



Outlook 2023

An investor's guide to the year ahead for the global economy, multi asset, equities, fixed income, Asian markets and more

Foreword



The impact of the events of the past year will be felt long into the next one, particularly the tragic consequences of the Ukraine war. Chief among them from a financial perspective is the shift in monetary regime, from one supportive of global markets to one with a focus on taming inflation.

This is challenging the outlook for assets and global economic growth and has led to both the ongoing volatility that has been a feature of 2022 and increasingly tight liquidity conditions.

Central banks have outlined their concerns about supply side pressures that could embed inflation into economic systems and lead to rising wages and prices. As they tighten financial conditions in response, the risk of a hard landing is increased, and could play out as an economic contraction and labour market weakness. For equities this will be expressed in lower corporate earnings, while in debt markets we are watchful for rising default rates and downgrades.

Other risks, including geopolitical uncertainty and a gradual decoupling of large economies from globalised supply and cooperation networks, may exacerbate the challenges facing asset markets in 2023. Meanwhile, consumer spending is at risk of a sharp decline as households battle a combination of higher energy and debt servicing costs.

However, there are signs that some of the pressures of 2022 may ease into 2023, particularly in terms of supply chain disruption and transport. Prices for air, sea, and land freight are falling and the backlogs created by Covid lockdowns are easing, which may help to soften the blow on consumption.

The gradual removal of quarantine restrictions globally has boosted investor confidence, with China now the only major economy where significant requirements are still in place. Further relaxation there would remove a distinct hurdle for both China and the global economy.

With so many factors in play, and many of these pointing to increased downside risk, we maintain a cautious outlook in preparation for the next 12 months of uncertainty, whilst always being mindful that markets are forward-looking and sentiment will rise before the data shows the economy to be on an improving track.

Anne Richards

CEO, Fidelity International



Contents

Overview	4
Macro	6
Multi asset	9
Equities	11
Fixed income	14
Asia	17
Private credit	20
Real estate	22

Overview



Andrew McCaffery
Global CIO, Asset Management

Rates overshoot risks inflation bust

Inflation has dogged markets this year and is likely to remain high, bringing an end to the era of easy money and increasing the risk that overtightening by central banks will trigger a sharp recession, an “inflation bust”.

Markets want to believe that central banks will blink and change direction, negotiating the economy towards a soft landing. But in our view, a hard landing remains the most likely outcome in 2023. The previous norm of central bank “whatever it takes” intervention during the financial crisis and the pandemic is going or has gone.

Until markets absorb this fully, we could see sharp rallies on the back of expected action by the Fed, only for them to reverse when it doesn’t materialise in the way they expect. Rates should eventually plateau, but if inflation remains sticky above 2 per cent, they are unlikely to reduce quickly even if banks take other measures to maintain liquidity and manage increasingly challenging debt piles.

A key factor to watch is where the dollar goes from here. In 2022, the strong dollar has proved

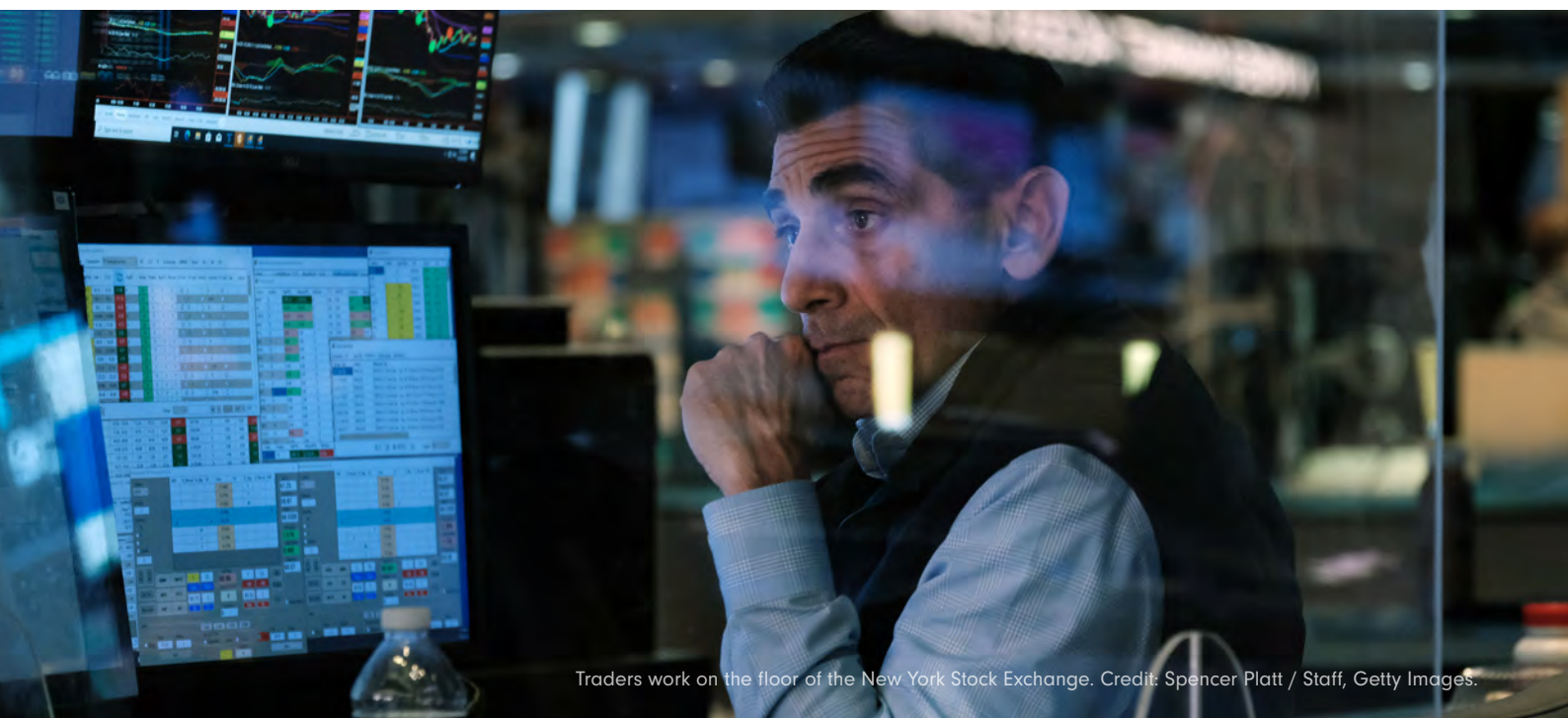
to be a wrecking ball for other economies, both in the developed world and for emerging countries that rely on hard currency debt. If the Fed continues to raise rates, an even stronger dollar could accelerate the onset of recession elsewhere. Conversely, a marked change in the dollar’s direction, potentially as its relative strength and confidence in monetary and fiscal policy making become an issue, could bring broad relief, and increase overall liquidity across challenged economies.

