



Steering through choppy waters

Fidelity International's outlook from the Equities investment team

For investment professionals only



Executive summary

Volatile markets require careful navigation

We expect a high degree of volatility and uncertainty for equity markets in 2023, with the IMF now expecting one third of the global economy to be in recession. One of our concerns is that if central banks stubbornly dig in and persist with high interest rates and balance sheet reductions to squash inflation, it could result in demand destruction on a scale far greater than in previous cycles.

Meanwhile, expect an inflection point in earnings in the middle of 2023 amid a recessionary fallout on top line earnings growth, an inflationary hit on costs and higher borrowing rates resulting in greater interest expense. However, earnings expectations are diverging across different markets, providing investors the opportunity to capitalise on select opportunities.

Based on our latest full year 2023 forecasts, we are most positive versus consensus in Japan. Pent-up demand (post COVID-19) will underpin growth. Valuations are close to the global financial crisis (GFC) trough, resilient corporate balance sheets mean that exposure to the rising cost of debt globally is limited, and buybacks and dividends are set for record highs.

In China, the market is anticipating an economic rebound as COVID-19 restrictions abate and policy driven investment in certain sectors start to show through. Low valuations among Chinese equities represent an attractive entry point. However, an uptick in infections, triggered by the abrupt ending of pandemic restrictions, could cloud the economic outlook in the short run.

US stocks are relatively well positioned to withstand a hard landing with corporates well capitalised and consumers benefiting from elevated savings levels and a strong labour market. However, markets are some way off from pricing corporate earnings downgrades that would reflect a full-blown recession. It could leave us with the risk of a more dramatic drop in the S&P500 if growth suddenly slows.

Finally, European equities are the most exposed to the current polycrisis. The outlook remains uncertain and conventional wisdom suggests that corporate earnings could be the next to fall. However, much of this is already priced into markets, which often look six months in advance and can sometimes start to recover before earnings reach the bottom or the economy starts to recover.

Toby Gibb - Global Head, Investment Directing - Equities and Fixed Income



The Equities Outlook provides an overview of our investment team's views and positioning in each of the key markets. Each of our portfolio managers has discretion over the positioning and holdings of their portfolios, and, as a result, there may at times be differences between strategies applied within a fund and the views shared in this document.

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Trading desk update

Global market sell-off closed out 2022

Global markets were treated to a “lump of coal sell-off” rather than a “Santa Claus rally” as further downbeat economic data and heightened recession fears added to market concerns over an impending economic slowdown. All sectors attributed to the sell-off, led by sharp declines in information technology and consumer discretionary.

US

Last month was as the third worst December for the S&P 500 index as the market’s optimism following softer CPI prints clashed with a continued hawkish Fed. The consistency of daily declines was also noteworthy: The S&P 500 had 14 days of negative returns in December (the second highest for any month in 2022) and only one day > +1.5% (the least of any month in 2022). Depressed volumes and liquidity compounded the effects with total equity market volumes averaging only \$458 billion/day or 10.8 billion shares/day, the second lowest reading of the year in notional terms and the third lowest in share terms.

The S&P 500 index declined 5.8% in December, with all major sectors in the red. Consumer discretionary (-11.0%), information technology (-8.5%) and communication services (-8.0%) underperformed while health care (-2.0%) and consumer staples (-2.7%) outperformed. Equity issuance was light in December at \$4.2 billion (below the YTD average of \$6.3 billion per month).

Europe

Europe ended the month -3.6% (+10% on the quarter), -12% on year and -18% in US dollar terms. Every sector ended in the red on the month apart from banks and that was just about flat, with technology -7%, auto, travel/leisure -6%, as funds de-risked into year end. Over the year, energy was the only sector in Europe to produce positive returns, outperforming the real estate and retail sectors by 60-70%. European value outperformed growth by 15%. The Stoxx600 index came back to pre-covid (2020) levels. While after decades of underperformance, the FTSE was outright higher - the total return index trading at an all-time high due to low valuations, exposure to energy and weak sterling.

