

Q4 2022 Investment Outlook

Into the unknown

FIL Investment Management
October 2022



Three themes for Q4 2022

Soft, hard or crash landing?

- The global economy is facing a confluence of shocks, most recently the severe reaction in UK assets and FX to the new fiscal package (roughly 10% of GDP, unfunded). Market confidence has continued to slide on persistently high levels of inflation, aggressive global policy tightening, the Russian energy squeeze, weak consumer confidence and other disruptions. These factors underlie our base case of a hard landing in 2023.
- Having hiked rates by 75bp in two consecutive meetings, the Fed maintains its hawkish stance. We think the terminal rate in this cycle is likely to exceed 4%, as Chair Powell pushed back at Jackson Hole against expectations for a near-term dovish pivot and promised to “keep at it until the job is done.” The US labour market remains highly resilient despite pressure in the housing market. We continue to anticipate a US hard landing, but not until 2023.
- While the ECB has hiked rates to 0.75%, we believe its window of opportunity for further hikes is closing. This is due to imminent recession risk largely driven by ever more severe disruptions to gas supply from Russia, which could lead to a 4-5% shock to Euro area GDP.

China – all eyes on the Party Congress

- China’s recovery from the abrupt economic downturn triggered by zero-Covid policy (ZCP) lockdowns has been uneven, as expected. While activity has improved, property construction suspensions, mortgage boycotts and recurring lockdowns in response to Covid outbreaks have prevented a more robust recovery.
- China’s fiscal and monetary policy are increasingly supportive, but the government has refrained from deploying wide-scale stimulus. The 20th Party Congress in October should set the stage for a more decisive policy direction beginning in 2023.

From monetisation to fiscalisation

















- Europe’s energy crisis has deepened following Russia’s termination of Nord Stream 1 gas flows, which has driven gas and power prices to intense peaks. The UK’s mini budget of energy bill subsidies and tax cuts is likely to be followed by moves by other national governments to provide fiscal support for households facing a tripling in utility bills.
- The BOE now faces some challenging policy choices. For the ECB, we expect a dovish pivot earlier than the market, given the near 100% likelihood of recession in the Eurozone. Extreme volatility in the currency markets is adding another layer of complication.
- Longer term, reconciling burgeoning public debt levels with fiscal rules will pose a political challenge. Markets are likely to remain volatile through Q4, given the many moving parts across all three major economic regions.

Source: Fidelity International, September 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:  Inflation: 	 	Growth:  Inflation: 	 	Growth:  Inflation: 	 	Growth:  Inflation: 	 
Scenario narrative	Central Banks and inflation shocks push the economy into a hard landing recession, which we define as 2 quarters of contraction combined with material labour market weakness.		A combination of easing consumer avoids or keeps shallow any recession. CBs manage successfully to control inflation with the economy remaining at 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 zero-Covid policy. 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	80% (70%)		5% (10%)		15% (20%)		0% (no change)	

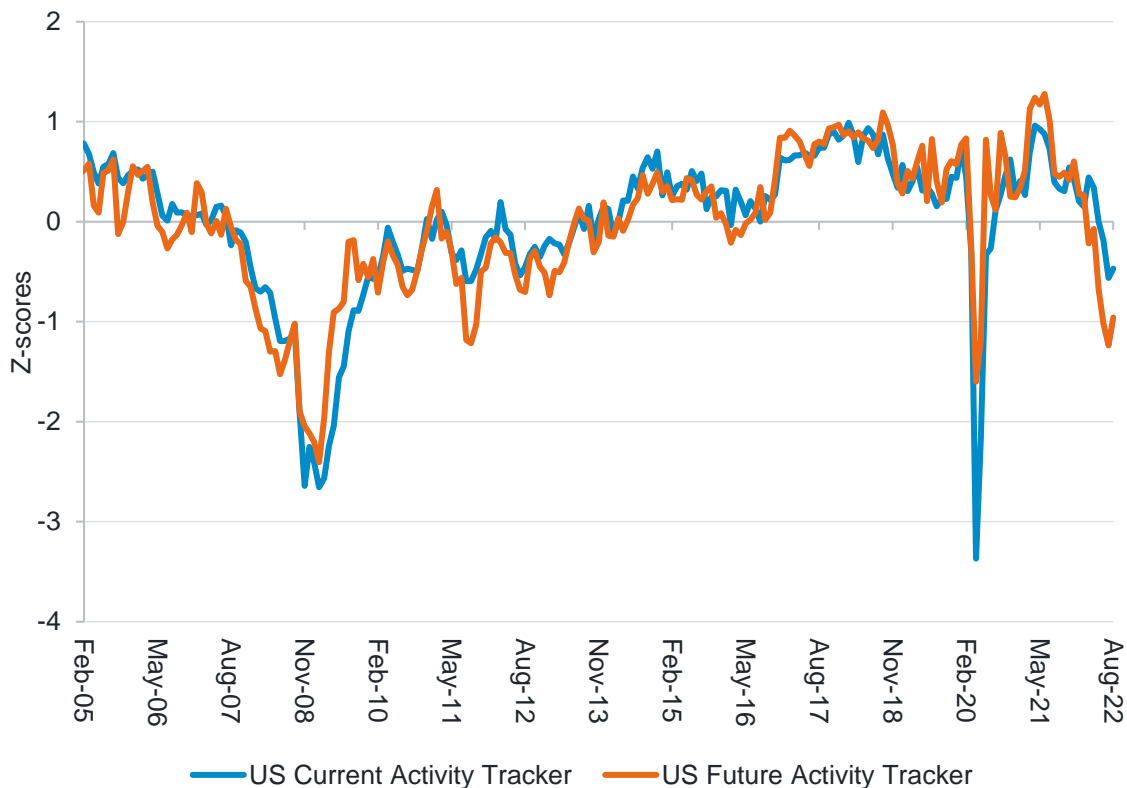
Note: Brackets show last month's probabilities. Growth/inflation arrows indicate deltas from current levels.

*Source: Fidelity International, September 2022.

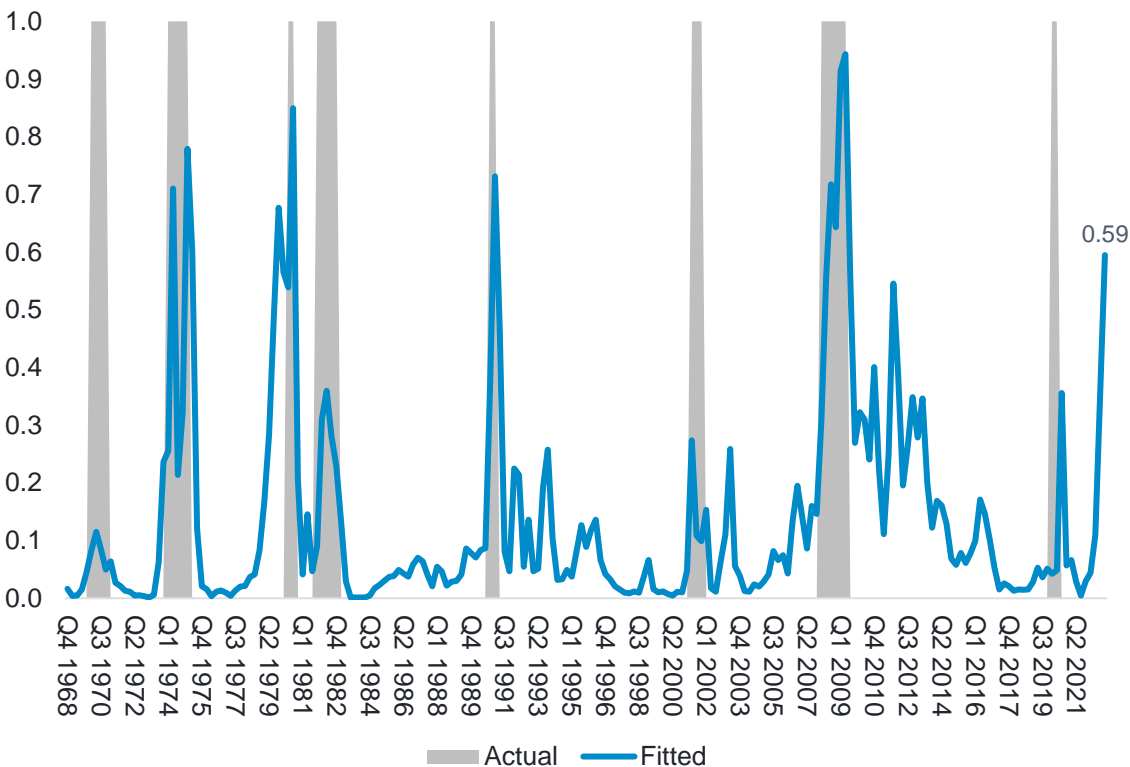
US activity trackers stabilized in August, but continue to signal recession ahead

Our trackers suggest a >50% recession probability, but timing is uncertain and dependent on the trajectory of policy and other factors

US current and future activity trackers improved slightly in Aug...
...but still reflecting a greater than 50% chance of recession



Source: Fidelity International, Fidelity Global Macro Research calculations, September 2022.



Source: Fidelity International, Fidelity Global Macro Research calculations, September 2022.

US Housing and Labour market tracker

Z-scores excluding COVID volatility

US Housing market indicators (Z-scores)	1970 Recession	1973 Recession	1980 Recession	1981 Recession	1991 Recession	2001 Recession	2008 Recession	2020 Recession	Lowest level ex COVID	Avg recession ex COVID	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22	Aug-22
Sales	0.32	-1.07	-1.62	-0.71	-1.31	0.07	-1.27	-1.35	-2.72	-0.69	-0.61	-0.33	-0.86	-1.04	-1.00	-1.48	-1.92	-1.88
Constructions	0.23	-0.15	0.17	-0.08	-0.36	0.17	-0.64	-1.88	-3.26	-0.10	-0.72	0.12	-0.14	-0.07	-0.93	0.07	-0.43	0.06
Price	-0.99	0.07	-0.18	-0.69	-1.07	0.00	-1.03	1.05	-2.65	-0.59	2.73	2.93	3.09	3.20	3.09	2.81	2.74	-0.50
Affordability					-1.15	-0.35	0.00	0.46	-1.13	-0.38	-0.21	-0.37	-0.57	-0.86	-0.97	-1.03	-0.99	
Inventory				0.09	0.07	0.60	-1.61	1.51	-2.61	-0.40	2.42	2.42	2.30	2.16	2.00	1.86	1.79	1.82
Risk and Sentiment					-1.36	0.26	-0.70	0.59	-2.38	-0.36	0.98	0.97	0.97	0.97	0.84	0.83	0.61	0.25
Housing Market Momentum	-0.15	-0.38	-0.55	-0.35	-0.86	0.13	-0.87	0.06	-2.46	-0.42	0.76	0.95	0.80	0.73	0.51	0.51	0.30	-0.05

Source: Fidelity International, Fidelity Global Macro Research calculations, Bloomberg, September 2022. *Denotes that the negative of the z-score is displayed, as the indicator is a negative indicator in terms of sentiment. Z-scores use averages and standard deviations based on periods running from the later of January 1970 and the first year the indicator was published, up to December 2019. Recession period z-scores are averages during NBER-defined months of recession. "Housing Market Momentum" is the average of the above 24 indicators. "Lowest level ex COVID" refers to the lowest level up to December 2019.

US Labour Market Indicators (Z-Scores)	1970 Recession	1973 Recession	1980 Recession	1981 Recession	1991 Recession	2001 Recession	2008 Recession	2020 Recession	Lowest level ex COVID	Avg Recession ex Covid	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22	Aug-22
Employment & related (exc. participation rate)	-1.6	-1.4	-1.4	-1.3	-0.8	-1.0	-1.4	-15.5	-3.9	-1.3	1.11	1.49	1.29	1.33	1.08	0.91	1.06	0.59
Labor Force Participation Rate	-2.0	-1.6	-0.3	-0.3	0.9	1.1	0.7	-1.5	-2.3	-0.2	-1.11	-1.06	-1.02	-1.11	-1.06	-1.11	-1.16	-1.02
Unemployment & related	0.9	-0.3	-1.1	-1.8	-0.3	0.1	-0.9	-11.1	-3.6	-0.5	1.35	1.50	1.63	1.66	1.64	1.60	1.57	1.52
Wages/Earnings						1.5	0.5	7.1	-1.9	0.7	3.12	2.10	3.31	2.80	2.93	3.07	3.29	2.84
Hard data	-0.6	-0.9	-1.1	-1.4	-0.4	-0.1	-0.7	-7.5	-3.1	-0.5	1.34	1.36	1.46	1.42	1.32	1.24	1.30	1.29
Job Openings/Hiring/Quits/Separations						-0.3	-0.7	-5.3	-2.8	-0.6	1.10	1.18	1.06	1.08	0.94	0.82	0.80	1.64
Surveys	-0.4	-0.8	-1.2	-1.5	-0.9	-0.7	-1.4	-4.5	-3.5	-1.1	1.37	1.34	1.53	1.04	1.20	0.91	0.89	0.87
Soft data	-0.4	-0.8	-1.2	-1.5	-0.9	-0.6	-1.1	-4.7	-3.3	-1.0	1.28	1.29	1.37	1.05	1.12	0.88	0.86	0.96

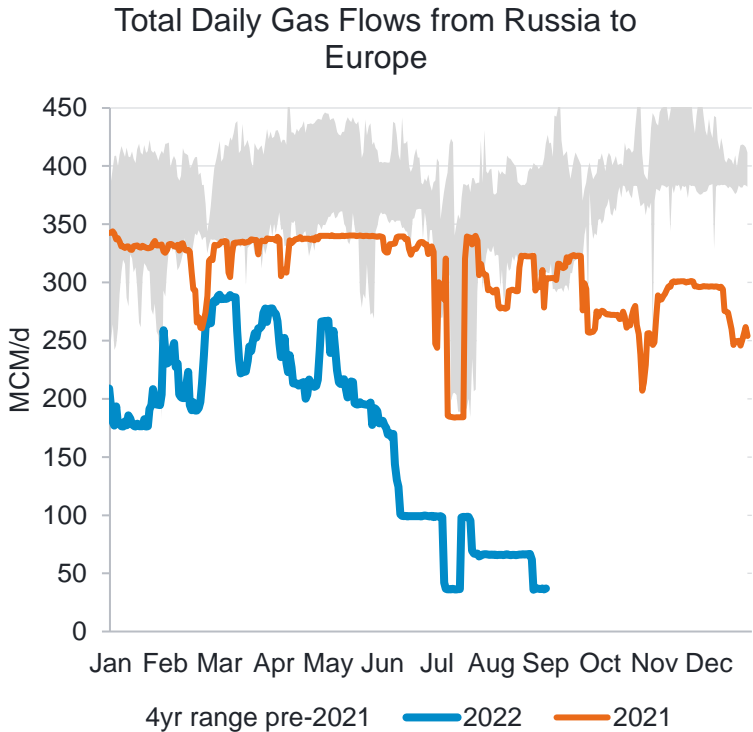
Notes – 1. Z-scores use averages and standard deviations based on periods running from the later of January 1970 and the first year the indicator was published, up to December 2019. 2. Recession period z-scores are averages during the NBER-defined months of recession. 3. "Labour Market Index" is the average of the above 37 indicators.*4. "Lowest level ex COVID" refers to the lowest level up to December 2019. 5. Conditional formatting for current z-scores uses the Average Recession ex COVID, 0, and the 95th percentile of the whole period, for the minimum, mean and maximum respectively 6.. For the purposes of setting the minimum in our conditional formatting, where indicators only have 2 or 3 periods of historical recession data, we encompass a further data point by setting the minimum to be the average of the Lowest Level ex COVID and the Average Recession ex Covid

*denotes that the negative of the z-score is displayed, as the indicator is a negative indicator in terms of sentiment, # - Ratio and not Z score, *@Averages of weekly scores are taken, and these are converted to monthly values,

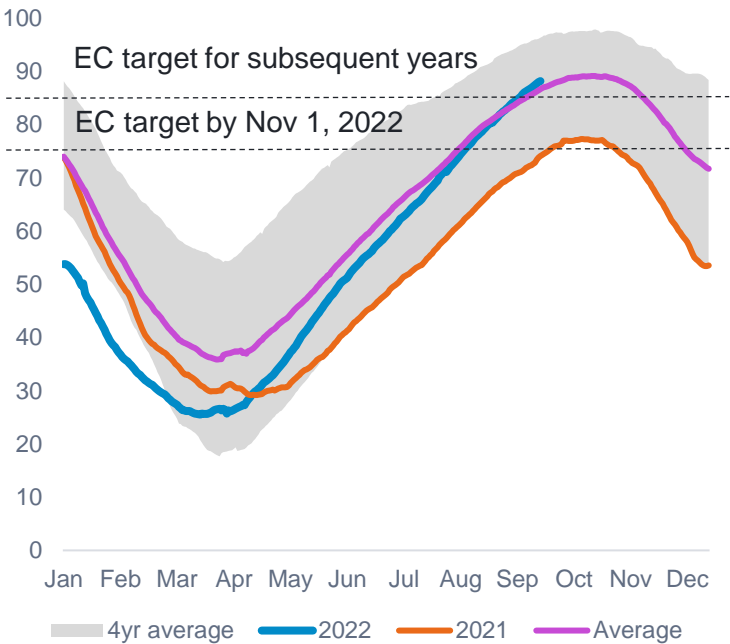
Source: Fidelity International, Fidelity Global Macro Research calculations, Bloomberg, September 2022.

Natural gas security increasingly tenuous; price volatility at extreme levels

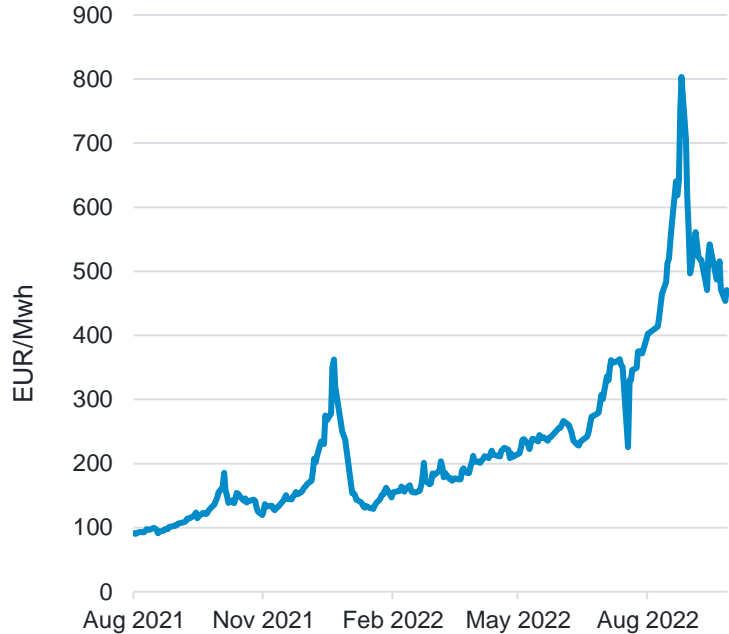
Total daily gas flows from Russia to Europe (MCM/d)*



EU natural gas storage inventories, % of full storage



German Power Baseload 1 year forward



*Includes all pipelines from Russia into the EU.

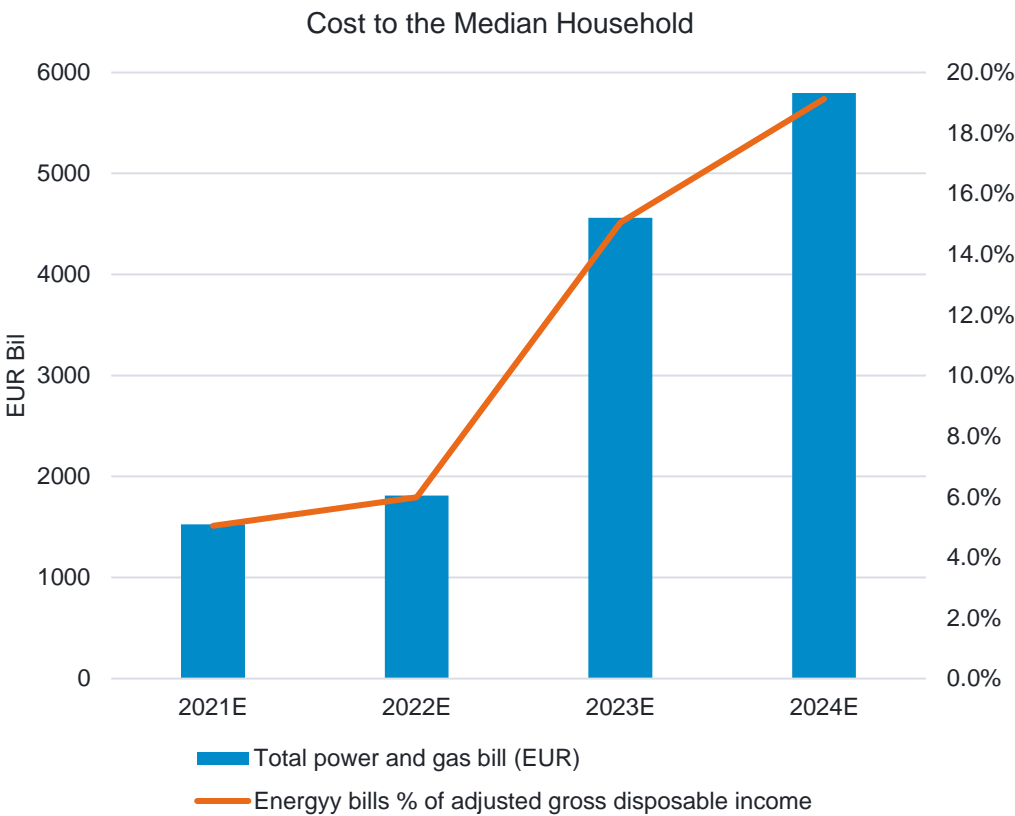
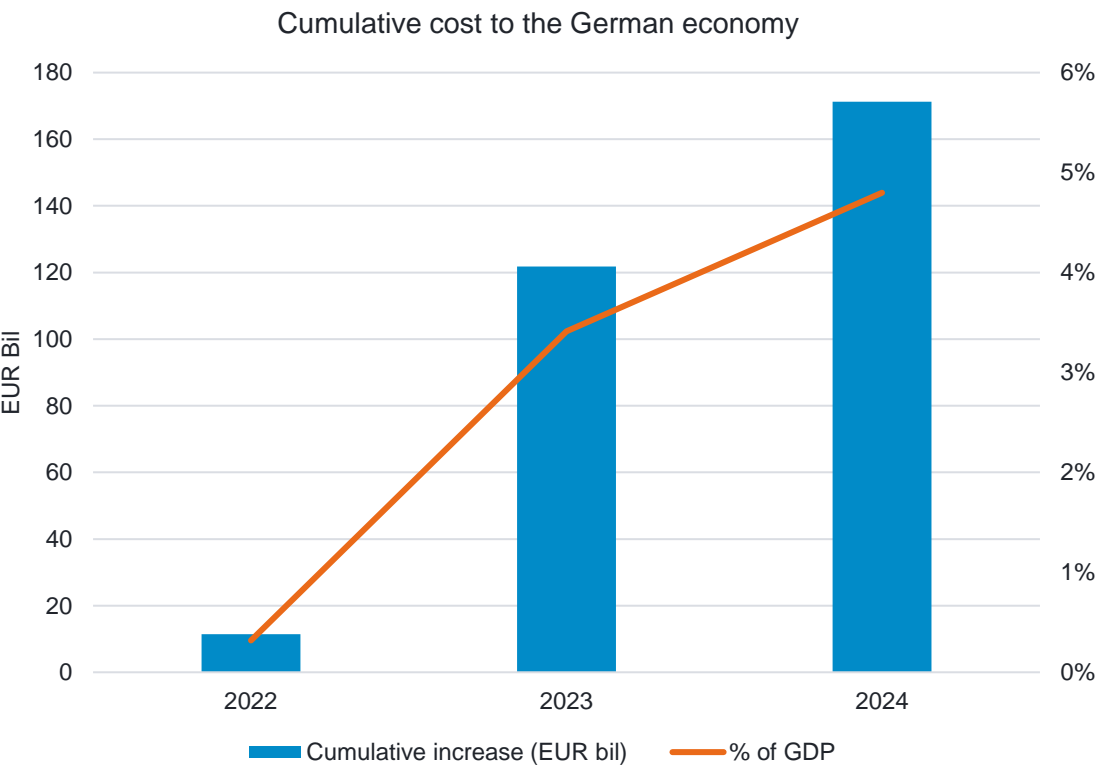
Source: Fidelity International, Bloomberg, September 2022.

