). The FLI indicates that global activity will accelerate in the coming few months, and fears of a global recession are indeed overblown. Since early 2019, many economic data points have been flatlining, rather than declining.

Risks appear manageable, for now

The picture is clearly not an outright positive one, with several risks to navigate. The US economy is 'catching down' toward the softness seen in the rest of the world. Consumer spending is the only growth driver at present and, while recently proving robust, is unlikely to continue at above-trend levels. Labour market indicators are plateauing, reflecting a healthy backdrop but showing that no slack remains in the system. Investment is slowing, which tends to lead the broader economy, as profit margins come under pressure. We think the most likely course is for the US to continue slowing given its fading fiscal stimulus, falling business confidence, elevated corporate debt and the mature stage of its economic cycle. The rest of the global economy should stabilise.

The US-China trade war continues to attract the headlines and buffet markets, but the actual impact on global growth could prove milder than feared. Standard economic models show that even in the case of a full trade escalation in the conflict, the direct drag on global GDP growth should be less than 0.3 per cent annualised over 2019/2020. We are monitoring the drag from uncertainty on corporate confidence and consumer confidence as a key signal to watch.

Trade war effects on global growth should be muted



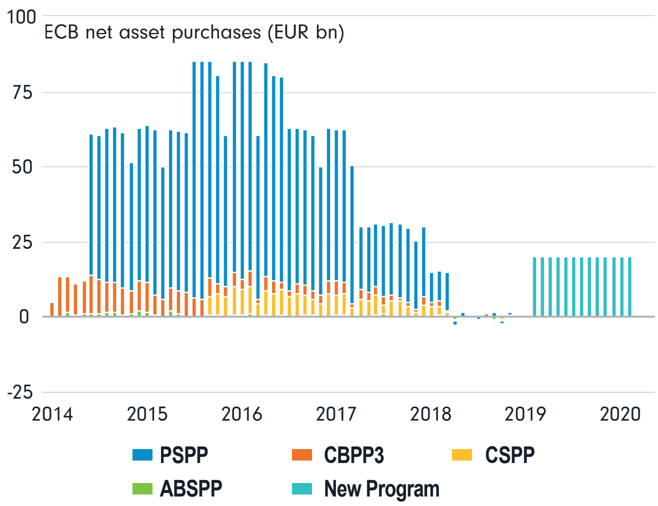
Trade war GDP impacts include both direct tariff effects, multiplier effects, and confidence effects. Does not include potential currency or policy effects. **Source:** Oxford Economics, June 2019.

While we think that some headwinds are transforming into tailwinds, growth is still subdued. This should cap expectations and investors should be wary of complacency while the economy remains delicately balanced.

Data and Policy: Central banks set the dovish tone

Just nine months after the previous quantitative easing programme was halted, the European Central Bank announced that asset purchases will restart in November. Moreover, the bank also cut deposit rates by 10 basis points and extended its forward guidance. The package underwhelmed the market. While the indefinite nature of the programme is positive and will dampen average market volatility over a multi-month period, overall the policy bundle will not be enough to reduce short-term bouts of volatility.

The ECB's new programme will be smaller than QE 1.0



Source: ECB, Fidelity International, September 2019.

The Fed's rate cuts look rather old-fashioned compared to the ECB's programme. This simplicity could change soon though, as the Fed's toolkit for monetary policy proves increasingly ineffective against upward pressure on money market rates. The unwinding of the balance sheet, or quantitative tightening, has finished, but the rapid pace of US government borrowing in the short term, and growth in cash in circulation means that reserve balances will continue to fall. This makes US money market rates harder to control.

We therefore expect subsequent meetings to announce new tools to help push market rates down, perhaps 'POMOs' ('Permanent Open Market Operations') to buy Treasuries in perpetuity or a Standing Repo Facility to lend at the upper end of the target band.

The Bank of England Monetary Policy Committee (MPC) made no change in its September meeting, the central bank's last chance to act before the Brexit deadline. In theory, the MPC's next meeting will be held when there is more clarity on the circumstances of the UK's departure from Europe, but in practice, any sort of certainty on Brexit is a long way off. This is damaging UK investment, and the data could continue to be disappointing. As it stands, the case for a rate cut is compelling and the MPC could come to the same conclusion by the end of the year.

The Bank of Japan is facing slowing growth both at home and abroad, as well as the risks posed by October's sales tax hike, which could dent consumption. The BOJ held monetary policy steady but said it would pay "closer attention" to economic momentum and review economic and price trends. Any further easing steps are likely to accompany operational tweaks to keep Japan's yield curve from flattening. Pushing down long and super-long government bond yields would further erode the already wafer-thin profit margins of Japan's financial institutions.

Gauges of Economic Activity in Real-time (GEARs): Stable and subdued

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

GEARs: Activity has stabilised

	Latest	3mma	Change
DM ave	1.2%	1.3%	-0.1%
EM ave	2.3%	2.4%	-0.1%
Eurozone	0.9%	0.9%	-0.0%
Japan	-0.1%	0.3%	-0.4%
UK	0.9%	0.5%	+0.3%
US	3.1%	3.3%	-0.2%
Germany	0.2%	0.7%	-0.5%
China	6.5%	6.2%	+0.4%

Source: Fidelity International, September 2019.

Activity near recent troughs

Despite their trade war, the behemoth economies of the US and China continue to hold up, and are respectably above their lows, although the US GEAR is somewhat overdependent on consumer strength and China has several pockets of concern.

China's GEAR continues to edge higher, comfortably above its lows after a big slowdown in the fourth quarter. However, real estate activity is slowing significantly after a surprisingly strong start to the year, and corporate revenues are having a weaker quarter. That said, economic uncertainty seems to be easing from its elevated levels.

In the US, consumption data weakened from unsustainably strong growth rates, but consumer components remain above-trend for now. Labour market indicators are flatlining, which reflects a healthy backdrop but with no slack remaining.

External trade components of many GEARs, having led this cycle on the way down, are starting to edge up, albeit from very weak levels. This could be an important bellwether for global recovery. The small open economies, such as Sweden, Switzerland and the UK, have managed to find a foothold after a very painful patch.

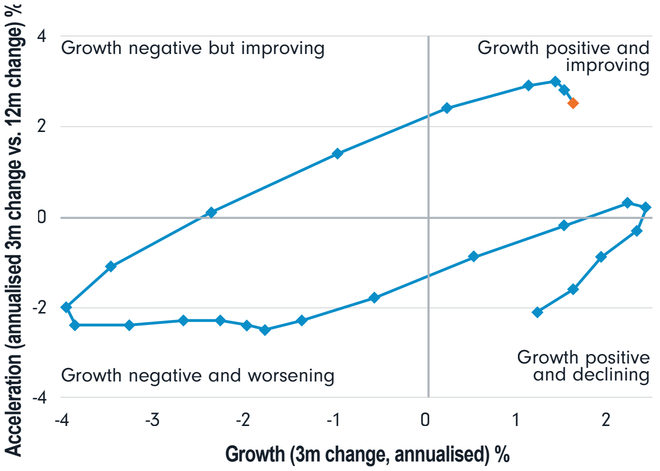
In the Eurozone, Germany's GEAR extends its straight-line deceleration towards contraction, but it would be unfair to focus overly on the country's cyclically-challenged plight; Spain, Italy and France have been stable, at varying levels of strength, throughout the first half and comfortably into the third quarter.

Fidelity Leading Indicator (FLI): Global recession fears are overblown

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.

The latest escalations in the US-China trade war have not derailed the positive drivers pushing the FLI into accelerating territory. The current upbeat reading suggests a buffer of resilience in the global system that should help it withstand further tariff increases. The global outlook has been supported by the dramatic plunge in developed market sovereign bond yields since 2018, as well as more supportive policy in China and other key emerging markets.

Firming FLI indicates healthy global activity



Source: Fidelity International, September 2019.

Global economy resilient despite trade policy headwinds

More than three-quarters of the FLI's underlying components are accelerating, a dramatic reversal from early 2019. Business Surveys and Industrial Orders continue to improve, with hard data on Germany's new foreign orders rebounding and Japan's inventory/sales ratio also improving.

Consumer/Labour indicators saw growth improve, although the underlying elements are mixed. US components suggest that the tight labour market is becoming a binding constraint with hours worked and jobless claims data both pointing to sub-trend but stabilising growth.

Global Trade lagged as both soft and hard data deteriorated. This sector has displayed pronounced mini-cycles around a flat trend in recent quarters, due to pre-stocking followed by demand destruction after successive trade war escalations. However, we are now on a downswing of one of these cycles.

Commodities remains the most supportive sector, with both hard and soft data improving, although this is possibly flattered by a resurgent Baltic Dry Index that may reflect regulatory constraints to supply in the near-term rather than surging demand for global shipping.

