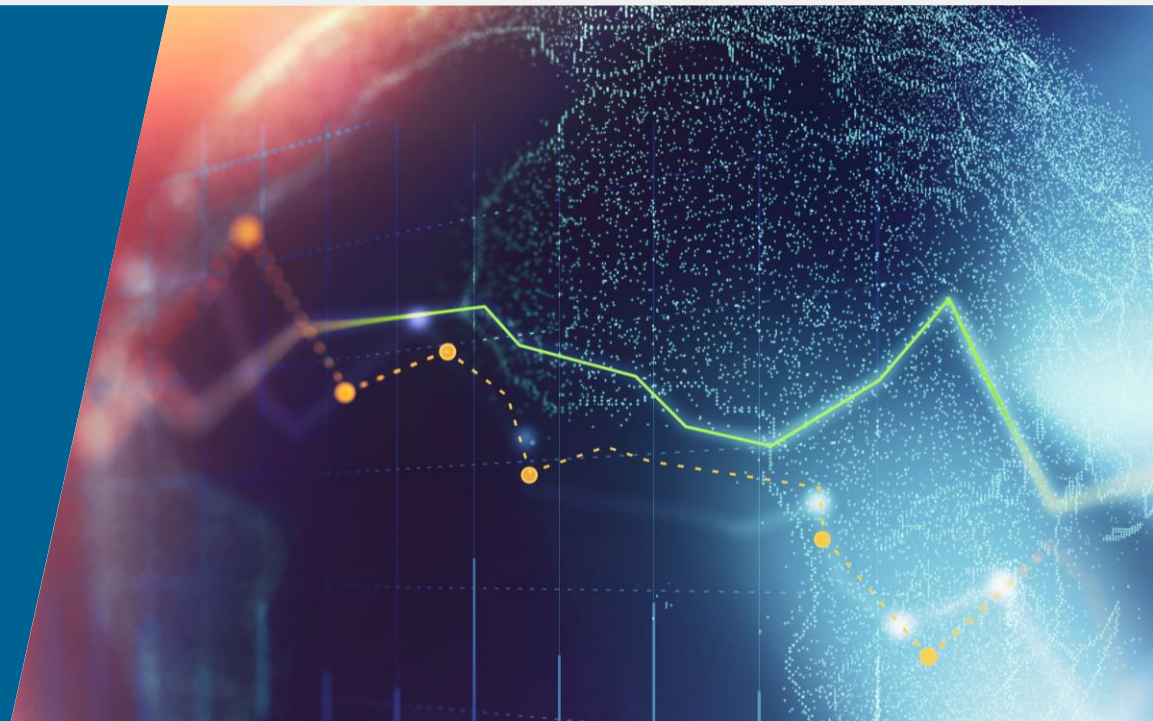


Q3 2022 Investment Outlook


The Great Reset

FIL Investment Management
July 2022



Three themes for Q3 2022: The Great Reset

Hard or crash landing?




- Rising inflation expectations on the back of persistently high current inflation has forced the Fed to match its hawkish rhetoric with hawkish action: we may see two consecutive 50bp hikes in Q3, with 75bp also remaining a possibility. The market is pricing in the peak in Fed funds at 3.50-3.75% in H1 2023.
- This suggests some acceptance of the hard landing risks stemming from aggressive tightening, as the Fed tries to gain control over inflation; we have raised the chances of a hard landing for the US economy to 60% from 35% last quarter.
- While the ECB and BOE are likely to pursue a shallower hiking path due to more imminent recession risk, and China is beginning its recovery from Zero-Covid Policy (ZCP) lockdowns, the downside risks to global growth have exponentially increased.

China re-emerges from lockdown



- China is re-emerging from ZCP lockdowns, which generated a short but severe economic downturn in April and May. While positive, we are cautious about the pace and strength of recovery, and on uncertainties related to post-lockdown behaviour, policy constraints, domestic and geo-politics and the potential for more variants and further lockdowns.
- China's fiscal and monetary policy are increasingly supportive, but whether its economic recovery is strong enough to offset a slowdown and potential recession in the US and Europe has yet to be seen.

The global consumer is put to the test



















- Buoyed by Covid stimulus, DM consumers start from a strong position, but are quickly seeing their real purchasing power eroded. Real wages in the US and EU have not kept pace, and the resulting discontent is reflected in record low consumer confidence indicators.
- China consumption may also prove sluggish, with the experience of ZCP lockdowns still fresh and unemployment rising sharply .
- A key piece of the puzzle with regard to the severity of the global landing is whether the global consumer, and in particular the US consumer and homebuyer, will survive inflation - and the rate hiking cycle - intact.

Source: Fidelity International, June 2022

Global Macro

Hard landing severity will depend on the extent of tightening engineered by central banks to tame inflation, and their tolerance of inflation overshoots relative to target

Global Macro Scenario Grid (0-12 months horizon)

	Hard Landing		Soft Landing		Stagflation		Reflation/Goldilocks	
Time horizon	0-6m	6-12m	0-6m	6-12m	0-6m	6-12m	0-6m	6-12m
Growth/Inflation dynamics (delta)	Growth: 		Growth: 		Growth: 		Growth: 	
	Inflation: 		Inflation: 		Inflation: 		Inflation: 	
Scenario narrative	Central banks push the economy into a recession, either accidentally or on purpose, in order to re-anchor dangerously rising inflation expectations.		A combination of demand destruction and supply resumption allows central banks to readjust mid-course after front loading hikes. They manage to achieve moderate and controlled inflation with near-trend growth.		Political/supply-side pressures mean Central Banks remain substantially behind the curve. This leads to de-anchoring in inflation expectations, which subsequently damages growth/ leads to a recession.		Supply-side pressures ease substantially with the end of the war and an end to China's strict ZCP. Inflation expectations remain anchored, allowing the Fed to stay behind the curve and demand to remain strong.	
Market implications	Equities: -- Govies: ++ Credit: --		Equities: - Govies: + Credit: -		Equities: - Govies: - Credit: -		Equities: ++ Govies: -- Credit: +	
Probability	60% (35%)		20% (40%)		20% (no change)		0% (5%)	

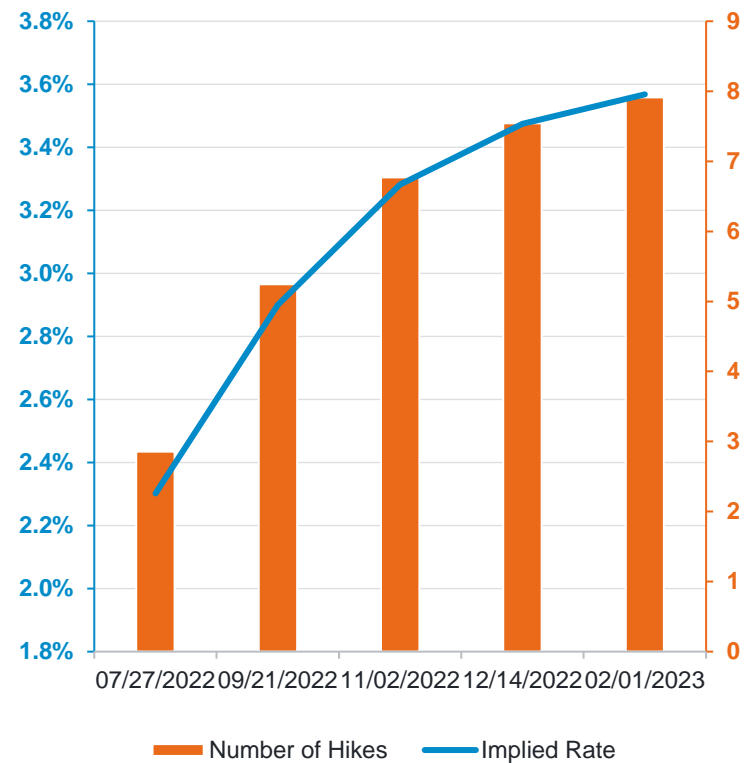
Note: Brackets show last month's probabilities. Growth/inflation arrows indicate deltas from current levels.

*Source: Fidelity International, June 2022.

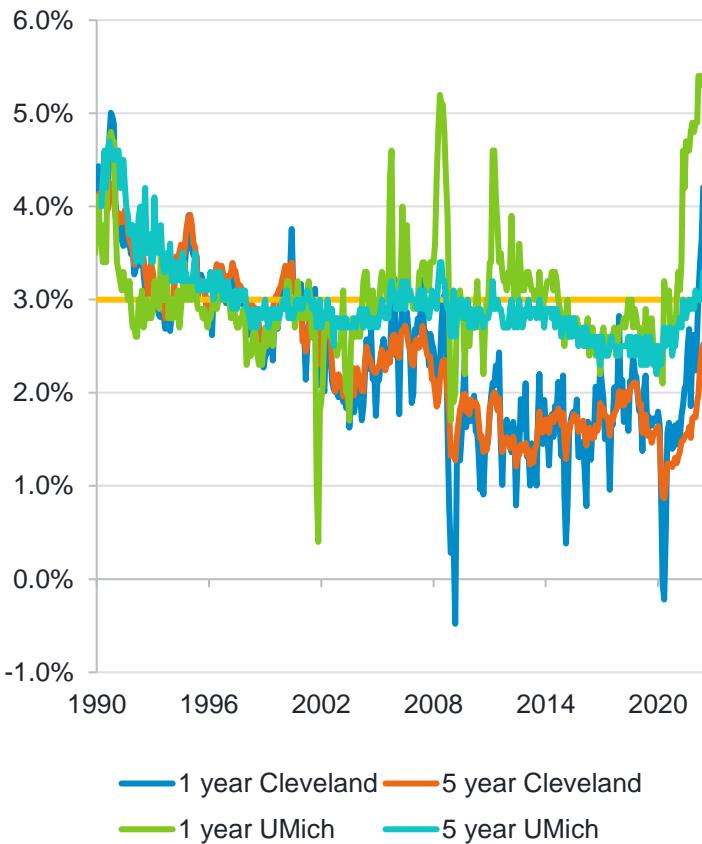
Can the Fed regain control?

Long-term inflation expectations now above 3%, triggering aggressive Fed action to curb aggregate demand

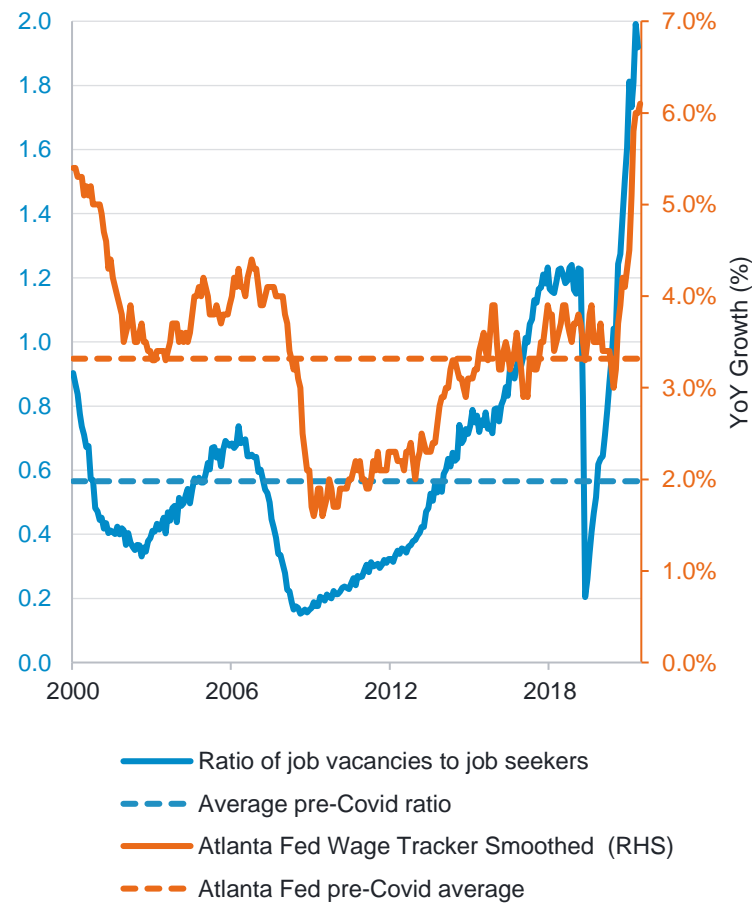
Market-implied path of Fed Funds



To re-anchor long-term expectations...



...wage growth must moderate

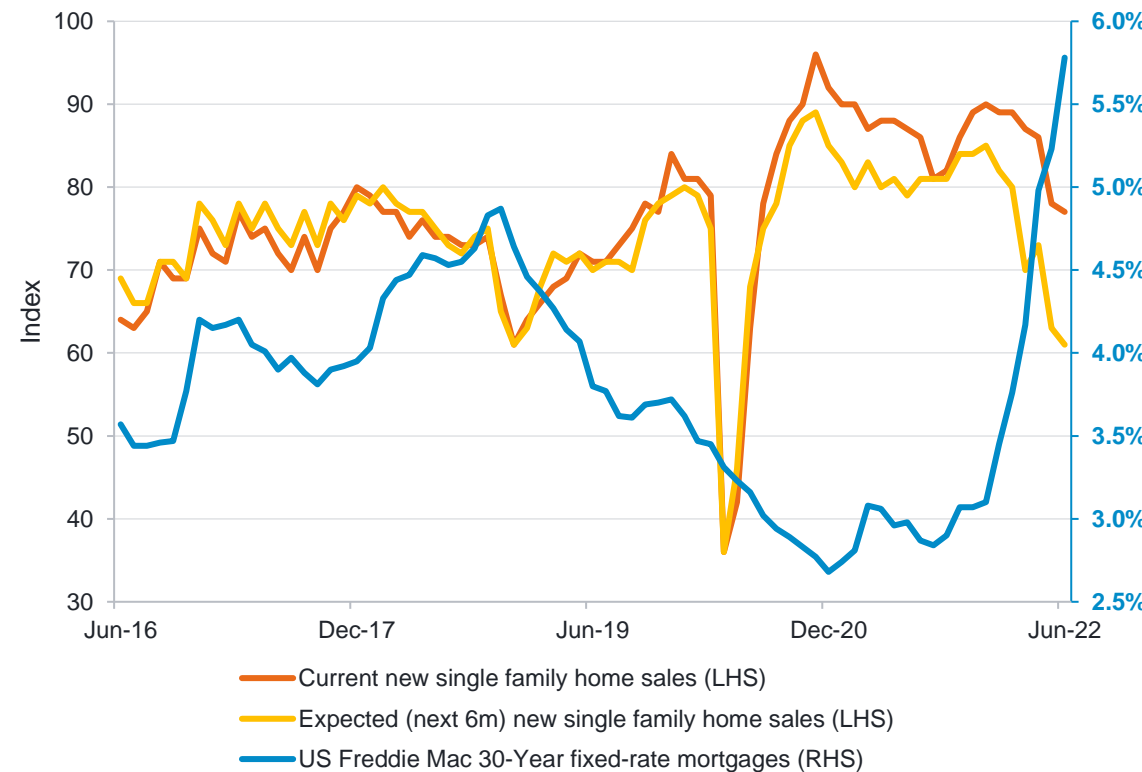


Note. Market implied Fed Fund Rate as of 27th of June. Number of hikes assumes 25 bps hikes.
Source: Fidelity International, Cleveland Fed Inflation Expectations, Haver Analytics, Bloomberg, June 2022.