Other parts of the world are on different trajectories. Japan has so far maintained looser policy settings; but any shift away from its current yield curve control could lead to unintended consequences for the yen and potentially add another layer of risk to the already elevated levels of volatility in FX markets.

China too has taken a different pathway in 2022, thanks to its zero-Covid policy and the reining in of its property market. In the next 12 months, we expect policymakers to continue to focus on reviving the economy, investing in longer-term areas such as green technologies and infrastructure. Any loosening of Covid restrictions will cause consumption to pick up. The deglobalisation that has arisen from the pandemic and tensions with the US will take time to work its way through but is a theme that will grow.

In this Investment Outlook, our asset class experts consider how to navigate this unusual crisis-driven cycle in 2023. Emerging markets and Asian countries, with a weaker growth correlation with the US and Europe, present one way to increase diversification, while cash and quality investment grade securities offer defensive characteristics.

As the dispersion of returns increases, investors will be able to seek out idiosyncratic elements in their portfolios rather than rely on whole market moves to generate returns. Opportunities should also begin to emerge among securities driven by longer-term themes such as decarbonisation and reindustrialisation, which could draw investor attention sooner rather than later.



Traders work on the floor of the New York Stock Exchange. Credit: Spencer Platt / Staff, Getty Images.

Macro



Salman Ahmed
Global Head of Macro and
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What happens next depends on the Fed

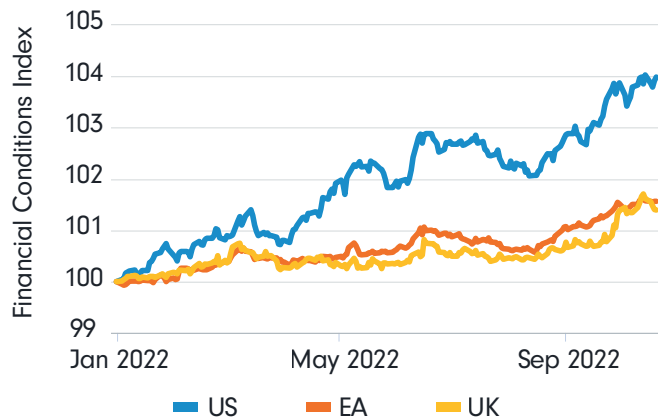
As we move into 2023, the global economy continues to face a confluence of challenges. From persistently high inflation and aggressive global policy tightening (led by the Federal Reserve) to the continued fallout of the Russia-Ukraine war and the energy crisis, weak consumer confidence and political disruptions, our base case remains a hard landing. Through the last quarter of 2022, our proprietary activity trackers have indicated a continuing slowdown, with a recession likely in the US and near certain in Europe and the UK.

In the US, the Fed appears set on raising rates significantly beyond neutral levels to bring inflation under control. We do not expect a pivot until there is a meaningful deterioration in hard data, especially inflation and the labour market. The US housing market is already showing signs of stress, as higher mortgage rates and reduced affordability stifle transactions. However, inflation and the labour market are still strong, compelling the Fed to keep going, given their focus on current spot data against the backdrop of underestimating inflationary pressures last year.

At this juncture, one important concern is that the Fed is too focused on backward looking data, especially in relation to the labour market. By the time that shows signs of weakness, it may already be too

late for the US economy. Real rates have been positive for some time and in some parts of the yield curve pushing towards pre-Global Financial Crisis (GFC) levels. We have repeatedly argued that the financial system cannot take positive real rates for any material length of time (due to high levels of debt) before financial stability becomes an issue. Given liquidity and assets are already under considerable pressure, the system could start to crack. There is a risk that if the Fed stays true to its current word and doesn't stop until inflation is back near 2 per cent, a "standard" recession could turn into something worse.

Chart 1: Financial conditions tighten globally



Notes: FCIs rebased to 100 at 31 December 2021. Higher values indicate tighter financial conditions, while lower values indicate looser financial conditions. Source: Fidelity International, Bloomberg, November 2022.

Alongside central banks, governments will have an important role to play in driving macroeconomic prospects for 2023. As we've seen in 2022 from the market gyrations caused by UK fiscal policy and political uncertainty, combinations of monetary tightening and mis-judged fiscal decisions have the potential to turn into financial stability risks. Indeed, the UK is not the only economy confronting fiscal and monetary policy challenges simultaneously, so it may prove a canary in the coal mine.

We will be watching for signs that the Fed and other key central banks are wise to this possibility and other risks, potentially easing off tightening in some cases until the impact of previous tightening is clearer. In any case, inflation is likely to moderate, but we expect it will do so gradually. Indeed, structural trends such as decarbonisation, deglobalisation, and the process of dealing with high debt levels are likely to keep up the inflationary pressure over the coming years.

This could limit central banks' ability to support growth with monetary stimulus, marking a regime change from the disinflationary post-GFC era when real interest rates (interest rates adjusted for inflation) were consistently driven further into negative territory to support growth. As noted above, the market reaction to the UK government's recent fiscal expansion plans demonstrates the difficulties that policymakers around the world could face when seeking to support growth while simultaneously controlling inflation.

We will be watching for signs that the Fed and other key central banks are wise to this possibility and other risks, potentially easing off tightening in some cases until the impact of previous tightening is clearer.

Europe has its own set of problems to deal with. Its 2023 will be decided by the direction of energy prices, the nature of fiscal support provided to consumers, and the weather. A warmer winter will reduce the chance of gas rationing or blackouts due to lack of supply (early indications are that this might be the case based on Europe's Weather Centre (ECMWF) and UK Met Office forecasts, which is good news). Alongside the continued tragic human cost of the Russia-Ukraine war, energy security will remain top of the agenda for Europe and the UK, which could be a significant driver of capital in the future.

