Q2 2018

Investment Outlook

Choppier waters ahead

- Markets are returning to more normal levels of volatility
- The macroeconomic landscape remains supportive, and even though developed world growth is easing, it is still robust
- Rising volatility means it is important to be more selective in how you take risk; and active security selection could provide additional value
- In our opinion, we are at the beginning of the end of the current economic cycle

Fidelity's outlook for equities, bonds and alternatives

Outlook: At a glance

Equity

Markets are reverting to more normal levels of volatility after two years of steadily declining levels. The macro landscape remains supportive, and though developed world growth is easing, it is still robust. We expect central bank policy moves to play a significant role in market performance in the short to medium term. In our opinion, this is the beginning of the end of the current economic cycle.

Fixed Income

Government bond yields fell towards the end of the quarter as geopolitical tensions in March drove a flight to quality. The 3 per cent mark in 10-year US treasury yields is being tested, and will act as a driver for global government bond markets. On a relative basis, we favour core European bonds, where the carry is still attractive and the ECB offers ongoing support to the market. The rising volatility in markets suggests security selection will be important from here.

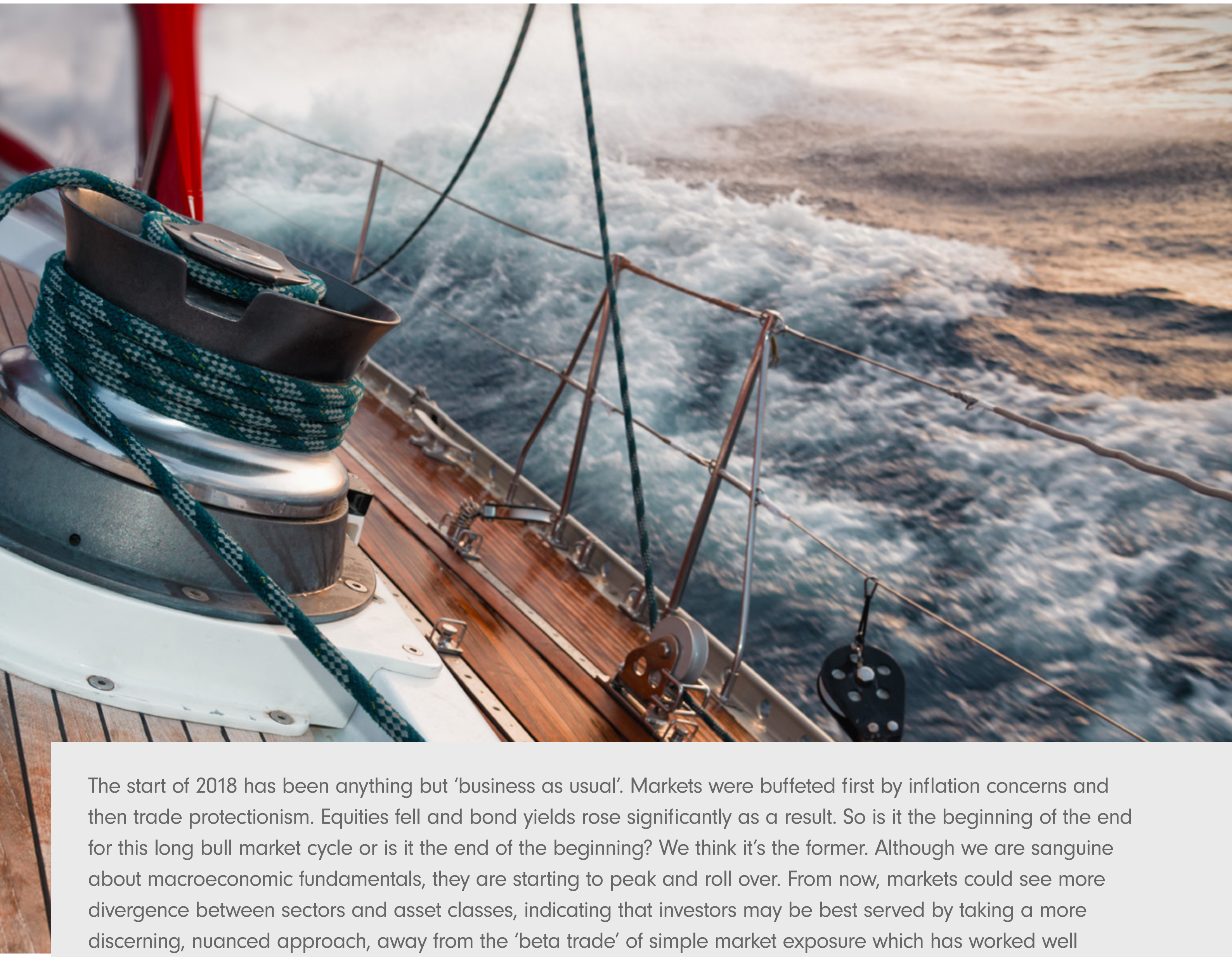
Alternatives

Commercial real estate markets remain buoyant, more so in Europe than the US where valuations are higher and interest rates rising. In prime markets, given that yields are at record lows, we gravitate towards selective assets in second tier locations. Finding value in the current market without compromising on asset quality or moving up the risk curve will remain a key challenge.

Commodities started 2018 strongly but market volatility created more risk aversion as the quarter progressed. In recent weeks, geopolitical tensions have affected several commodities. Although fundamentals remain supportive for commodities overall, a stronger dollar could act as a headwind. An easing of geopolitical tensions might see some of the increased risk premia that have been built into commodities such as oil, start to reduce.