Signs of US slowdown are undeniably present, though consumer behaviour has been slow to adjust

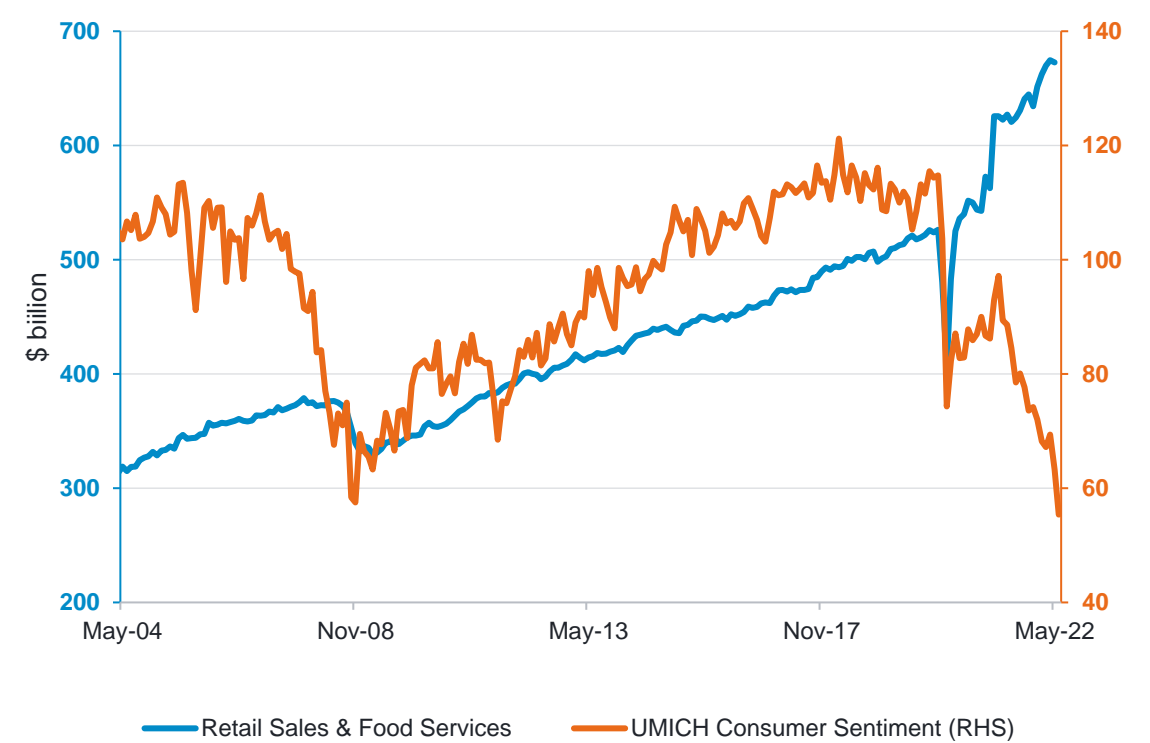
Consumer unease and mortgage rates are on the rise

US mortgage rates rise, current and expected new home sales fall...



Source: Fidelity International, Datastream, June 2022.

... but weak sentiment hasn't yet curtailed stimulus-buoyed retail activity

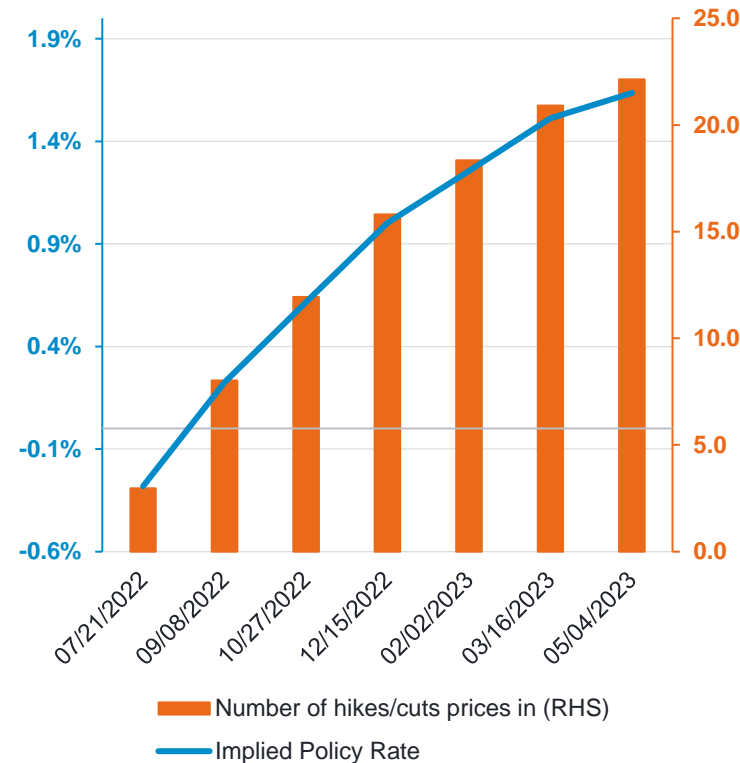


Source: Fidelity International, Datastream, June 2022.

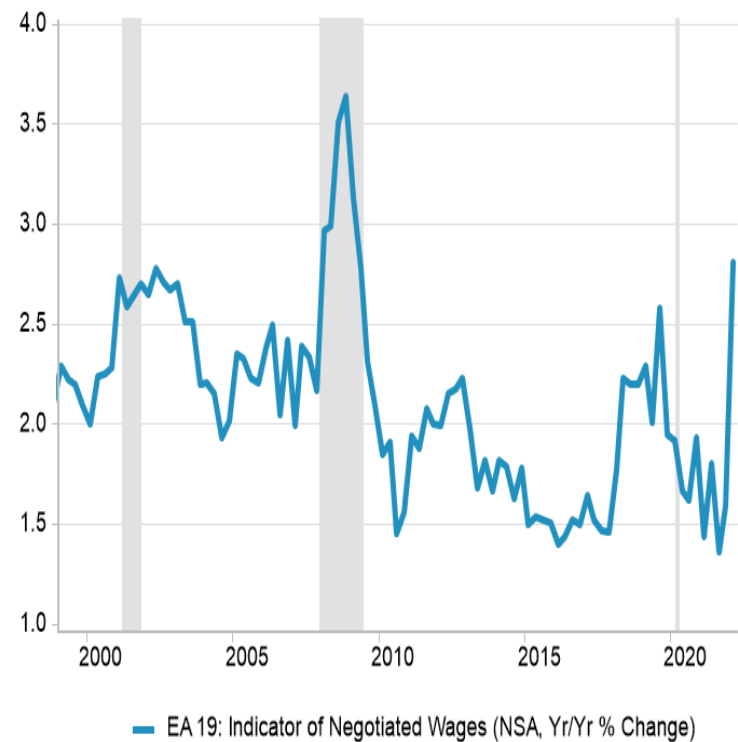
ECB: Rates likely to exit negative territory in 2022, but a dovish turn and anti-fragmentation tools are also on the table

The Bank aims to balance its inflation target against fragmentation and recession risks

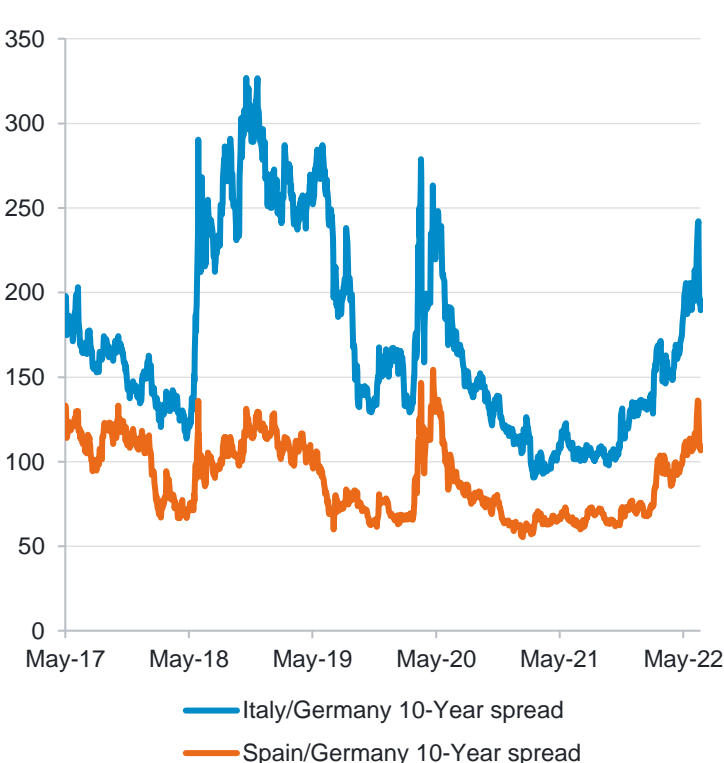
Market-implied path: ECB policy rate



Wage-price cycle



Peripheral spreads (bps)



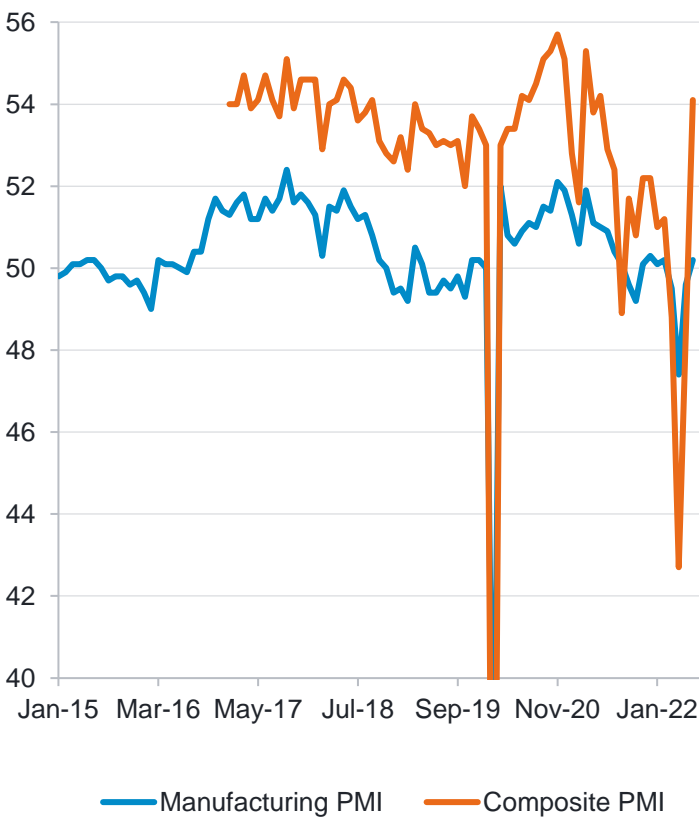
Note: Implied rate as of the 27st of June. Number of hikes assume 10bps hikes.

Source: Fidelity International, Haver Analytics, Bloomberg, June 2022.

Early days in the China recovery

PMIs bounce out of contraction in June; jobless rate among the youth continues rising

China manufacturing and composite PMIs



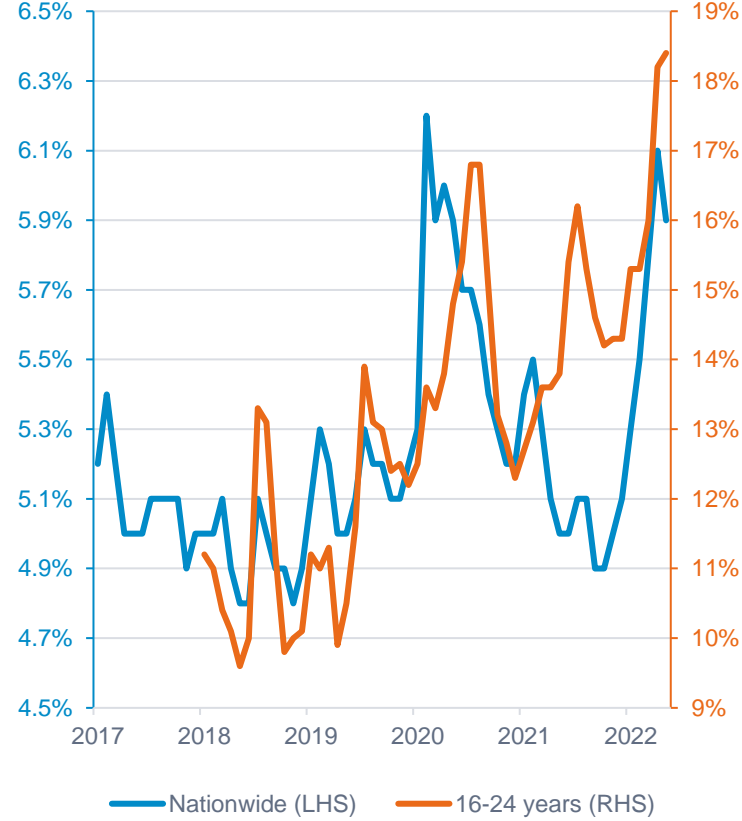
Source: Fidelity International, Bloomberg, June 2022.

Average weekly volume of primary property sales



Source: Fidelity International, GS, CREIS, Gao Hua Securities Research, June 2022.