Another significant determinant of 2023's economic picture will be China. There are tentative signs that strict anti-Covid measures will be relaxed (though slower than expected), which would be positive for economic growth, and we expect monetary and fiscal policy to stay loose (and be loosened further), putting a floor under economic developments which have been under severe pressure. Uncertainty about the future of renminbi price trends persists; we believe the PBoC is willing to accept some depreciation to support export growth especially given relatively low inflation. In the wake of the 20th Communist Party Congress, we will be watching closely to see the potential policy

feed-through in areas ranging from digitisation, national security and the focus on self-reliance to the opening up of capital markets, while keeping a close eye on the tense US-China relationship.

What does all this mean for investors? While the macroeconomic outlook for 2023 makes for disconcerting reading, it is important to remember that markets rarely follow economics in straight lines and the appearance of 'value' across asset classes (especially in fixed income and some parts of equity markets) will be an important trend to assess alongside macro developments.



Federal Reserve Board Chairman Jerome Powell. Credit: Brendan Smialowski / Contributor, Getty Images.

Multi asset



Henk-Jan Rikkerink
Global Head of Solutions and Multi Asset

Defensive for now until volatility subsides

Global asset markets face no shortage of headwinds as we look ahead to 2023. As the Federal Reserve attempts to get a grip of soaring inflation in the US, the dollar's rapid appreciation has sucked capital away from other regions. Europe and the UK are in the middle of an energy crisis, with no clear endpoint for the devastating Russia-Ukraine war. Inflation remains high across most global regions, consumer confidence is at rock bottom, and China's economy is stuck in first gear. This multitude of challenges paints a complicated investment backdrop heading into next year, and we expect volatility to remain high for some time.

We believe defensive positioning will remain important for investors going into 2023. Cash and uncorrelated assets will form a key component of multi asset portfolios until volatility subsides. Government bonds are also likely to have a role to play, especially now that yields are much more attractive. If 2023 brings a hard landing, as we believe it will, central banks should ease off hiking rates as growth slows. The structural tailwinds that drove the bond rally over the last 40 years may have diminished somewhat, but government bonds are still the go-to asset for portfolio diversification in a recession.

Deteriorating environment not yet reflected in equities

The time will come to allocate back into equities too. But for now, the deteriorating environment is

not reflected in earnings forecasts or valuations, implying there could be further downside to come. We expect volatility to remain high, and sentiment is low enough that sharp risk-on bounces will be likely, if short-lived. Earnings estimates for 2022 have gradually declined as the year has progressed, but estimates for 2023 have barely budged, an anomaly given the challenging outlook for the coming year. Valuations have fallen somewhat; pockets of real value are emerging. However, many markets are a long way from what we might call 'cheap' compared to history.

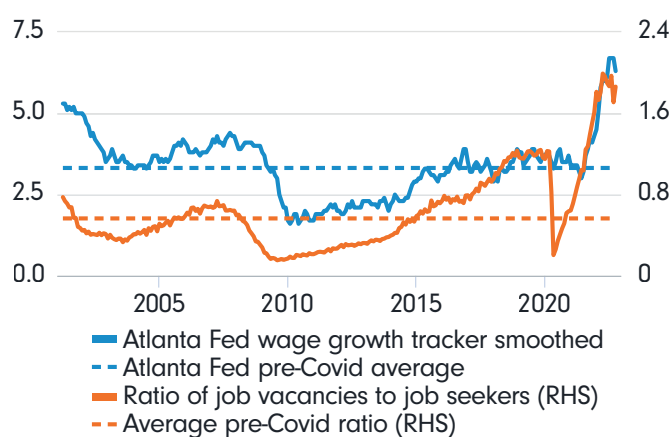
Potential catalysts for sentiment to pick up

As we move into 2023, we are focused on finding pockets of growth in a low growth world.

While the overall investment outlook is gloomy, there are several themes that could provide the catalyst for sentiment to improve.

First, signs that hard US data is moderating could be a harbinger of the much-feted Fed pivot. Although we do not expect it soon, when it does arrive, it should boost risky assets such as equities and credit, as well as government bonds.

Chart 2: Job market and wages have peaked but remain strong



Source: Refinitiv, Fidelity International, October 2021.

Second, any relief for European consumers, either by an unexpected end to the war or a comprehensive fiscal support package would improve the region's outlook.

Third, any indication that Chinese authorities are prepared to relax strict Covid rules or refocus on growth and away from reform would be taken very positively by markets.

Lastly, we will be watching guidance from the Bank of Japan closely for any indication they are ready to step away from yield curve control. This would stem the yen's devaluation and could potentially push global government bond yields higher.

Deglobalisation

We expect the structural theme of deglobalisation and re-shoring to continue in 2023. China is going through a transition phase, and we believe the gradual bifurcation of China and the West will continue. While this may be a drag on China, the reconfiguring of supply chains will provide opportunities for other countries too, especially Mexico and Canada, but also some Latin American economies and Thailand and Vietnam.

Less correlated exposures will be an important part of the investment arsenal

Of course, the first rule of multi asset investment is to understand the difference between asset behaviour over the long and the short term. Over a longer time horizon, we see no reason for undue pessimism. Economies will survive this particular bout of challenges and doubtless emerge stronger when they do. As long-term investors, it is important not to lose sight of the big picture, but to be alert to opportunities along the way, with the aim of both capturing short-term upside and mitigating downside.

In 2023 and beyond, we believe multi asset investors must make use of as broad a toolkit as possible. From liquid absolute return strategies (aiming for positive, uncorrelated returns) to listed alternatives (including infrastructure and renewables) to private assets (including private equity, private credit and real estate), less-correlated exposures will be an important part of the investment arsenal. Indeed, the coming years and their challenges call for wider sources of diversification and risk, where investors will be forced to look beyond traditional assets to deliver outcomes over the long term.

Equities



Marty Dropkin
Head of Equities, Asia Pacific



Ilga Haubelt
Head of Equities, Europe

Market uncertainty to remain high amid tighter policy

We expect a high degree of volatility and uncertainty for global equities in 2023, as stubbornly high inflation and interest rate rises lead to a rough landing for large parts of the global economy. However, earnings expectations are diverging across different economies, allowing investors to capitalise on select opportunities.

