Fidelity INTERNATIONAL

# Global Asset Allocation Insights

March 2024

Fidelity Solutions & Multi Asset

# Improved cyclical outlook supports a ‘risk-on’ stance

## A constructive environment for risk but with a focus on the best opportunities


### Summary

The macroeconomic backdrop looks much the same as it did last month. Fiscal support in the US has kept US growth resilient while fading supply side shocks continue to drive inflation lower. We are entering into a period of positive seasonality, which should provide support for risk assets in the short term. Interest rates in developed markets have plateaued; most central banks are expected to cut rates in 2024 and some emerging markets are already easing. The recent Fed pivot towards a more dovish stance provides a strong tailwind for equity and bond markets. The Fidelity Leading Indicator continues to paint an upbeat picture consistent with a ‘soft landing’ scenario (which is our base case), however the moderate improvement in momentum highlights the risk of the global industrial cycle re-accelerating in a ‘no landing’ scenario.

We remain overweight equities and move credit up to neutral. Our quant indicators corroborate our risk-on stance given that volatility is receding. Credit conditions in the US and Europe are easing; lending standards are moderating, loan demand is rising, and companies are generally able to access financing. Credit spreads are tight following the recent risk-on rally and a lot of good news is already priced in, however we have a more positive view of high yield this month as the carry is increasingly attractive. We are still cautious on the prospects of the European economy.


### What has changed?

- **Stickier US inflation:** January CPI data indicated that the Fed’s first rate cut might be delayed and raises the prospect of a ‘no landing’ outcome.
- **More positive view of US HY**: Spreads are tight, but fundamentals are solid and yields are attractive.

### What has stayed the same?

- **Soft landing still on track for now:** Recent inflation and labour market data still points to a Goldilocks environment.
- **Diversifying dollar:** The US dollar remains a useful portfolio diversifier, given the positive correlations between equities and bonds.

### What are we watching?

- **US inflation:** A material picks up in inflation would likely cause the Fed to cut less than expected this year, putting downward pressure on both equities and bonds.
- **Geopolitics:** The US election will begin to dominate the news cycle as November nears. The outcome could have significant ramifications for markets.

# The key themes driving markets

## Improved cyclical outlook supports a ‘risk-on’ stance

| | Key view | Thesis | Investment implications |
|---|---|---|---|
| 1 | **A supportive backdrop for risk due to resilient growth, decelerating inflation, and policy easing expectations** | ▪ Our outlook for US growth has improved materially.<br>▪ A soft landing is now our base case and the chance of a no landing is also growing | ▪ Good environment for equities<br>▪ HY to outperform IG<br>▪ Supportive environment for carry trades |
| 2 | **Regional differentiation is high; the US outperforms while Europe lags** | ▪ We believe US assets will trade in a more pro-growth regime, although inflation risks remain prominent<br>▪ Rate cuts in Europe could come earlier than US<br>▪ Japan is in a different place in its policy cycle with solid earnings | ▪ Preference for US and Japanese equities<br>▪ Favour USD vs EUR/GBP. Bunds relatively attractive<br>▪ UW JGBs and Japanese banks remain interesting |
| 3 | **Latent inflation risks means bond-equity correlation could be persistently positive** | ▪ We prefer the front end of the credit curve where yield-to-duration risk is compelling<br>▪ Low implied volatility means using options is interesting | ▪ Sweet spot for short duration credit<br>▪ Long USD inflation swaps vs EUR<br>▪ Use of options for hedging and upside capture |
| 4 | **A good environment for TAA given dispersion in markets** | ▪ We are looking for more asymmetric or thematic opportunities from the use of Tactical Asset Allocation rather than broad market exposures | ▪ Convertible bonds, US mid-caps and min vol as catch-up plays.<br>▪ Thematically, we like AI/semis, financials, clean energy, carbon, biotech<br>▪ India, Indonesia, Brazil, S Korea, Taiwan are select EM equity markets. Favour EM rates with high real yields such as South Africa, Brazil, and Mexico |

Source: Fidelity International, as of February 2024. 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.