Market volumes fell dramatically, with continued outflows from Europe, 46 weeks in a row. Although the market is anticipating a recession, earnings revisions were positive for the region through 2022 (driven by energy, forex, and margin expectations) before finally turning slightly negative in Q4.

Asia

China’s reopening outlook led to outperformance in Hong Kong (+8.1%) and China (+5.2%) versus other Asian markets. Meanwhile India (-5.5%), Taiwan (-5.6%), and Korea (-6.2%) lagged on selected outflows and concerns that the current Fed rate hike cycle may take longer than expected. ASX 200 (AUD) and MSCI Australia (US\$) declined 3.4% and 2.1% respectively in December. Within MSCI Australia, materials were the only sector with positive returns, buoyed by strength in major iron ore players. Underlying iron ore prices rallied, as China’s property support measures and easing pandemic curbs raised hopes of a recovery in construction activity.

For Japan, the TOPIX declined during the month (-4.76%). The Bank of Japan (BoJ) revised its yield curve control (YCC) policy earlier than the market expected, which led the yen strengthening and putting downward pressure on equities. By sector, financial stocks including banks and insurers greatly outperformed the TOPIX, as well as defensive sectors (utilities, personal care, daily necessities). In contrast, the semiconductor, technology, automobile, health care and durable consumer goods sectors all underperformed.

In terms of flows, Taiwan (-US\$2,885 million), Indonesia (-US\$1,344 million) and South Korea (-US\$1,305 million) led outflows in December. Vietnam (+US\$497 million), Thailand (+US\$369 million) and India (+US\$263 million) bucked the trend. For China, northbound and southbound totalled Rmb35 billion and Rmb8 billion net inflows. Last year saw record-low northbound inflows since 2016.

US

Rate hike fears weighed on equities

Equity markets fell in December, reflecting the Fed's confirmation that financial conditions would remain restrictive. Following a 0.50 percentage point interest rate hike (versus previous four hikes of 0.75 percentage points), sentiment quickly turned negative after the Fed reiterated its hawkish monetary policy measures. Fed officials anticipate further interest rate hikes in 2023, citing a strong employment market. The projected terminal rate increased from 4.6% in September to 5.1% in December.

Within the S&P500, all sectors participated in the sell-off, with consumer discretionary, information technology and communication services among the weakest performers. From a style perspective, value stocks outpaced growth and quality names, while mid-caps surpassed small and large-cap stocks.

The Q4 earnings season is around the corner and so far, all the incoming waves of estimates are heading lower. By all indications, it all adds up to a choppy sideways market for stocks in 2023.

Fed policy path in focus

We expect equity markets to continue facing elevated levels of volatility with monetary policy likely remain restrictive as the Fed tries to restore price stability. A recession looks likely to provide downside pressures because of higher borrowing costs and increasing economic uncertainty. There is an increasing probability that the Fed will slow the pace of rate increases and perhaps even reduce rates at some point this year. Inflation will likely prove the key to this - CPI has peaked in the US. As a result, there should be less doubt about the future direction of interest rates and the terminal policy rate, which should boost investor confidence. However, our greatest concern is that if the Fed wants to regain lost credibility by stubbornly digging in and persisting with high interest rates and balance sheet reductions (long after pausing rate hikes), it could result in demand destruction on a magnitude far greater than in previous cycles.

Earnings results from US corporates have started to result in some downward revisions, as the weaker economic environment and higher interest rates are reflected in company results. In 2023, we are likely to see declines due to the impact of higher borrowing costs and prices going forward, in the form of lower earnings expectations, compared to last year's declines due to a contraction in valuation multiples.

However, the US is typically a relative haven during periods of turbulence. US corporates are well capitalised, and consumers benefit from elevated savings and labour market strength. The global nature of US equities' revenue generation suggests there are opportunities in both strong and weak US dollar environments.

Europe

Rising interest rates unsettle equities

European equities edged lower after the European Central Bank (ECB) raised interest rates by 0.50 percentage points at its December meeting, bringing the deposit facility rate to 2%. On the back of upward revisions to the inflation outlook, the ECB said further significant rate hikes are expected at a steady pace to ensure that inflation returns to its 2% target. ECB members continued with their hawkish rhetoric, signalling that the deposit rate could reach 3% in March and that 0.5% interest rate hikes may become the near-term normal.

