

January 2022

Global Asset Allocation Insights

Fidelity Solutions & Multi Asset

Professional investors only



Topics in focus

Macro outlook

Key macroeconomic themes and their implications for asset allocation.

Regional cross asset views

Insights from the team's discussions of cross-asset views across global regions, including the US, Europe and Asia.

Core allocation view

Overview of the team's core investment views, including breakdown across equity regions, fixed income sub asset classes and currencies.

Thematic ideas

A snapshot of the team's current thematic trades and 'best ideas', held where applicable in portfolios alongside core asset allocation positions.

Introduction

The medium-term outlook for the current cycle remains healthy and supportive for equity markets. However, there are several near-term risks. Short-term growth momentum is slowing, key central banks are moving towards faster policy normalisation, and there is another wave of Covid-19 forming.

Offsetting these concerns are robust household balance sheets, tentative signs of policy easing in China, peaking supply chain bottlenecks, and strong corporate earnings. Higher volatility has led to improved positioning metrics, and our risk-aversion models are also recovering. However, we **remain neutral in our positioning on equities**, with an increasingly positive bias on the short-term outlook.

Within equity regions, we **remain positive on emerging markets**. We are increasingly selective in developed markets, as we **reduce the UK from neutral to underweight**. Consumers in the UK are under pressure from slowing growth, rising activity restrictions related to the deteriorating Covid picture, and higher inflation and cost of living combined with tax rises and withdrawal of pandemic support.

As the Fed has announced tapering, we **maintain our underweight US duration**. Conversely, the market has largely priced out the BoE hawkishness, so we **close out the gilt overweight** after strong performance. ECB policy is expected to diverge further from the Fed's, and we **upgrade bonds to neutral from underweight**. In credit, we maintain our **preference for higher yielding credit markets** with default risk expected to remain low.

In FX we maintain our **long US dollar position**, which can benefit from a tighter Fed and looser fiscal in the US, and offers a hedge for the portfolio if central bank liquidity withdrawal becomes an issue.

	View	Change
Equity	○○●○○	-
Credit	○○●○○	-
Duration	○●○○○	▼
Cash	○○○●○	▲

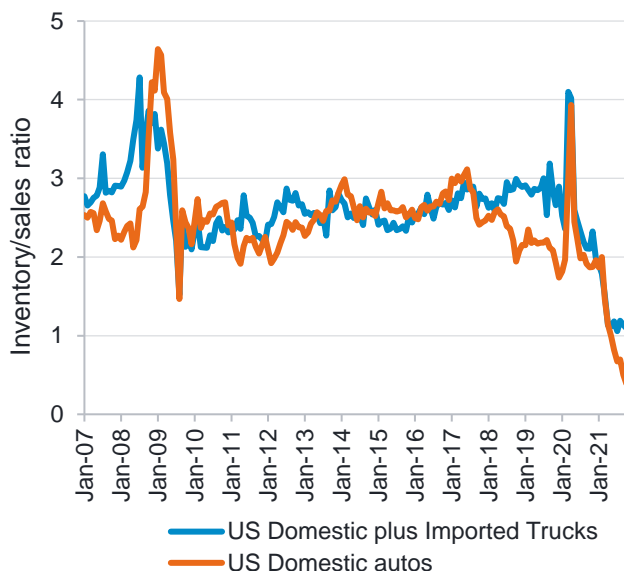
Macro outlook

Omicron enters the Catch-22 mix

The emergence of the Omicron variant has the potential to be a game-changer for the near-term macro and market outlook – and should be treated as such. The speed of the policy reaction has been notable. Policymakers, having learned from mistakes related to Delta, seem determined to act pre-emptively this time around. To gauge the potential economic fallout, we are tracking key viral variables including symptom severity, vaccine resistance and transmissibility compared to other variants. Recent news flow about the severity of disease after contracting Omicron has been encouraging, though the speed of transmission is now clearly shown to be orders of magnitude higher than previous variants. Restrictions are being stepped-up in a number of countries across the globe.

Were it not for Omicron, there were some indications that re-reflation could have taken hold as the dominant narrative in early 2022. Over the last several weeks, there has been evidence of the US labour market repairing, resilient corporate earnings supported by developed market demand and a helpful pivot towards easing in China. Indeed, over the longer-term, the two legs of potential re-reflation appear intact, specifically a high level of excess savings and depressed inventories presaging a restocking cycle.