Equities

Overview

What's changed

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

Key takeaways

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

Investment implication

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

Fidelity aggregate analyst forecasts

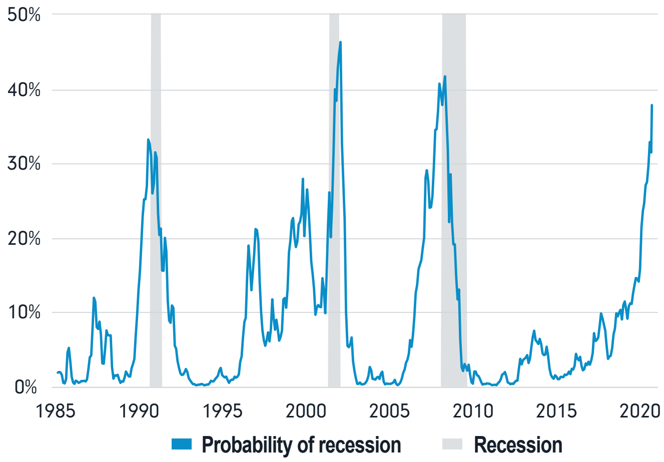
Global equity forecasts	2019	2020	2021
Earnings growth	1.0%	7.8%	8.6%
Return on equity	13.8%	14.3%	14.5%
Dividend yield	2.6%	2.8%	2.9%
P/E valuation	16.1x	14.7x	13.5x
P/B valuation	2.2x	2.0x	1.9x

Source: Fidelity International, 24 September 2019.

Climbing a wall of worry

Equities faced a challenging environment as continuing concerns over US-China trade frictions and a weakening global economic outlook weighed on markets in the first half of the quarter. Other geopolitical disruptions, including the turmoil in Hong Kong, a still unresolved Brexit, a deepening economic crisis in Argentina and the collapse of Italy's coalition government caused further worries. On the data front, Germany, Europe's largest economy, is on the verge of recession and export-oriented Japan faced softening sentiment driven largely by concerns over the impact of a trade war. To add to all of this, the inversion of the 2-year and 10-year US Treasury yields, typically preceding recessions, was a new drag on equities. In the face of such a 'wall of worry', overall sentiment improved in the latter half of the quarter with US equities once again near all-time highs.

US yield curve suggests 38% chance of recession in 2020



Source: Fidelity International, Federal Reserve Bank of New York, July 2019. This model uses the difference between 10-year and 3-month Treasury rates to calculate the probability of a recession in the United States 12 months ahead.

Fidelity aggregate analyst forecasts

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%

These are estimates of return per year in USD, based on our proprietary modelling, for illustrative purposes only. They reflect the views of investment professionals at Fidelity International. Indices used for calculation: US equities - S&P 500, European equities - MSCI EMU, Japanese equities - TOPIX, DM equities - MSCI World, EM equities - MSCI EM.
Source: Fidelity International, March 2019.

As monetary levers become increasingly exhausted, we are watching whether policymakers will start to turn to fiscal expansion. The Eurozone could lead the way and we are already seeing easier fiscal conditions supporting growth in Europe. As bond yields fall, into negative territory for both Germany and France, it reduces the cost of fiscal stimulus and the European Central Bank's call for fiscal support at the September meeting becomes increasingly compelling.

As expansionary fiscal policies start to take effect, inflation expectations should recover. When that happens, expensive low volatility assets are likely to be discarded to make way for purchases of riskier assets. There will be few buyers of low volatility stocks at that time given how crowded this trade has become. The biggest risk at that point will be a disorderly transition from safe to risk assets, and investors should not take for granted that hedges will work exactly as expected.

As expansionary fiscal policies start to take effect, inflation expectations should recover. When that happens, expensive low volatility assets are likely to be discarded to make way for purchases of riskier assets. There will be few buyers of low volatility stocks at that time given how crowded this trade has become. The biggest risk at that point will be a disorderly transition from safe to risk assets, and investors should not take for granted that hedges will work exactly as expected.

Markets mask a style shift

Equity market 'internals' in September provided some insight into how this might play out. Beneath benign top-level performance, equity markets experienced a sharp reversal in this year's momentum trade. Momentum, which changes its composition through time, has been dominated this year by quality-growth names as investors sought the safety of defensive growth and drove valuations to extremes. In September however, quality-growth stocks sold off and previously shunned value stocks outperformed.

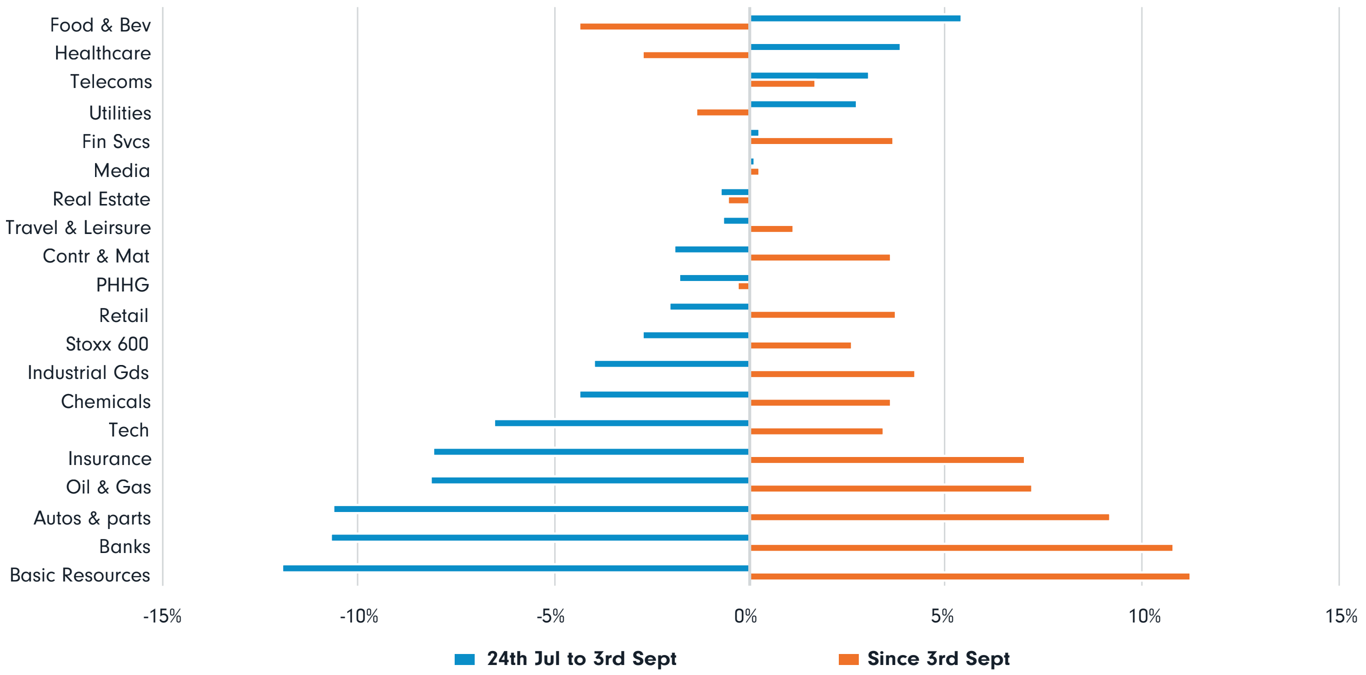
> Renewed optimism around US-China trade talks, hopes of avoiding a 'No Deal' Brexit, and increasingly dovish central banks helped drive an increase in risk appetite and the switch to value, but a more concrete improvement in the outlook for economic growth is required for a longer-term change in market leadership.

Similar moves have been quite common since the end of the financial crisis, each time disappointing those hailing the 'return of value'. Such reversals are not uncommon, especially when the momentum trade is stretched, differences in valuations between quality and value are extreme, and ownership is concentrated in pockets of the market.

The persistence of such reversals depends on the broader market environment. Renewed optimism around US-China trade talks, hopes of avoiding a 'No Deal' Brexit, and increasingly dovish central banks helped drive an increase in risk appetite and the switch to value, but a more concrete improvement in the outlook for economic growth is required for a longer-term change in market leadership.

Value may have been unloved for some time, but it continues to be a sound investment philosophy likely to deliver long-term returns for those invested at the right time. On the contrary, momentum rarely 'crashes' for good. Instead, in the event of a more certain macro outlook and increasingly available growth opportunities, we may see the momentum trade evolve to focus more on cyclical growth than defensive growth.

Markets undergo swift sector rotation



Stoxx 600 sector returns. Source: Bloomberg, September 2019.