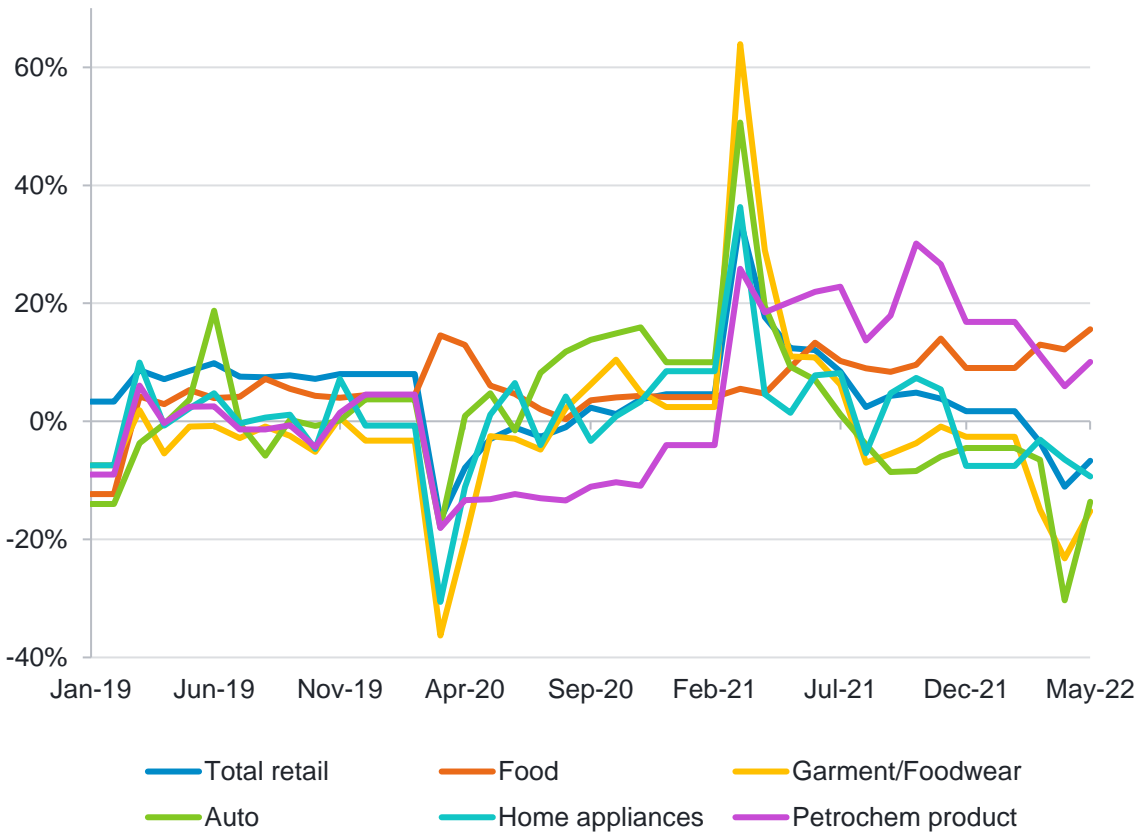
Urban surveyed unemployment rates



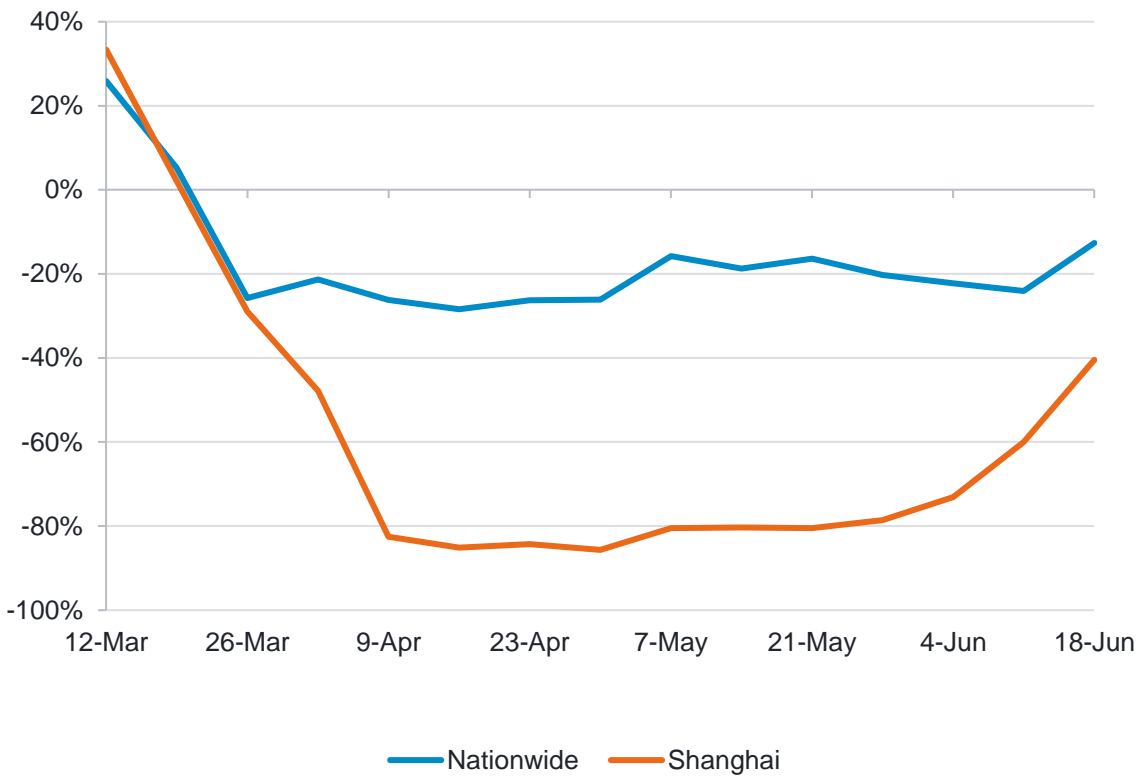
Source: Fidelity International, GS, June 2022.

Reopening and policy are supportive in China, but uncertainties in policy execution, consumer/corporate behaviour, global growth and politics may be offsetting factors

Retail sales by sector



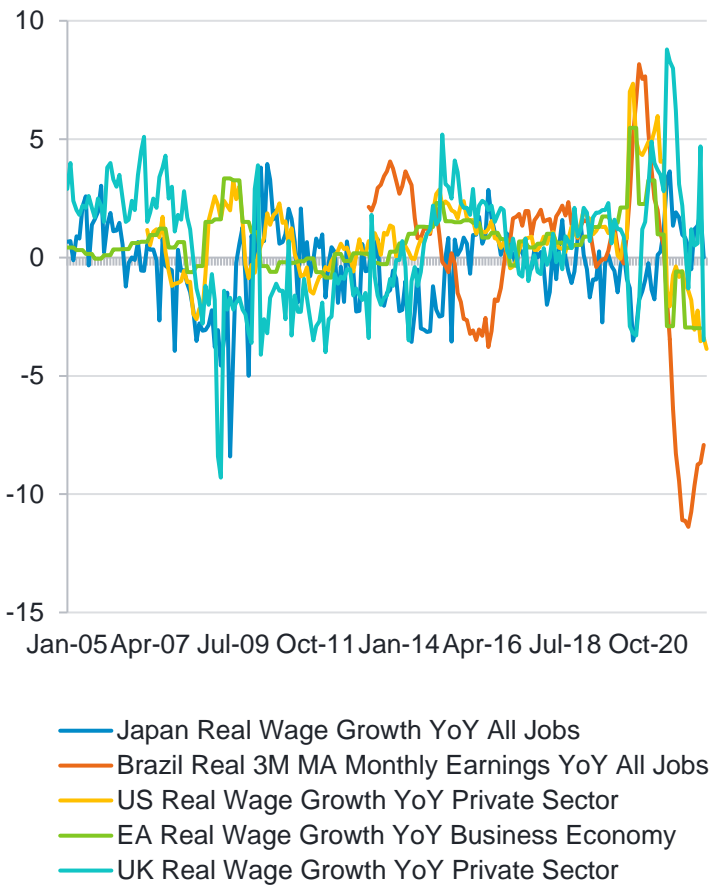
7 day moving average for trucking activity shows the impact of Shanghai's lockdown



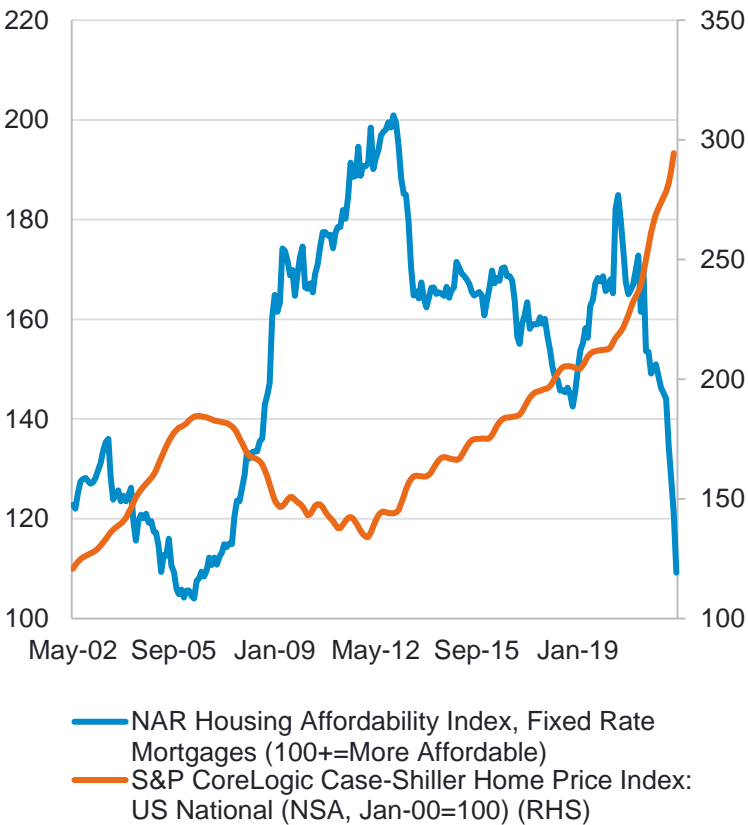
Source: Fidelity International, Haver Analytics, G7, June 2022.

How long will the global consumer remain resilient, given persistent inflation and tightening credit?

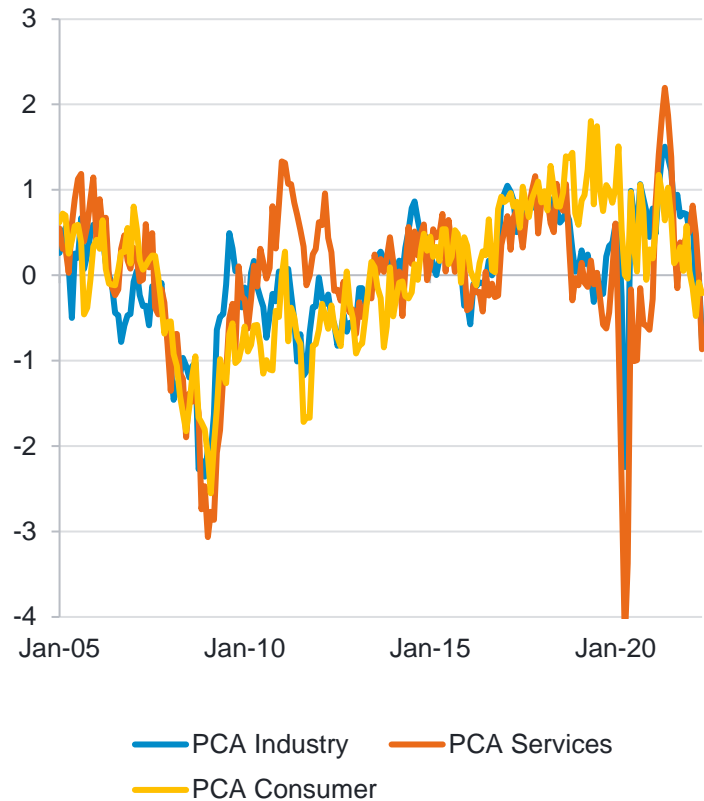
Global real wage growth (YoY)



US housing affordability



Fidelity Future Activity Tracker (Z-scores)



Source: Fidelity International, Haver Analytics, Bloomberg, June 2022.

Global Investment Research

Negative sentiment persisting across all regions except China, say FIL analysts

Negative global leading indicators moderated, but continue to be dragged down by the US and LatAm

Management sentiment by region

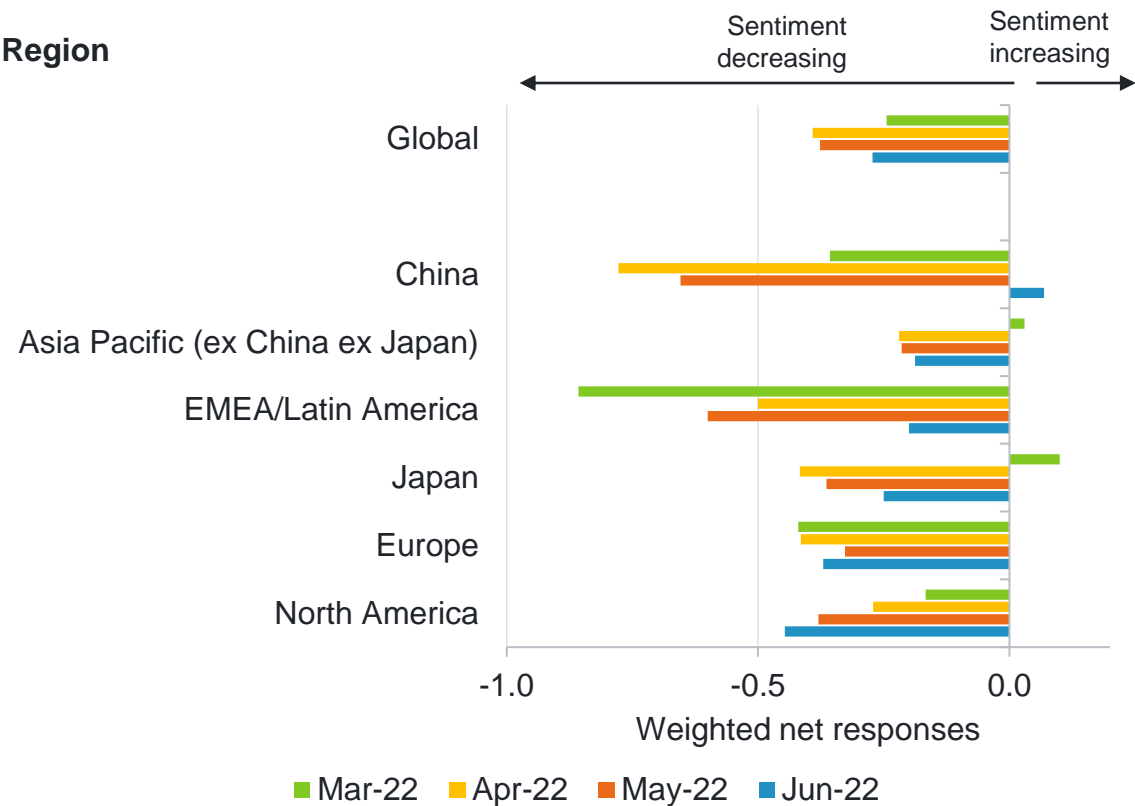


Chart shows proportion of responses reporting management sentiment is positive minus those reporting management sentiment is negative; strong negative and strong positive receive a higher weighting. Question: "Based on your recent research and interactions with companies, to what extent, if at all, has your perception of management sentiment over the next 6 months changed?"

Source: Fidelity International Global Investment Research, June 2022.