Chart 1: Inventory restocking should drive re-reflation in 2022



Source: Haver, Fidelity International, December 2021.

Still, we recognize that Omicron has increased stagflationary risks for H1 2022, due to a potential combination of growth slowdown and inflationary effects as global supply chains are once more disrupted. This will exacerbate the Catch-22 dilemma in 2022 for central bankers, who find themselves caught between defending credibility on inflation while preserving the trajectory of the recovery and maintaining real negative rates.

When the facts change...

With facts on the ground changing month-to-month, policymakers have been forced to pivot rapidly to address the increasing drumbeat of very high inflation. Despite Omicron uncertainty, the Federal Reserve doubled the pace of asset purchase tapering at its December FOMC meeting and opened the door to three rate hikes in 2022, while the BoE ended Covid emergency accommodation with a 15bp hike. As expected, the ECB remained comparatively dovish, guiding away from rate hikes in 2022 and maintaining flexibility to adjust its QE programmes to counter any unexpected negative future shocks.

We believe that the Fed will need to continue to walk a fine line in 2022, because of its implicit policy objective of maintaining negative real rates to support financial conditions and maintain debt sustainability.

Central banks in emerging markets will also face difficult choices given the pressure from the China slowdown, the effect of domestic tightening throughout 2021, and the global liquidity withdrawal by the DM central banks. Emerging markets will remain vulnerable to external shocks including variants and energy and food inflation. On the positive side, however, China appears committed to ensuring a soft landing related to the government's reform of its "three mountains" of property, education and healthcare. As a result, the PBOC is likely to continue with as much accommodation as the government requires, which should mitigate tail risks of severely negative macro outcomes.

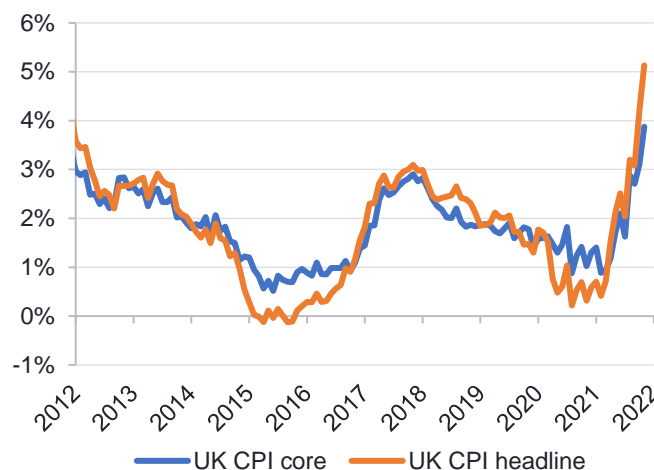
Beyond Covid and policy, many more questions in store for 2022

2022 is likely to be yet another year of unprecedented firsts - and potentially the end of a decades-long bull market in DM government bonds. We expect high volatility both in business and policy cycles, with inflation coming off its peak but settling at a steady state significantly above pre-Covid levels. Decarbonization and net zero targets will be a critical theme again in 2022 and far beyond, as private capital continues to surge into low carbon technologies and away from high-emissions sectors.

Geopolitics will continue to impact supply chains and resource availability, with Russian gas supply into Europe and heightened tensions at the Russia-Ukraine border being key focal points. The US-China economic rivalry will persist as a fundamental driver of the macroeconomy and markets. Developments in trade and investment relations next year may have material implications for corporate investment, the capital markets and more.

With multi-year fiscal programmes underway in the EU and US and a growing level of gridlock in the latter, attention is likely to turn to economic regulation. We expect the White House to focus on big tech, climate change and minimum wage (domestically) and to pursue advancement of its minimum tax agreement proposal (internationally). Anticipation of gridlock in the US Congress after November 2022 could presage an acceleration of policy activity. Across the world, China's regulatory programme to support "common prosperity" will also continue to have implications far beyond its borders. Once again, 2022 will be new territory for investors, giving truth to the adage "May you live in interesting times."

Chart 2: BoE acts to protect credibility over inflation



Source: Refinitiv, Fidelity International, December 2021.