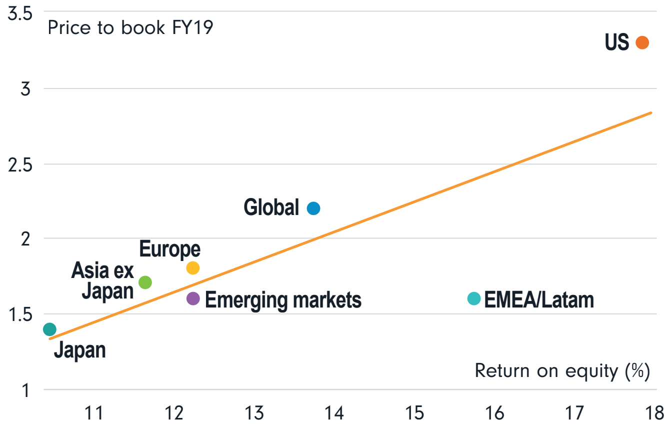
Regions

FIL aggregate analyst forecasts

Earnings growth forecasts	2019	2020	2021
Global	1.0%	7.8%	8.6%
US	0.3%	10.5%	8.95%
Europe	-1.2%	4.9%	6.4%
Asia ex Japan	4.1%	8.1%	10.9%
Global emerging markets	4.9%	8.6%	11.7%
Japan	-1.0%	4.8%	6.8%
EMEA/Latam	6.2%	6.4%	8.2%

Source: Fidelity International, 24 September 2019.

Valuations marginally more attractive than the end of last quarter



Based on FY19 results. **Source:** Fidelity International, 24 September 2019.

US: Equities flying high amid weaker fundamentals

The S&P 500 is still high compared to historical levels, yet economic fundamentals have deteriorated over 2019 with the US manufacturing sector close to recession. Faced with this mixed picture, investor sentiment remains fragile. As we head towards the end of the year, we expect volatility to increase as the Federal Reserve eases policy further.

US macro numbers have been mixed of late. The manufacturing ISM dipped below the 50-mark signalling contraction, with declines in new orders, production, and employment. The ISM data surprised everyone, but more positively non-farm payrolls did not hurt sentiment to a large degree.

The US market has seen a massive rotation into value stocks in September. Perceived improvement in US-China trade negotiations helped ease investor concern about an impending recession, lifted bond yields and sparked the rotation, pushing momentum stocks into retreat. Whether the trend lasts remains to be seen but for the rally to continue interest rates will have to start rising, possibly due to an imminent rebound in global economic growth. Investors should consider rotating away from overbought defensive assets into largely-ignored cyclical stocks and take advantage of higher volatility to buy the dips.

In the technology sector, quarterly numbers were largely fine but did not live up to elevated expectations. Consumer stocks are more positive, but lack of inflation is an issue. Financials remain under pressure and to make a convincing case for buying banks requires the belief we are mid-cycle - a stretch in our opinion.

Europe inc UK: Measures fall short

The ECB announced an interest rate cut and a massive new bond-buying program in a bid to stimulate the ailing Eurozone economy. While both the deposit rate cut and the amount of monthly quantitative easing asset purchases fell short of market expectations, this was offset by the changes to the ECB's forward guidance and the open-ended nature of the measures. While the overall package is expected to dampen volatility and will provide temporary support, it may not be sufficient to further boost the 'hunt for yield' in the near term.

Despite UK Prime Minister Boris Johnson's bullish tactics standing in stark contrast to Theresa May's approach, Brexit proceedings have served to highlight the fundamentally fragile nature of the government's position and lack of majority. Many institutional investors are ignoring the UK stock market because of the Brexit factor, but in so doing they are ignoring value that cannot be obtained elsewhere. Lingering uncertainty and volatile sentiment towards the UK will ensure that market dispersion remains elevated. At current valuations, there will be unforeseen stock winners from even 'bad certainty' and, hence, proper diversification will enable investors to capture a proportion of the certainty windfall in any Brexit outcome.

Asia-Pac ex Japan: Long-term growth story, short-term volatility

We believe the long-term outlook for Asia Pacific ex Japan is positive, but in the short-term there is likely to be some volatility. The trade dispute between the US and China could escalate further and is widely expected to last well into next year. Concerns of a slowing global economy centre around weak Chinese data and will dampen investor sentiment. Ongoing political unrest in Hong Kong doesn't seem to be fading despite a withdrawal of the extradition bill, which triggered these protests. However, prudent macroeconomic and fiscal policies will help economies across the region to respond to the headwinds, ensuring that growth remains robust.

In China, we expect economic growth to moderate this year, given a challenging environment owing to lingering trade tensions. Chinese policymakers remain committed to stimulating domestic demand and loosening financial conditions to cushion short-term headwinds. Additionally, growth in India is likely to be driven by increased public spending, higher capacity utilisation rate, tax cuts and an uptick in private investment. In Australia, low-cost resources, modest population growth, high dividend yields and healthy dividend growth, as well as disciplined capital management should continue to attract investor interest.

Overall, equity valuations in Asia Pacific ex Japan are above their long-term averages but are attractive relative to other regions.

Japan: Bifurcation in the economy

Japanese stocks have lagged their global peers so far this year, as uncertainty over US-China trade frictions and the impact on the global economy have clouded the outlook for corporate earnings. While the analyst revision index has already reached its typical bottom and earnings trends should stabilise in the coming quarters, share prices are likely to remain volatile amid a steady stream of geopolitical news flow. While not immune to external headwinds, the Japanese economy remains relatively stable and H1 growth rates were ahead of market expectations.

Confidence among Japanese manufacturers has clearly weakened, but sentiment in the non-manufacturing sector is robust. Employment conditions remain tight and capital expenditure plans are supported by non-cyclical factors such as investment in labour-saving technology. The Bank of Japan remains highly accommodative and extensive counter measures will be deployed to mitigate the effects of the October 2019 consumption tax hike. Against this macro backdrop, there has been a clear bifurcation in corporate earnings between the manufacturing and non-manufacturing sectors.

Looking ahead, it is possible that we see more manufacturing companies announce downward revisions to full-year guidance at the interim stage, especially if the Yen appreciates further, although aggregate earnings should be up year-on-year in the second half of fiscal 2019 given the low hurdle rates.

Global emerging markets: Fed policy shift supports equities

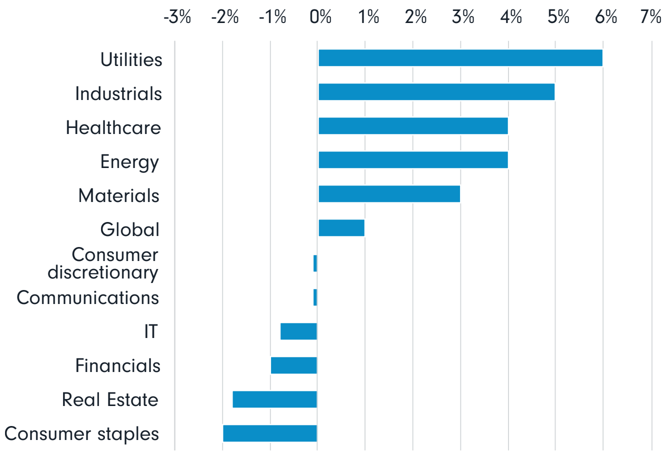
The favourable fundamentals underlying emerging markets have mostly persisted despite the difficult last quarter. The US economy has slowed but this deceleration helped convince the Federal Reserve to turn dovish and start cutting rates. The policy change reduced upward pressure on the US dollar, which in turn benefited emerging markets equities - much of emerging markets equity underperformance in 2018 was related to the rising US dollar.

Looser Fed policy in the US has also allowed some emerging markets central banks, such as India and Indonesia, to ease monetary policy in their economies. In September, China's central bank partially rolled over loans from its one-year liquidity facility but kept the lending rate unchanged - a sign it is willing to maintain adequate credit to support a slowing economy but wary of excessive stimulus.

Over the next quarter, emerging markets may be negatively impacted if the global economic outlook deteriorates and the US-China trade conflict deepens. But the emerging market story is a long-term narrative. The powerful trend of the vast and growing consumer base in the developing world underpins a multi-year growth opportunity, with structural drivers around urbanisation and lifestyle changes helping to drive demand for goods and services in underpenetrated markets.

Sectors

Fidelity International's net income forecasts for 2019 (above/below consensus)



Source: Fidelity International, IBES, September 2019.

Top: Renewables stand out within utilities

While we are not bullish per se on the sector, we are considerably more positive on earnings expectations for utility stocks than the consensus view. Investors' preference for defensive stocks combined with declining bond yields have driven recent performance in regulated and integrated utilities, but it is renewables that look most attractive. Renewable assets are gaining traction across regions given declining input costs, emission reduction targets and the low interest rate environment. We think these trends will continue and the growth outlook looks positive for the sector.