Germany: Economic impact of energy price increases (without intervention)

Total incremental economic cost of around EUR 170bn

Total cost to the German economy of around EUR 170bn or 5% of GDP (2022-24)

Without intervention, energy would rise from 5% to 19% of household consumption

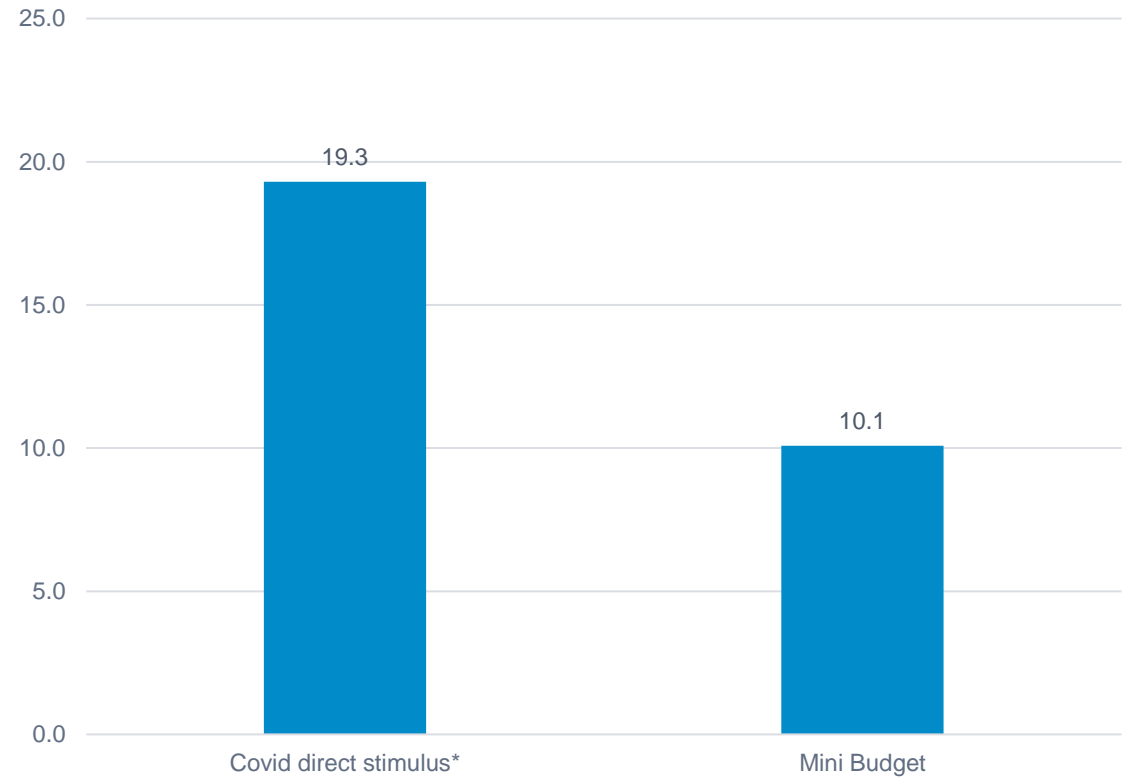


* Assumes unchanged levels of gross disposable income and consumption from 2019.
Source: Fidelity International, Fidelity Global Macro Research calculations, Destatis, Eurostat, Bundesbank, September 2022. Source: Fidelity International, Fidelity Global Macro Research calculations, Destatis, Eurostat, Bundesbank, September 2022.

UK Macro under stress

The latest fiscal package is significant in size with no accompanying financing analysis and estimates; this is an important variable in this cycle when CBs are reducing their balance sheet holdings

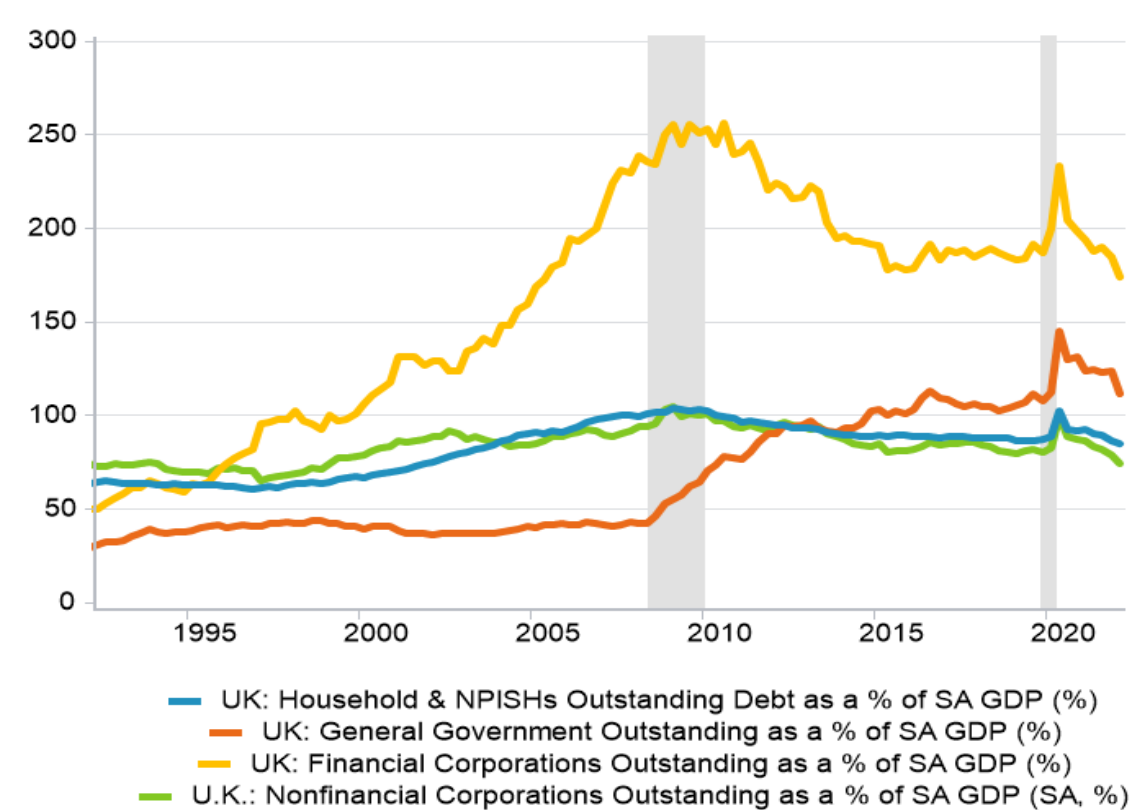
UK Fiscal stimulus as % of GDP



Note - * direct stimulus refers to additional spending and foregone revenue

Source: IMF, Fidelity International, September 2022.

UK government debt as % of GDP



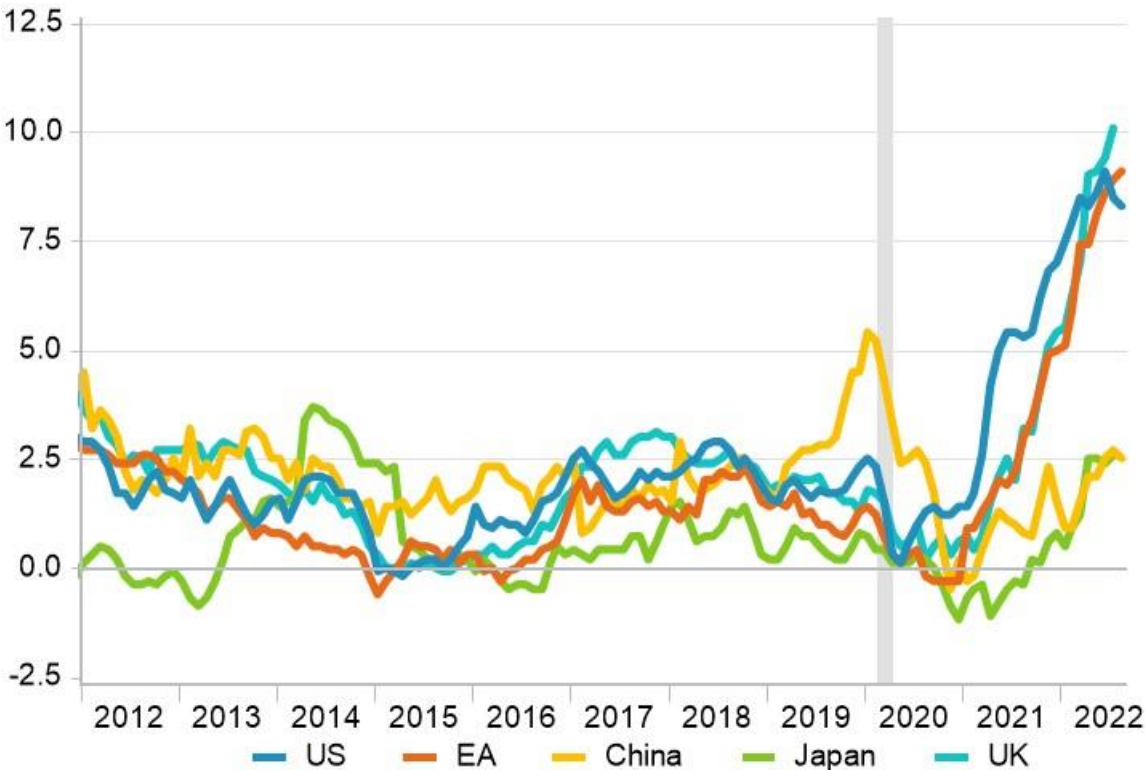
Note - Above General government outstanding debt numbers are based on non-consolidated data and have a wider scope than the consolidated debt figures. This includes data for other public sector bodies such as public corporations and the Bank of England.

Source: Haver, ONS, Fidelity International, September 2022.

The Fed will “keep at it until the job is done”

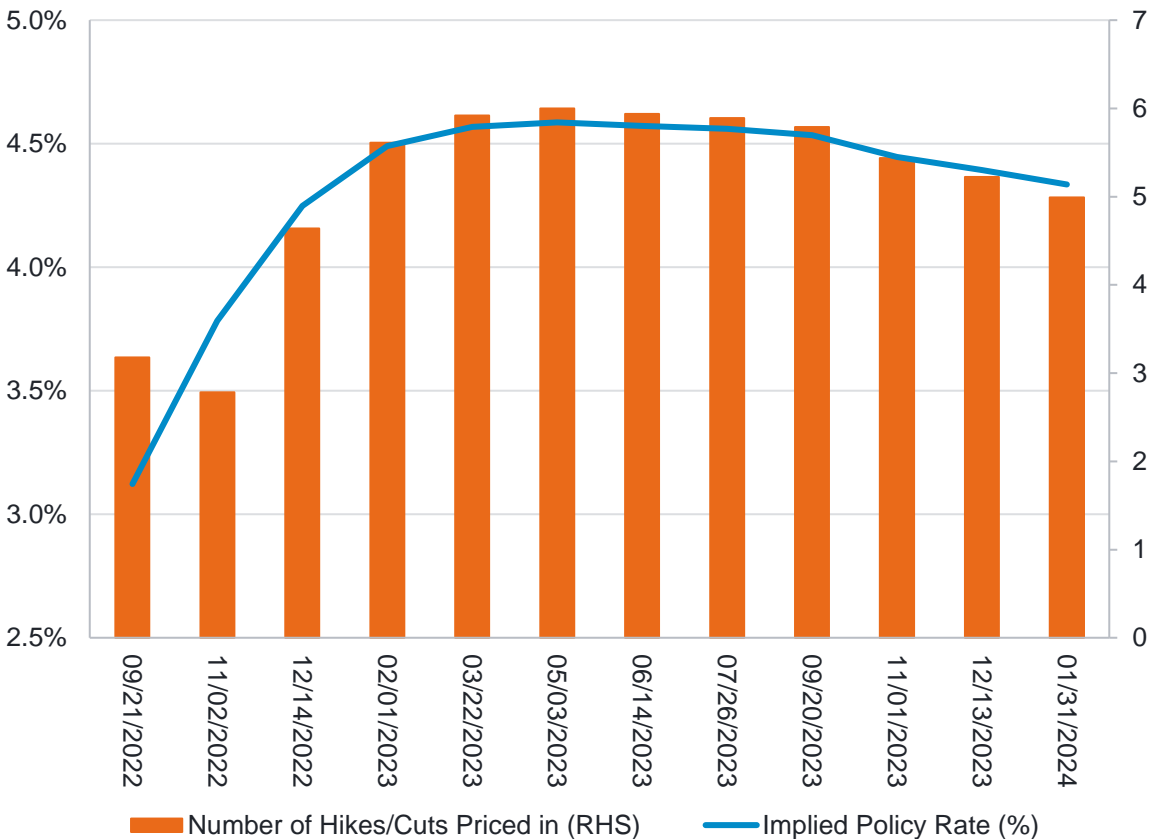
Tighter conditions to slow economic activity with more rate rises expected before a pivot

Global headline CPI rates (% YoY)



Notes: FCIs rebased to 100 at 31 December 2022.
Source: Fidelity International, Bloomberg, September 2022.

Market-implied path: Fed Funds

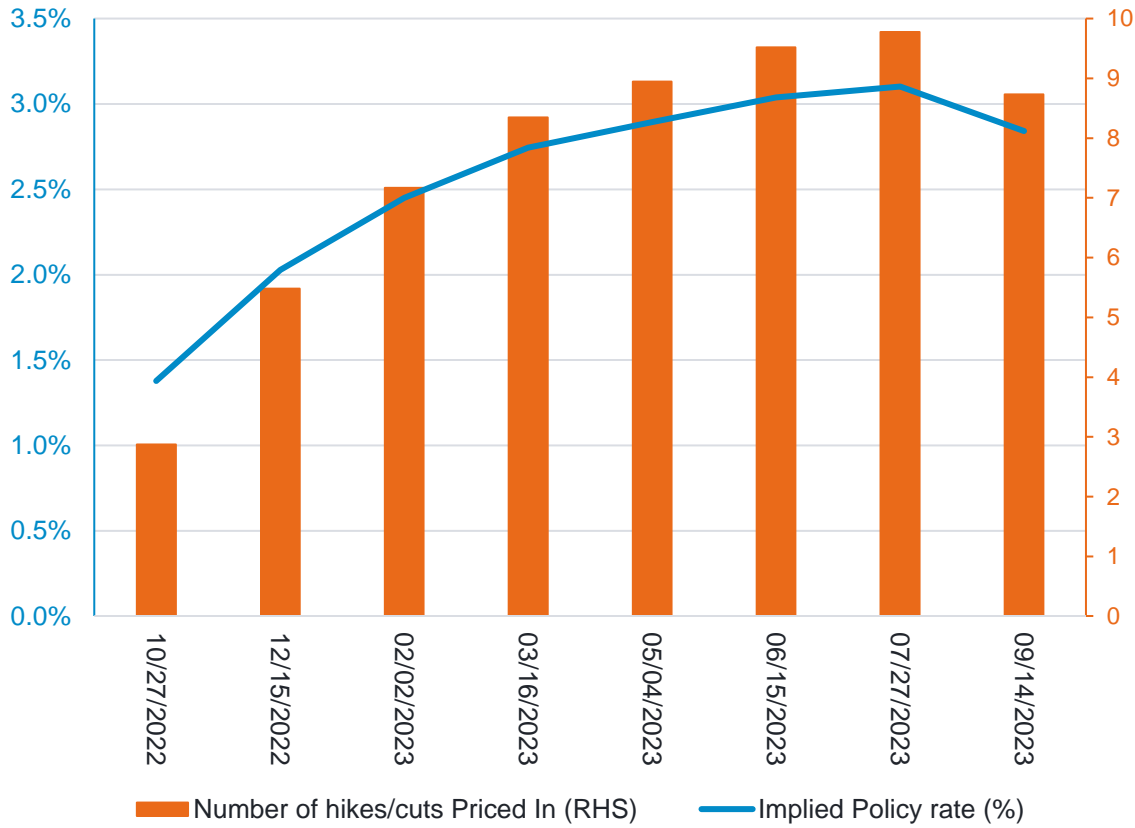


Note: Updated as of the 27 September. Number of hikes assumes 25bps increments.
Source: Fidelity International, Bloomberg, September 2022.

ECB and BOE tightening challenge

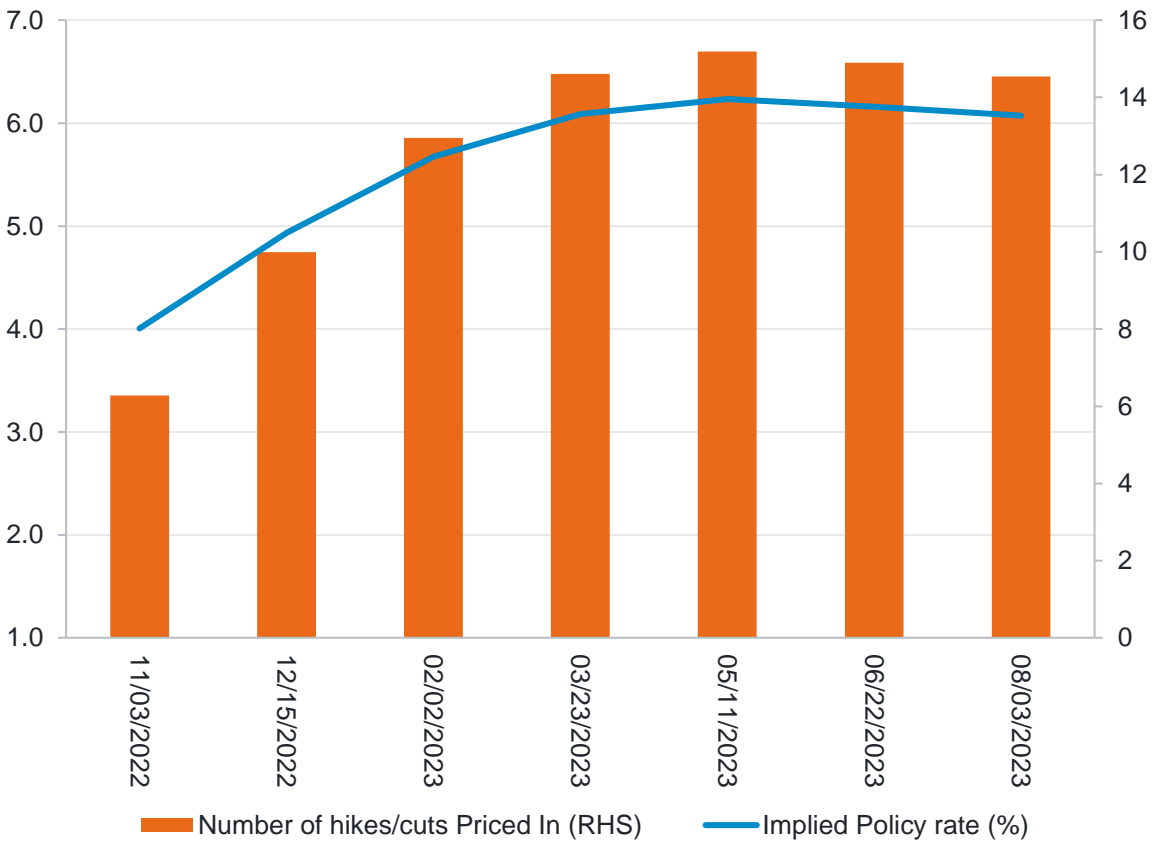
Markets now pricing in rates above neutral, but the hiking window is closing fast, with many challenges ahead

Market-implied path: ECB Bank Rate



Note: Updated as of the 27 September. Number of hikes assumes 25bps increments.
Source: Fidelity International, Bloomberg, September 2022.

Market-implied path: BOE Bank Rate

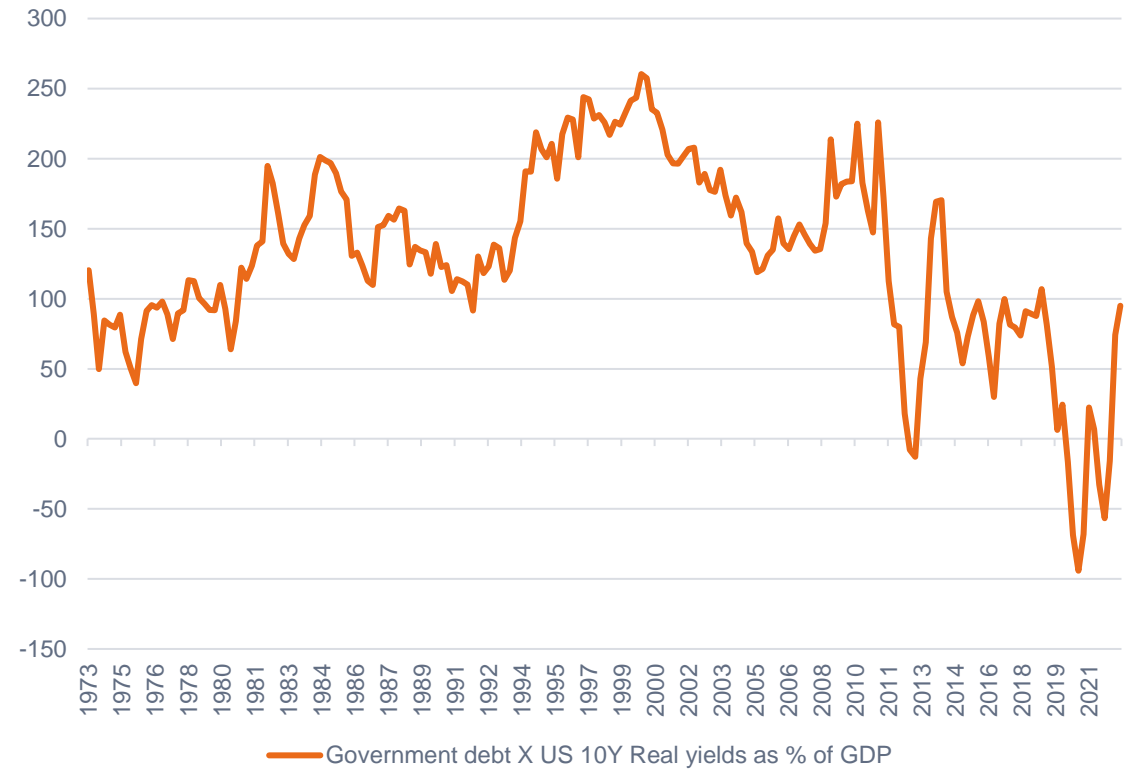


Note: Updated as of the 27 September. Number of hikes assumes 25bps increments.
Source: Fidelity International, Bloomberg, September 2022.

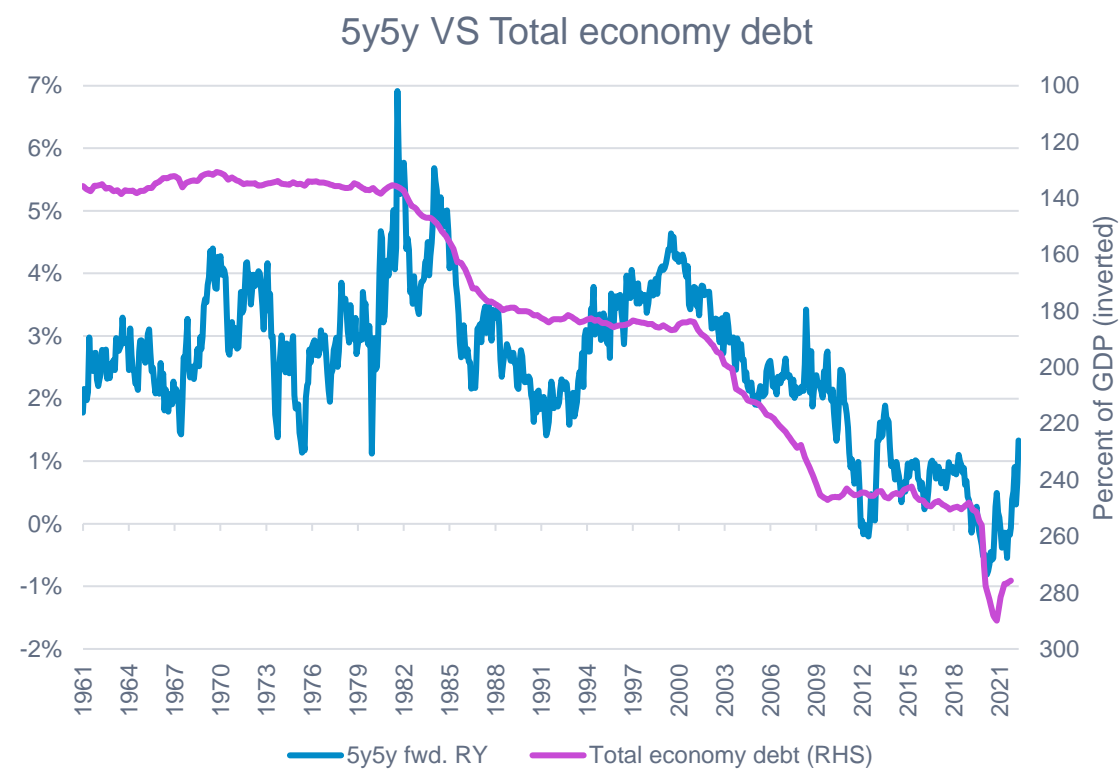
Real yields have turned into positive territory across the curve

Real yields have increased sharply and are unsustainable with the current debt levels

US Government debt servicing (US debt * real yields as % GDP)



US total economy debt as % of GDP and real yields



Note: For September 2022 Real yields 5Y5Y have been calibrated using data as on September 27th, For Q3 2022 nominal GDP same values as Q2 2022 have been used

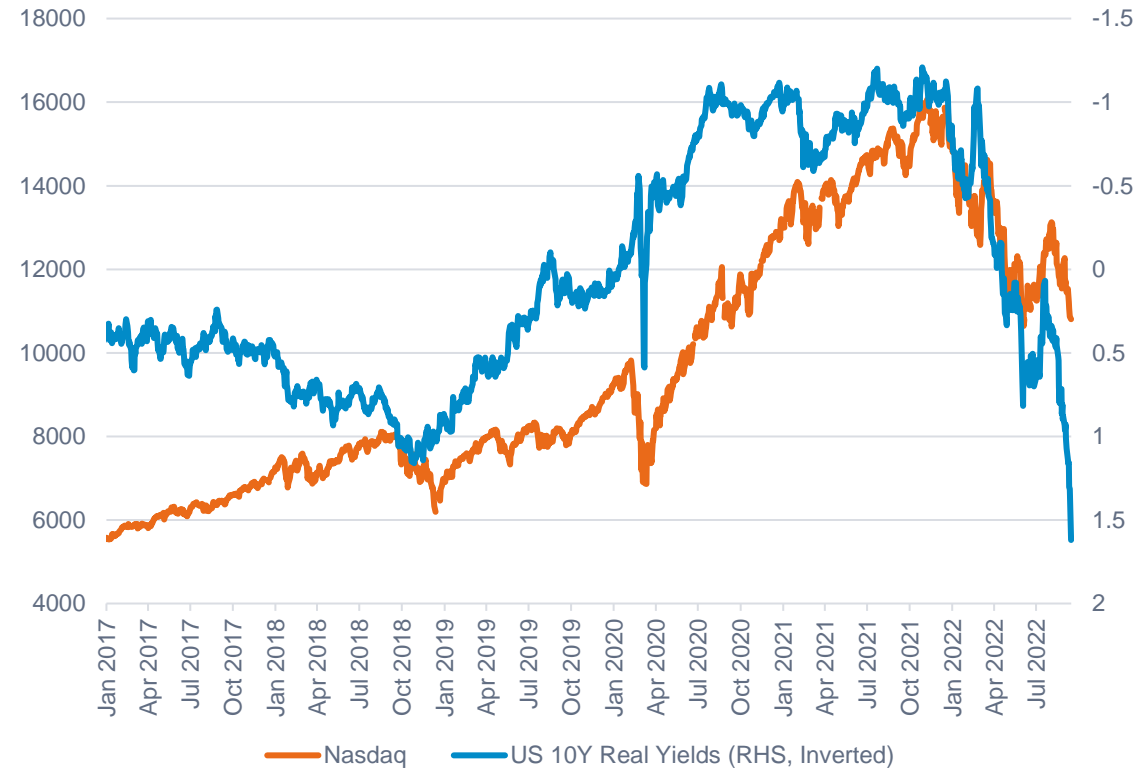
Source: Fidelity International, Bloomberg, September 2022.