Macro research powering asset allocation

Fidelity's Global Macro & SAA team contributes to Fidelity Solutions & Multi Asset's tactical asset allocation process by providing key macro inputs, working alongside the investment team to understand and respond to the macroeconomic drivers of markets.

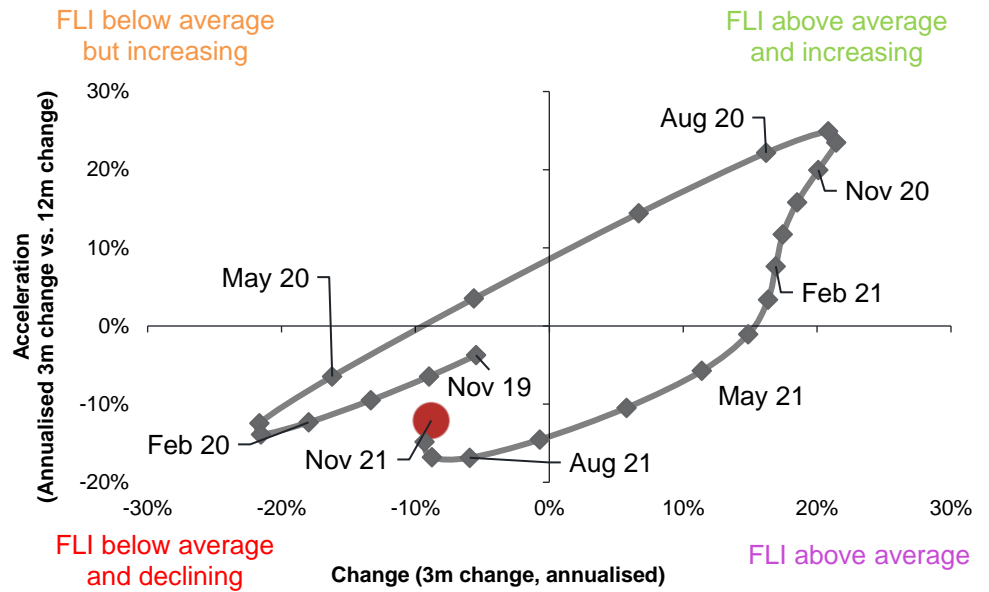
Fidelity indicators

Fidelity Leading Indicator (FLI)

The FLI is a proprietary quantitative tool, designed to anticipate the direction and momentum of global growth over the coming months, and - importantly for investors - identify its key drivers. In practice, it is designed to lead global industrial production and other global cyclical variables by around three months. Fidelity Solutions & Multi Asset uses this as a common and repeatable reference point through the tactical asset allocation process.

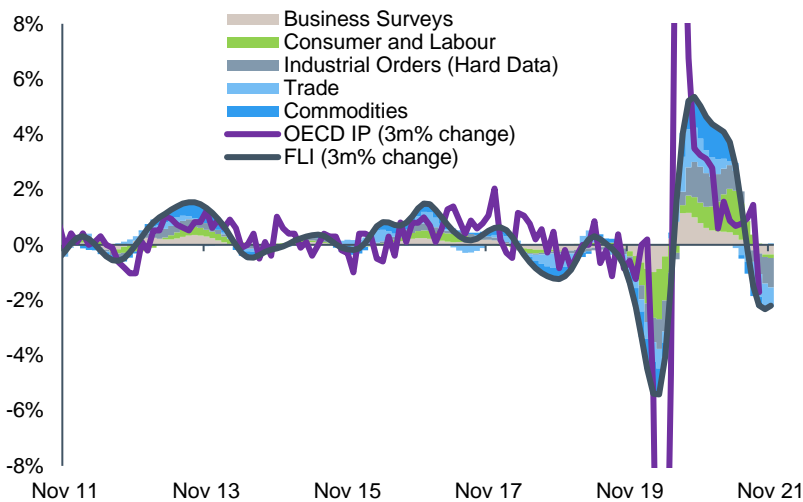
The FLI Cycle Tracker remains in the 'bottom-left' quadrant (below average and declining) but is showing some minor support. The 3-month FLI change could be stabilising at a double-digit rate. Yet the latest Omicron variant and its rapid transmissibility could put another dent in the recovery in early 2022. The FLI quantitative bet remains negative, pointing to a risk-off view, combined with a long duration position, but continues to move away from its highest conviction reading in September.