Leading indicators by region

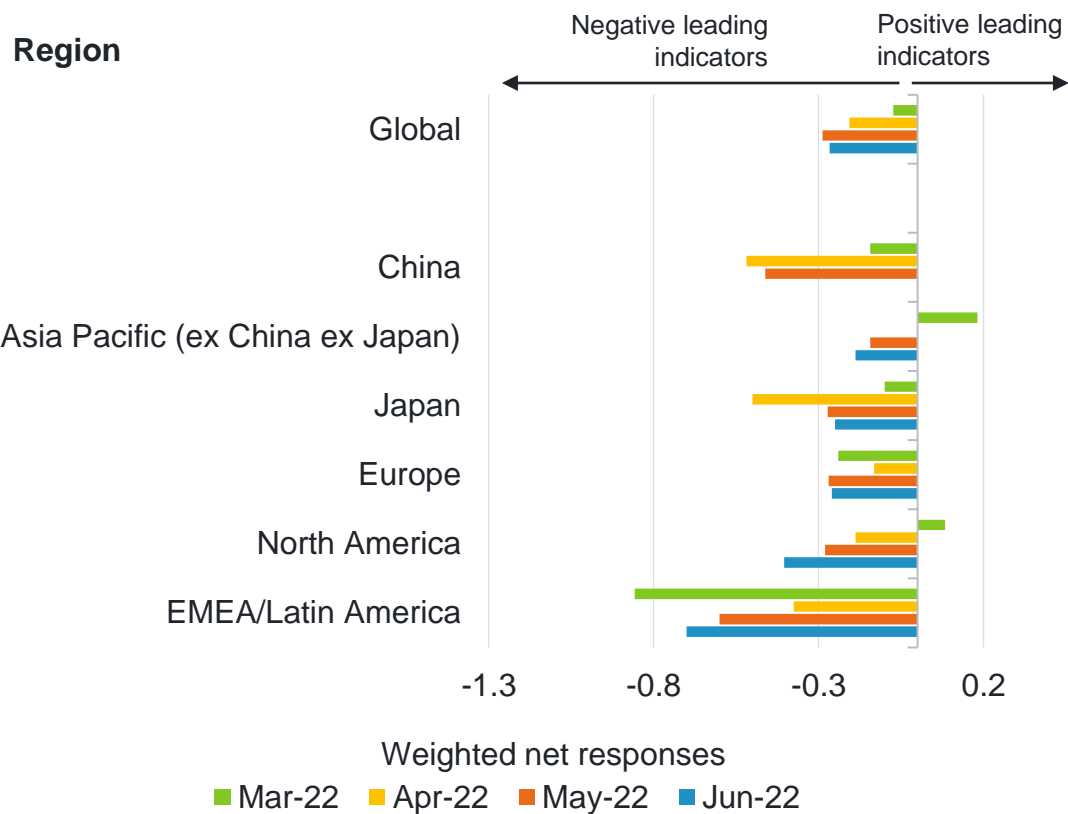
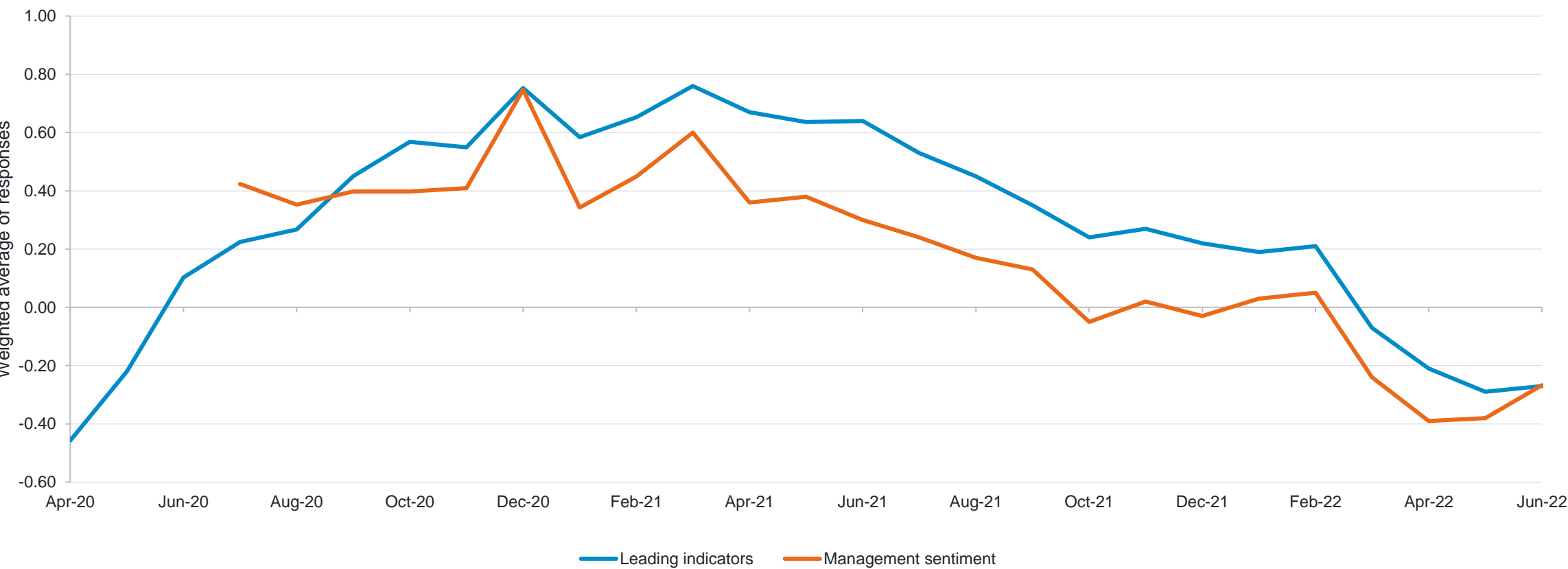


Chart shows proportion of responses reporting leading indicators are positive minus those reporting leading indicators are negative; strong negative and strong positive receive a higher weighting. Question: "What is the outlook for leading indicators over the next 6 months at your companies?"

Source: Fidelity International Global Investment Research, June 2022.

Management sentiment rebounds slightly while leading indicators stabilise in negative territory

FIL analyst survey corporate leading indicators and management sentiment, June 2022



Source: Fidelity International Global Investment Research, June 2022.

Inflation in both labour and non-labour costs resurges

Our analysts expect to see costs rising once again

A modest acceleration in labour costs...

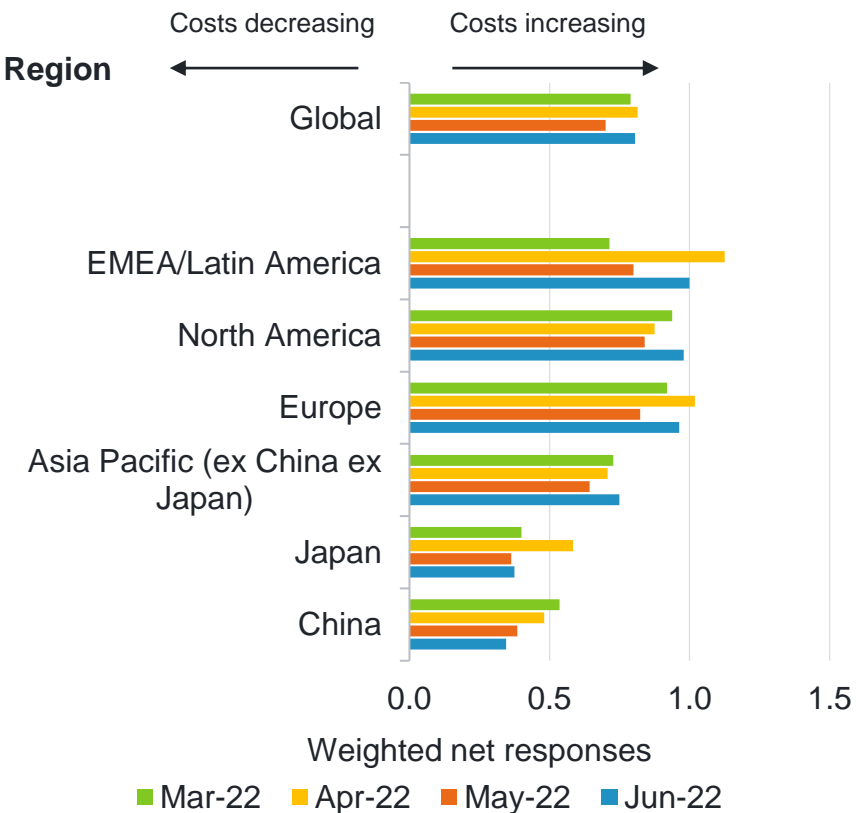


Chart shows proportion of responses reporting costs are increasing minus those reporting costs are decreasing; significant increases and significant decreases receive a higher weighting. Question: "What are your expectations for total labour costs over the next 6 months compared to current levels?"

Source: Fidelity International Global Investment Research, June 2022

... matched by a more marked increase in non-labour costs

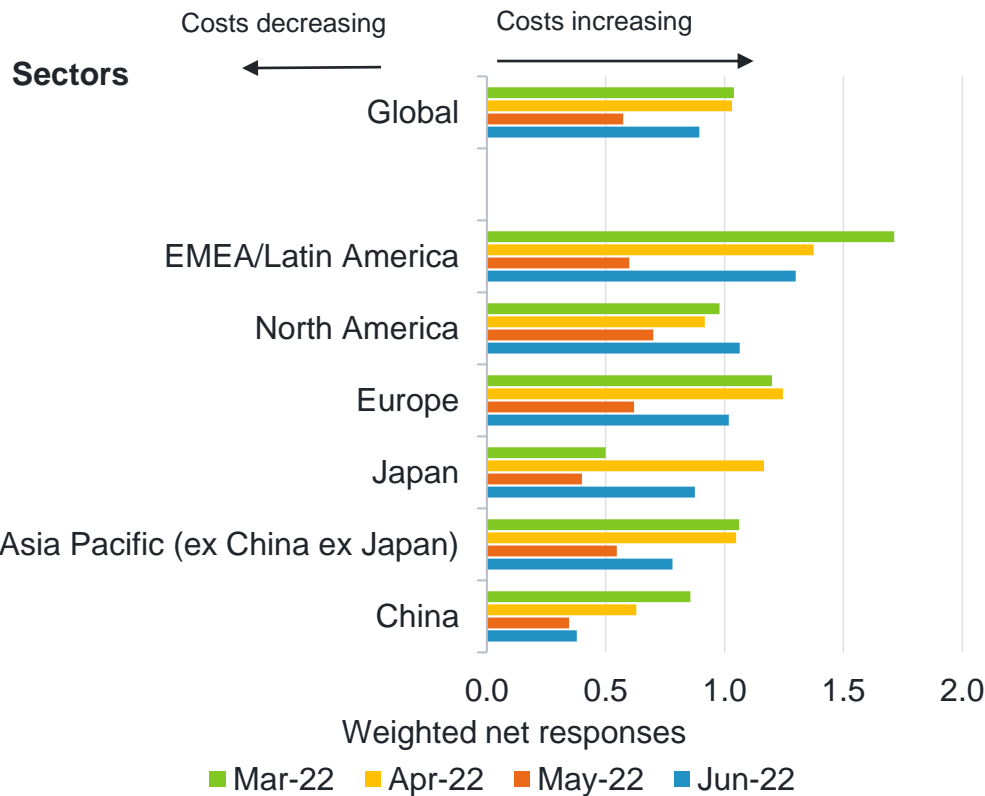
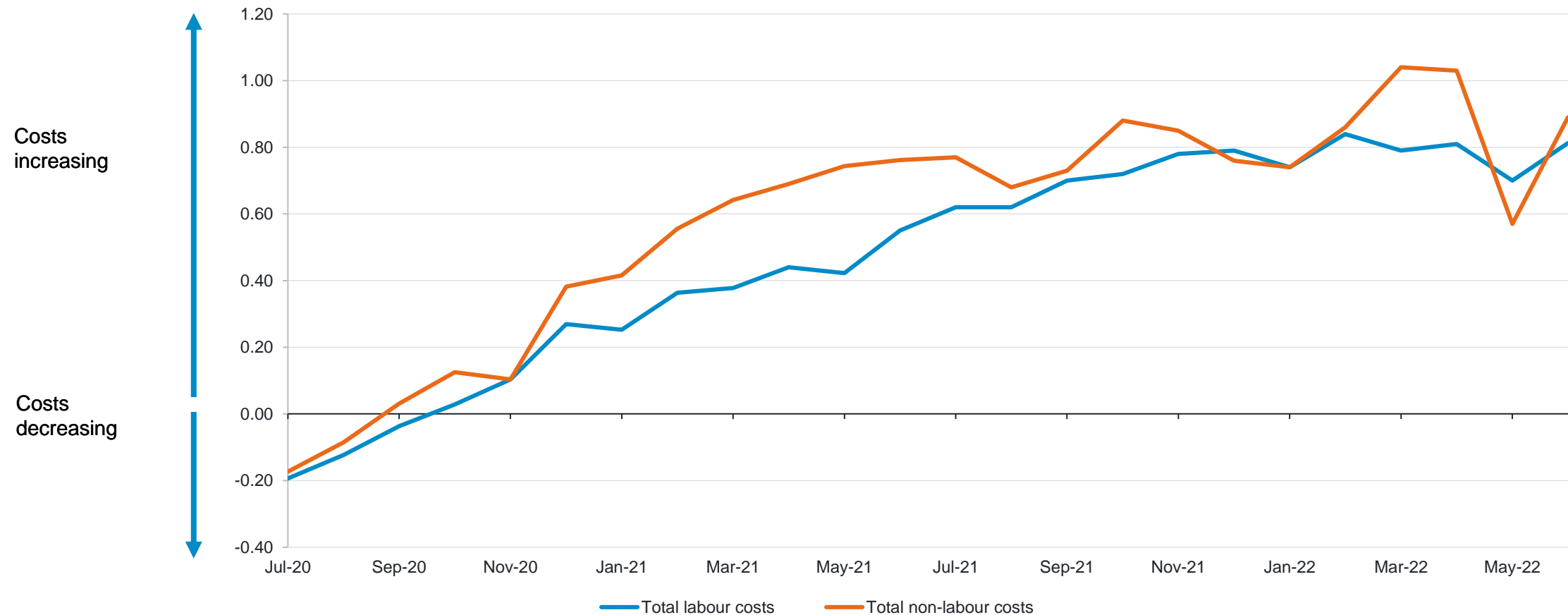


Chart shows proportion of responses reporting costs are increasing minus those reporting costs are decreasing; significant increases and significant decreases receive a higher weighting. Question: "What are your expectations for total non-labour input costs over the next 6 months compared to current levels?"

Source: Fidelity International Global Investment Research, June 2022.

Relief on global costs was short lived, with non-labour costs bouncing back strongly

Global costs weighted averages - labour and non-labour



Source: Fidelity International Global Investment Research, June 2022

Multi Asset

Multi Asset: Key takeaways

Cautious for now: Underweight risk assets

- We believe risk assets do not fully reflect increased chances of a hard landing. Our core view is underweight equities and credit, although we acknowledge the possibility of a bounce in the coming weeks given very negative sentiment. We are also overweight government bonds in order to avoid being underweight duration.

Prefer selected emerging market equities vs Europe

- Europe has a challenging Q3 ahead. However, some emerging market economies, particularly those that export commodities, have supportive valuations and a better relative growth outlook. We are neutral on US, Japan, and Asia Pacific equities.

Expect dollar strength to continue

- We think the dollar's strength could continue while the Fed is still aggressively tightening. However, we think the recent yen weakness could carry on, as rate differentials with Japan and RoW continue.

Defensively positioned in credit

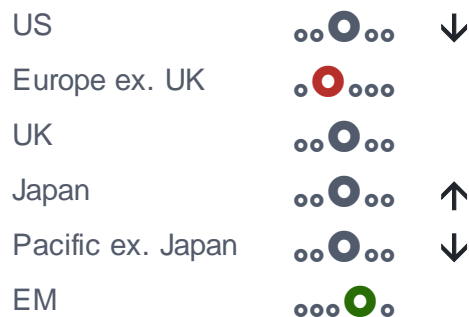
- Given the macro headwinds, we prefer investment grade to high yield bonds to increase defensiveness. Investment grade offers relatively better valuations, while we think high yield spreads could widen further from here. Within government bonds, we are neutral, awaiting further information on central bank plans.

Tactical Asset Allocation (TAA) at a glance: Cautious short term, more constructive on medium-term outlook

Multi Asset



Equity Regional



Credit



Other Key Views

Commodities

- We expect upwards pressure in energy, industrial metals and agriculture.

US Sectors

- Underweight consumer, utilities.
- Overweight healthcare, financials, industrials, and real estate.

Thematics

- Adding to EU renewables trade
- Still retain cash and reviewing higher beta healthcare exposure which has done well recently.