Alternatives such as listed infrastructure and hedge funds offer interesting opportunities compared to equities. Despite recent moderation in equity prices, medium-term return expectations are low, and listed infrastructure can offer 4-5 per cent yields. Long/short equity funds and global macro strategies should become increasingly prominent as economic conditions cause asset classes to diverge in performance, creating more opportunities for nuanced directional bets.

Choppier waters ahead



The start of 2018 has been anything but 'business as usual'. Markets were buffeted first by inflation concerns and then trade protectionism. Equities fell and bond yields rose significantly as a result. So is it the beginning of the end for this long bull market cycle or is it the end of the beginning? We think it's the former. Although we are sanguine about macroeconomic fundamentals, they are starting to peak and roll over. From now, markets could see more divergence between sectors and asset classes, indicating that investors may be best served by taking a more discerning, nuanced approach, away from the 'beta trade' of simple market exposure which has worked well until recently.

About the views

This investment outlook provides a representative summary of the views of Fidelity International's investment teams. At Fidelity, individual portfolio managers have considerable flexibility and ultimately fiduciary responsibility for all investment decisions within their portfolios. Given this portfolio manager discretion, there may be differences between the broad, representative views shared here and the strategies applied within specific Fidelity funds.

Equity

Overview

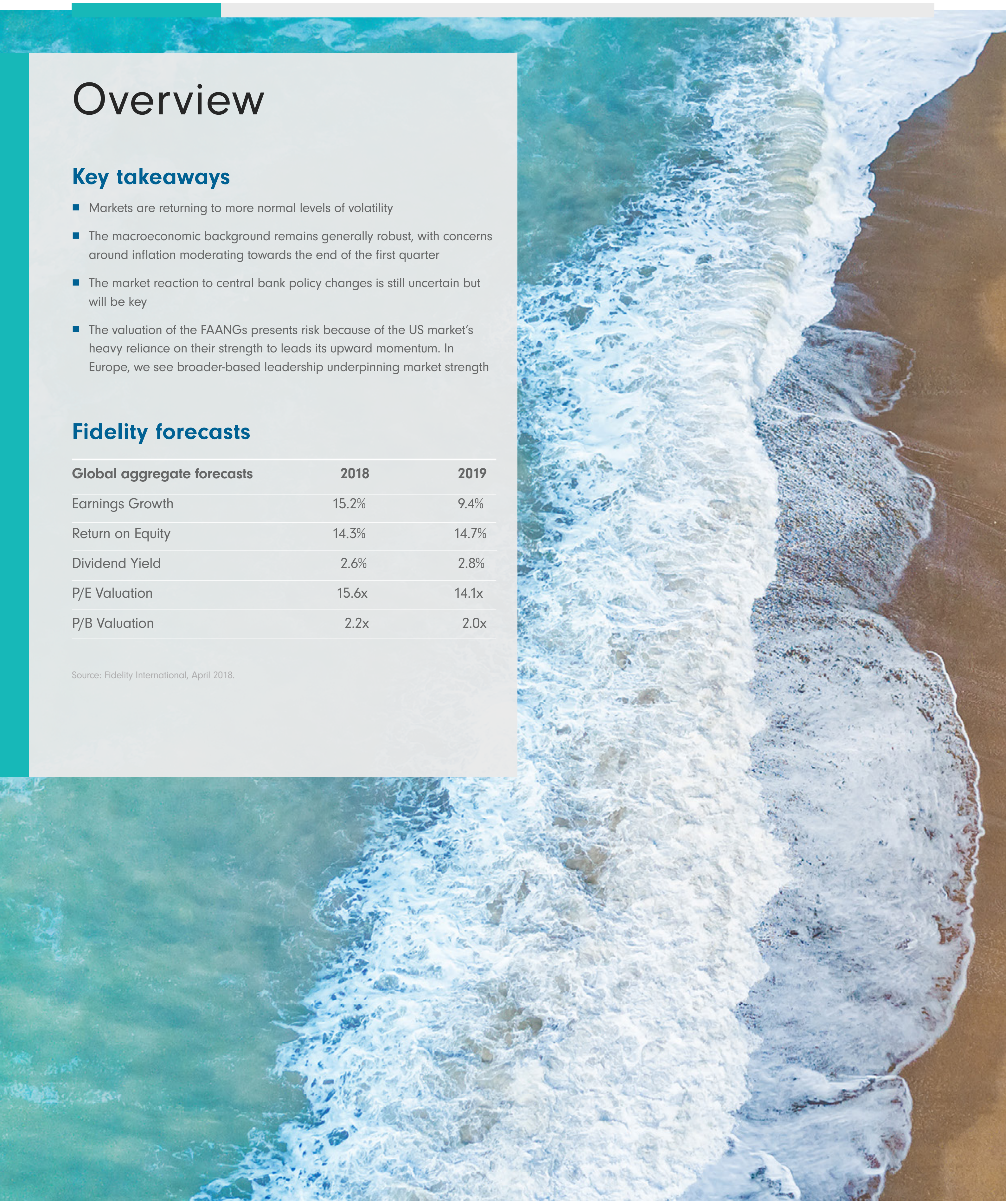
Key takeaways

- Markets are returning to more normal levels of volatility
- The macroeconomic background remains generally robust, with concerns around inflation moderating towards the end of the first quarter
- The market reaction to central bank policy changes is still uncertain but will be key
- The valuation of the FAANGs presents risk because of the US market's heavy reliance on their strength to leads its upward momentum. In Europe, we see broader-based leadership underpinning market strength

Fidelity forecasts

Global aggregate forecasts	2018	2019
Earnings Growth	15.2%	9.4%
Return on Equity	14.3%	14.7%
Dividend Yield	2.6%	2.8%
P/E Valuation	15.6x	14.1x
P/B Valuation	2.2x	2.0x

Source: Fidelity International, April 2018.