RWE looks well positioned as a renewables play in Europe. We also like Engie, which had a good second quarter and the company's full year forecasts look conservative in comparison to Q2 results. SSE's poor start to 2019 masks improvements in strong underlying businesses such as renewables, which may receive more attention now that it has sold its overhanging retail division.

While low bond yields have boosted the valuations of utility companies, September's rotation away from defensives into value has made them relatively more attractive. But the threat of nationalisation lingers in the background. A Labour government in the UK, and some calls for nationalisation of assets in France and Germany pose risks to the sector. For example, National Grid looks meaningfully mispriced, most likely based on fears of a Labour government.

Bottom: Lofty expectations in consumer staples

Consumer staples is the most negatively correlated sector to bond yields so the falling yields we have seen over Q3 have acted as a pervasive rising tide for share prices. But the sector has become expensive, despite low multiples on tobacco stocks flattering sector valuations, and expectations are high. We forecast the market will be slightly disappointed by earnings from the sector this year.

AB InBev is an example of a company with stretched expectations that could disappoint as it loses market share in key areas. Chinese tissue maker, Hengan, is struggling to execute its distribution strategy and that could disrupt its sales more than the market expects.

A key consideration for the US market is that while consumer demand remains resilient this year, given the tailwind of the government tax windfall and employment gains of last year, comparisons were always going prove challenging.

Sector to watch: ESG increasingly impacting energy

Energy companies are facing challenges around the oil price and cost of capital making for a complicated outlook.

Oil prices started the year strongly only to fade in the summer before the recent Saudi oil production facility attack propelled them back up. Despite the yo-yoing oil price, energy company prices haven't matched the fluctuations. We believe part of that comes down to the disappearance of the marginal buyer of oil stocks. The increasing attention on fossil fuels and their impact on the climate has deterred the marginal buyer and reduced the correlation between spot energy and company stock prices.

On a recent to trip to Texas we met with 27 companies and nearly all of the management teams reported that ESG was becoming more important. This is not a surprise, given that a company's attitude to ESG can have a material impact on its prospects. As investors become more mindful of the risks around poor sustainability, the cost of capital for companies with 'good ESG' policies has fallen while it has risen for those with bad ones. Sifting through these companies' ESG practices will make a big difference to spotting future winners and losers.

Fixed Income

Overview

What's changed

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

Key takeaways

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

Investment implication

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

Forecast tables

Capital market assumptions	3 years	5 years	10 years
US Treasuries	1.0%	1.3%	2.0%
German government bonds	-1.2%	-1.2%	-1.1%
US investment grade	2.4%	2.8%	3.4%
European investment grade	0.0%	0.3%	0.7%
US high yield	3.6%	4.1%	4.8%
European high yield	2.5%	2.4%	2.5%

These are estimates of return per year in USD, based on our proprietary modelling, for illustrative purposes only. They reflect the views of investment professionals at Fidelity International. Indices used for calculation: US Treasuries - 10 year US treasury from ICE BofAML par yield curve, German government bonds - 10 year German government bond from ICE BofAML par yield curve, US investment grade - ICE BofAML US Corporate Index, European investment grade - ICE BofAML Euro Corporate Index, US high yield - ICE BofAML US High Yield Index, Euro high yield - ICE BofAML Euro High Yield Index.
Source: Fidelity International, June 2019.

From fear to reassurance

This quarter has proved particularly eventful. Both geopolitics and debt market fundamentals have been at the forefront of investors' minds. Trade war rhetoric combined with weakening economic data to support government bond prices which, alongside traditional safe-havens such as gold, topped total returns across the asset classes.

To us, the market reaction highlights the negative interpretation by investors on the Fed's rate cut in July, which was seen more as a warning of rising recession risk. This drove many 10-year yields in developed market government bonds to all-time lows, including Gilts, Bunds and BTPs. The yield on 30-year US Treasuries also reached new lows, with the 2-year and 10-year US yields inverting for the first time since 2007, prompting more concerns about the vulnerability of the economy.

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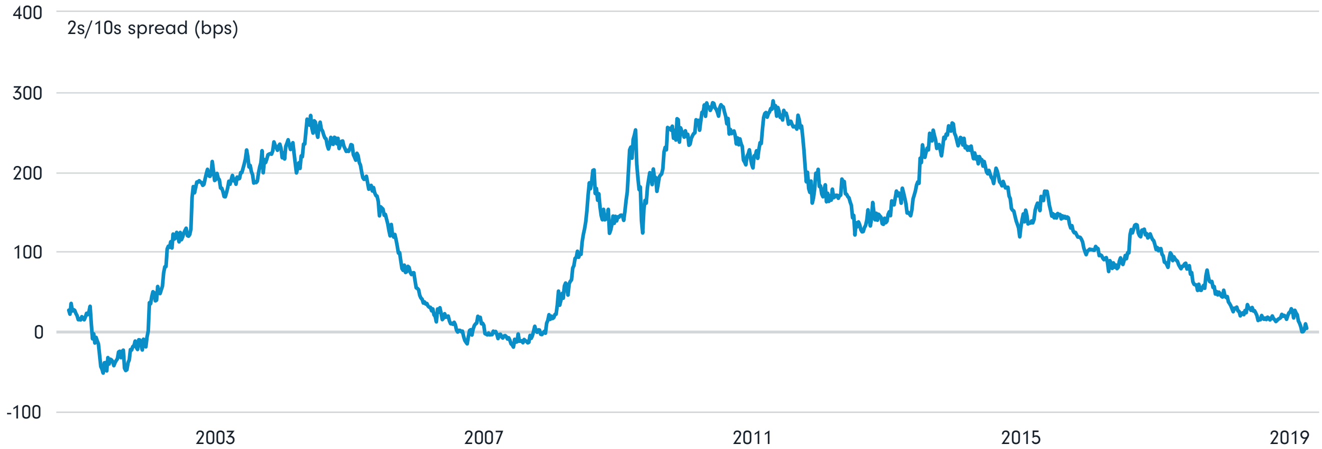
The Fed's September cut was accompanied by an altogether more assured performance from the Fed Chair, Jerome Powell, despite no clear consensus appearing from the 'dot plot' for rate moves for the rest of the year. However, markets took confidence from the Fed's willingness to act if the economy warrants it.

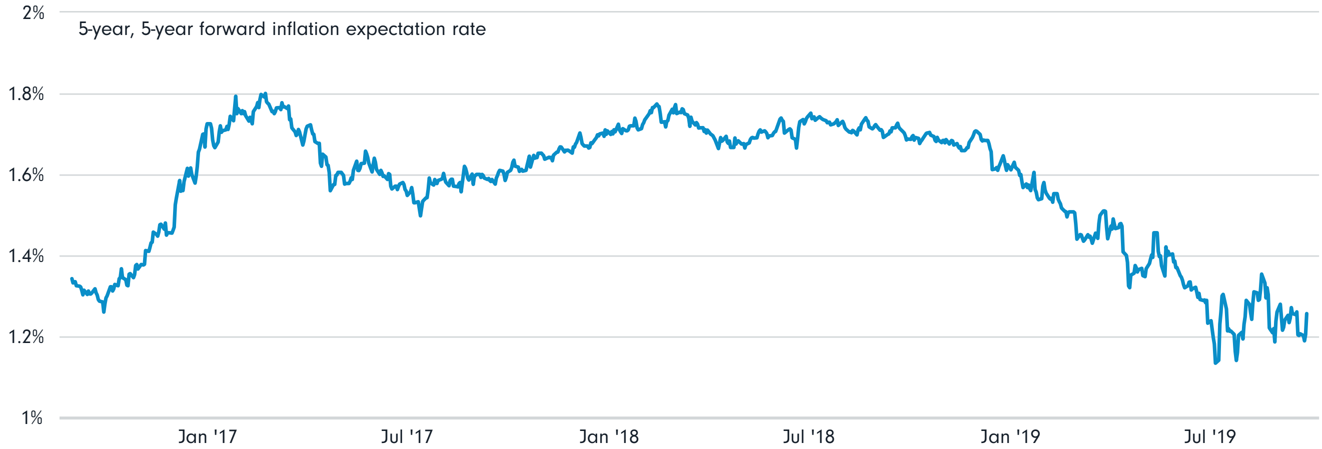
On the macroeconomic front, the US consumer is one of the few areas of the US economy to have avoided a contraction. Inflation expectations remain stubbornly low and the data is weak. The August ISM manufacturing number dropped to 49.1, well below expectations, and is the first reading below 50 for three years. The employment and new orders components both contracted with new export orders a dismal 43.3, the lowest since the depths of the financial crisis.

US Treasury 2s10s curve has inverted



Source: Refinitv, September 2019.

European inflation expectations remain exceptionally low



Source: Fidelity International, Bloomberg, August 2019.