Source: Fidelity International, Bloomberg, September 2022.

Rise in real yields have led to significant damage in equity markets

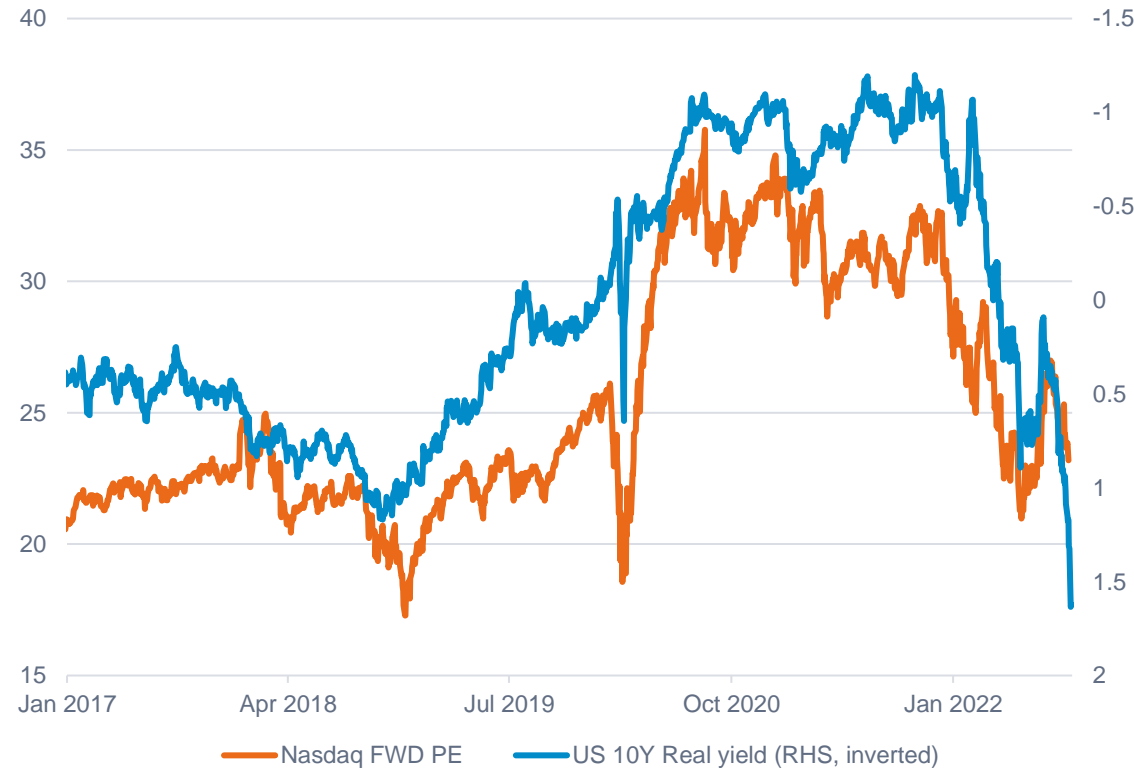
Equity markets have dropped sharply in line with the increase in real yields

US real yields and equity correlation



Source: Fidelity International, Bloomberg, September 2022.

US real yields and equity FWD PEs

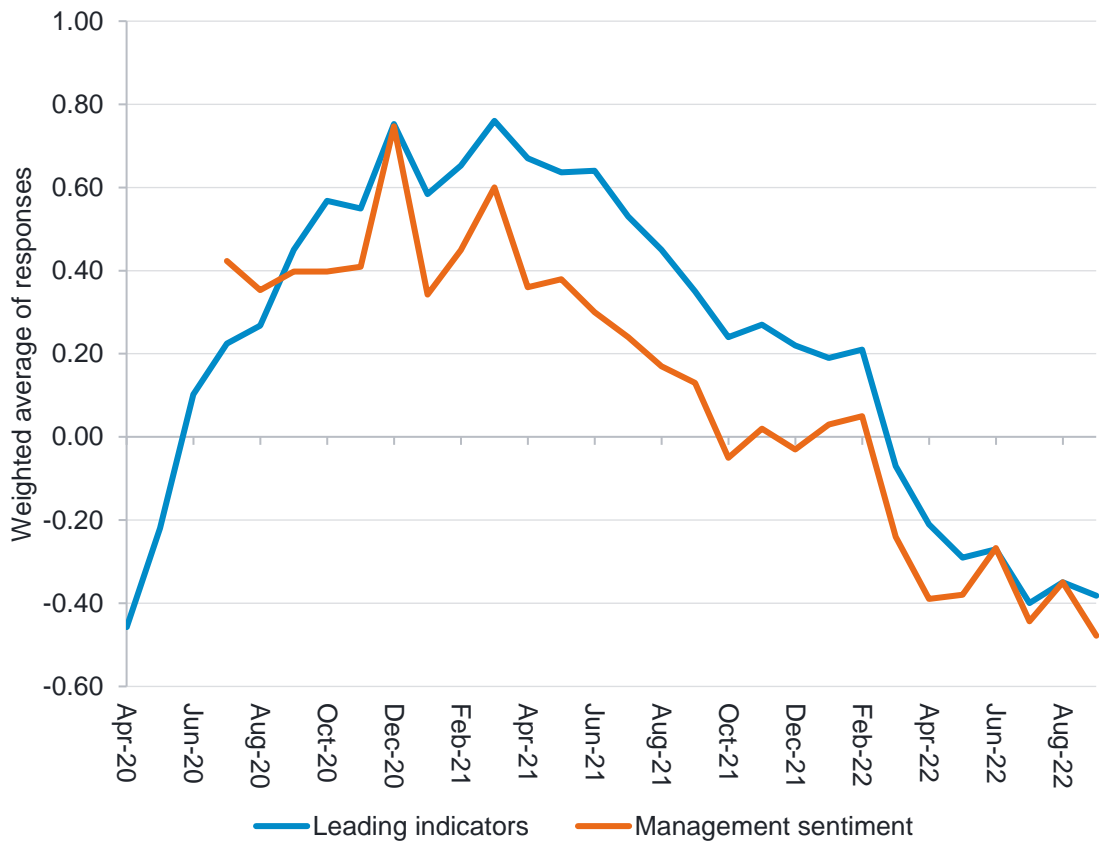


Source: Fidelity International, Data Stream, September 2022.

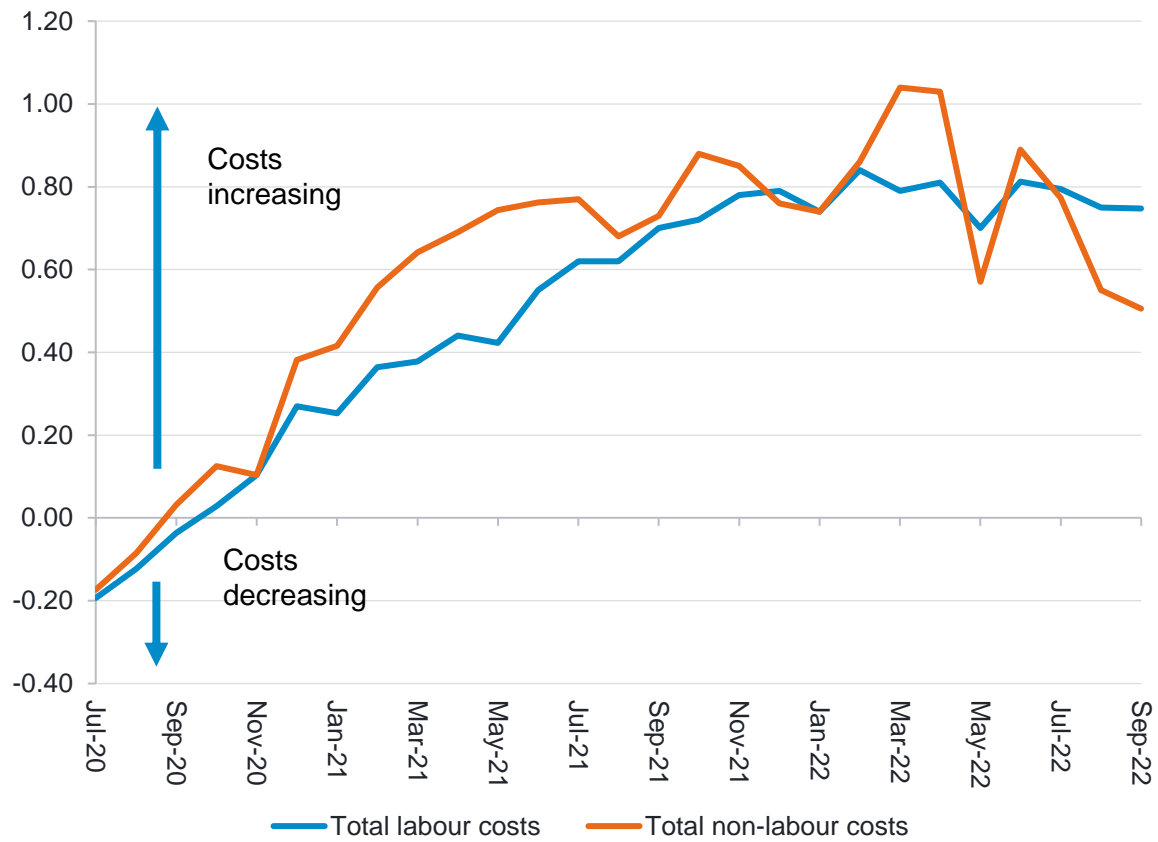
Global Investment Research

Management sentiment remains in the doldrums, while costs continue to rise but acceleration slowing

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



Global costs weighted averages - labour and non-labour



Source: Fidelity International Global Investment Research, September 2022.

Negative sentiment persisting across all regions, say FIL analysts

Leading indicators dragged down by China and Europe

Management sentiment by region

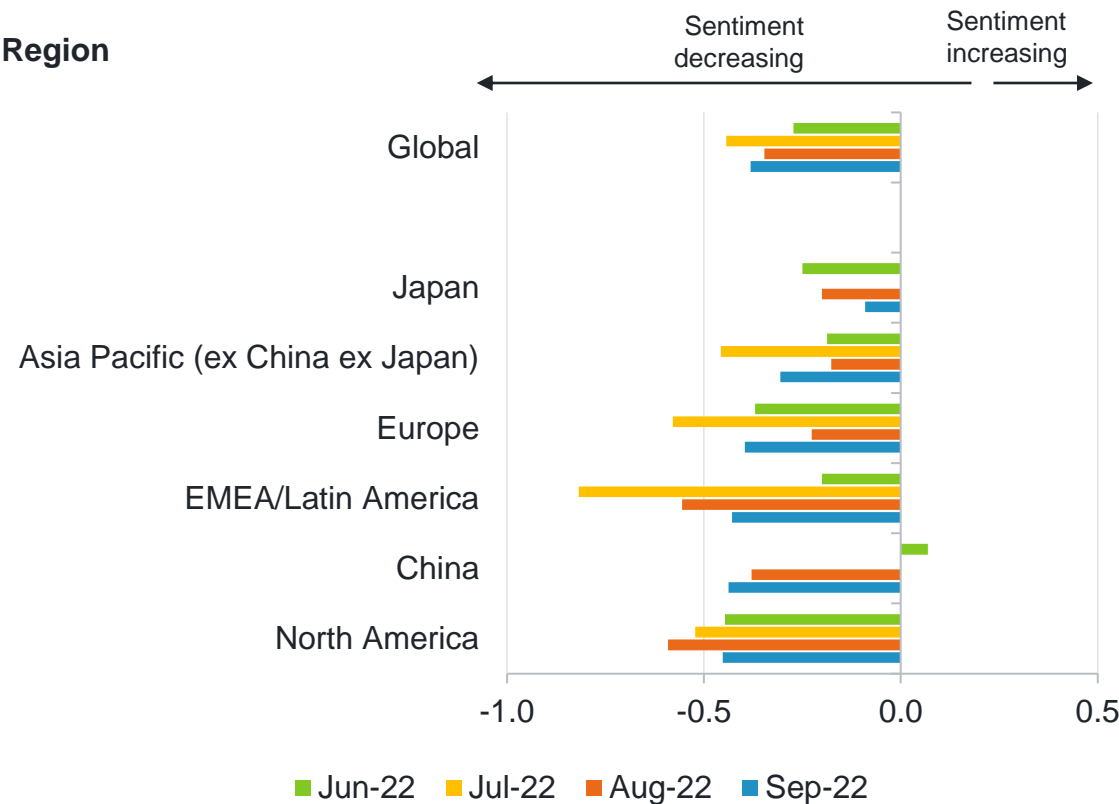


Chart shows proportion of responses reporting management sentiment is positive minus those reporting management sentiment is negative; strong negative and strong positive receive a higher weighting. Question: "Based on your recent research and interactions with companies, to what extent, if at all, has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

Source: Fidelity International Global Investment Research, September 2022.

Leading indicators by region

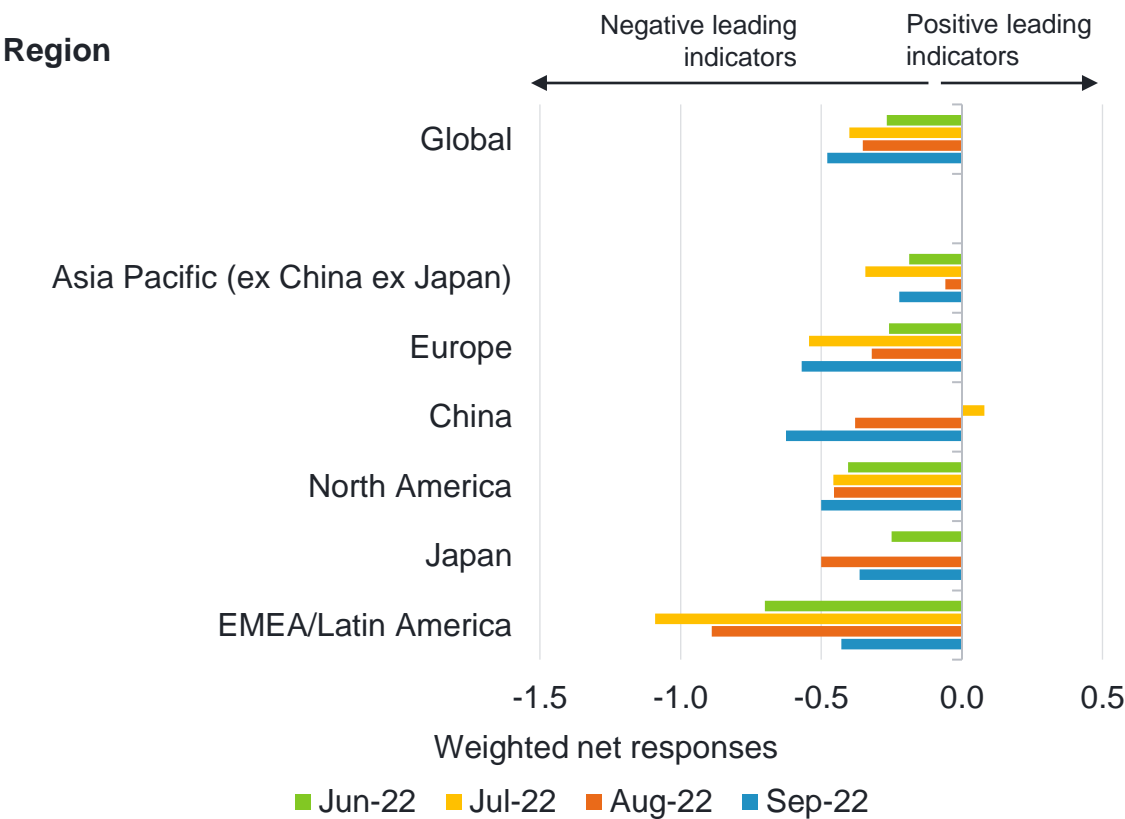


Chart shows proportion of responses reporting leading indicators are positive minus those reporting leading indicators are negative; strong negative and strong positive receive a higher weighting. Question: "What is the outlook for leading indicators over the next 6 months at your companies?"

Source: Fidelity International Global Investment Research, September 2022.

Costs increase again, but signs that pace is slowing

Our analysts expect to see costs rising once again

Labour costs increasing in every sector

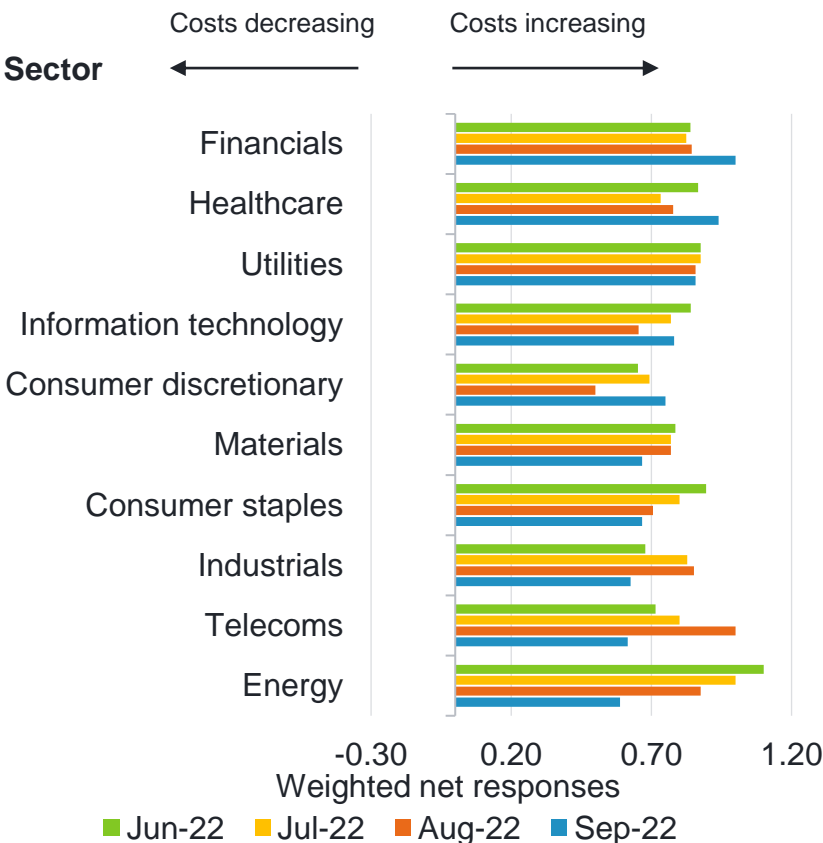


Chart shows proportion of responses reporting costs are increasing minus those reporting costs are decreasing; significant increases and significant decreases receive a higher weighting. Question: "What are your expectations for total labour costs over the next 6 months compared to current levels?"

Source: Fidelity International Global Investment Research, September 2022

Non-labour cost inflation slowing in industrials and staples

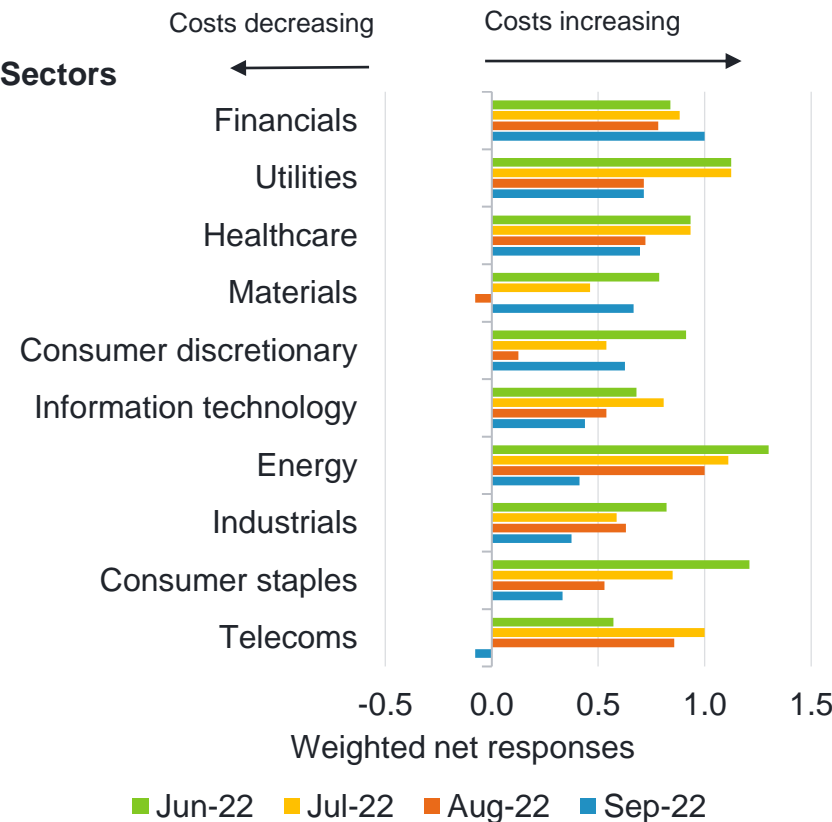
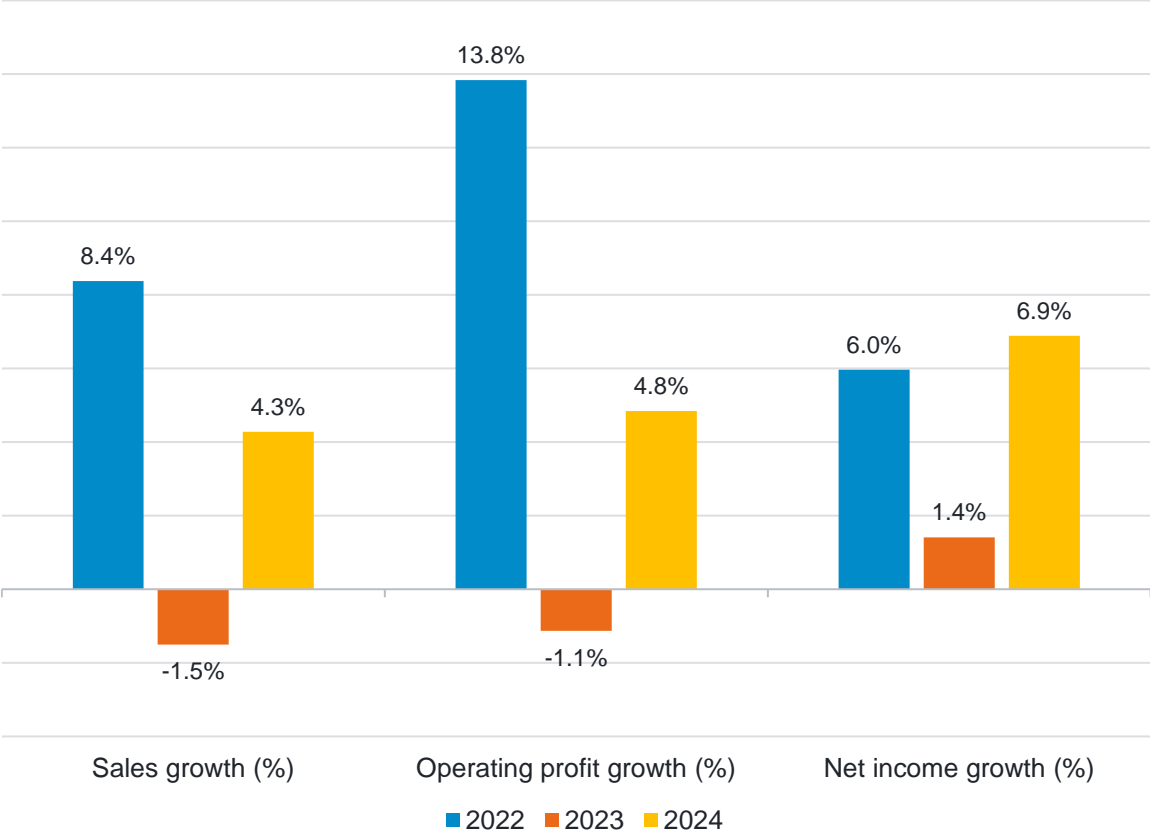


Chart shows proportion of responses reporting costs are increasing minus those reporting costs are decreasing; significant increases and significant decreases receive a higher weighting. Question: "What are your expectations for total non-labour input costs over the next 6 months compared to current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

Source: Fidelity International Global Investment Research, September 2022.