# A supportive backdrop for risk

## Due to resilient growth, decelerating inflation, and policy easing expectations

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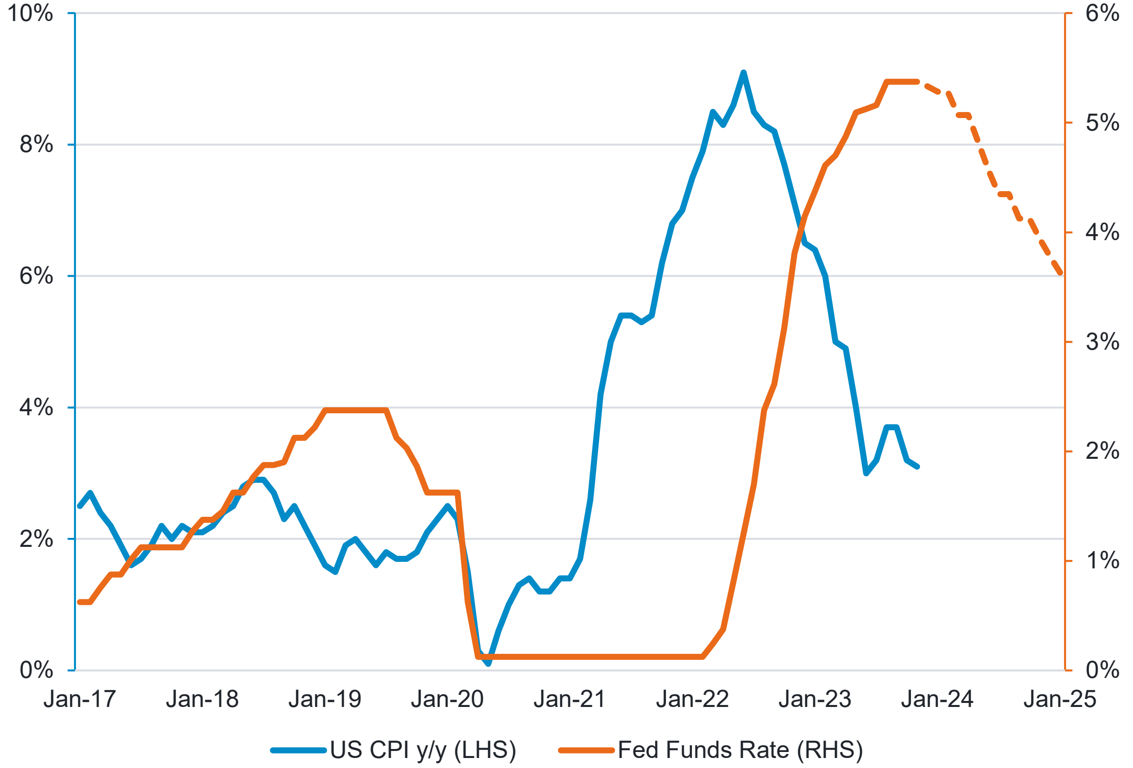
- **Favour equities:** Growth remains resilient, positioning is improving, inflation is declining, and the Fed has signalled that interest rates will fall in 2024. Valuations are generally at or slightly above historical averages. Tight labour markets and stabilising consumer sentiment continue to support the economy in the current late-cycle environment. Our quant models are supportive of taking more risk, volatility is low, and the Fidelity Leading Indicator is still tracking in the 'above average and increasing' quadrant. Higher rates are weakening the medium-term fundamental outlook, however, and we will be monitoring growth data closely this year.
- **High yield bonds to outperform investment grade bonds:** We believe that strong growth will support the more cyclical high yield segment compared to the more defensive investment grade. Investors embraced credit in the recent risk rally. While this has led to extended valuations in the form of tight credit spreads, flows are still supportive and yields are attractive.

