

Q4 2023 Investment Outlook

Resilience, refinancing, and recession risk

FIL Investment Management
October 2023



Resilience, refinancing, and recession risk

Three themes for Q4 2023

Diverging signals

- The economy is proving resilient, and expectations of a soft landing are rising. But positive headline data conceal a more nuanced picture. Reported inflation has started falling but our analysts are expecting both labour and non-labour costs to be sticky, and possibly even rise again.
- There are also signs that central banks' tightening monetary policies are not feeding through to the economy as quickly as hoped. Many companies, for example, are earning interest on their deposits but are not yet paying extra for the debt they accumulated at ultra-low rates during the pandemic. This situation could reverse rapidly as corporates begin to refinance their debt next year. We will be watching balance sheets and debt maturities closely.

Higher for longer?

- It appears likely the Federal Reserve has come to the end of its tightening cycle in the US, while the Eurozone won't be far behind.
- Nevertheless, there is little indication from central banks that they plan on cutting rates soon. It is likely we are entering a 'higher for longer' environment.
- This comes with risks, especially with corporate maturity walls coming fast into view. At the same time it is possible that central banks begin cutting rapidly if financial systems prove less resilient than they appear.
- The situation remains sufficiently uncertain to lead us to believe a recession is still more likely than not. We estimate there is a 60 per cent chance of a cyclical recession, in which unemployment in the US rises to 4.4-6.5 per cent over the next 12 months.

China – opportunity amid the uncertainty?

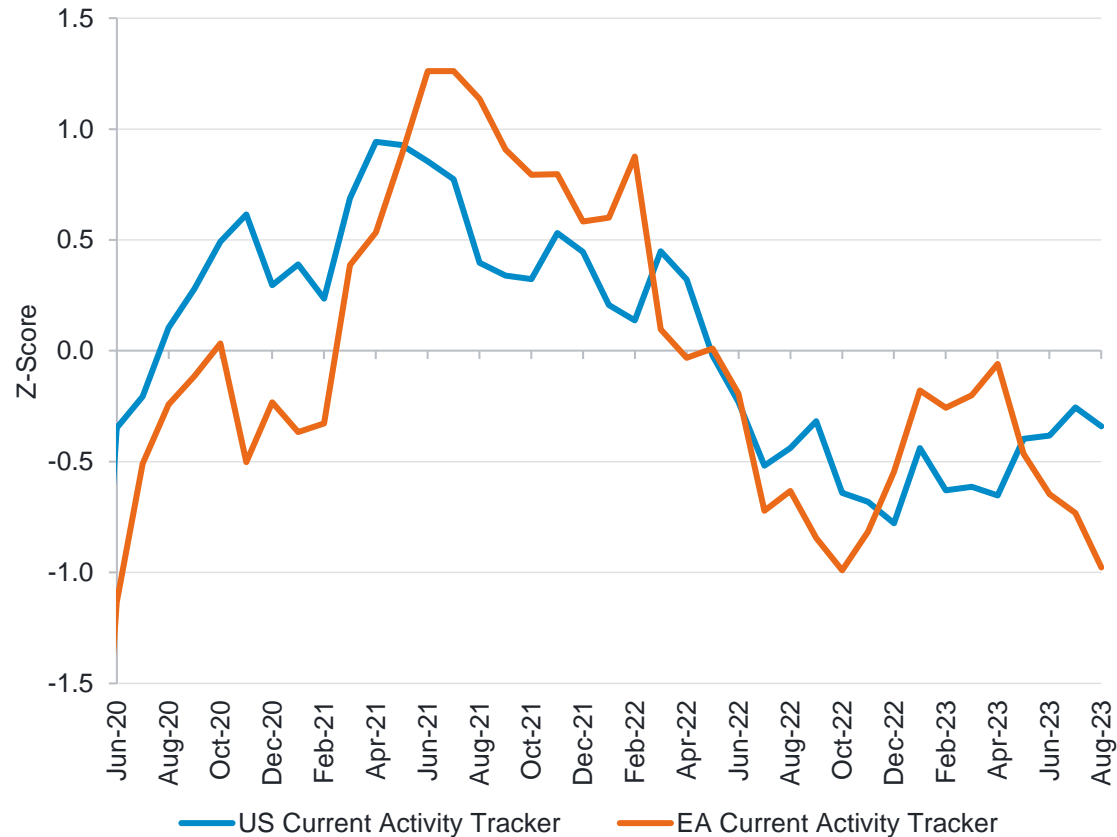
- China's post-pandemic recovery has underwhelmed. Following years of lockdowns, Chinese consumers are now reluctant to spend. Policymakers recognise that reviving the real estate sector, in which much of consumers' wealth is locked, is one way they can help restore confidence.
- Despite the stuttering recovery, there remain bright spots. Middle classes are spending less on big-ticket items, but more on going out, for example. Equities, meanwhile, now trade at an historic discount.
- We still expect China to achieve its 5 per cent annual growth target, but much hinges on restoring confidence among consumers.

Source: Fidelity International, October 2023.

Global Macro

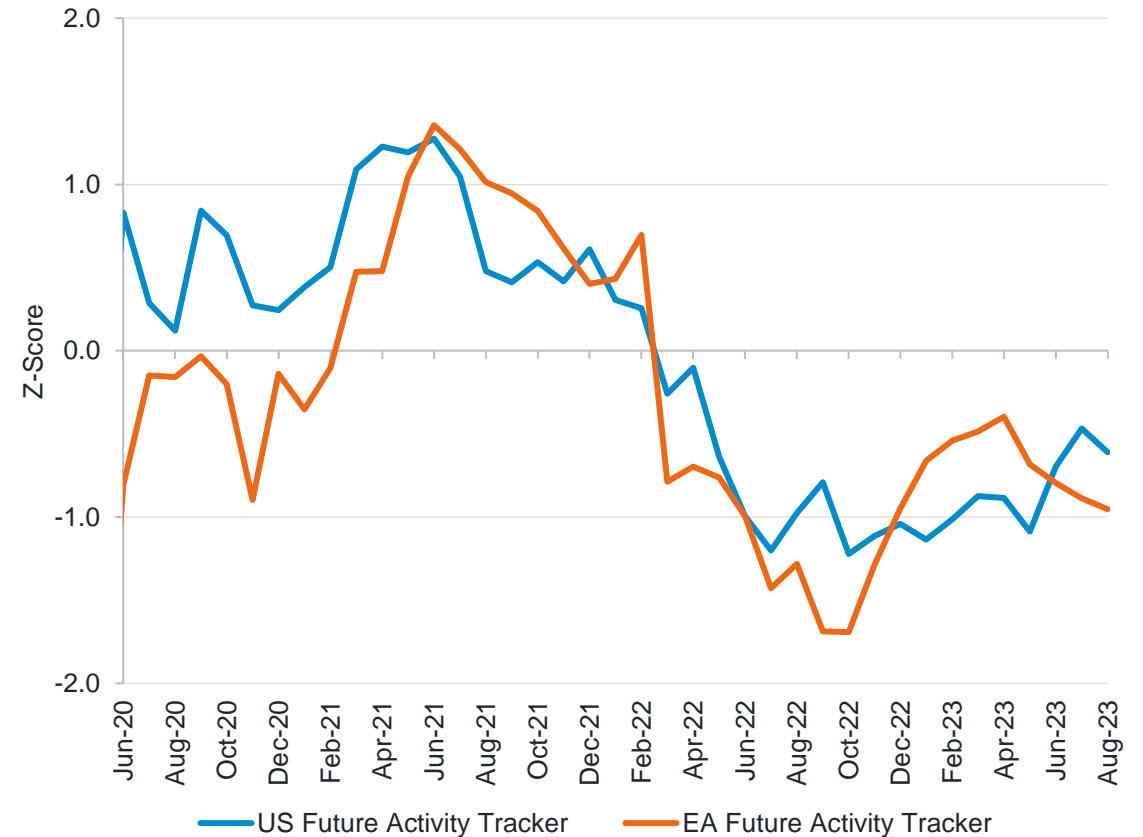
The US consumer continues to provide strong support to growth, while Euro Area industry is already in recession

US and EA Current activity trackers



Source: Fidelity International, FIL Global Macro Team calculations, LSEG Datastream, September 2023.

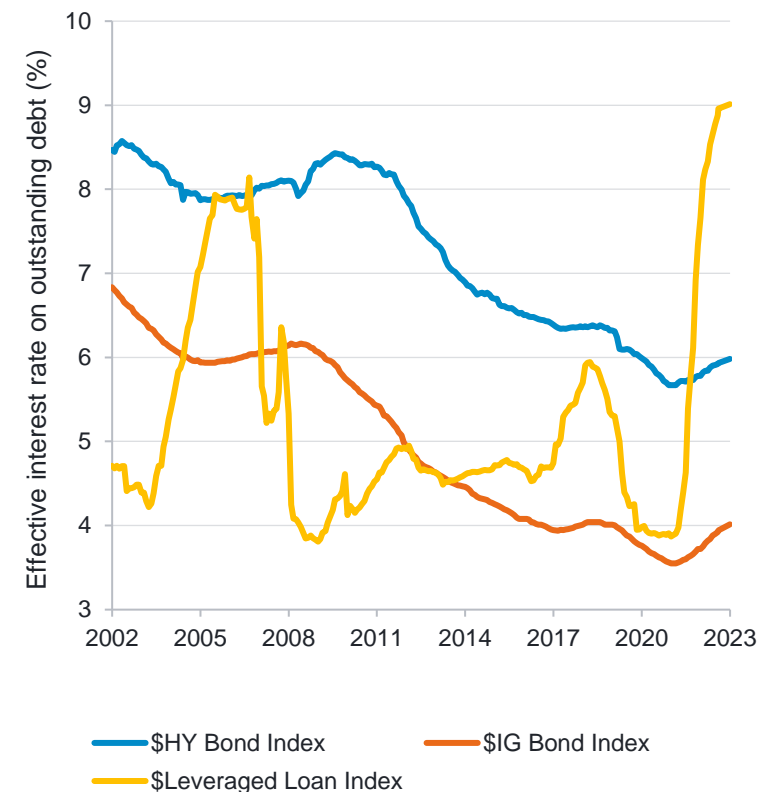
US and EA Future activity trackers



Source: Fidelity International, FIL Global Macro Team calculations, LSEG Datastream, September 2023.

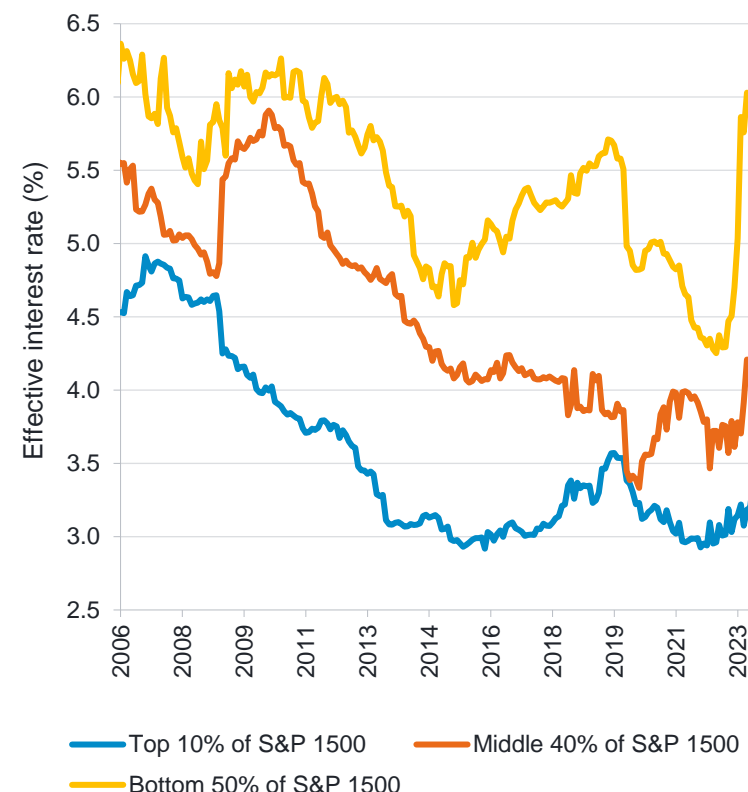
The effects of policy tightening are coming through in a lumpy, disaggregated manner across the US financial system

Effective interest rates paid on corporate bonds showing very little pass-through...



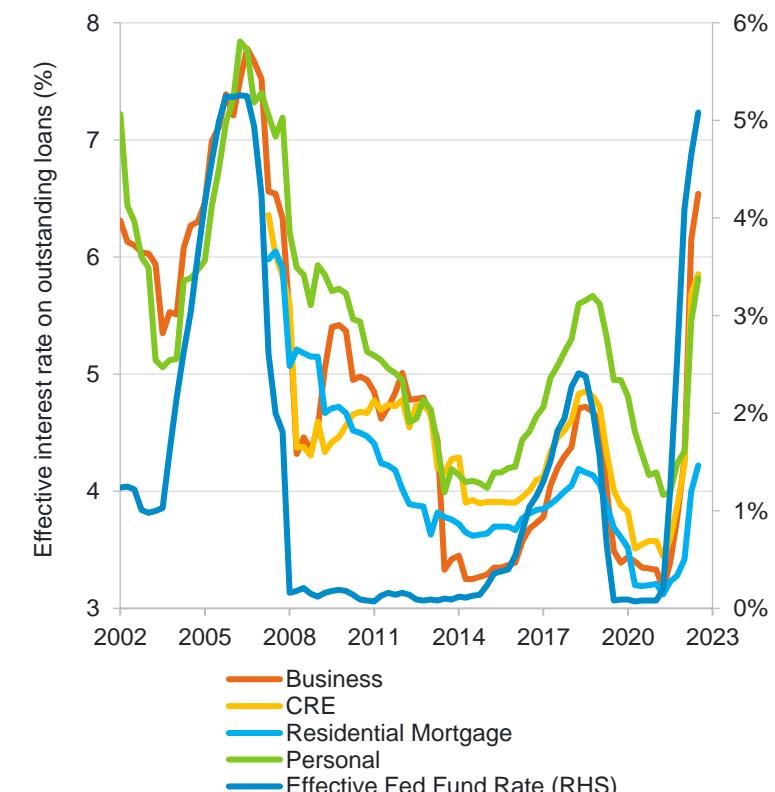
Source: Fidelity International, Bloomberg, Deutsche Bank, Pitchbook, September 2023.

...but smaller companies are starting to feel meaningfully higher interest rates



Source: Fidelity International, SG Cross Asset Research, Factset, September 2023.

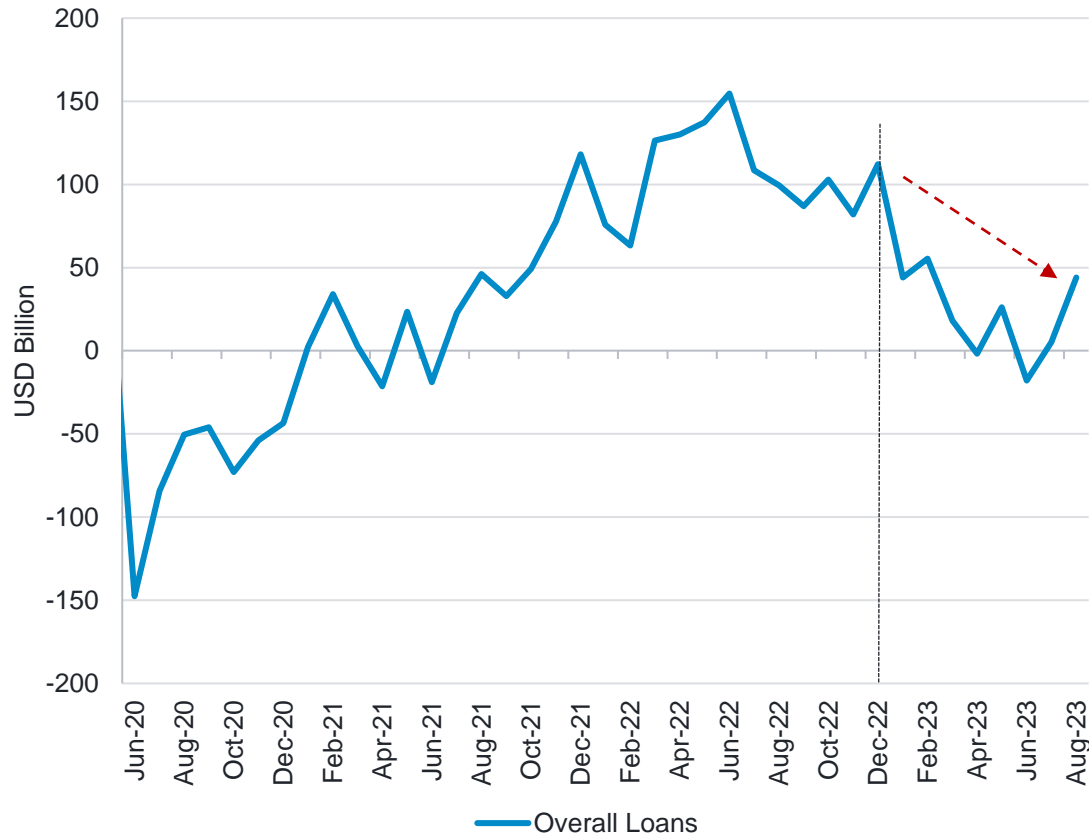
Bank loan interest rates generally showing greater linkage to policy rates



Source: Fidelity International, Bloomberg, Deutsche Bank, FFIEC, September 2023.

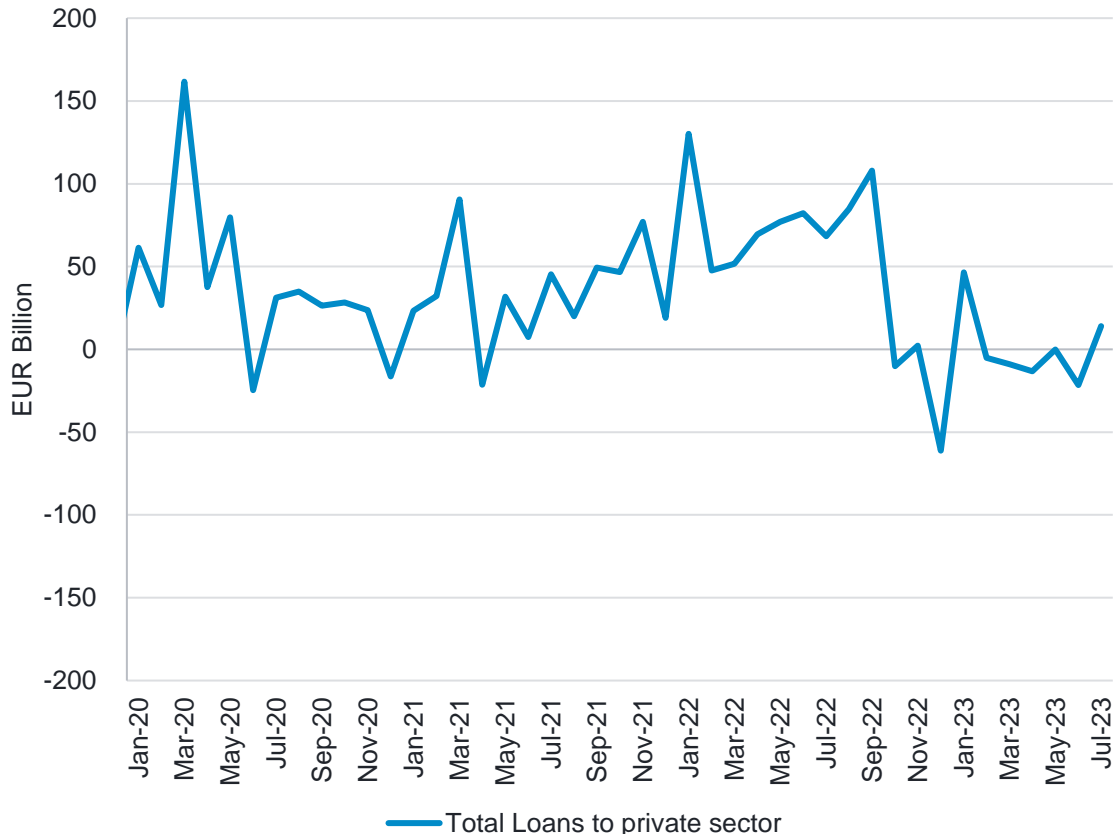
The flow of credit is also showing the effects of tightening, particularly in the Euro area

Bank loans & leases monthly flows – sector components



Note – bank credit flows have been calculated using Fed’s H8 data which report net credit flows. August credit flow data is as of week ending August 23rd for 2023. 2023 numbers have been annualised
 Source: Fidelity International, Haver Analytics, Federal Reserve H8 data, September 2023.