Equity

Outlook

Equity markets are returning to more normal levels of volatility, but even 'normal' has come as a shock to investors who have been cushioned by a long period of unusually calm conditions. We think we are entering the end of the cycle, but this stage could be drawn out given healthy fundamentals.

Investors' main concern is that key central banks are shifting towards tighter monetary policy and the US Federal Reserve may be less inclined in future to act to support equity markets.

Developed market growth has been cooling a little but its recent trend has been robust and supportive for equity markets. In addition, emerging markets continue to grow strongly. Similarly, concerns about rising inflationary pressure have eased since the beginning of the year, when stronger than expected US wage growth jolted markets.

Investors' main concern is that key central banks are shifting towards tighter monetary policy and the US Federal Reserve may be less inclined in future to act to support equity markets. It is unclear how central banks' unwinding of monetary stimulus will affect economies, and indeed what level of withdrawal is feasible in practice given its magnitude.

We believe that even small interventions by central banks can have a significant impact on sentiment-driven markets that are near the top of the cycle. Similarly, unexpected shifts in macroeconomic data could rock markets because of the dependence on momentum - this is typical late-cycle behaviour.

These factors reinforce our opinion that the current economic cycle still has some life but that the beginning of the end is coming into view, with a market turn perhaps 6-18 months away.

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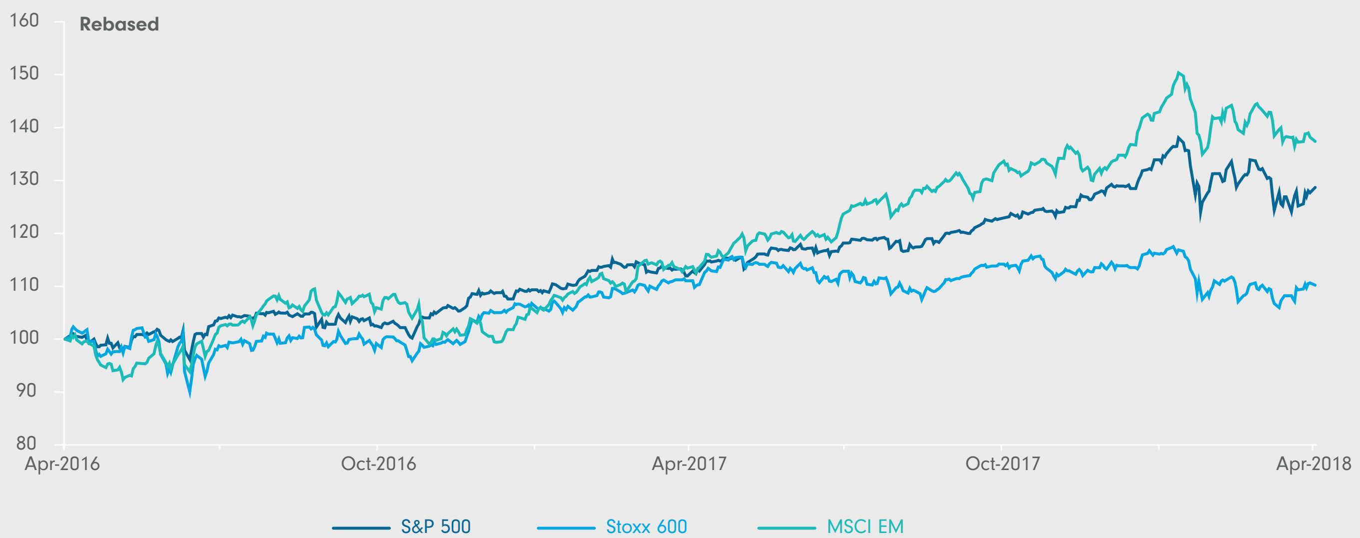
Equity returns will remain more volatile this year



