

# INVESTMENT OUTLOOK

Fidelity's market and investment view

## In this issue:

- Hard or soft landing?
- Bonds are back
- China: if not now, then when?

October  
2023



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# Outlook at a glance

**Current view:** ✓ Positive — Neutral ✗ Negative

**3 month change** (since the previous Investment Outlook): ▲ Upgrade ► Unchanged ▼ Downgrade

Asset classes	Current view	3 month change	At a glance
 <b>Equities</b>	—	►	The key to the outlook is whether we can avoid a recession. If so, then earnings can drag the market higher.
 <b>Bonds</b>	✓	►	The bond rally has been deferred yet again by rising yields. But the potential rewards are now increasing.
 <b>Property</b>	✓	►	Property offers investors bond-like income and equity-like growth. Having corrected, real estate looks attractive again.
 <b>Commodities</b>	—	►	Gold, oil and copper will remain volatile as long as the interest rate, growth and political backdrops remain so uncertain.
 <b>Cash</b>	✓	►	It's always good to have some cash to hand. Rising interest rates mean it can now also earn its keep in a portfolio.
Regions	Current view	3 month change	At a glance
 <b>US</b>	—	►	A hard or a soft landing is the big unknown in the US. But beyond the Magnificent Seven, that uncertainty is priced in.
 <b>UK</b>	✓	▲	Political uncertainty is the perennial cloud. Very cheap valuations and the UK's income advantage are the silver lining.
 <b>Europe</b>	—	▼	The case against Europe is easy. Recession looms. But valuations are attractive and stock picking opportunities abound.
 <b>Japan</b>	✓	►	Less cheap than it was, Japan is still attractive as improved governance, healthy inflation and growth provide support.
 <b>Asia Pacific ex-Japan</b>	—	▼	Hard to generalise. China is cheap but a catalyst is elusive. India is expensive and could be volatile ahead of its election.

# Looking for direction

The end of the holiday season can sometimes seem like a fresh start, a new sense of purpose. It doesn't feel that way in the markets this year. No-one is sure where things are heading. There's a feeling of drift and plenty of uncertainty about the key questions: are interest rate hikes about to really bite? Are we heading towards a recession? Are markets too optimistic?

It's not really surprising that investors are looking for safe havens. The professionals are buying protection against a market fall via bets on the Vix volatility index; the rest of us may simply be sheltering in cash, which is paying a decent income for the first time in many years and feels like a port in the storm.

That's been reflected in the performance of financial markets since our last snapshot in July. They've gone nowhere, with one key exception. The oil price has soared since the summer on the back of production cuts from the key suppliers, Saudi Arabia and Russia. And that goes a long way to explaining the lack of vigour in other markets. Pricier oil adds to companies' costs; it raises the prospect of an economic downturn or recession; it pushes inflation higher and that, in turn, justifies the 'higher for longer' narrative around interest rates and the rising bond yields that reflect the shift in expectations.

The chart on the next page paints a reassuring nine-month picture since the start of the year. Markets have generally gone

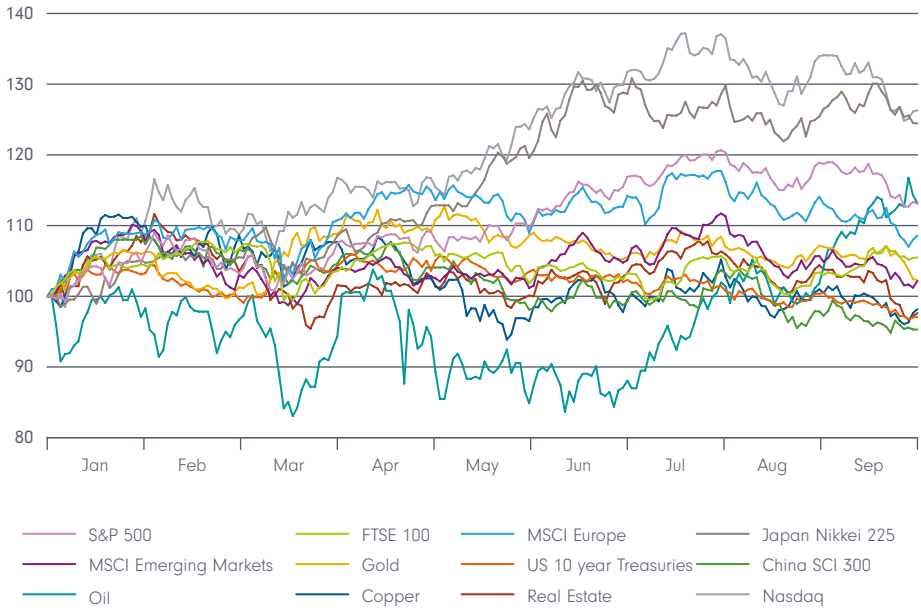
sideways or risen. After a difficult 2022, that's an improvement, although over the past 18 months most investments remain under water in inflation-adjusted terms.

