Q2 2022 Investment Outlook

The "Grand Chessboard" Reconfigured: Stagflation Risks Intensify

FIL Investment Management

April 2022

Three themes for Q2 2022

Timeline of the Ukraine war will influence economic outcomes

- In addition to its tragic human toll, the war in Ukraine will reconfigure the post-Cold War order (the "Grand Chessboard")* in economic and geopolitical terms. We believe that significant damage to the global economy has already taken place. The path and the timeline to resolution and easing of trade disruptions will determine the extent of further damage to growth and inflation, for Europe and the ROW.
- Expectations for a moderation in energy prices and supply chain-related disruptions have been dashed and instead these will continue to put upward pressure on inflation and dampen growth. The range of outcomes is wide, with extreme left and right tail risks. We believe these risks are not yet fully recognised by the market and we advocate nimbleness and use of hedges, where appropriate.

The return of Volckerism: Taming inflation takes centre stage

- The US Fed has invoked the hawkish stance of former Fed Chair Volcker, who tamed inflation in the 1980s, and it initiated lift-off at the March FOMC meeting. We expect the Fed to front load hikes and the ECB to continue its hawkish tone but believe that the war-induced growth shock and the necessity of maintaining negative real rates will lead to dovish pivots by mid-year, with the ECB likely to pivot first.
- If our scenario plays out as expected, the coming quarter will be a challenging one for DM risk assets. We advocate positioning for the high likelihood of stagflation in DM, with a base case of recession in Europe. Careful engagement with risk assets at this stage is critical.

Conditions support China outperformance, but this is not 2008

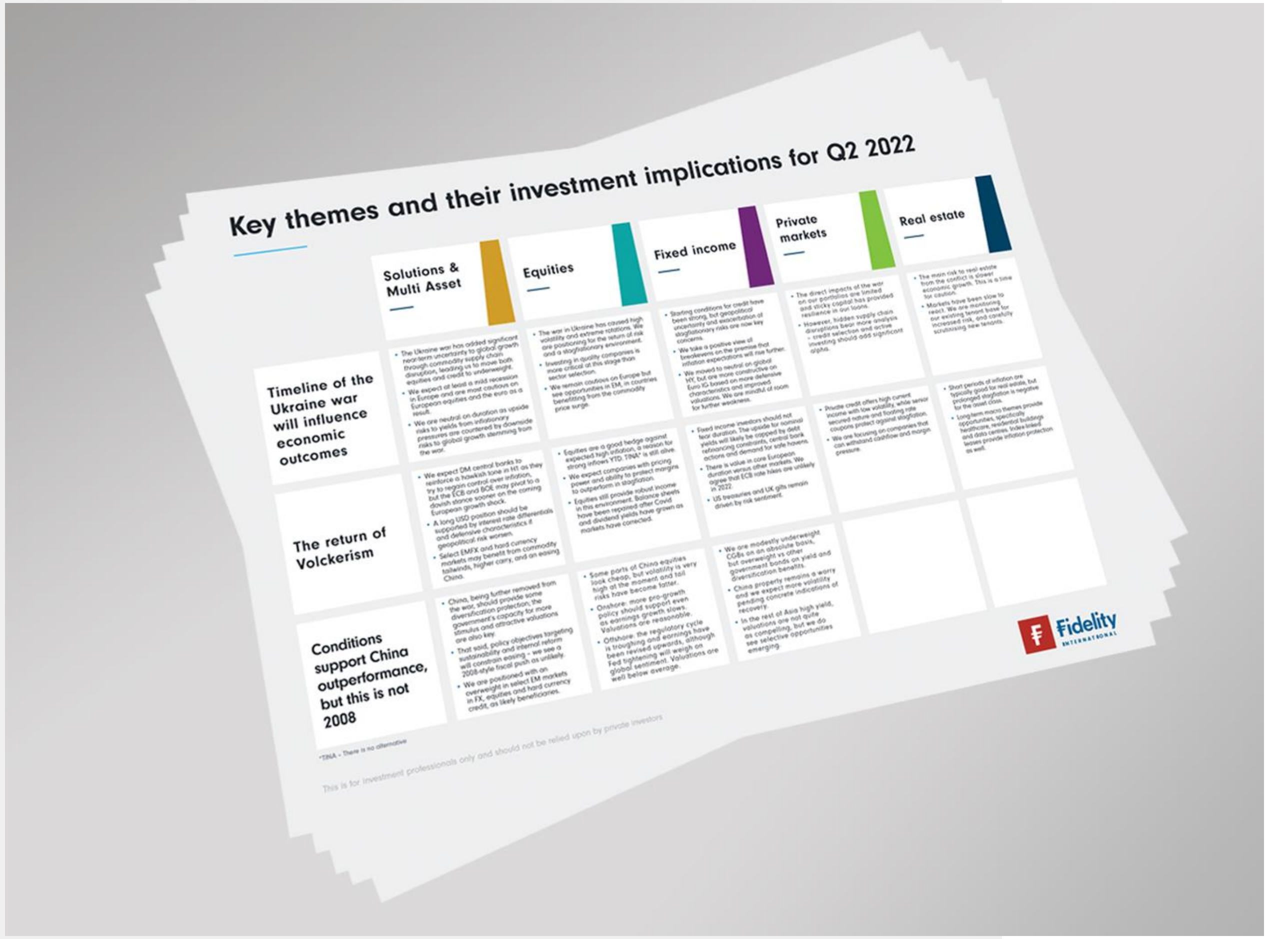
- China, further removed geographically and economically, offers diversification and more attractive starting valuations. The government has capacity for further monetary and fiscal easing, but uncertainty remains high. Covid resurgence also bears watching.
- Policy goals prioritising deleveraging, property sector reform and sustainable growth mean that decision paths are not as straightforward as they were in 2008 when faced with the financial crisis. We should not expect the China government to repeat its GFC role as the “fiscal put” and to dislodge the global economy from its stagflationary trajectory.

Source: Fidelity International, March 2022; *The Grand Chessboard refers to a 1997 book by US diplomat Zbigniew Brzezinski about the power dynamics in Eurasia during the Cold War.

Key investment implications of the three themes

Read the full investment implications for Q2 2022

[Click here]



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Global Macro

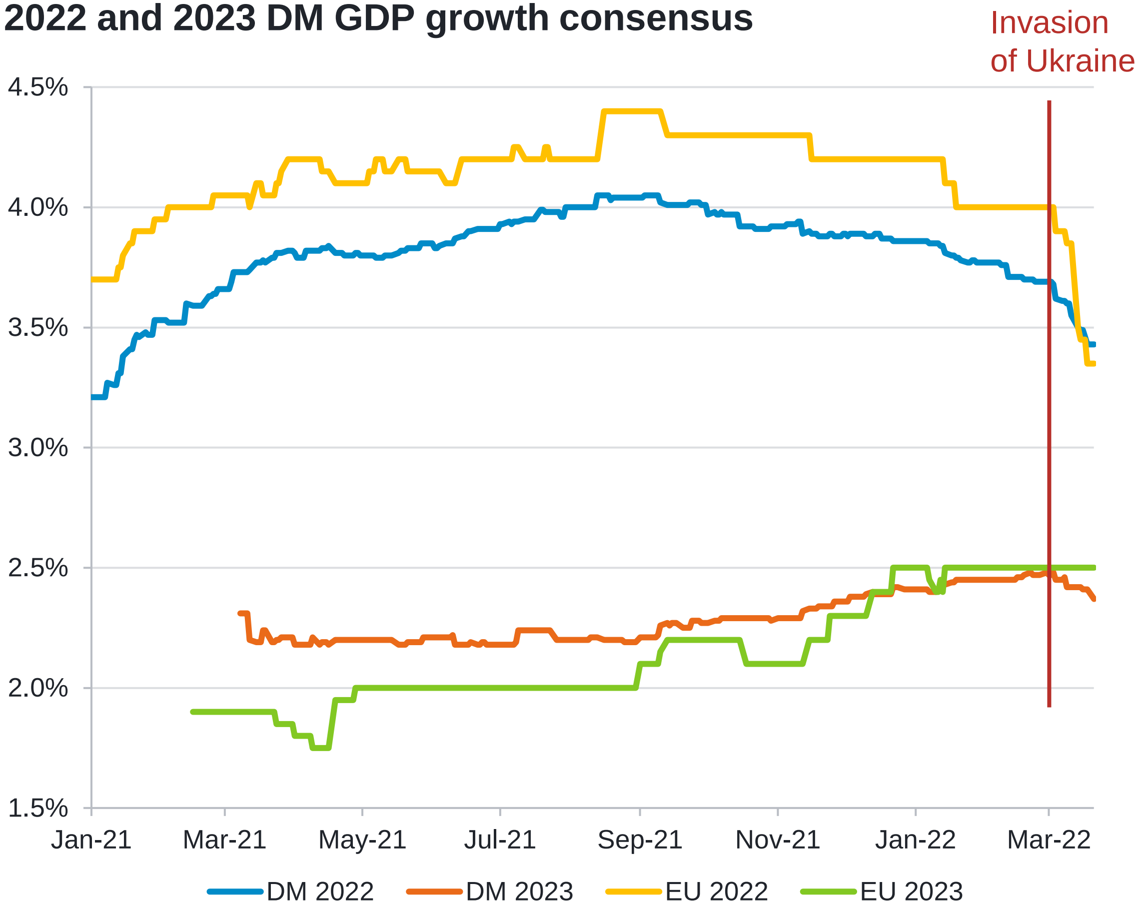
Global Macro: Key takeaways

The war in Ukraine exacerbates global inflation pressures and increases downside growth risks, with European recession risks mounting.

- The Russia-Ukraine war is set to dramatically redefine the global order, from both economic and geopolitical angles
- In the near term, the associated shocks through trade and financial channels are exacerbating global inflation pressures, with inflation now likely to peak later and at higher levels
- At the same time, a hit to growth driven by the shock to commodity prices and overall confidence in particular is likely to be meaningful, though its magnitude and duration remain uncertain
- Europe is the most exposed, with a strong possibility of at least a modest recession. While the pass-through to the US is relatively limited for now, it is not totally immune with stagflation our base case for 2022
- Faced with prospects of 'higher for longer' inflation, central banks are determined to tighten policy, pushing concerns about downside growth risks to the side for now
- We believe the Fed will remain hawkish and carry out a front-loaded hiking cycle combined with some QT this year. However, growth headwinds will likely keep the Fed limited to 4-5 hikes, fewer than the 7-8 priced in
- With the ECB facing more acute growth risks, we expect a dovish pivot in one of the upcoming meetings. We do not expect rate hikes this year and think the Asset Purchase Programme (APP) might not end as currently planned
- China, while further removed from the conflict, faces policy objectives that preclude 2008-style fiscal easing as well as a concerning resurgence in Covid cases. Patience will be needed for policy implementation