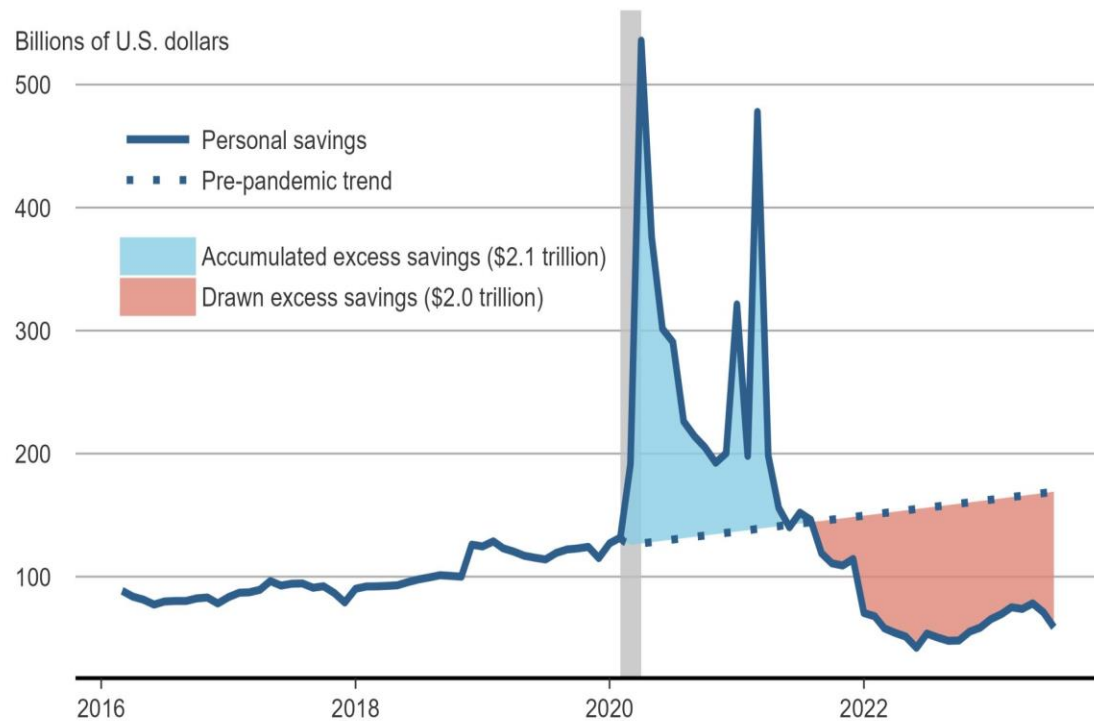
Euro area - Bank lending monthly flows



Note – *Loans to other FI includes loans to other financial intermediaries and loans to insurance corporations & pension funds; 2023 flows are from Jan-July and have been annualised for comparison with 2022 and 2015-19 averages.
 Source: Fidelity International, Haver Analytics, ECB, September 2023.

US household excess savings have nearly depleted, removing this shock absorber

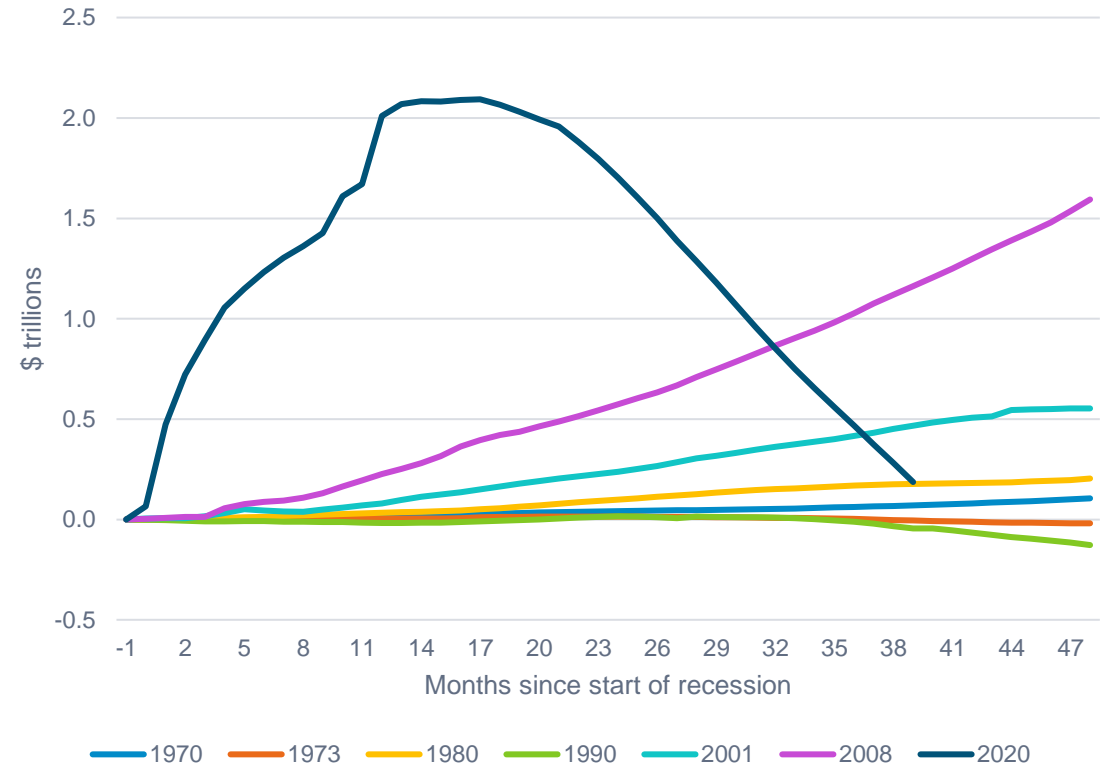
Aggregate personal savings versus the pre-pandemic trend



Note: Excess savings calculated as the accumulated difference in actual de-annualized personal savings and the trend implied by data for the 48 months leading up to the first month of the 2020 recession as defined by the National Bureau of Economic Research.

Source: Fidelity International, FRBSF staff calculations, BEA, September 2023.

Aggregate excess savings following onset of recessions

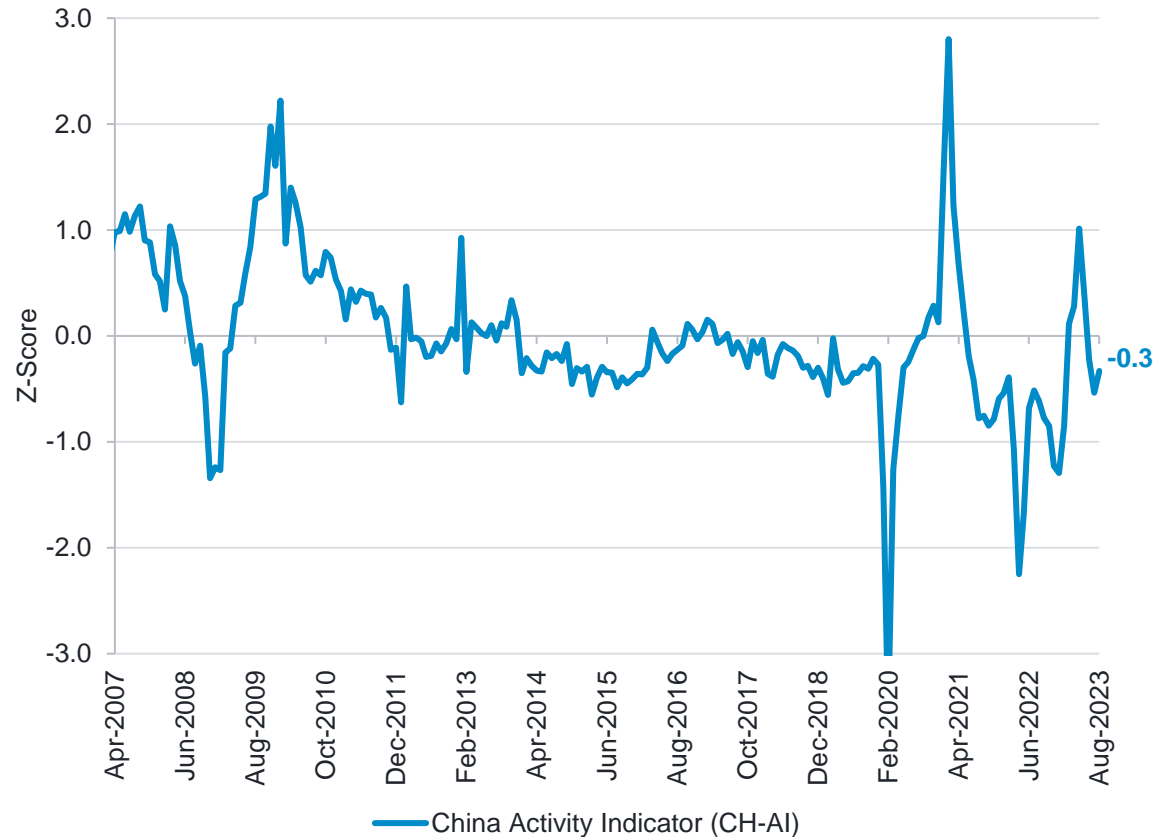


Note: Excess savings calculated as the accumulated difference between actual personal savings and the trend implied by data for the 48 months leading up to the first month of each recession as defined by the National Bureau of Economic Research. For simplicity, the two recessions in the early 1980s are combined.

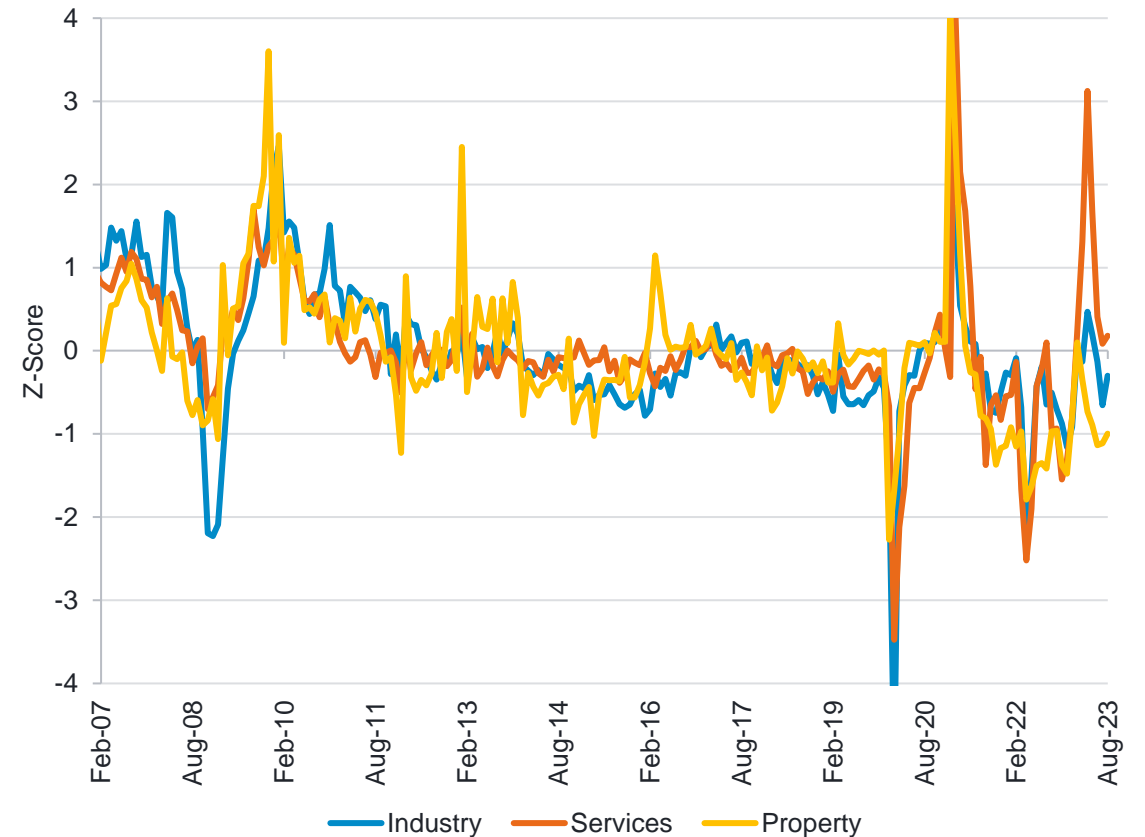
Source: Fidelity International, FRBSF staff calculations, BEA, September 2023.

Moderately rebounding activity in China led by the manufacturing sector

China activity indicator (CH-AI)



China activity indicator - components



Source: Fidelity International, FIL Global Macro Team calculations, Bloomberg, Haver Analytics, Wind Database, September 2023.

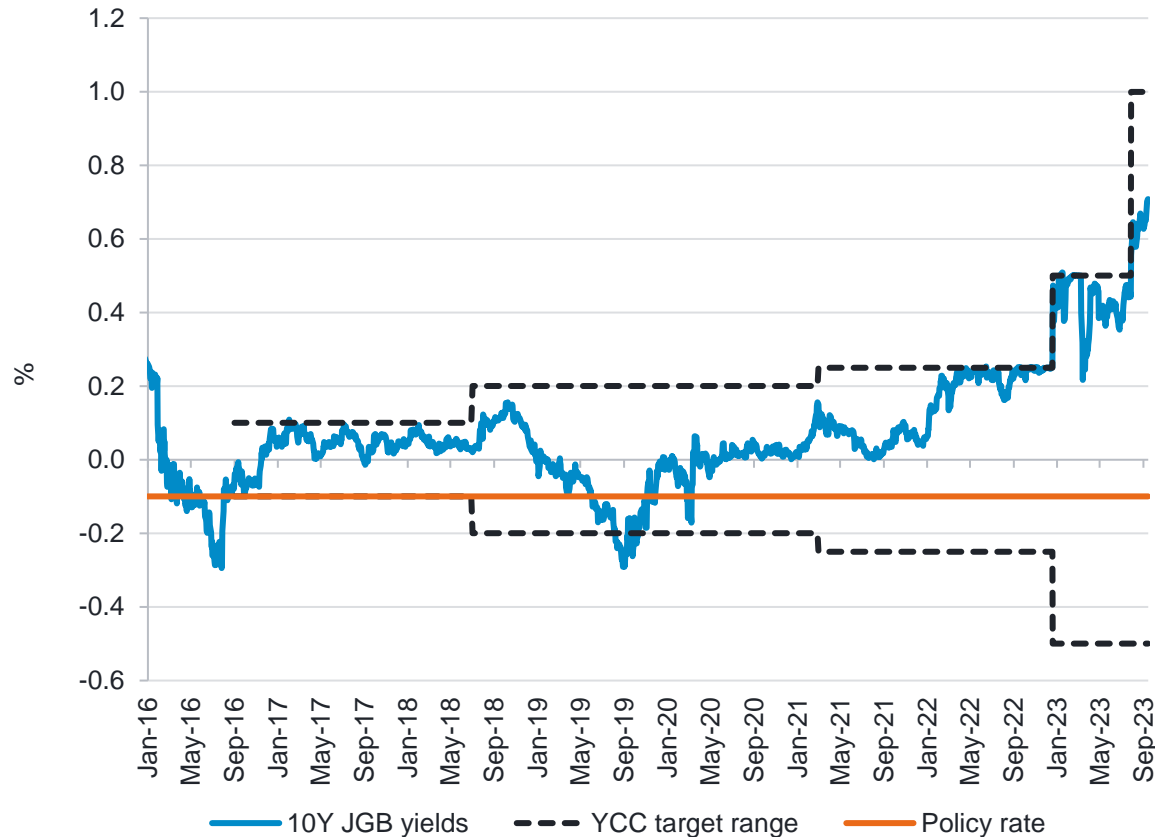
China fiscal and administrative easing has added up to ~0.7% of GDP in 2023

Category	Policy action	Details
Monetary	<ul style="list-style-type: none"> Benchmark interest rate (1Y MLF) cut Reserve requirement ratio cut Deposit rate cut by commercial banks Re-lending and re-discount loans for SMEs, rural and private sectors Keep FX stable at reasonable levels 	<ul style="list-style-type: none"> 25bps cut (10bps in June, 15bps in August) 25bps cut in March and September Commercial banks lowered deposit rates by window guidance CNY200bn quota issued in June (~0.15% of GDP) Stronger USDCNY fix to guide RMB Index higher; FX RRR cut by 2%
Fiscal	<ul style="list-style-type: none"> Official fiscal deficit Local Government Special Bond Issuance <i>Local Government refinancing bond quota (no official statement from MOF yet)</i> Personal income tax rebate 	<ul style="list-style-type: none"> Widened to 3.0% in NPC 2023 (from 2.8% in 2022) CNY3.8trillion (~3.1% of GDP) CNY1.5trillion (~1.2% of GDP) < CNY100bn (~0.1% of GDP)
Property	<ul style="list-style-type: none"> Policy bank financing to support developers to ensure project completion and delivery Marginal relaxation to “3 red lines” Encourage equity and debt financing for developers Lower mortgage rates for homebuyers (allow homeowners to enjoy first property mortgage rate) Relax purchase restrictions in core regions (including Tier 1 cities) Lower outstanding mortgage rates 	<ul style="list-style-type: none"> CN350bn policy bank loans quota was allocated (~0.29% of GDP) in Q4-2022 Allow property developers to refinance conditionally CNY100bn quota (~0.1% of GDP) Broad-based implementation including Tier 1 cities Broad-based implementation, release demand for home upgraders Window guidance (a 50bps broad-based cut is equivalent to lowering interest burden by ~CNY190bn annually, or ~0.15% of GDP)
Regulatory	<ul style="list-style-type: none"> Government extended EV tax reduction to end-2024 Healthcare sector anti-corruption Securities stamp duty cut 	<ul style="list-style-type: none"> Estimated tax reduction of ~CNY115bn (~0.1% of GDP) Sector-specific regulation tightening Estimated annual tax relief of ~CNY140bn (~0.1% of GDP)

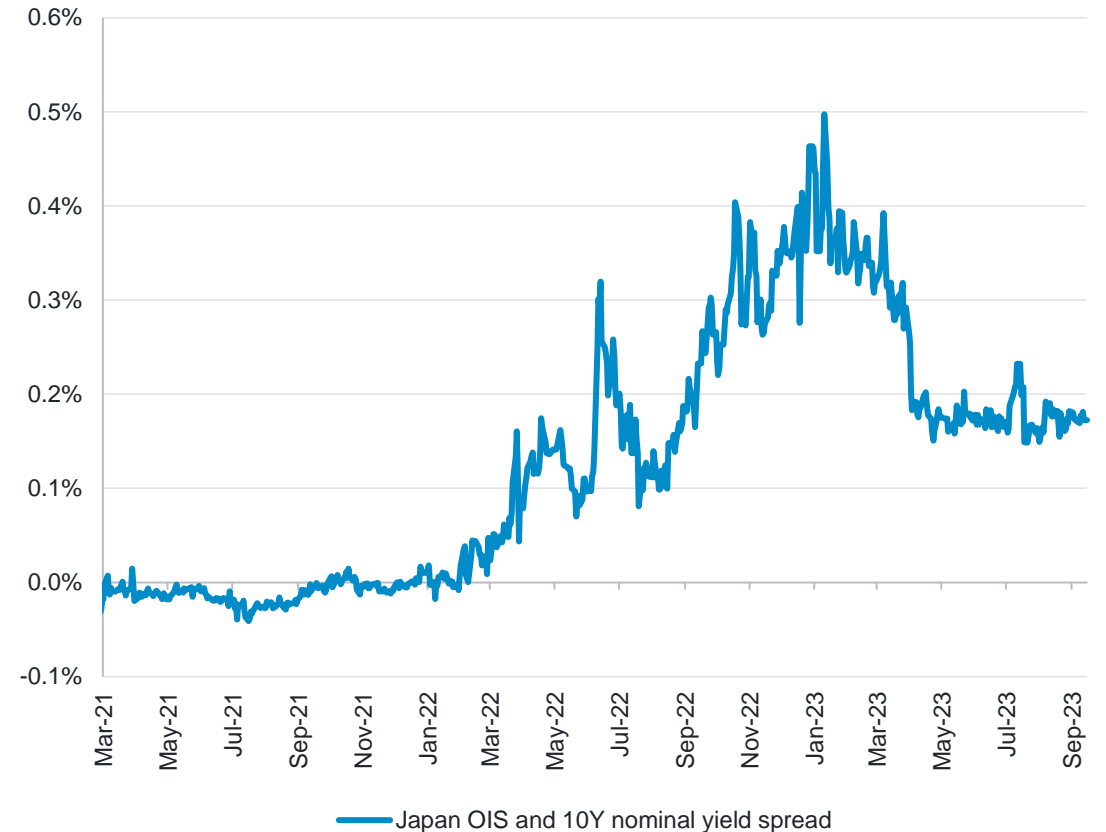
Source: Fidelity International, State Council, PBoC, MoF, September 2023.