The headline indices have been boosted by the performance of a relatively narrow subset of companies. Strip out the technology stocks in America, and a few dominant companies in Europe, and the rest of the market looks less exciting.

The Nasdaq remains at the top of the leaderboard. The big technology stocks continue to look like the most defensive corner of the market and their growth prospects are still better than you can find elsewhere. But even here there has been a de-rating from the eye-watering valuations that have come with years of outperformance.

The second-best performer year to date has been Japan, although it's worth noting that for overseas investors the benefit has been considerably reduced by the weakness of the yen. The Japanese currency has fallen victim to the Bank of Japan's decision not to follow the rest of the world towards a normalisation of interest rate policy. But there's plenty going for the Japanese market as we discuss on page 16.

China is stuck at the bottom of the performance table. It remains the biggest disappointment for investors this year. Hopes that the end of Covid would trigger a market rally came to nothing and shares in Shanghai and Shenzhen are among the cheapest in



Source: Refinitiv, total returns in local currency, 1.1.23 to 30.9.23

**Past performance is not a reliable indicator of future returns. When investing in overseas markets, changes in currency exchange rates may affect the value of an investment. Investments in emerging markets can be more volatile than other more developed markets. There is a risk that the issuers of bonds may not be able to repay the money they have borrowed or make interest payments. For full 5 year figures, see page 7.**

the world now. Just as Japan turned up when investors least expected it, perhaps China will turn out to be the contrarian investment opportunity of 2024. If not now, then when?

Next year may not be so kind to the US market as politics becomes the main focus again ahead of November's Presidential election. The bitter wrangling over the debt ceiling does not augur well and voters in the world's most dynamic economy may well feel underwhelmed by the choice they are likely to be presented with in a year's time.

The big story over the summer has been the re-emergence of a higher-for-longer narrative around US interest rate policy. It's hard to remember that not long ago we were assuming that interest rates would be on their way down again by now. The Federal Reserve may not even have delivered its final rate hike yet and the return to easier money next year and in 2025 could be painfully slow.

That's been bad news for bonds, which have endured persistently rising yields this year. Yields and prices move in opposite

directions, so the bond market rally has been consistently kicked down the road. As we discuss on page 10, however, the risk/reward balance looks more and more compelling the longer this process goes on. Other bond-like investments such as commercial property have also suffered. Here, too, the correction is starting to look like it has run its course.

### **Sleeping bull**

So, what looked like the early stage of a bull market after the market bottomed last October, now looks less promising. The key question is whether we head into recession or experience the hoped-for soft economic landing. In the absence of recession, corporate earnings tend not to fall very much and the forecasts for next year and 2025 remain encouraging.

Valuations are neither particularly cheap nor expensive in most cases, so continued growth in company profits could feed through into a prolonged recovery for the market. It feels like we are getting closer to the end of the post-financial-crisis bull market, but history shows that prices can drift higher for an extended period.

While we wait to find out where shares head next, there are at least plenty of opportunities to diversify portfolios. Bonds offer an attractive yield now and the prospect of a capital gain to come as and when interest rates do start to come down again. And cash is paying a good income too. Sometimes, we just have to be patient.