### Falling inflation marks the end of the rate hiking cycle, providing a supportive environment for risk assets



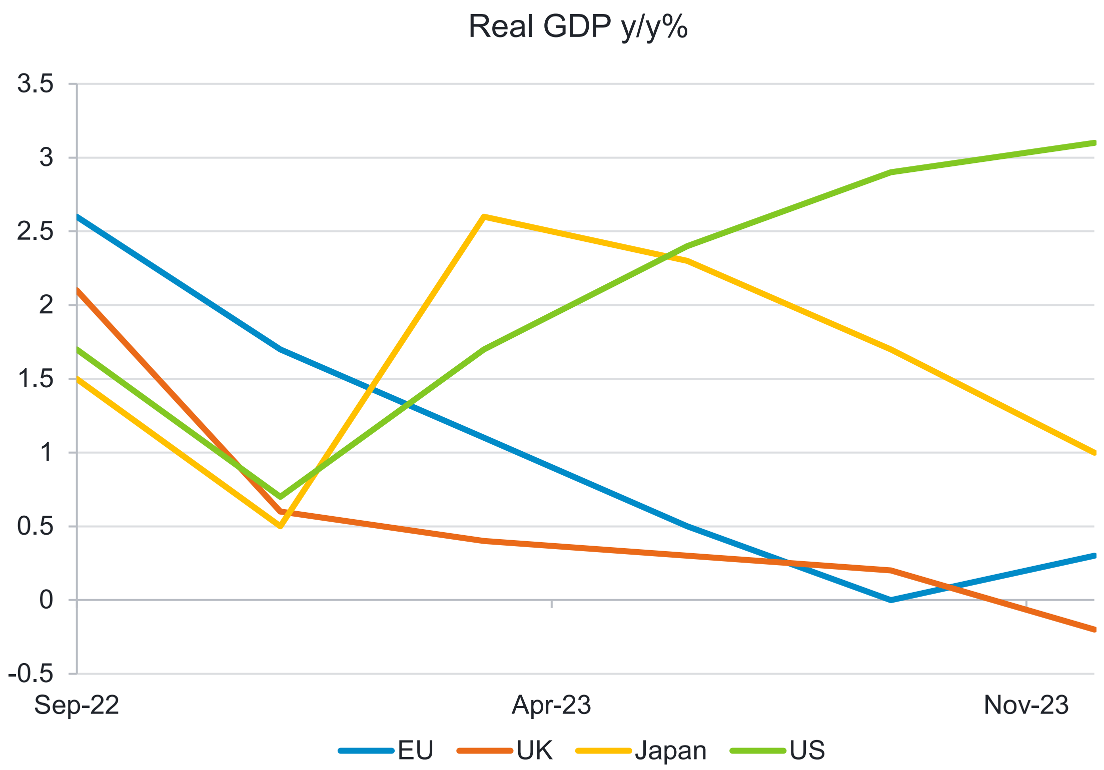

Source: Fidelity International, as of February 2024. Views reflect a typical time horizon of 12 –18 months and provide a broad starting point for asset allocation decisions. However, they do not reflect current positions for investment strategies, which will be implemented according to specific objectives and parameters. Chart source: Bloomberg, Haver Analytics, February 2024. *Dotted lines shows market implied Fed Funds Target Rates.

# Regional differentiation is high; the US outperforms while Europe lags

2

- **Preference for US and Japanese equities**: The US equity market is where the growth is. Valuations might be a little high, but we particularly like the better valued mid-cap part of the market. There is still no landing in sight for the US economy and the recent Q4 earnings season was solid. In Japan, business activities continue to recover especially in the service segment, which has been supported by reopening and tourist flows, while manufacturing is benefiting from tech related activities.
- **Prefer Bunds over Japanese government bonds:** Weak growth and falling inflation dynamics support lower Bund yields. Europe is the major region most likely to slip into recession. In Japan, the BOJ remains on its policy normalisation path although appears in no hurry. Material upside in yields will only occur after the BOJ exits from negative rates, which looks more plausible in 2024 when there are clear signs that wage growth is sustainable from the next round of Shunto wage negotiations.
- **Favour the US dollar over the euro and sterling:** US exceptionalism looks set for another round this year, which will support the dollar. Given the weakness in Germany, the ECB may be forced to cut before the Fed. In the UK, wage inflation might be stickier in than in Europe, but sterling remains a preferred funding currency due to its high beta properties