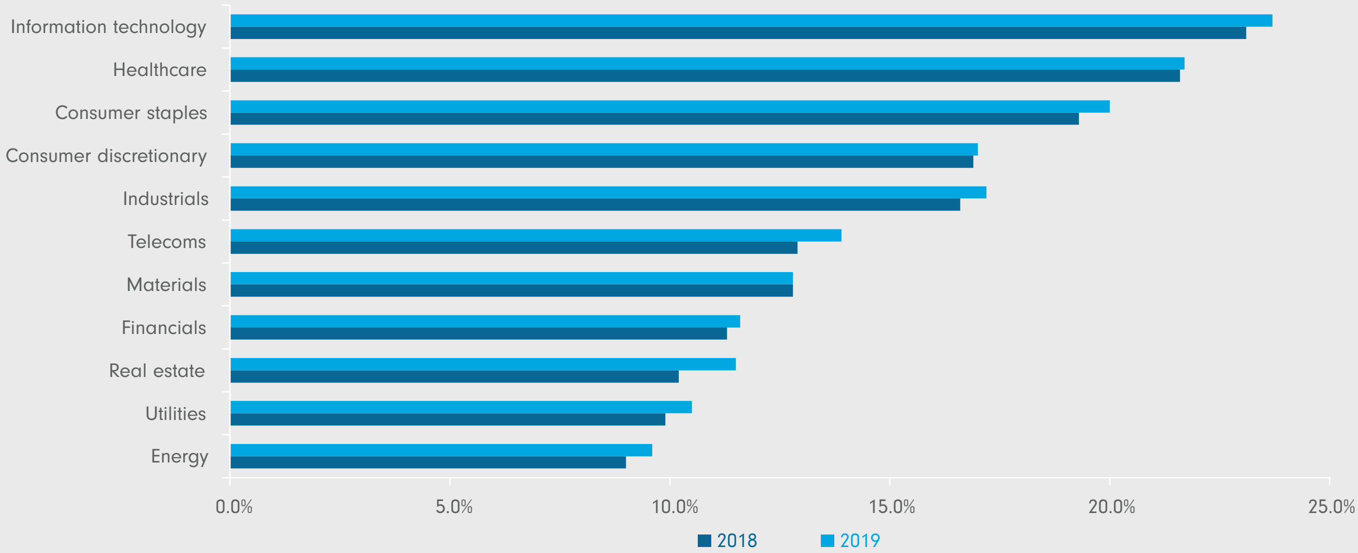
Source: Datastream, April 2018

Price return, 12 months to:	30 Apr 2014	30 Apr 2015	30 Apr 2016	30 Apr 2017	30 Apr 2018
S&P 500 Composite	19.3%	10.4%	-0.4%	14.7%	11.8%
STOXX Europe 600 E	13.9%	17.1%	-13.7%	13.4%	-0.5%
MSCI EM US	-4.2%	5.3%	-19.8%	16.4%	19.1%

Equity

Sectors and regions

Sector returns expected to hold up
Return on equity forecasts by sector



Source: Fidelity International, April 2018

Outlook

Although the 'Goldilocks' economic scenario of above-trend growth and below-trend inflation remains intact, recent company earnings reports show the effects of increased wage inflation and some pressure in distribution and transportation costs from a higher oil price, particularly in the US. This strengthens our view that cyclical sectors will not be able to maintain their outperformance over defensives and we note recent signs that this is, indeed, reversing. In this environment, being more selective about where and how you take risk is prudent.

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In the US, FAANG stocks (Facebook, Apple, Amazon, Netflix and Alphabet (Google)) remain highly valued and, unusually, the group led into, as well as out of, the market corrections in February and March. This could partly be due to the influence of the US tax breaks. The FAANG's strong performance has led to a concentration of US market returns, which creates risk - but also opportunities for re-rating in the underappreciated parts of the US market.

In Europe, markets have a broader base of support, which makes us more positive on the region. In China, we expect the economy to slow gradually but this has largely been priced into markets, and the Chinese government has historically been able to carefully manage the economy. Japan could prove volatile given its high exposure to global trends.

In terms of sectors, we are cautious on consumer discretionary. In particular, we are concerned about auto stocks, where profits are peaking and finances are deteriorating, and retailers, which face headwinds from more restrained consumer spending. These industries constitute a significant part of the sector, leading to our negative view on consumer discretionary. In energy, prices should be range-bound and we do not expect undersupply or oil price shocks, and given that the oil majors have de-rated, there is scope for upgrades in the sector.