Bank of Japan: expectations for further tweaks to yield curve control are building, but rates are unlikely to be adjusted any time soon

The path of YCC



Japan OIS and 10y nominal yield spread



Source: Fidelity International, Bloomberg, September 2023.

Source: Fidelity International, Bloomberg, September 2023.

Global Investment Research

Management sentiment appears neutral...

Weighted average of responses

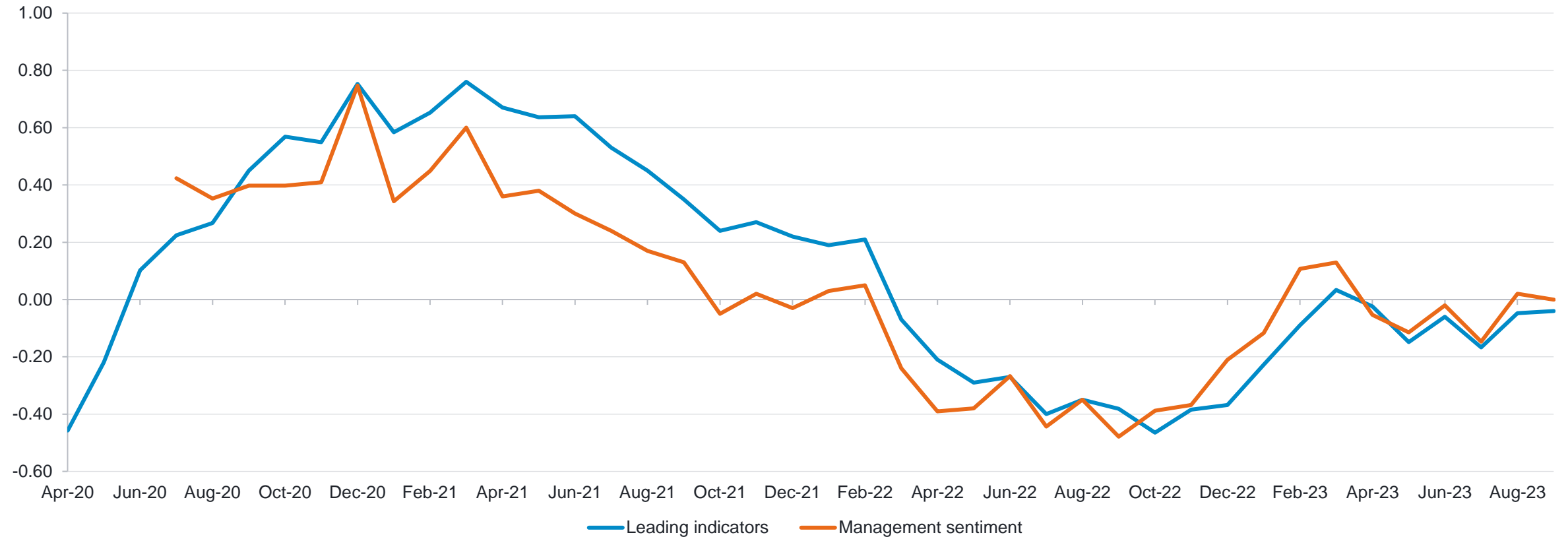


Chart shows proportion of responses reporting management sentiment and leading indicators are positive minus those reporting management they are negative; strong negative and strong positive receive a higher weighting. Questions: "Based on your recent research and interactions with companies, to what extent, if at all, has your perception of management sentiment over the next 6 months changed?"; "What is the outlook for leading indicators over the next 6 months at your companies?". Source: Fidelity International, September 2023

... But there are significant regional divergences; Japan roars ahead while EMEA/LatAM languishes

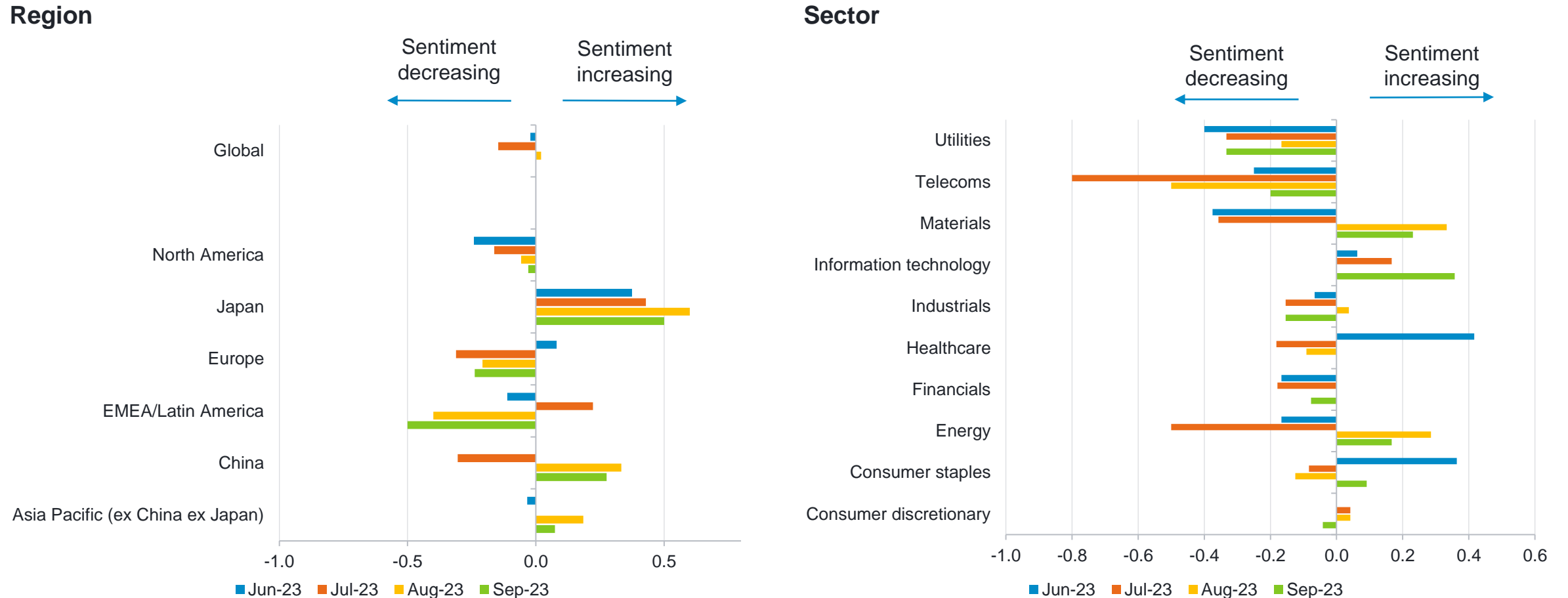


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Our analysts' expectations for costs swung upwards over the last quarter

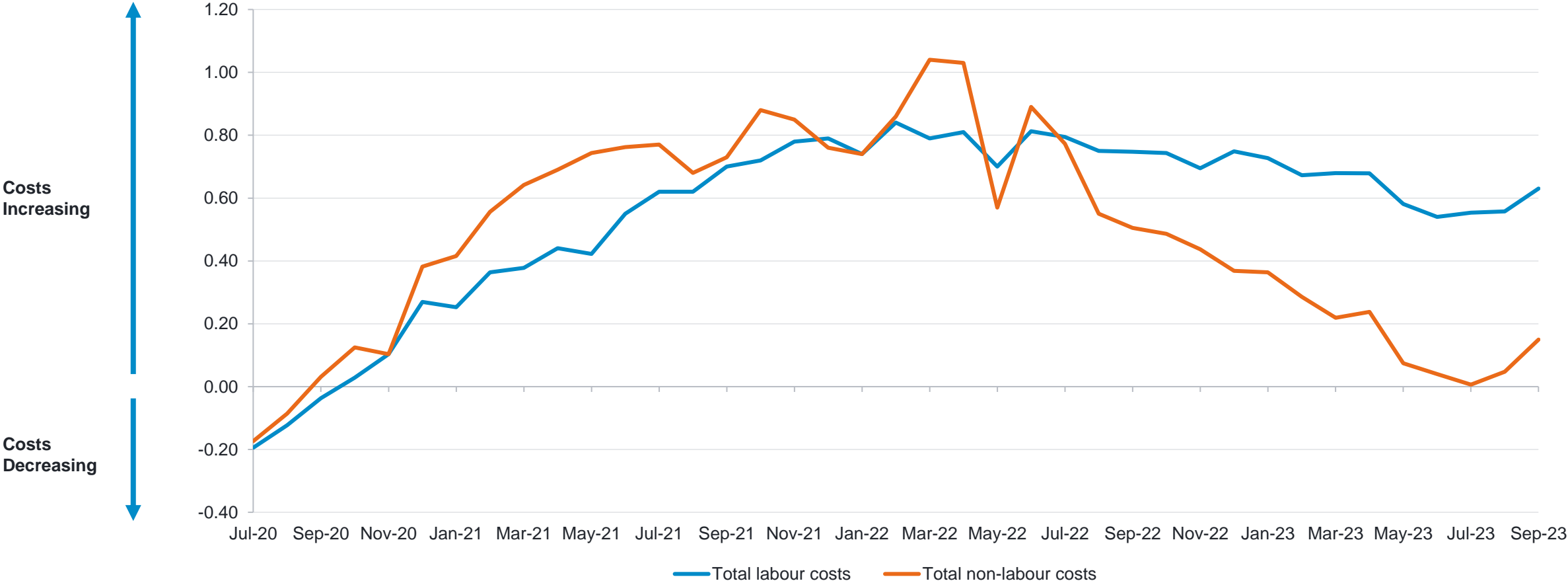
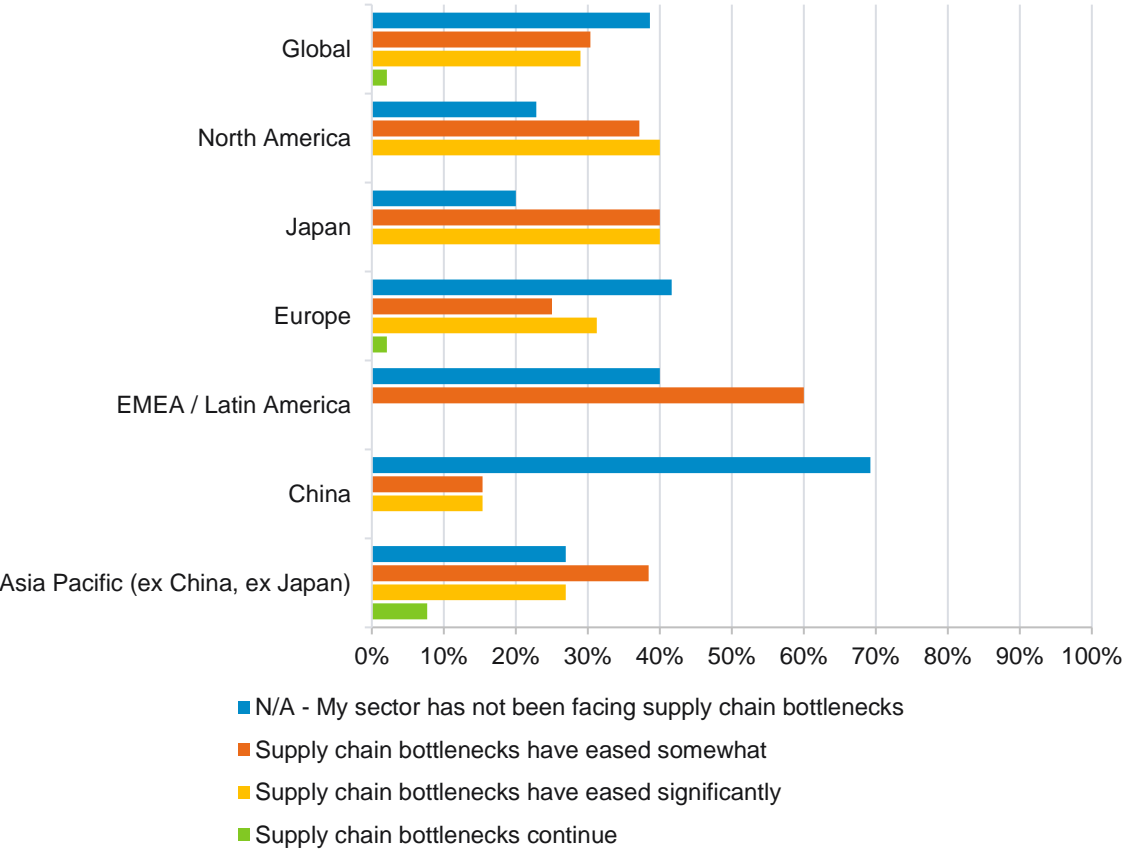


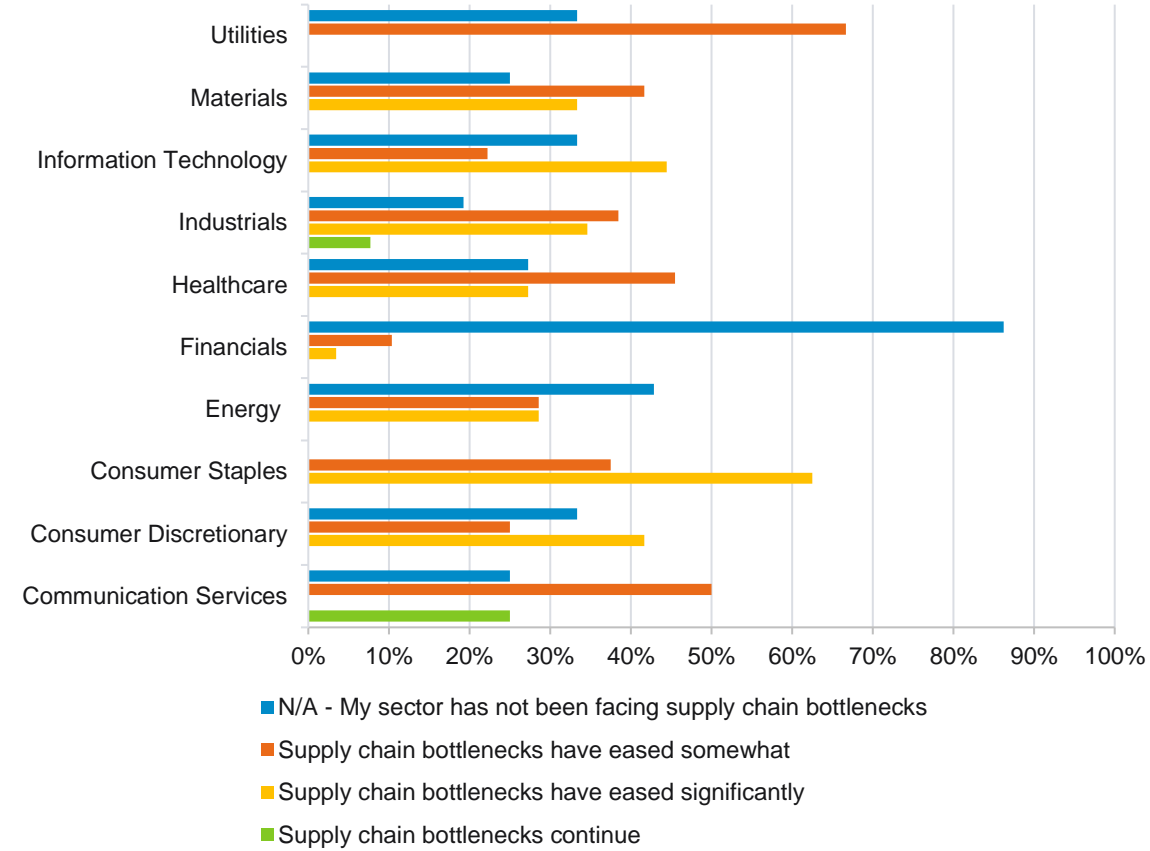
Chart shows proportion of responses reporting costs are increasing minus those reporting costs are decreasing; significant increases and significant decreases receive a higher weighting. Questions: "What are your expectations for total labour costs over the next 6 months compared to current levels?"; "What are your expectations for total non-labour costs over the next 6 months compared to current levels?". Source: Fidelity International, September 2023

Sectors like industrials and communication services still face significant supply chain bottlenecks - beware hidden inflation pressures

Region



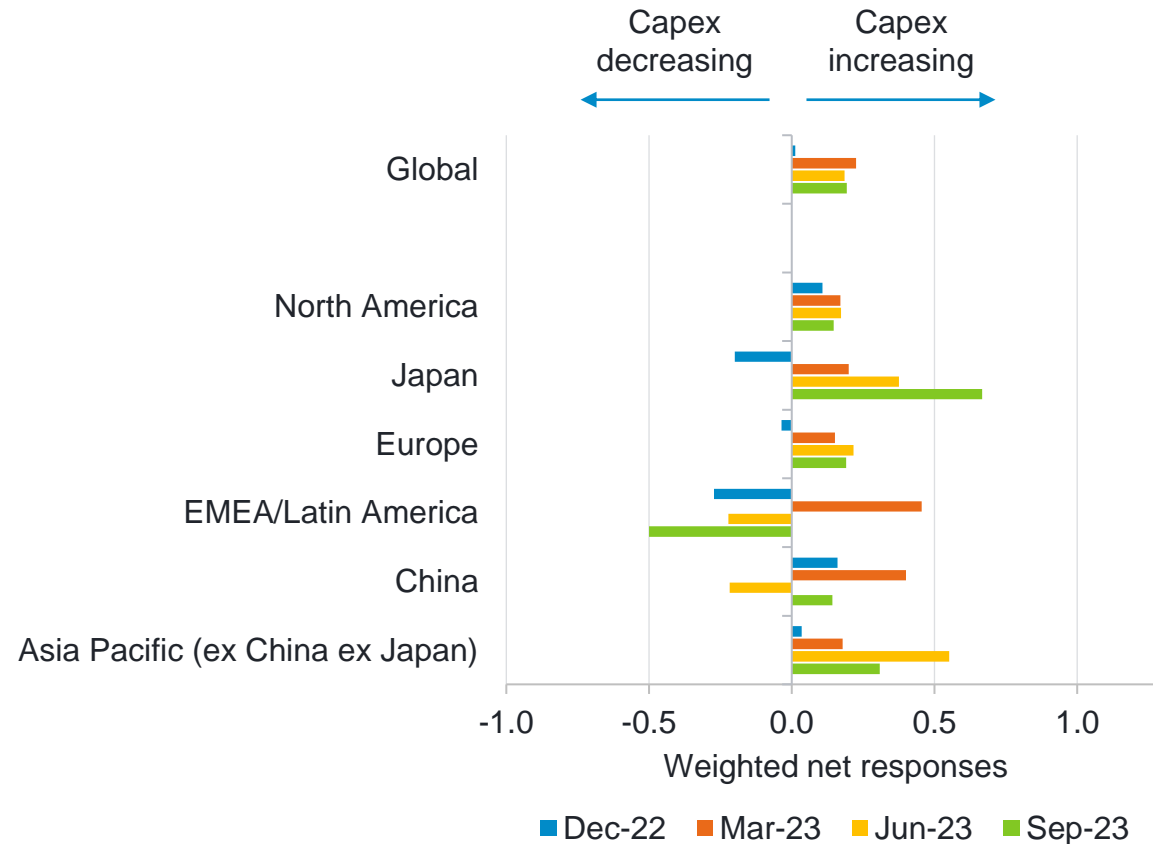
Sector



Question: "To what extent have you seen supply chain bottlenecks ease at your companies over the past six months?" Source: Fidelity International, September 2023

Analysts continue to anticipate higher capex costs, though telecoms companies buck the trend