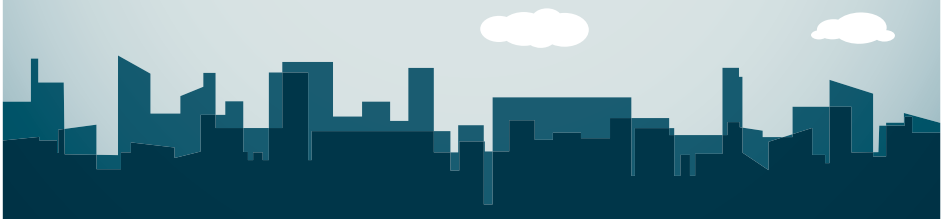


(as at 30 September)	2018-19	2019-20	2020-21	2021-22	2022-23
S&P 500	4.3	15.2	30.0	-15.5	21.6
Nasdaq	0.5	41.0	30.3	-26.3	26.1
FTSE 100	3.2	-18.1	25.4	0.9	14.7
MSCI Europe	-0.1	-0.3	28.0	-24.3	29.7
Nikkei 225	-7.8	8.7	29.1	-10.0	25.5
MSCI Emerging Markets	-1.6	10.9	18.6	-27.8	12.2
Gold	22.5	25.4	-8.3	-5.7	10.9
Oil (WTI Crude)	-26.5	-32.7	91.7	12.3	8.2
US 10yr Treasuries	16.8	12.6	-5.1	-16.5	-2.6
China CSI 300	13.5	22.7	8.0	-20.1	-0.6
Copper	-9.1	17.1	34.1	-14.1	6.9
Real Estate (S&P Global REIT)	16.4	-17.7	32.8	-19.8	3.2

Source: Refinitiv, total returns in local currency as at 30.9.23

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# Asset classes and world stock markets

While this quarterly *Investment Outlook* aims to keep investors abreast of developments in a range of different asset classes and geographical areas, recent events have shown how difficult it can be to predict how these will perform in any given circumstances. This is particularly the case today as the full impact of a very rapid tightening of monetary policy in the face of persistent and high inflation starts to be felt. As ever, investors find themselves in familiar but uncharted territory. In this evolving environment, the importance of diversification cannot be overstated even if a simple bond/equity split has failed to deliver more recently. Investing is proving to be more challenging than ever against a fast-changing backdrop, but there are always opportunities, and we hope this Outlook will help to identify these.





# Equities

Current view — Neutral | 3 month change ► unchanged

The stock market rally that began a year ago ground to a halt over the summer. Since then, markets have drifted as investors have resigned themselves to higher-for-longer interest rates and more competition from other investments.

Looked at over a two-year time horizon, most markets remain under water. That is particularly the case in inflation-adjusted terms. The main indices in the US, Europe and Asia are down by around a fifth in real terms since the start of 2022. Japan is the exception, having benefited from its relatively low valuation.

However, when you consider how far and fast interest rates have risen over the past two years, equity markets have performed better than might be expected. Consumers have proved surprisingly willing to pay higher prices as inflation has risen. In the absence of a recession, company profits tend not to fall very much. As long as valuations are not too demanding (and outside the US they are not), share prices can continue to rise in this environment.

The key question is whether we can now avoid a recession next year. The risk is that the negative impact of higher interest rates

has simply been deferred. With little scope for valuation multiples to rise much further, investors are counting on forecast increases in earnings being delivered next year and in 2025.

The second important question is what happens to bond yields. Often shares do well as bond yields rise because they reflect better growth in the economy. Now rising yields are starting to feel like a headwind for equities because they reflect higher inflation and indicate a prolonged period of restrictive interest rates.

Within the equity market, defensive growth looks attractive. That argues for continued outperformance by the big technology companies. Although the US stock market is the world's most expensive, this preference for relative safe havens may keep it out in front.

Shares look less relatively attractive, but investors focused on the long-term should continue to have a big exposure to the asset class that has delivered the best returns. Investors may choose to hold more bonds and cash, but equities should remain the core, not least because they offer the best prospect of outpacing inflation.

# Bonds

Current view ✓ Positive | 3 month change ► Unchanged

It's been a year of frustration for bond investors. We started 2023 thinking that the peak in the interest rate cycle was close and that the cost of borrowing would start to fall. That pivot to easier policy keeps being kicked down the track, and the re-emergence of a higher-for-longer rate narrative has put upward pressure on bond yields.