Fixed income

Overview

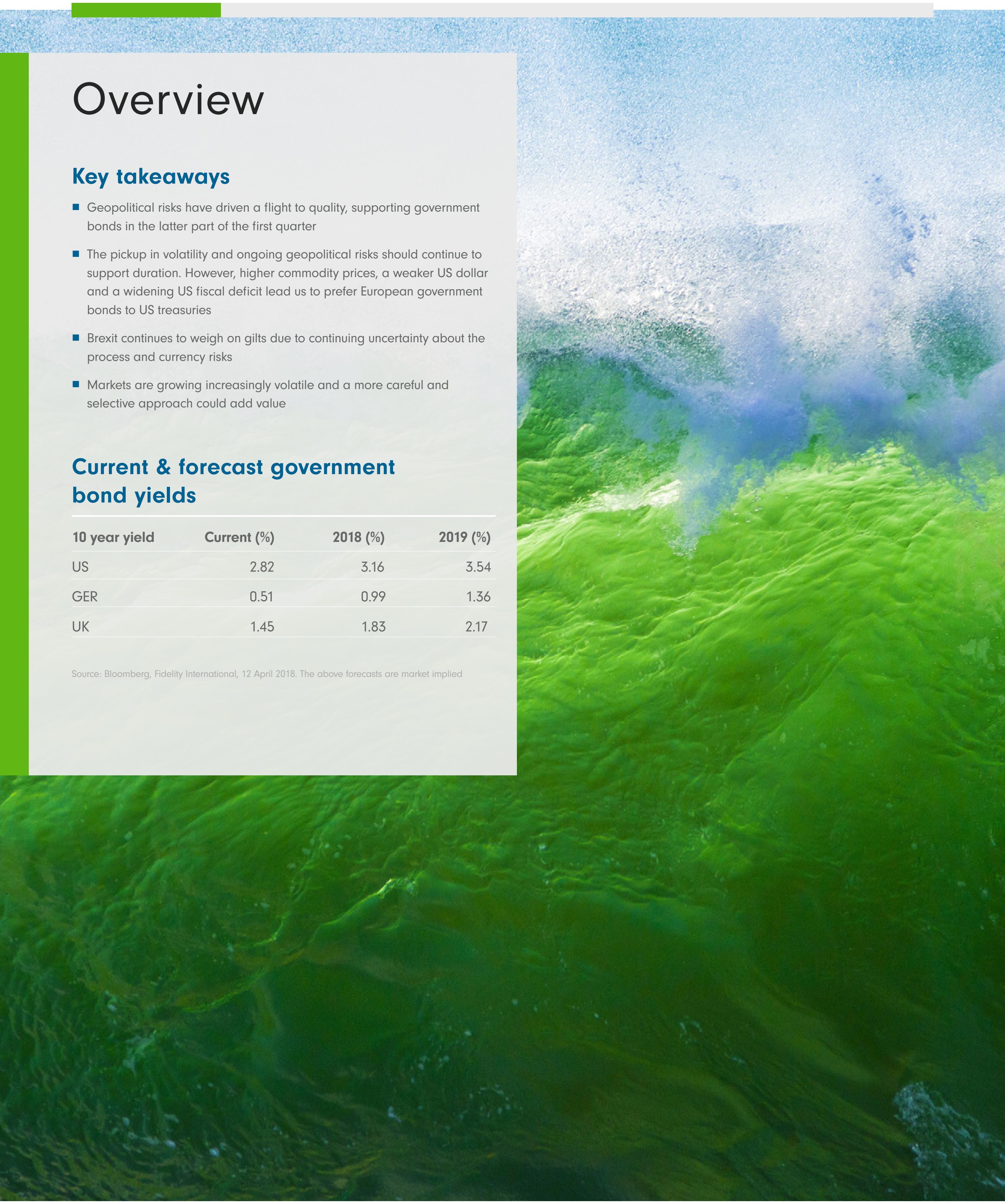
Key takeaways

- Geopolitical risks have driven a flight to quality, supporting government bonds in the latter part of the first quarter
- The pickup in volatility and ongoing geopolitical risks should continue to support duration. However, higher commodity prices, a weaker US dollar and a widening US fiscal deficit lead us to prefer European government bonds to US treasuries
- Brexit continues to weigh on gilts due to continuing uncertainty about the process and currency risks
- Markets are growing increasingly volatile and a more careful and selective approach could add value

Current & forecast government bond yields

10 year yield	Current (%)	2018 (%)	2019 (%)
US	2.82	3.16	3.54
GER	0.51	0.99	1.36
UK	1.45	1.83	2.17

Source: Bloomberg, Fidelity International, 12 April 2018. The above forecasts are market implied



Fixed income

Outlook

Despite the volatility in US treasuries, global government bonds actually ended the first quarter higher on a hedged basis, primarily supported by the strength of Eurozone peripheral debt. Importantly, government bonds benefitted from a flight to quality as geopolitical risks reignited in March.

In the US, treasury yields are caught between opposing secular and cyclical forces. With US growth tracking at around 3 per cent, policy is continuing to normalise, driving yields cyclically higher. But the secular trends of lower growth and higher debt should keep terminal rates low and longer-term yields anchored. Against this backdrop, the Federal Reserve will continue to raise rates if conditions remain conducive to tightening but are unlikely to surprise with more hawkish commentary. We expect three rate rises this year, in line with market consensus.

For 2019, we note that markets are currently pricing only 1.5 rate increases versus the three rises implied by the Fed Open Market Committee's 'dot plot'. We suspect that slowing growth may prompt a slower pace of tightening from the Fed next year than FOMC members currently project.

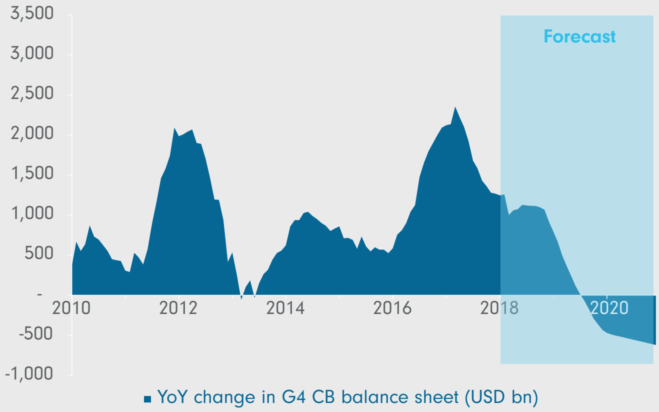
A tight US labour market and strong business surveys point to a risk of higher inflation ahead, and we see core CPI drifting up to around 2.7 per cent by late summer. In the short term, the upward pressure on US treasury yields remains in place, with markets continuing to test the 3 per cent mark. However, the perceived safety of US government bonds in a world marked by geopolitical risks should cap yields.

The recent flattening of the yield curve in Europe has somewhat reduced the attraction of euro duration, prompting us to reduce our exposure. The curve remains relatively steep and we still see some value, particularly in core eurozone government bonds. On peripheral countries we have moved to neutral after spreads tightened following buying by European banks and a relatively sanguine news flow.

In the UK, macroeconomic data is pointing to underlying weakness in the economy, and the prospect of a second quarter interest rate rise by the Bank of England is diminishing. Although the BoE may surprise the market and hike before the summer, over the long term the economy is not strong enough to withstand higher interest rates. Brexit uncertainty still lingers in the background and could become a meaningful driver for all UK assets once again.

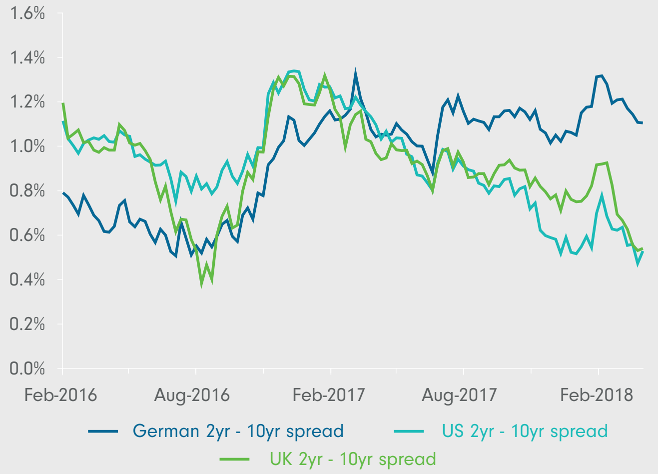
Overall, across the fixed income universe, security selection is becoming increasingly important as markets grow more volatile: simply buying beta in fixed income may not lead to the kind of returns in has generated in the recent past.