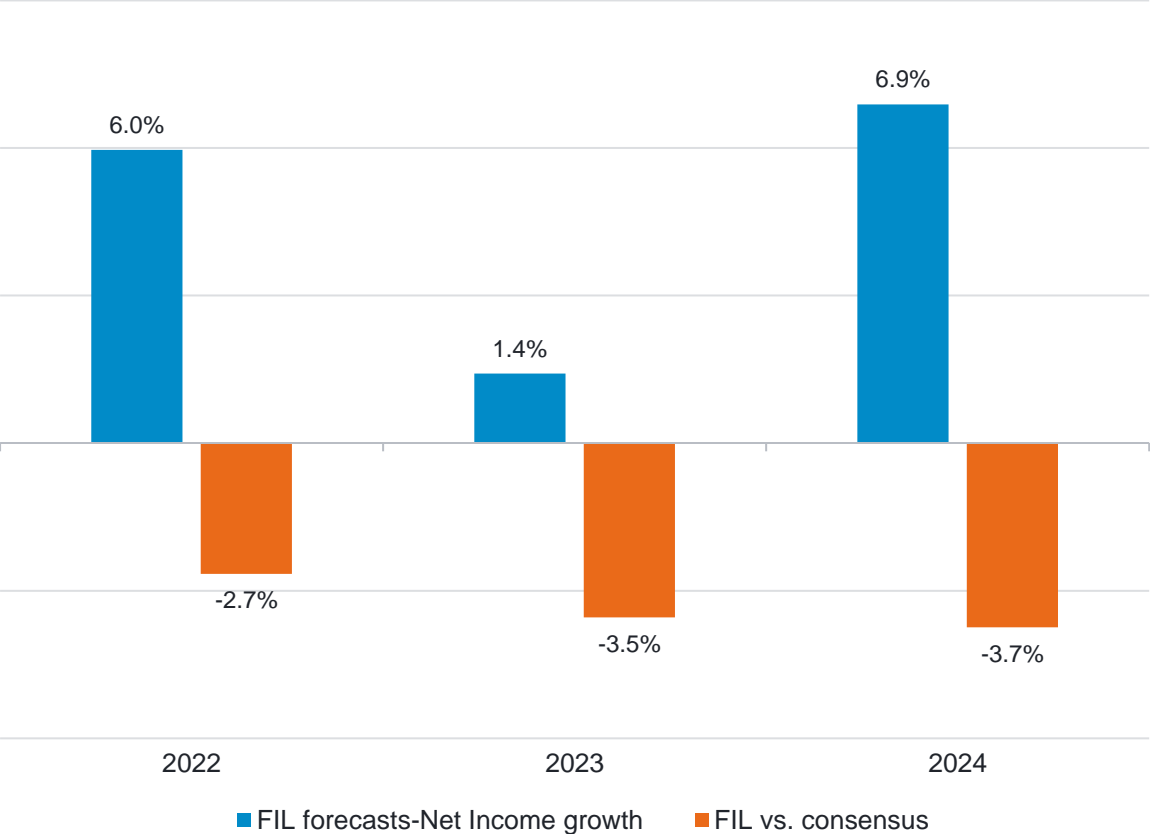
Research Big Picture

Global Growth forecast



Source: Fidelity International, IBES, 10 Sep 2022

Fidelity vs Consensus YoY Growth %

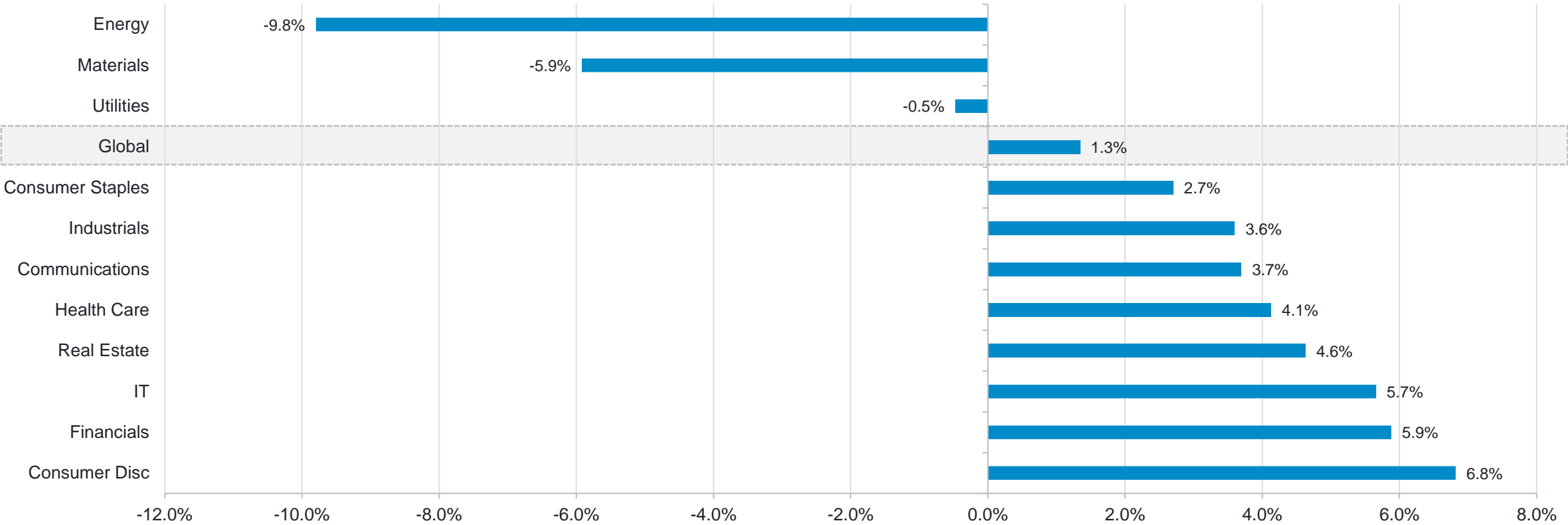


Source: Fidelity International, 10 Sep 2022

Global Sales

Aggregate sales growth estimates by sector (CAGR over CY22-24)

Growth, YoY

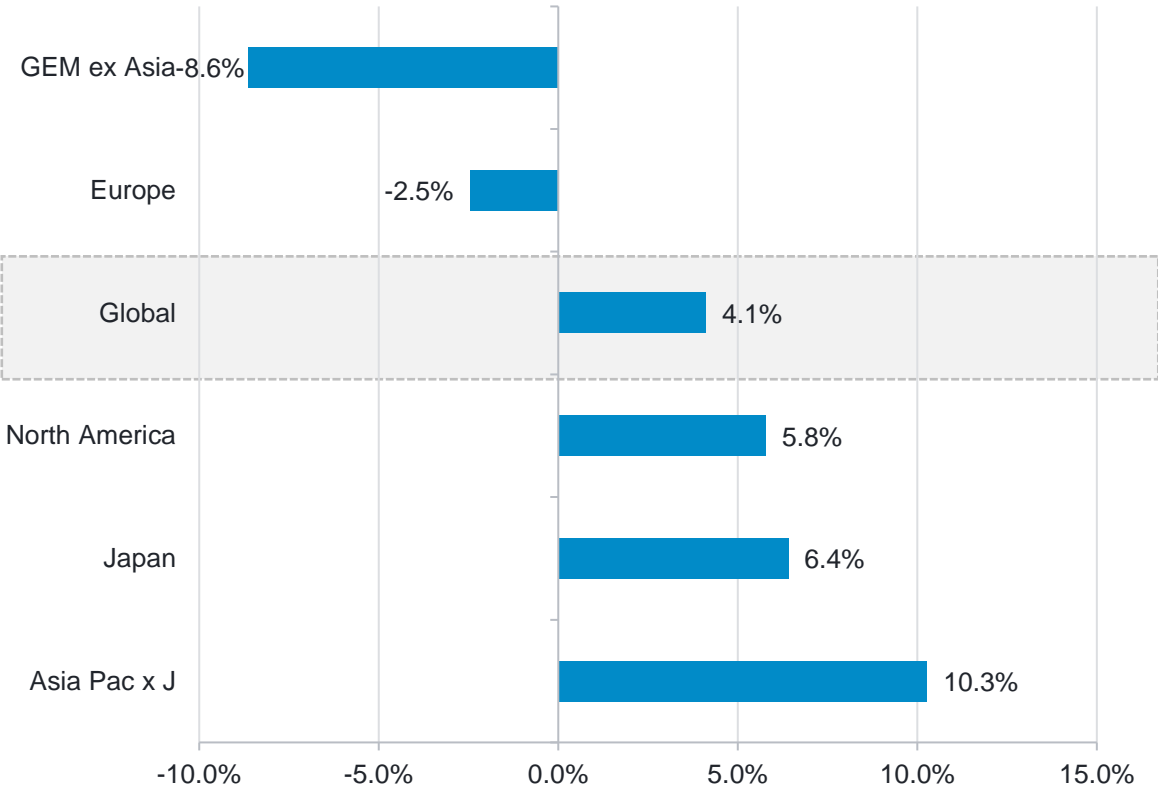


Source: Fidelity International, 10 Sep 2022

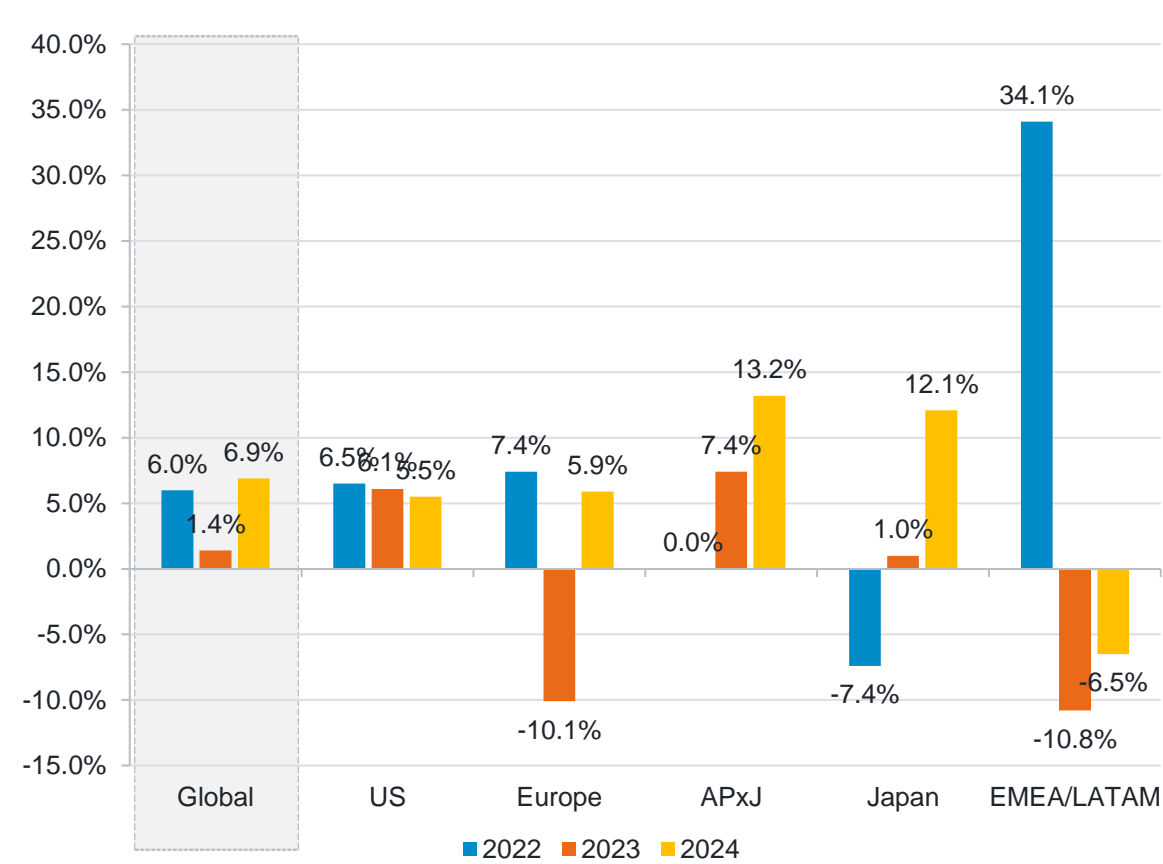
Earnings Outlook by Region

Aggregate earnings growth estimates by region

Aggregate earnings growth estimates by region (CAGR over CY22-24)



Aggregate earnings growth estimates by region, YoY

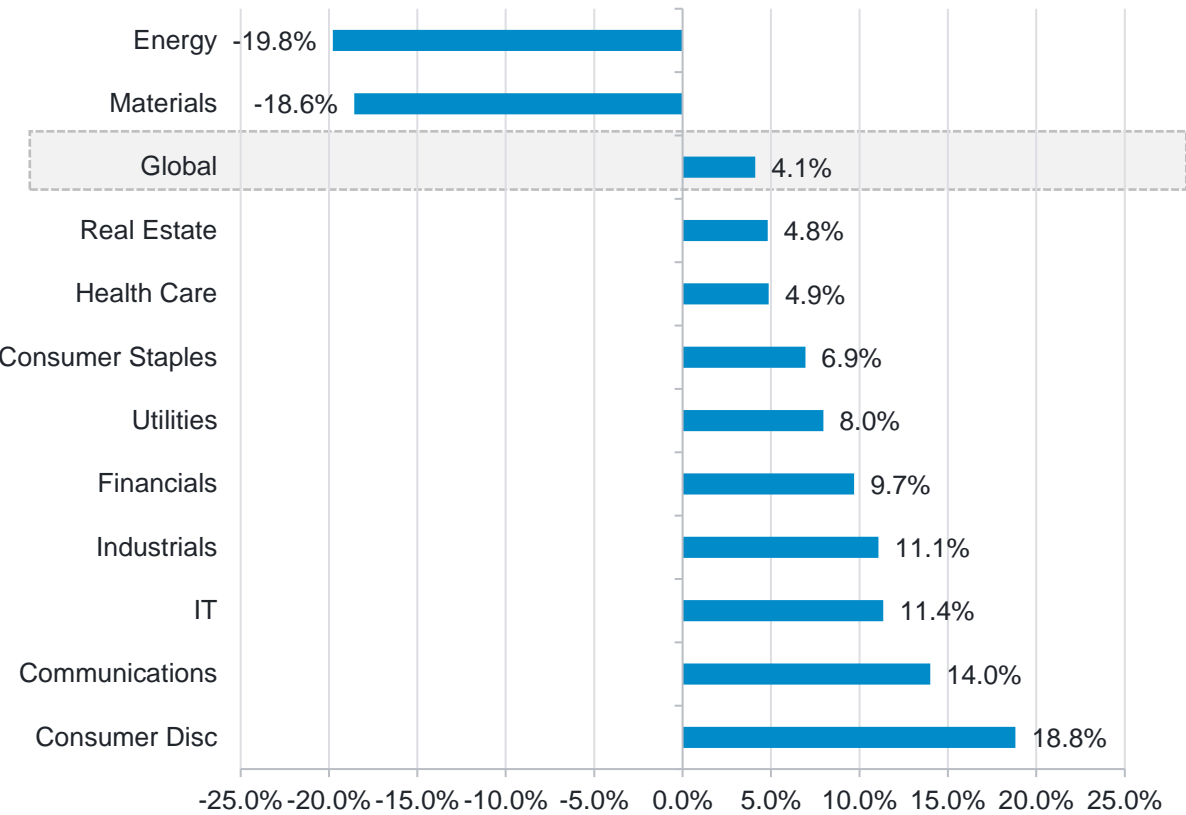


Source: Fidelity International, 10 Sep 2022

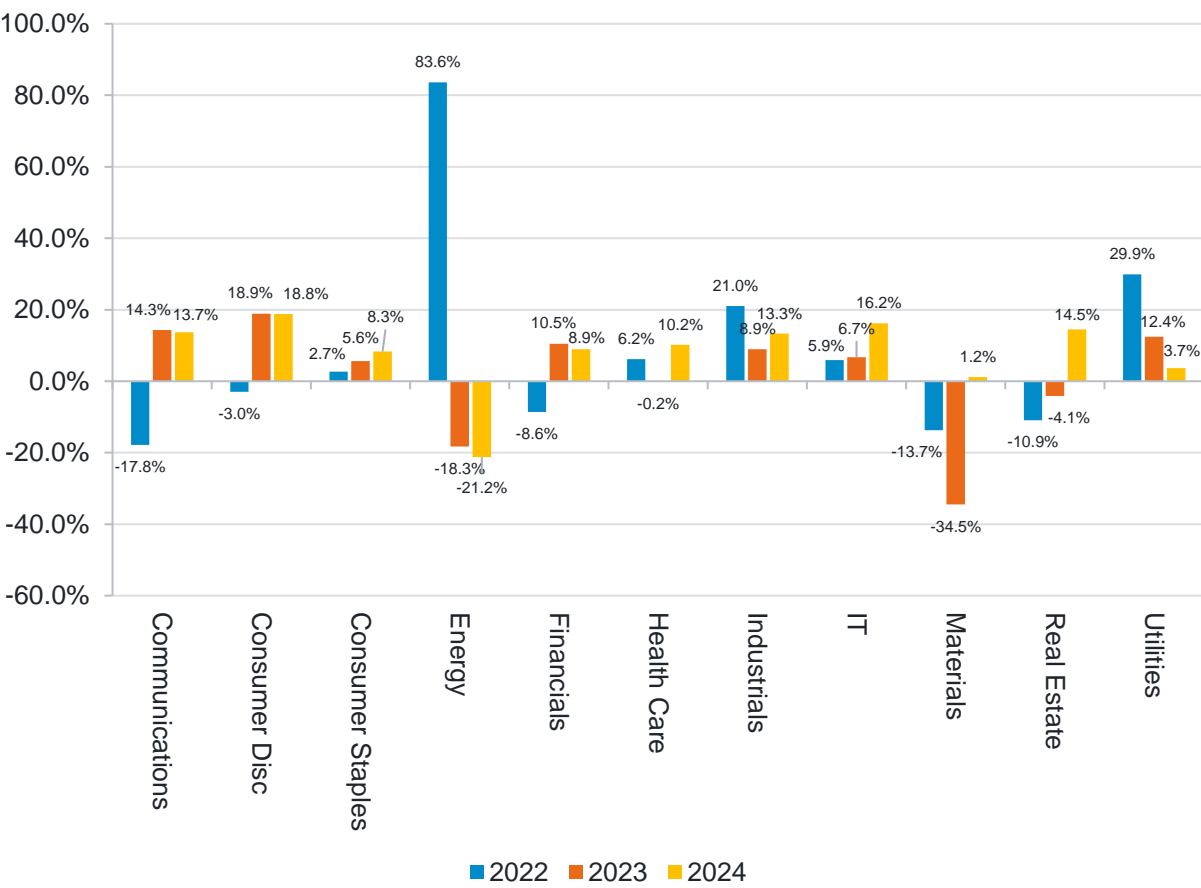
Earnings Outlook by Sector

Aggregate earnings growth estimates by sector

Aggregate earnings growth estimates by sector (CAGR over CY22-24)



Aggregate earnings growth estimates by sector, YOY



Source: Fidelity International, 10 Sep 2022

Multi Asset

Multi Asset: Key takeaways

Cash is king

- We believe that the deteriorating macro outlook is not reflected in earnings forecasts. While broad equity indices are down significantly from their highs, a sober look at valuations and earnings expectations suggest further downside. We are positioned defensively with a max overweight to cash.

Prefer US equities to Europe

- Europe is facing a uniquely negative economic outlook driven by energy prices. The bear case is added to by the ECB, which is now committed to a hawkish path. We prefer the safety of the US where economic data are more resilient, especially sectors with relatively reasonable valuations.

US Dollar is key

- Higher terminal rates, stubborn inflation, and weak sentiment suggest continued momentum. However, EM FX face headwinds; they have been surprisingly resilient recently as the dollar has strengthened, and could come under pressure, especially given weakness in China.

Defensively positioned in credit

- We prefer investment grade (IG) credit on valuations grounds. We are underweight EM hard currency debt, however. Valuations in non-distressed names are relatively tight and are vulnerable to the stronger dollar and the general tightening of credit conditions.

Key views and asset allocations

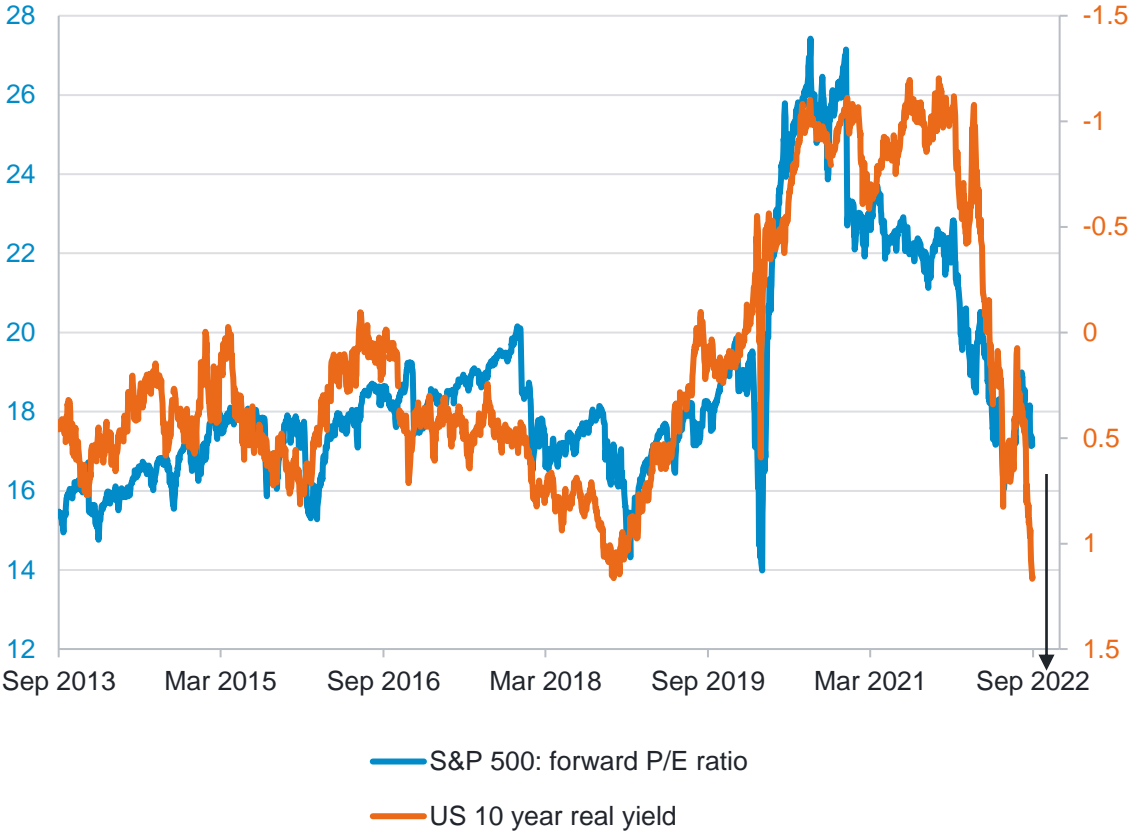
Core views	Core asset allocation	Other investment implications
Deteriorating macro outlook not reflected in earnings forecasts	<ul style="list-style-type: none"> Overweight Cash, underweight Equity 	<ul style="list-style-type: none"> Underweight Global Semiconductor equities Underweight US Homebuilder equities Overweight US Consumer Staples and 'Quality' equities vs. S&P 500
The energy price shock on households and industry is very large, especially in Europe	<ul style="list-style-type: none"> Underweight European Equity (vs. US) 	<ul style="list-style-type: none"> Overweight European Staples Equities vs. European Industrials Overweight Korean equities vs. German DAX, UK mid-caps Underweight European Automaker equities Long Malaysian Ringgit vs. Korean Won, Thai Baht Long Australian Dollar vs. Basket (including GBP)
Global central banks are committed to do 'whatever it takes' to fight inflation Financial conditions are tightening on all fronts, with the full impact yet to be seen	<ul style="list-style-type: none"> Overweight Cash, underweight Credit Overweight Investment Grade Corporates vs. EM Hard Currency Debt 	<ul style="list-style-type: none"> Overweight India Overweight Brazil Equities vs. World Overweight US Healthcare Equities vs. US Growth Equities
China is set to remain weak, for idiosyncratic reasons	<ul style="list-style-type: none"> Long USD vs. EMFX 	<ul style="list-style-type: none"> Short Taiwan Dollar, Chinese Yuan vs. USD Short New Zealand Dollar Asian Electric Vehicle beneficiaries vs. China equity index

Source: Fidelity International, September 2022

Multi Asset: With growth slowing and real yields surging, we look to cash for now

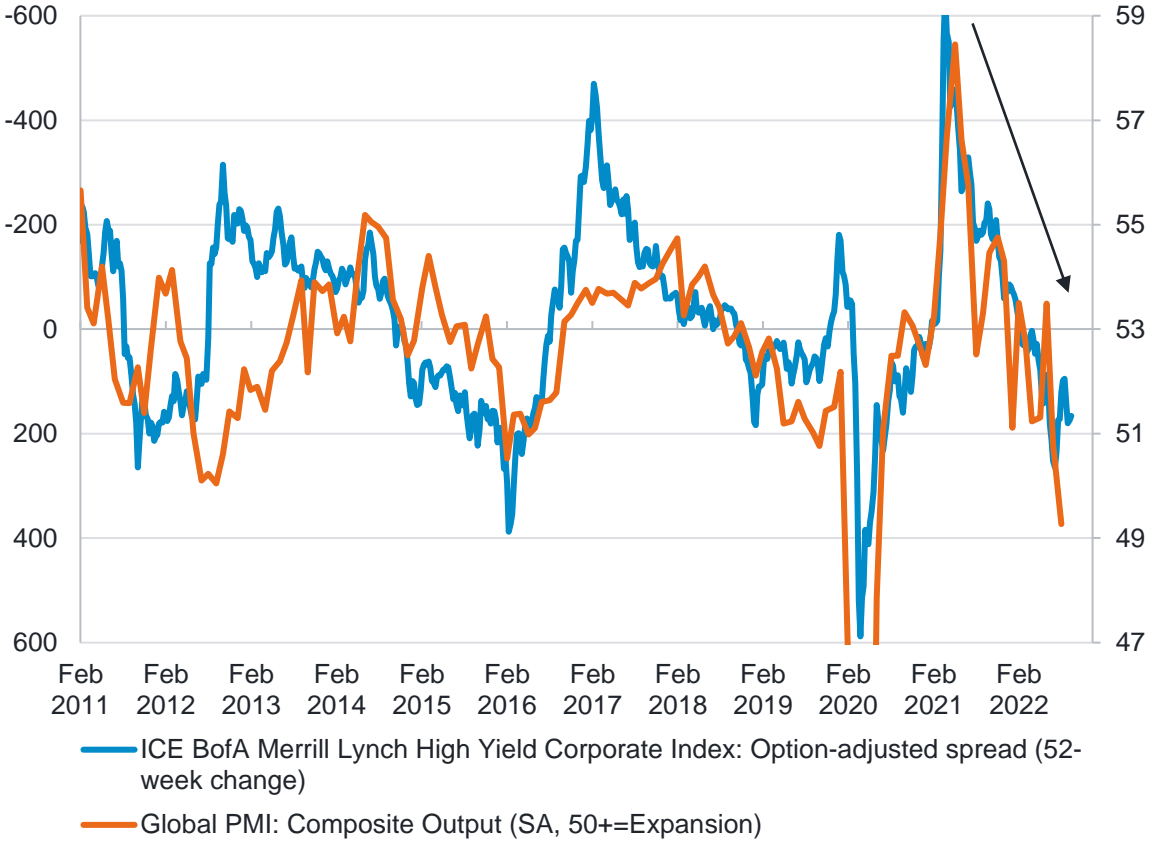
Multi Asset	
Equity	ooo
Credit	ooo
Duration	ooo
Cash	ooo

The tighter monetary policy required to combat inflation suggests further weakness in major equity indices



Source: Bloomberg, September 2022.