ECB underwhelms

European Central Bank President Mario Draghi delivered his final Governing Council meeting and announced that monthly purchases of 20 billion euros will restart in November. The deposit rate was cut by 10 basis points and forward guidance was extended.

In our view, the package was underwhelming. The market had expected more, with talk of 40-60 billion euros of purchases per month. While the indefinite or "state contingent" nature of this programme is positive and will dampen average market volatility over the longer term, the size of purchases will not be enough to reduce short-term bouts of volatility.

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Brexit dominates

Brexit dominates the UK story. Concerns over a 'No Deal' peaked in August, causing Gilts to rally and sterling to sell-off sharply. However, the situation remains fluid with Parliament challenging the Government's course. In response, Gilt yields have risen and sterling has rallied. While 'No Deal' is not our base case, if it does occur we could see a comprehensive package of both monetary and fiscal loosening, which should support government bonds in the short term.

Beyond Brexit, the UK economy is weak and in our view warrants accommodative action from the Bank of England. The growth outlook is lacklustre, with data suggesting we could be set for two consecutive quarters of negative GDP growth, plunging the UK into a technical recession.

Sub-asset classes

Inflation-linked: Inflation expectations fall amid yield pressure

Global inflation expectations fell as risk markets came under pressure and nominal bond yields across the developed market world reached new record lows. Valuations across inflation markets do look relatively cheap and there has been a pick-up in capital flows into the asset class as a result.

In the US, year-on-year (YoY) headline CPI was 1.8 per cent for July, up from 1.7 per cent in June, while core CPI was 2.2 per cent, up from 2.1 per cent. Energy continued to drag the headline rate lower as falling oil prices earlier in the year fed through to price declines. The recent attack on Saudi oil production facilities pushed oil prices higher, although the US is not a net exporter of crude oil and is somewhat less sensitive to external shocks in the oil markets.

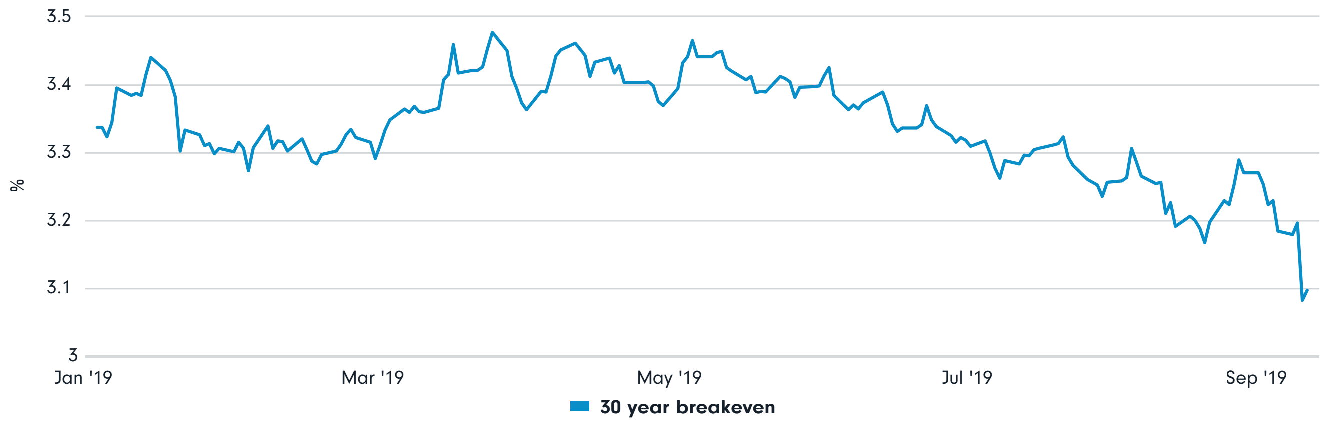
Euro area flash inflation estimates for August came in at 1.0 per cent for headline inflation, down from 1.1 per cent in July, and 0.9 per cent for core inflation which is unchanged from July. The core data was weaker than expected for the second month in a row and provided cover for the ECB's comprehensive easing package at their September meeting.

In the UK, the Chancellor confirmed that the retail price index (RPI) would be aligned with the consumer price index including owner occupier's housing costs (CPIH) - but not before 2025. Given RPI has been up to 1 per cent higher than CPIH, the prospect of lower inflation linked-bond coupons, which are currently indexed to RPI, caused a sell-off in long-dated breakevens. We moved to being short UK breakevens prior to the announcement, and believe they are fundamentally expensive with the prospect of the reform supporting our underweight stance.

Positioning

- The fall in US breakevens over August has strengthened our view that US inflation markets are fundamentally cheap. With core CPI at 2.2 per cent and US breakevens trading around 1.6 per cent for August, we see value at these levels. To add to this, the US consumer remains in a healthy position, with unemployment at record lows and wages continuing to rise.
- We remain neutral Euro breakevens. On the one hand inflation expectations look cheap relative to inflation measures, however, underlying inflation prospects remain very weak amid feeble growth and wage inflation in the euro area.

UK breakevens sold-off on RPI reform concerns



Source:Fidelity International, Bloomberg, September 2019.

Investment grade: Falling yields support credit demand

Falling government bond yields over the quarter supported investment grade (IG) credit total returns, while credit spreads were broadly unchanged over the quarter. The stock of negative yielding assets reached an all-time high at around $17 trillion in August, which further supported flows into IG credit as investors are pushed into credit in their hunt for yield.

Strong demand for European credit supported prices despite supply rising 28 per cent year-on-year (YoY) to August. Euro credit curves have flattened, and even turned negative for the 5-year versus 2-year maturities. New issues that came to market with a negative yield have subsequently struggled to perform, and there was a slight pickup in issuance in longer maturities as borrowers tried to entice investors with more attractive coupons. Meanwhile, we don't think the ECB's new asset purchase programme is enough to provide material support for credit spreads. It is likely that new demand from the ECB will be more than offset by supply from European and non-European companies.

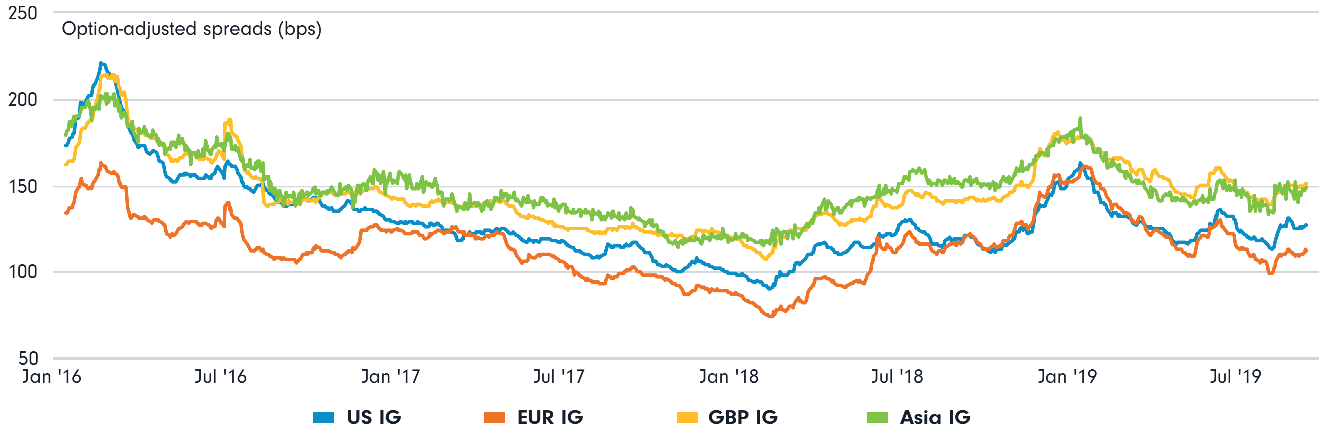
US IG credit underperformed its global peers but some notable deals did come to market. Occidental Petroleum borrowed $13 billion across eight tranches to finance its acquisition of Anadarko Petroleum, with the issuance relatively oversubscribed demonstrating robust credit demand.

Brexit continues to take centre stage for sterling IG, which has, somewhat surprisingly, outperformed its global counterparts over August in terms of credit spread due to the strong domestic 'buy and hold' money that is willing to purchase sterling assets.

Positioning

- We continue to prefer European IG to US IG on a relative basis. Central bank policies and rhetoric from the US President around currency manipulation could put pressure on US IG credit spreads.
- Brexit will be associated with binary outcomes over the next few weeks, leading us to remain cautious on sterling IG, preferring to be in the more defensive areas of the credit market. We are looking for an opportunity to add over the next few months as it could provide a good opportunity to buy quality names at more attractive valuations.

Investment grade credit spreads largely unchanged



Source: Fidelity International, Bloomberg, ICE BofA Merrill Lynch bond indices, shows option-adjusted spreads, to the end of September 2019.