## US growth outperformance is supportive of USD

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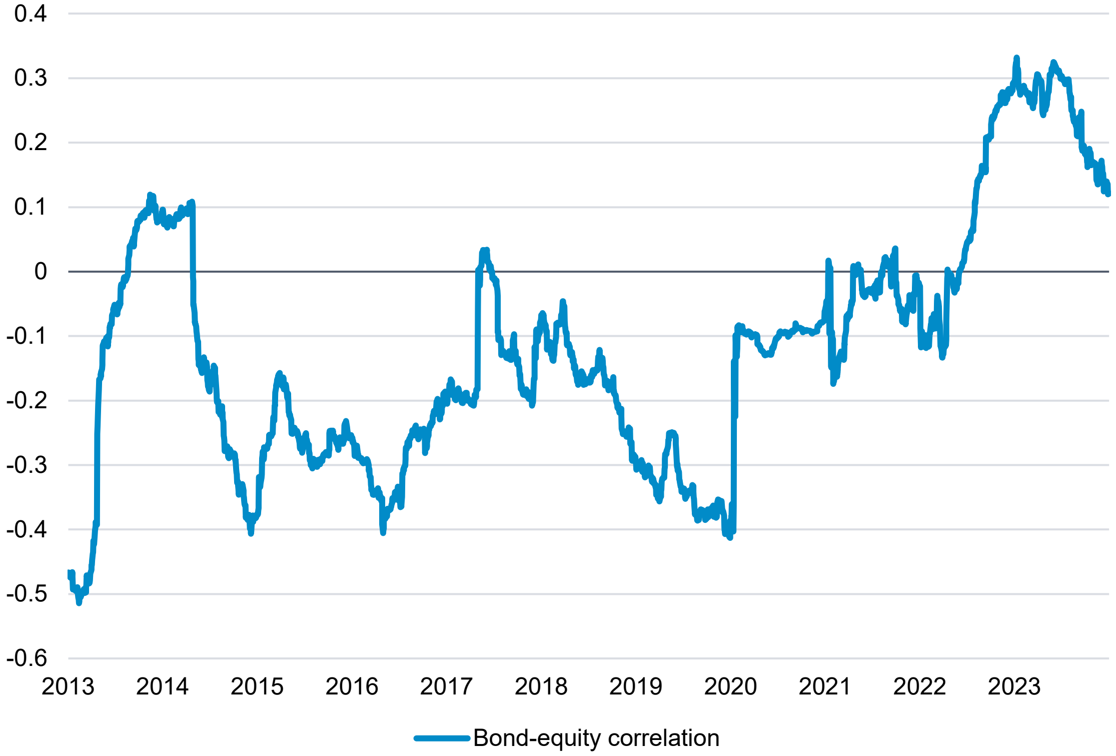
# Inflation risks means bond-equity correlation could be persistently positive

3

- **Sweet spot for short duration credit:** The positive growth outlook should make credit attractive. However, we are wary of the risk that interest rates, although high now, are likely to fall over the year. Short duration credit strikes the right balance of high yields but with a lower sensitivity to falling rates.
- **Long USD inflation swaps vs EUR inflation swaps:** Given the strength of the US economy, inflation could possibly be harder to tame than thought or even start to tick up again. However, the European economy remains very weak and inflation there looks to be well under control.
- **Use of options for hedging and upside capture:** Higher bond-equity correlations reduce the attractiveness of bonds as a provider of protection in portfolios against downside equity moves. Put options are therefore a good way to hedge risks and build robust portfolios at the moment. In addition, options are currently relatively cheap because implied volatility is low, which means that call options are also a good way to capture upside potential.

## High bond-equity correlation makes options relatively more attractive for downside protection




Source: Fidelity International, as of February 2024. 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. Chart source: Refinitiv, Fidelity International, February 2024. 12-month rolling correlation of daily price returns of MSCI World and ICE BofA Global Broad Market indices.