Bond markets now seem rather too relaxed on inflation



Source: Markit, BofA; Haver Analytics, August 2022

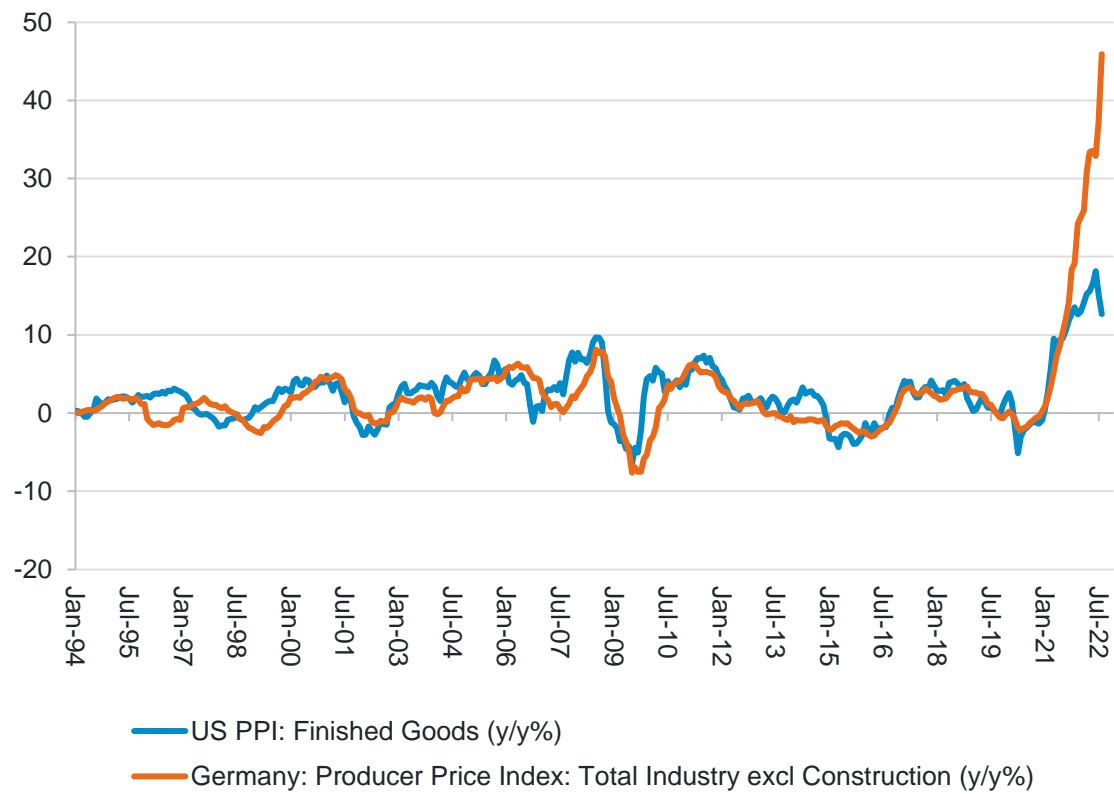
Equity Regions: prefer US to Europe

Europe likely faces a far worse winter than the rest of the world

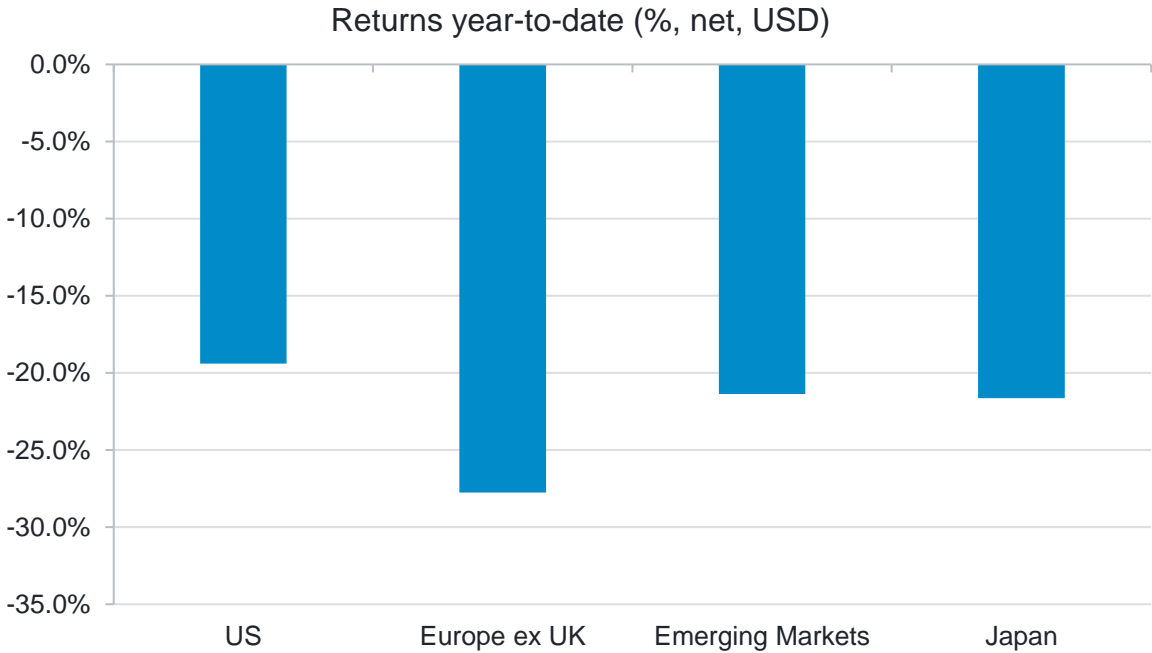
Equity Regional	
US	ooo●o
UK	oo●oo
Europe ex. UK	o●ooo
Japan	oo●oo
Pacific ex. Japan	oo●oo
EM	oo●oo

European industry faces a price shock far greater than the rest of the world, which will hurt profits and limit production

Europe’s underperformance year-to-date has not been as large as might be expected, suggesting more downside risk



Source: BEA, Bundesbank; Haver Analytics, September 2022.



Source: Bloomberg, MSCI net return indices in US\$, as of September 20th; September 2022

Credit: investment grade looking safer on valuations and fundamentals

EMs still too vulnerable to ‘buy the dip’, and many lack valuation support

Credit

IG Credit

Global High Yield

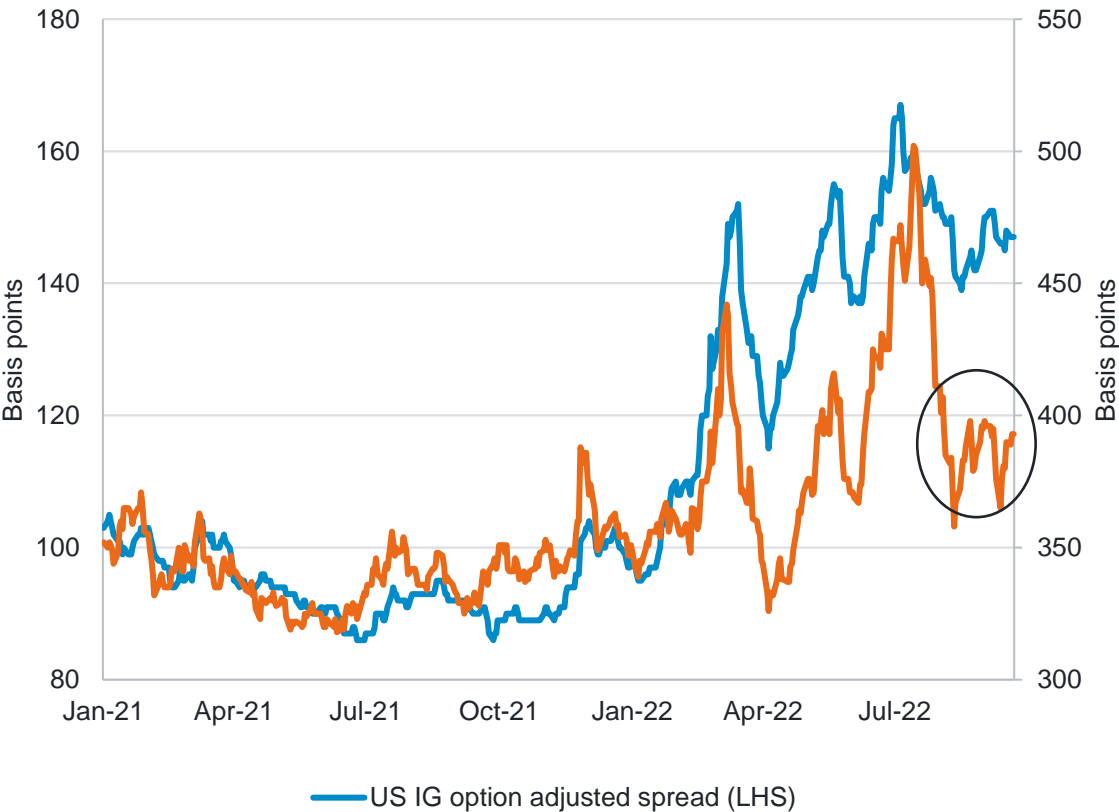
EMD \$

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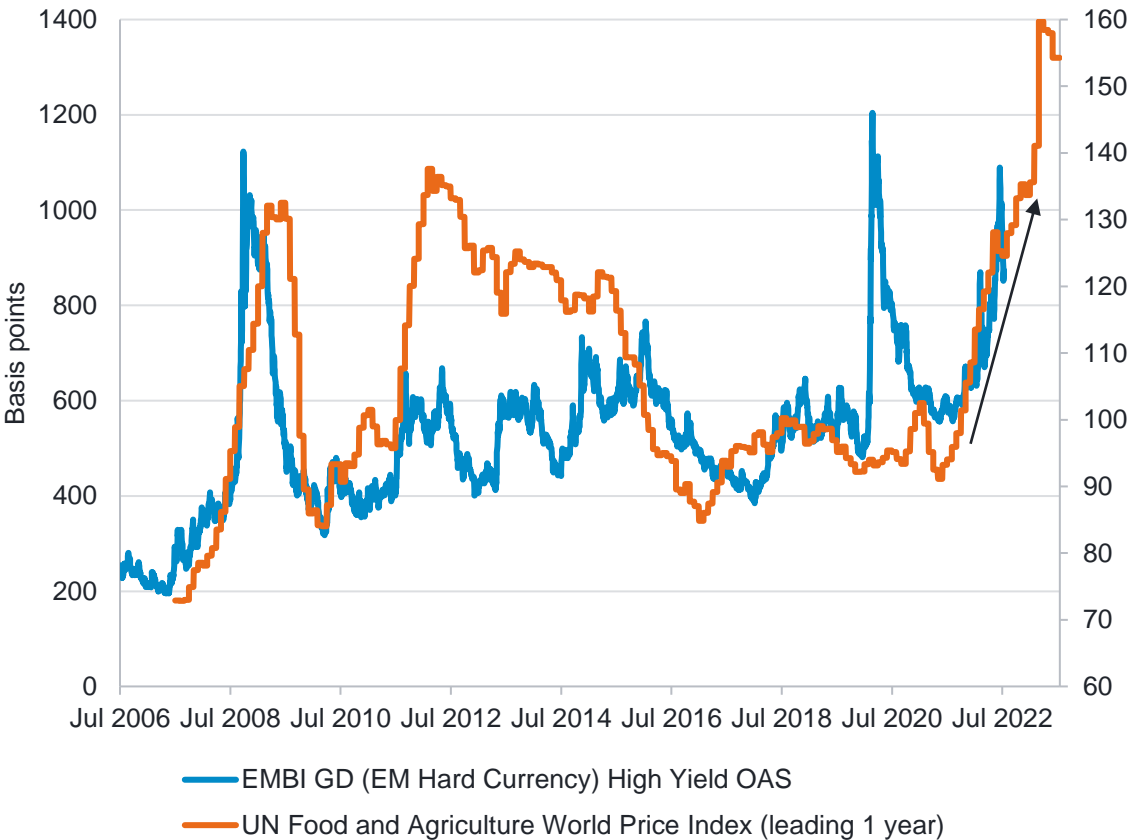
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Excluding the most distressed countries, Emerging Market debt valuations have not corrected all that much



Indices used: JPM EMBI GD BB; ICE BofA US corporate. Source: Refinitiv, Fidelity International, September 2022.

The EM Debt index contains many countries that are acutely vulnerable to rising food prices and a strong US Dollar



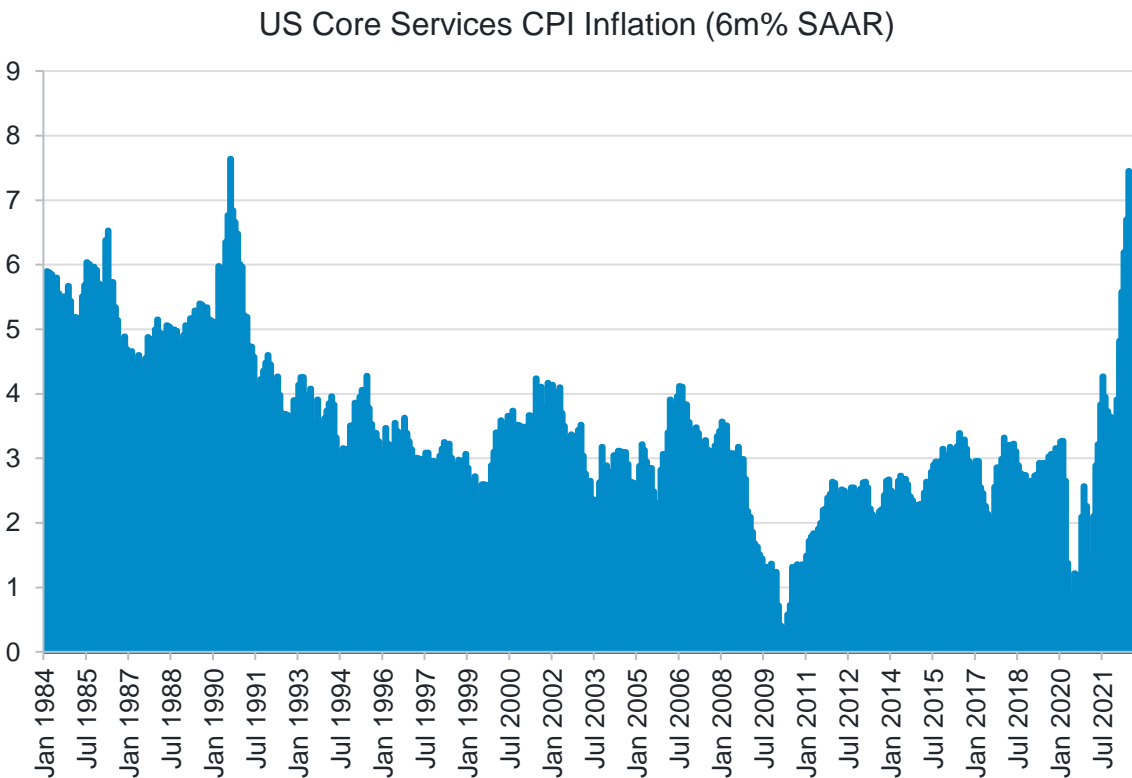
Index used: JPM EMBI GD. Source: JP Morgan, UN; Bloomberg, August 2022

FX: reinitiating long USD, as Fed keeps ‘hiking for bad reasons’

EMFX does not look stretched to the downside, so makes for an attractive hedge

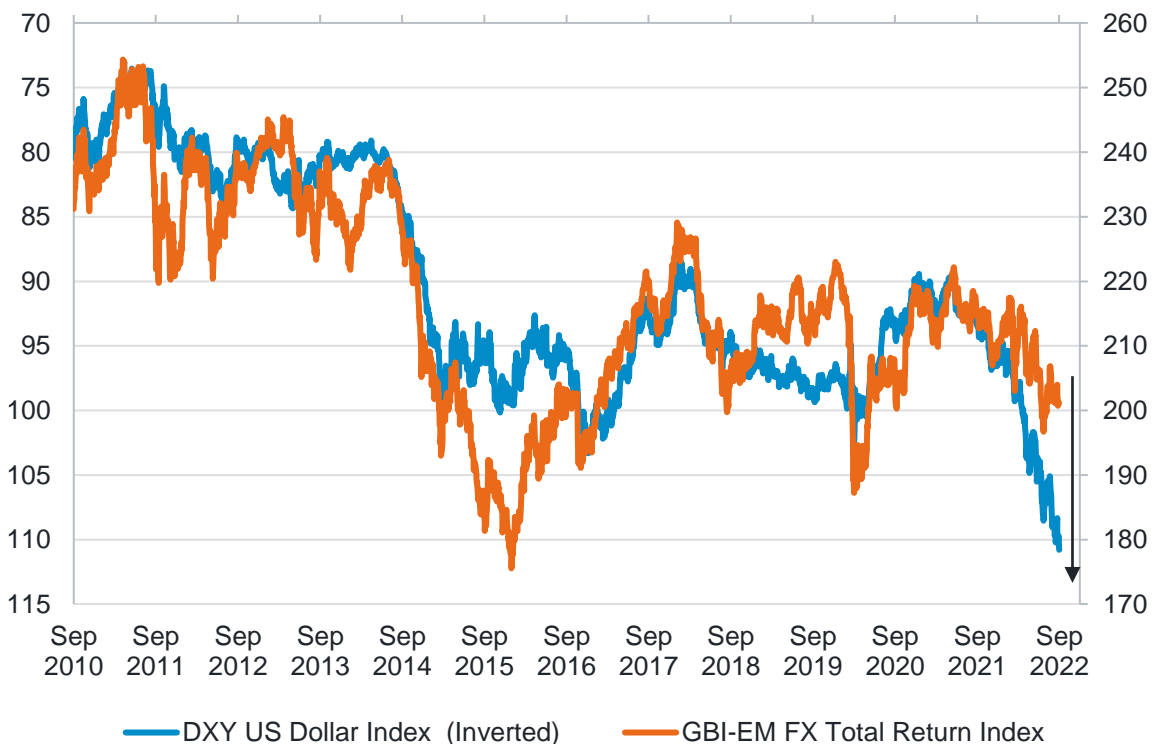
Currency	
USD	ooo●o ↑
EUR	oo●oo
JPY	oo●oo
GBP	oo●oo
EM Fx	o●ooo ↓

The latest US CPI report brings us back to the 1980s, and opens the door to more painful US Dollar Strength



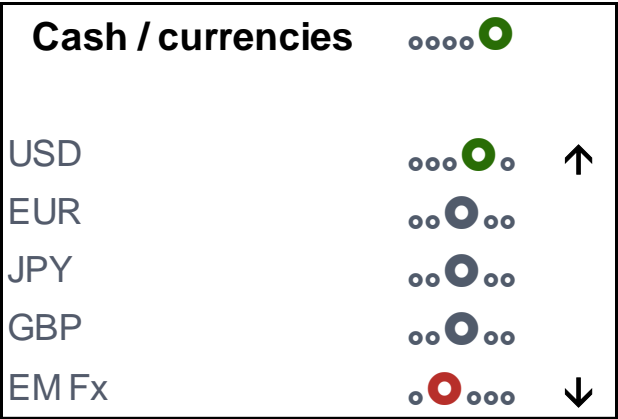
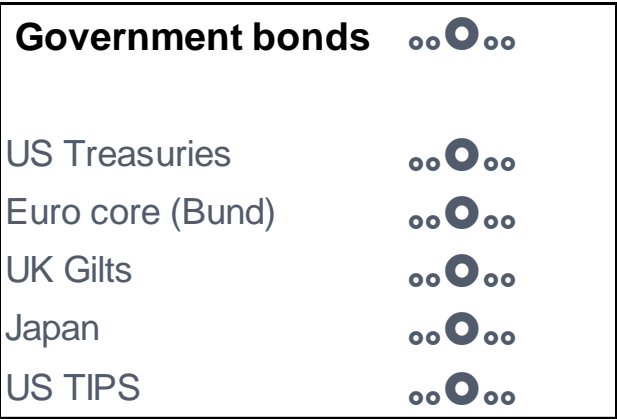
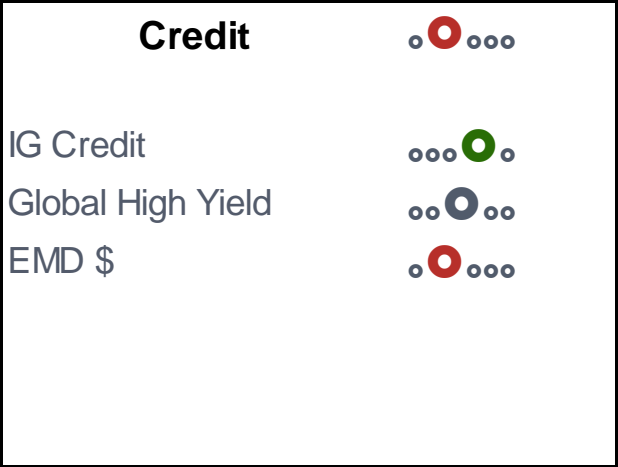
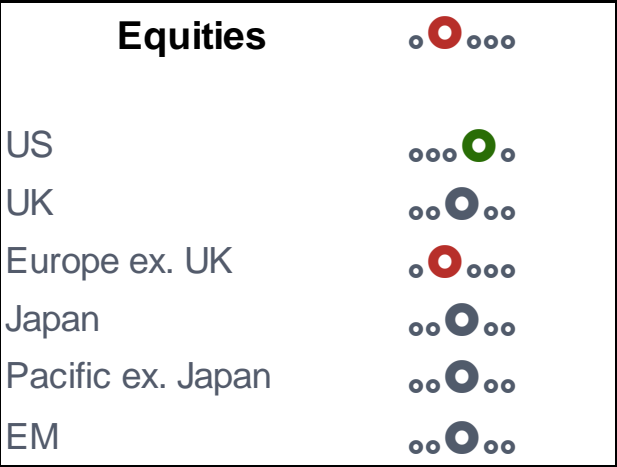
Source: BLS, September 2022.

EMFX has not yet fallen as much versus USD as most major crosses, suggesting further USD strength could hit EM more



Source: Bloomberg, September 2022.

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



Other Key Views

Commodities

- Underweight commodities overall as macro headwinds have intensified.
- Energy still interesting, but recession risks are outweighing supply/demand fundamentals and make us neutral.