Markets continue to expect central banks (led by the US Federal Reserve) to stop hiking at the first sign of inflation cooling, but there is a growing risk that by then it may be too late. The squeeze on the consumer is already taking place and some parts of the global economy are headed for recession or are already there.

Regionally, Europe looks the most exposed. Much depends on whether businesses and consumers can make their way through the winter without blackouts that weaken demand and on how the Ukraine conflict develops from here. Tail risks for stock markets remain and a recession seems baked in, as the European Central Bank ploughs ahead with rate rises at a time when households are already suffering from the surge in the cost of living.

After the sharp sell-off spurred by the worsening outlook and government missteps, there is a case for the UK equity market becoming an attractive hunting ground in 2023. While the UK market has done better than most this year, partly due to sector composition (with most large cap earnings derived from outside the UK), it remains relatively cheaply valued with a forward PE that is around 25 per cent below long-term averages and close to 50 per cent cheaper than the US. The large cap FTSE 100 index remains primarily a play on the global economy and a beneficiary of sterling weakness, while small and mid-cap names tend to be more exposed to the domestic economy. The latter are unloved and could be beneficiaries of any positive surprise on the economic front.

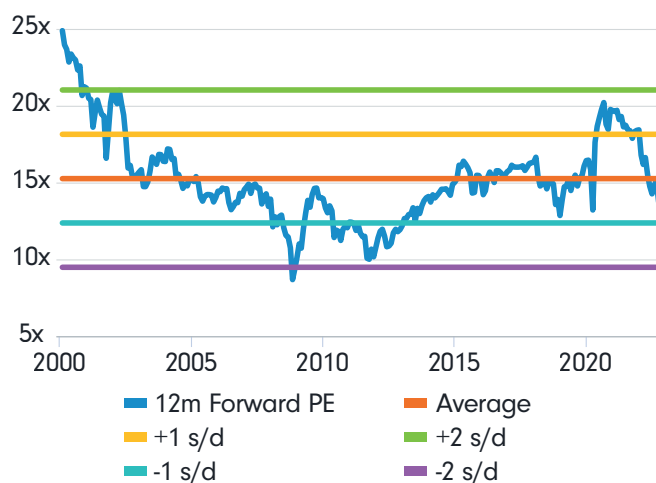
The US presents a different picture. While there are some signs of increasing pressure on consumers, real data has yet to turn downwards, and markets are some way off pricing in the sort of corporate earnings downgrades that would reflect a full-blown recession. That leaves us with the risk of a more dramatic drop in the S&P 500 next year if growth slows suddenly. Nevertheless, small/mid-cap stocks appear cheap relative to large caps, which should present some opportunities. Meanwhile, growth stocks still look relatively expensive versus value stocks, with the valuation gap at historic highs.

Dollar strength

Another potential risk for investors is further US dollar appreciation, which would continue to erode corporate earnings. Emerging markets have historically been especially sensitive to changes in the greenback's value and US companies are not immune to these headwinds as their offshore revenues begin to shrink. The S&P 500's foreign exposure is around 30 per cent.

For global equities, multiples will continue to decline as discount rates rise. Corporate profits and earnings will need to adjust further to reflect the uncertain economic picture, which is likely to persist near term. Valuations are likely to come down further as companies publish annual earnings numbers and expectations in the first quarter.

Chart 3: 12m Forward Price to Earnings (MSCI AC World) - Expect further downward revisions in 2023



Source: Fidelity International, IBES, 15 October 2021. Note: Consensus estimates based on IBES MSCI World forecasts.

Investors should also monitor the trajectory of China. Not only is it a big market in its own right but it was also among the first in and first out of lockdowns, and the first major market to show signs of earnings fatigue. Its performance in the coming months may indicate how things will play out in developed markets.

China is investible but investors need to be selective

In China, monetary conditions are more accommodative with relatively low inflationary expectations. The big question for the first months of the year is whether the economy can start to perform. Unlike Europe there is no energy crisis, and our base case is for a moderate and gradual recovery of growth as the year

progresses. Domestic earnings will improve, as should margins, against the backdrop of renewed levels of investment in infrastructure. We are positive on consumer staples, financials, and healthcare, but in general much has been discounted across the market.

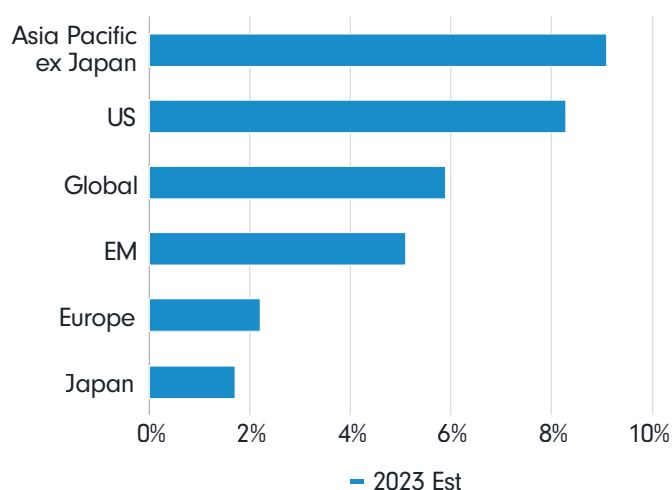
Caution required

If central banks remain excessively hawkish and over tighten monetary conditions through a mix of interest rate hikes and quantitative tightening, there is a risk of an inflationary bust this year, with economies struggling to mitigate the damage. This could hurt both the real economy and asset prices.

We remain cautious of current conditions and believe now is the time to be invested in high quality stocks that are best placed to weather market volatility, while also looking for opportunities to gain exposure to long-term secular growth sectors like clean energy and electric vehicles. Defensive areas such as financials and utilities could outperform as the economic slowdown takes hold. For utilities, we favour names (ex-US) with valuations that provide a good margin of error and where better cash generation/certainty of returns will be rewarded, despite elevated power prices that are likely to come off - a headwind to earnings growth.

Regionally, we are more positive versus consensus in Asia Pacific excluding Japan, with the Asean and Indian economies standing out, building on a robust recovery thus far in 2022. Within the region, we are long-term positive on both India and Indonesia, amid robust multiyear growth supported by favourable demographics, including a growing middle class and rising disposable incomes. 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.

Chart 4: Consensus earnings forecasts (FY23)



Source: IBES earnings estimates, Fidelity International, 30 September 2022.