The pan-European STOXX600 index fell 12.9% for the year, its worst performance since 2018. The energy sector ended the second year higher (up 25.5%) as crude prices rallied on tight supplies due to the Ukraine war while rate sensitive technology (-27.6%) and real estate (-31.9%) sectors lagged peers.

Remaining cautious amid an uncertain environment

Heading into 2023 we remain cautious despite European equities rebounding strongly in the fourth quarter. Macroeconomic indicators are weak, suggesting there will be a recession in Europe. Although there are indications that inflation may be moderating, the outlook is uncertain and short-term confidence remains very fragile. Investors' optimism is set to reverse as the decline in household purchasing power could further hit corporate margins and, as such, lead to a wave of earnings downgrades.

Our aggregate estimates indicate that more sub-sectors will register a decline in profitability this year, as measured by net income growth. We expect profits to decline in the materials, real estate, transportation, energy, and auto industries. Additional sub-sectors are expected to register a decline in profitability, given the headwinds of higher costs, including raw materials, labour, and interest expenses.

However, there are opportunities in sectors that have not yet returned to pre-Covid levels of activity and so should see stronger tailwinds as the market continues to normalise post-pandemic, as well as those that enjoy a particularly strong tailwind from a stronger dollar. Companies with lower-than-average debt levels should also prove relatively resilient, as they will be shielded from higher interest costs and the need to raise more equity. Europe is more geared to China than most other regions from both an economic and stock market perspective and therefore is set to benefit from reopening. Sectors in Europe with the highest revenue exposure to China are semiconductors, materials, luxury goods, energy and autos.

Japan

Rate hike fears dampened sentiment

Japanese equities fell in December, amid fears of an economic slowdown due to the Fed's interest rate hikes. US data pointed to persistent inflation, which raised worries that the Fed may keep interest rates higher for longer. Shares also came under pressure after the Bank of Japan (BoJ) surprised the market with a tweak to its bond yield control that allows long-term interest rates to rise more. The move is aimed at easing some of the costs of prolonged monetary stimulus. Many market participants were caught unawares amid expectations of no changes to the Bank's yield curve control until Governor Haruhiko Kuroda steps down in April.

At sector level, real estate, transportation equipment and precision instruments were the biggest decliners, while interest-rate sensitive stocks among banks and insurance companies were the leading gainers. Small-cap stocks fared better than their larger counterparts, while value names outperformed growth stocks.

Positive outlook on stocks despite ongoing volatility

With the global economic outlook darkening, Japan has been an outlier - showing a degree of resilience as COVID-19 restrictions ease and the economy finally reopens. Unlike many other countries, the economic policies of the Japanese government and central bank are a positive mix of fiscal expansion and monetary easing.

Pent-up demand among both consumers and businesses will continue to underpin growth. We have started to see a pickup in the number of inbound tourists taking advantage of the weak yen. Corporate valuations are supportive and compare favourably with those in other developed markets, such as the US.

A high degree of negative news has already been priced in, and recent earnings results have been strong despite concerns about an economic slowdown overseas. Inflation is at a much lower pace, within a narrow range compared to other regions.

Meanwhile, Bank of Japan Governor Haruhiko Kuroda's term will end in the Spring and speculation over the future direction of monetary policy in Japan is set to intensify. It is not yet clear who will succeed him, but it remains to be seen how much longer the Bank of Japan can continue with its existing policy.

If the view that long-term rates have peaked gains traction, this would help to put a floor under equity markets. It would also support a bottoming out in Japanese stocks, and one would expect some of the names that performed poorly in 2022 to come back quite strongly.

Emerging markets

EM markets fell but still outperformed developed peers

Emerging markets declined in December after posting a strong rebound in November but still managed to outperform most developed markets. Sentiment turned negative after the Fed reinforced its hawkish monetary policy stance and delivered a 0.50 percentage point interest rate hike.