Policy support fading precipitously in 2018



Source: Fidelity International, Bloomberg, December 2017. Assuming €30bn per month in ECB support (PSPP) from January to September 2018, dropping to €15bn per month from October to December 2018; Fed balance sheet shrinking at $10bn per month from October 2017, increasing $10bn per quarter to a maximum of $50bn; and BoJ purchases slowing at a rate of 0.25 per cent year-on-year.

Global curves continue to flatten

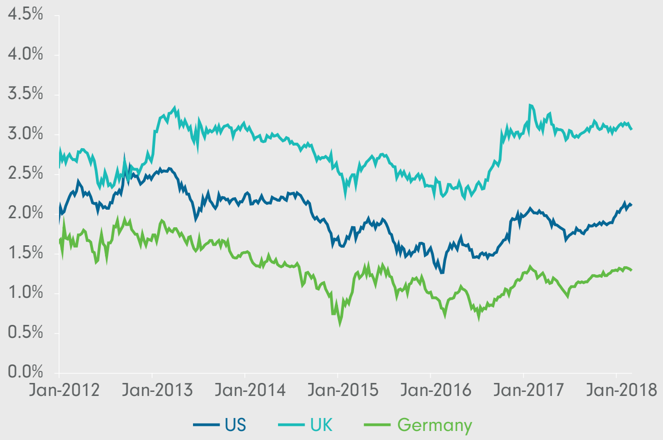


Source: Fidelity International, Bloomberg, 31 March 2018

Fixed income

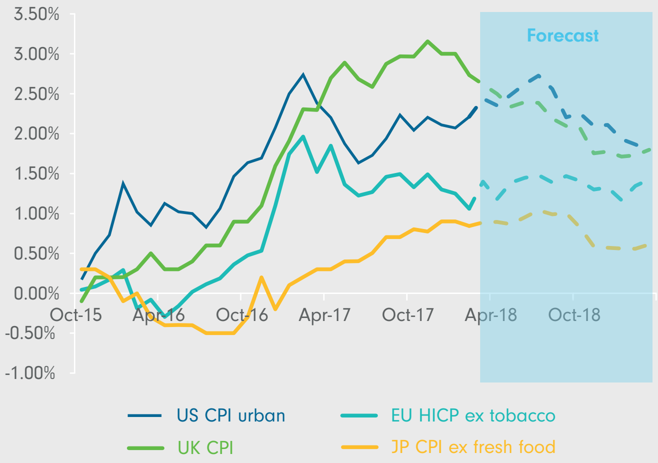
Sectors and regions

10y inflation breakeven rates indicate rising inflation expectations



Source: Fidelity International, Bloomberg, 30 March 2018

Fidelity inflation forecasts do not project a lasting pickup



Source: Fidelity International, Bloomberg, 30 March 2018

Outlook

We are increasingly comfortable about credit markets, especially compared with six months ago, given the global economy is strong and corporate fundamentals across all regions are solid. However, investment grade spreads have widened as volatility picked up and issuance, particularly in euros, rose. We see more opportunity in European investment grade than the US or Asia because of strong credit fundamentals and ongoing support by the European Central Bank which is at least two years behind the Fed on its monetary path.

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High yield has outperformed investment grade but we remain cautious towards the asset class , which continues to be highly correlated with equity markets, and is less attractive on a risk-return basis than investment grade debt or leveraged loans. The macroeconomic backdrop has supported high yield to date, with good earnings and low default rates. However, we do note signs of distress in US retail and telecoms sectors. In Europe, geopolitical risks have returned, whether that's risks posed by the prominence of populist parties following the recent Italian elections or by ongoing tensions between Russia and the US following the latest round of sanctions.

Emerging market bond fundamentals remain solid, but we see little opportunity for further spread compression in hard currency government bonds this late in the cycle. Economic growth across emerging markets is currently strong but recent data have turned weaker, with the Purchasing Managers Index (PMI) decelerating. There are pockets of value in countries with higher yields and improving economic profiles such as Ecuador, Argentina and Angola. Better opportunities lie in the local currency debt space. Emerging market inflation-linked bonds look particularly attractive, given that inflation has troughed while real yields remain elevated compared to developed markets.

Alternatives

Key takeaways

- Given that yields are at record lows in prime markets, we prefer careful asset selection in established second-tier locations. This year also presents a window of opportunity for selective asset disposal to crystallise profits.
- Finding value in the current market without compromising on asset quality or moving up the risk curve will remain a key challenge. Lack of supply will be the main factor behind near-term outperformance for both new acquisitions and existing assets across all markets.
- While real estate fundamentals remain sound, the possibility of a major external event disrupting the real estate investment cycle remains a risk.

Commercial real estate

Outlook

Investor interest in commercial real estate remains buoyant, particularly in Europe as institutions become increasingly concerned about North America due to stretched valuations and rising interest rates. Europe is late in its cycle, having seen 21 consecutive quarters of yield compression[1] and a third consecutive year of investment turnover above €220 billion.[2] However, economic data indicates that other regions such as the US and some Asian markets are more advanced in their cycles and the European cycle has even further to run. Furthermore, Europe continues to enjoy a supportive interest rate environment, with no interest rate increase expected until mid-2019 and the ECB committed to bond purchases until the end of September 2018.