High yield: More volatility to come

The high yield market is caught between supportive monetary policy and stretched valuations, feeding into a volatile quarter. Risk sentiment turned decidedly negative at the start of August, with continuing trade war tensions, renewed concerns over the risk of recession and dovish central bank messaging. Dovish monetary policy is technically supportive but valuations are high and the risk of recession exerts pressure on corporate balance sheets. Spreads generally recovered in the second half of the quarter, driven both by technicals and the search for yield, especially in Europe.

In the US, negative risk sentiment was fuelled by mixed corporate earnings and strained US-China trade relations. The credit markets have seen a continued flight to quality and indeed US investment grade outperformed high yield in August.

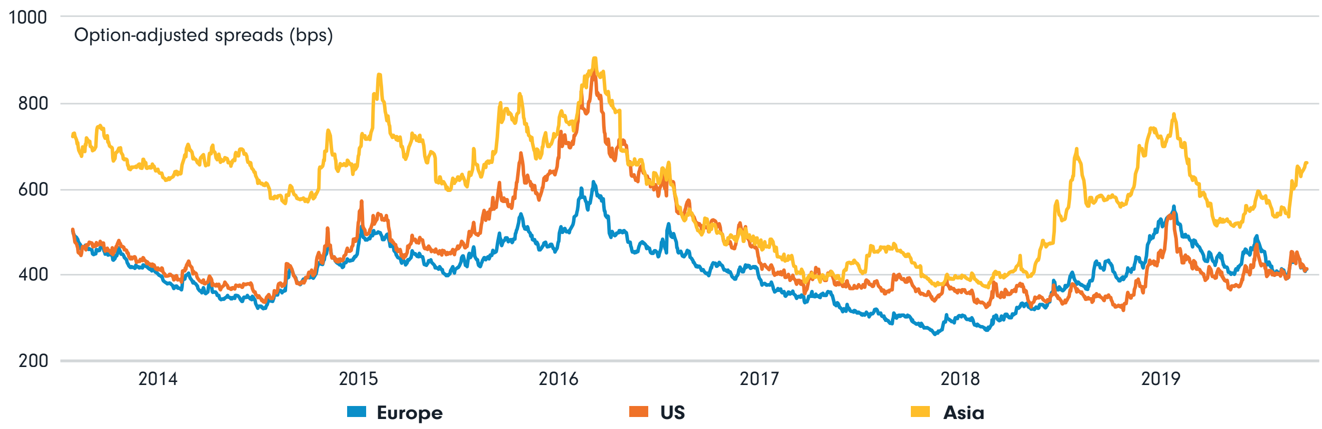
In Europe, increased risk aversion and volatility characterised the quarter. A dovish ECB and hunt for yield dynamics have been supportive, but the macroeconomic picture is mixed at best and valuations are at the high end of recent ranges. Increasing price dispersion, particularly between higher and lower quality names, offers opportunities but needs to be carefully managed for liquidity and idiosyncratic risk.

In Asia, a re-escalation of US-China trade tensions and recession concerns from a continued US Treasury yield curve inversion weighed on risk sentiment. China's July economic data was disappointing, with weaker industrial output and retail sale figures while the Yuan reference rate plunged to its weakest level in more than 11 years.

Positioning

- We remain neutral in high yield overall as we expect more volatility in the months to come. Despite the continuing search for yield, investors are sharply focused on the potential for an end to the credit cycle and a return to higher levels of default.
- We retain a positive view on Asian high yield due to attractive valuations, although liquidity management is a top priority. Amid the uncertainty, a trade war resolution and fiscal stimulus ramp-up in China could act as tailwinds.

High yield credit spreads move wider



Source: Fidelity International, Bloomberg, ICE BofA Merrill Lynch bond indices, shows option-adjusted spreads, to 31 August 2019.

Emerging markets: Opportunities for upside

After a strong July, emerging market debt (EMD) had a tougher time in August, followed by some recovery at the end of the quarter. Both hard currency sovereigns and corporates delivered slightly positive returns mostly driven by falling US Treasury yields despite widening spreads. Local markets felt pain after poor EM FX performance outweighed some tailwinds from duration and carry. The sell-off in August brought valuations more in line with the backdrop of lacklustre growth momentum after reaching stretched levels in some countries at the start of the quarter.

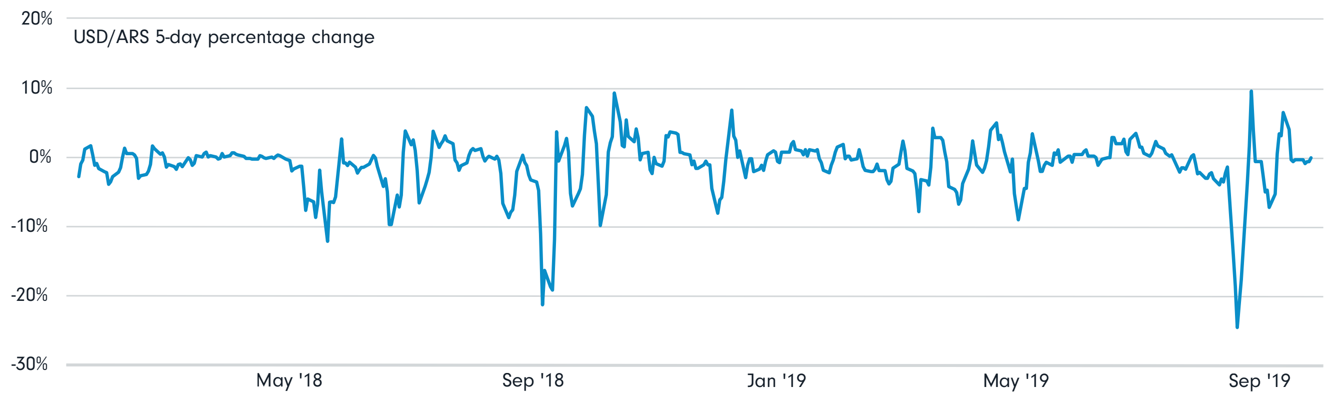
Argentina's government suffered a major defeat in the primary election causing a sell off for all asset prices in the country. Selective defaults were temporarily declared on local debt and capital controls were introduced. Government bonds fell sharply in anticipation of a debt restructuring, although it's unlikely an agreement with US dollar bondholders can be found in the short term given the lame duck position of President Mauricio Macri. However, the bonds are trading at distressed levels and the balance of risks are tilted towards the upside from here.

Nearly all EM currencies weakened against the US dollar amid escalating trade tensions between the US and China, as well as spill over effects from the sharp depreciation of the Argentine peso. In local duration markets, we saw a continuation of July's rate cutting spree from many central banks. Chile, Peru, India, Indonesia, Philippines and Thailand were among the countries who lowered interest rates, including a hefty 150bps cut by the Central Bank of Egypt. We continued to benefit from our structural long position in EM rates.

Positioning

- We keep a positive outlook for EM credit overall, backed by the chorus of dovish global central banks and further domestic stimulus expected from China.
- In the portfolio, we used the weakness across the broader EM currency markets to add tactical positions in several places including Russia, Brazil, the Philippines and India. On the other hand, we moved from overweight to underweight in Israel and Korea. Our positioning is nimble, and we are hesitant to add too much beta here as the path for EM currencies may remain rocky in the near term; growth is still sluggish, and the US/China trade war continues to dampen sentiment.

Déjà vu? Another bad summer for the Argentine Peso



Source: Refinitiv, September 2019

Multi Asset

Overview

What's changed

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

Key takeaways

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

Investment implication

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

Which is right: Bonds or equities?

The strong US equity rally throughout June and most of July, moderated in Q3 despite the Fed cutting rates for the first time in a decade. The conventional wisdom says markets should take confidence from policy easing but, instead, uncertainty over the global economy, President Trump's tariff escalation and US accusations that China was driving down its currency to make it more competitive weighed on investor sentiment.

While equity markets are still strong on a year-to-date basis, there is persistent demand for safe-haven assets such as gold and US Treasuries. This suggests that markets are still undecided on whether the price action in bonds or equities is correctly indicating the economic path forward from here.