Regionally, emerging Asia was the best performer, followed by emerging Europe, Middle East, and Africa (EMEA) and Latin America, though all regions ended in negative territory. Within emerging Asia, Chinese equities rose as the country eased its strict zero COVID-19 policy. China's central bank kept its benchmark lending rates unchanged for the fourth consecutive time. Indian equities declined as its currency depreciated against the US dollar. Within Latin America, the Brazilian market slid. Its GDP growth slowed by a higher-than-expected margin in the third quarter as higher interest rates dampened consumer spending. At sector level, communication services and consumer discretionary were among the positive performers, while information technology and energy disappointed.

EM risks appear priced in

EM equity markets has been significantly derated, particularly when compared to developed markets. However, we are of the view that a lot is already reflected in the price. Inflation, geopolitical tensions and slowing growth have wreaked havoc on EM markets through 2022 and is likely to persist into the new year. Markets have been grappling with rising recessionary risks, which will no doubt be deeper in areas where the consumer is most exposed to higher gas prices. Geopolitics remains a tail risk for markets.

Fed rate hikes can break the energy market, but only temporarily. Medium term we anticipate that inflation will remain persistently high driven by a long list of contentious issues including energy security, the shift to green energy, climate change impact on agriculture/soft commodities, supply chain security, and deglobalisation. EM is generally less impacted given the propensity to burn coal (or given the benefits of access to cheap gas in the Middle East). The likes of China, India, Indonesia, South Africa, Brazil and the GCC are not as badly affected as the rest of the world.

As a risk asset EM has undoubtedly been punished, however, many EMs have made strides versus previous crises such as the 2013 'taper tantrum'. At a country level, the finances of some the most vulnerable economies have been shored up, inflationary pressures have been less pronounced, and where necessary there has been a build-up of reserves and arguably the most proactive central bank policy moves in the world.

China has been highly topical, not least because as the largest single market in our universe it plays a central role in driving sentiment towards the asset class and performance of the index in aggregate. Whilst remaining cautious, we do not believe its problems are systemic; China is in a difficult place, but it has cyclical issues which will be overcome. Policy is evolving and so we must remain vigilant. After a particularly challenging 2022, a sustained change in sentiment has scope to significantly influence returns.

Asia Pacific ex Japan

Asian equities remained resilient

Last month, stocks remained broadly unchanged, while some regions continued to experience fluctuations. Foreign inflows into the Chinese and Hong Kong markets remained strong, reversing the record selling post the Communist Party Congress in October. Investors preferred these markets for their attractive valuations. Better-than-expected earnings from major Chinese internet companies last month and steps taken by authorities to ease pandemic-related quarantine requirements lent support to the rally in China.

Chinese and Hong Kong markets continued to recover

Chinese and Hong Kong equities were the biggest positive outliers within the broader Asian market. Investor sentiment remained positive amid signs of an improving regulatory environment and supportive government policies. China recently indicated a more growth-friendly policy environment in 2023 to revive an economy hamstrung by COVID-19 restrictions, a property market slump, and a regulatory overhang. Furthermore, China's reopening raised hopes that the pace of economic recovery from COVID-19 disruptions could accelerate in 2023.

Conversely, Taiwanese, and South Korean markets slid sharply and gave up some gains from November. Indian equities also edged lower and gave up some gains from the previous month. Domestic sentiment weakened amid fears over growing recession risks and monetary tightening by central banks globally. Nonetheless, foreign and domestic institutional investors remained net buyers of Indian equities, recording positive flows. Australian markets declined in-line with global equities. The Reserve Bank of Australia (RBA) raised interest rates by 0.25 percentage points and highlighted that the board intends to increase rates further, but it is not on a pre-set course.

A cautious outlook given ongoing uncertainties

Looking ahead, we continue to advocate for valuation discipline as the reopening of China has prompted investor interest, especially as the nation has remained underweight in many global investors' portfolios over 2022. Global central banks may also over-tighten, potentially causing some collateral damage. Expect downward revisions to margins and earnings as the full brunt of cost input inflation comes through. Nonetheless, there are some stock opportunities in a select number of areas that have faced significant selling pressure to the point where the risk-reward potential looks compelling.