# A good environment for TAA given dispersion in markets

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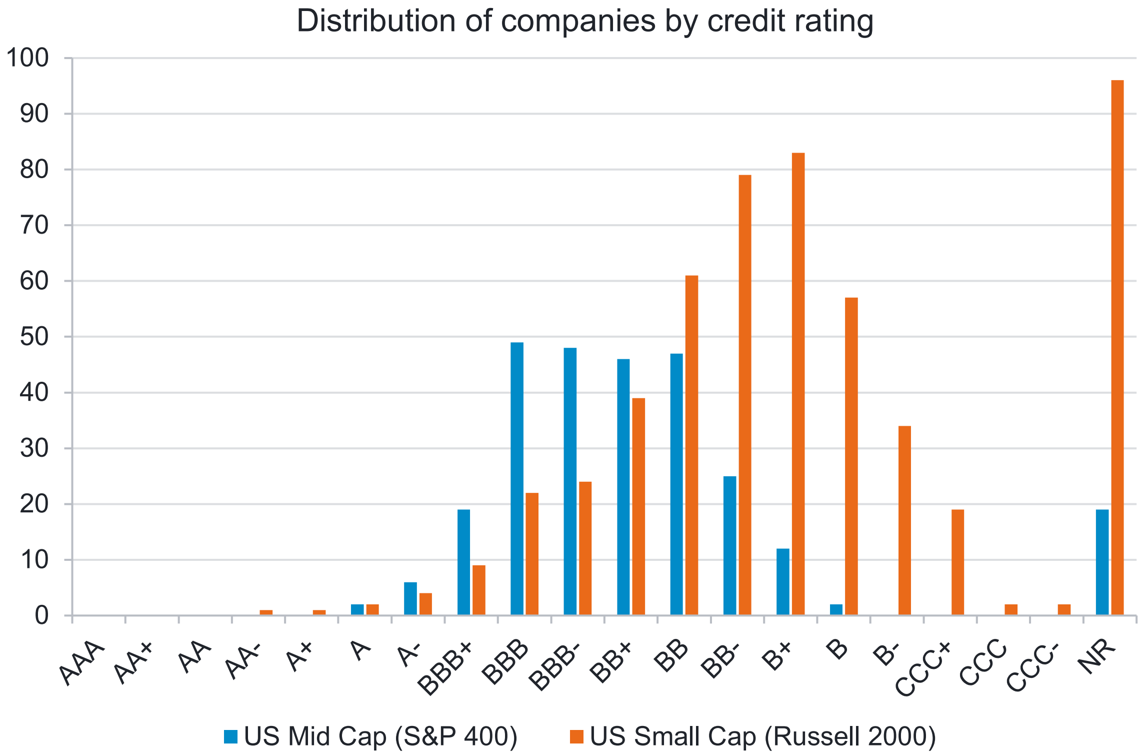
- **US mid-caps:** This area of the US market offers strong long-term growth at a reasonable price and should have the resilience to withstand higher rates better than some areas of the market, which might be important if US inflation proves hard to get down further.
- **Biotech:** Positive sentiment and falling rates have both been positive for biotech equities historically, yet the sector is yet to fully participate in the recent risk rally caused by these very factors. There is plenty of potential for biotech to 'catch up' with broader sentiment given the outlook for innovation and prospect of falling interest rates.
- **Carbon:** The price of EU emissions allowances now reflects a lot of gloom about Europe's economy and positioning is very low in futures markets, meaning there is scope for positive news to catch the market off guard. And at these levels, EUAs will be more in demand by those needing to hedge, particularly the maritime industry, which enters the emissions trading system later this year.
- **Selective EM exposures in equities and FX/rates:** The picture in many ex-China EMs is still positive. Aside from the likely diversification benefits relative to other equity holdings, the more benign inflation and growth outlook in many EMs, for example Brazil, India and Indonesia, means that they are further along in the economic cycle than many DM countries.