Region



Sector

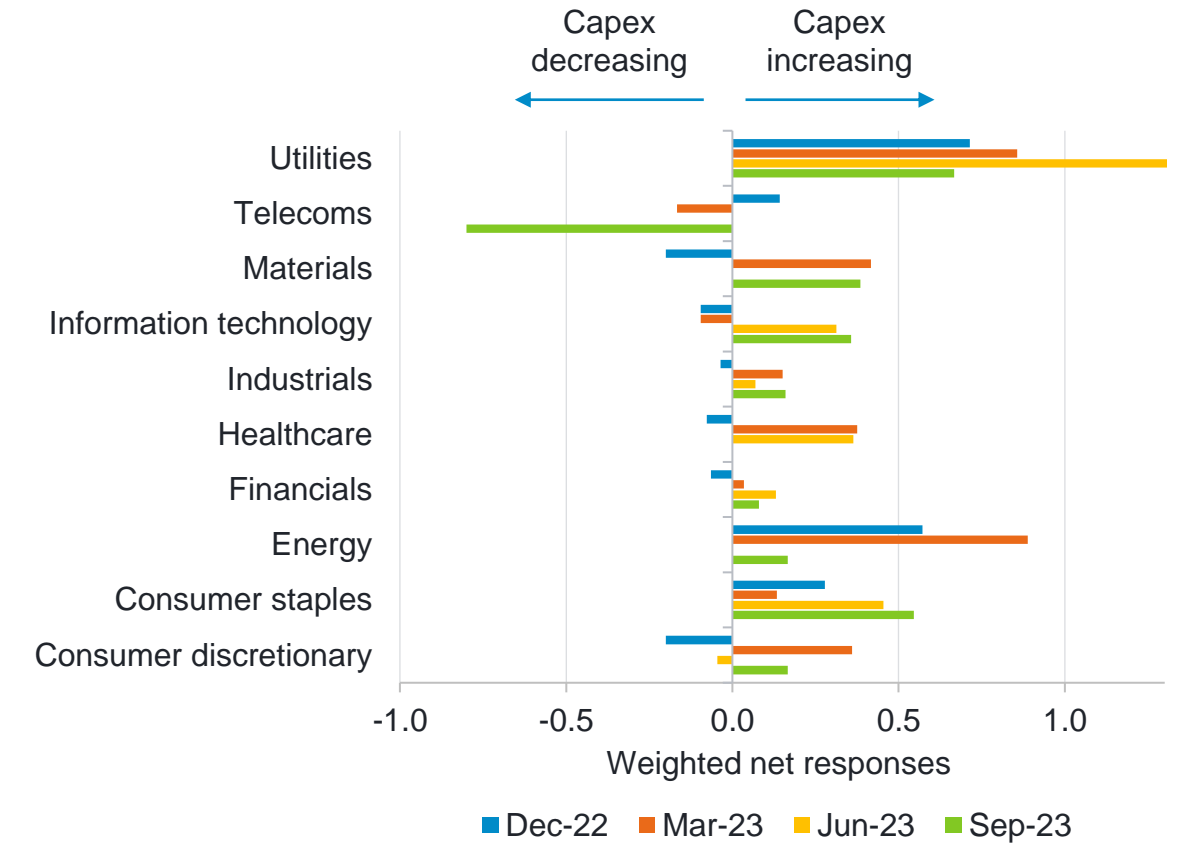
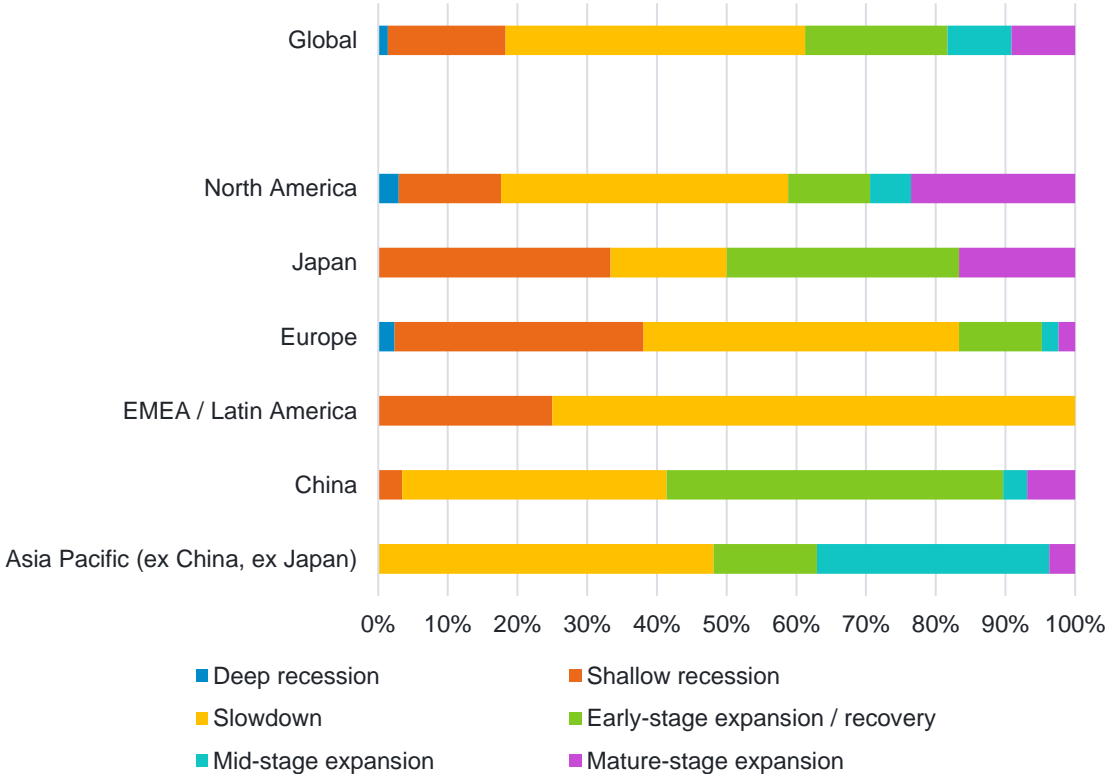


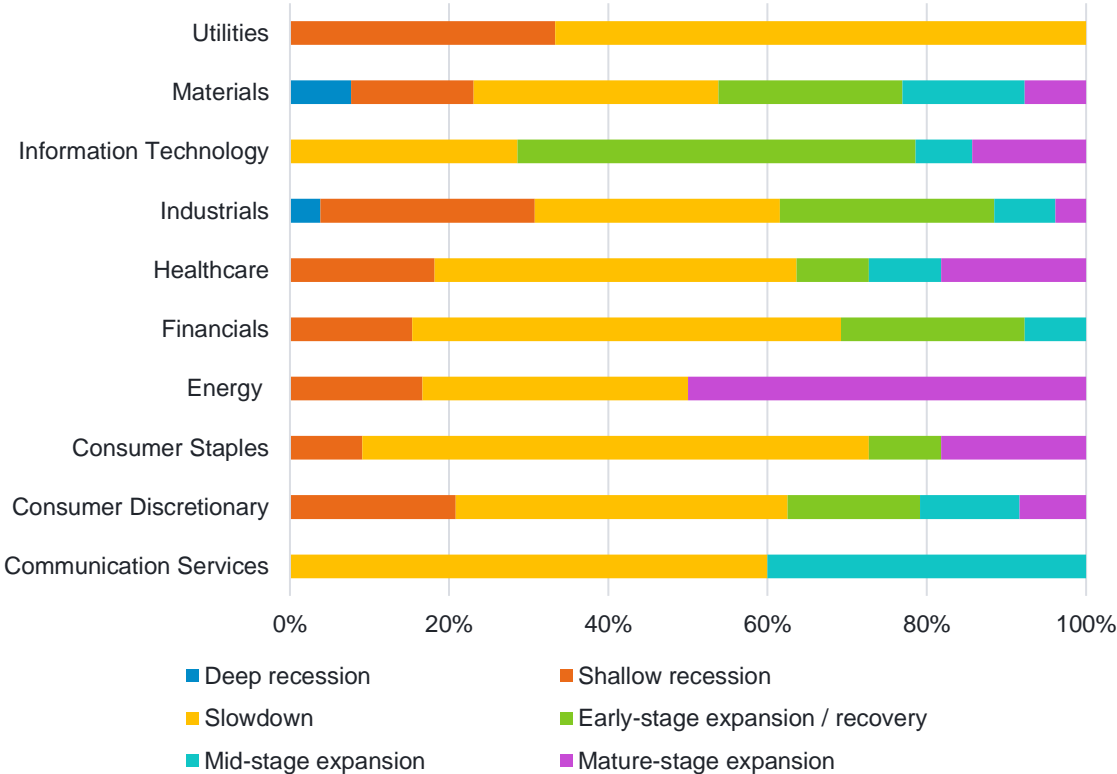
Chart shows weighted average of responses. Question: "What are your expectations for capex over the next 12 months compared to current levels?". Source: Fidelity International, September 2023

Most analysts expect an economic slowdown over the next 12 months, but not a deep recession. Will inflation be enough to support the top-line?

Region



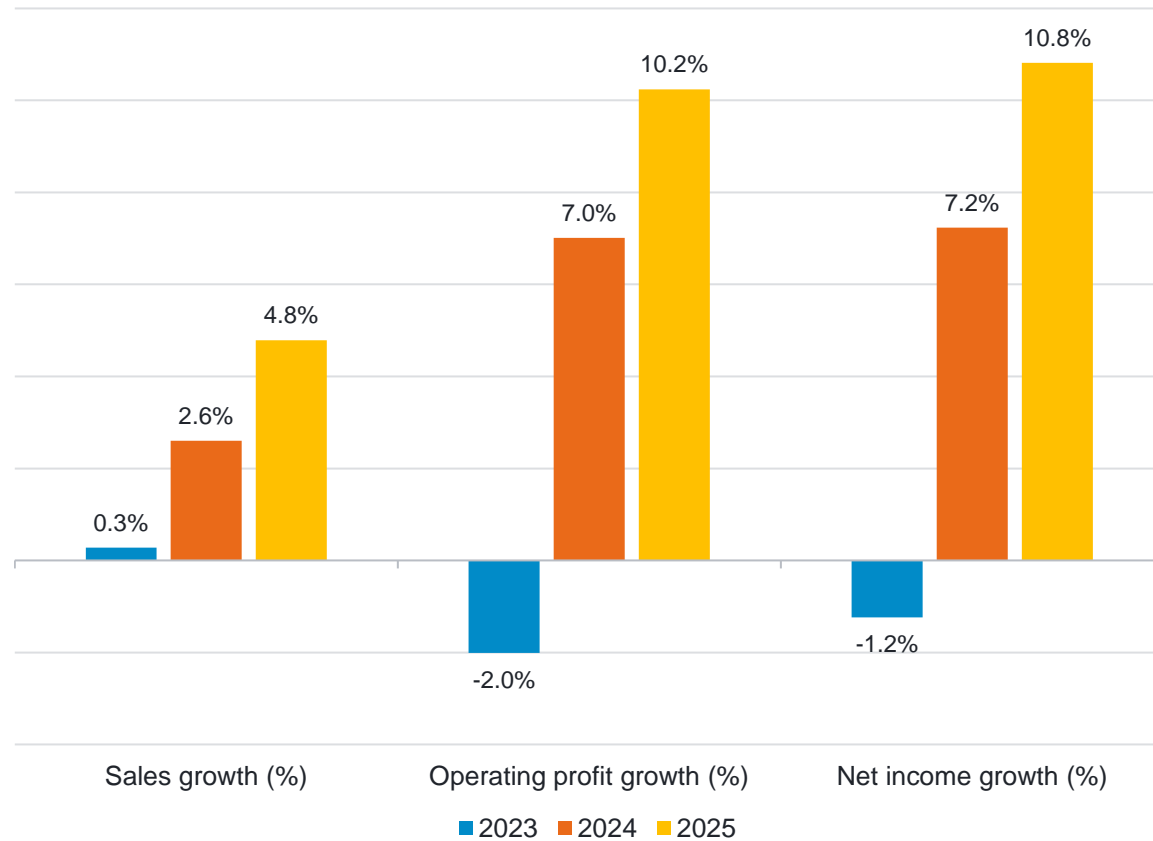
Sector



Question: "What economic scenario are you building into your financial forecasts for the next 12 months?". Source: Fidelity International, September 2023

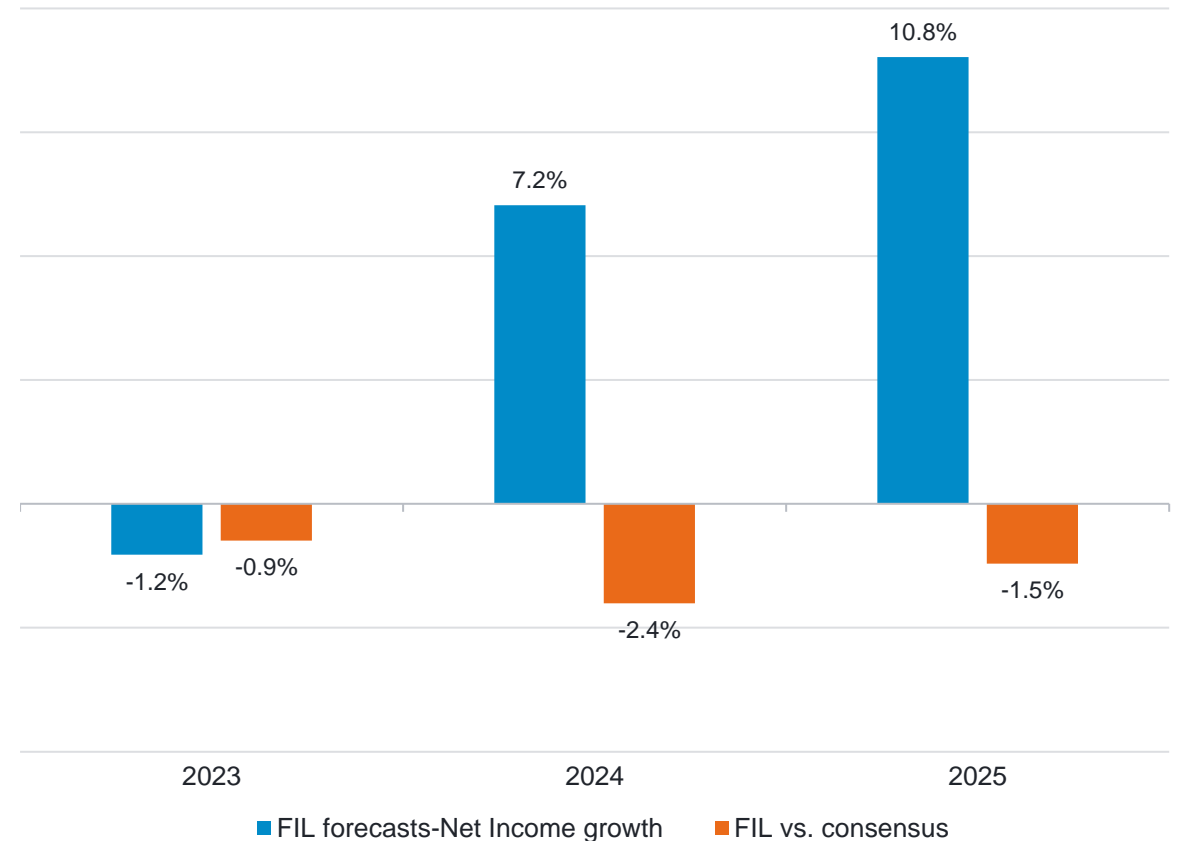
We expect a bounce back in growth from next year, though remain slightly below consensus expectations

Global Growth forecast



Source: Fidelity International, IBES, 28 Aug 2023

Fidelity vs Consensus YoY Growth %



Source: Fidelity International, 28 Aug 2023

Multi Asset

Multi Asset: Key takeaways

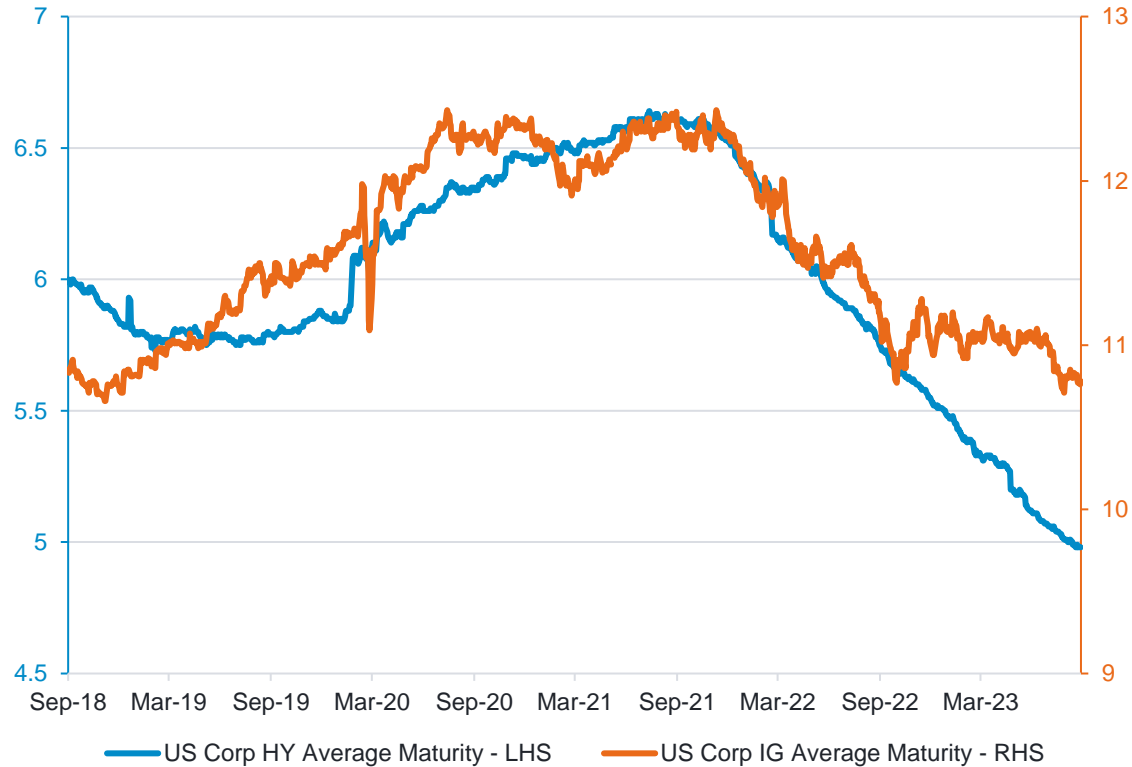
	Key view	Thesis	Investment implications
1	High rates create stress and positioning looks extended	<ul style="list-style-type: none"> Companies are refinancing at higher coupon rates. Cracks are emerging in the markets in leveraged loans, private debt, commercial real estate Leading indicators of earnings – new orders, credit costs and availability, money supply – point to weak earnings Investor positioning is overweight risk, and sentiment is elevated relative to the fundamentals 	<ul style="list-style-type: none"> Cautious on equity and credit Favour IG over HY Corporate debt Tilt to defensive equity sectors – staples and healthcare over cyclicals such as consumer discretionary, Swiss Markets Index over MSCI World and allocate to US min vol
2	DM central bank rates to plateau; some EMs already easing	<ul style="list-style-type: none"> Terminal rates are approaching as progress is being made on bringing down inflation. This means bond volatility should decline However, near term resilient growth data is likely to put a floor under bond yields in the short term 	<ul style="list-style-type: none"> Preference for UK duration over JGBs Preference for TIPS over nominal bonds Allocate to EM FX carry Buy platinum
3	More cautious on Europe	<ul style="list-style-type: none"> Earnings picture is becoming less bright, with a slew of profit warnings and weaker economic momentum Weaker Chinese growth and debt issues are likely to feed into weaker growth in Europe 	<ul style="list-style-type: none"> Cautious on European Equities, EUR and GBP Avoid Italian BTPs Allocate away from European industrials and China exposed equities
4	Looking for value in rich markets	<ul style="list-style-type: none"> Looking for more asymmetric or thematic opportunities from use of Tactical Asset Allocation rather than broad market exposures Idiosyncratic ideas in EM (not just China) 	<ul style="list-style-type: none"> Favour banks broadly and Japanese Equities Selective EM exposures: Brazil, Mexico, and South Africa rates; Indonesia, Brazil, Korea and Taiwan equities

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

High rates create stress and positioning looks extended

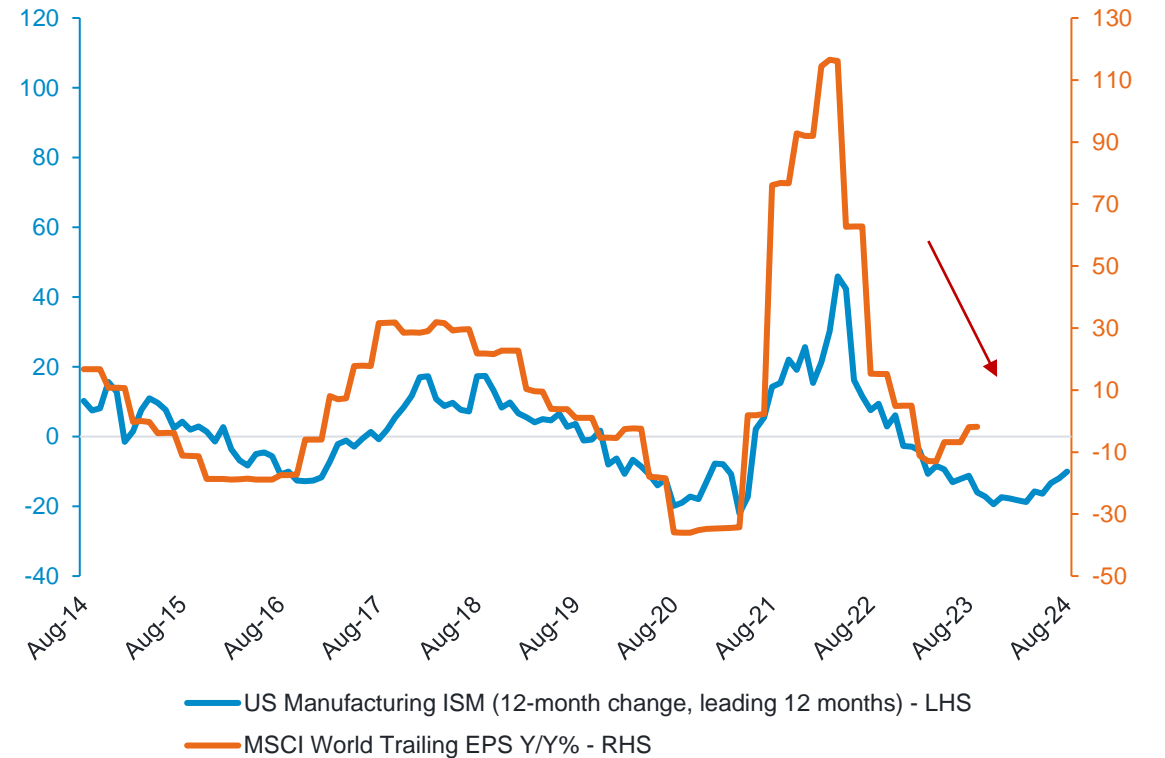
Underweight equities and credit, prefer IG to HY

Impending maturity walls in HY and high refinancing rates likely to be a headwind for the asset class



Source: Bloomberg, Fidelity International, September 2023.