FLI Cycle Tracker



Source: Fidelity International, December 2021.

FLI: 3-month % change versus OECD IP



Source: Fidelity International, December 2021.

Four out of the five sectors are in the bottom-left quadrant, with indicators declining and below average. Commodities stand out and have moved back in the bottom-right quadrant with indicators declining but above average. Australian forward orders have picked up and the direction of travel seems to be improving for the Baltic Dry Index as well. Early signs that China may be past the worst with regulations easing and more supportive monetary policy could support broad commodities from here.

The Consumer and Labour sector has stabilized in the bottom-left quadrant below average and declining. As Covid cases start to rise again, due to seasonality and the Omicron variant, consumer confidence has weakened across the board and especially in the US. Levels remain fairly good though, particularly in Germany.

Regional cross asset views

US

Omicron has quickly taken over as the dominant variant in the US. Hospitalisations have mostly been among the younger cohort, but severity could be milder. Before Omicron, reopening confidence was very strong. Surveys indicate supply chain problems are expected to peak by 1Q22 with some bottlenecks already easing. Exports are improving and port congestions are starting to ease indicating inventory replenishment is on the way.

Our analysts remain above consensus for earnings expectations for the US and consumer discretionary sector. Materials and communication services are seeing upwards earnings revisions. Treasury yields have been volatile recently, digesting multiple crosswinds from the Fed's hawkish tone and faster taper to the threat of Omicron. There are now three rate hikes priced in for 2022, however the terminal rate remains anchored.

We are monitoring Latin America as a possible buying opportunity. The region has been under a lot of pressure recently given the slowdown of growth momentum and heightened volatility. However, equities in the region are very cheap and a lot of negative news could be priced in already.

Asia

Japan is carrying out a large fiscal programme, however the impact on GDP is likely to be low (1-2%) because a significant share is in handouts, which are often saved, 40% of the package is Covid prevention measures, which have not been fully spent in the past, and infrastructure spending is low. Last year, the BoJ bought the entire additional supply of JGBs in order to keep yields low and stable. However the context this year is very different. Inflation is rising and fiscal spending is substantial. How the BoJ reacts to the changing environment will drive macro markets including JGB yields and the yen. Omicron is a key unknown - if Japan goes into lockdown again, inflation could be subdued.

Fidelity's analysts continue to forecast earnings below consensus across Asia ex Japan, but well ahead of consensus for Japan.

Europe

Europe is the epicentre of the current Covid pandemic, with a spike in cases that preceded Omicron. Restrictions are being tightened across the continent but have been surprisingly well tolerated so far. Italy and France are more sensitive to domestic restrictions, while Germany is more sensitive to the China slowdown and global restrictions. Inflation surprised to the upside, driven by energy and services. We are watching out for high wage growth as this would put pressure on inflation. The ECB's PEPP is set to end in March as planned and rate hikes are unlikely until 2024.

The energy price spike has impacted Europe and the UK differently. Europe imports 80% of its natural gas but the UK only 50%. The industrial sector in the UK accounts for roughly 12% of natural gas demand, in contrast to Europe at 22% and China at 30%. This reflects the heavy weighting of services vs industry in the UK economy. However, UK growth is still exposed to natural gas volatility - the UK has no storage, it is at the end of the pipeline, and its renewable energy supply is less predictable. Price rise pass-through has been delayed but we expect a 30% rise in utility bills in the UK by mid-2022, taking the average dual fuel bill to £1,489. The primary mechanism for energy prices to impact on growth in the UK appears to be on households and the consumer sector via higher utility bills.

Building regional cross-asset views

Deep-dive analysis across region-specific dynamics, incorporating bottom-up input from across Fidelity's global research platform