## US mid-caps generally have higher credit ratings and should be more resilient to higher rates

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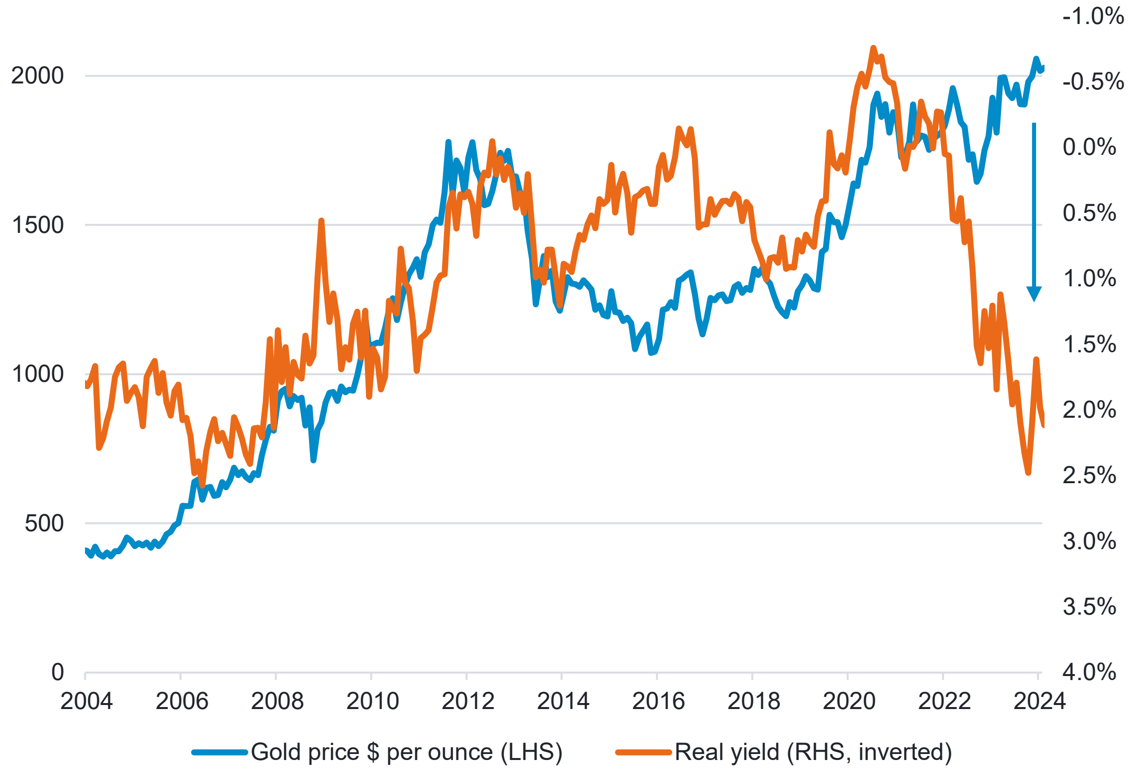
# Other tactical views

## Examples of current ideas

- **Commodities:** We are seeing signs of a burgeoning manufacturing recovery which underpins our more constructive outlook. We have now positioned pro-cyclically; essentially long copper versus gold.
  - **Overweight industrial metals**: The worst of the manufacturing slowdown is behind us with PMIs improving at a time when metals supply is being broadly revised down, notably with the surplus for copper being wiped away during a time when structural energy transition demand is coming together.
  - **Underweight precious metals**: We have chosen to fund our positive view on copper out of gold where the outlook is lacklustre. Gold's appeal is eroded by elevated nominal and real yields, and portfolio construction benefits are undermined by a lack of defensive as demonstrated by the positive correlation with equities.
  - **Neutral petroleum**: Oil is currently in the middle of a $70-90 range with mixed positioning. Fundamentals look balanced by OPEC+ supply curbs amidst upside risks from geopolitics.

### Higher real yields are a drag on gold




Source: Fidelity International, as of February 2024. 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. Chart source: Refinitiv, Fidelity International, January 2024. Real yields calculated as 10-year US government bond yields minus 10-year US inflation expectations.



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# Improved cyclical outlook supports a ‘risk-on’ stance

## A constructive environment for risk but with a focus on the best opportunities

**Equities:** The continuation of US exceptionalism in the form of resilient economic activities keeps us positive on US equities. Earnings have been solid so far; profit margins are stabilising. We remain overweight Japan as earnings revisions and economic surprises are positive. We also retain our overweight to UK large caps, although our conviction is lower this month. We stay underweight Pacific ex Japan due to weak fundamentals. We remain neutral on EM – China’s weak recovery balances out a more positive outlook in Latin America and several Asian markets. European equities still look vulnerable. The region is at risk of slipping into recession and the ECB appears wedded to backwards-looking data that keeps it hawkish.

**Credit:** We are not yet willing to go outright long credit beta, despite the resilient US growth data and recovery in the global manufacturing cycle. We prefer to express a developed market vs emerging market view in a carry positive way, by moving overweight high yield and underweight EMD, and wait for better entry points to go net long credit beta. We particularly favour US high yield.

**Government bonds:** We prefer Bunds to Gilts due to the softer inflation outlook in Europe and potential for fiscal divergence from the UK. We continue to prefer inflation-protected US government bonds over nominals – we believe that the market is under-pricing inflation risk premium. We maintain our underweight JGB view, although we reduce conviction given inflation dynamics put less pressure on the BOJ to tighten policy.