Fixed income



Steve Ellis
Global CIO, Fixed Income

A new era for interest rates

Bond yields are finally starting to look attractive again but are they priced for the scale of the downturn ahead?

Fixed income markets head into 2023 hopeful of a long-awaited shift to a new reality, yet the end of more than a decade of monetary largesse has brought with it substantial risks.

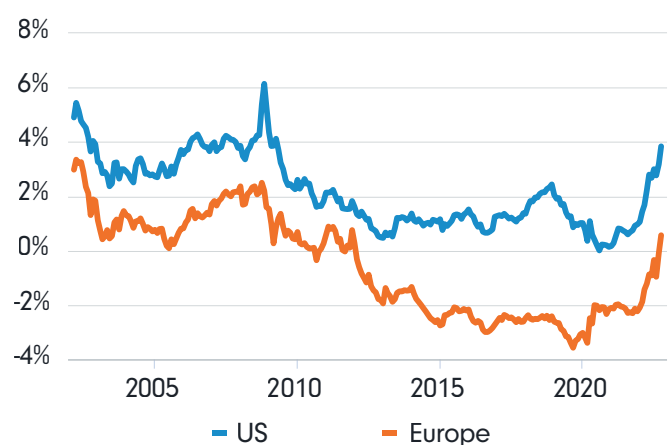
Central banks continue to tighten financial conditions, increasing the risk of an inflation bust across a glut of economies. Even if policymakers are forced to back down by markets and the scale of the prospective slowdown, we believe interest rates will settle far higher than they have been at any point over the past decade.

This should be good for bonds, which have struggled through a decade of zero yields, but there are the first signs of cracks in financial systems in response. UK authorities' struggle with the fallout of a budget full of unfunded tax giveaways may well prove a model for others. The Federal Reserve in particular is pressing on with tightening that has turned the dollar into a

wrecking ball for a growing number of markets. At some stage, the Fed and other central banks may be forced to balance their inflation-fighting mandates with the need for financial stability.

Chart 5: Corporate bond yields begin to look more attractive versus dividends

Corporate IG yields minus dividend yields since 2002

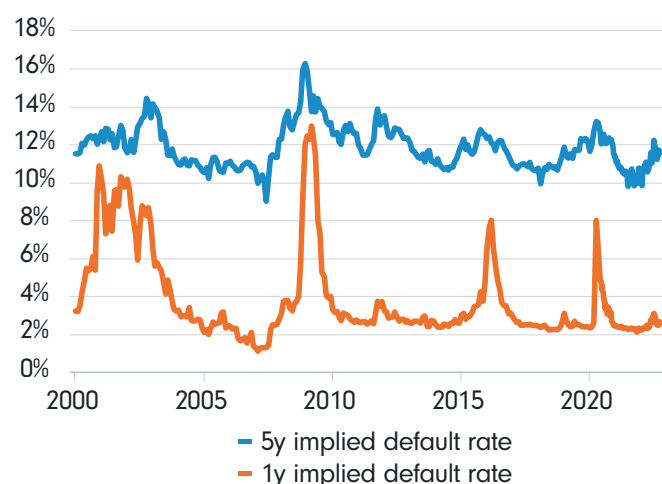


Source: Refinitiv, Fidelity International, October 2021.

Too much too late

It is clear that developed world central banks began this round of tightening too late and that the outcomes are likely to be painful. Were the US to head into recession next year, credit defaults would rise significantly. So far, the market is yet to reflect these risks, notably in high yield credit. We calculate market implied default rates for the high yield segment at just 2.7 per cent in the US currently - roughly what might be expected in a very shallow recession. By contrast, realised defaults peaked at around 14 per cent during the global financial crisis. Prudent credit selection within high yield is therefore essential.

Chart 6: Default rates not priced for recession



Source: Refinitiv, Fidelity International, October 2021.

The interest burden is also likely to be crucial. If high yield is to mean yields of 8-10 per cent in the months and possibly years ahead, then this will alter the outlook for both existing and future borrowers. Adjustments will be required across the curve.

Looking at duration

On the surface, the high risk of a hard landing seems to make US and core Europe duration relatively attractive. We expect policymakers will finally be forced into a long-speculated pivot towards easier policy. The difficulty over the past year has been predicting when that will occur. At the time of writing, the prospect of the Fed pivoting has been pushed out to at least March 2023.

Inflation will likely prove the key to this. Consumer price growth in the US and Europe has remained stubbornly high, but the first falls may allow central banks to shift. In turn that may finally halt the dollar's gains and allow emerging markets including China to start to grow faster.

For Europe, the shock to energy prices and associated risks have made the economic pain more evident. Markets continue to project rate hikes lasting well into 2023; we reckon the ECB will eventually deviate from this path and avert a deeper recession. In the meantime, investors will need to be highly selective. Credit spreads, both for corporates and for the more stretched government borrowers, have widened significantly, but there may be more to come if soaring energy costs drive Germany into a deep recession.