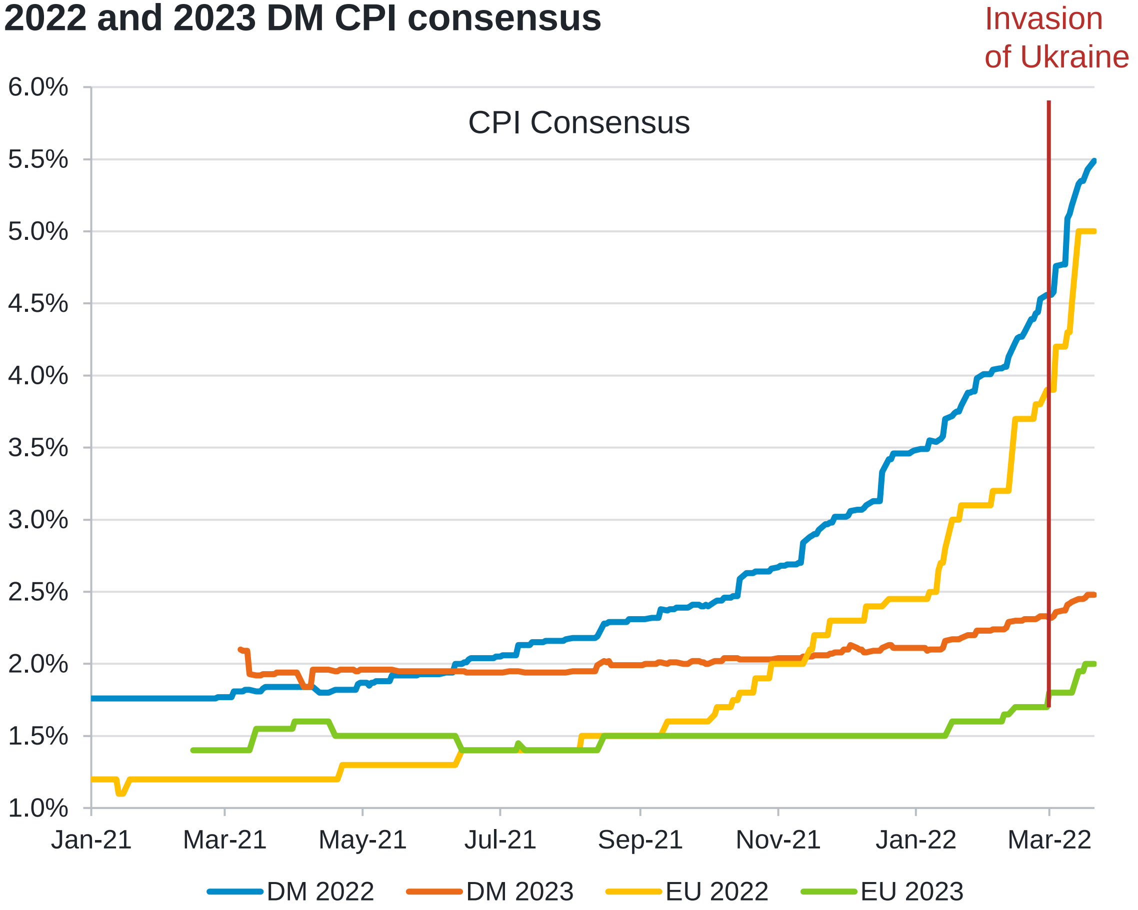
Stagflationary dynamics even more pronounced for DMs following Ukraine invasion

2022 and 2023 DM GDP growth consensus



Source: Fidelity International, Bloomberg, March 2022.

2022 and 2023 DM CPI consensus



Source: Fidelity International, Bloomberg, March 2022.

Downside risks to economic growth vs consensus in all regions

- Much damage to growth has already been done as the war in Ukraine will lead to global spillovers, through trade and financial channels
- Consensus forecasts have been slow to react to the war and we expect estimates to be revised down once the full impact becomes apparent.
- We believe that the spillovers from the war are likely to be bigger, farther reaching and more durable than is currently believed, especially in a scenario of further escalation.
- EM forecasts are more uncertain. Many EMs have tighter monetary policy to combat inflation but might increase fiscal spending to offset this.
- EU countries more dependent on Russian oil and gas will be hurt the most.
- Physical supply disruption on top of extreme price inflation will weigh on European industry.

2022 consensus growth forecasts vs FIL upside and downside case and risk assessment*

	2022 growth			
	Consensus	FIL upside case	FIL downside case	Risk assessment
Global	**4.0**	**4.2**	**1.6**	**Downside**
DM	**3.5**	**3.2**	**0.7**	**Downside**
US	3.6	3.8	2.5	**Downside**
Eurozone	3.5	2.5	0.5	**Downside**
UK	4.0	3.5	1.5	**Downside**
Japan	2.7	3.0	1.5	**Downside**
EM	**4.9**	**4.9**	**2.3**	**Downside**
China	5.2	5.5	4.0	**Downside**
India	7.8	9.0	6.0	**Downside**
Russia	1.5	-5.0	-15.0	**Downside**
Brazil	0.5	1.5	-1.5	**Downside**
Mexico	2.1	3.0	1.5	**Downside**
Turkey	3.4	4.0	2.0	**Downside**
Indonesia	5.2	6.0	4.0	**Downside**

* Bloomberg consensus as of 15 March 2022. Source: Bloomberg, Fidelity International, March 2022.

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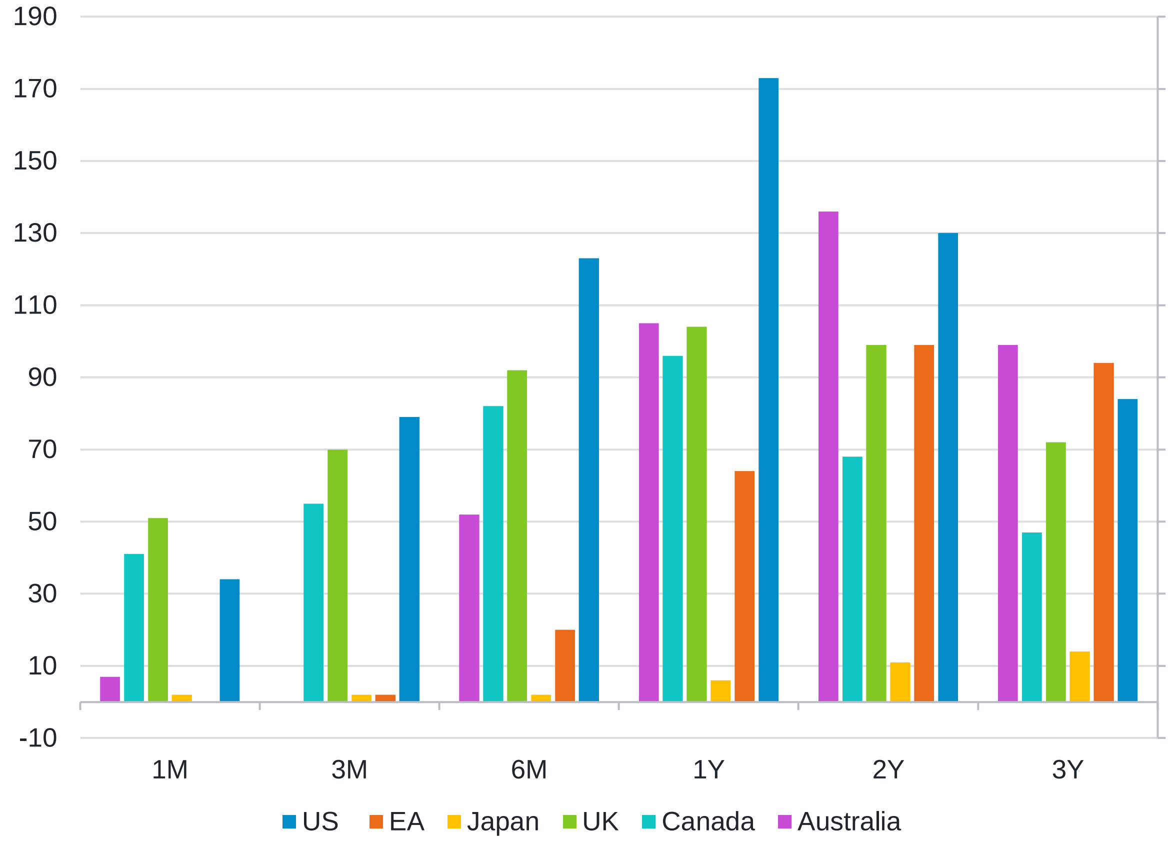
The return of Volckerism: Taming inflation takes centre stage

The Fed announces an aggressive hiking schedule, but growth headwinds are likely to limit increases

- **Fewer hikes in 2022 than consensus:** We expect no change to the Fed's hawkish narrative until at least mid-2022. However, we believe further tightening of financial conditions driven by the Fed's hawkishness as well as by the fallout from the war should be sufficient to cool down the economy through the year, removing the case for the aggressive hiking outlined by the Fed.
- We therefore expect only 3 or 4 hikes in 2022, combined with some balance sheet reduction.
- We think recessionary risks facing the US economy are higher than those being assessed by the Fed.
- But for now, even the ECB remains complacent about the upcoming growth shock, despite Europe's clear vulnerabilities.
- **CB put nowhere in sight yet:** This creates further headwinds for asset markets as the central bank put remains further out of the money in this cycle given very high inflation.

3m change in implied policy rates across key DM economies



Dates: 21st December 2021 – 21st March 2022

Source: Fidelity International, Bloomberg, March 2022.

Stagflation in the 1970s

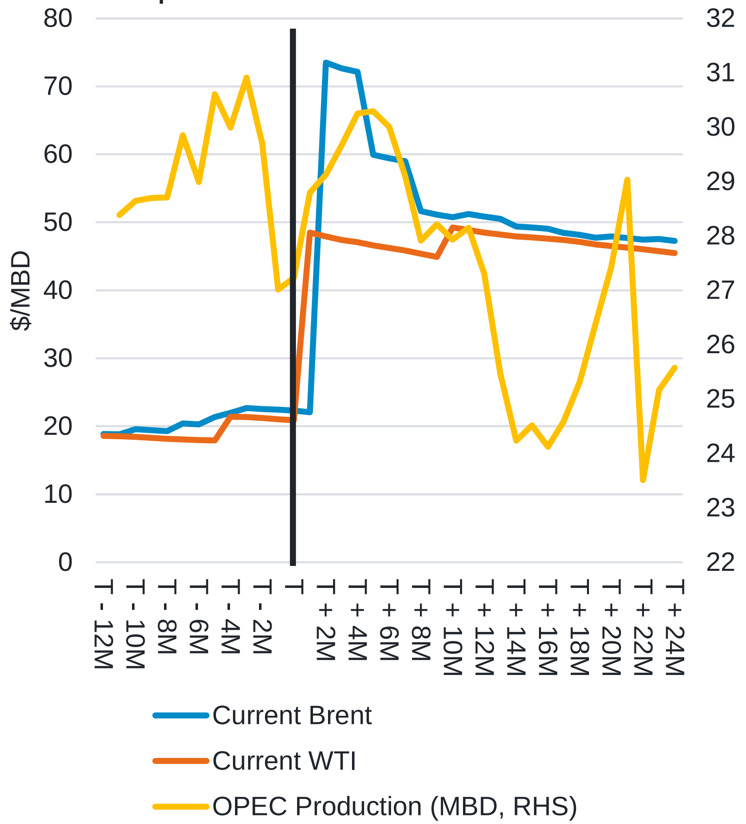
The combined price and supply shock of the OAPEC oil embargo led to substantial macro and market impacts

Parallels between the 1970s and now

- The 1973 oil embargo caused an immediate price spike. But it was around 12m before economic indicators and equity markets troughed
- Initially the Fed hiked to combat inflation, but turned dovish as recession became imminent
- Implications for today: Even if the war were to end peacefully and swiftly, the experience of 1973 indicates that damage, once embedded, will take time to work its way through the system.