**Cash/currencies:** We retain our long dollar view, due to resilient US growth and inflation data and its beneficial role as a portfolio diversifier. We remain underweight the euro and sterling; both currencies look fundamentally weak. We still like selective EM FX on the whole. There is likely to be a rotation this year towards cyclical and balance of payments dynamics, which favours some of the more value FX.

| | Mar-2024 | Feb-2024 | Jan-2024 | Dec-2023 |
|---|---|---|---|---|
| Equities | ○○○●○ | ○○○●○ | ○○○●○ | ○○○●○ |
| Credit | ○○●○○ | ○●○○○ | ○●○○○ | ○○●○○ |
| Government bonds | ○○●○○ | ○○●○○ | ○○●○○ | ○○●○○ |
| Cash | ○●○○○ | ○○●○○ | ○○●○○ | ○●○○○ |

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# Key asset allocation views at a glance

## Positive view of equities but still selectively taking risk

### Equity regions

| | View | Change | Rationale |
|---|---|---|---|
| US | ○○○●○ | - | Economic activity continues to support a soft landing outcome. Inflation and labour market data are moderating gradually. Earnings season has been solid so far. |
| Europe ex. UK | ○●○○○ | - | Economic activity is still pointing to a recession, although expectations are low. Earnings season has been mixed so far. |
| UK | ○○○●○ | - | Valuations remain attractive on multiple metrics. UK equities could benefit if commodity prices rebound. |
| Japan | ○○○●○ | - | Economic surprises and earnings revisions are positive and business activities continue to recover. |
| Emerging markets | ○○●○○ | - | We remain concerned about China’s recovery, but we are more positive about the outlook for Mexico, Brazil, and India. |
| Pacific ex. Japan | ○●○○○ | - | Economic activities are weak and survey data remains soft. Weakness in the industrial metals and a lacklustre China economic recovery are risks to the region |

### Government bonds

| | View | Change | Rationale |
|---|---|---|---|
| US Treasuries | ○●○○○ | - | Expectations for Fed rate cuts in 2024 have been scaled back due to the continued strength of the US economy. |
| Euro core (Bund) | ○○○●○ | - | Inflation momentum has dropped sharply and poor economic conditions now warrant the ECB shifting to a more dovish stance. |
| UK Gilts | ○●○○○ | ▼ | The UK might be in technical recession, but the real income squeeze is ending, services PMIs are resilient, and inflation is stickier than most other regions. |
| Japan govt bonds | ○●○○○ | ▲ | Inflation dynamics are shifting, goods and food is turning deflationary while services inflation is persistent. Material upside in yields will only occur after the BoJ exits its negative interest rate policy. |
| Inflation linked bonds (US TIPS) | ○○○●○ | - | Value continues to emerge in US breakevens as they are currently priced for a benign inflation outlook at a time when the probability of a ‘no landing’ is rising. |

### Credit

| | View | Change | Rationale |
|---|---|---|---|
| Investment grade (IG) bonds | ○○●○○ | - | The recent risk-on rally has led to significant credit spread tightening. We prefer Euro IG to US IG. |
| Global high yield | ○○○●○ | ▲ | Fundamentals are stabilising. Valuations are stretched but yields make HY attractive from a carry perspective. |
| Emerging market debt (EMD, hard currency) | ○●○○○ | ▼ | Spreads are tight for EMD IG but wide for EMD HY. Sticky US inflation data that led to a stronger US dollar does not bode well for EM issuers. |

### Currencies

| | View | Change | Rationale |
|---|---|---|---|
| USD | ○○○●○ | - | US exceptionalism is back, reducing the likelihood of deep Fed rate cuts. The dollar remains a key portfolio diversifier but significant upside from here is unlikely. |
| EUR | ○●○○○ | - | Fundamentals are weak and should prompt the ECB to shift to a more dovish approach. |
| JPY | ○○●○○ | - | Fed rate cuts would support the yen, however the BoJ is likely to keep financial conditions easy. |
| GBP | ○●○○○ | - | Poor fundamentals and high beta make sterling a good funding source for our conviction trades in the dollar and EM FX |
| EM FX | ○○○●○ | - | A shift away from carry as the main market driver is likely to favour some of the more value EM FX. |

Source: Fidelity International, as of February 2024. Change reflects directional difference in view versus previous month. Vi ews 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.

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