Government bonds



Currency



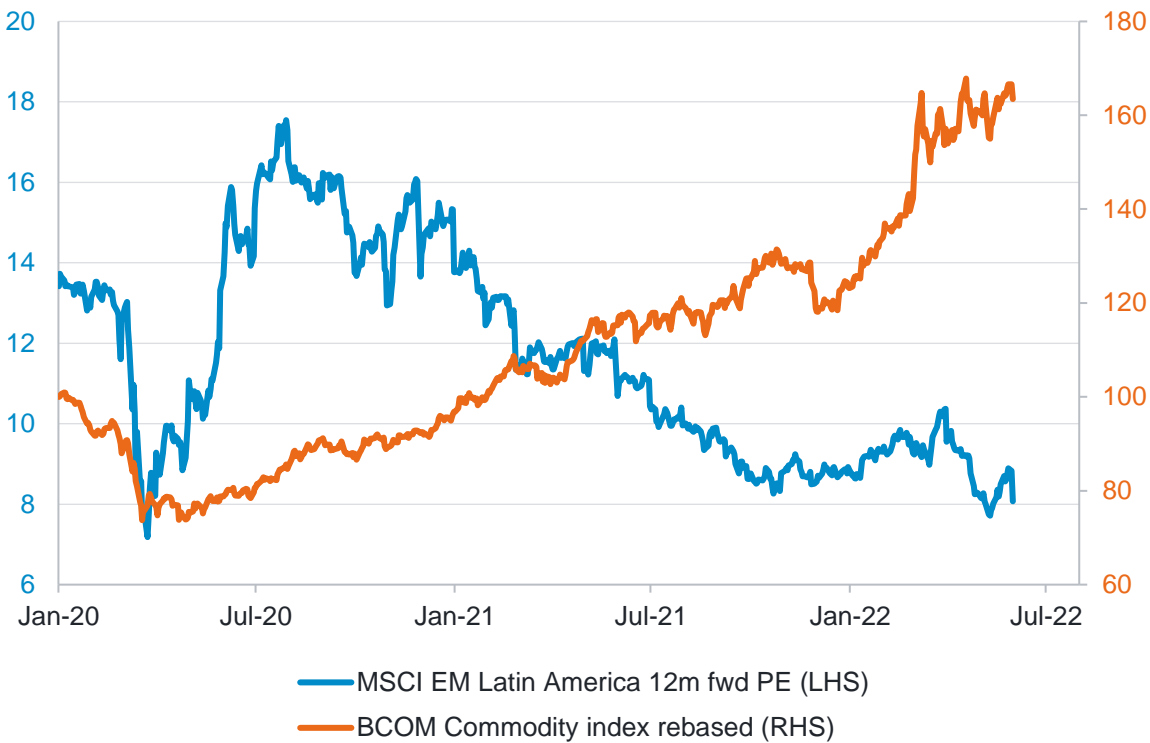
Source: Fidelity International, June 2022. Note: Red is Underweight; Grey is Neutral, and Green is Overweight; arrows signify change in positioning vs previous month.

Regional equities: Overweight emerging markets vs. Europe

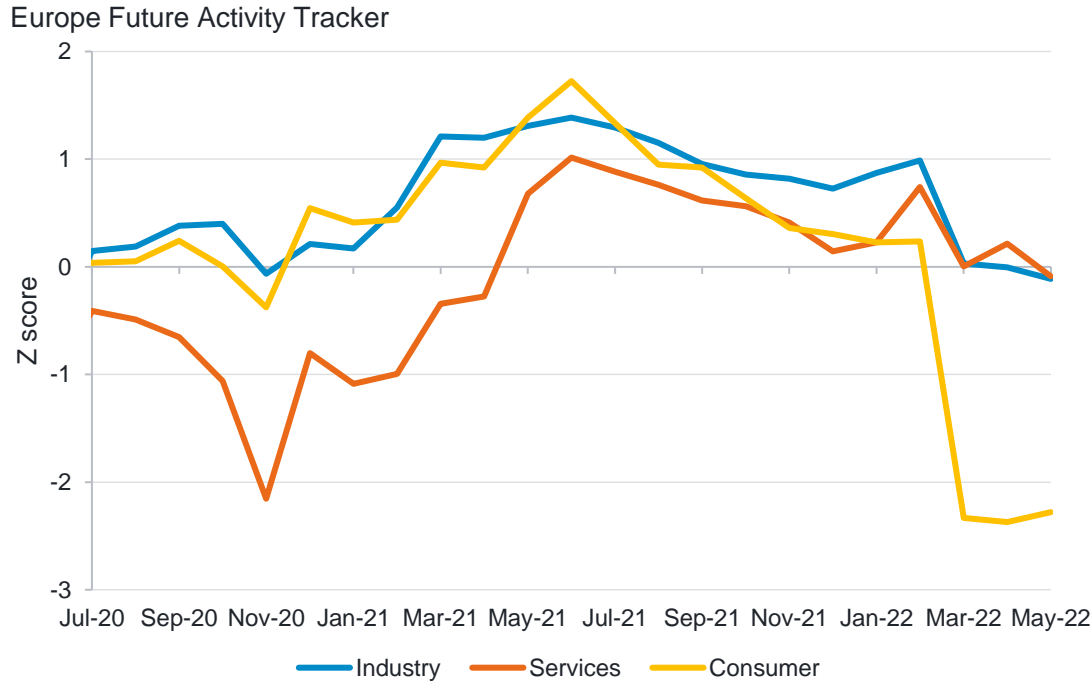
Looking for relative resilience to elevated commodity prices

Tight demand and supply dynamics should keep commodities elevated in the near term, helping EM commodity exporters. EM valuations are attractive, especially LatAm.

We expect at least a technical recession in Europe as consumers are under extreme pressure. We are underweight Europe equities as a result.



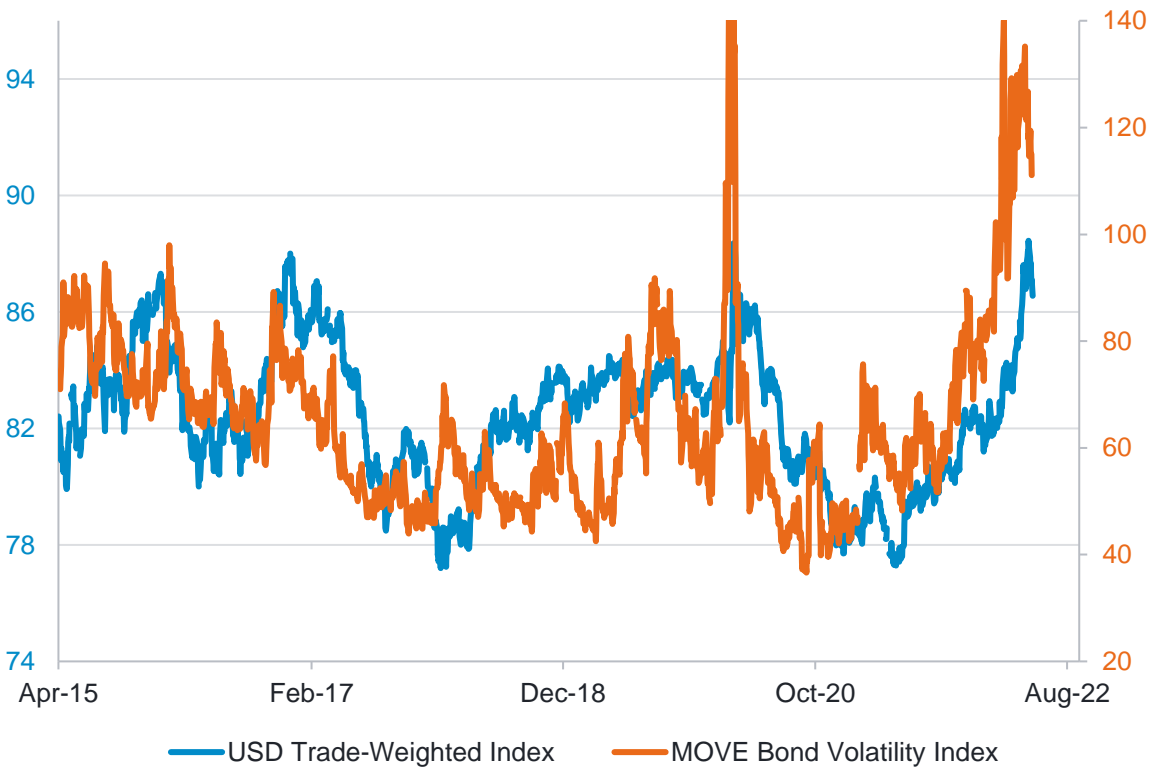
Source: Refinitiv, Fidelity International, June 2022.



Source: Fidelity International, June 2022.

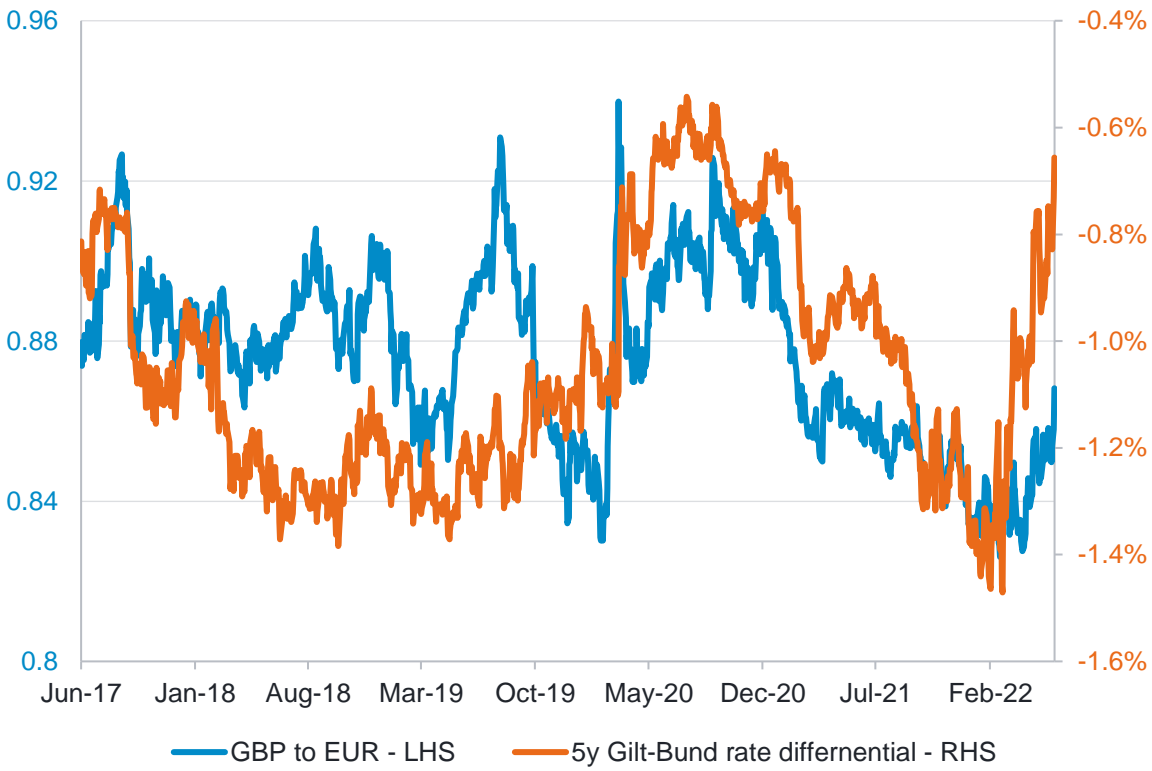
Dollar strength likely to continue despite long run, but not expecting Fed pivot in Q3

As long as macro uncertainty remains elevated, so will the US dollar



Source: Deutsche Bank, Bloomberg, June 2022.

We are also turning tactically positive on EUR/GBP, which lags yield differentials after a clear hawkish turn from the ECB

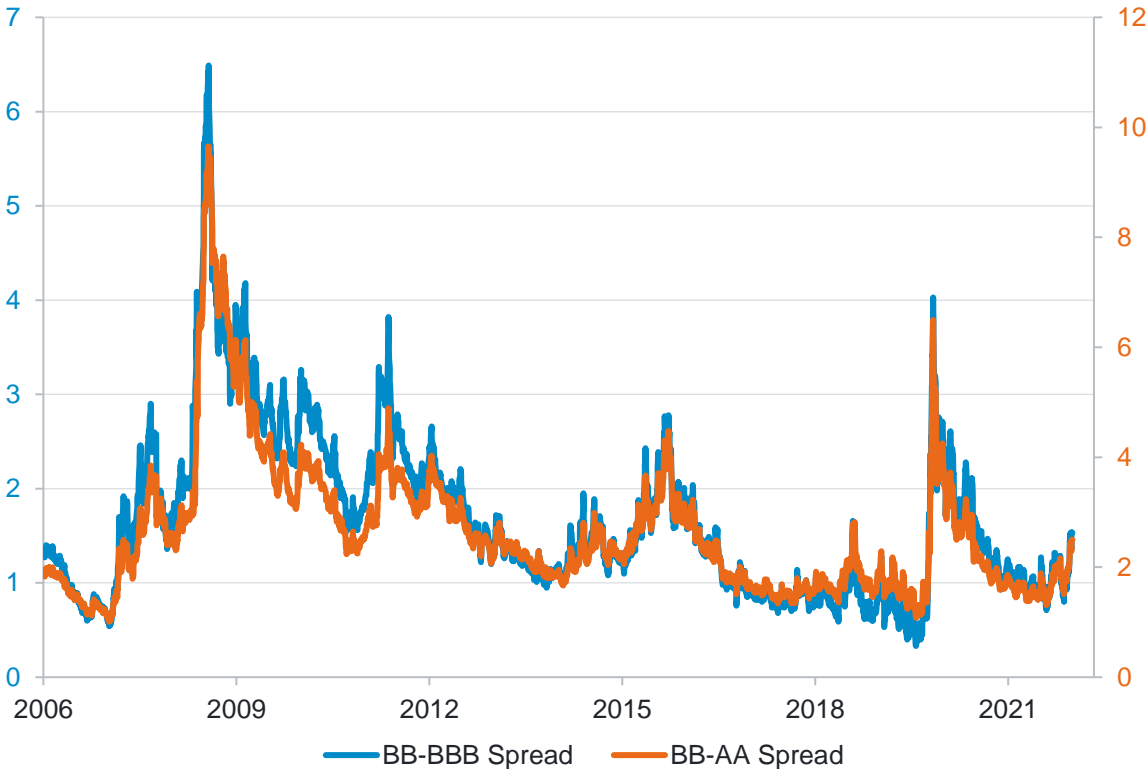


Source: Refinitiv, Fidelity International, June 2022.

Credit: Overweight investment grade vs. high yield

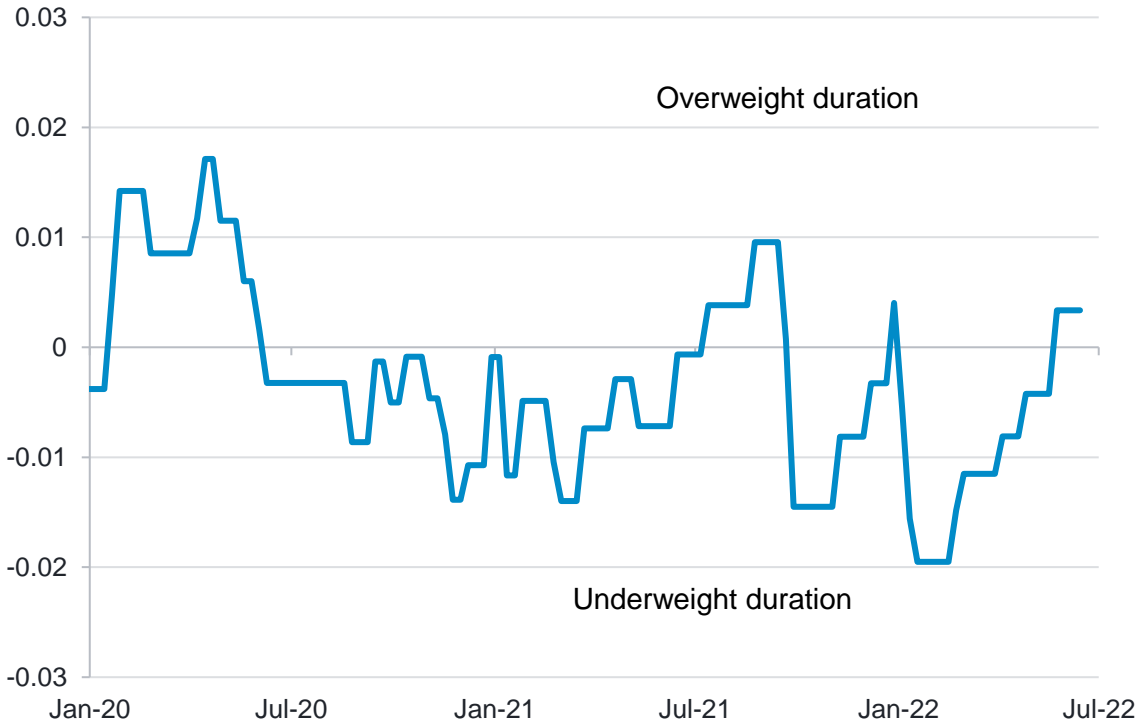
IG has higher quality relative to history, with valuations worrisome for high yield

US corporate spreads: In a true risk-off environment, high yield (BB) spreads over IG are likely to move much wider than today



Source: Bloomberg, Fidelity International; June 2022.