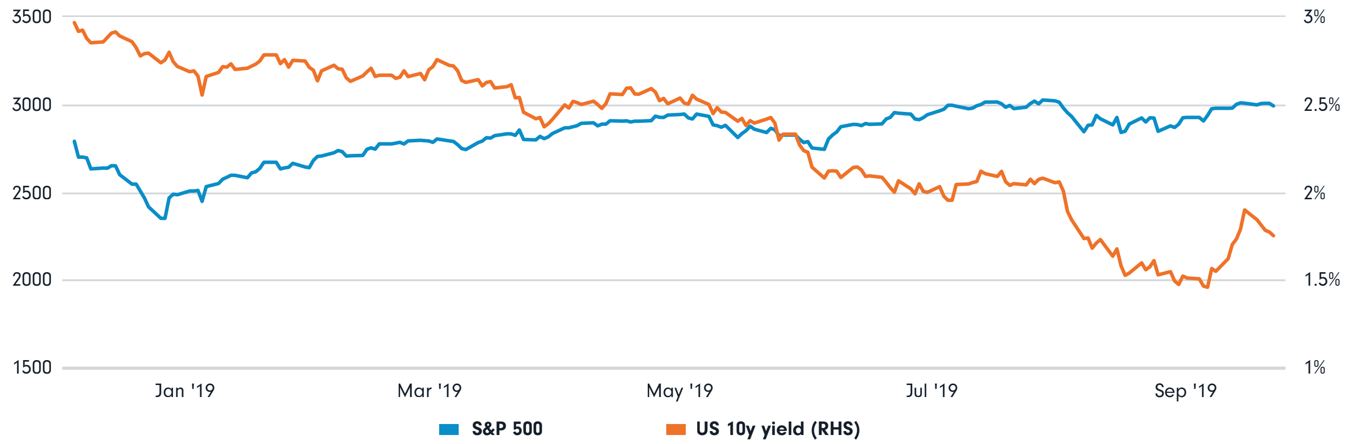
We see two possible scenarios emerging. The first is of flatlining but not declining growth, which acknowledges the global slowdown, but sees some acceleration along with central bank support keeping markets near their current levels. The second scenario is a further slowdown in manufacturing and capital expenditure feeding through to hurt the still-resilient consumer and service sectors. This would require markets repricing to lower earnings expectations, forcing sustained monetary and fiscal stimulus.

At this point, the majority of evidence points to the first scenario, and, despite August's US manufacturing ISM showing contraction, non-manufacturing held up, a reassuring sign for those investors not calling an imminent recession. Moreover, manufacturing in the rest of the world looks to be stabilising at weak levels, and our Fidelity Leading Indicator suggests acceleration.

Against this backdrop, we have not made any changes to our high-level asset allocation views. We maintain a negative view on duration, are positive on cash and neutral on equities, albeit with nuanced outlooks across markets. Our preference is still for high quality US duration as negative yielding debt is around $15 trillion at the end of Q3. In equities we are biased to emerging Asia given the extent positive news is baked into earnings in both Europe and the US.

Dovish monetary policy in emerging markets has helped offset the headwind of a strong US dollar and has led to significant spread tightening supporting EM performance. Given heightened valuations of US duration assets, some of our managers have positions in hard currency emerging market debt.

Bonds and equities telling a different story



Source: Refinitiv, September 2019.

Sub-asset classes

Equities

- **US** - We maintain our neutral view. Relative earnings are holding up, and Fed dovishness continues to act as a tailwind, but there are concerns over the outlook for the technology sector's earnings and economic growth.
- **Europe** - Banks are under pressure, German growth is concerning, Brexit headwinds are increasing, and trade tensions with the US and a slowing China persist. We are cautious given markets are not pricing these risks adequately. On the UK we are neutral given the risk of binary outcomes on Brexit.
- **Japan** - We remain neutral on Japan. Valuations are still relatively attractive, but margins are beginning to show signs of weakness and October's VAT hike is a headwind. Trade tensions and tech weakness is seeing exports suffer.
- **Asia Pacific ex Japan** - Australia continues to be impacted by slower Chinese growth and trade headwinds, but house prices have seen positive signs. There is still liquidity in Hong Kong despite China slowing. We remain neutral on the region overall.
- **Global emerging markets** - We remain positive on emerging markets, with a tilt towards Asia. EM central banks have significant room to ease, contributing to our view of the region's higher likelihood of hitting earnings forecasts relative to others.

Fixed income

- **US Treasuries** - US Treasuries remain an important allocation for defensiveness as well as income relative to other developed market government bonds. However, given the significant moves year to date, we maintain our neutral view.
- **Euro** - We remain negative on core and peripheries. As a defensive asset, many European investors still maintain an allocation, but we maintain our preference for US duration exposure. Italian government bond yields have reached all-time lows but we do not see fundamentals supporting this move given political uncertainty and trade headwinds.
- **Inflation-linked bonds** - Our view is still positive as inflation-linked bonds remain an important defensive asset for investors looking to hedge any surprise return to inflation, despite little sign of this appearing at present.
- **Investment grade** - We retain a neutral view at a global level and maintain our preference for US dollar denominated issues with relatively short duration exposure. We are carefully watching credit quality within the investment grade space.
- **High yield** - US high yield has continued its strong performance year-to-date, but is vulnerable to any change in course by the Fed. European high yield is at more attractive valuations than US high yield, but Eurozone headwinds leave us unwilling to move from a neutral view. In our income-generating portfolios, we continue to have a positive view of Asia high yield. Technicals and corporate balance sheets are attractive, and the sector is more domestically focused and is therefore less vulnerable to trade wars.
- **Emerging market debt** - Hard currency debt is important for our income-focused range as part of a thesis to add to US dollar duration given poor valuations elsewhere. On local currency debt we maintain a positive view. Since the Fed reversed policy, nominal and real yields are attractive, oil price stabilisation has reduced pressure on the major oil importers, EM central banks are dovish, and FX is cheap. Given the late cycle environment, we remain biased to quality in corporate credit, and prefer to gain exposure to emerging market debt through government issues.

Currency

- **US dollar** - Rate cuts, falling growth and inflation, 'twin deficits', poor policymaking and fundamental over-valuation has us negative on USD despite its resilience this year. 'US exceptionalism' in monetary tightening and growth is over.
- **Euro** - Despite headwinds for the Eurozone, EUR seems to be pricing excessive pessimism. The currency is fundamentally cheap, has a current account surplus and ECB easing is fully-priced.
- **Japanese Yen** - JPY remains attractive as a 'defensive' asset with supportive near-term technicals. Significant upside potential remains, based on valuation, and the Bank of Japan looks set to remain on hold.

Real Estate

Overview

What's changed

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

Key takeaways

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

Investment implication

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

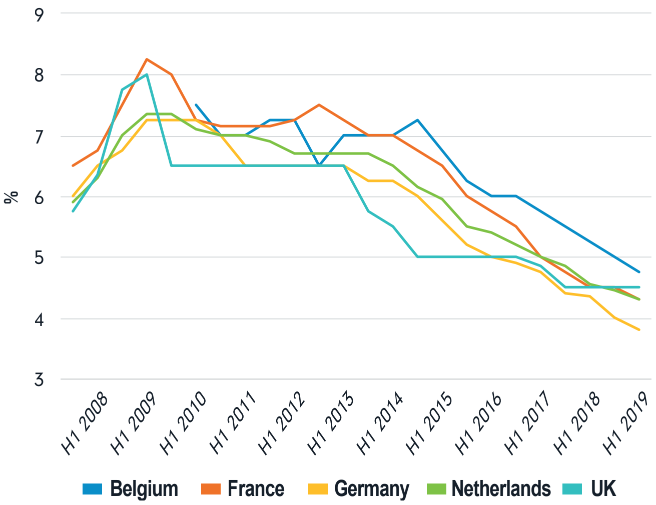
Capturing performance in competitive market requires tailored approaches

Given yields for core commercial real estate are at record lows, investment strategies will be focused either on delivering net operating income (NOI) growth, which may prove challenging in a weakening economic environment, or seeking slightly higher yields without taking on too much additional risk.

The industrial and logistics sector offers an opportunity to capture rising rental values in the UK and Europe. While higher allocations to this sector should boost performance, the drivers and performance traits of different sub-segments are distinct:

- In the urban warehouse sector, we expect to see stronger rental growth driven by a rapid evolution of e-commerce and supply chains. The restricted availability of land and greater property management potential should provide some additional performance. However, yields are low and finding opportunities remains a challenge in this competitive market.
- The classic 'big box' warehouses tend to deliver higher yields but lower rental growth prospects. At current prices, funding pre-let development may be a good way to maximise returns as it offers extra yield.
- There are regional variations. Rental growth in the Eurozone continues to lag the UK despite lower yields, in some cases below 4 per cent for prime assets. However, many of the developer-led pockets of new supply are close to being fully absorbed, which should pave the way to long-awaited rental growth. The one caveat is that, similar to the UK, urban warehouses will see notably stronger rental uplifts, but absolute increases are likely to be below those in the UK.