The main segments of the European market are experiencing healthy demand, boosted by strong corporate fundamentals across the region, while supply continues to lag in most places as markets are quick to absorb new development completions. Five-year average annual office take-up levels by occupiers are forecast to reach 10.1 million square meters per year, significantly higher than previous forecasts.[3]

We identify several areas of increasing risk as the market enters the late stages of one of the longest real-estate investment cycles in history. With competition for assets intensifying, there is greater potential for mispricing and a temptation for investors to shift away from their core strategy or move up the risk curve. Although spreads between core eurozone prime and secondary yields have remained well above 200 basis points in this cycle, compared with 60-75 basis points in 2006-07, we believe that parts of the core markets are being priced as keenly as prime real estate.[1] The industrial sector is a good example of this, with very strong investor appetite due to structural changes in supply chains and consumer behaviour driving up prices.

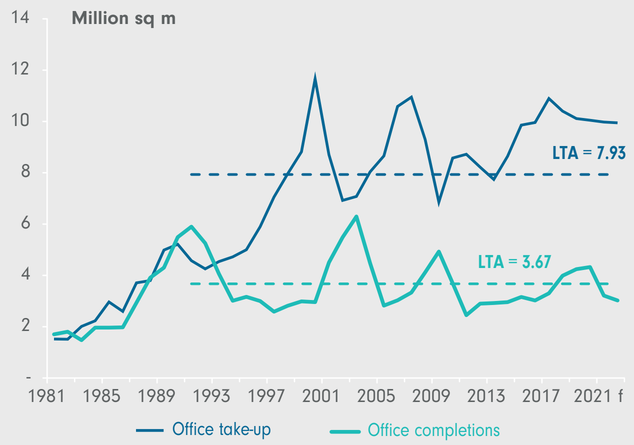
Despite the relatively benign fundamental landscape, it is important not to overlook the possibility of major external events disrupting the real estate investment cycle. A major correction in equity markets, China's economic growth slowdown, Trump's tariffs and ongoing geopolitical tensions around Russia remain on investors' minds.

Length of the late recovery phase (economic growth positive and accelerating)

	Av length (months)	Current length (months)	Difference (months)
Spain	25	10	15
Germany	16	6	10
Sweden	13	5	8
Switzerland	14	6	8
Finland	23	15	8
Hong Kong	15	7	8
Italy	13	5	8
France	16	9	7
Greece	12	7	5
Singapore	10	5	5
USA	16	12	4
Taiwan	15	12	3
Netherlands	16	14	2
Austria	13	12	1
Japan	11	11	0
Denmark	16	26	-10

Source: Oxford Economics, February 2018. Period covered: 1993 -2017.

Supply and demand imbalance, Western Europe (incl UK)

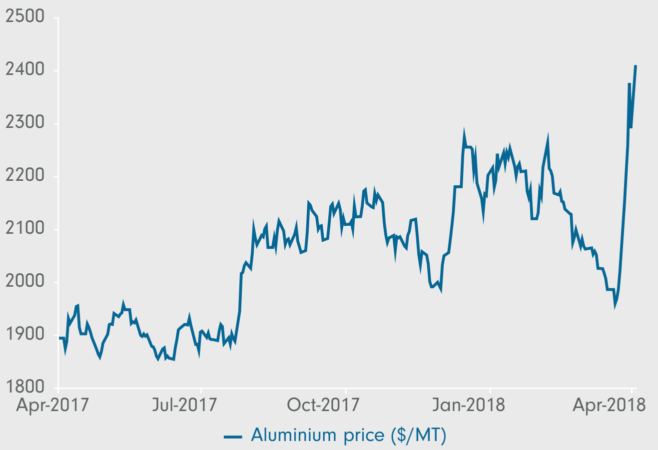


LTA = long term average. Source: Fidelity International, Jones Lang LaSalle, February 2018.

[1]CBRE Research, March 2018.
[2]Fidelity International, Real Capital Analytics, January 2018.
[3]Jones Lang LaSalle, February 2018.

Commodities

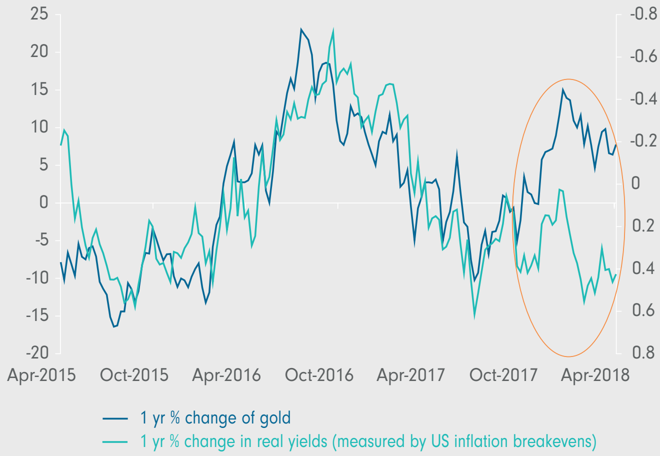
Spot the sanctions related price move



Source: Datastream, April 2018

Price return, 12 months to:	LME alluminium
30 Apr 2014	-4.1%
30 Apr 2015	10.1%
30 Apr 2016	-13.6%
30 Apr 2017	14.0%
30 Apr 2018	18.6%

Gold has diverged from real yields in recent months



Source: Datastream, April 2018

Price return, 12 months to:	LMB gold bullion
30 Apr 2014	-11.9%
30 Apr 2015	-8.7%
30 Apr 2016	9.5%
30 Apr 2017	-1.9%
30 Apr 2018	3.6%

Outlook

Commodities have seen a mixed start to 2018. A strong beginning to the year in markets was offset by higher risk aversion as volatility rose across February and March. More recently, several commodities markets have been affected by geopolitical tensions, with oil prices benefiting from tensions in the Middle East, and aluminium prices spiking higher as the US announced new sanctions against Russia.