Company earnings will stay under pressure. Cyclical risks remain, credit stress is building from refinancing at higher rates

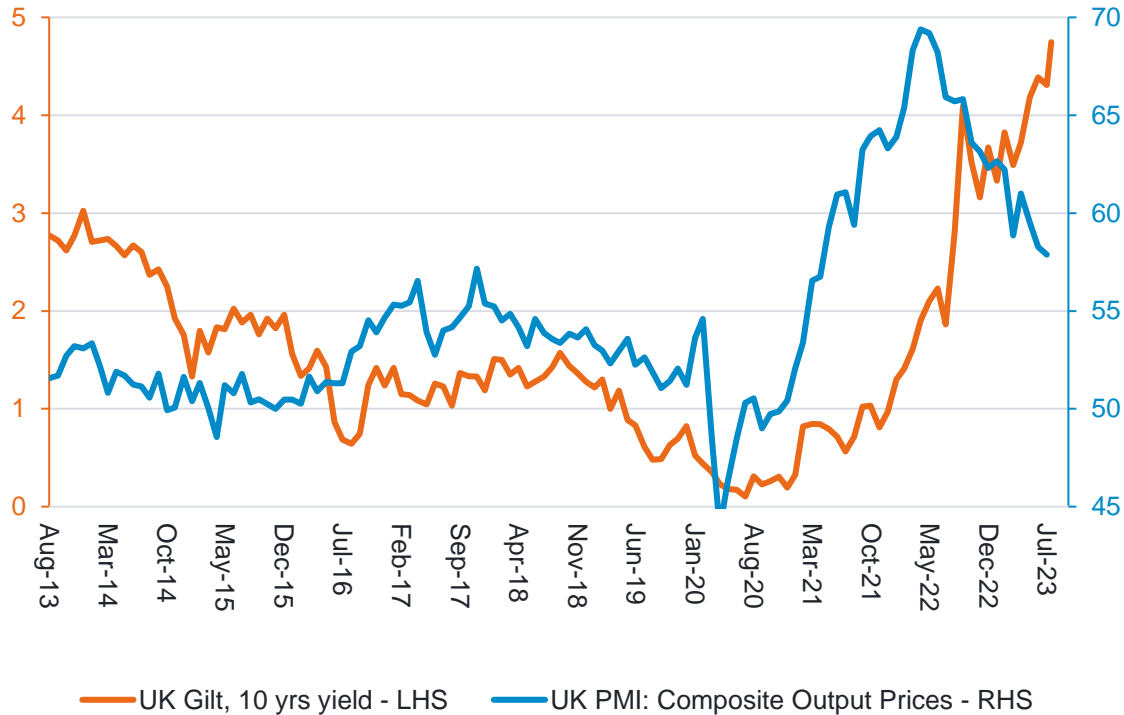


Source: ISM; Bloomberg, Haver Analytics, Fidelity International, September 2023.

DM central bank rates to plateau; some EMs already easing

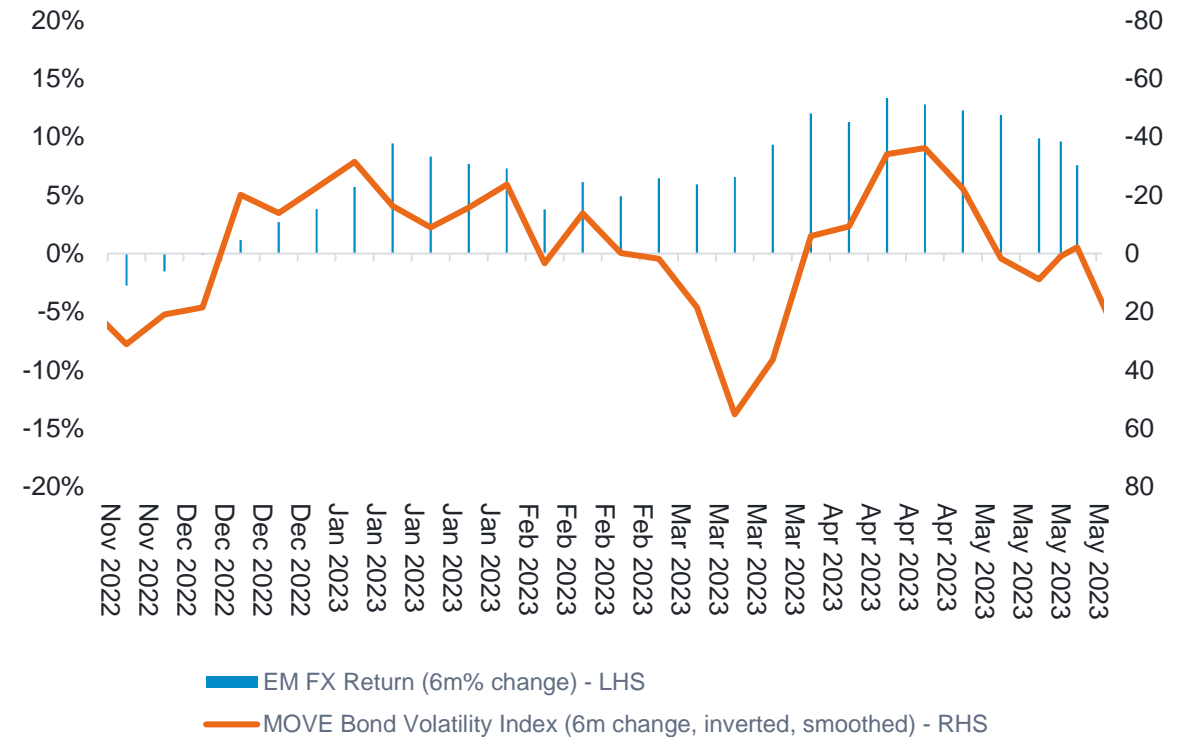
Prefer Gilts over JGBs, allocate to EM FX carry trade

Weaker economic outlook for the UK and already-high yields offer good entry point for UK Gilts.



Source: Haver Analytics, Fidelity International, August 2023.

Peak US rates should encourage a 'low volatility' regime that supports carry trades. EM fundamentals such as yields and inflation are supportive.



Source: Bloomberg, Fidelity International, August 2023

Even more cautious on Europe

Tilt away from Europe equities, especially consumer discretionary and industrials

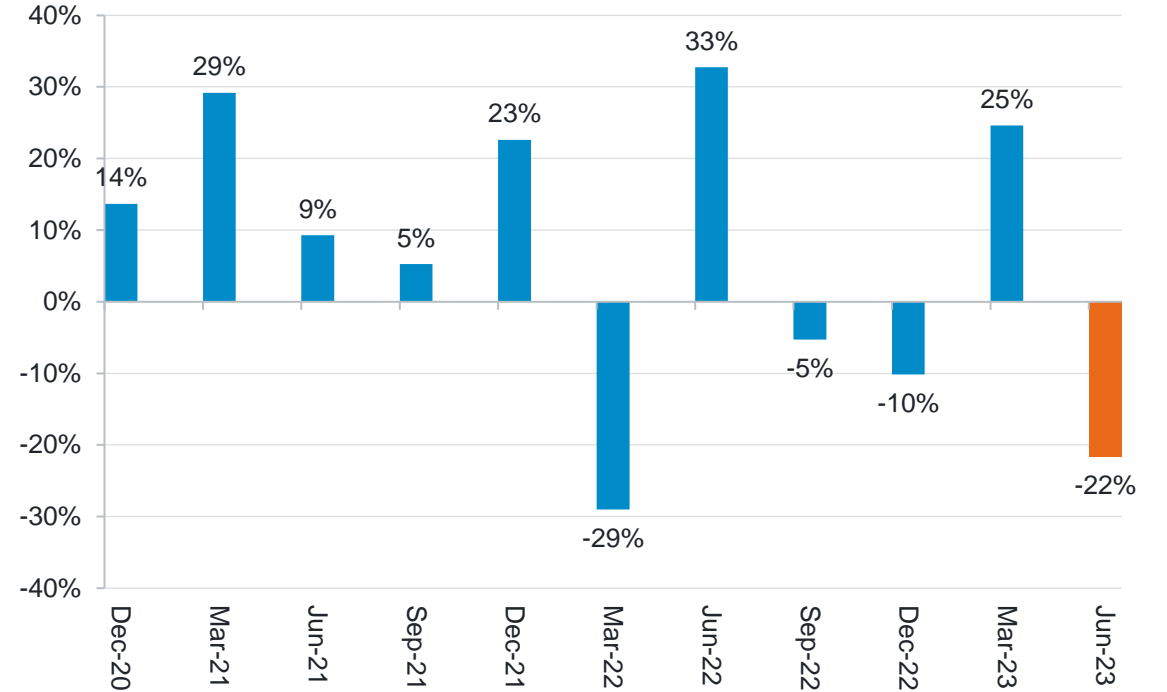
A number of profit warnings in European industrial segments and broad softening of economic data support an underweight to European equities.



Source: Bloomberg, Fidelity International, August 2023.

Bank earnings mask underlying weakness in the broad market

QoQ growth in European earnings - ex financials



Source: Bloomberg, Fidelity International, August 2023.

Looking for value in rich markets

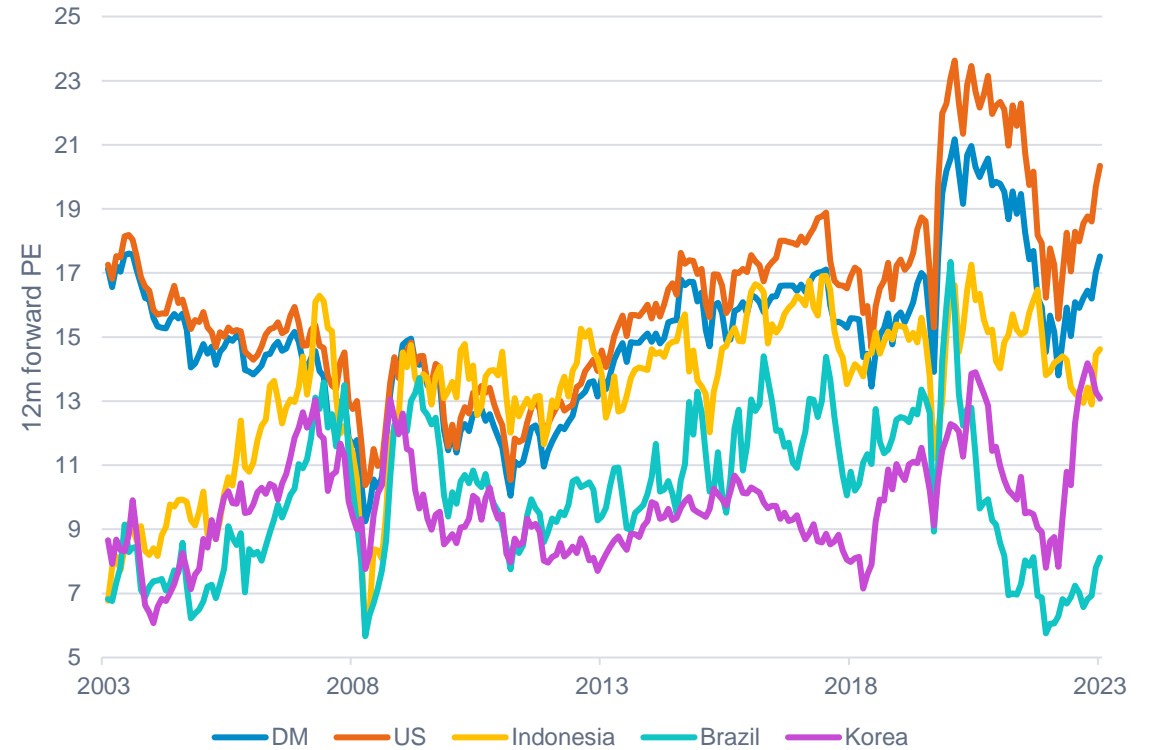
Favour Japanese equities, banks, and select EM countries

Japan's positive earnings momentum and relatively cheap valuations make it an attractive equity market



Source: Bloomberg, Fidelity International, September 2023.

Select EMs have positive growth outlooks and trade on attractive valuations



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

Key asset allocation views at a glance

Prefer defensiveness and emerging markets

Equity regions

	View	Change	Rationale
US	○○●○○	-	The market is no longer pricing for a recession in 2023 and is recognising the increased chance of a soft landing.
Europe ex. UK	●○○○○	-	Both manufacturing and service activities continue to show notable signs of weakness. Economic surprises remain deeply negative.
UK	○○○●○	-	Economic data has been better than feared and concerns of an imminent recession have dissipated. Survey data is still weak.
Japan	○○○●○	▲	Earnings revisions breadth is improving, business activities continue to recover and valuations are relatively attractive.
Emerging markets	○○○●○	-	We turn more cautious on the structural story in China, but keep a positive view on EM ex-China, with a particular focus on commodity producers.
Pacific ex. Japan	●○○○○	-	Economic data remains on the soft side compared to expectations. The weakness in industrial metals and China's lacklustre recovery are risks to the region.

Credit

	View	Change	Rationale
Investment grade (IG) bonds	○○○●○	-	We maintain our conviction in IG vs HY, although we are aware that this is a consensus trade.
Global high yield	●○○○○	-	HY valuations are expensive both relative to IG and versus its own history. Credit tightening is gradually feeding through although fundamentals have been resilient.
Emerging market debt (EMD, hard currency)	○○●○○	-	Dollar strength and shrinking global liquidity could weigh on the outlook.

Government bonds

	View	Change	Rationale
US Treasuries	●○○○○	▼	We enter a synthetic long breakeven trade by moving underweight nominal Treasuries and overweight TIPS as breakevens have lagged the oil rally.
Euro core (Bund)	○○●○○	-	Growth looks fragile but core inflation has been somewhat resilient, creating a mixed outlook for European rates.
UK Gilts	○○○●○	-	Our conviction is growing. Inflation looks to be normalising and the housing and labour markets are softening.
Japan govt bonds	●○○○○	▼	The BOJ is still on track to end YCC and CPI is above target and showing signs of persistence.
Inflation linked bonds (US TIPS)	○○○●○	▲	Against the robust US economic backdrop, we initiate a long breakeven trade, in anticipation of the markets pricing in a higher term premium for longer-dated treasuries.

Currency

	View	Change	Rationale
USD	○○○●○	-	US growth looks fairly solid, meaning inflation might not fall to target easily. The Fed's job is not done yet.
EUR	●○○○○	-	The ECB looks to have finished its hiking cycle and the European economy is struggling, especially Germany.
JPY	●○○○○	-	The rate differential with the US, worth around 6% annualised, is a huge barrier to the yen rallying.
GBP	●○○○○	-	The heightened chance of a UK recession is not yet reflected in market expectations for BoE rates.
EM FX	○○○○●	-	The current volatility regime should be supportive of EM FX carry, while RMB depreciation should be less of a headwind as more China stimulus comes through.