We think that Asian markets centre around China, with heightened news flow related to the property market, given how critical it is to the country's GDP growth. There appears to be some traction with respect to restarts in the property sector – mortgage repayments are starting back up and the sales decline is stabilising, indicating that the property market may be potentially close to bottoming out. In the meantime, China has been easing COVID-led restrictions and the reopening theme is in play. The easing of mobility restrictions could result in a material stock market rebound. We remain mindful of the potential for volatility as economic data releases may not match the pace of ground activity immediately.

Outside of China, India and Asean offer long-term structural opportunities, especially financials, which tend to be proxies for an emerging middle class and rising consumer trends over the longer term. On its own, Indonesia is a net energy exporter and is one of a few countries to benefit from increased energy prices, which should persist into 2023. A meaningful pick-up in economic activity is evident across the broader Asia region, with clear improvements in these markets.

UK

Recession fears gripped markets

UK equities fell in December, capping what proved a difficult year for markets. Conviction remained low as investors grappled with recessionary fears amid high inflation and tight financial conditions, while optimism about China's reopening helped offset some losses. The Bank of England raised interest rates by 0.50 percentage points, as expected, while signalling that more rate hikes may be required to bring persistently high inflation under control.

Economic data remained weak, with property prices falling for the fourth consecutive month in December, marking their longest contraction since the 2008 financial crisis, according to Nationwide. In another sign of the economy teetering on the brink of recession, the country's GDP contracted by 0.3% in the third quarter, from a previous estimate of 0.2%.

Against this backdrop, all sectors except health care ended the month lower, with telecommunications and technology stocks among the worst performers. From a style perspective, value stocks outperformed growth/quality stocks, while large-cap names outperformed their smaller counterparts.

Uncertain economic outlook will weigh heavily on stocks

There is clearly a lot of economic and geopolitical uncertainty globally, as the UK economy grapples with historically high levels of inflation. Most indicators point towards a slowdown or recession as inflation and rising interest rates take their toll on consumers and businesses. The unpredictable demand picture, combined with ongoing supply chain pressures, is adding to the volatility we are starting to see emerge in company earnings.

A negative outlook is now being reflected in share prices, with some sectors and areas of the market particularly depressed. While the environment is likely to remain uncertain, particularly for companies and consumers in need to refinance their debts, these valuation levels, and the large divergence in performance between different parts of the market, creates good opportunities for attractive returns from UK stocks in the longer term.