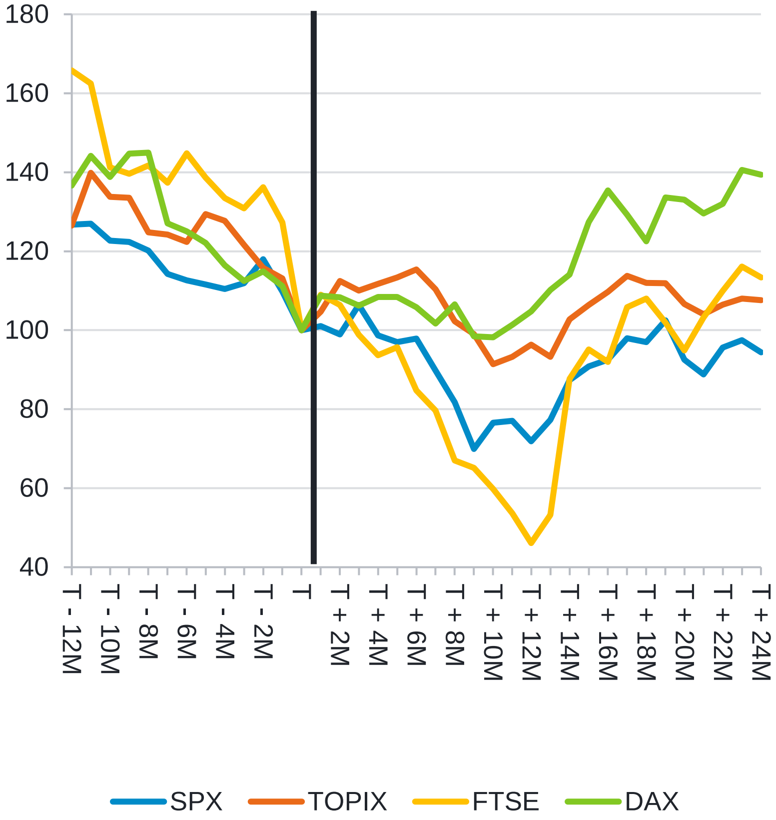
Oil market

Prices and production



World equity markets

Rebased to 100 at time T

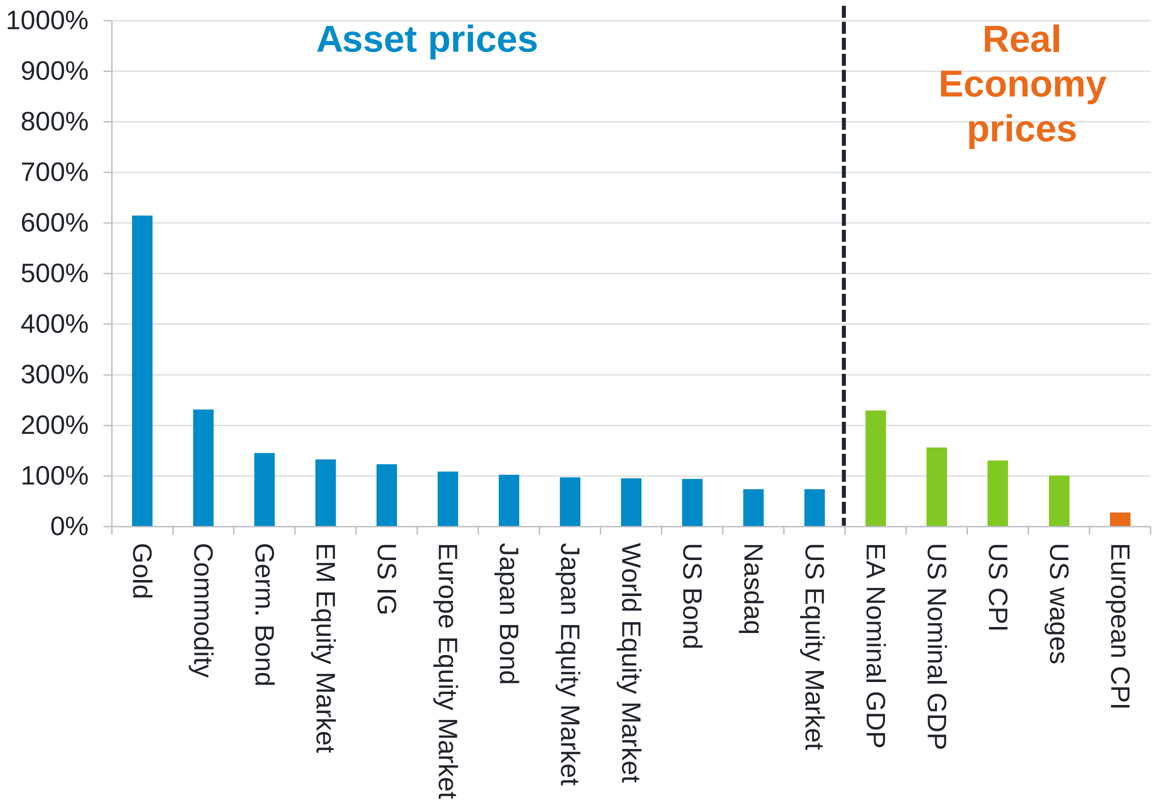


Note: Current Brent/WTI calculated by inflating historical prices with current CPI levels.
Source: Fidelity International, Refinitiv Datastream, March 2022.

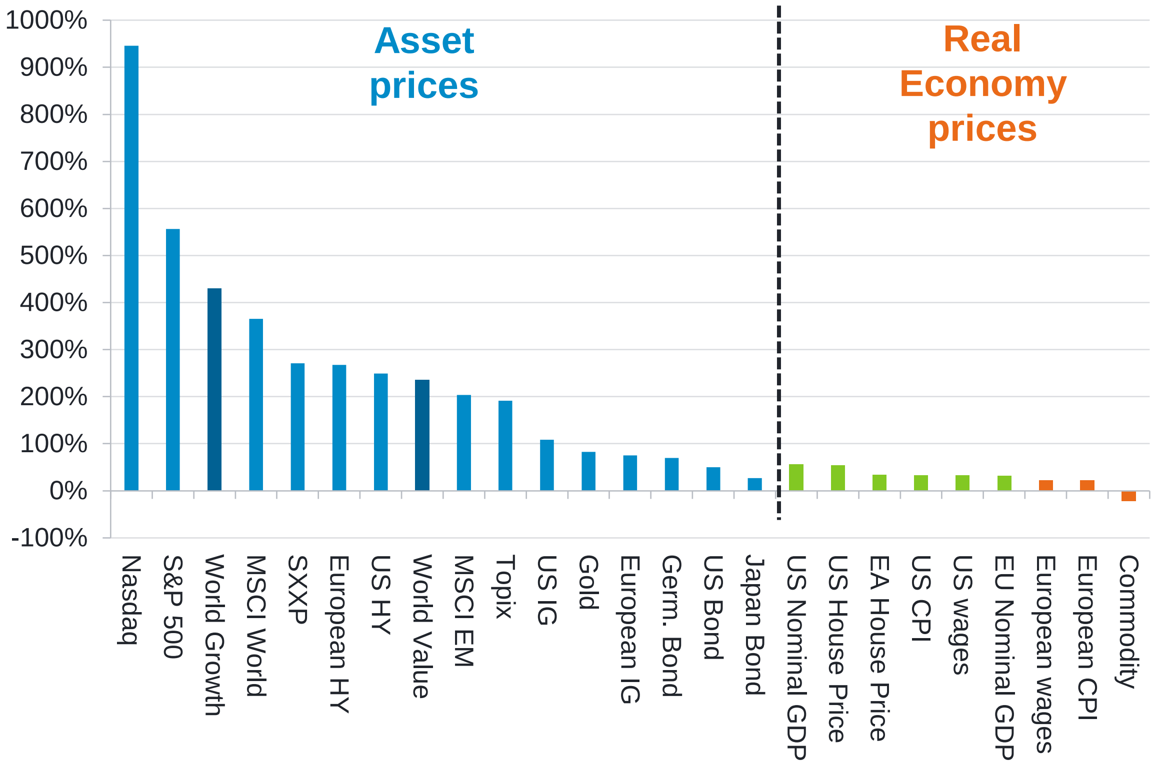
Asset returns in the 1970s

The 1970s saw a very different outcome for asset market performance compared to the current experience

Asset price inflation and 'real economy' inflation during the 1973-1983 decade



Asset price inflation and 'real economy' inflation since January 2009



Note: Total return performance in local currency

Source: Fidelity International, Datastream, STOXX, Haver Analytics, FRED, Goldman Sachs Global Investment Research, March 2022.

China Insights: Key takeaways

Patience is needed for policy implementation. This will not be like 2008.

- **China headwinds are now largely priced in,** including zero-Covid, the Ukraine war, Fed policy, regulatory tightening, the US-China relationship, export deceleration, global supply disruptions, rising costs
- **But more patience is needed on policy implementation**, and this will be influenced by geopolitics and the global economy
- **Don't expect a fiscal put:** We should not expect China to step in to 'rescue the economy' with massive fiscal stimulus as in 2008. We expect the government to continue to prioritise internal reform and sustainable economy

Policy outlook

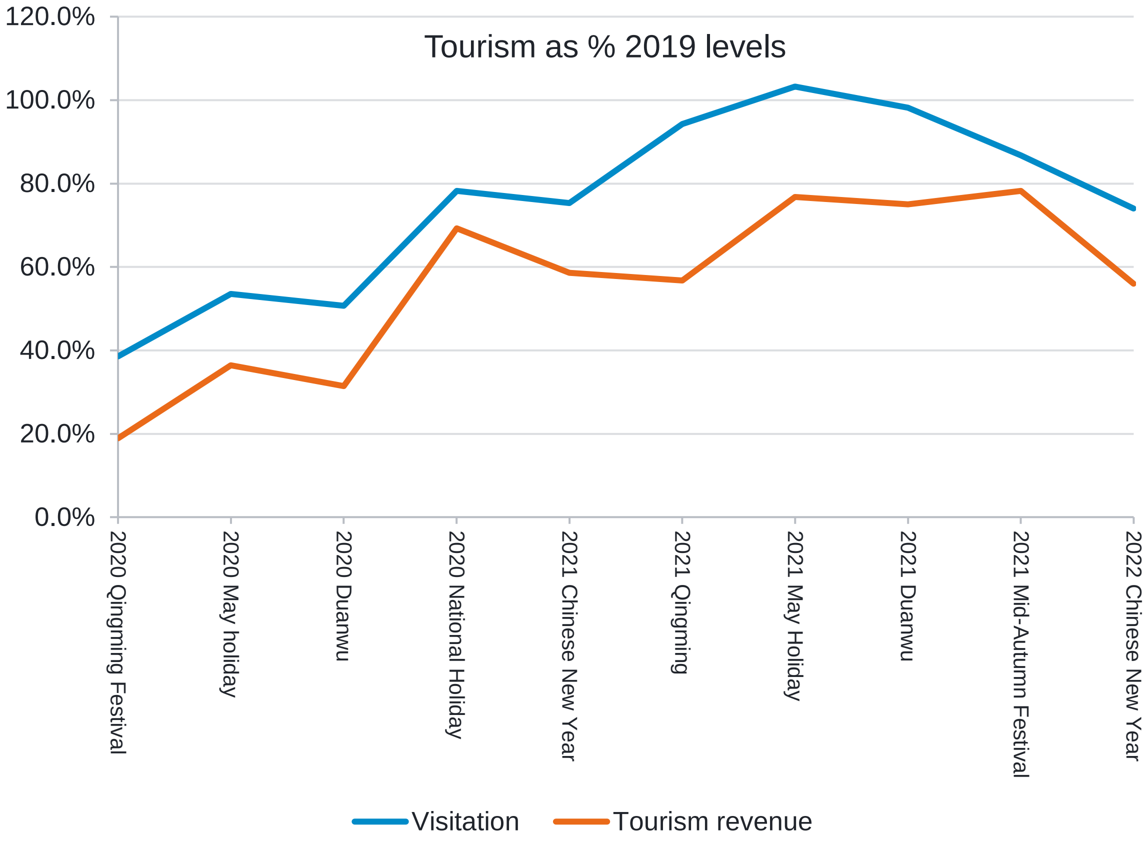
- Monetary and fiscal easing coming through, but so far targeted and limited measures.
- The "whatever-it-takes" speech by Vice Premier Liu He may be an important turning point on the policy front
- But we believe the focus will be on stabilisation rather than an outright boosting of the economy
- Regulatory tightening announcements have likely peaked, we are moving into the implementation phase
- Common prosperity measures on property, education, technology and healthcare sectors not likely to be reversed

Covid policy remains the biggest variant to China macro economy

Relaxation of zero-Covid policy is not expected, given potential impacts on >80 cohort and rural areas

- Containing Covid is increasingly costly and achieving the GDP target is challenging.
- Government is trying to get this round under control but at the same time, it is planning the exit.
- National Health Commission of China issued the 9th version of Covid-19 diagnosis and treatment guideline:
    - 1) for asymptomatic patients, no need to go to the hospital, only do quarantine;
    - 2) lowering the criteria for releasing patients, in order to free up medical resources;
    - 3) adding therapeutic treatment options including Paxlovid and domestic neutralising antibody.