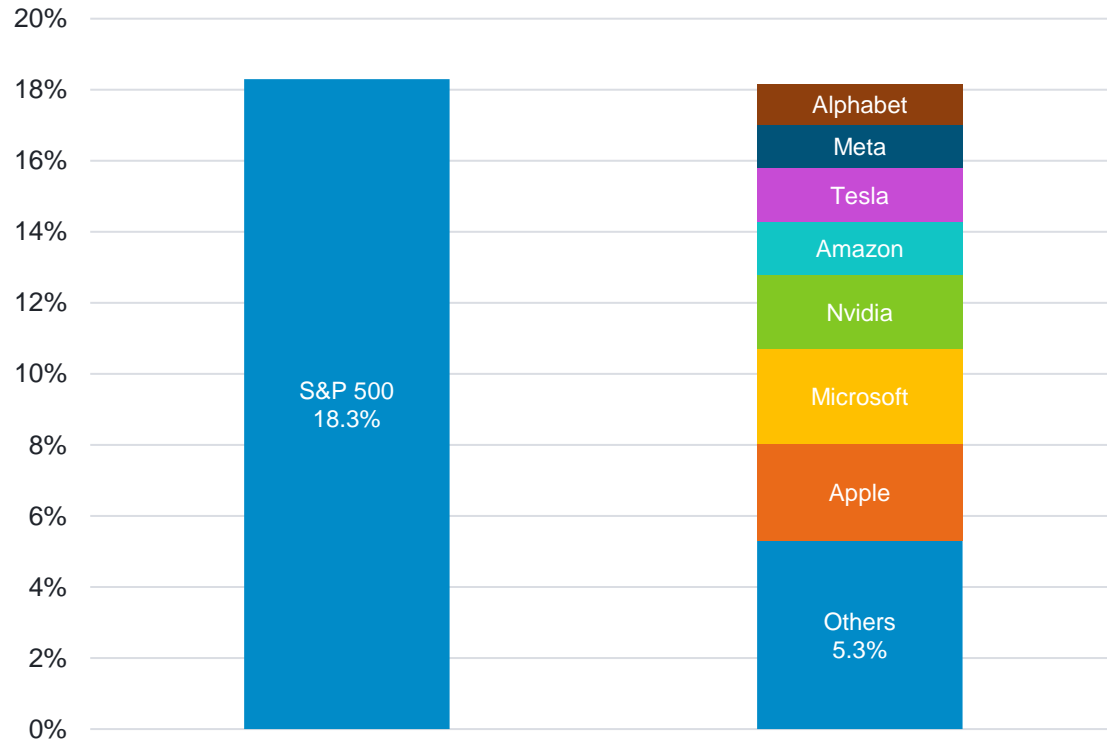
Source: Fidelity International, as of September 2023. Change reflects directional difference in view versus previous month. Views reflect a typical time horizon of 12–18 months and provide a broad starting point for asset allocation decisions. However, they do not reflect current positions for investment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

Equities

Concentration in US equities continues; correlation flips back

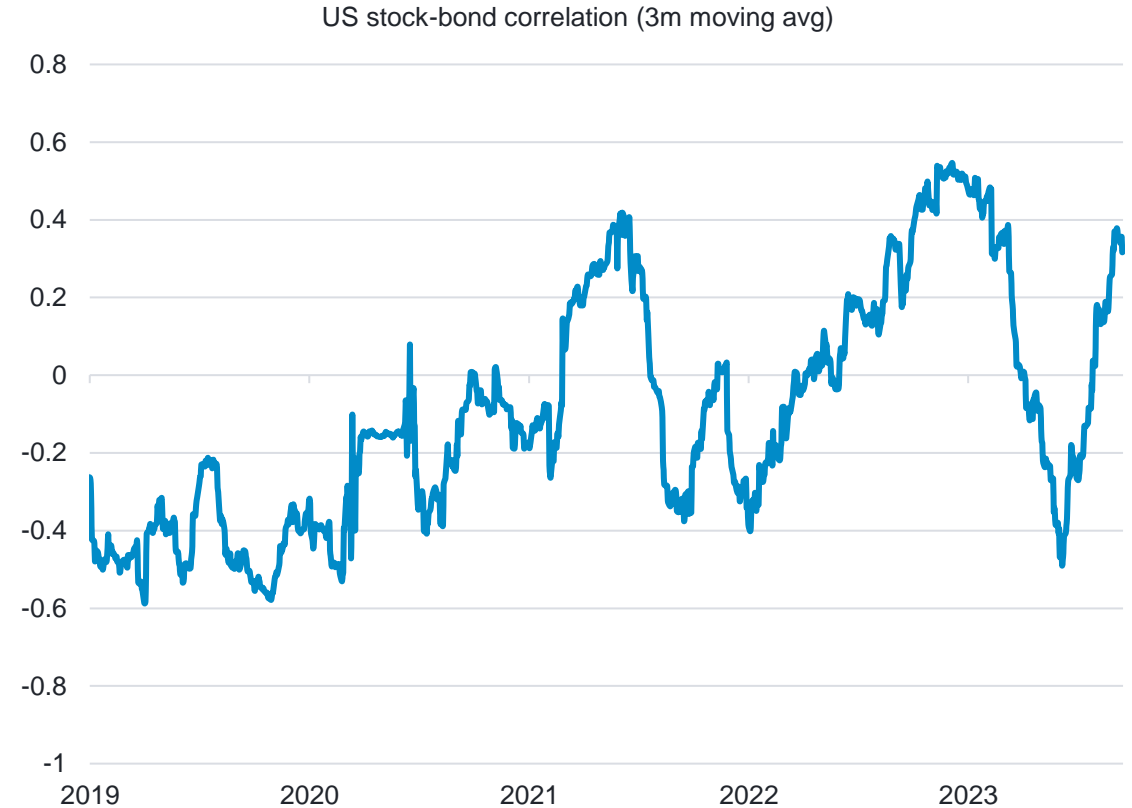
S&P 500 performance dominated by AI-related stocks; stock-bond correlation back to positive

Two-thirds of S&P 500 return this year from "magnificent-7" stocks



Source: Fidelity International, Bloomberg, August 2023.

Stock-bond correlation moves back to positive in Q3

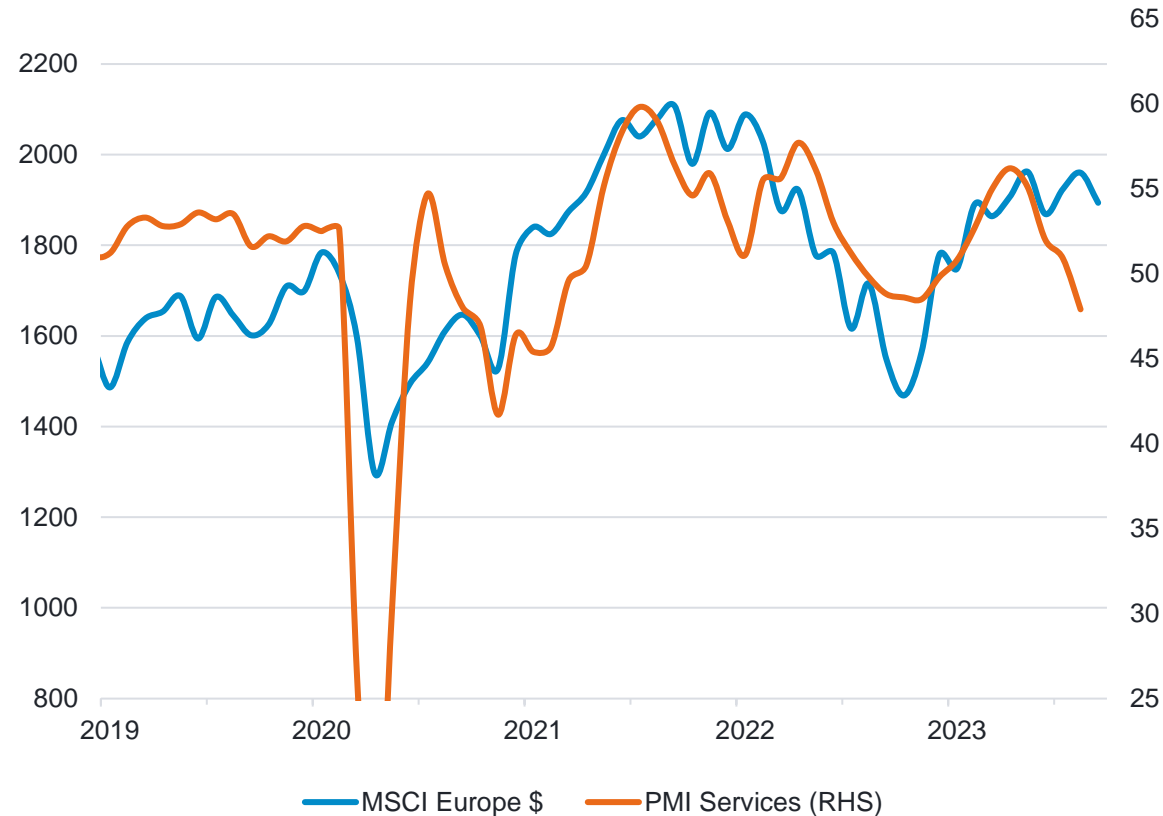


Source: Refinitiv, September 2023.

Contrasting fortunes in Europe and Japan

Europe looks gloomy while Japan looks bright

Europe services sector trending down and equities may follow



Source: Fidelity International, Bloomberg, August 2023.

Upswing in sales and earnings growth in Japan

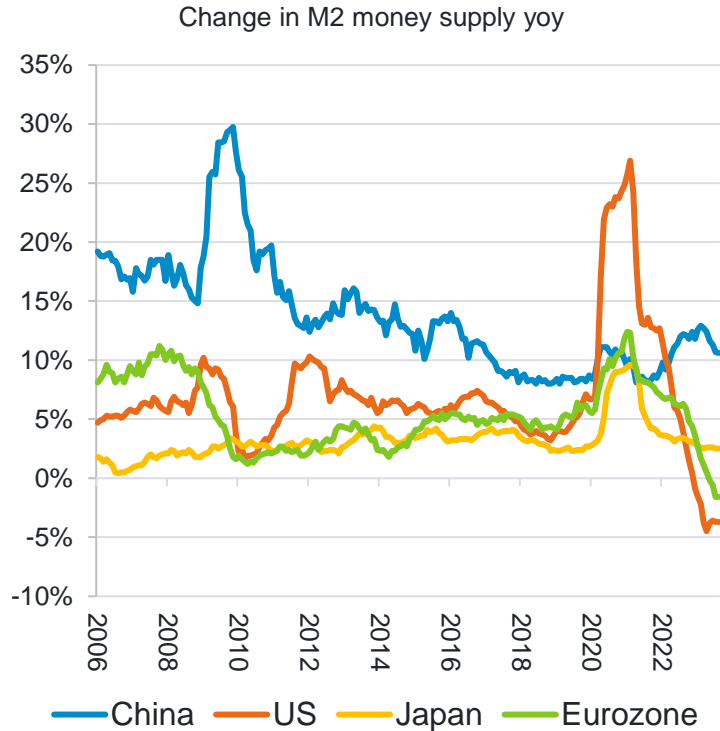


Source: Fidelity International, Ministry of Finance, August 2023.

China has further room to ease; India benefitting from investor flows

China has capacity for stimulus; Investors very negative on China but risk-on in India

China monetary policy response benign vs other DMs



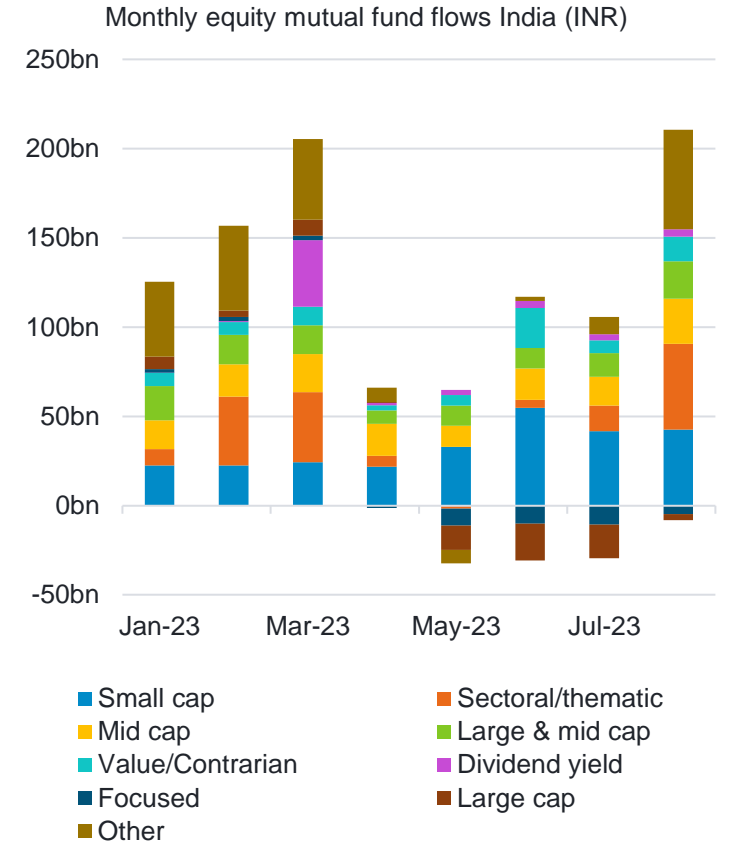
Source: Fidelity International, Haver Analytics, August 2023

Alibaba selling at IPO price 9 years ago, but EPS quadrupled



Source: Refinitiv, Fidelity International, September 2023

Strong inflows to Indian equities this year



Source: Fidelity International, Association of mutual funds in India, September 2023

Equities: Investment implications

We remain cautious on global equities

- Many of the trends from the last quarter continue in this quarter.
- Equity concentration is high, with AI-related stocks driving performance in the S&P 500. This lack of breadth is a risk.
- US stock-bond correlation has flipped positive, making it harder for investors to achieve diversification benefits. However, as inflation moderates and a Fed pivot approaches, we could see the correlation swing back.

Divergence between regions becoming increasingly stark

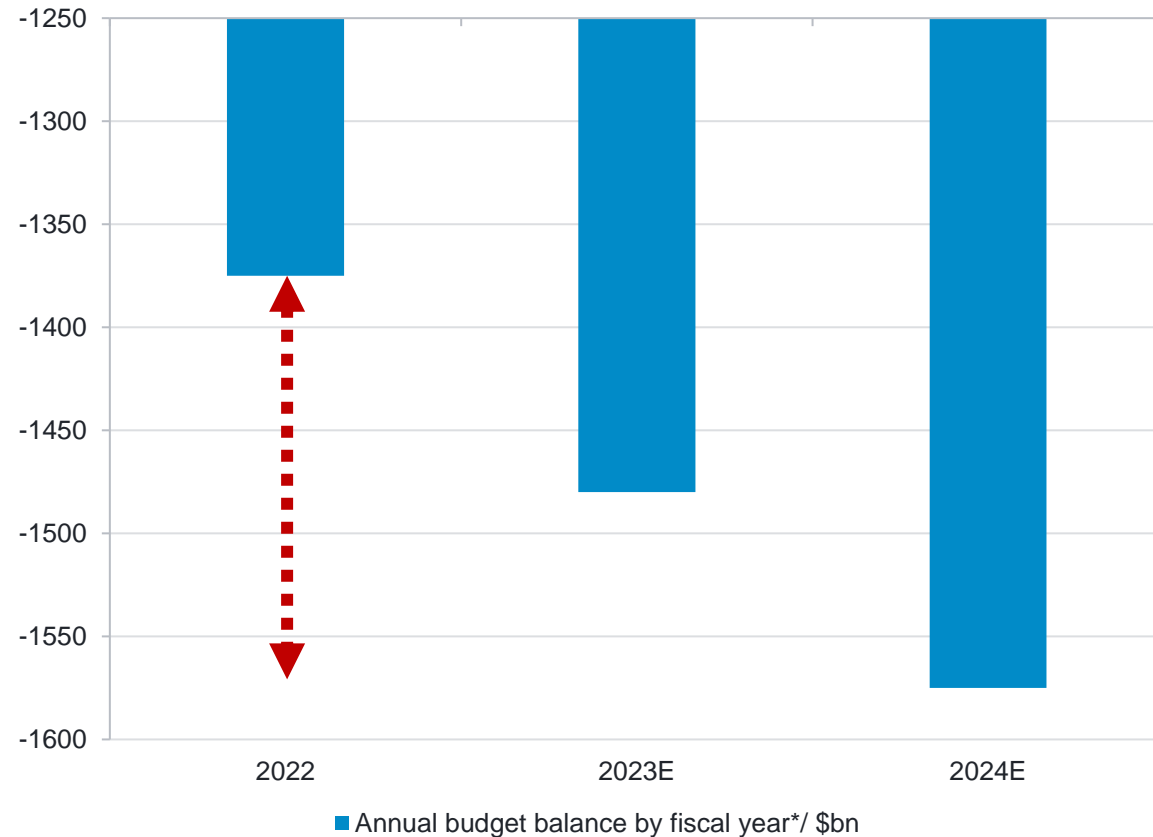
- Europe – facing macro headwinds with anaemic growth and stubborn inflation. Activity is slowing and the outlook for equities is cloudy.
- Japan – economic growth, contained inflation, positive sentiment, and rising sales and earnings mean Japan is a bright spot.
- China – macro challenges and negative sentiment but may be overdone. Policymakers have a growth friendly attitude and some compelling stock bargains available.
- India – accelerating GDP growth, rising capex, positive monthly equity flows this year with small cap demand outpacing large caps all point to a stronger outlook.

Fixed Income

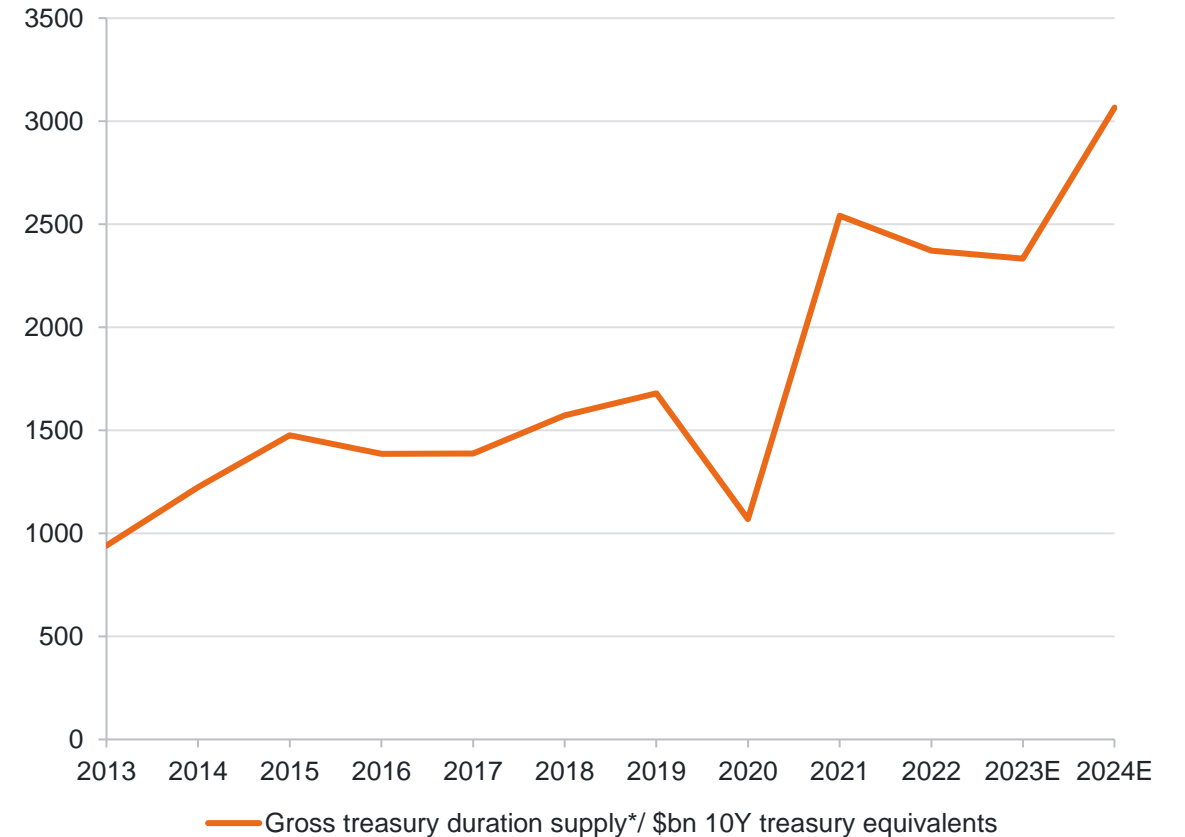
The US continues to have a debt problem

A larger deficit in the US means higher supply of treasuries, which will place further pressure on yields

The US deficit is predicted to continue widening



Treasury supply is expected to rise by 30% next year



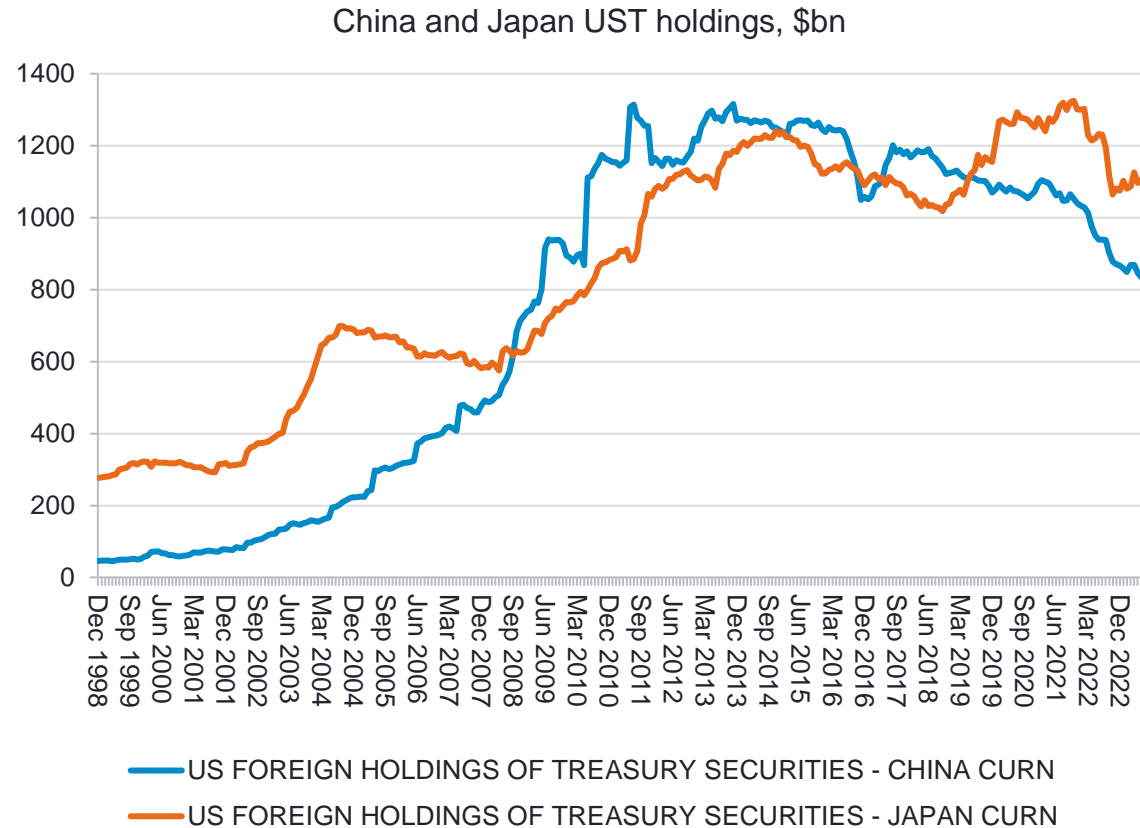
Source: Fidelity International, JP Morgan, August 2023. *FY23 and FY24 are JP Morgan estimates.