For those who think that the impact of higher interest rates on the economy has simply been deferred, the current rise in yields only makes a stronger case for increasing the bond weighting in a balanced portfolio. In due course, rates will start to fall again, and investors will then enjoy a capital gain. In the meantime, they are able to lock in a very attractive income.

The counter argument is that economies have proven more resilient than expected to rising interest rates. With no recession on the horizon to worry about, central banks can continue to focus on squeezing inflation out of the system. And that means that rates can stay high.

Our view is that the balance between risk and reward is firmly skewed towards investing in government bonds, which is the part of the fixed income universe that is most sensitive to movements in interest rates. The chance of rates falling from their current level is greater than the possibility that they will rise much further.

When it comes to corporate bonds, it's a slightly different story. That's because these bonds are also influenced by the health of the economy and its impact on companies. As the economy slows, more of these may fall into difficulties and become unable to meet their obligations to lenders. This is likely to become a bigger problem as more companies are obliged to refinance their debts at much higher rates.

For this reason, investors who are reaching for the extra income that corporate bonds offer compared with government bonds should err on the side of caution and only invest in the debt of the highest-quality companies. So-called high yield bonds might look attractive on the basis of the income they offer, but the risks of failure are commensurately higher.

# Property

Current view ✓ Positive | 3 month change ► Unchanged

Property markets around the world are marching to very different beats. Europe and the UK are much further down the track when it comes to the correction in prices than either the US or Asia. Not only have property prices fallen further in our own market over the past year, they may have actually started to rise again in recent months. We are clearly closer to the turn here.

We are not out of the woods though. Even after the falls so far, the sector is vulnerable to further increases in bond yields. In both the Eurozone and the UK, the difference between investment grade corporate bond yields and those on property is not material. High yield bonds now offer a much higher income than commercial property.

However, investors should bear in mind a key difference between property and bonds when making this comparison. Unlike bond coupons, which are fixed, property rents offer investors the prospect of growth too. And in a modestly inflationary environment they can be an excellent way of hedging against rising prices.

When there is a shortage of supply – and this is particularly the case with high-quality buildings that are compliant with ever tighter environmental regulations – rents can and do rise in line with inflation. Property can offer bond-like income with equity-like growth.

That is before we have even considered the opportunity to add value to a building by, for example, improving its emissions. The appetite for modern space creates great opportunities for re-developing so-called stranded assets that are no longer fit for purpose.

So, the next year to 18 months could be a good time to gain some exposure to the real estate sector, albeit the ride could be bumpy in the short term if interest rates have not yet reached their peak.

# Commodities

Current view ► Neutral | 3 month change ► Unchanged

The three commodities that we track in the Outlook – gold, oil and copper – have all been volatile over the past three months. But they have been so for very different reasons.

Gold has been falling ever since the spring when it peaked during the short-lived banking crisis in March. That indicates one of the reasons to hold gold – its safe haven characteristics during periods of upheaval. But the appeal of gold to investors is also influenced by the outlook for alternative investments, in particular for those which offer the income which gold does not. When investors can earn a return on cash or bonds they are less inclined to park their money in the precious metal. And that is what has taken the shine off gold in recent months.

The oil price has been one of the biggest movers in the past quarter, highlighting the uneven relationship between commodity prices and the state of the global economy. The cost of a barrel of oil has risen from a low point of just over \$70 in June to a peak of nearly \$100, despite the fact that fears about recession have intensified.

The reason is that oil reflects expectations about growth but also the arithmetic of supply and demand, which can sometimes be more politically than economically driven.

Since the summer, the main producers of oil, Saudi Arabia and Russia, have said that they intend to limit the supply of energy and the market has responded as you would expect, by raising the price of an asset that is perceived to be more scarce.

Finally, copper, where a long-term bullish case has been overpowered by shorter-term supply considerations. Sometimes known as Doctor Copper, for its ability to reflect the health of the global economy, the red metal has drifted this year after rising strongly in 2022. That reflects expectations for growth in China, one of the world's leading consumers of copper. Last year, investors hoped for a rebound in activity as China emerged from Covid; the reality has been very different in 2023.

The long-term case for investing in copper is focused on its use in industries supporting the push towards net zero. The metal is used in electric cars and renewable energy networks. In the short-term, however, this bullish argument plays second fiddle to whether or not China is growing.