China to maintain zero-Covid policy in 1H2022



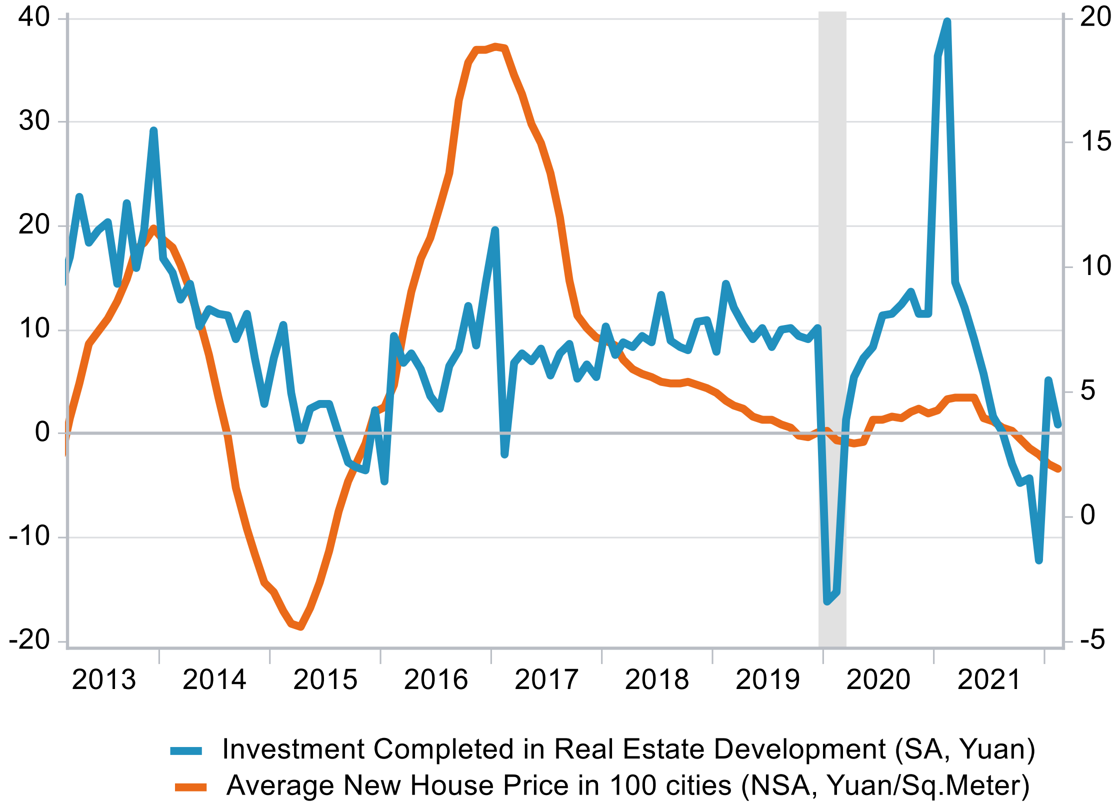
Source: WIND

Monetary and fiscal policy have turned accommodative, but is it enough?

More stimulus is needed, particularly in China property, for a strong growth rebound

- Economic headwinds in H2 2021 led to policy pivot toward accommodation, including PBOC rate cuts, increased total social financing (TSF) and lifting of coal mining restrictions.
- However, credit growth has improved only slightly, with longer-term credit demand remaining weak.
- Components of increased TSF do not yet target the property sector, which dominates the China economy.
- China property update:
    - City-by-city property policy easing is rolling out selectively, but there are no convincing signs yet that the market has troughed.
    - New home sales continue to fall. More supportive policies will be needed to halt the decline; we expect SOE developers will benefit the most if/when they arrive.
    - Restructuring of the sector remains a priority for the central government and a pillar of the "three mountains" reform programme.
    - Thus we do not expect a "fiscal put" from China, even if the global economy enters a downturn in 2022.

China real estate development and average new house price growth (% YoY)

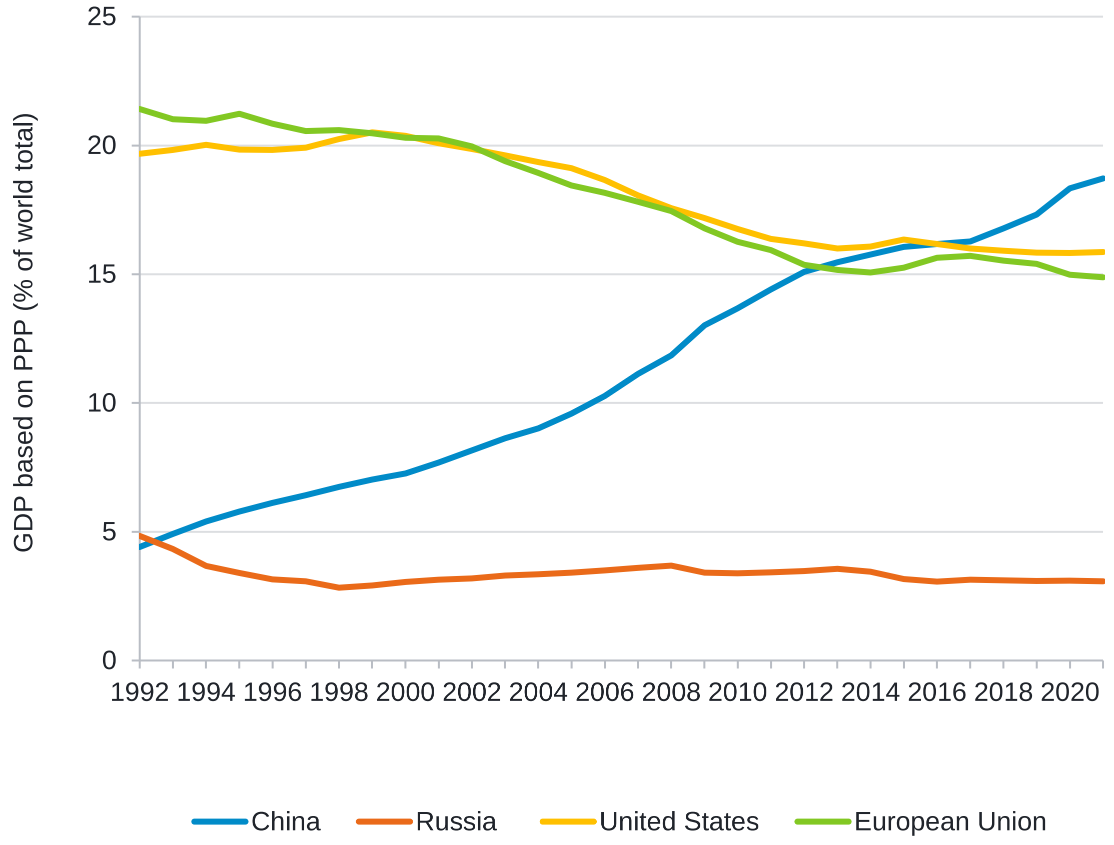


Source: Fidelity International, Haver Analytics, March 2022.

China is significantly more integrated into the world economy than Russia

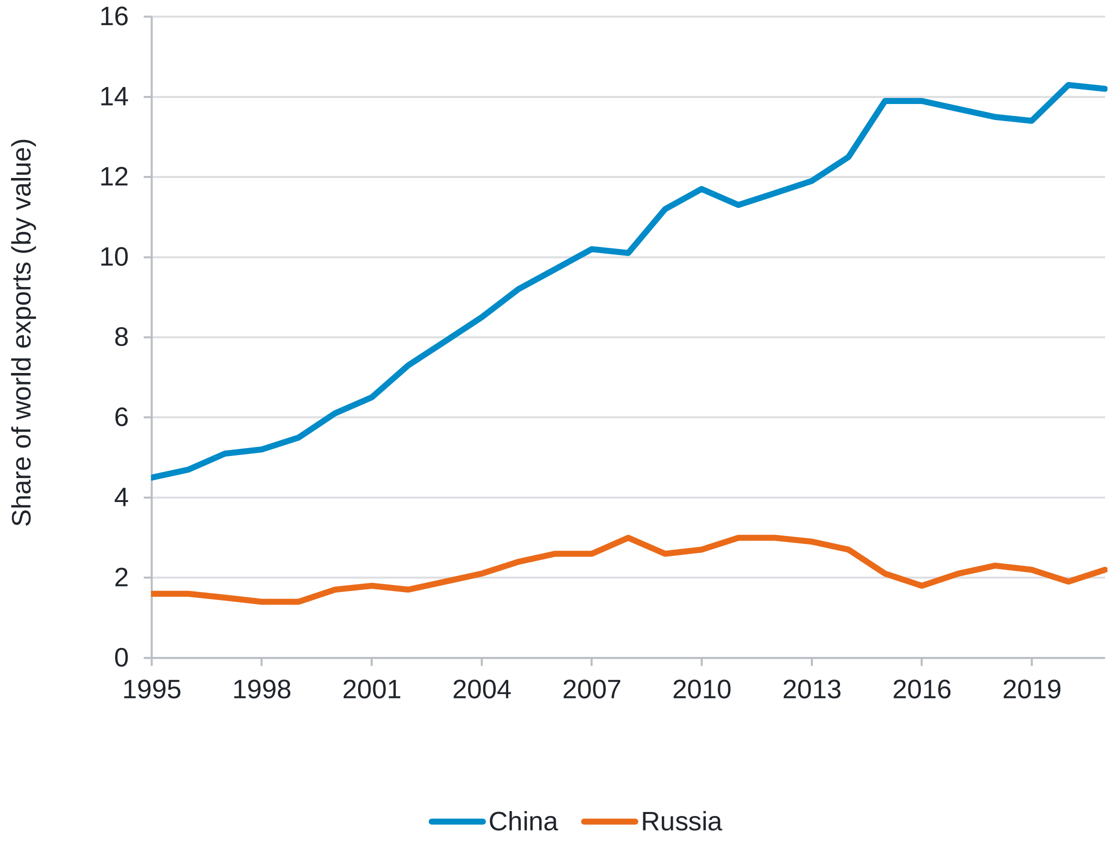
The trajectory of global growth is increasingly dependent on China policy decisions

China's global economic clout is much greater than Russia's



Source: Fidelity International, IMF WEO October 2021 Database, March 2022.

China's global export share is several times larger than Russia's

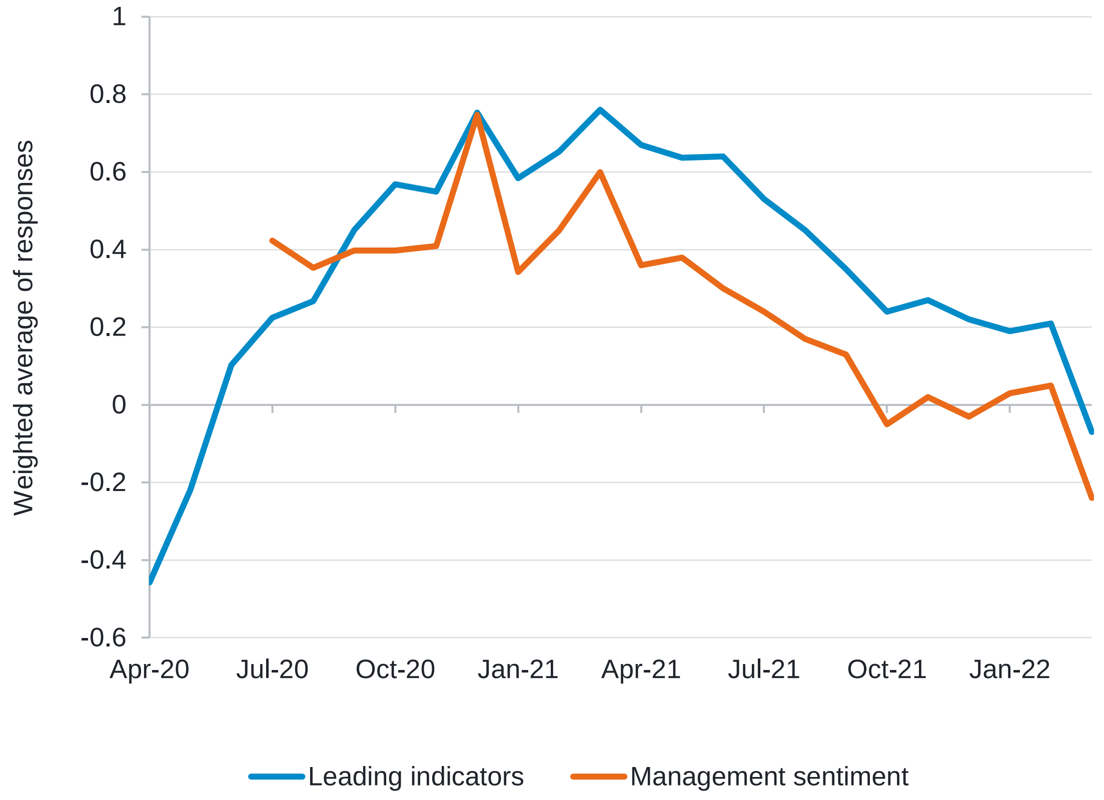


Source: Fidelity International, IMF, Bloomberg, March 2022.