US Sectors

- Strong underweight consumer discretionary, underweight communication services and materials.
- Strong overweight healthcare, overweight industrials, and real estate.

Thematics

- Long renewables – structural growth runway and policy support
- Long software/tech – strong earnings and guidance in Q2; offers structural non-cyclical growth.

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

Equities

Equities: Key takeaways

Higher discount rates have deflated multiples

- Longer duration cash flows have been derated and value has proved resilient in falling equity markets. Whilst inflation may have started to rollover, it remains unclear how much damage higher rates will do to corporate earnings.

US still trades at a premium to other DMs

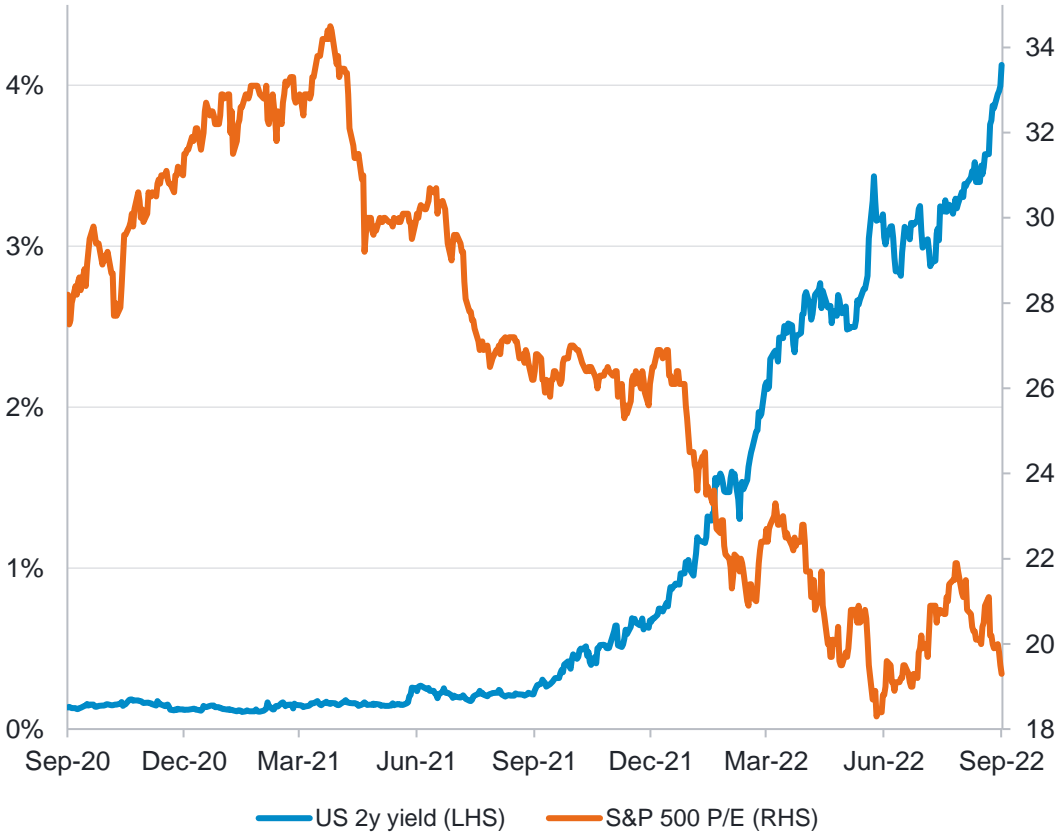
- The chasm between valuations in the US and the rest of the developed equity universe remains substantial.

China – more policy support needed

- The group remains cautious on China equities for the coming quarter, given policy uncertainty, the halting nature of the recovery, and continued downside risks in China property. However, the 20th Party congress could provide more clarity on policy, and given how weak sentiment is, there is the chance of a positive surprise.
- We are more optimistic on China equities over a longer time horizon due to positive secular drivers.

Navigating the trade-off between higher discount rates and inflation peaking is key

Higher discount rates have depressed multiples...



Source: Refinitiv, Fidelity International, September 2022.

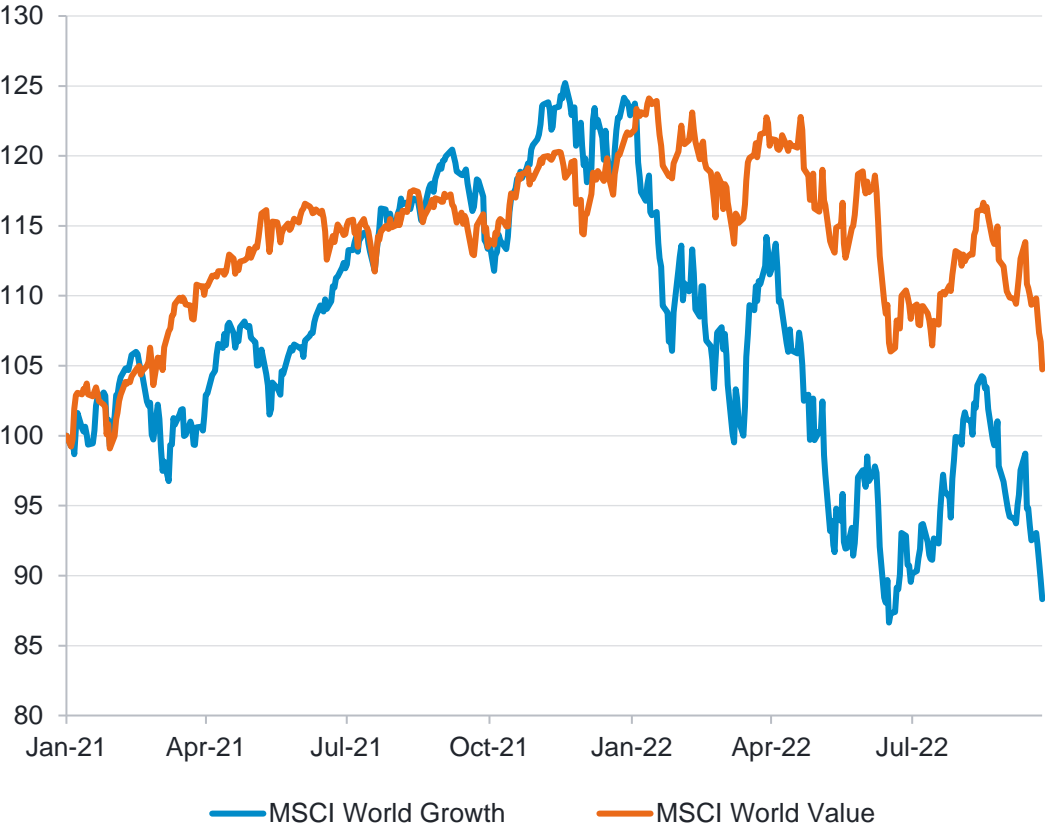
... but inflation peaking could ease pressure. US breakevens have already rolled over



ICE BofA 1-10 Year US Inflation-Linked Treasury Index. Source: Refinitiv, Fidelity International, September 2022.

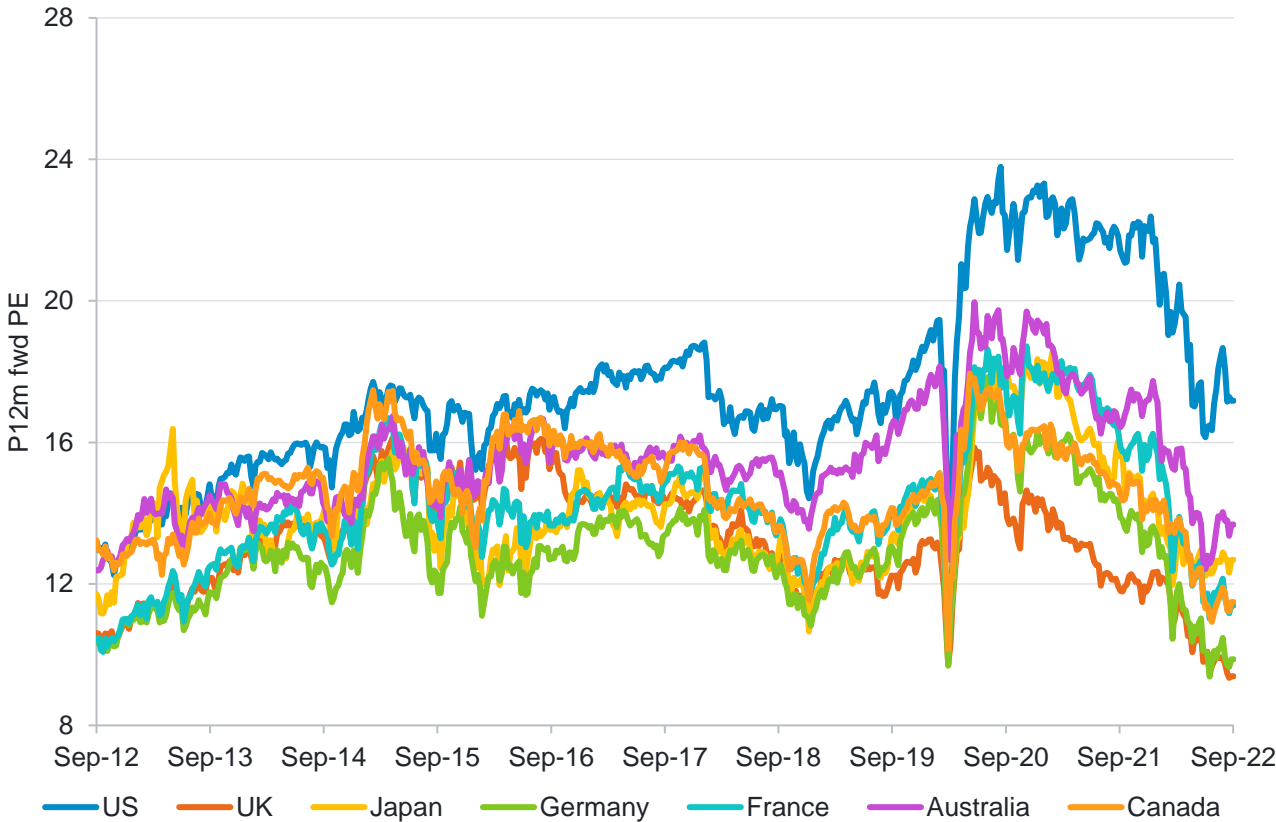
US valuation gap vs other DMs remains wide

Longer duration growth stocks have been hurt by higher rates



Source: Refinitiv, Fidelity International, September 2022.

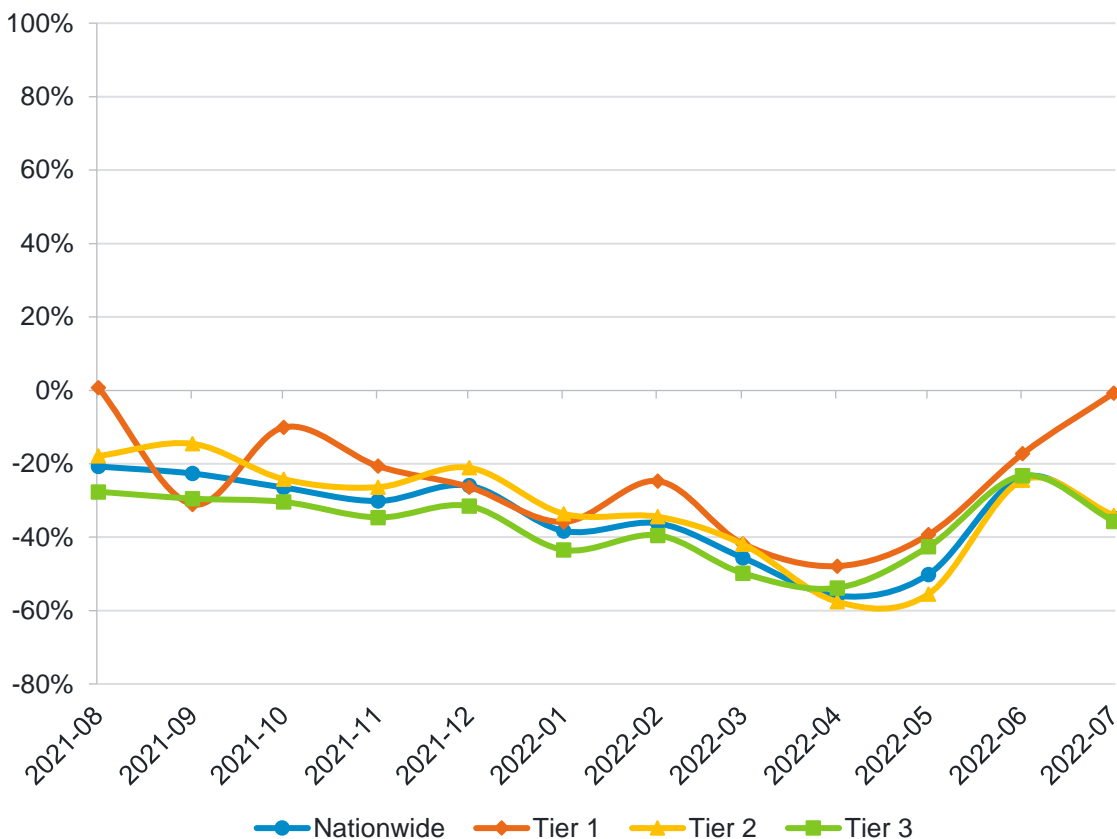
Investors still paying a premium for US exposure



MSCI indices. Source: Refinitiv, Fidelity International, September 2022.

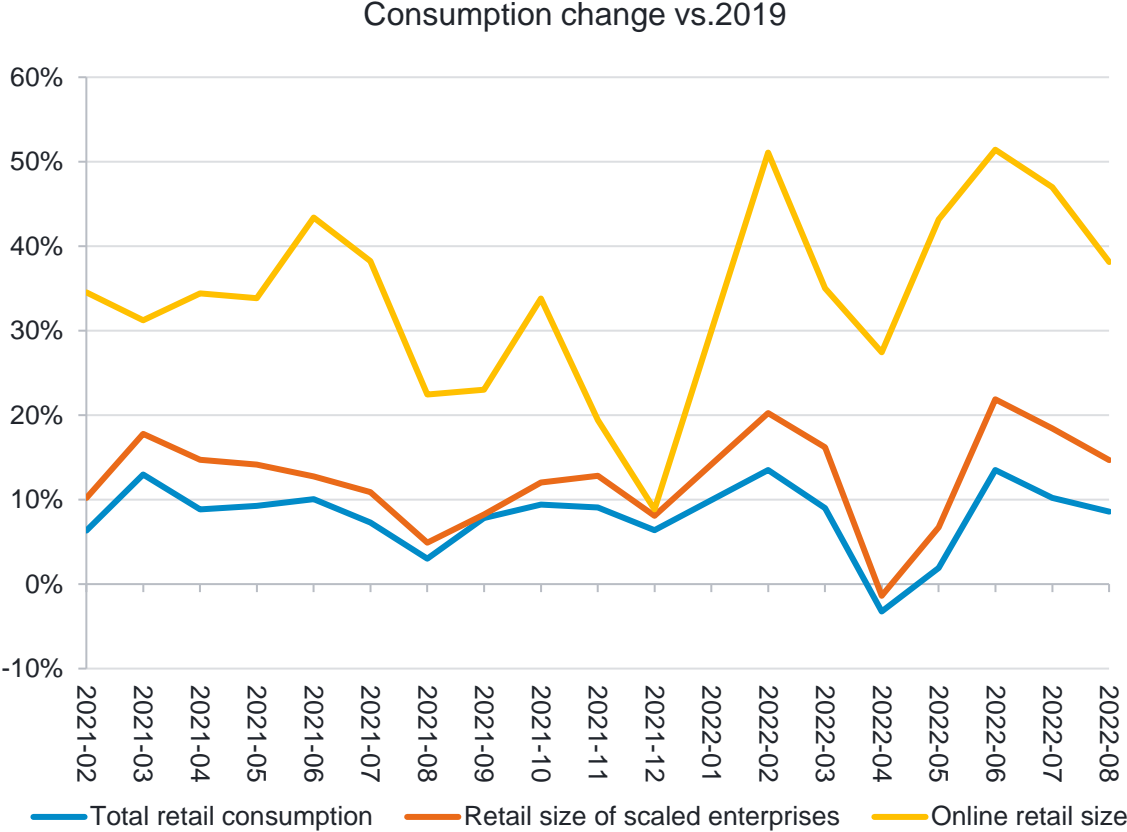
Cautious on China given ZCP, policy uncertainty and property sector instability

New home sales GFA YoY, hit by mortgage boycott in July...



Source: CICC, July 2022

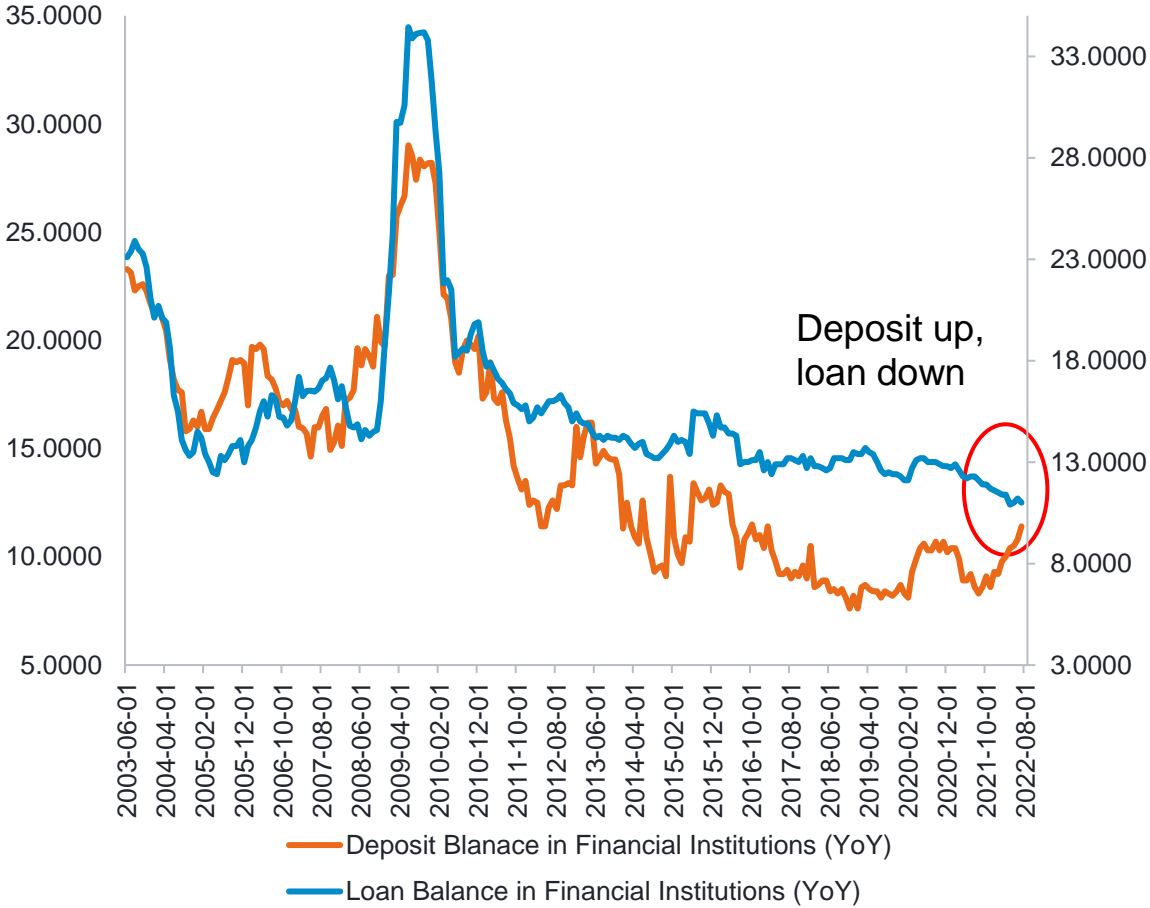
... while the broader recovery path remains choppy



Source: National Bureau of Statistics, August 2022

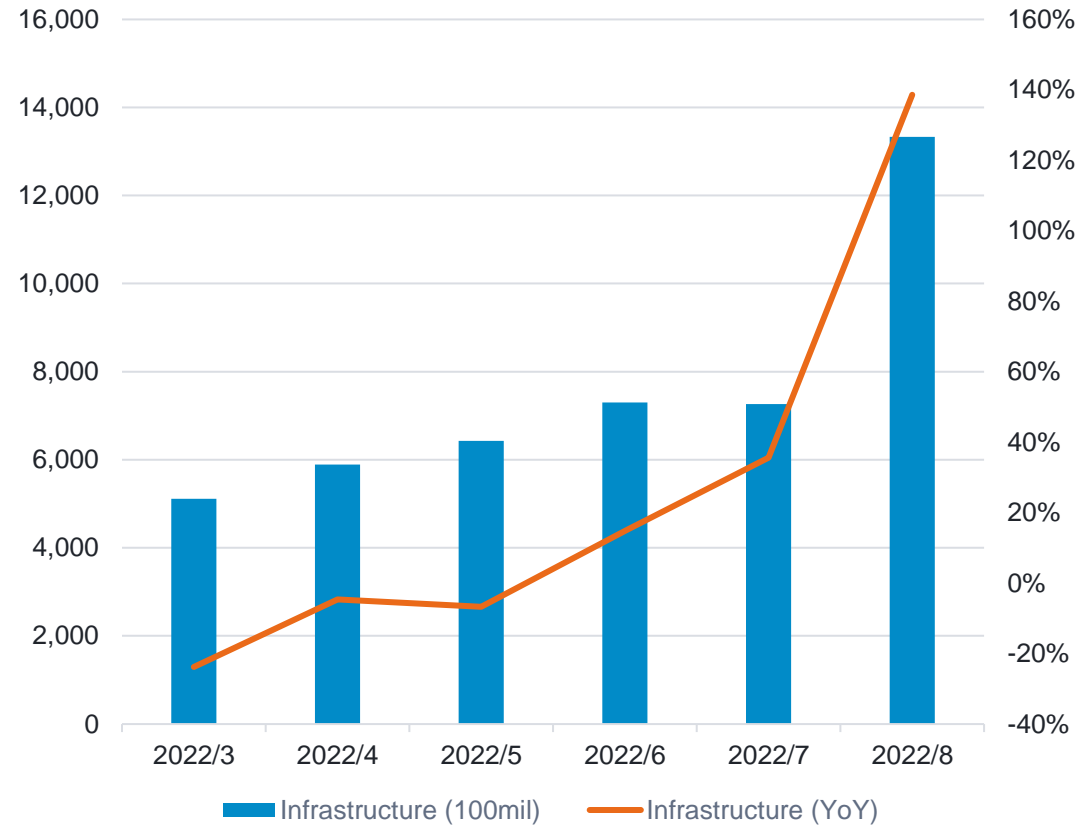
China is providing monetary and support, but shying away from wide-scale stimulus

Monetary policy is more supportive but credit expansion channel is suppressed by ZCP...



Source: PBOC, WIND

... while infrastructure projects are ramping up



Source: CICC, as of September 11th, 2022

Fixed Income

Fixed Income: Key takeaways

Time to be defensive

- Investors should prioritise protection in this recessionary environment. We favour IG bonds, where valuations remain relatively attractive, especially in Europe. IG yields barely moved after Powell's Jackson Hole speech, which could signal that hawkish sentiment is reaching a saturation point.

Long US and EU duration

- Europe and the US are on the brink of recession. We believe the Fed and the ECB will need to dial down their hawkishness to reflect this next year, meaning US Treasuries and Bunds should find support.

High yield (HY) not offering enough recession protection

- The risk of a hard landing is not yet fully priced into HY spreads. The implied 1y default rate in US HY is just 2.3%, roughly what might be expected in only a very shallow recession. We believe it is not yet time to get bullish on high yield.

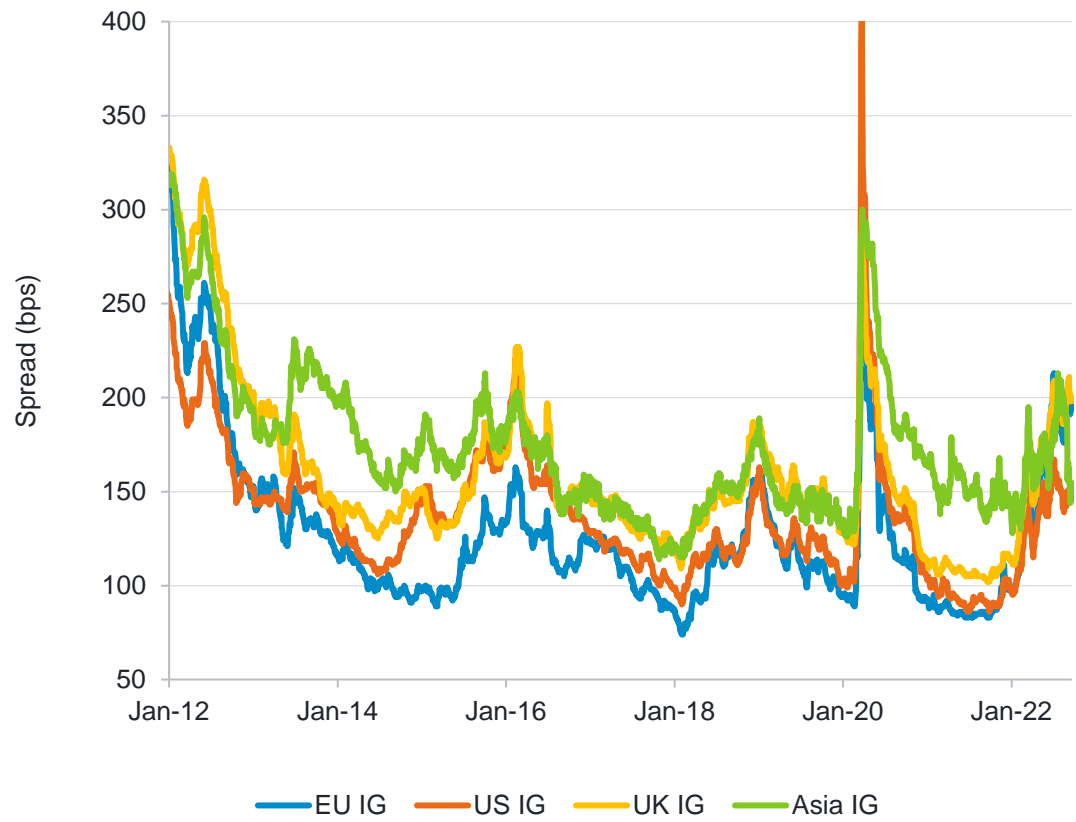
Central bank hawkishness makes breakevens unattractive for now

- UK and US breakevens should come under further pressure from hawkish central banks focused on inflation. However, we do see value in US breakevens over a longer horizon.