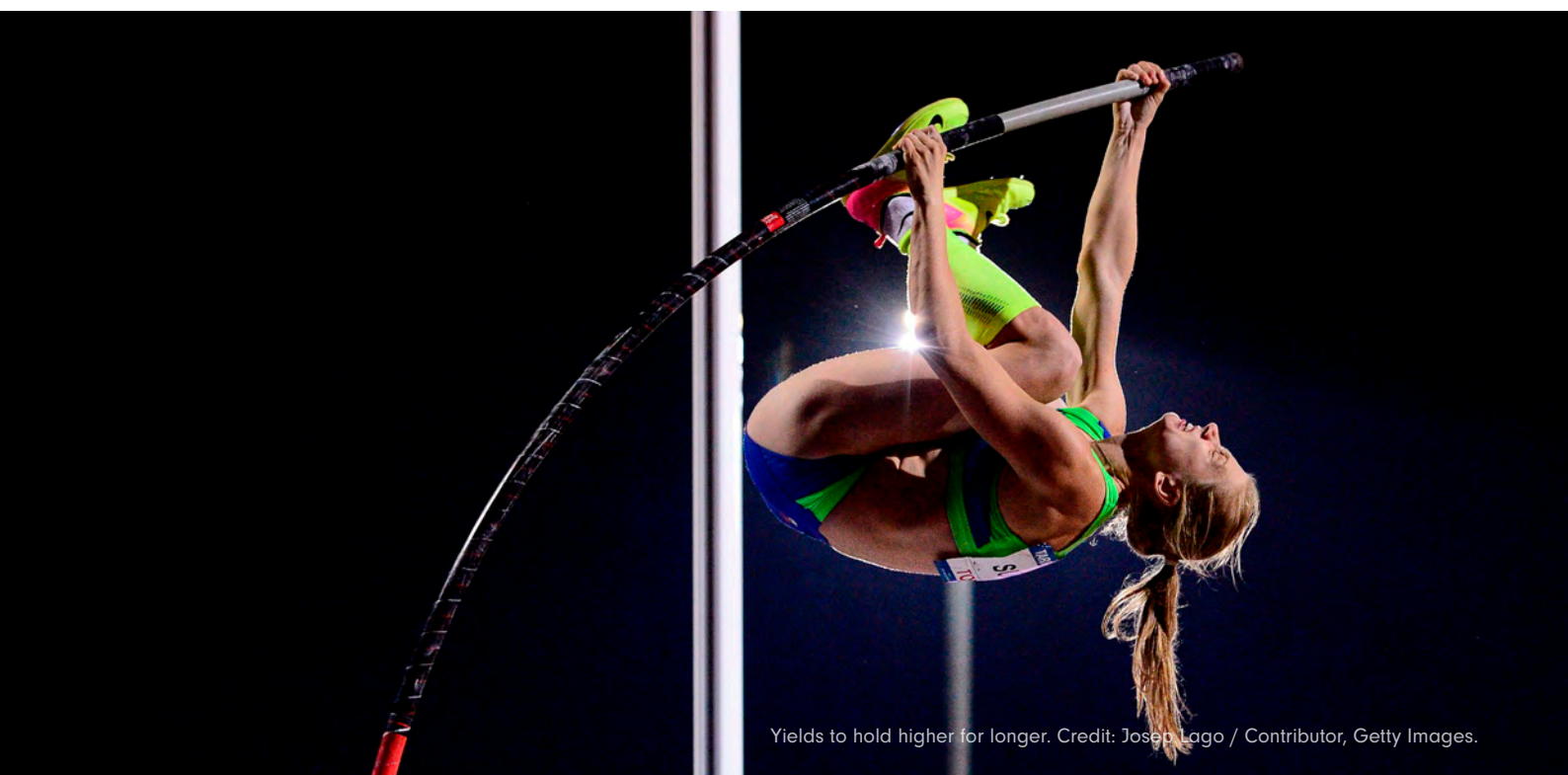
Elsewhere, emerging markets and Chinese property investments have been among the hardest hit by the dollar's strength. That points to the potential for a big rally when the greenback finally turns, but it is again perilously difficult picking the right moment.

With that cocktail of risks in mind, as we navigate various stages of the hiking cycle, it is inevitable that some investors will look to shift portfolio asset

allocations towards higher quality assets. We can see that flight to quality already in recent demand for cash strategies.

Not priced for a demand shock

The biggest risk for us as investors is that policymakers may have already pushed the system too far. Monetary aggregates are falling at or to levels not seen since the Great Depression and yet central banks are pushing ahead with more tightening. As base effects kick in, we may discover that the inflation of the past 18 months is less sticky than we believed, and that we have negatively shocked domestic demand far more than was necessary. We are not priced for that yet and it could swiftly change market dynamics.



Yields to hold higher for longer. Credit: Josep Lago / Contributor, Getty Images.

Asia

Building on resilience



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Asia's shifting growth model

Asian central banks are largely dancing to the Fed's tune, but sufficient foreign exchange reserves and moderate external debts are allowing many of them to show greater resilience than in previous tightening cycles.

The strong dollar and global rate hikes led by the US Federal Reserve have triggered a few rounds of knee-jerk outflows from Asian markets this year, and might continue to rack nerves in 2023, but despite this we see the region showing greater resilience than in previous tightening cycles.

With improving fiscal positions and relatively mild inflation, Asian economies today have greater leeway to adjust their pace of tightening based on domestic needs, even as they come under pressure to follow the Fed's direction. Moreover, China may continue down its own path of easing, Japan has been sticking to yield curve control (YCC), and India can stay nimble on the back of a robust domestic economy.

China divergence

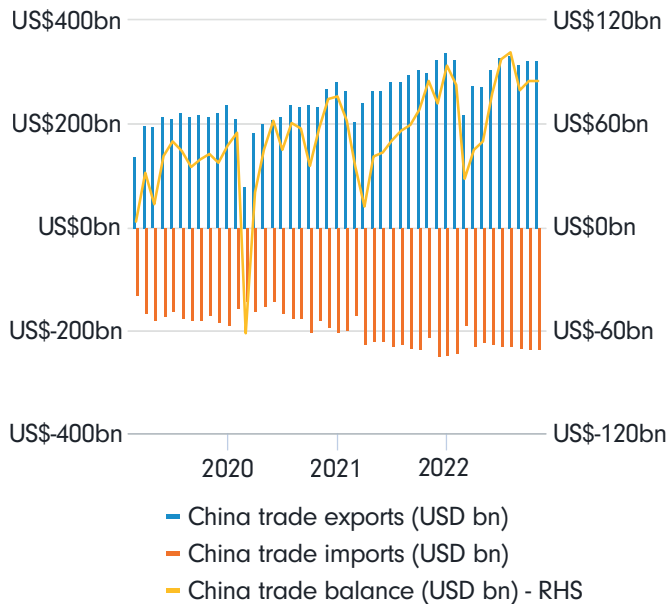
We believe China will buck a global trend of rate hikes and remain in a relative easing stance,

providing a tailwind for its economy in the coming year. But instead of broad-based rate cuts, we think easing is more likely to come in targeted modes, such as geographically applied mortgage-rate reductions.

Despite dollar strength, the renminbi should remain relatively more stable when measured against the broader China Foreign Exchange Trade System (CFETS) basket of currencies. And we think China government bonds could remain one of the most stable types of sovereign securities, potentially offering diversification benefits for global investors.

Nevertheless, the Chinese economy faces a number of near-term challenges including weak income growth, relatively high youth unemployment and a potential softening of exports. We expect the country's gradual reopening to ensue in the coming months and provide impetus for a moderate recovery.