Global Investment Research

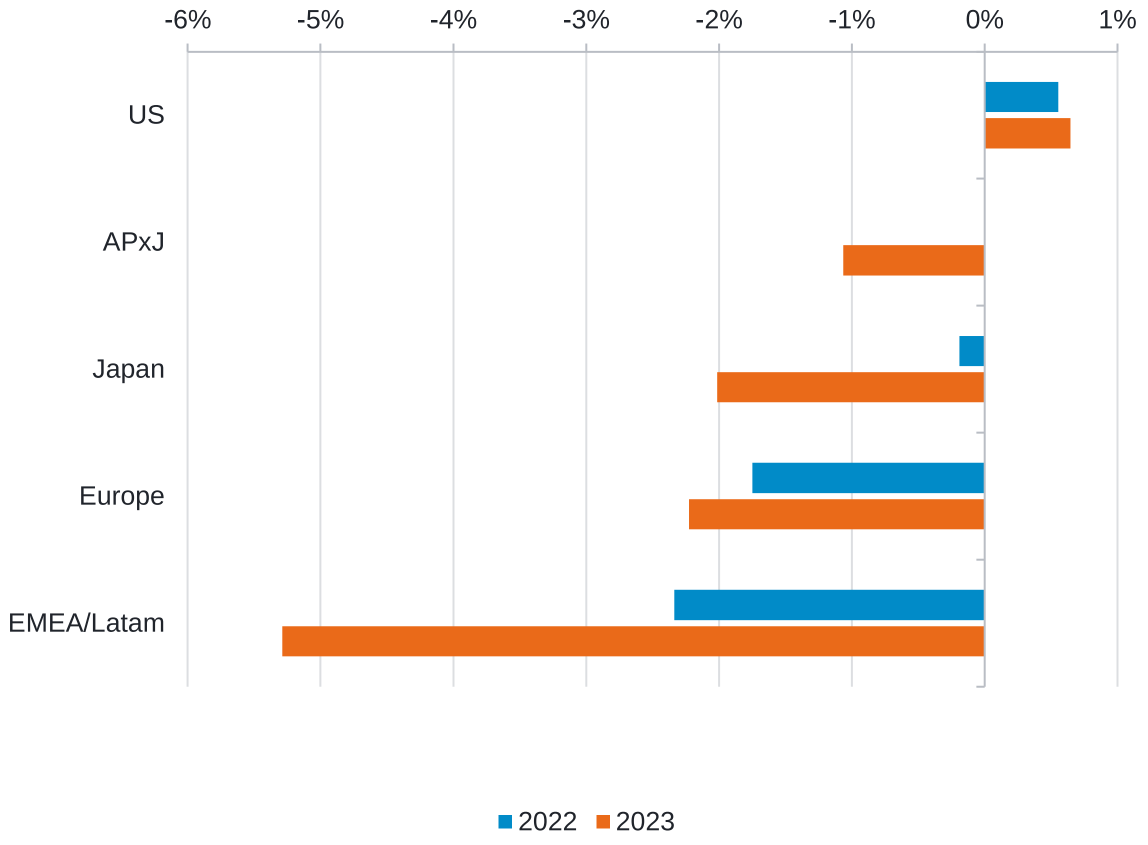
Corporate sentiment and earnings forecasts down sharply since the war began

Leading indicators and management sentiment both in negative territory, a first since the monthly FIL analyst survey began



Source: Fidelity International, March 2022.

FIL analyst earnings revisions since the invasion of Ukraine



Source: Fidelity International, March 2022.

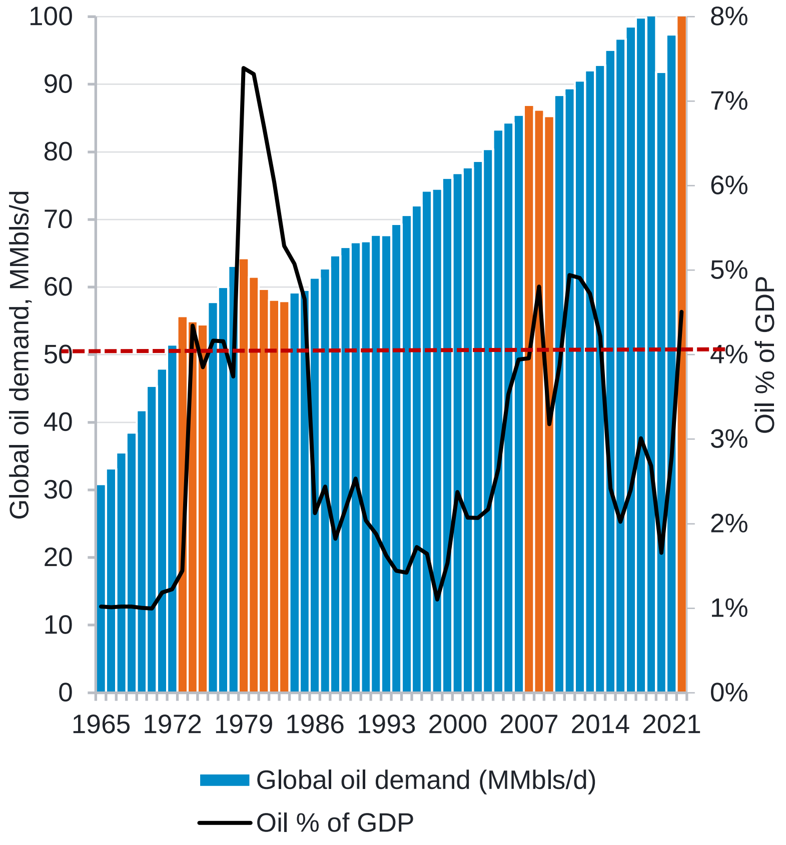
Energy: Already inflationary, exacerbated by war

The energy transition will be impacted

Energy disruptions will have long-term impacts

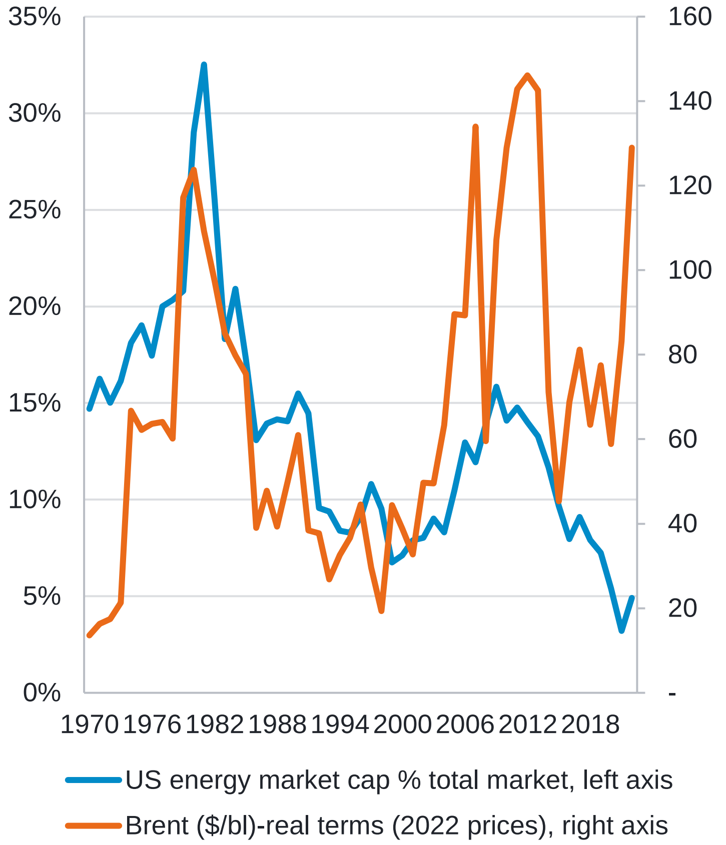
- The value of global oil has exceeded 4.0% of GDP, the historical threshold for demand destruction
- There are few easy short-term solutions to dependence on Russian oil and gas. Longer-term, the conflict will cause a fundamental replumbing of worldwide energy flows.
- We expect Russia to export more oil and gas to China and India, while the West will focus on energy security and potentially a temporary resurgence of fossil fuels: increased North Sea drilling, more coal generation, more US shale.
- Renewables will take time and regulatory incentives, raising the price of clean power.
- Nuclear power may experience a renaissance in Europe.

Global oil as a % of global GDP



Source: Sanford Bernstein, March 2022.

US energy market cap vs. real oil price



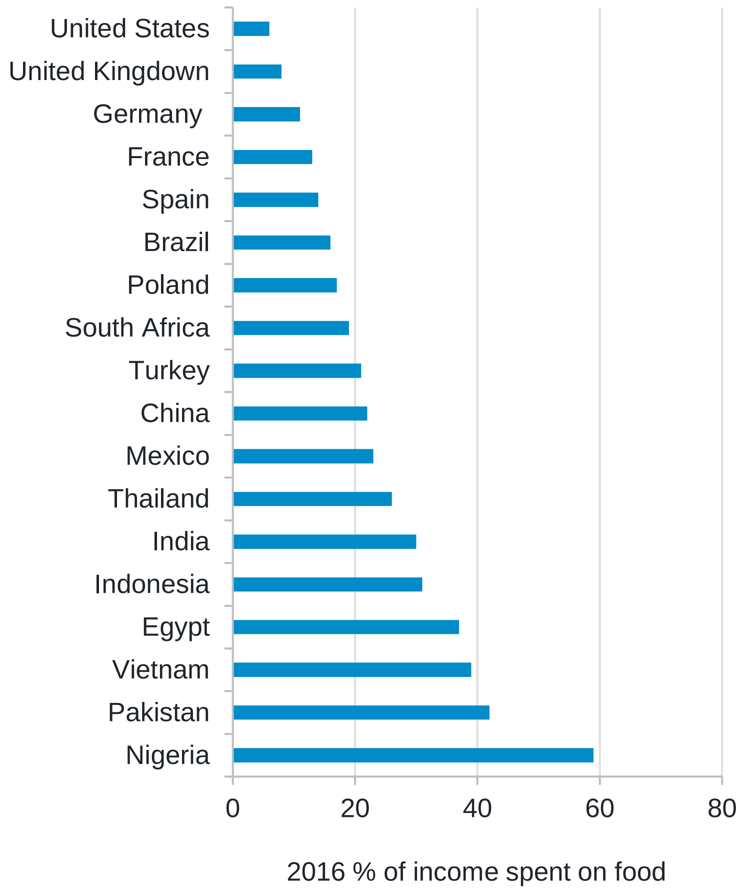
Source: Bloomberg, Fidelity International, March 2022.