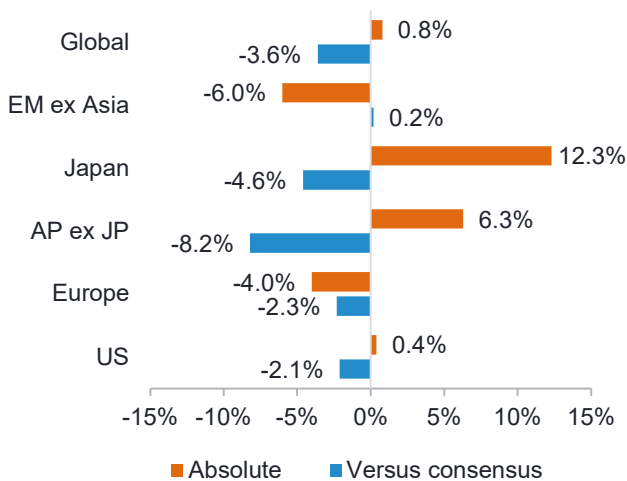
Market Data

GLOBAL					
Absolute Returns (USD)					
		1 Month	3 Months	YTD	1 Year
INDEX	MSCI AC World	-3.9	9.9	-18.0	-18.0
SECTORS	C Disc	-7.0	-0.7	-31.6	-31.6
	C Staples	-1.4	11.3	-6.0	-6.0
	Energy	-3.5	18.0	34.5	34.5
	Financials	-2.4	14.5	-9.2	-9.2
	Health Care	-1.1	13.2	-5.7	-5.7
	Industrials	-2.0	17.6	-12.6	-12.6
	IT	-7.8	5.9	-30.9	-30.9
	Materials	-2.6	16.3	-11.1	-11.1
	Comm. Svcs.	-4.5	2.5	-35.3	-35.3
	Utilities	0.1	10.5	-3.9	-3.9
	Real Estate	-3.2	6.1	-24.0	-24.0
	MAJOR MARKETS	US	-5.9	7.1	-19.5
Europe		0.0	19.4	-14.5	-14.5
EM ex Asia		-3.4	5.9	-16.0	-16.0
Asia ex Japan		-0.1	11.4	-19.4	-19.4
Japan		0.3	13.3	-16.3	-16.3
STYLES	Value	-2.3	14.4	-6.9	-6.9
	Growth	-5.5	5.3	-28.4	-28.4
	Quality	-4.6	9.5	-23.4	-23.4
	Risk	-0.8	11.0	-13.0	-13.0
	Momentum	-2.5	13.1	-18.7	-18.7
	Large Cap	-4.1	9.5	-17.9	-17.9
	Mid Cap	-2.8	11.8	-18.4	-18.4
	Small Cap	-3.1	10.6	-18.3	-18.3

Absolute Returns (Local)					
		1 Month	3 Months	YTD	1 Year
INDEX	MSCI AC World	-4.7	7.5	-15.6	-15.6
SECTORS	C Disc	-8.0	-3.0	-29.9	-29.9
	C Staples	-2.3	8.3	-2.7	-2.7
	Energy	-4.0	15.7	41.3	41.3
	Financials	-3.2	11.7	-5.8	-5.8
	Health Care	-1.9	11.0	-3.7	-3.7
	Industrials	-3.4	13.8	-8.8	-8.8
	IT	-8.3	4.4	-29.6	-29.6
	Materials	-3.7	12.2	-6.5	-6.5
	Comm. Svcs.	-5.1	0.8	-34.2	-34.2
	Utilities	-0.8	7.9	-1.2	-1.2
	Real Estate	-3.8	4.4	-22.5	-22.5
	MAJOR MARKETS	US	-5.9	7.1	-19.5
Europe		-2.7	10.5	-8.0	-8.0
EM ex Asia		-3.6	2.9	-11.9	-11.9
Asia ex Japan		-0.8	8.3	-15.1	-15.1
Japan		-5.2	3.2	-4.1	-4.1
STYLES	Value	-3.1	11.9	-4.1	-4.1
	Growth	-6.4	3.0	-26.4	-26.4
	Quality	-5.1	7.8	-21.8	-21.8
	Risk	-2.3	6.9	-8.0	-8.0
	Momentum	-3.5	10.0	-15.6	-15.6
	Large Cap	-4.9	7.3	-15.6	-15.6
	Mid Cap	-3.8	8.7	-15.2	-15.2
	Small Cap	-4.1	7.5	-14.8	-14.8

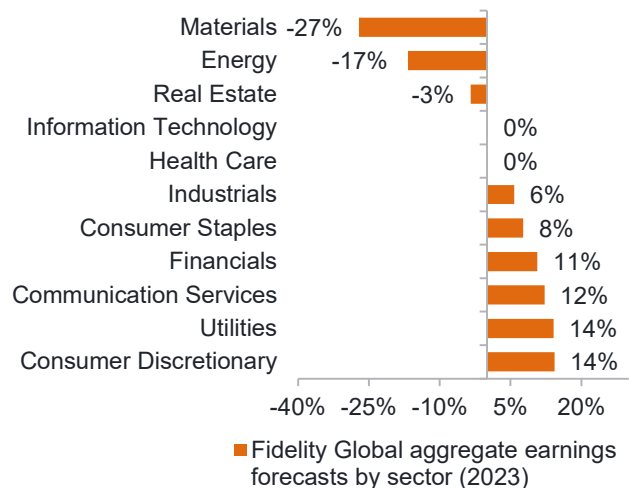
Source: Refinitiv DataStream, 31 December 2022.

FIL earnings forecasts vs consensus (FY23)



Source: Fidelity International, IBES, 31 December 2022.

FIL sector earnings forecasts (FY23)



Source: Fidelity International, 31 December 2022

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