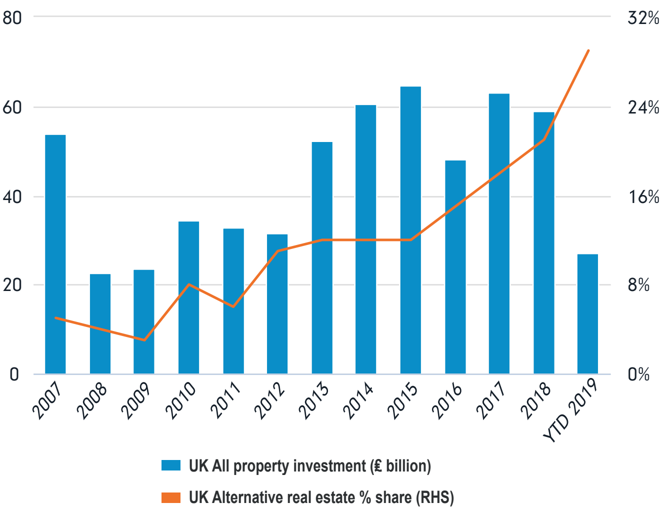
European industrial/logistics report lower yields than in the UK



Source: CBRE, end Q2 2019.

Alternative sectors should also continue to do well having delivered top performing returns across a wide selection of European markets. Alternative real estate segments accounted for 30 per cent of UK real estate investment market activity in the first eight months of 2019 versus a long-term average share of 12 per cent.[1] It is the only segment of the UK market to have seen no deterioration in demand. Investors have been attracted to a combination of factors, including its growing liquidity and its stable, and, in some subsectors, high yields.

Demand for alternative sectors is holding steady



Source: Fidelity International, Property Data, September 2019. .

[1] Source: Fidelity International, Property Data, September 2019.

Regional breakdown

Eurozone is more resilient than it appears

Manufacturing output remains a major drag on the Eurozone's economic outlook as sentiment deteriorates, but the latest indicators suggest that there may be some resilience to the downside risks, such as trade and geopolitical tensions. The Eurozone is supported by a strong labour market and robust consumer sentiment across the board, including in Germany. The European Central Bank's latest rate cut and new stimulus programme should also help. Overall, the short-term outlook is more of a balancing act of relatively robust domestic conditions and negative external forces, rather than a clear deterioration.

We expect the Eurozone real estate market to benefit from:

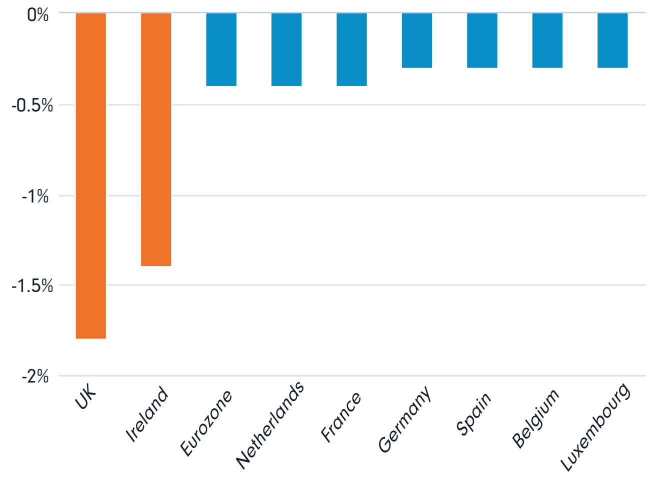
- The ongoing diversification needs of international investors and unfulfilled real estate allocations;
- Political and cyclical shifts away from investing in the US, partly due to the strong US dollar;
- Generally lower currency hedging costs when investing in Europe.

Furthermore, the economic impact from a 'No-Deal' Brexit scenario is not significant for most of the Eurozone, with the exception of Ireland. Consultants at Oxford Economics suggest the impact will be limited to around a cumulative 0.3 per cent to 0.4 per cent reduction of GDP relative to the 2021 year-end baseline projection across most Eurozone markets. However, sector level impacts are expected to be asymmetric, with wholesale and manufacturing sectors most affected.

The structural challenges of the growing e-commerce sector, changing consumer expectations and rising operational costs, have dampened investor sentiment towards mainstream retail in Europe. The challenges and risks associated with deploying new capital into Eurozone real estate, whether it is pricing, product availability or risk assessment, remain in place. But strategic focus on sustainable income and tenant analytics should enable stronger performance.

The economic impact from a no-deal Brexit is not significant for most of the Eurozone

Average annual GDP impact over the next three years from no-deal Brexit



Source: Oxford Economics, September 2019.

Positioning

- The short-term economic outlook remains a balancing act and prudent investors should lower return expectations and focus on sustainable income. However, should global markets pick up, the robustness of the Eurozone economy could surprise on the upside, feeding into stronger total return expectations.
- Understanding the nature of income will continue to grow in importance as we move further into the advanced stages of the cycle. Investors who can analyse their tenant exposure and optimise income by managing tenant quality, diversity and duration should outperform. In particular, a careful assessment of tenants in the manufacturing sector will be necessary regardless of which economic path unfolds. Notwithstanding some pockets of strength such as automation and highly specialised areas, manufacturing will be disproportionally hurt by slowing economies.
- Maintaining an underweight position in the traditional retail property sector remains a priority as e-commerce and retailer affordability pressures grow.

Brexit continues to cloud the outlook

The UK economy reported a sharp 0.2 per cent contraction in Q2 due to ongoing Brexit-related distortions, including the overhang following Brexit stockpiling in the first quarter. While the economy has modestly improved in the third quarter, Brexit re

mains a crucial 'known unknown', with still no clarity over which scenario is most likely.

The extended uncertainty has adversely impacted investor sentiment. Having already slowed substantially in the first half of 2019, we expect the full-year real estate investment activity to fall below £40 billion for the first time since 2012. Performance is also down: the average monthly UK All Property total return shrank to just 0.2 per cent[2], with negative capital growth reported in each month.

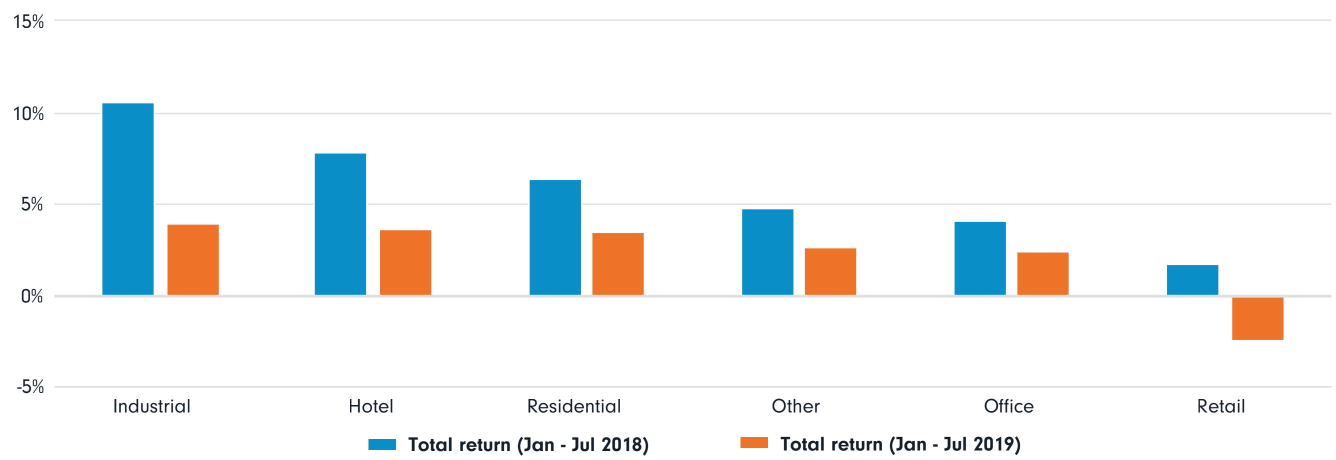
Sectoral differences persist. Retail and increasingly office sectors are reporting weak performance year-to-date. Industrial and logistics has performed the best. Alternative sectors have delivered strong returns in 2019, including hotels, residential and other alternatives, and this is the only segment where we expect to see little or no slowdown in investor demand.

Positioning

- Moderately increasing cash reserves is sensible at this point in the cycle. This should create strategic benefits regardless of which Brexit scenario plays out. Under a no deal Brexit, a cash cushion will mitigate potential cash outflows. Under a more moderate Brexit outcome, it will give investors a lead in deploying capital back into the market, especially as accessing investment opportunities should become easier and pricing points more favourable.
- UK real estate market performance will remain modest relative to the recent past. Over the near-term, total returns for stronger market segments could reach close to 5 per cent per annum. Growing liquidity across several alternative sectors, redevelopment potential and strong income characteristics will be the key near-term investment themes.

[2]Source: MSCI UK Monthly Property Index, over the January-July 2019 period.

UK industrial/logistics and alternative sectors continue to outperform



Source: Fidelity International, MSCI UK Monthly Property Index, July 2019.

Important Information

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