Consumers worldwide grapple with higher food prices as well as energy costs

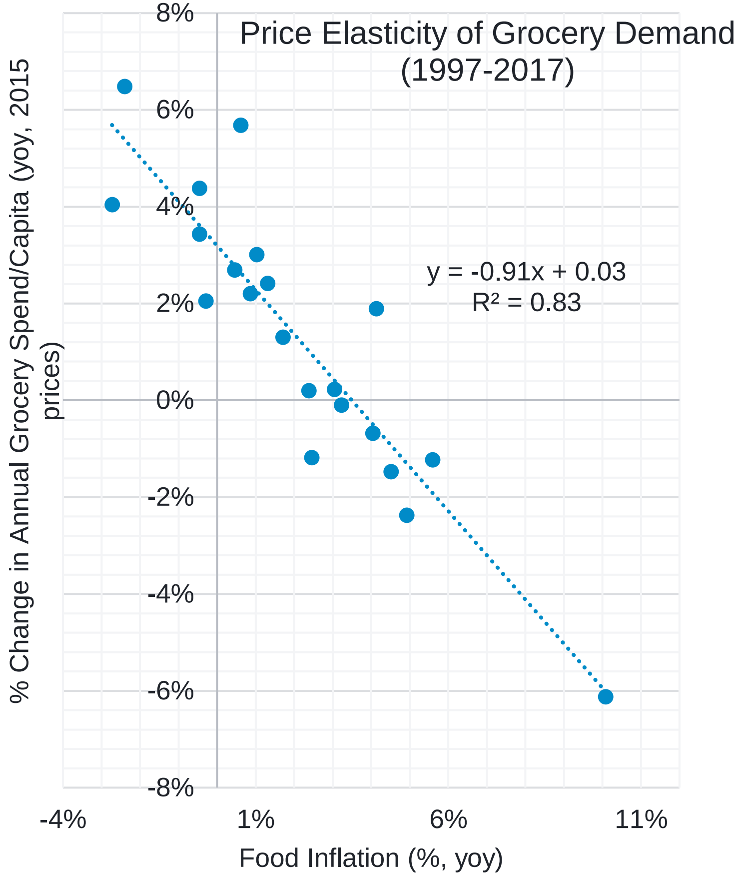
The war is compounding food cost inflation

- With Russia and Ukraine normally accounting for around a third of global wheat exports, higher food prices will continue to impact household spending and balance sheets
- Wheat prices are 50% higher since 1 February.
- Low income country consumers and lower income cohorts in developed markets spend >30% of income on food.
- Persistently high food inflation has the potential to incite social unrest; for example, the Arab Spring was triggered by agricultural inflation
- In general, a rise of 60% of raw materials prices equates to around a 7-30% pricing increase of fast-moving consumer goods

Exposure to food inflation, by country



UK food price elasticity



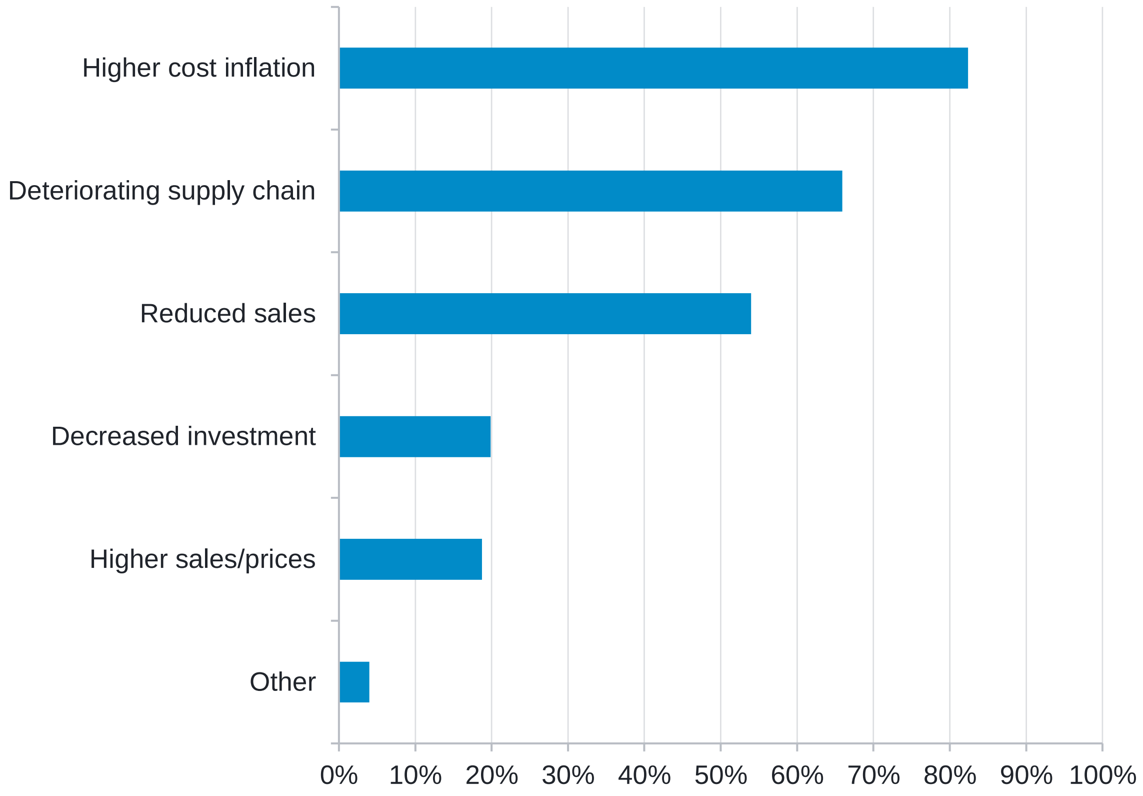
Sources: Our World in Data/ USDA, UK ONS, Fidelity International analysis, March 2022.

War sanctions extend disruption in global supply chains, producing more inflation

Supply chains

- Russia sanctions and the war are disrupting supply chains, which had started to ease in early 2022.
- Both Russia and Ukraine are key producers of industrial raw materials such as titanium (used in aerospace), palladium (catalytic converters) and neon gas (semiconductors).
- The full impact of disruption has yet to be felt - most industries are holding 6-12 months of inventories.
- Most companies under FIL coverage had assumed that supply constraints would ease by midyear, thus weighted their earnings guidance to H2 2022.
- Real time data from ports and ships at bay and company anecdotes suggest that constraints have been easing, but not as quickly as seasonal trends would predict.
- China Covid lockdowns are also potentially introducing more unanticipated supply chain pressures at this stage.

Top war-induced concerns for FIL companies under coverage



Question: “Please rank from most to least important or from greatest impact to least impact the second-order effects from the conflict in Ukraine. Tick N/A for any that do not apply.” High importance/impact is rank 1-3 out of 7. Source: Fidelity International, March 2022.

Multi Asset

Multi Asset: Key takeaways

Cautious for now: Underweight risk assets

- The current mix of risks makes us cautious on the near-term outlook for risk assets. As a result, the team's core view is underweight equities and underweight credit.

Stagflation: Growth is weakening, inflation is surging

- We are neutral duration on these conflicting drivers for government bond yields.

Long USD and select Emerging Markets

- We see tactical support in the USD and increasing areas of interest in emerging markets and Asia Pacific, which benefit from China easing and commodity strength.

Brighter outlook next year

- Over the medium-term (12-18 months) we are more optimistic as a result of easing China policy and some relief from pricing pressures and supply chain disruption. We expect a more dovish narrative from DM central banks in H2. Labour markets are tight and consumer balance sheets have a strong starting point.

Tactical Asset Allocation (TAA) at a glance: Cautious short term, more constructive on medium-term outlook

Multi Asset

Equity	○●○○○	↓
Credit	○●○○○	
Duration	○○●○○	
Cash	○○○○●	↑

Equity Regional

US	○○●○○	↑
UK	○○●○○	
Europe ex. UK	○●○○○	
Japan	○○●○○	↓
Pacific ex. Japan	○○○●○	↑↑
EM	○○○●○	

Credit

IG Credit	○○○●○	↑
Global High Yield	○●○○○	↓
EMD $	○○○●○	↑

Rates

US Treasuries	○○●○○	
Euro core (Bund)	○○●○○	
UK Gilts	○○●○○	
Japan	○○●○○	↓
US TIPS	○○●○○	↑

Currency

USD	○○○●○	
EUR	○●○○○	↓↓
JPY	○○●○○	↑↑
GBP	○●○○○	
EM Fx	○○○●○	

Other Key Views

Commodities

- Upside in Gold, Platinum and Agriculture

Sectors

- Underweight Consumer
- Overweight Healthcare and Industrials

Thematics

- Adding to Cyber Security and Renewables

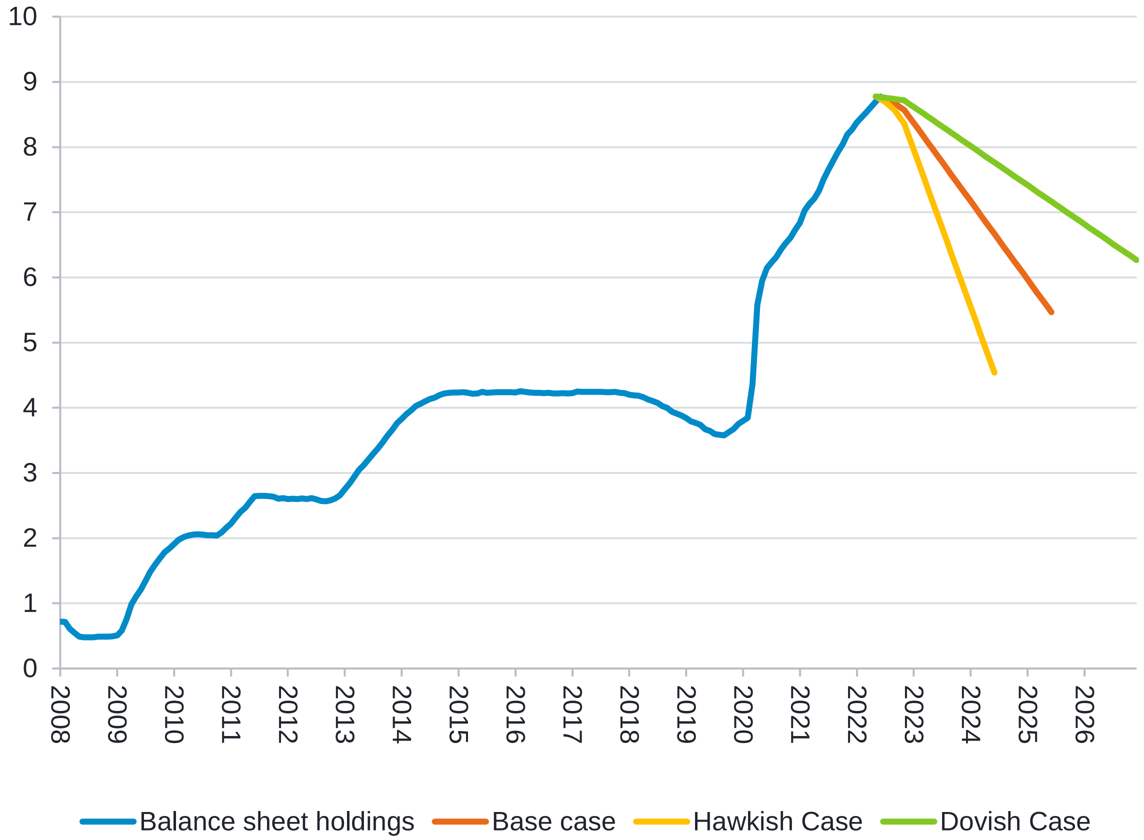
Source: Fidelity International, March 2022. Note: Red is Underweight; Grey is Neutral, and Green is Overweight; arrows signify change in positioning

US Dollar: The ultimate tactical portfolio hedge when duration is no longer defensive

USD is a beneficiary of a hawkish Fed as well as a hedge against geopolitical volatility

- Despite geopolitical risks, Federal Reserve policymakers have not softened their tone on choking off inflation.
- This contrasts with the ECB and BoE, which we expect to turn dovish sooner, potentially opening up significant interest rate differentials in the developed markets
- USD therefore provides a better tactical hedge than duration, given doubts that a Fed put will emerge in response to slowing growth exacerbated by the Ukraine war.
- Even though we suspect the Fed will not achieve 7-8 rate hikes in 2022 as currently priced in by the market, we see value in the dollar as a geopolitical hedge:
  - If the war were to end swiftly and peacefully, focus would move back onto the Fed tightening, supporting the dollar.
  - In the event of the conflict intensifying, the dollar has safe-haven properties.