# United States

Current view — Neutral | 3 month change ► Unchanged

On the face of it, the S&P 500 has had a reasonable year to date, regaining much of the ground it lost in 2022. Scratch beneath the surface, however, and it is a more nuanced picture. The market has been driven higher by the strong performance of a handful of big technology stocks. The rest of the market has gone sideways for a couple of years. The situation is even worse when it comes to smaller companies. The Russell 2000 index has been drifting lower since 2021.

While investors have been gravitating towards the defensive safety of the so-called Magnificent Seven (the likes of Amazon and Apple), they have been much more wary of investing elsewhere. When you read that the US market is expensive on around 20 times expected earnings, remember that this is skewed by the much higher valuations of the big tech companies. The average PE ratio for the Russell 2000 has fallen from 22 to 13 since 2021.

So, to an extent, investors have already priced in an economic squeeze. While there is little evidence of that pain yet, and there remains considerable uncertainty about when it might arrive and just how hard the landing will be, shares are not as complacent as they seem.

Investors are still pricing in an earnings recovery next year and in 2025. Following a modest decline in 2023, the expectation is that profits will grow in the double digits in both of the next two years. How realistic that is remains to be seen, but if it is achieved then the broader market could play catch up in 2024.

One reason why we have not seen more evidence of economic pain is that US companies and consumers are less interest-rate-sensitive than in the past. The prevalence of fixed rate mortgages and the foresight of companies refinancing their debts when rates were low during the pandemic means that many borrowers are paying nothing like the current rate of interest. A key question then is what happens when those cheap loans start to roll over.

The current market limbo could end in one of two ways – with a bang or a whimper. The bang would see recession arrive next year, undermining the earnings recovery story and leading to a rapid de-rating of valuations. A more agreeable outcome – the whimper – would be a gentle decline in inflation towards the Fed's target, allowing the central bank to take its foot off the brakes.

Even this better outcome is unlikely to lead to a big rally in US share prices from here, so we retain a cautious stance. That said, it rarely makes sense to bet against the US stock market except during moments of significant overvaluation. That is not where we are today.

# United Kingdom

Current view ✓ Positive | 3 month change ▲ Upgrade

It is tempting to be overly pessimistic about the UK. The recurring theme of the past 10 years or so has been political uncertainty, from Scottish independence to Brexit and the short-lived Truss government. We have shown ourselves incapable of completing a relatively short stretch of high-speed railway and once again we are re-inventing our education system. The polls suggest that we will try a different flavour of government next year, without a great deal of enthusiasm or confidence that the new lot will be any better.

But look through the stock market lens and Britain is a pretty solid performer. Over the past 10 years, it's true that we've lagged the US and Japan. But we're bang in line with the rest of Europe, and we've done better than most emerging markets. The UK stock market has been less volatile than most and delivered a higher income stream. The worst that can be said is that our home market is just a bit dull.

The reality is that the UK economy is doing better than we think. Inflation is finally on the way down, but wage growth remains strong. Mortgage rates are off their peak. Unemployment has risen a bit recently, but it remains low. Households are benefiting from relatively high savings on which they are getting an increasingly good return. We now seem to have recovered from the pandemic better than our European neighbours and the consensus is that we should avoid recession.

What is interesting from an investment perspective is that this is not really reflected in the relative performance and valuation of the main stock market indices. The FTSE 100 index, which is more reliant on overseas earnings, has significantly outperformed the more domestically focused FTSE 250 and SmallCap indices. Over two years, the blue-chip index is up a few percentage points while the smaller two indices have both fallen by about a fifth.

That's at odds with the earnings growth outlook, which stands at just 5% for the FTSE 100 next year versus 14% for the FTSE 250 and 21% for the SmallCap. And it is not reflected in valuations either. The FTSE 100 and the FTSE 250 trade on just over 10 times expected earnings, while the SmallCap is on only 8.5 times forecast profits. When it comes to dividend yield, the FTSE 100 offers 4.2%, the FTSE 250 is 4.6% and the SmallCap 4.9%.

So, there is a pretty good valuation argument for investing in the UK, and even more so in the smaller, more domestic indices.