We continue to see attractive opportunities in IG markets

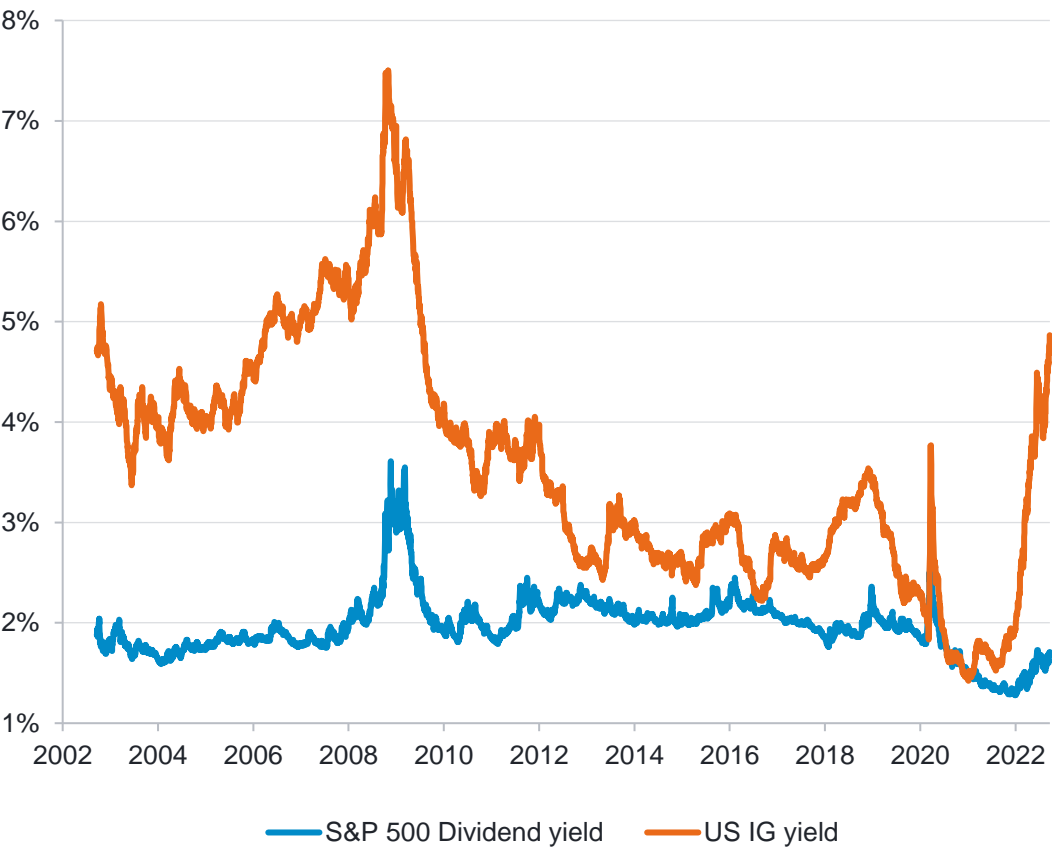
However, selectivity is key given growth outlook and central bank action

IG is relatively cheap in most regions...



Source: Refinitiv, Fidelity International, September 2022.

... and yields are now well above equity dividend yields

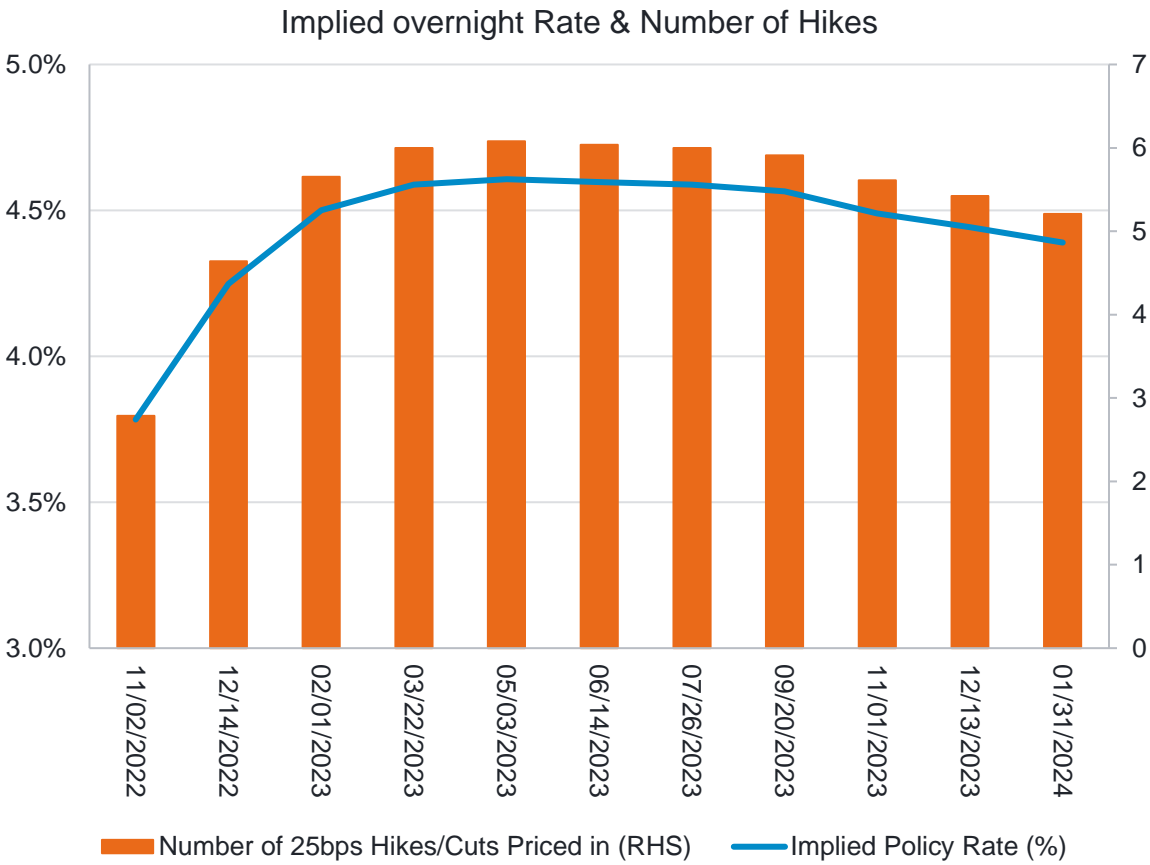


Source: Refinitiv, Fidelity International, September 2022.

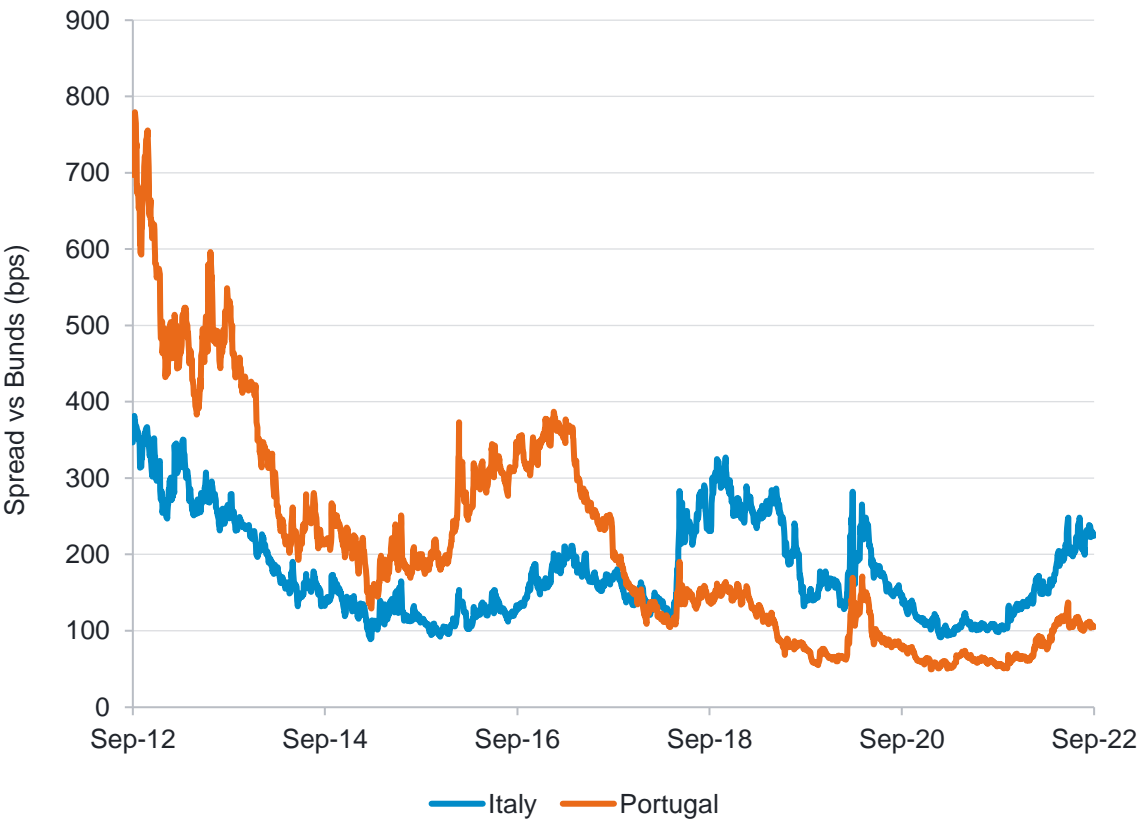
Long duration

High risk of recession in both Europe and the US lead us to be overweight USTs and Bunds...

... but we are wary of periphery debt for now as spreads keep widening



Source: Bloomberg, Fidelity International, September 2022.

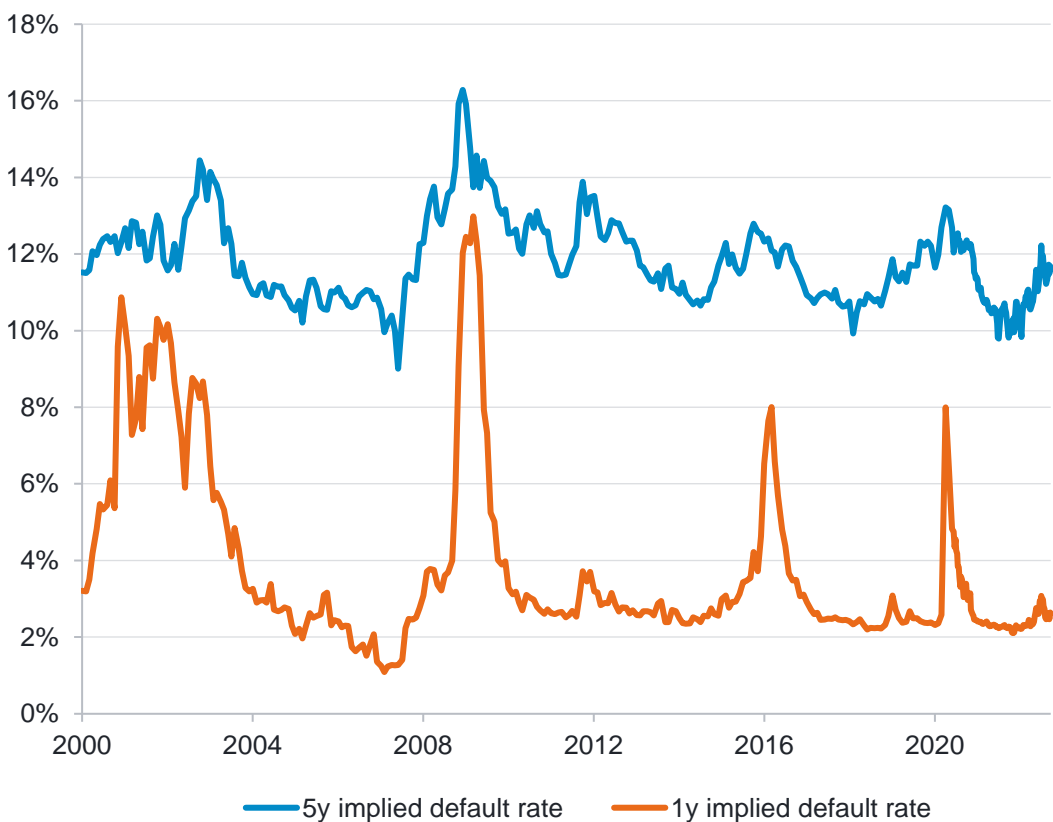


Source: Refinitiv, Fidelity International, September 2022.

US and EU HY not yet pricing in risk of hard landing

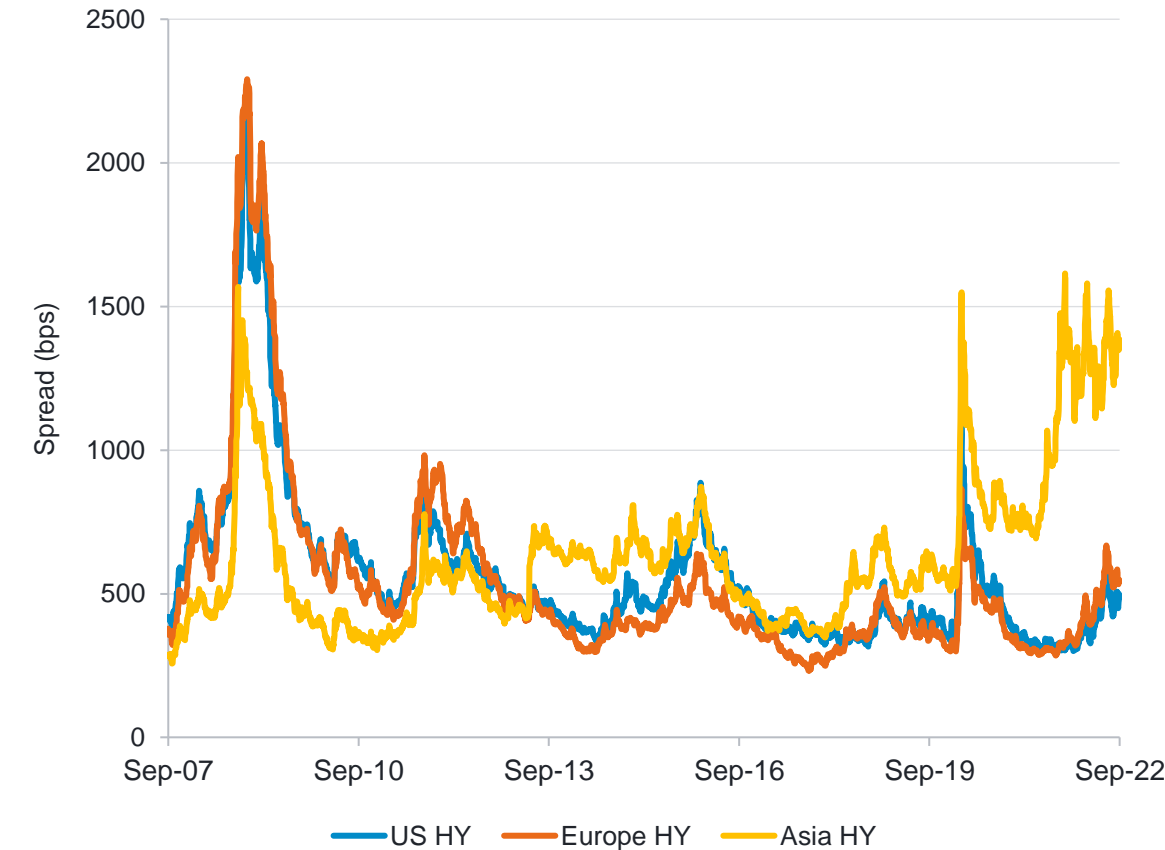
Asia HY looks better value given China policy support

Implied default rate of US high yield unrealistically low given recession risks



Source: Fidelity International, September 2022.

Spreads creeping up but room for further widening in US and Europe

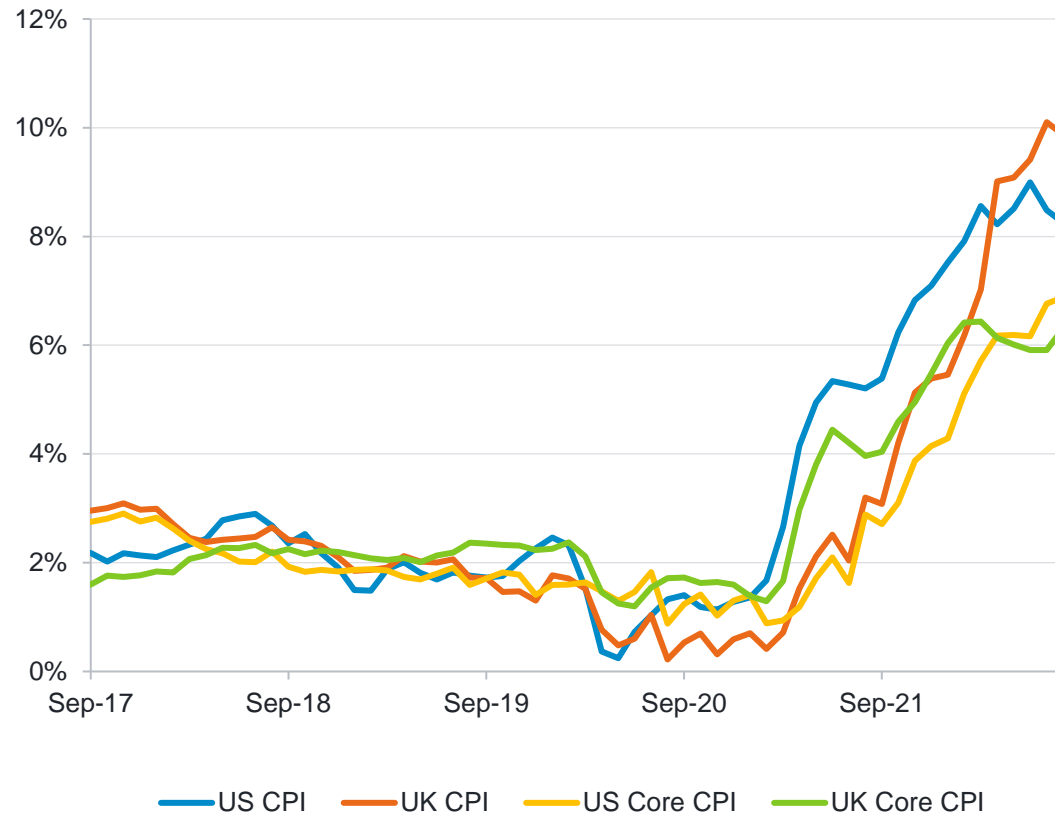


Source: Refinitiv, Fidelity International, September 2022.

Breakevens unattractive for now

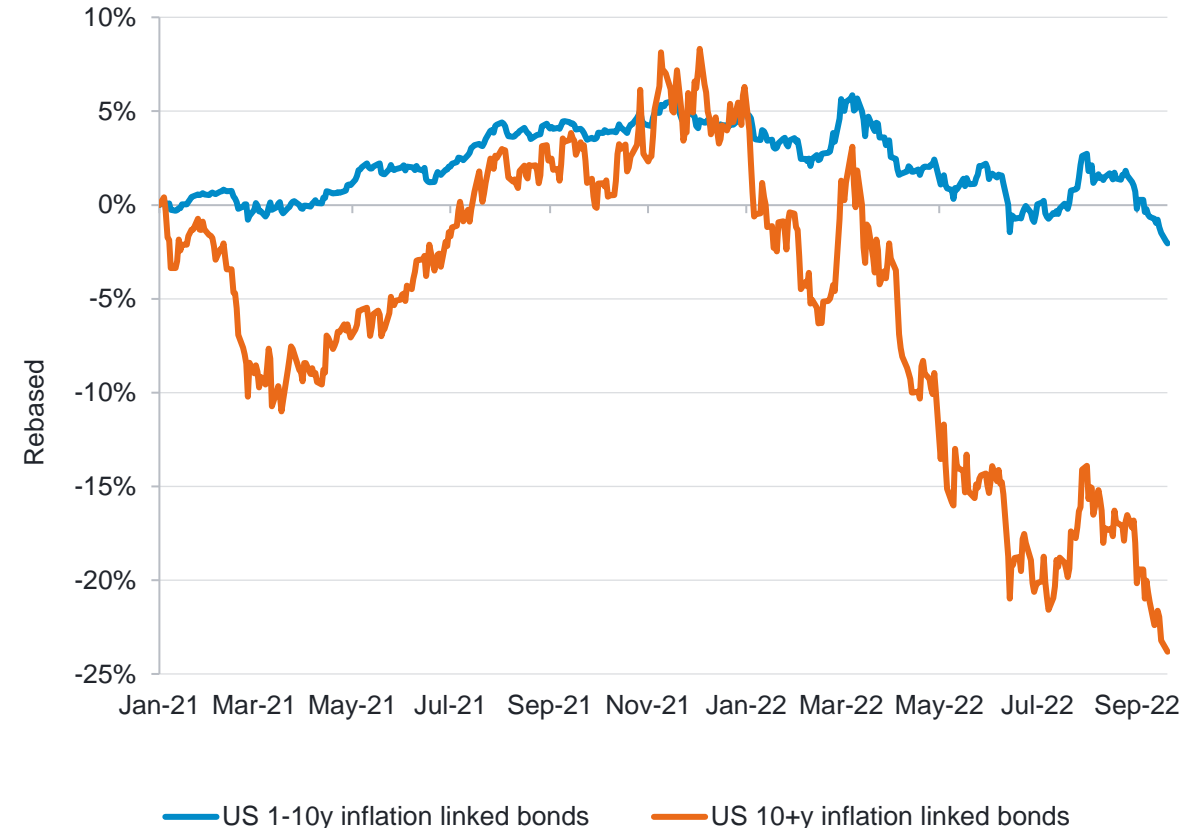
Central banks are focused on bringing inflation down, but US breakevens offer long-term value

High inflation will compel central banks to stay hawkish for Q4



Source: Refinitiv, Fidelity International, September 2022.

We retain a preference for 1-10yr inflation linked bonds over longer dated linkers



Source: Refinitiv, Fidelity International, September 2022.

Private Credit

Private Credit: Key takeaways

A defensive port to ride out the storm

- Floating rate nature of loans provides consistent income generation and positive total expected returns under a range of rising spread and interest rate scenarios.
- Inherent structural protection given loans' senior positioning at the very top of the capital structure, while the asset also features comparatively lower volatility rates.
- Valuations suggest significant excess spread income even after modelling for GFC-type default rates.

Sector composition focuses on defensive industries

- The business profile typically favoured by private equity sponsors prioritises recurring revenues, granular client exposure, high EBITDA margins, and good cash generation. Deal composition across syndicated, club, and direct loans skews towards technology, health care, and business services.

Underlying credit metrics remain robust (for now)

- CCC exposure as a percentage of the index remains moderate, and the maturity wall is manageable.
- Interest coverage ratios will deteriorate due to higher interest rates and reduced operating income, but the strong starting point provides a cushion and indicates most borrowers will have the liquidity to navigate through a tougher trading period.

Structures becoming more attractive

- New debt issues are structured more conservatively, factoring in the weakening macro picture.
- Primary issuance is pricing with a significant premium to encourage investor participation.
- Deals are being structured with higher equity cushions and lower senior leverage.

Default rates expected to rise, but valuations remain supportive

Current spread levels imply a 19.1% 1-year forward default rate (twice the max ever historical default rate of 10.5% in the GFC). Fitch has forecast default rates to reach 3% in their base case and 5% in their severe case.