Core allocation views

Asset class	View	Change	Rationale
Equities			
US	○○○●○	-	The economic surprise index for the US has picked up and the progress towards the debt ceiling should provide support to sentiment in the US. Covid cases are set to rise but we expect to see limited restrictions on activities.
UK	○●○○○	▼	Growth picture is starting to roll over in the UK, rising covid cases and policy will likely curtail activities somewhat. Consumers are in a difficult spot given higher inflation. Tax rises are coming, while pandemic support measures are no longer in place.
Europe ex. UK	○●○○○	-	COVID picture has clearly worsened in Europe with some renewed restrictions in some countries that could impact activities in the coming months. Growth is likely impacted for the next couple of quarters.
Japan	○○○●○	-	Valuations remain cheap and the COVID picture has improved. The recent potential easing in supply chains and China policy would be supportive. However, the fiscal package could disappoint, and economic surprises are weaker on a relative basis.
Pacific ex. Japan	●○○○○	-	We remain underweight as the region remains the main funding source for overweights elsewhere in the portfolio. The earnings picture continues to be weak.
Emerging markets	○○○●○	-	Our overweight is led by a more positive outlook on EM Asia. China policy seems to have passed peak tightening. Valuations are attractive on both absolute and relative basis for EM Asia. We remain cautious on EMEA but are becoming more interested in Latin America given the very cheap valuations
Credit			
Investment grade (IG) bonds	○●○○○	▼	Central banks appear happy to support credit in the event of stress, which reduces left tails risks - "IG is the new government bond". Spreads are near post GFC highs and carry is likely to drive returns rather than yield compression.
Global high yield	○○○●○	▲	The shock to sentiment from Omicron appears to be transitory. Leverage is improving strongly as earnings rebound and ratings migration is positive. HY would be vulnerable to a substantial taper tantrum but higher spreads would help to offset this compared to IG.
Emerging market debt (EMD, hard currency)	○○●○○	-	EM assets should benefit from the hunt for yield although a stronger USD may lead to further outflows and worsening sentiment. The DM-EM growth gap will likely be narrower in 2022, but the China slowdown and commodity weakness are risks to EM PMIs.
Duration			
US Treasuries	○●○○○	-	The Fed has retired the transitory label for inflation and is accelerating tapering which allows for earlier rate hikes. The passing of the infrastructure package and additional spending plans could exert further upward pressure on yields.
Euro core (Bund)	○○●○○	▲	There is a higher level of uncertainty over the path of ECB policy right now. We think the latest COVID wave may further kick the can into February on the transfiguration of PEPP/APP.
UK Gilts	○○●○○	▼	The labour market seems to be holding up reasonably well and the BoE surprised markets by raising rates in December by 0.15%. Gilts had outperformed a decent amount over the last month and the view on a BoE policy mistake has to a large extent played out.
Japan govt bonds	○○○●○	-	Given the fall in US real yields, the hedged pick-up against JGBs is now less attractive, so we maintain the overweight, as a way to tilt the portfolio empirically short duration.
Inflation linked bonds (US TIPS)	○○●○○	-	While the taper is expected to put upward pressure on TIPs given the Fed's buying power in that market, we do not expect a repeat of the 2013 taper tantrum.
Currency			
USD	○○○●○	-	Softer global growth or a tighter Fed (or an odd combination of both) would support the dollar. A more benign growth backdrop or a dovish turn at the Fed would change our view.
EUR	○●○○○	-	We continue to see policy divergence as the wedge that drives EURUSD lower. Any hawkish pivot from ECB will change our view.
JPY	○○●○○	-	We find it hard to take a positive view on JPY. It might be cheap, but it is likely to weaken as a result of higher global yields.
GBP	○●○○○	-	We think the market is overestimating the scale of rate hikes the BoE will eventually carry out.
EM FX	○○●○○	-	EM outlook is too diverse to go broadly long. A move dovish Fed and stronger global growth are factors we are looking at to change our view.

Source: Fidelity International, as at December 2021. 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.

Fidelity Solutions & Multi Asset

Fidelity Solutions & Multi Asset is a global team, managing portfolios using a wide range of asset classes, including equities, fixed income, real estate, infrastructure and other alternatives. The team specialises in building and managing outcome-focused strategies for clients, combining asset classes to deliver investment objectives through time.

As at 31 August 2021, the team manages over \$58bn on behalf of institutional and retail clients across global regions. Our large team includes Investment Management, Global Macro & Strategic Asset Allocation, Research, Client Solutions and Implementation resources, supported by Fidelity's significant operational infrastructure to deliver investment services to clients. We work with colleagues across Fidelity's bottom-up investment teams across key asset classes, capturing research from this substantial global research platform.

For further information on Fidelity Solutions & Multi Asset's strategies and services, please contact your local Fidelity representative.

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