Chart 7: China trade balance stays strong



Source: Bloomberg, Fidelity International, November 2022.

Japan sticks to its guns

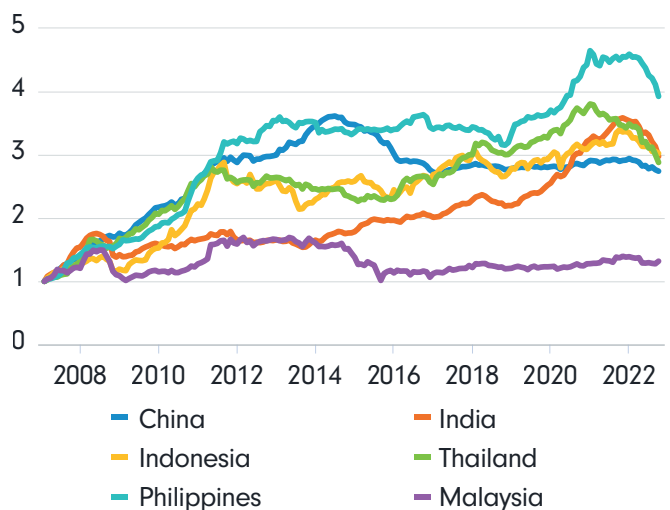
In Japan, mild inflation has allowed the central bank to maintain a loose monetary stance through YCC, with price increases among the smallest in the world. This, however, has come at the cost of a volatile yen, and inflation has crept up above 3 per cent in October. The Bank of Japan may keep employing YCC for a loose setting next year, as long as the weak yen does not significantly push up import costs.

A favourable trend in improving returns on equity has emerged among Japanese companies and we believe it will continue next year. In addition, Japanese equities can offer an attractive diversifier for global investors due to their large cash piles, which help minimise debt-servicing burden.

Regional resilience

Elsewhere in Asia, we hold constructive views on countries like India and Indonesia, where robust growth outlooks help offset concerns about inflation or the strong dollar. India benefits from strong domestic consumption, rising investment, healthier balance sheets of banks, and growing high-tech exports. Although it faces considerable inflationary pressure as a commodity importer, we believe India is on track to deliver decent real GDP growth next year.

Chart 8: EM Asia FX reserves



Source: Bloomberg, Fidelity International, November 2022. Rebased to 1 as of 31/01/2007.

Indonesia's current account surplus has been driven by strong commodity exports, mainly in coal and crude palm oil. Notably, the country has managed to consolidate fiscal deficits this year and should continue to do so in 2023. We are positive about Indonesia's growth prospects, although its large trade surplus may gradually shrink as commodity prices stall. With more

modest inflationary pressure, the country initially lagged most Asian peers in this rate-hike cycle, but we have seen its central bank playing catchup on monetary normalisation.

Compared to previous tightening cycles, many Asian countries have reduced their reliance on external funding, thanks to the growth of domestic capital markets. This should help limit the impact of capital outflows induced by the Fed's aggressive tightening. With lessons learned from history, most countries in the region have today accumulated much stronger foreign exchange reserves than they had in the 2008-09 Global Financial Crisis or the 1997-98 Asian Financial Crisis.

For long-term investors, the occasional outflows from both equity and fixed income markets in Asia this year have depressed valuations and made securities look more attractive in parts of the market. With recession risks looming in much of the developed West, global investors may look East in 2023 for both diversification benefits as well as growth potential.



Credit: Fred Dufour / Staff, Getty Images.

Private credit



Michael Curtis
Head of Private Credit Strategies

Private credit may prove a defensive option

The private credit markets could prove a defensive option as economies brace for recession in 2023, due to their structural features and the relative strength of the asset class.

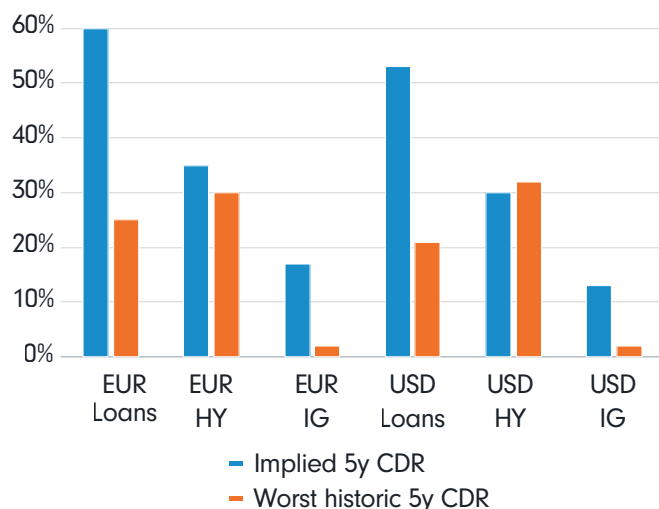
Private credit has features that can help investors avoid the most dramatic levels of volatility in other asset classes, not least because as floating rate structures they are able to provide increasing income generation in a rising rate environment.

Direct lending facilities, for example, can be long dated and tightly covenanted in lenders' favour, while senior secured loans enjoy the relative protection offered by their positioning at the very top of the capital structure.

This inherently conservative asset class has also positioned itself defensively heading into the volatility. While default rates across the sector are likely to increase over the coming year, these should be limited compared to public assets, and any pricing weakness is likely to be less severe than it was during the Global Financial Crisis (GFC).

Certain private credit products have always been resilient, with historically low default rates for collateralised loan obligations (CLOs) even in times of stress (no CLOs have defaulted since the GFC, and even before then the few defaults that did occur were mostly seen in BB-rated tranches). Meanwhile, current spread levels in the senior secured loan market suggest that a fair amount of bad news has already been priced in. Current valuations imply a one year forward default rate of 19.1 per cent, around twice the greatest ever default rate of 10.5 per cent experienced during the GFC. For context, Fitch has predicted a 3 per cent default rate in its base case for the upcoming volatility and 5 per cent in a more severe default scenario.

Chart 9: Implied 5y default rates appear pessimistic versus worst historical levels



Source: Credit Suisse Western European Leveraged Loan Index - EUR Only DM to Maturity; CS US Leveraged Loan Index DM to Maturity; High Yield and IG ICE BAML OAS; Data as of 19-Oct-2022. Recovery Rates assumed at 60% for Leveraged Loans, 30% for High Yield and 40% for IG based on historical recovery rates and seniority. HY and IG historical default rates based on S&P 2021 Annual Global Corporate Default And Rating Transition Study (1982 to 2021). Leveraged Loan historical default rates from Morningstar US & European LL Indexes (2000 to 2022). EUR Leveraged Loans BDRs down to 41% with 30% Recovery Rates and 31% with 0% Recovery Rates.