Our quant model is now recommending a neutral stance on duration



Source: Fidelity International; June 2022.

Equities

Equities: Key takeaways

Volatility likely to stay high in Q3

- Until inflation is brought under control and central banks reduce their hawkish rhetoric, markets are likely to be volatile, favouring bottom-up stock picking. Earnings-based valuations are back around long term averages but profitability is still high compared to history.

Rotation to value could continue

- The rotation to value we have witnessed in 2022 so far could well continue for the time being. Value still looks relatively cheap on forward PE metrics. High growth tech stocks have borne the brunt of higher discount rates. However, there could be opportunities to find fallen angels here in Q3.

US consumers come under pressure

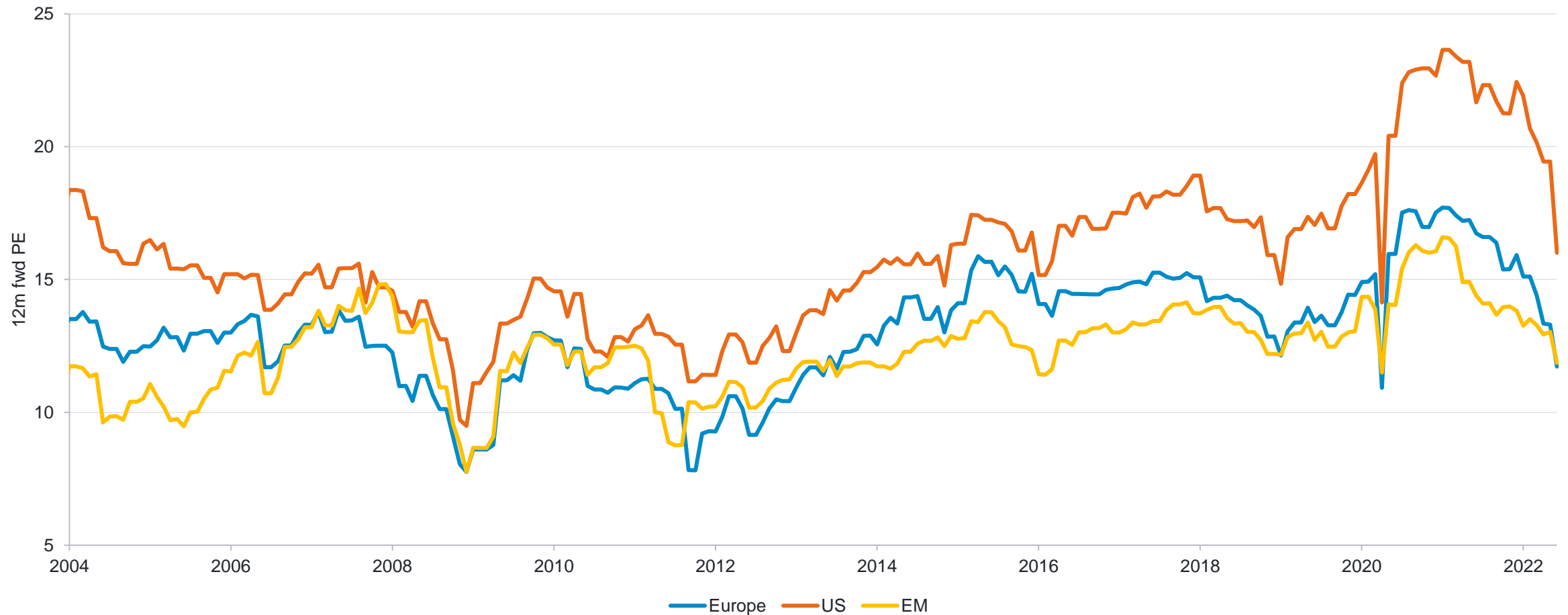
- Real wages and savings rates are turning negative in the US, while mortgage rates increased dramatically. Consumer balance sheets are strong for now though. As costs rise and orders fall, margins could come under pressure.

Japan could present opportunities

- Japan could offer a DM diversification option that has exposure to EM and China, which could be a source of growth if the Covid situation improves.

Volatility likely to stay high until inflation is under control

But valuations are normalising and volatility creates opportunities for bottom-up stock selection



Datastream indices, IBES forecasts. Source: Refinitiv, Fidelity International, June 2022.

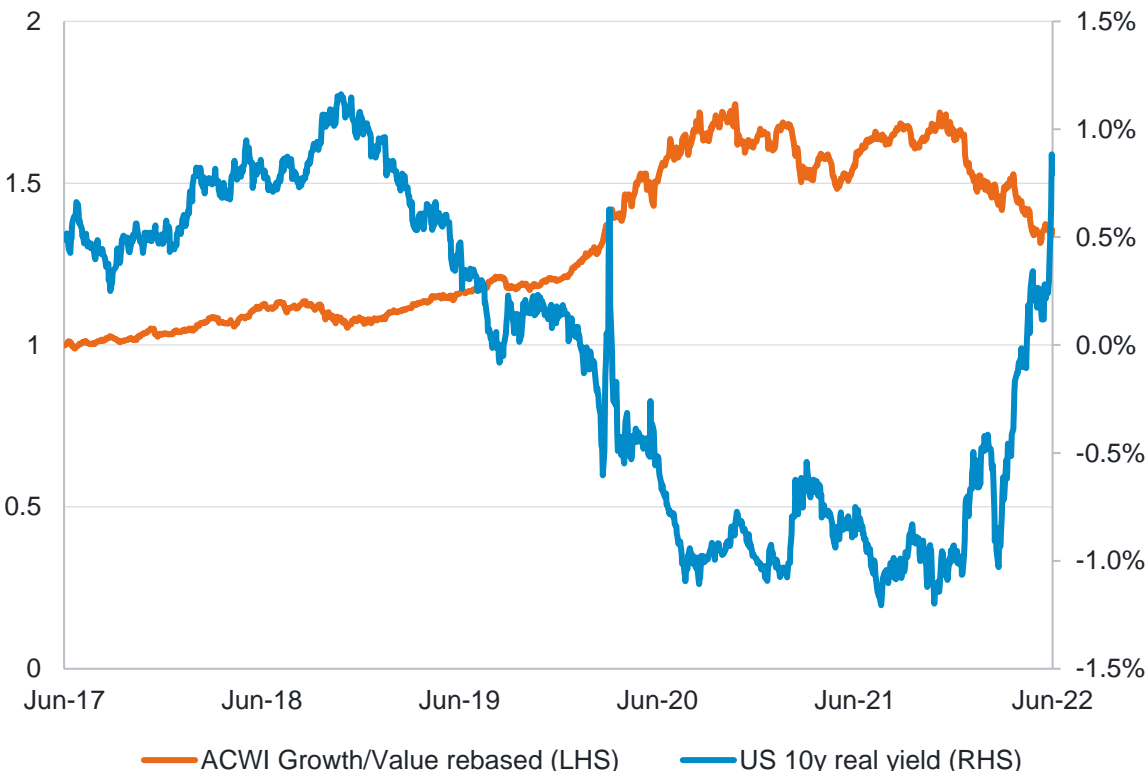
Value could outperform growth for some time

Value is still relatively cheap....



Source: Refinitiv, Fidelity International, June 2022.

...and the rotation was caused by the rise in real yields, which could stay high for some time



Source: Refinitiv, Fidelity International, June 2022.

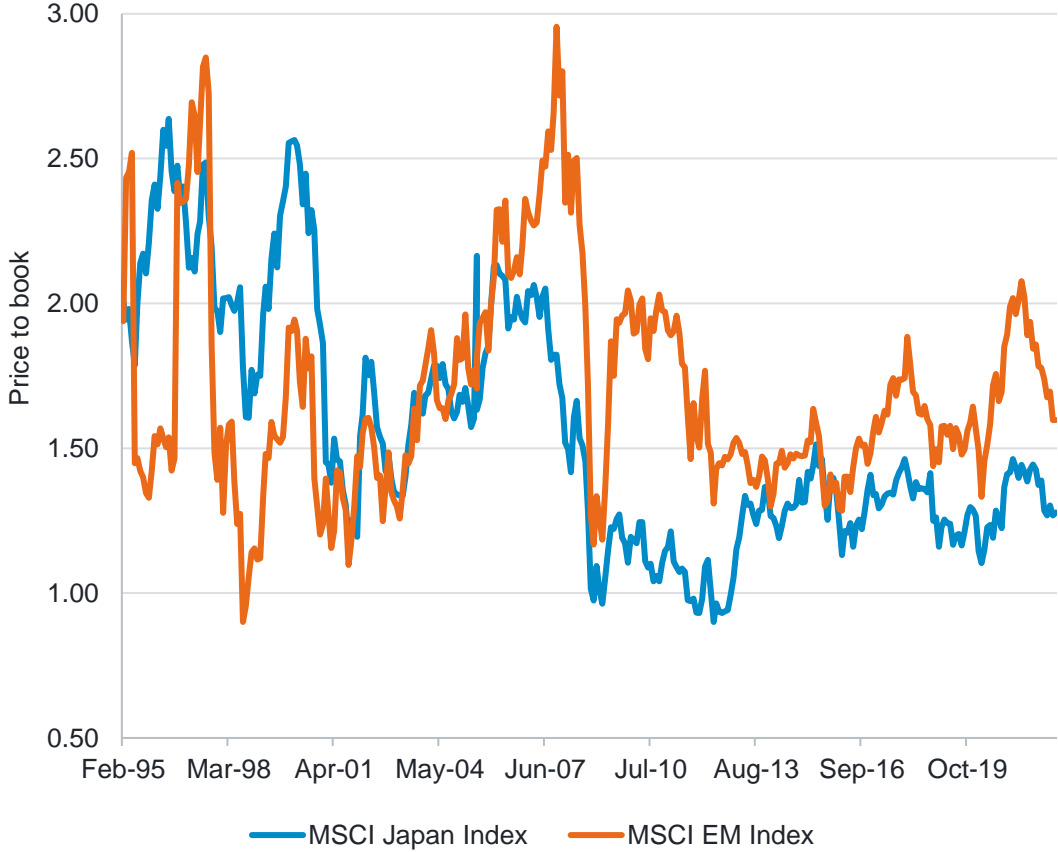
Japan's leverage to EM / China growth recovery adds to its diversification appeal

Japan is well leveraged to EM...



MSCI Japan (local currency), MSCI EM (\$). Source: Refinitiv, Fidelity International, June 2022.

... while still looking cheap



Source: Fidelity International, Bloomberg, 31 May 2022.

Fixed Income

Fixed Income: Key takeaways

Risk of hard landing not priced in

- The Fed is still tightening aggressively, raising the risk of a hard landing. Further tightening could widen credit spreads as expectations for defaults in a recessionary environment rise. Capital preservation is key.

Do not fear duration

- We don't believe that central banks will be able to deliver on current market expectations for tightening. This means duration is becoming attractive.

Very attractive valuations in Euro IG

- Yields in Euro IG have now risen to levels not seen since 2019. We consider this a good buying opportunity. However, we put a strong emphasis on high-quality credit, such as A-rated companies, banks and industrials as well as German corporates, all of which have features that should be able to withstand the effects of a potential recession.

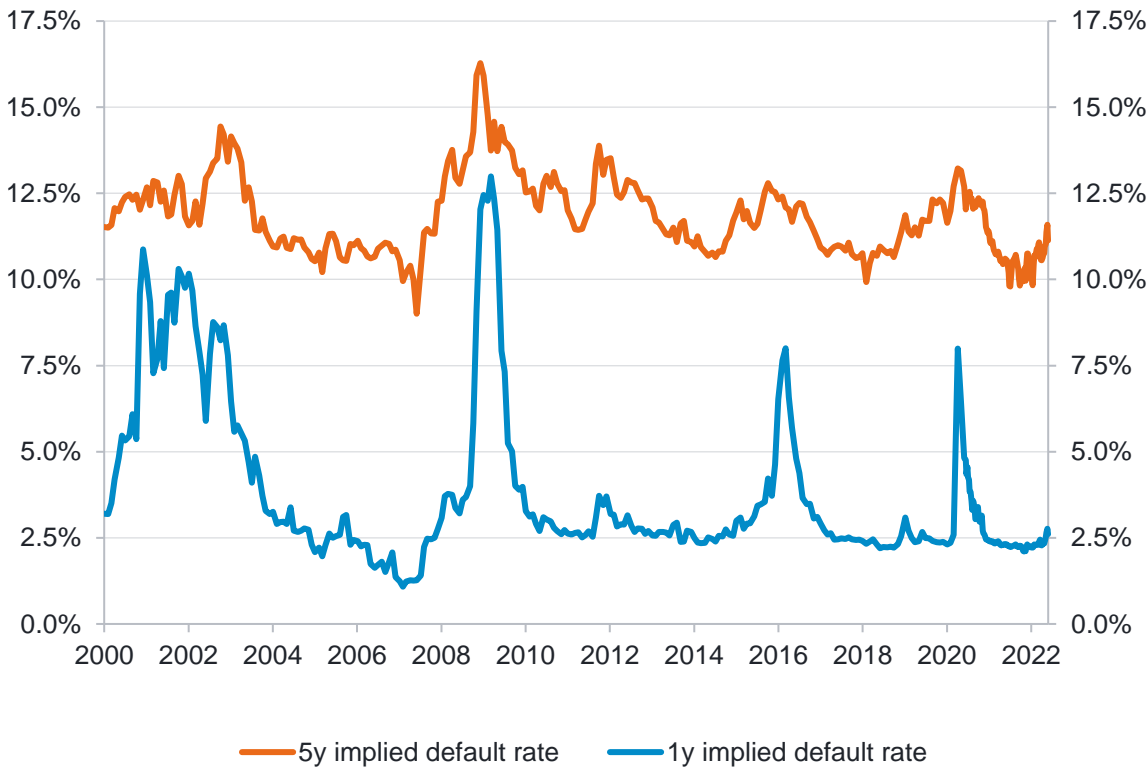
Narrative could change quickly, presenting opportunities

- Economic conditions can and do change. It might not happen in Q3, but we may see both growth and monetary policy shift sooner than the market expects. When that happens, there will be considerable opportunities on offer.