# Europe

Current view — Neutral | 3 month change ▼ Downgrade

It's not hard to make a negative case against European shares. The economic outlook is poor, with the region on the brink of recession. Unsurprisingly, the region's stock markets have gone into reverse following their strong rally last winter. Europe has underperformed the US and UK over both three and six months.

Money supply is a good leading indicator of what will happen to the economy and here the picture is unambiguous. Inflation-adjusted money supply is falling faster than it did in the wake of the dot.com bust and after the financial crisis. Both cases coincided with recession, and it seems likely that history will repeat itself.

Evidence of real economic pain in the region is mounting. Order intake is declining across the board and profit warnings have started to occur. Pricing is also in retreat in some sectors like autos, which suggests that the peak margins enjoyed during the pandemic shortages are coming to an end.

The economic outlook is important, but it is not the whole story for investors. Valuations also matter and here the picture is more encouraging. European shares are always cheaper than their US counterparts but currently they are extremely cheap. Typically, over the past 35 years or so, Europe has traded on a forward PE ratio a couple of points cheaper than the US. Today the gap is nearly 8 points. Since 1988 the differential has never been this wide.

There are some interesting divergences that active managers can take advantage of. Usually when manufacturing activity slows, investors gravitate towards more defensive sectors. But recently cyclical sectors like capital goods, luxury, chemicals and semiconductors have outperformed. Less volatile areas like consumer staples now look relatively attractive, not least because European staples companies are now materially cheaper than their US counterparts.

Even within sectors there are big opportunities. Some leading companies trade on close to 10-year low valuations. Meanwhile there's a big gap between the valuations of some locally focused stocks like Zara-owner Inditex and other luxury names that are exposed to flagging Chinese demand. The premium investors are paying for the most expensive stocks in a sector over the cheapest is wider than at any point since 1990.

So, Europe faces some big challenges, but it is cheap and there are stock picking opportunities too.

# Japan

Current view ✓ Positive | 3 month change ► Unchanged

We have been positive on the Japanese stock market for some time. Fortunately, it has rewarded our confidence with only the US's Nasdaq market coming close to the Nikkei's 25% year to date return in local currency terms. The weakness of the yen has taken some of the shine off that stellar performance, but Japan has still been one of the best places to be invested this year.

The Nikkei stands at a 30-year high and has now retraced pretty much all the ground it lost during its grinding 25-year bear market from the late 1980s until the Abenomics reforms in 2012 rekindled interest in this sleeping giant of a stock market.

Unlike in the US and European markets, Japan's performance has been broad based. The largest US companies account for essentially all the S&P 500's growth and disguise more generalised weakness among smaller stocks. In Japan, the performance of the top 15 companies by size is bang in line with the index as a whole. That's a reflection of positive earnings revisions across the board and suggests the rally could be more durable.

The performance of the Japanese market has been value rather than growth stock focused. In part, that's due to a raft of reforms being promoted by the Tokyo Stock Exchange (TSE) which are designed to raise governance standards and profitability. These have had the biggest impact on the most out of favour stocks, which have the most to gain from raising their game in this way.

It also reflects a general improvement in the Japanese economy. GDP growth is running at an annualised 4.8%, way above the long-run trend. As a healthy level of inflation takes hold, the growth is in nominal not just inflation-adjusted terms too. That helps companies increase their sales and margins. The days of sapping deflation look to be in the past now.

The good news is that there is still plenty of work to do. Japanese companies are still cash rich and often trade below their book value in the stock market. And the majority of smaller companies are yet to respond to the TSE's guidance. This is a multi-year process.

Despite all this, the Japanese market remains relatively cheap, although after the recent rally it is no longer excessively so. The multiple of expected earnings, at just under 15, is in line with the long-run average. On other measures, however, such as price to book value, Japan is much cheaper than its peers in the US and Europe.



# Asia and emerging markets

Current view — Neutral | 3 month change ▼ Downgrade

China's fall from grace in investment terms has been spectacular. Over the past couple of years, the performance of Chinese shares has diverged dramatically from both its emerging market peers and from developed markets like the US too. Since 2021, shares traded in Shanghai and Shenzhen have lost more than 30% of their value while US shares have moved sideways.