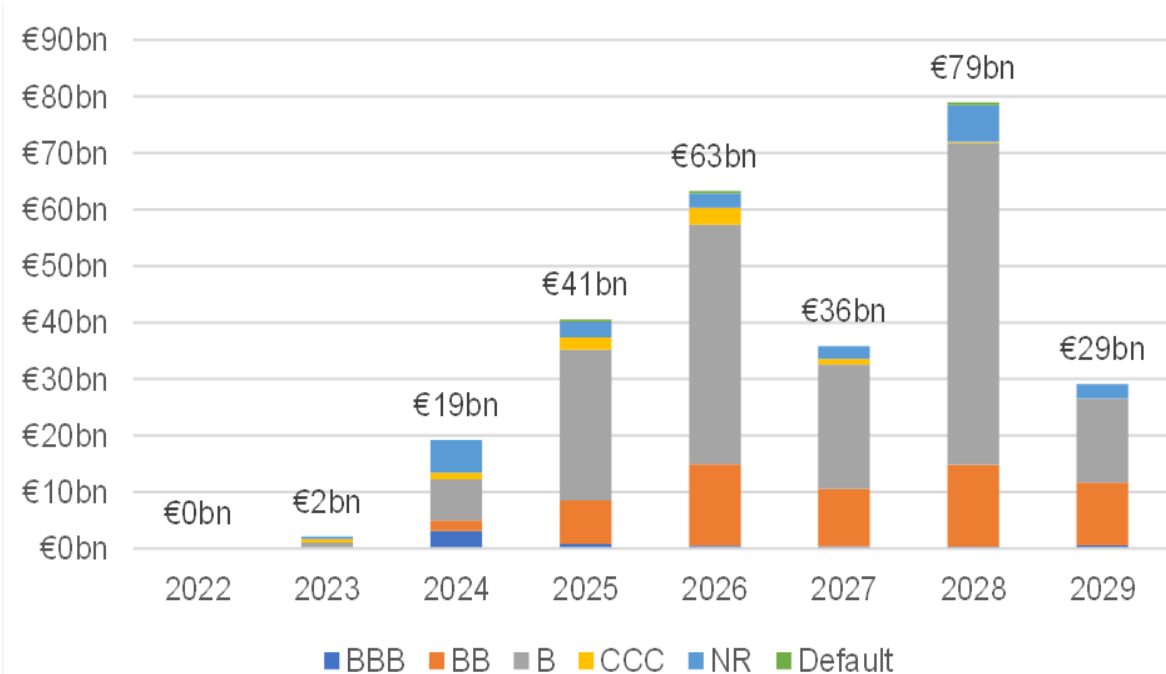
Trailing 12 Month Default Rates and Forecast



Source: Morningstar European Leveraged Loan Index, Fidelity International, September 2022. Fitch forecasts from Fitch Ratings Semi-Annual Defaults Insight. Market implied 1Y default rate implied using 3Y DM for EUR loans and FI Quant RNS calibration

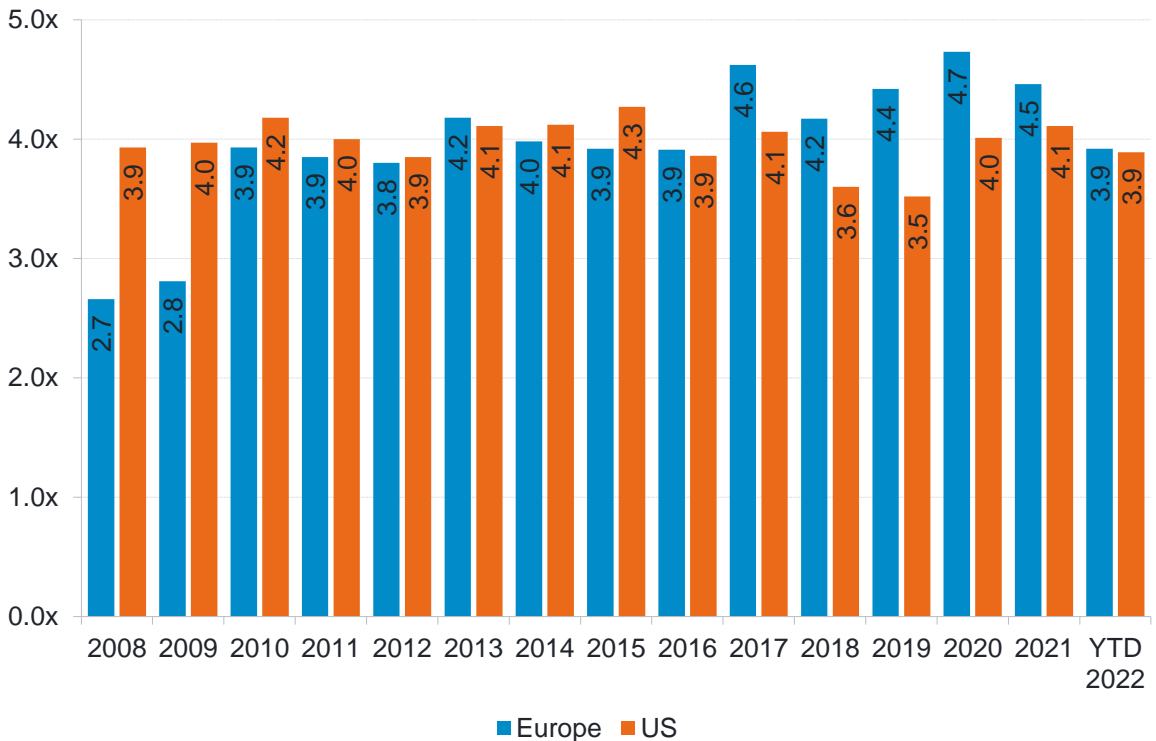
Private borrowers not under pressure to refinance until beyond 2024

Limited maturities means there is additional protection against rising default rates...



Source: Credit Suisse Western European Leveraged Loan Weekly – September 20th 2022

...while interest coverage levels, as a measure of affordability of debt, offer reasonable protections against rising rates

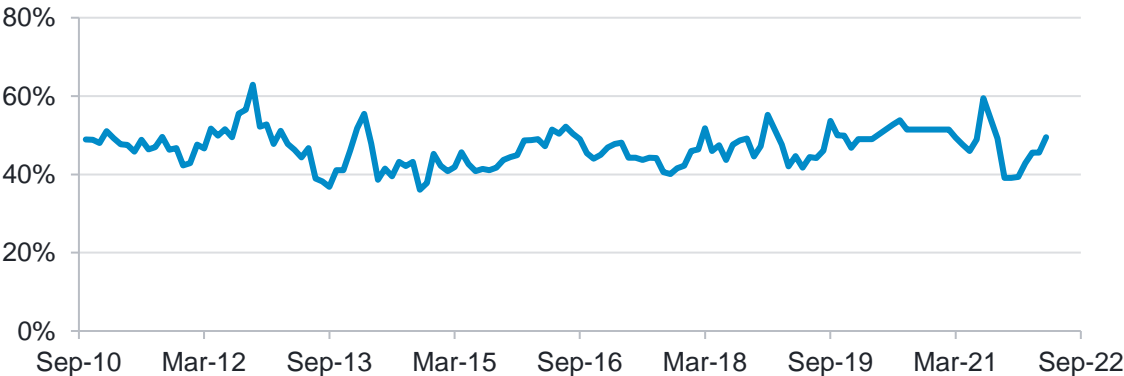


Source: Pitchbook/LCD

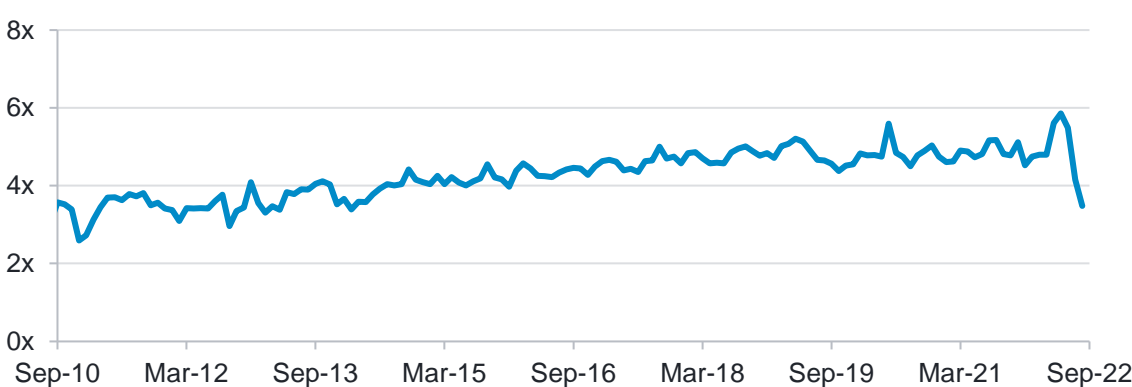
Primary markets could offer investors value as terms strengthen and yields rise

New issuance is coming with higher pricing and more conservative debt structures (higher equity cushions/lower leverage levels) providing attractive opportunities for market participants

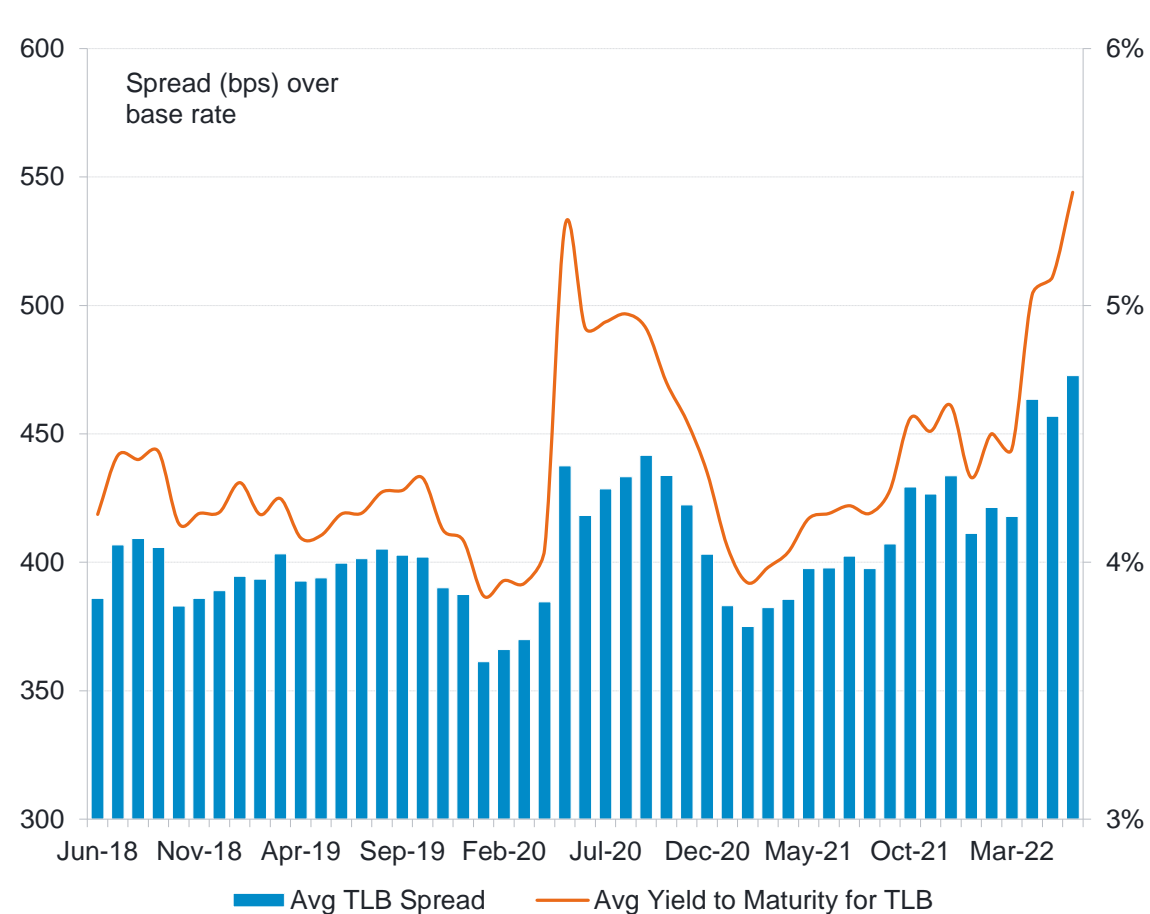
Rolling 3 Month Equity Contribution



Rolling 3 Month 1L Debt / EBITDA



Average Term Loan B Primary Spread and YTM



Source: Pitchbook/LCD

Real Estate

Real Estate: Key takeaways

Investment market gearing up for a busier Q4

- Q3 investment activity has continued the weakness seen last quarter, as the typical summer lull turned to a hibernation.
- The 'wait and see' period that often follows a market shift should end in Q4 as buyers/sellers realise higher rates are not going away any time soon.
- The steeply discounted currency could be a 'wildcard' for the market as some investors may use real estate as a play on currency.

Inflation protected leases

- There is some inflation protection via index linked leases, particularly in mainland Europe. These will drive rents and support values to some degree as yields shift outwards.
- But weak economic growth is a problem that together with high inflation may lead to overrenting in portfolios. This could hit valuations.
- Indexation is not a permanent protection as rents will be marked to market at some point.

Real estate pricing shifts well underway

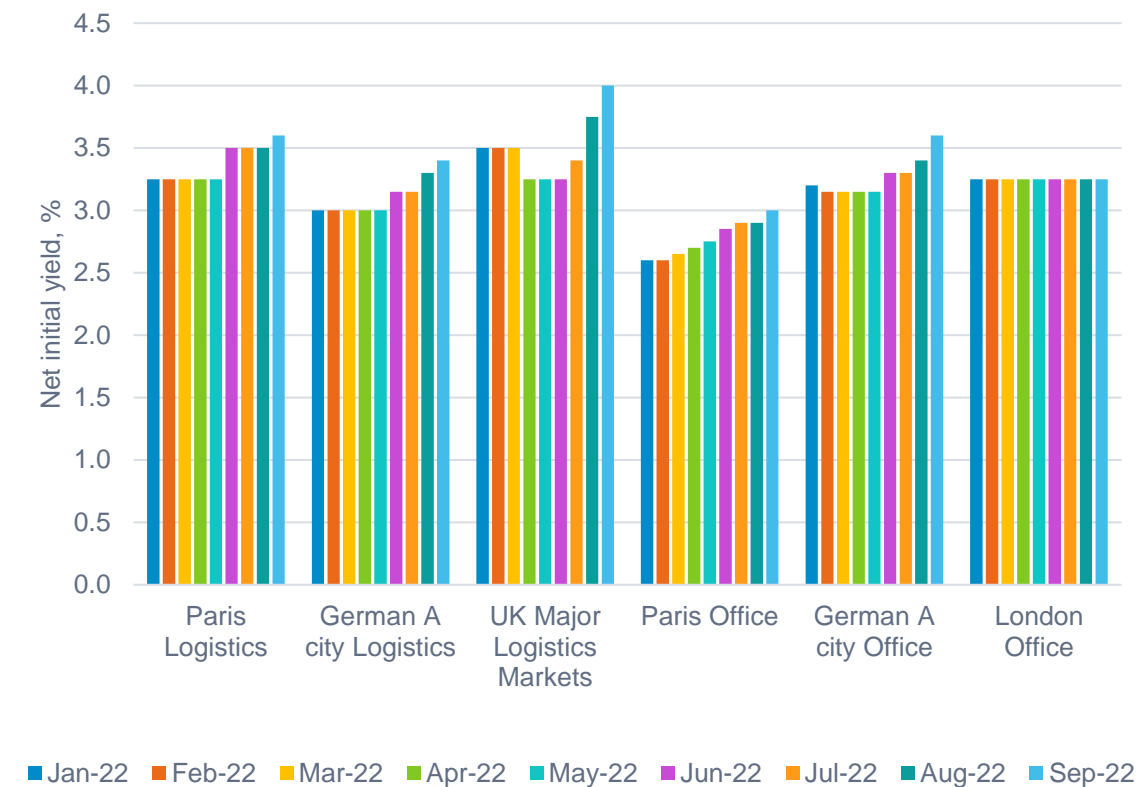
- There is a long lag between changes in interest rates and real estate values. This is more a function of how values are determined in the sector than a lack of sensitivity on behalf of investors.
- We have already seen pricing shift by 40-50bps at a market level, and we expect to see a similar yield shift by the end of Q4 as increased investment activity reveals where valuations truly lie.

Occupiers activity remains a bright spot

- Office take-up continues to improve, with a sharp focus on sustainability. The energy crisis has highlighted the relative attraction of 'green' buildings from an occupational cost perspective, but may also spur rationalisation of space.
- There are no signs of a significant slow down in demand for industrial space, despite announcements from e-commerce players. Vacancy rates remain low, supporting rents even when demand eases (occupier markets are inherently cyclical!).

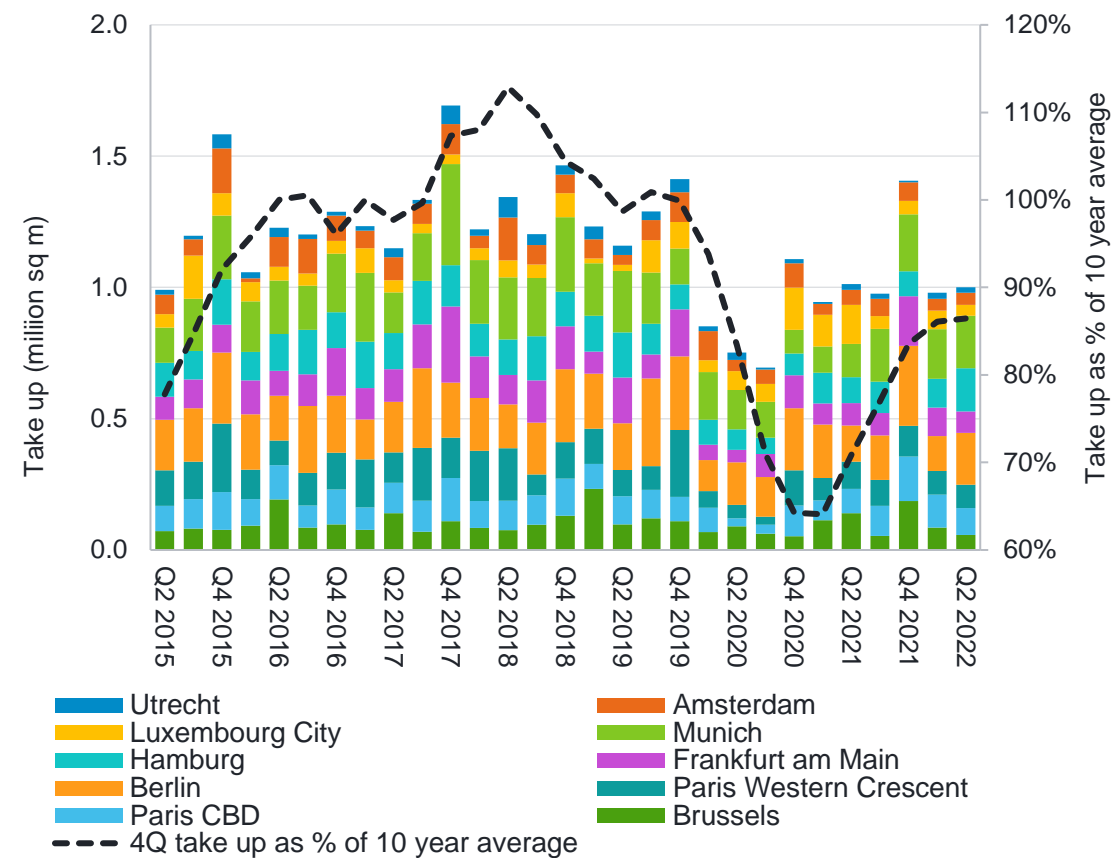
The summer marked a turning point for yields and repricing is not over yet

European net initial yield moves year to date



Source: CBRE, September 2022

Demand for office space in line with the same period last year

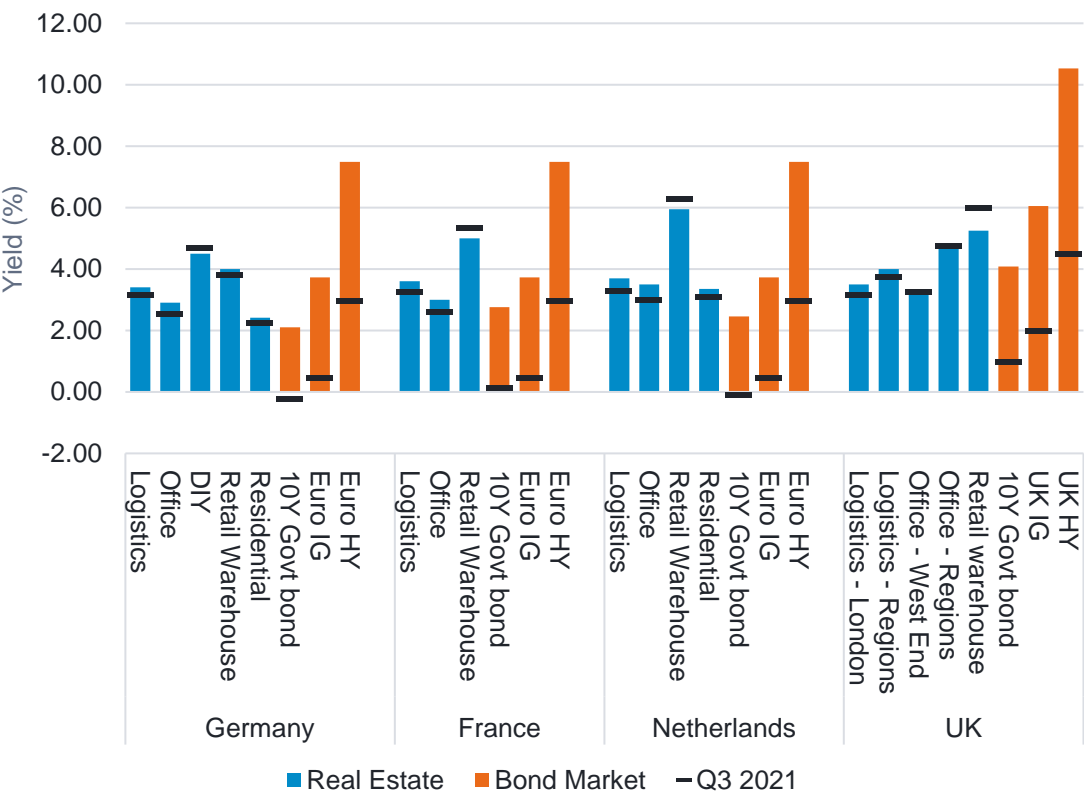


Source: CBRE, Fidelity International June 2022

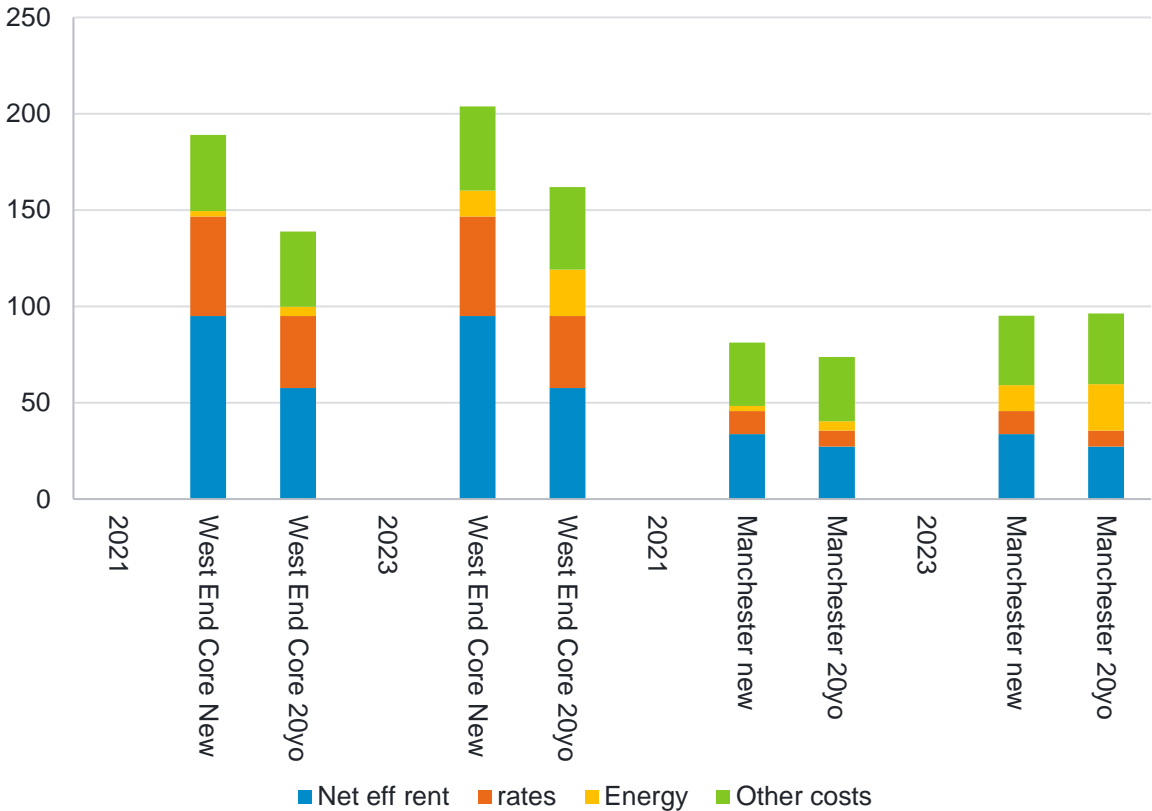
Real estate pricing looks vulnerable

Yield spreads have narrowed and occupational costs are rising rapidly

Risk premia for real estate being squeezed



Energy costs erode occupancy cost differentials between new and old buildings



Sources: Fidelity International, CBRE, September 2023, Bloomberg 26/09/2023; Lambert Smith Hampton 2021.

Source: Lambert Smith Hampton, Fidelity International, September 2022. Note: Other costs include fit out, furniture, insurance, internal R&M, mech & elec R&M, external R&M, int moves, reinstatement, security, cleaning, waste disposal, plants, water/sewage, tel, catering, reception, post/courier, printing and mgmt fees.

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