While geopolitical concerns cloud the outlook for commodities such as oil, the fundamentals for the energy market remain positive. OPEC and Russia have succeeded in restricting oil production, with excess oil inventories falling globally and the alliance now within sight of seeing oil inventories return to their five-year average. Strong demand growth has also helped, with the demand for oil growing by around 1.6 million barrels per day (b/d) in 2017, and forecast to grow by another 1.53 million b/d in 2018.[4]

China accounts for around 50 per cent of global demand for many industrial metals, making the outlook for the sector closely related to the health of China's economy, which has been resilient over the past six months given tighter credit conditions which are weighing on growth. Import data for March suggests strong industrial demand and indicates that China isn't the reason for the recent moderation in European and Japanese data. It also points to the global economy remaining robust for now.

Although fundamentals remain supportive for commodities overall, a stronger dollar could act as a headwind. Provided the global economy ex-US continues to grow strongly, any dollar strengthening should be limited. But if the rest of the world decelerates and the US continues to grow strongly, potentially boosted by late-cycle fiscal stimulus, then the Federal Reserve could be forced to tighten monetary policy more than expected, enabling the dollar to appreciate and causing negative effects for a wider range of assets than just commodities.

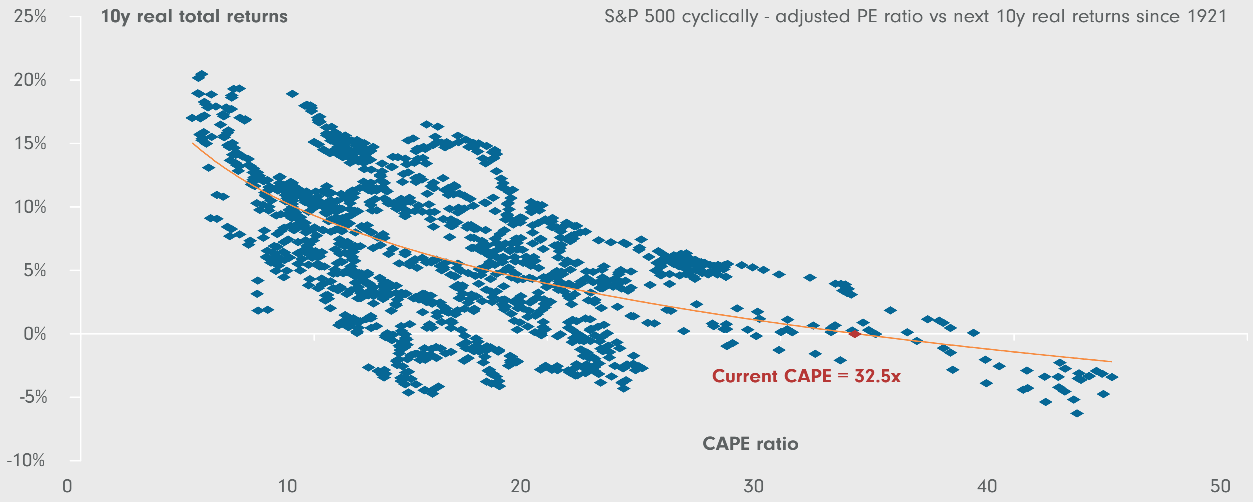
Similarly, a reversal of geopolitical tensions might see some of the risk premia that have been built into commodities such as oil, fading. For gold, reduced political tensions would be negative, particularly considering its decoupling from the direction of real rates in recent months. Over the medium to long term, real rates are the major driving force behind gold, so the precious metal's recent divergence could close sharply if geopolitical concerns dissipate.

There is some evidence to suggest that markets are becoming desensitised to tweets from President Trump. If that's the case, oil might serve as a better political hedge than gold around geopolitical tensions, particularly given the influence of the situation in Syria, Iran and Yemen on prices.

[4]International Energy Agency (IEA).

Infrastructure

US cyclically-adjusted P/E points to very low real returns



Source: Robert Shiller, Fidelity International, Haver Analytics, 2017.

Price return, 12 months to:	30 Apr 2014	30 Apr 2015	30 Apr 2016	30 Apr 2017	30 Apr 2018
S&P 500 Composite	19.3%	10.4%	-0.4%	14.7%	11.8%

Infrastructure and alternative strategies

Alternatives such as listed infrastructure and hedge funds offer interesting opportunities for investors. While both have been valuable on their own merits over the past two years, we are now at the stage of the cycle where they look attractive relative to equities overall. Equity valuations remain elevated based on current earnings, despite recent price declines, and medium-term return expectations are relatively low. In this context, a listed infrastructure vehicle yielding around 4-5 per cent or a hedge fund able to deliver an uncorrelated return stream begins to look attractive in absolute terms, in addition to their traditional diversification benefits.

Open-ended strategies like long/short equity funds and global macro strategies should become more central to investor thinking in future. This is partly down to economic conditions. As we approach the end of the cycle, equity returns become increasingly unreliable, and investors may look to strategies that can deliver returns independent of the equity market direction. Stock and asset-class performances are already showing greater dispersion, effectively making the rewards for active management greater. This environment should continue as monetary policy begins to diverge more meaningfully over the next few years and volatility remains relatively high.

The gradual unwinding of quantitative easing means investors are running higher risks across a broader range of asset classes than would normally be the case. This makes the traditional role of alternatives as a source of diversification more important. Alternatives are not risk free or even necessarily low risk, but they do tend to present different types of risk. Even when things go wrong (such as negative impacts on listed infrastructure fund prices following the UK's Labour Party rhetoric at the end of last year around infrastructure nationalisation) they tend to do so at times when at least some other assets are doing well. Alternative assets and investment strategies look set to play an important role in investor portfolios for the foreseeable future.

Important Information