A market made of sterner stuff

Indeed, the European senior secured loan market is a fundamentally different beast now than it was going into the GFC. Back in January 2007, no deals were cov-lite, while some 97 per cent of the facilities in the market now have no covenants. This naturally reduces the risk of defaults going into 2023 as companies won't break covenants that don't exist, allowing cyclical companies more room to navigate to the other side of the turmoil.

Similarly, interest coverage levels have strengthened over the last 15 years and now stand at around 3.9x compared to 2.7x in 2008, making the debt more affordable going into a potential recession. The proportion of CCC-rated facilities in the Western European Leveraged Loan Index has fallen to 4 per cent from 20 per cent heading

into the GFC. That said, we believe the rating agencies may not continue the lenient approach to downgrades adopted over the pandemic.

More defences, but not immune

While we expect private markets to perform relatively well into 2023 there will be opportunities for investors to find assets at considerable discounts, though careful due diligence will be required to avoid value traps. The borrowers that access these markets operate in the real economy, facing sluggish consumer demand, rising rates, and market volatility. And although issuers are not under intense pressure to refinance existing deals – the maturity wall of senior secured facilities that needs to be replaced before 2024 is only €18 billion for example - there will be some names that are forced into amend-and-extend deals, or that may even default.

Although the recessionary backdrop will have an impact, we expect that many investors will benefit from a relatively calmer environment in the private credit markets compared to public ones. Given the volatility and balance of control shifting to lenders, we believe the next 12-24 months could create opportunities in the private credit space.

Real estate



Neil Cable

Head of European Real Estate Investments

Challenges ahead but with potential opportunities

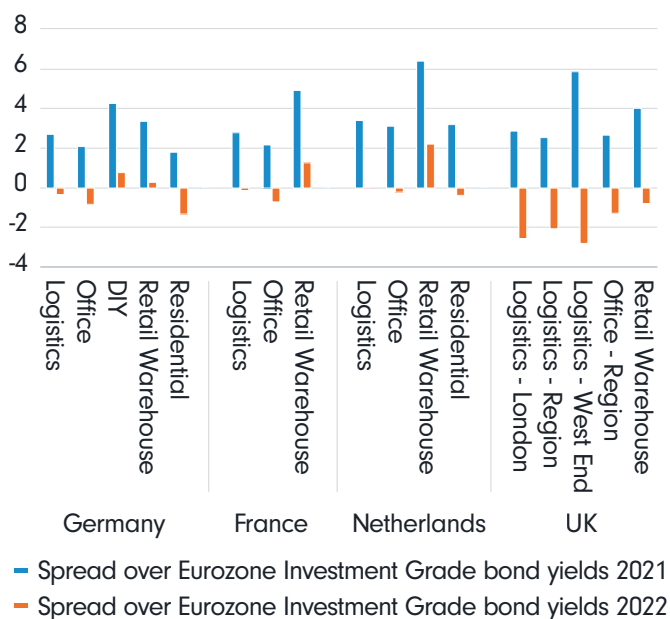
Against a volatile economic backdrop, the real estate market's focus is shifting towards the ongoing cashflow available over the next 12 months. As the tightening cycle slows and rates stabilise, however, opportunities should begin to emerge for investors prepared to take them.

The coming year is likely to be a challenging one for real estate but should also create opportunities to lock in higher yields and generate long-term value.

Signs of recovery in the wake of higher lending rates could seem elusive in the first half of 2023. Private markets are not as liquid as their public counterparts and, as their pricing trends can lag other asset classes, they may continue to decline over the first two quarters of the coming year. But that will be precisely the period in which purchasers have the greatest negotiating power.

Yields will rise further to reflect tighter financial conditions, but we don't expect a cycle like that of the 1990s, nor that prices will sink to the lows of the Global Financial Crisis. There are still plenty of buyers in real estate and, given private market investments have become a key part of many well-diversified portfolios, there is unlikely to be a wholesale withdrawal of capital from the space.

Chart 10: European real estate set to reprice after spreads narrow more quickly than



Source: Fidelity International, CBRE, September 2021 and September 2022; Bloomberg, as at 30/09/2021 and 26/09/2022.

Instead, we expect the upcoming cycle to be relatively short. If interest rate levels begin to stabilise, we believe that most valuations will readjust by the middle of next year. As the market moves closer to the bottom, there will be some interesting opportunities for investors with long-term capital to deploy.

The biggest differential may arise between buildings that are sustainable and those that are not.

A return to rational pricing

Indeed, we should see a fundamental strengthening of terms in 2023. After a long period of low interest rates, during which a lot of real estate seemingly offered the same standardised yield almost regardless of quality, we're now moving into a period of more rational pricing. This creates the potential for more differentiated returns between sectors, property types, and locations that active real estate investors can take advantage of.

Sustainability premia set to increase

The biggest differential may arise between buildings that are sustainable and those that are not. Not only has the energy efficiency of a building become more important as energy costs have risen, but evolving regulation is continuously ratcheting up sustainability standards. With an alphabet soup of requirements from EPC ratings to Sustainable Financial Disclosure Regulation coming thick and fast across Europe especially, the next few years will bring huge opportunities and risks for those who can get ahead of the changes and those that get left behind.

Some buildings will become stranded as landlords can no longer lease them unless they meet minimum standards. This will increase not only the 'brown discount' for non-compliant buildings but also the scope for the most sustainable buildings on the market to attract outsized 'green premia' in the near term, especially as buildings with the strongest credentials are in short supply.

An eye on cashflow

Finally, 2023 will be the year that the pricing landscape in the real estate market goes back to basics. After almost a decade of chasing ever-compressing yields due to the increased allocation of capital to the sector, we're now entering a period where the focus will be on cashflow - maintaining income where you can and growing it where opportunities to pick up higher-yielding assets arise. The focus on delivering alpha will remain but this will be much more a function of the quality of the building, and the ability of the manager to actively manage it, than it will be of past drivers like historically low rates or prime locations.

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