Fed balance sheet scenarios (tn. USD)



Source: Fidelity International, February 2022. Notes: * Targeting balance sheet size of 20% GDP
Base Case: Holdings under QT forecast using max cap of $100bn per month and pre-pandemic BS target
Hawkish Case: Holdings under QT forecast using max cap of $200bn per month and pre pandemic BS target
Dovish Case: Holdings under QT forecast using max cap of $50bn per month and pre pandemic BS target

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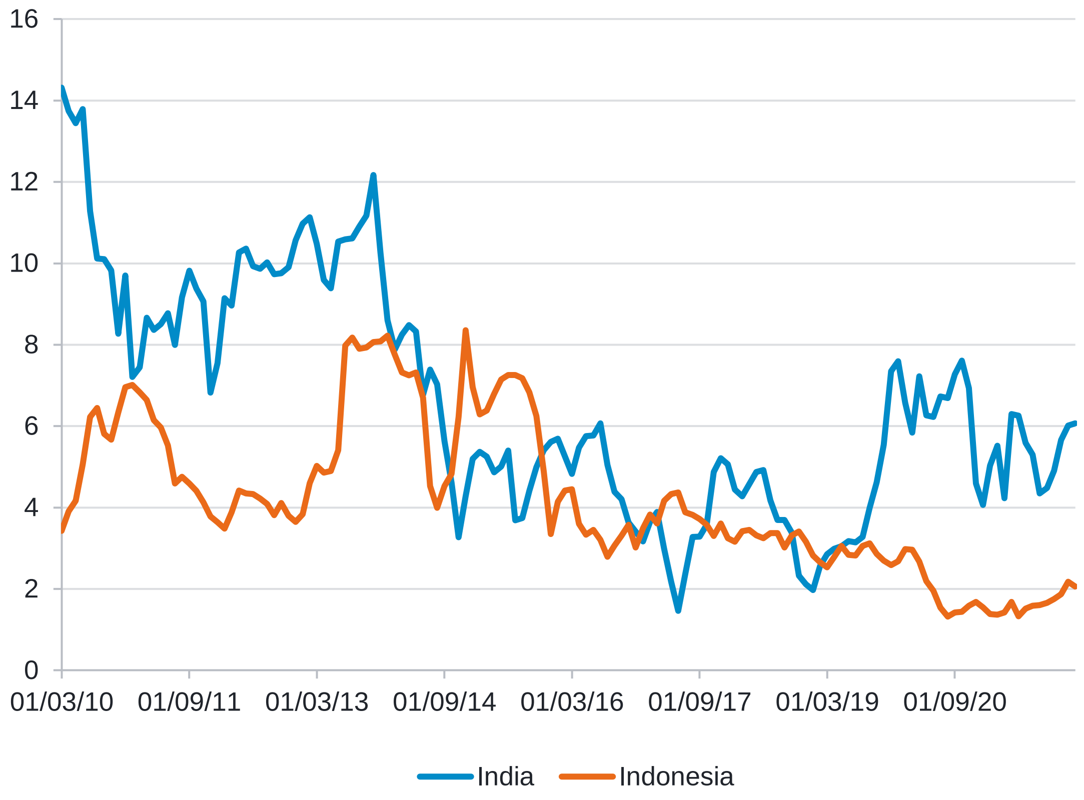
Emerging markets offer select opportunities and are less impacted by Ukraine war

EM FX is attractively valued and offers strong carry, with the worst behind it

- We are finding increasing areas of interest in emerging markets and Asia Pacific.
- We are overweight **EM equities** based on more supportive China policy. China should provide some diversification protection from the war in Ukraine. However, Covid resurgence a risk.
- Overweight ASEAN, e.g. Indonesia
- **EM Hard Currency** yields (ex Russia & Belarus) look higher than justified by fundamentals
- Spreads have widened significantly, even for regions not directly affected by the war
- Selectively overweight **EM FX**, mainly commodity currencies

Unlike the West, near-unprecedented highs in inflation are not seen in many EMs



Source: Refinitiv, March 2022.

Equities

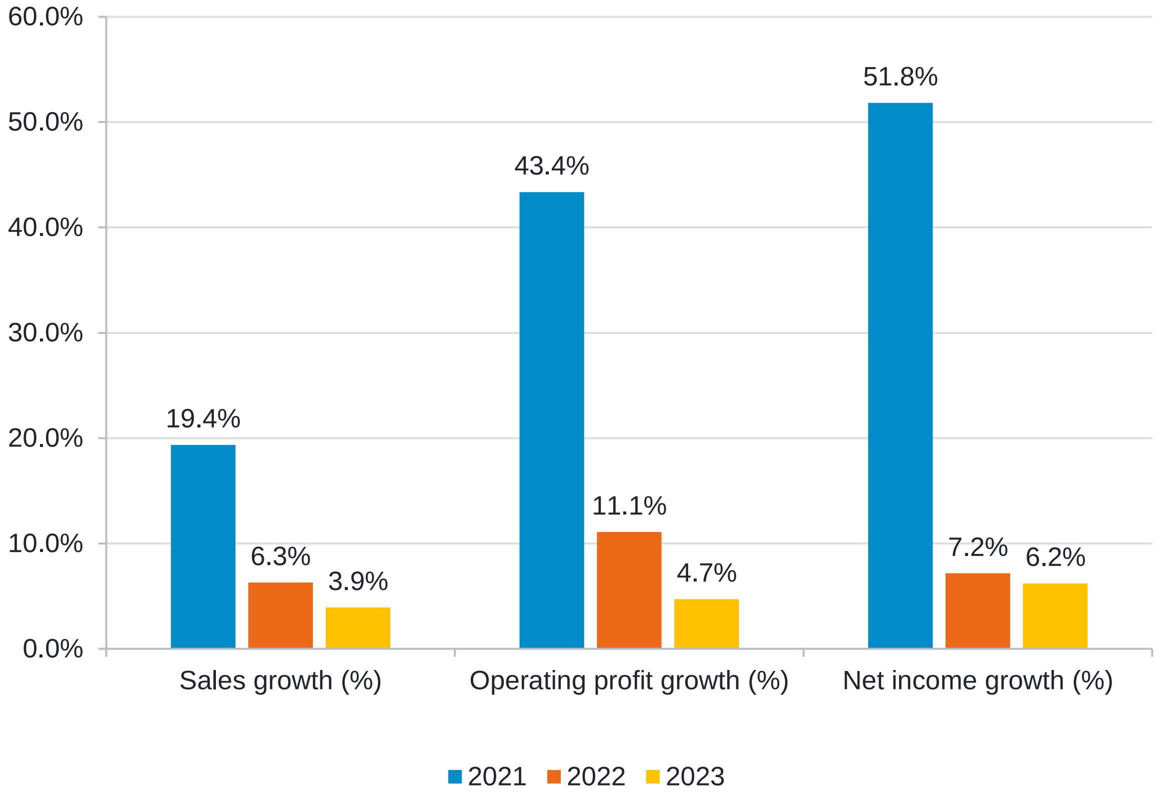
Equities: Key takeaways

- **Market parameters have shifted,** with financial conditions getting worse…risk is back and there is justification for reasonably high risk premia.
- **Interest rates move higher,** but Equity Income should be seen as implicitly indexed on inflation, and equity risk premia should be read against real interest rates. A tightening is compatible with decent returns as long as real interest rates remain that low.
- **Volatility is rising,** and the earnings-per-share revision ratio is weaker. Even if our estimates are below consensus, margins are under pressure and risks are to the downside with very high Producer Price Index readings (a multiple of high CPI numbers).
- **Inflation hedge:** Investors need to protect against high inflation and equities should be relatively well placed in this environment. It’s well reflected in robust inflows and with visible help of historical high share buybacks.
- **Pricing power is key:** In a stagflationary environment, companies that have pricing power should outperform.
- **A quality bias** is even more important at this stage in the cycle than a view on an ongoing, but much more nuanced, value rotation

Finding quality companies with earnings stability is key

- The Covid cycle is nearly over, but all eyes are on new risks: war in Europe and Omicron BA.2 in China
- The Ukraine war has caused high volatility and extreme rotations. We are still cautious in Europe but finding more opportunities in EM.
- Finding quality companies with earnings stability will be key. This will likely be more important than sector allocation, because the supply chain disruption and stagflationary dynamics cut across the economy.
- US consumer impact is important to watch:
  - The war and high inflation has caused consumer sentiment in the US to plummet.
  - One-year consumer inflation expectations are at multi-decade highs propelled by the Russia invasion. But their 5-year view is still in its 20-year channel. So consumers appear to be "seeing through" the current spike, just as they did in the 2008 oil surge.
  - Household incomes are coming down from high levels.
  - A war plus high inflation is uncharted territory for millennials. The key question is: are they going to save or spend?

Global growth forecast: deceptive nominal growth, flattish in real terms, with a possible margin squeeze

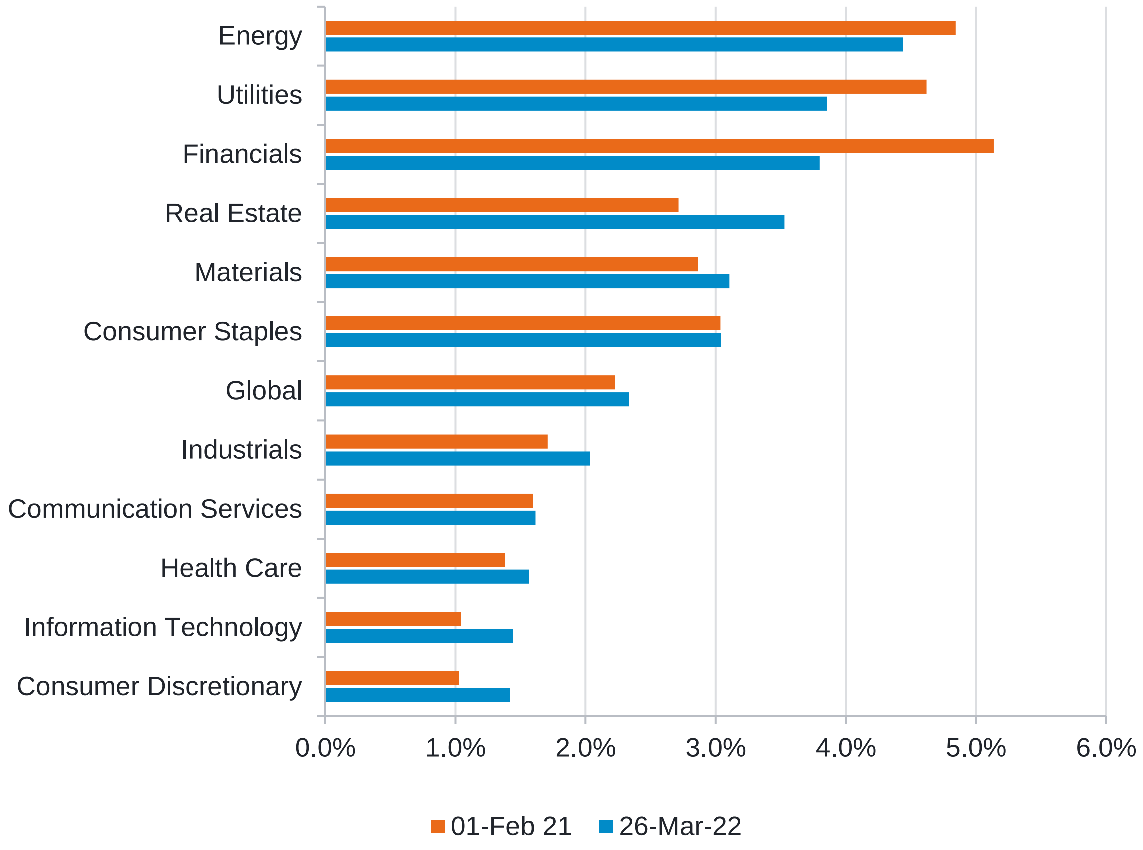


Source: Fidelity International, March 2022.

Companies with pricing power set to outperform as inflation eats at margins

- Investors need to protect against high inflation and equities should be relatively well placed in this environment.
- Companies that have pricing power should outperform, as rising cost pressures eat away at margins
- Equities still provide robust income. Balance sheets have been repaired after Covid and dividend yields have grown as markets have corrected.
- Central bank support is fading but corporates and retail investors still have deep pockets. TINA (There Is No Alternative) still alive as real rates could surprise on the downside.