Source: Fidelity International, JP Morgan, August 2023

Heavy issuance could weigh on duration in the short term but demand will win out

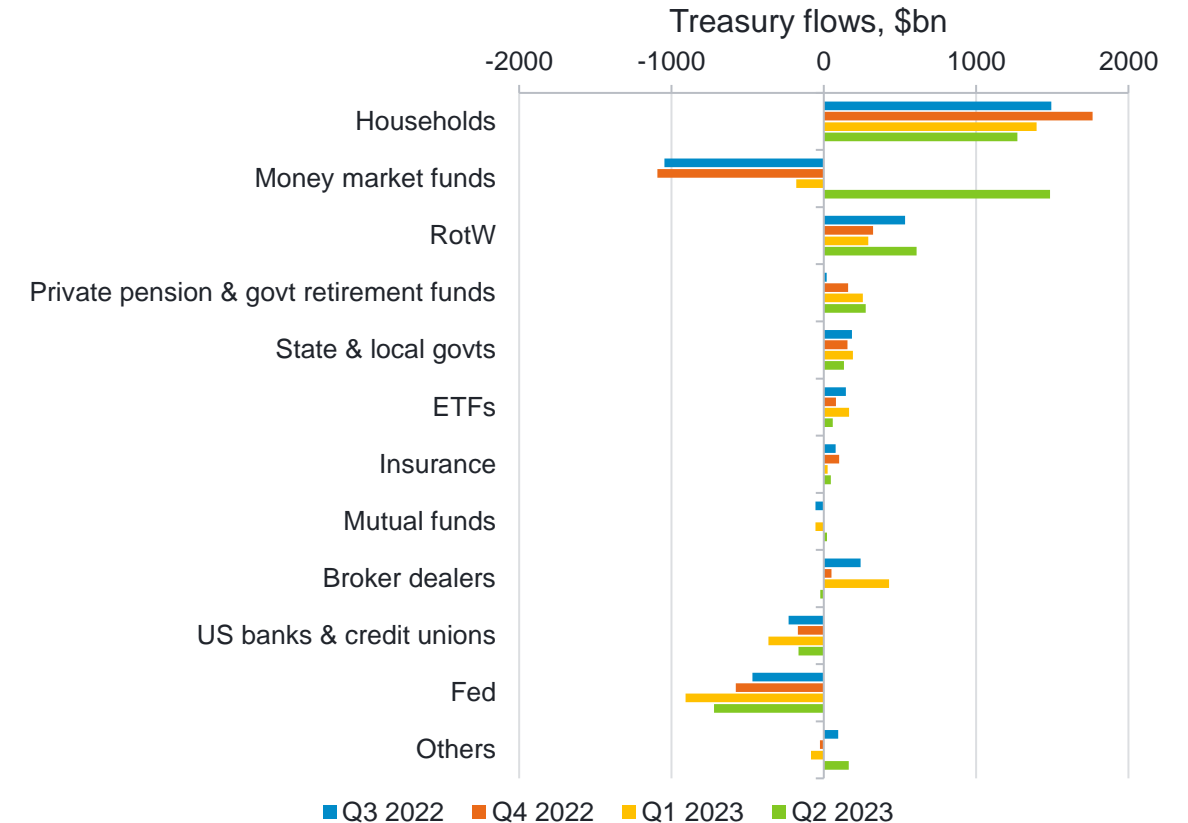
We expect core yields to eventually decline

China and Japan reducing holdings of UST...



Source: Refinitiv, Fidelity International, September 2023.

... and Fed selling. Households stepping in

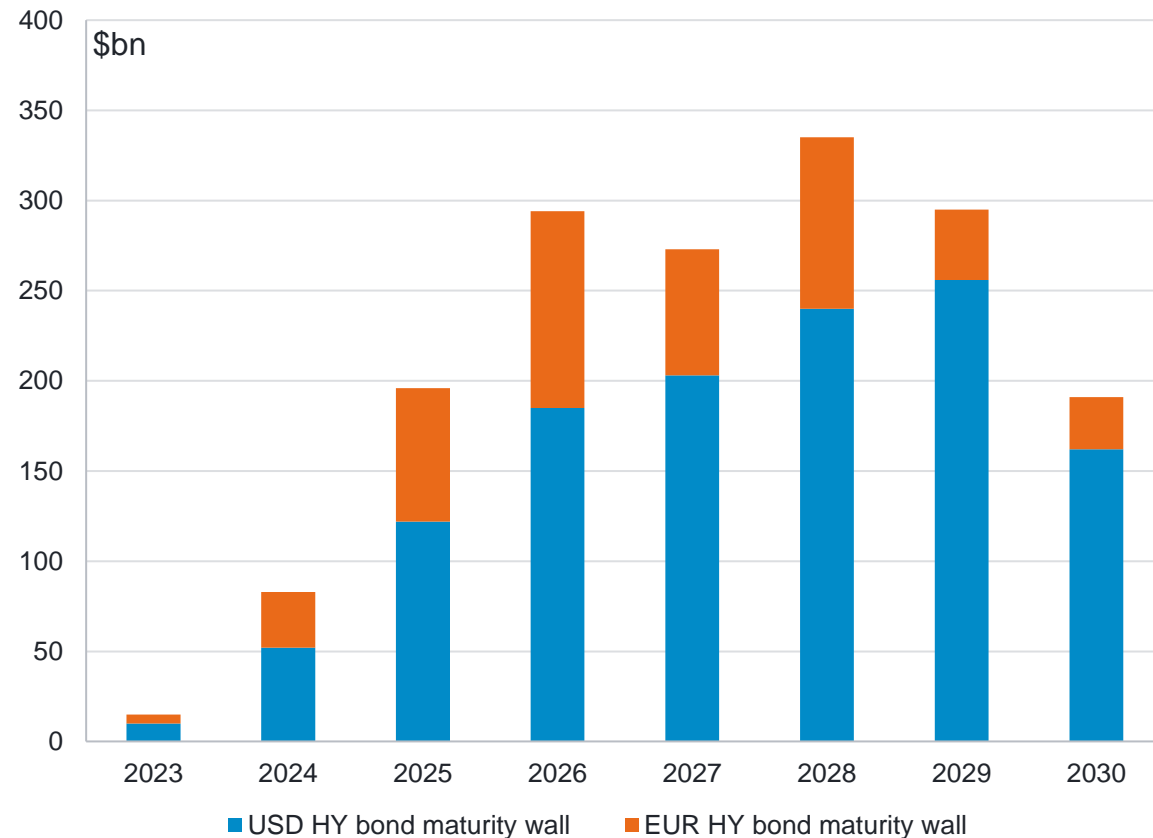


Source: Societe Generale, Federal Reserve, Fidelity International, September 2023.

Higher rates are putting high yield companies under pressure

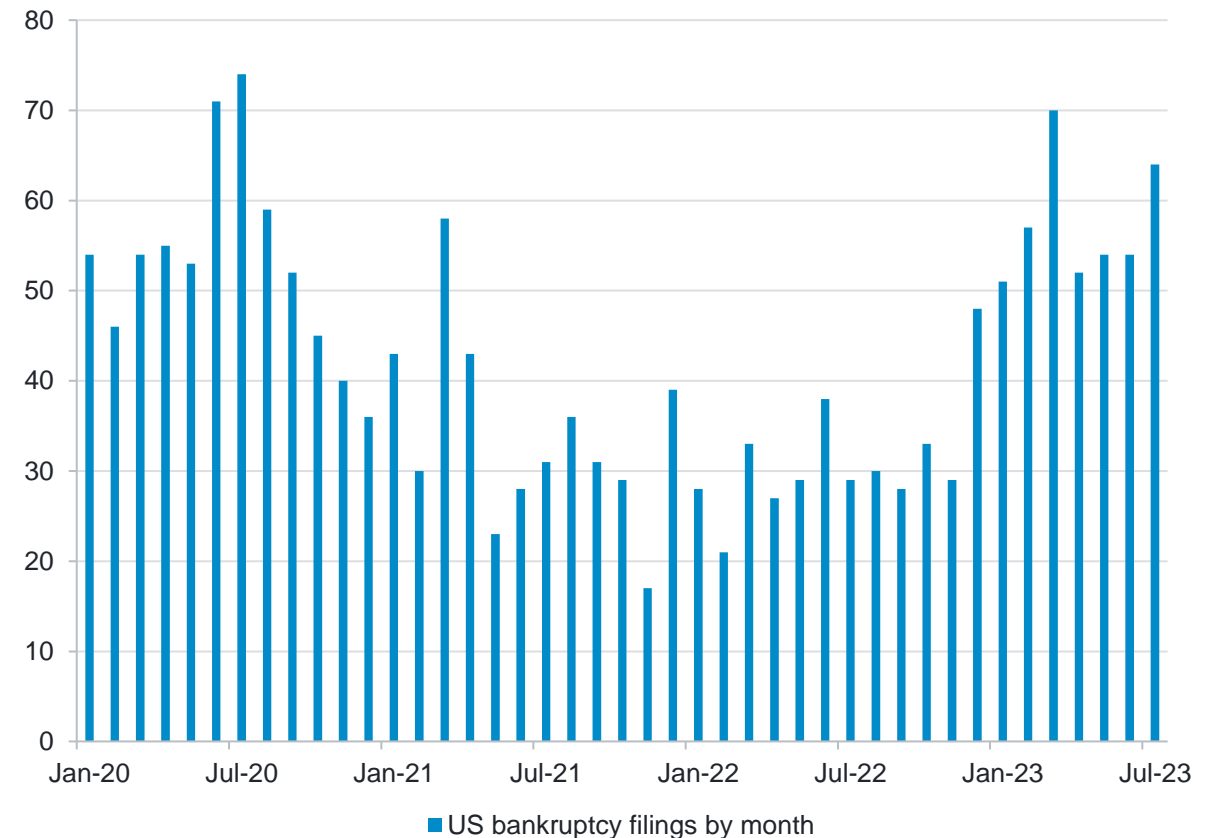
With a large maturity wall upcoming, this will only get worse

Debt is going to have to be refinanced at very high rates



Source: Fidelity International, Bloomberg, 31 August 2023.

We are already seeing the impacts of this in smaller companies



Source: Fidelity International, covers S&P Global Market Intelligence covered-US companies, 1 August 2023.

Fixed Income: Investment implications

Inflation has fallen fast yet policy is still tight

- Inflation has retrenched but Fed's bias is still hawkish.
- We believe monetary transmission mechanism is delayed not broken. This means current policy could increasingly cause tightening of financial conditions, increasing the risk of recession.
- Increasing US budget deficit will lead to more Treasury issuance. This is driving up expectations of the neutral rate of interest and putting upward pressure on yields.

Continuing to take a defensive approach

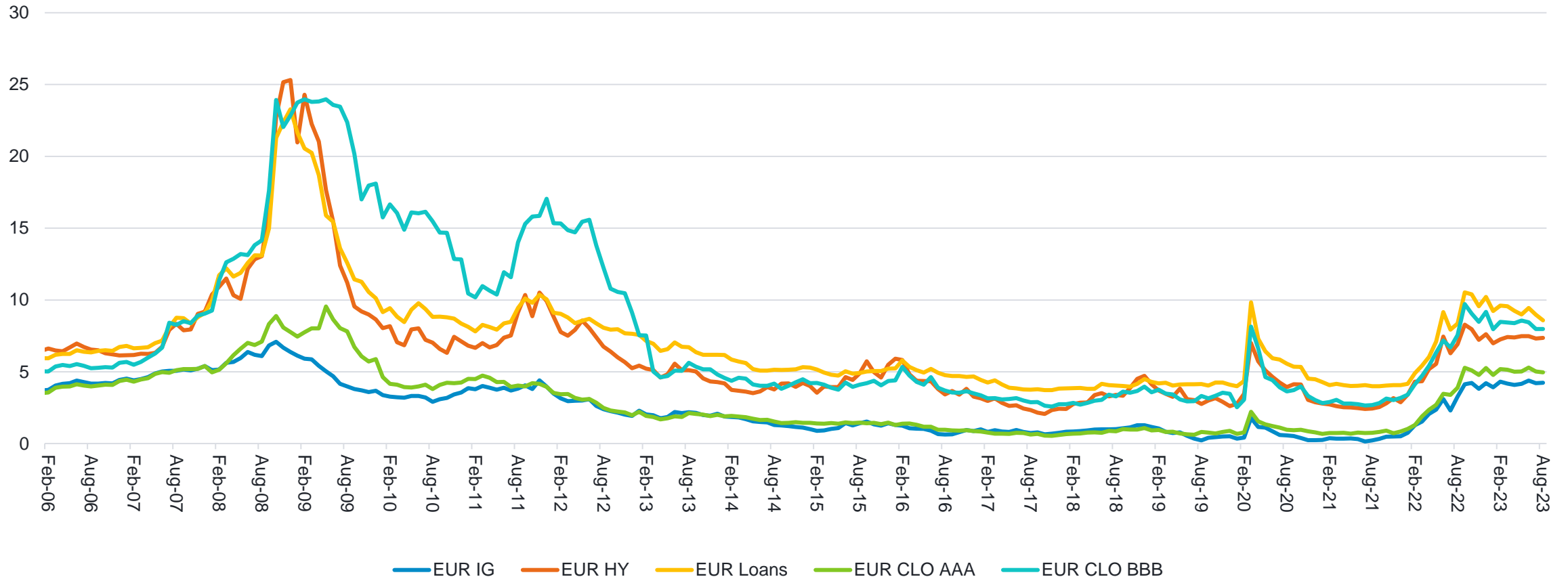
- We are overweight USD and EUR duration
- US duration providing protection against risk of recession and offering decent yields for risk-free investing.
- Europe has anaemic growth and ECB looks like hiking cycle done.
- High quality credits offering strong protection and attractive yield. High yield not compensating for the risk of recession.

Private Credit

European senior loan and CLO yields still compelling

The yields provided by European loans and structured credit remain relatively attractive. Despite the recent tightening in spreads, yields remain above historical averages due to much higher interest rates implying a very attractive income return over the next year.

Historical Yields across EUR Credit

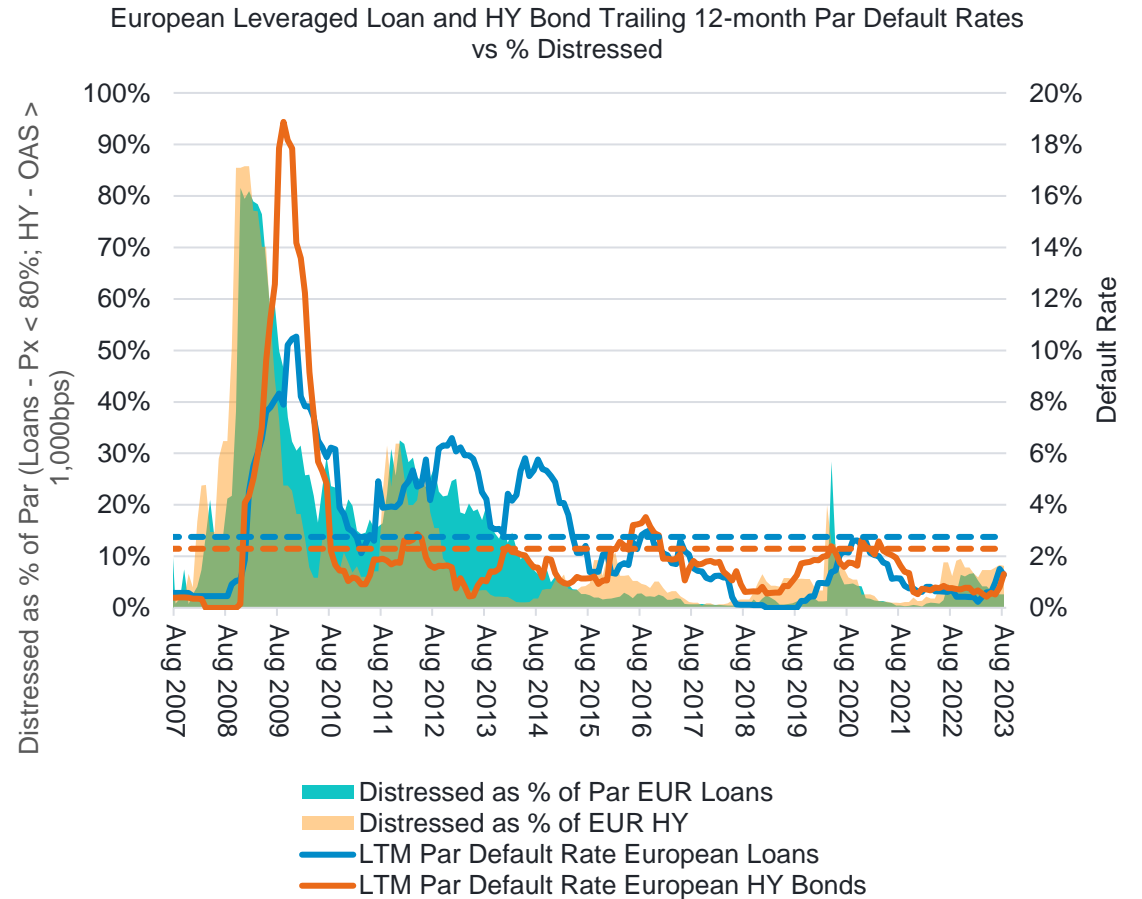
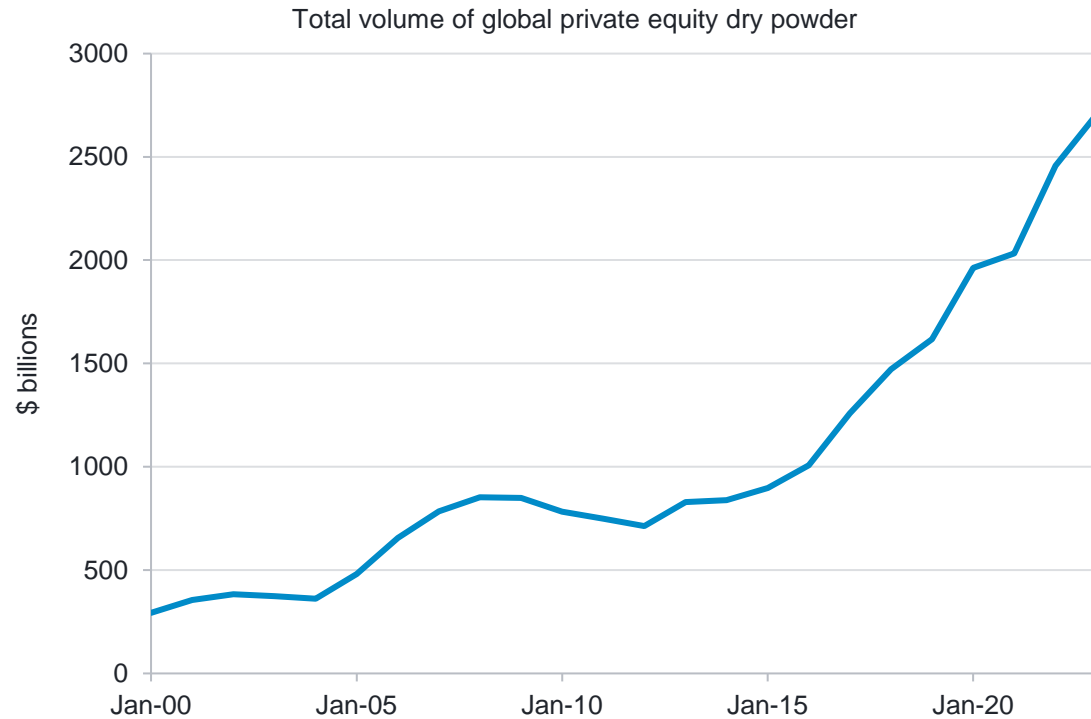


Source: EUR IG: ICE BofA Euro Corporate Index Yield to Worst; EUR HY: ICE BofA Euro High Yield Index Yield to Worst; EUR Loans: CS Western European Leveraged Loan Index EUR denominated only Yield to 3 Year Call; EUR CLO AAA: Citivelocity and JPM Secondary Discount Margins + 3Y Euro Swap rate; EUR CLO BBB: Citivelocity and JPM Secondary Discount Margins + 5Y Euro Swap rate; Fidelity international, 31 August 2023

Issuers well-supported as pressures rise

Private equity sponsors have plenty of dry powder available to support portfolio firms – more than twice the amount of capital that they had going into the Global Financial Crisis....