Risk of hard landing not yet priced in to credit markets

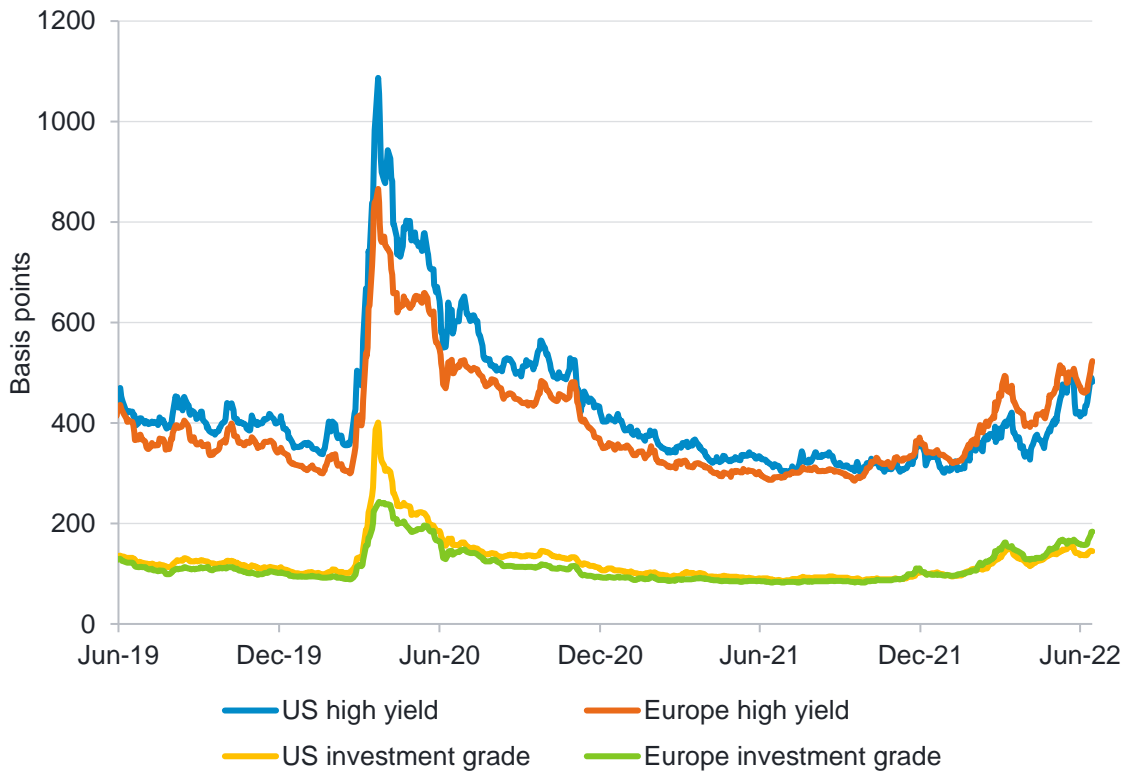
Capital preservation is key for now

Implied default rate of US high yield is still unrealistically low given risk of recession



Source: Fidelity International, ICE BofAML and Moody's, 2022. Analysis uses Fidelity's proprietary quant credit curves and converts spreads to market-implied default estimates including an allowance for a credit risk premium calibrated based on historic 1-year global realised defaults.

Spreads creeping up but room for further widening

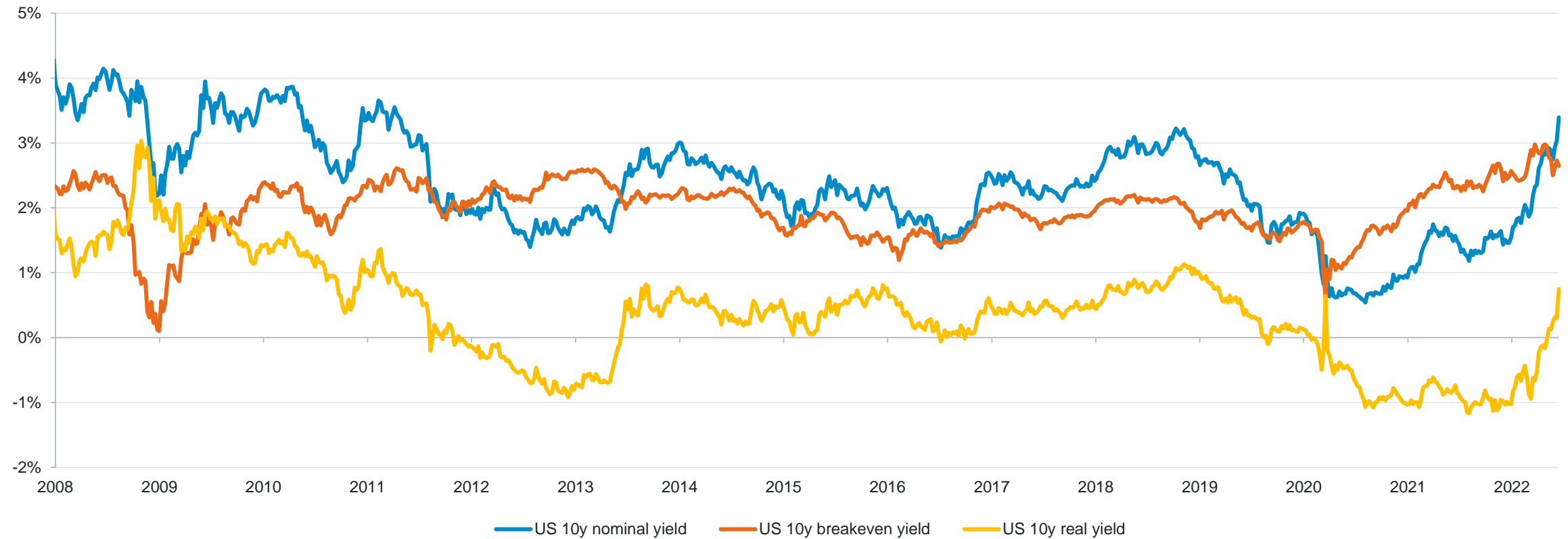


Source: Refinitiv, Fidelity International, June 2022.

Do not fear duration

Despite today's hawkishness, we don't think central banks will eventually carry out as much tightening as is currently priced in. Starting to favour overweight positions in US Treasuries and core Europe government bonds

US yields have exploded this year, but it's difficult to see how they could move meaningfully higher from here

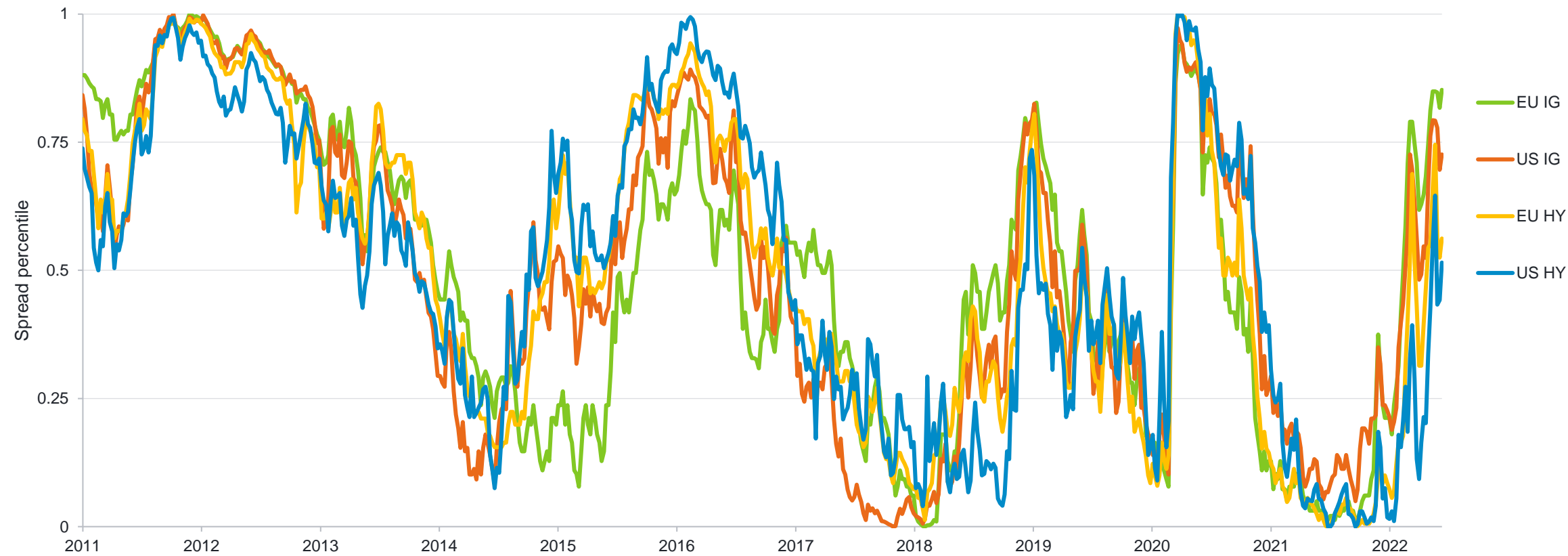


Source: Refinitiv, Fidelity International, June 2022.

Valuations in Euro IG have become more attractive

However, quality is key to protect against possible growth slowdown

Euro IG spreads now wide versus history



ICE BofA indices. Spread percentile 01/01/2011 - 10/06/2022. Source: Refinitiv, Fidelity International, June 2022.

Private Credit

Private Credit: Key takeaways

Anticipate increasing pressures to become fully visible in earnings over the next 12-18 months

- Unprecedented challenges for analysts to understand company transportation networks, supply chains and inventory build. Potential for an abrupt slowdown but the severity is hard to gauge. Working with companies to understand alternative short and longer term goods sourcing strategies and the impact this will have structurally on earnings. Renewed focus on hedging strategies for raw material costs, FX and interest rates.

Due to earnings pressure we expect risks at the lowest end of the ratings scale to increase, but structural features should prevent high default rates

- Around 98%* of broadly syndicated loans are cov-lite, so do not carry covenants that could trigger a default, while hedging and pricing structures dilute the impact of rising rates. The bulk of existing European loans do not need refinancing until 2024 or after, and private equity owners are expected to step in to provide liquidity to those portfolio companies that need it.

Limited demand for risk from Collateralised Loan Obligations (CLOs), the largest buyers of European leveraged loans

- CLOs are not net new buyers of assets at the moment, but not forced sellers either. Around 80 CLOs are warehousing stock, with step-up pricing to kick in end Q3 for some older warehouses. Banks working on a number of solutions to counter lack of supply, including print and sprints, terming out warehouses or unwinding. Warehouses that are “full on the ramp” may consider splitting assets across warehouses.

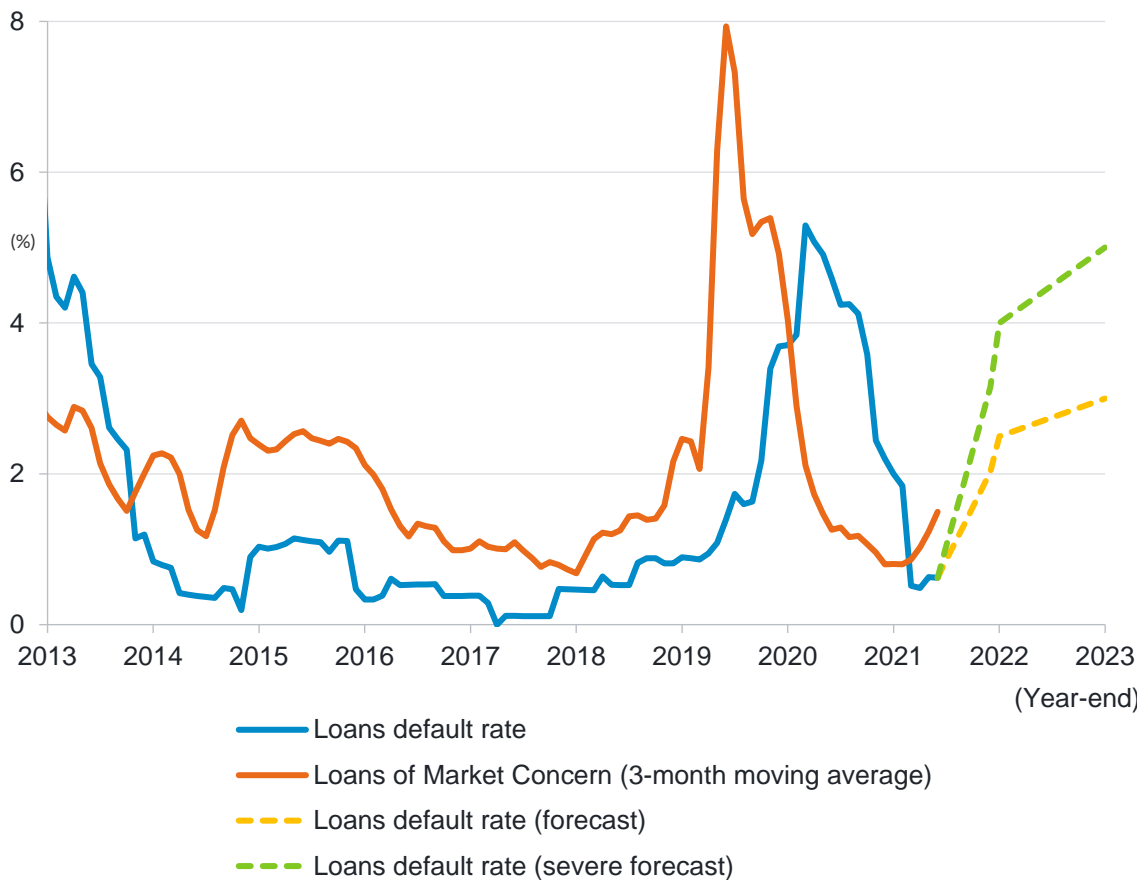
Opportunities exist for investors with the cleanest portfolios and available liquidity

- Focus on defensive companies with sticky recurring revenues, high and stable margins and strong cash generation. Leverage loan market heavily weighted towards these sectors such as healthcare, software and business services. This should provide good opportunities during periods of market dislocation.

*Sources: Fidelity International, *LCD S&P Global Market Intelligence Global Leverage Lending Report Q1 2022, ** CS WELLI composition as at 29 April 2022.

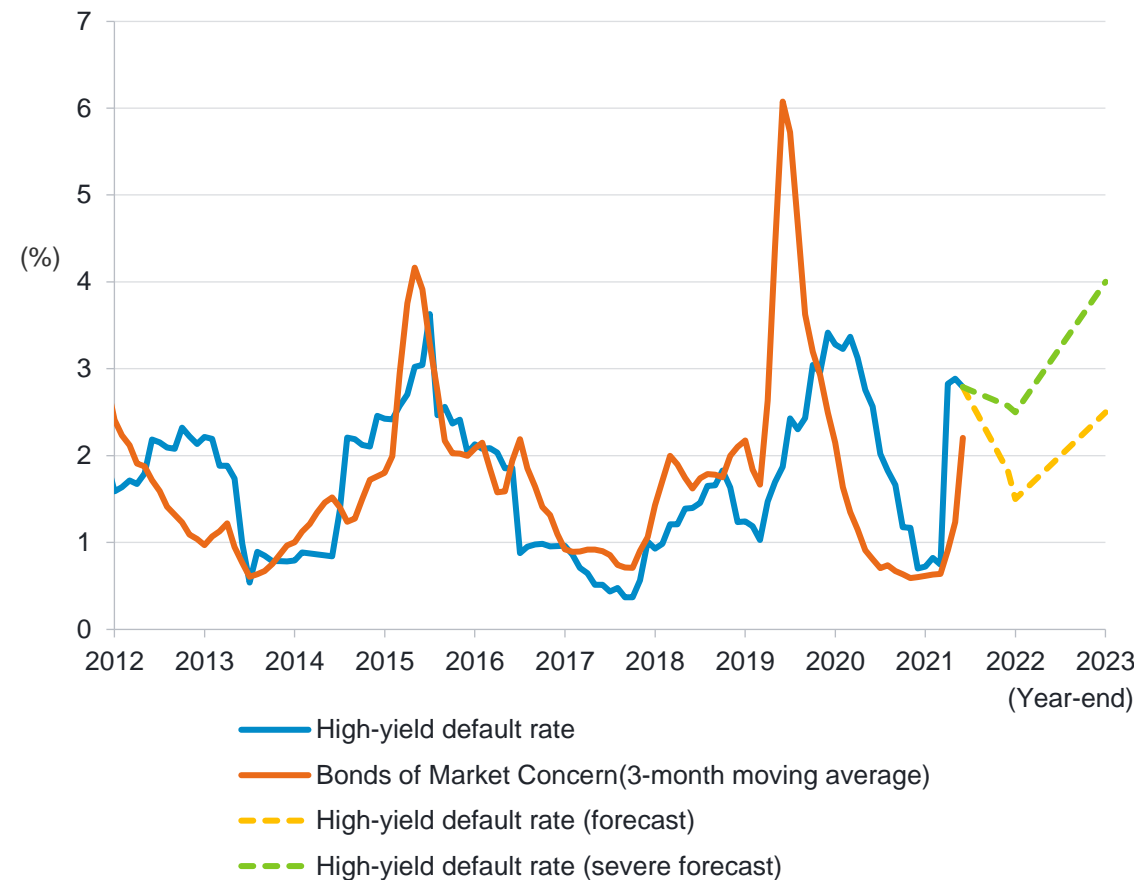
Defaults expected to increase, but not to reach previous peaks

Loans of Market Concern vs. Default Rate



Source: Fitch Ratings.