If this were a reflection of sharply deteriorating earnings, it might be understandable. But that's not the case. Often, a company's shares have gone backwards despite its profits growing strongly. Rather, it reflects a loss of confidence in the Chinese economy, its long-term growth potential and its economic model. This could be a big over-reaction. Harder to spot is the catalyst for a reversal.

The problems in China are well understood. Recovery from Covid has been disappointing this year and consumers are reluctant to spend. The country's export industries are struggling with lower demand and greater protectionism from the US, in particular. And the property sector, a key driver of economic growth, is in desperate need of support if confidence is to be restored.

So, there are many challenges ahead. The question is whether the sell-off has now gone too far. China is cheap, but is it too cheap? It is starting to feel like one of those moments that in retrospect were an obvious turning point. If not now, then when?

A market which is definitely not too cheap is India. Standing at an all-time high, the Indian stock market has doubled since the bottom of the pandemic correction. It has more than quadrupled since the financial crisis. Who would have predicted 20 years ago that an investment in India would have done four times as well as one in China?

India is always quite expensive. Domestic buyers keep the market buoyant, and flows into small and mid-cap companies recently are a good indicator of retail buying. Some professional investors are seeing this as a signal to take some profits off the table.

Elsewhere in Asia, a key driver for markets such as Korea and Taiwan is the replacement cycle for consumer electronics. A pick-up in demand is forecast for next year as kit that was bought during the pandemic comes to the end of its useful life.

Emerging markets tend to suffer when investors feel uncertain about the world and they have had an unexciting year to date, led lower by China. However, their long-term structural advantages remain in place and a weaker dollar as US rates start to fall is typically good news for the asset class.

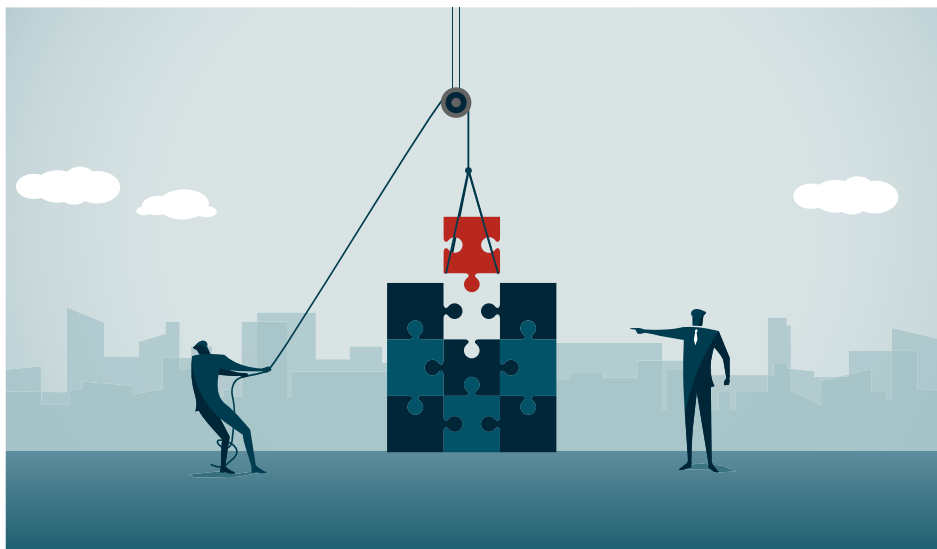
# In summary

As we run into the year-end, 2023 looks like it will repair most but not all of last year's damage. Most markets have delivered positive returns in the year to date but remain under water on a two-year view. After the fireworks of the pandemic plunge and rapid recovery, markets have drifted and there is a lack of conviction about where they go next.

Things have not turned out exactly as we thought nine months ago. China has disappointed; central banks have stayed hawkish for longer, dashing bond investors hopes; beneath the surface, the apparently buoyant US market has been less strong than it has seemed.

The key question remains just how hard the economic landing will be after the most aggressive rate-hiking cycle anyone can remember. For the first time in years, investors have a plausible alternative to equities. The risk/reward balance for bonds looks increasingly attractive as yields move higher and cash looks compelling, especially as inflation retreats.

Earnings are forecast to bounce back over the next couple of years. But they will need to do so as valuations have little scope to re-rate higher. As ever, a well-balanced portfolio, spread across different asset classes and geographical regions, makes sense.



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