....this promises a supportive backdrop that should help to contain the default rate outlook. Spikes in distressed credits typically lead spikes in defaults; currently the proportion of distressed credit is falling.

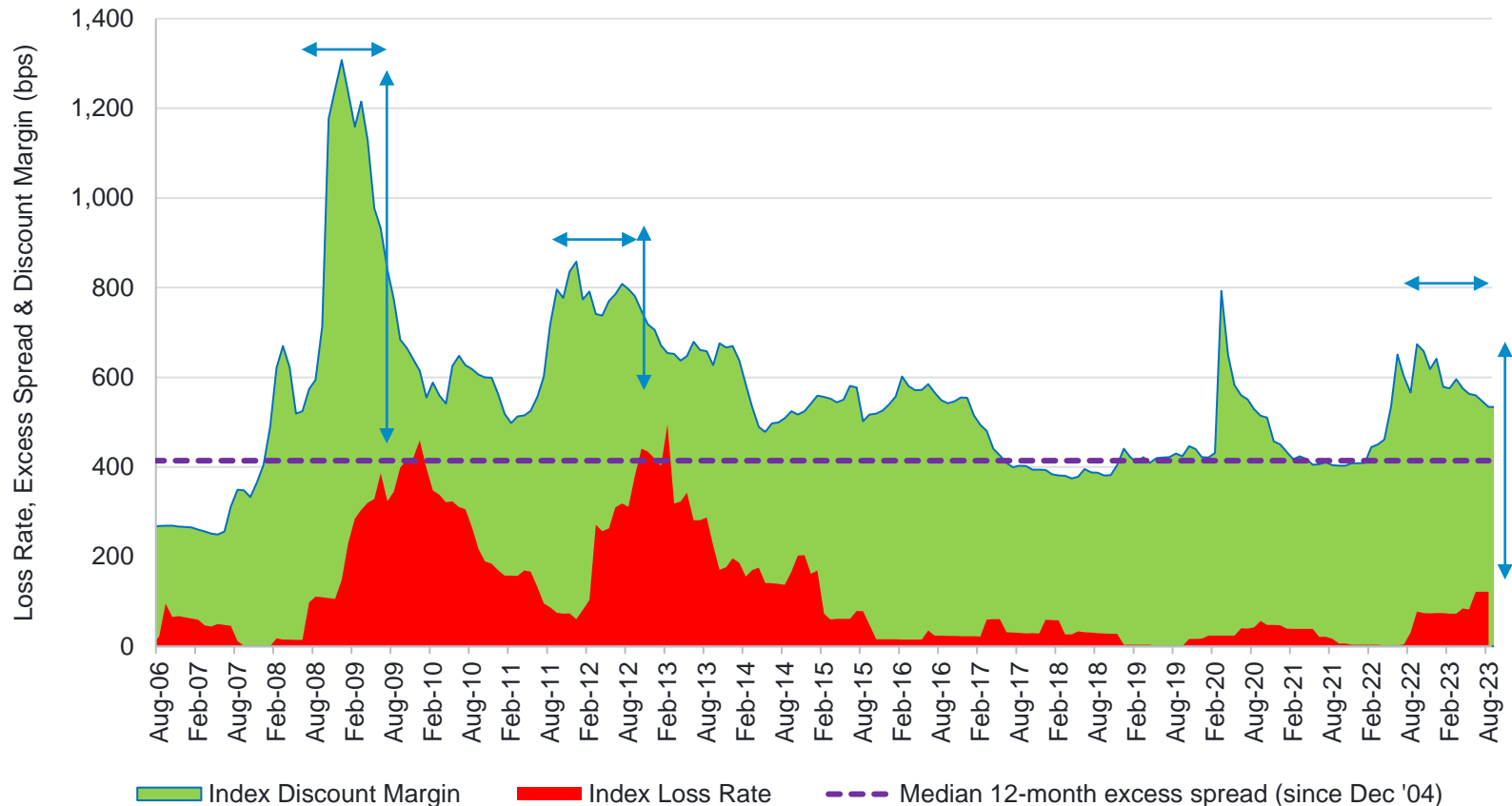


Source: Preqin; Fidelity International, 31 August 2023.

Source: Default Rates: Loans from LCD/Pitchbook; Bonds: BAML; Distressed: CS Western European Leveraged Loan Index and ICE BofA Euro High Yield Index; Fidelity International, 31 August 2023.

Historically, excess spreads above risk-free rates more than compensate for default, allowing investors to harvest a very compelling liquidity premium with low duration

Western European Loans - Widening in Discount Margin leads Losses by c. 8-12 months and compensates sufficiently for losses in the following 12 months. Over 400bps since December 2004.



- As of August 31 2023 the discount margin in the Western European loan market stood at around 534 basis points over Euribor before expected losses.
- At a historical liquidity premium of c. 400bps, this means the market is currently pricing in a default rate of 3% at a 60% recovery rate over the next 12 months.
- Fitch is currently forecasting a 4% default rate to end-2024 under their base scenario and 6% under their pessimistic scenario.
- Under the Fitch default scenarios, we can still expect the European leveraged loan index to return an excess spread of 370bps and 290bps over cash, under the base and pessimistic scenarios, respectively.

Source: Credit Suisse WELLI and Credit Suisse Default Rates and Recovery Rates; Fidelity International, 31 August 2023

Private Credit: Investment implications

An in-built resilience

- The lagged impact from higher rates should lead to a weakening economic backdrop and increased pressure on risk assets. Spreads will need to widen across credit, with private credit well positioned to withstand this pressure given the focus on defensive industries, the seniority of their positioning at the top of the capital structure, and the institutional buyer base.
- Rising debt costs are pushing interest coverage ratios lower and while revolving credit facilities can act as liquidity buffers, higher for longer rates will drive rating downgrades into 2024.

Issuers well-placed to withstand pressure

- In the short to medium term, we expect default rates to rise from their historic lows while remaining contained. This will not be a repeat of the Global Financial Crisis.
- Borrowers have been proactive in addressing near-term maturities and extending facilities while private equity sponsors are sitting on record amounts of dry powder – reported to be around \$2.72 trillion* globally – and have demonstrated that they are willing to use this available liquidity to support portfolio companies.

*As of early September 2023, Preqin

A strong vintage for returns and terms

- Current yields offered by private credit are difficult to ignore, delivering outsized year to date returns while implying continued income generation given the current level of rates.
- The European senior loan market has delivered total returns of 11.5 per cent year to date to mid-September. On a forward-looking basis, returns for European leveraged loans look compelling even after factoring in defaults at historical levels, with coupons implying over 8 per cent of income return for loans at the index level over the next 12 months at current market valuations.

A less volatile outlook

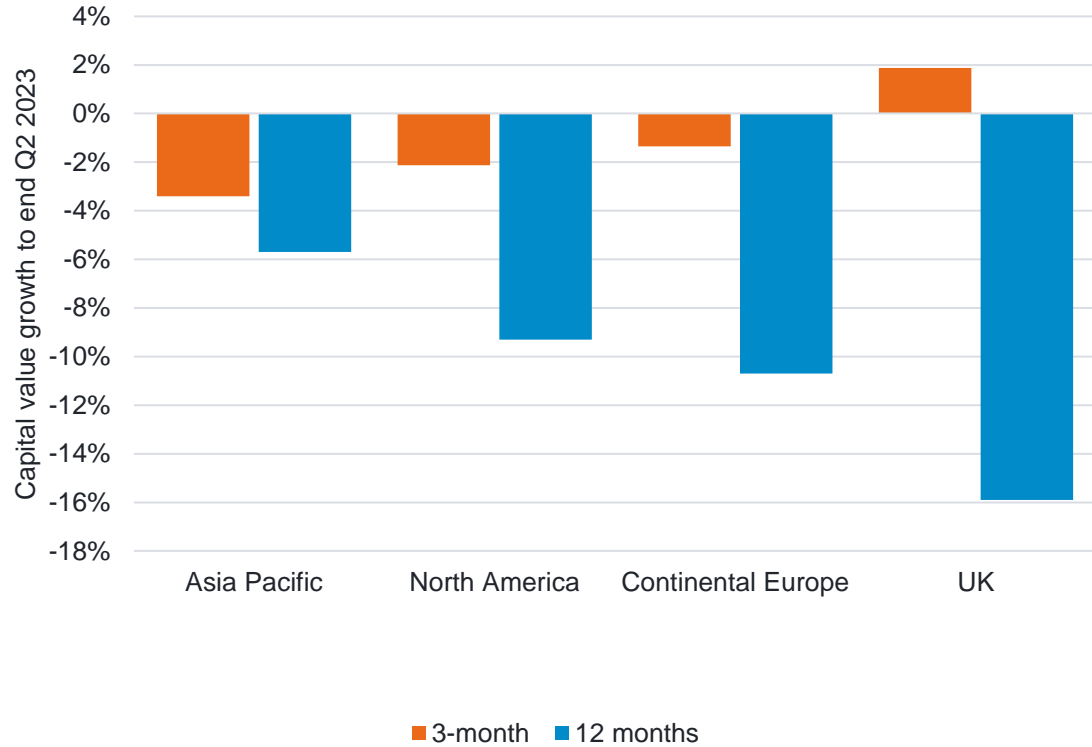
- Fidelity analysis shows that after a change in rates policy, senior loans are likely to be less volatile than high yield or investment grade fixed income products.
- We believe that the high quality carry across private credit should result in strong income generation with lower volatility, whether sticky inflation in Europe results in rates remaining higher for longer or the monetary policy transmission mechanism is alive and well.

Real Estate

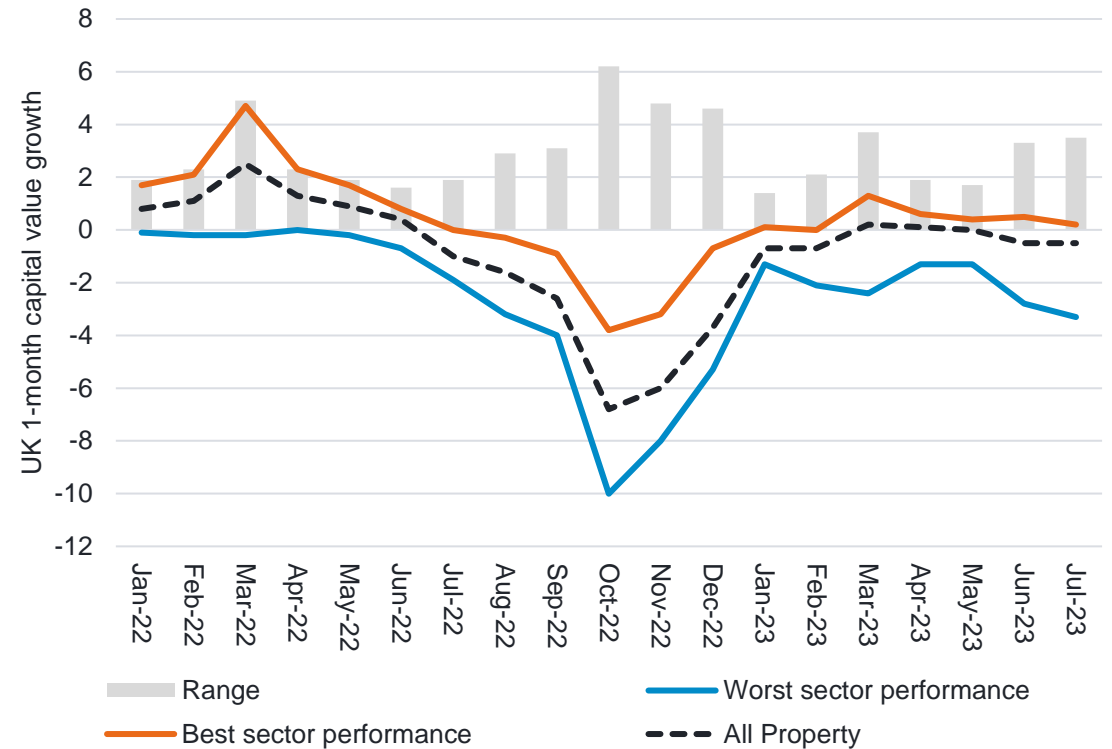
Real estate values are stabilising as interest rates near peak

But starting to see fragmentation in the market as sentiment weighs against offices and commodity space

European markets further through re-pricing in this cycle



Sector level performance is diverging as sentiment weighs against “commodity” offices



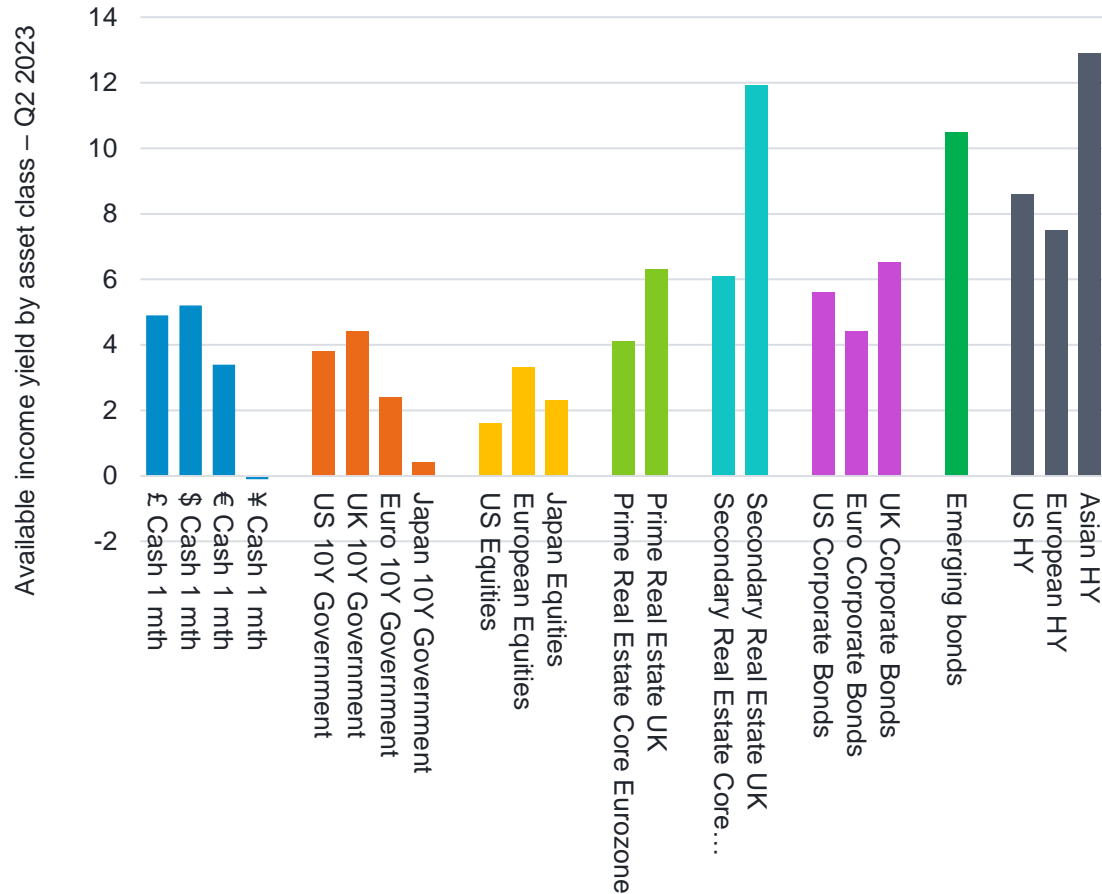
Source: MSCI Global PFI, Fidelity International, Q2 2023.

Source: MSCI UK Monthly Property Index, Fidelity International, August 2023.

Relative pricing of real estate makes it vulnerable to higher for longer scenario

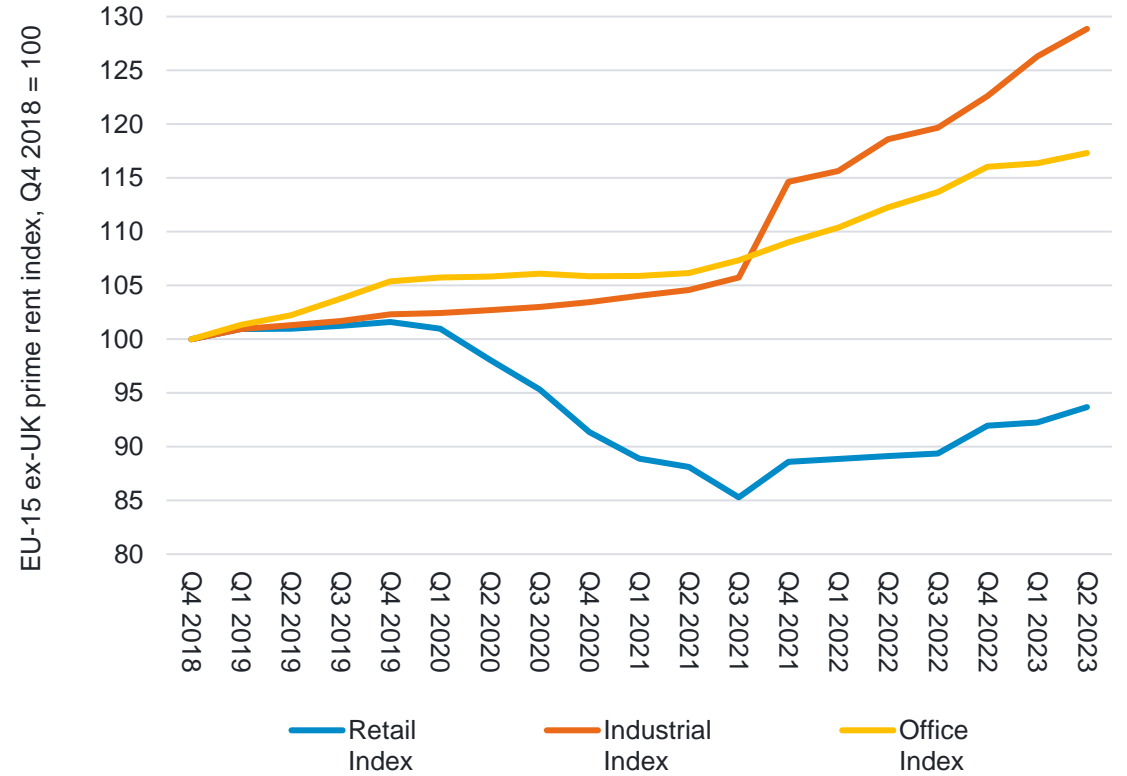
Occupier market resilience supports rental value growth, but vulnerable if bankruptcies continue to rise

Rising interest rates exerting pressure on real estate pricing



Source: Bloomberg, CBRE, Merrill Lynch, Fidelity International, 30 June 2023.

Prime rents continue to grow as a result of supply shortages



Source: CBRE EMEA Indices, Fidelity International, Q2 2023.

Real Estate: Investment Implications

Re-pricing provides attractive entry point for investors

- Values are stabilising after falls of c.15-25 per cent in year to Q2 2023; power has shifted to the buyer as many investors wait to see the bottom of the cycle reached.
- Next 12-18 months should be a good vintage for real estate investment - higher yields and robust fundamentals should generate attractive income and capital growth over the next 5 years.

Market fundamentals providing resilience

- Unusually tight demand/supply balance in Europe is providing short term resilience in the market.
- In a period of volatility, we favour logistics, residential and life science assets, which are set to benefit from the long term secular themes of demographic change, technological change and sustainability.

Sustainability delivers opportunities & fragmentation

- Weak demand for 'unsustainable' buildings is creating a further 'brown discount', but many owners lack asset management capabilities to deliver necessary enhancements to restore assets' value/attractiveness.
- We see opportunities for value-add green building strategies in both office and industrial sectors, supported by re-pricing and strong demand for sustainable and energy-efficient properties.

“Higher for longer” remains a key risk

- Spreads versus bonds still look relatively tight, and higher for longer may result in a further wave of re-pricing, particularly for lower yielding markets/sectors.
- Rising bankruptcies could weaken occupier market fundamentals, resulting in weaker demand and rising vacancy, and downward pressure on rents.

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