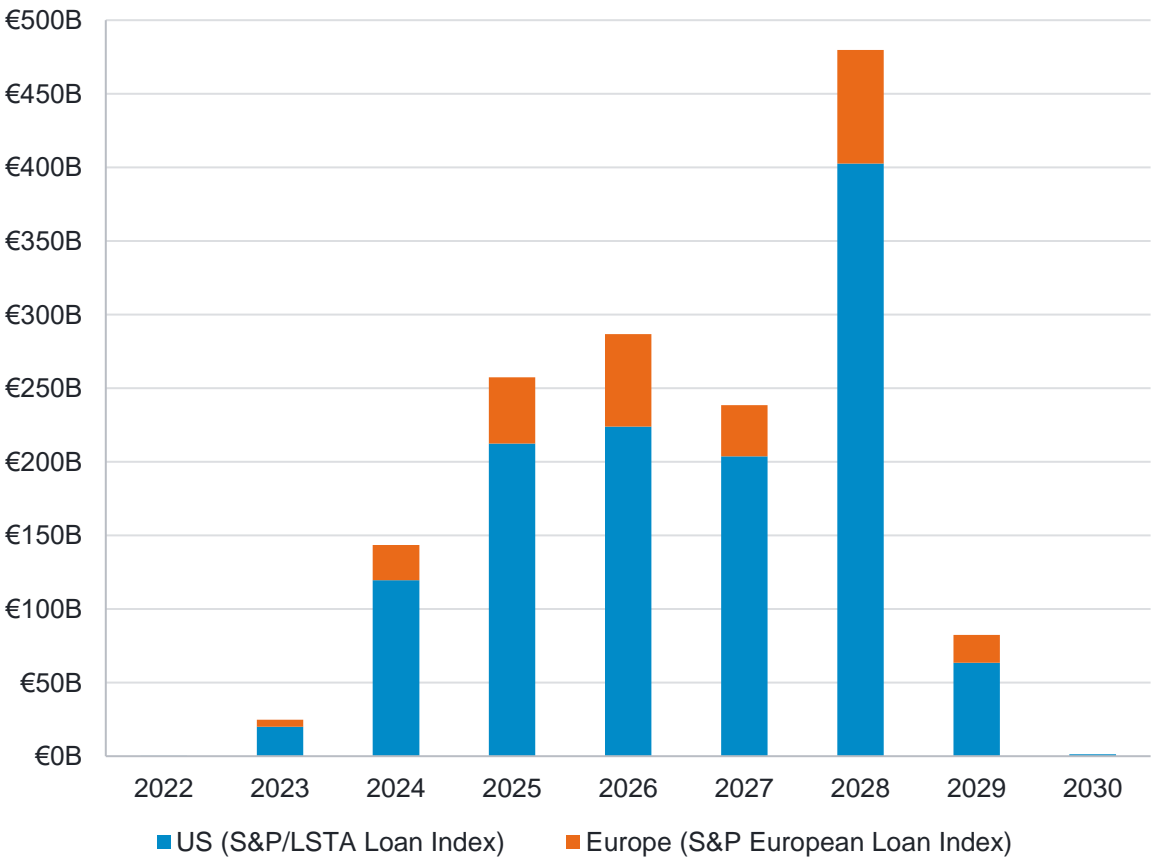
Bonds of Market Concern vs. Default Rate



Source: Fitch Ratings.

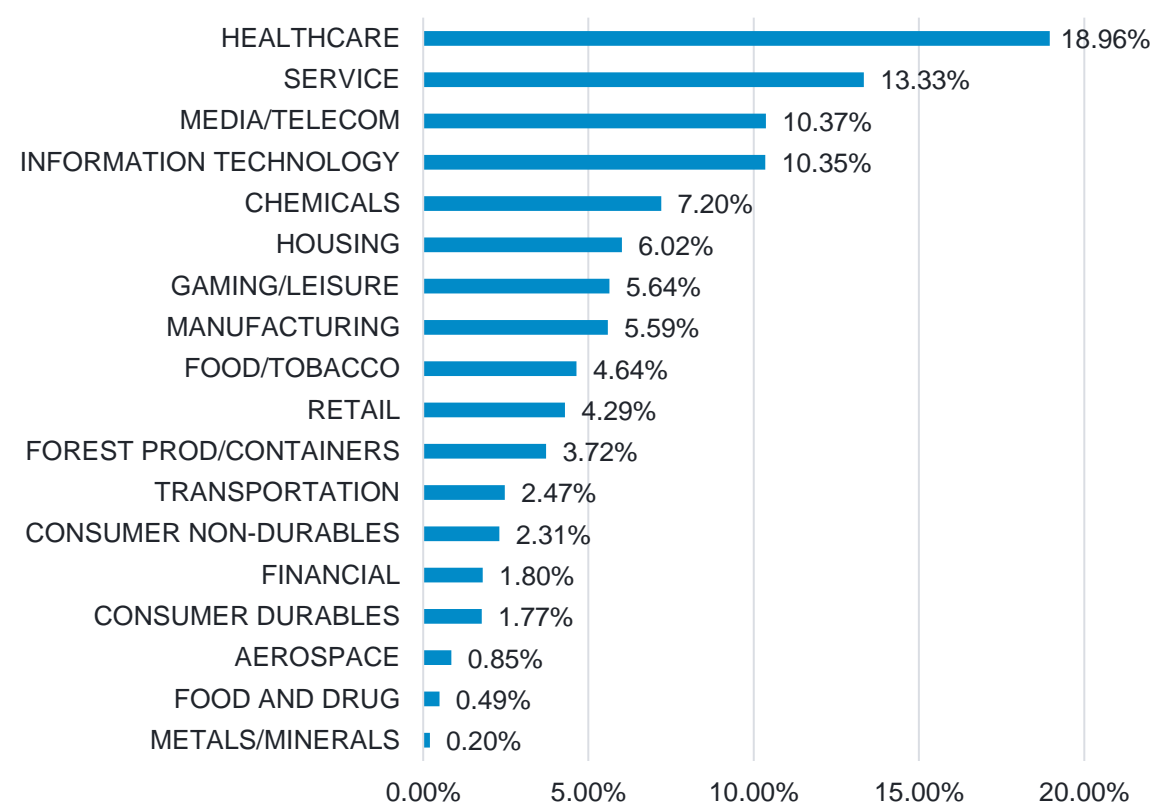
European issuers under little immediate pressure to refinance in more difficult markets

Global Leveraged Loan Outstanding Maturity Profile



EUR Global Leveraged Lending Report, 2022.

Credit Suisse European Leveraged Loan Index



Credit Suisse European Leverage Loan Index (EUR only).

Real Estate

Real Estate: Key takeaways

A nervous investment market

- There is a thinner pool of bidders for assets on the market, and the pipeline of buildings coming to market has declined significantly.
- Appears to be a 'sellers strike' underway, while buyers digest a rapidly rising cost of debt.
- Current pending transaction activity points to one of the lowest quarters of investment since the depths of the first Covid lockdown.

Inflation protected leases

- There is some inflation protection offered via index linked leases, particularly so on the Continent, which will drive rents, and hence support values to some degree as yields shift outwards.
- However, weak economic growth is a problem, which together with high inflation may lead to overrenting in portfolios which will hit valuations.
- Indexation is not a permanent protection as rents will be marked to market at some point.

Real estate pricing

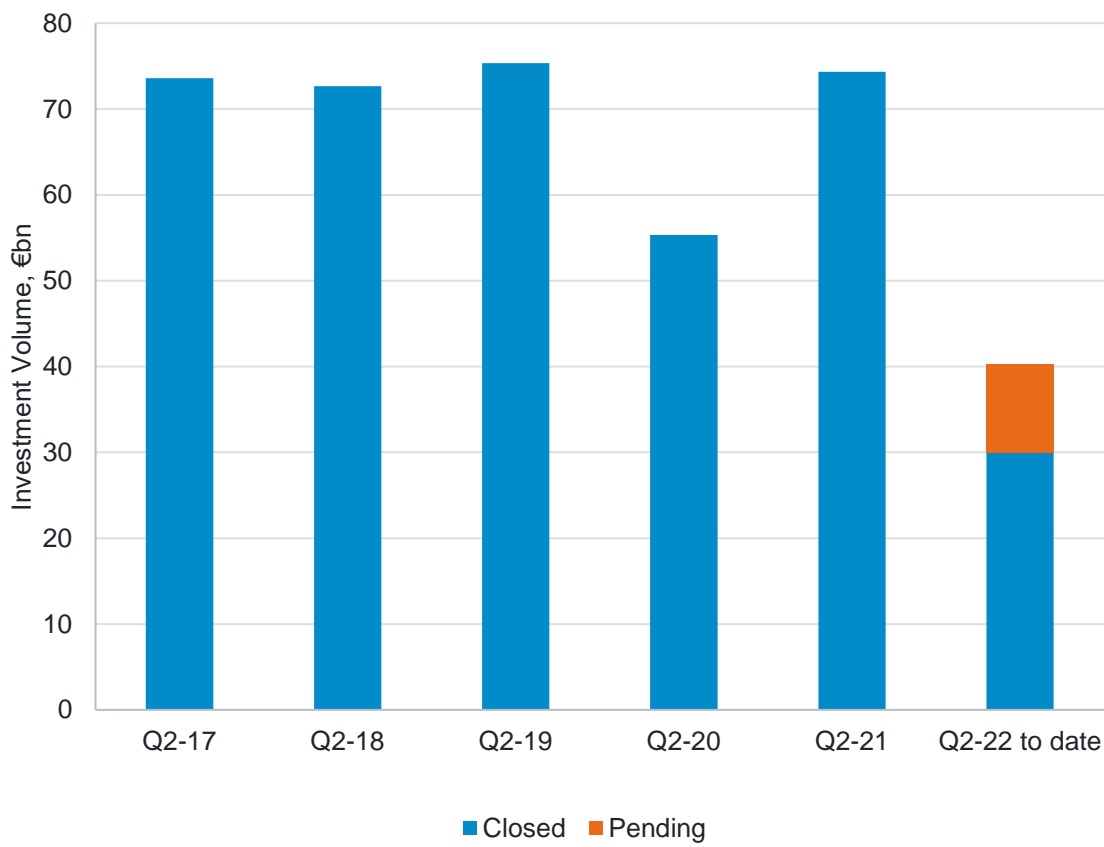
- There tends to be a long lag between changes in interest rates and real estate values, which is more a function of how values are determined in the sector, than a lack of sensitivity on behalf of investors.
- Anecdotally, we have seen deals pulled from the market due to a failure to meet the asking price, which means there is no new evidence to say values are lower, despite the likely reality that they are for certain sectors.

Occupiers still active

- Activity continues to pick up in the office occupier market, with a sharp focus on sustainability. Prime office rents have been surpassed in some markets for highly sustainable offices where availability is very low.
- No signs of a significant slow down in demand for industrial space, despite high profile announcements from ecommerce players. Vacancy rates remain at de minimis levels which will support rents even if/when demand eases to some degree.

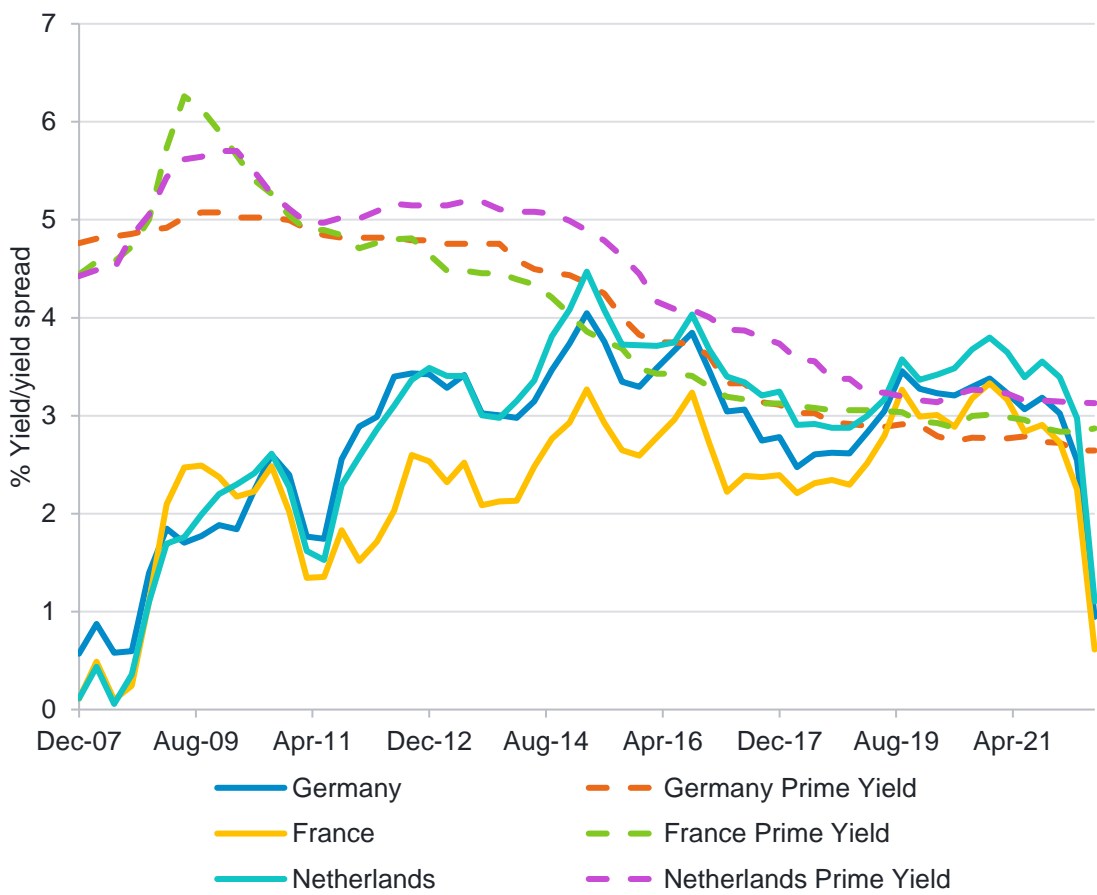
A nervous investment market is reflected in low transaction volumes

European transaction volumes



Source: Real Capital Analytics, June 2022

Yield spread between prime property yields and 10Y gov bonds



Source: CBRE, Refinitiv Eikon, Fidelity International June 2022