Dividend yield estimates, 2022 average

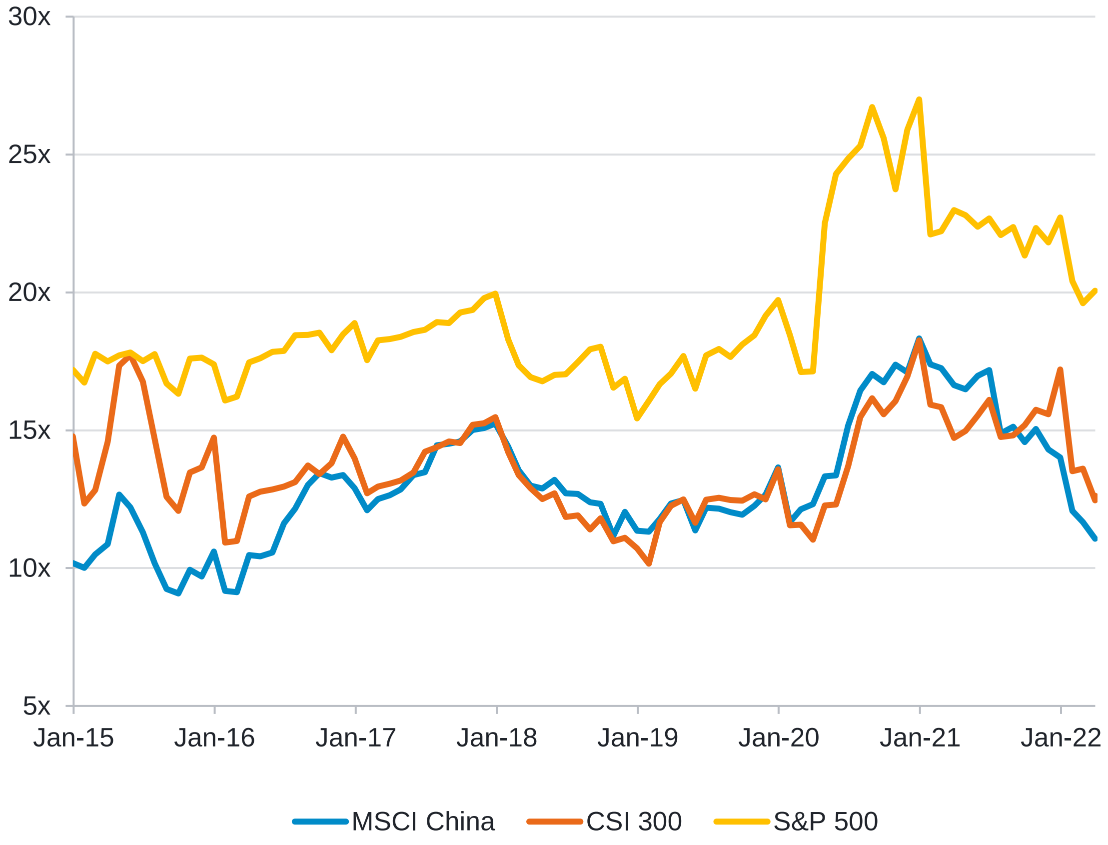


- Source: Fidelity International, March 2022.

China equity should outperform in relative terms, but volatility is very high

- Some parts of China equities look cheap, but volatility is very high at the moment and tail risks have become fatter.
- We expect both onshore and offshore equity to perform relatively well over the next quarter.
  - Onshore: Stability is key in year of 20th Party Congress, while more pro-growth policy should support even as earnings growth slows. Valuations are reasonable.
  - Offshore: The regulatory cycle is bottoming out and earnings have been revised upwards, although Fed tightening will weigh on global sentiment. Valuations are well below average.
- Longer-term trends still in play – China onshore equities are under-owned by foreign investors, China's rising middle class is driving consumption and China is a fertile ground for innovation.
- However, the sort of blanket easing seen in previous policy cycles (2008) is unlikely to happen this year. Policymakers are focused on stabilisation rather than boosting.

12 Month Forward Price-to-Earnings



Source: Bloomberg, Fidelity International, March 2022.

Fixed Income

Fixed Income: Key takeaways

Stagflation challenges

- For fixed income investors, the stagflationary backdrop presents several challenges, as yields are caught in the crosshairs of higher inflation and tighter policy on one hand and slower growth ahead on the other.

Do not fear duration

- We don’t believe that central banks will be able to deliver on current market expectations for tightening and real yields could move further into negative territory from here. This means fixed income investors should not fear duration.

Inflation-linked securities

- Inflation-linked securities stand to benefit, as they offer inflation protection, exposure to falling real yields and can help diversify the exposure to higher beta segments of the market.

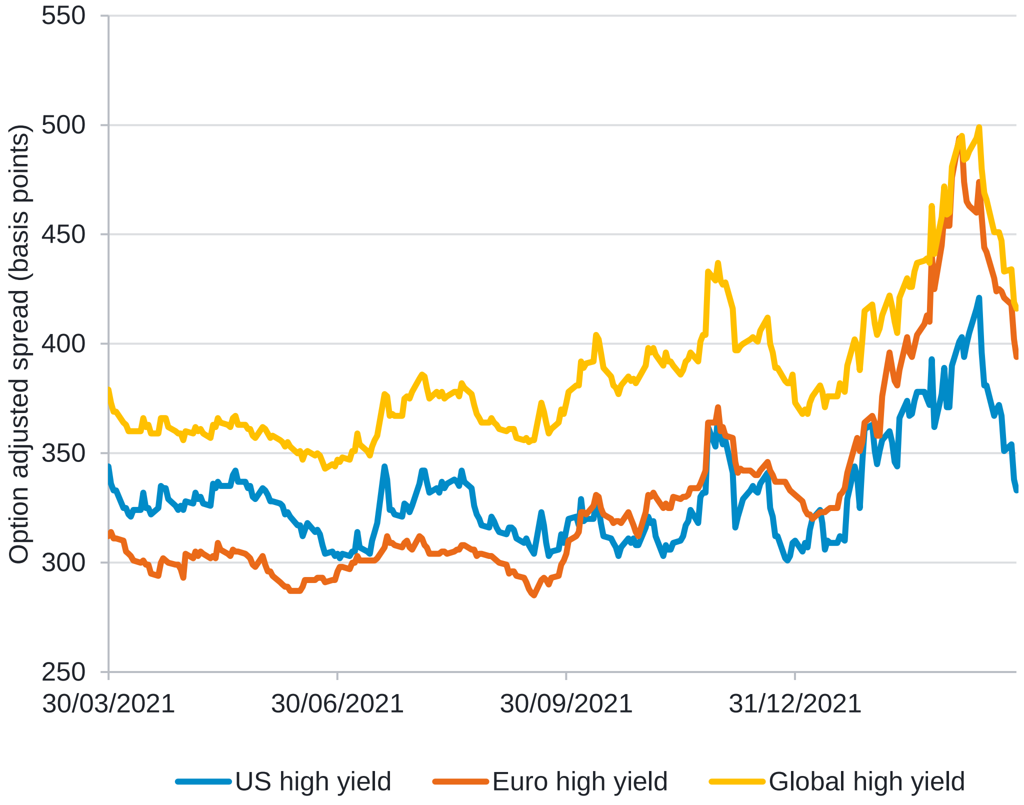
Asia investment grade credit and Chinese debt offer opportunities

- These asset classes benefit from a long duration profile, geographical distance from the epicentre of the conflict, support from forthcoming policy accommodation in China and attractive valuations.

Fixed income credit valuations are improving but not yet attractive

- Since the beginning of the conflict, we have further added to breakeven positions on the view that inflation expectations will rise further.
- Most HY companies have little direct exposure to Russia. However, we are moving to a neutral stance in global HY - fundamentals are strong but geopolitical uncertainty remains paramount to global HY and credit markets in general.
- We are constructive on Euro IG from a valuation perspective, given that spreads are now considerably cheaper compared to the beginning of the year as a result of the invasion. However, we are mindful that there is room for further weakness from here.
- We see challenges ahead for peripheral debt. Italy is more exposed to a potential disruption in natural gas supply as a result of the conflict.

Spreads widened following increased geopolitical uncertainty; European HY at greater risk



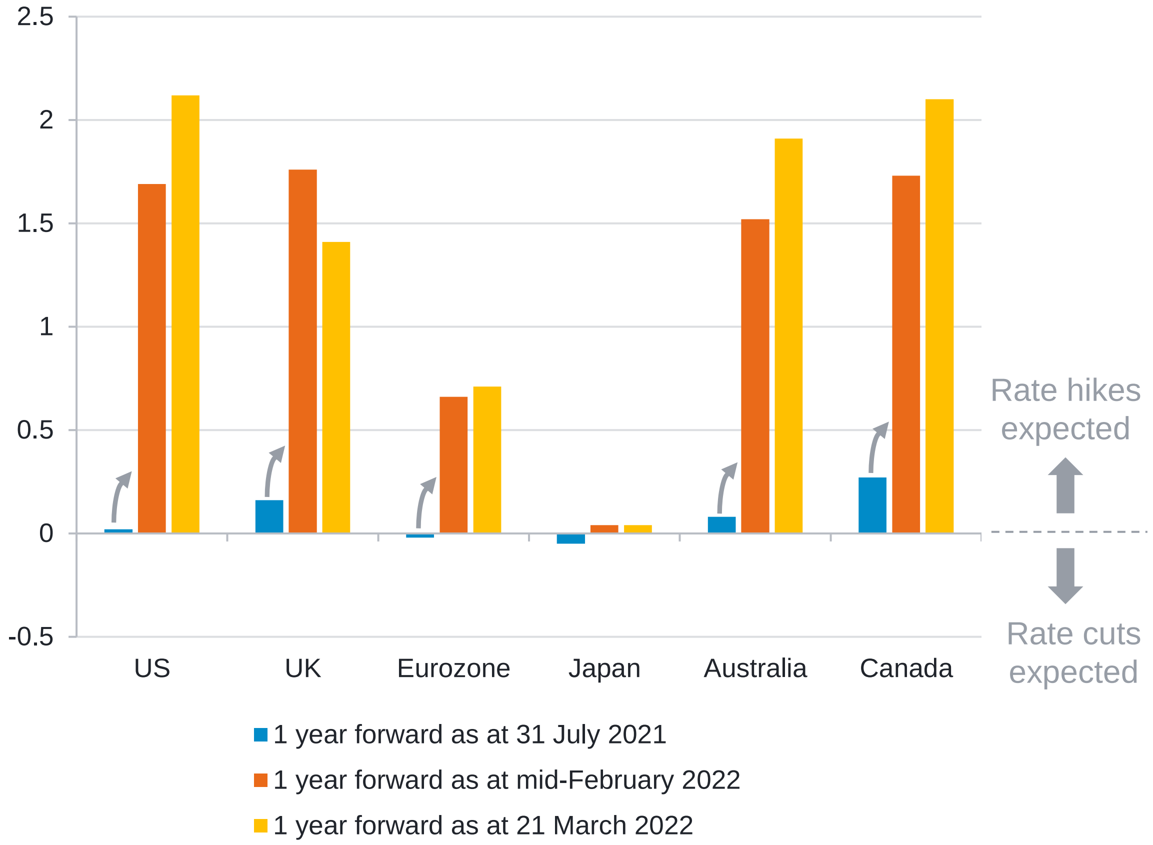
Source: Refinitiv, Fidelity International, March 2022.

Central banks are hawkish, but the window for interest rate hikes is narrow

We are overweight European rates as the market is pricing in more hikes than we believe are possible this year

- We don’t believe that central banks will be able to deliver on current market expectations for tightening, meaning fixed income investors should not fear duration. The upside for nominal yields will likely be capped by debt refinancing constraints, central bank actions and demand for safe havens.
- There is value in core European duration versus other markets. We see the ECB adhering to its stated sequencing, should they go ahead with policy tightening later in the year, ending QE before any rate hike is considered. Rate hikes, if they will happen at all, are a 2023 affair.
- US treasuries and UK gilts remain driven by risk sentiment. In the US in particular investors have recently shrugged off some very positive macro data releases of late, especially on the labour front.

Expect change in policy rates 1 year forward

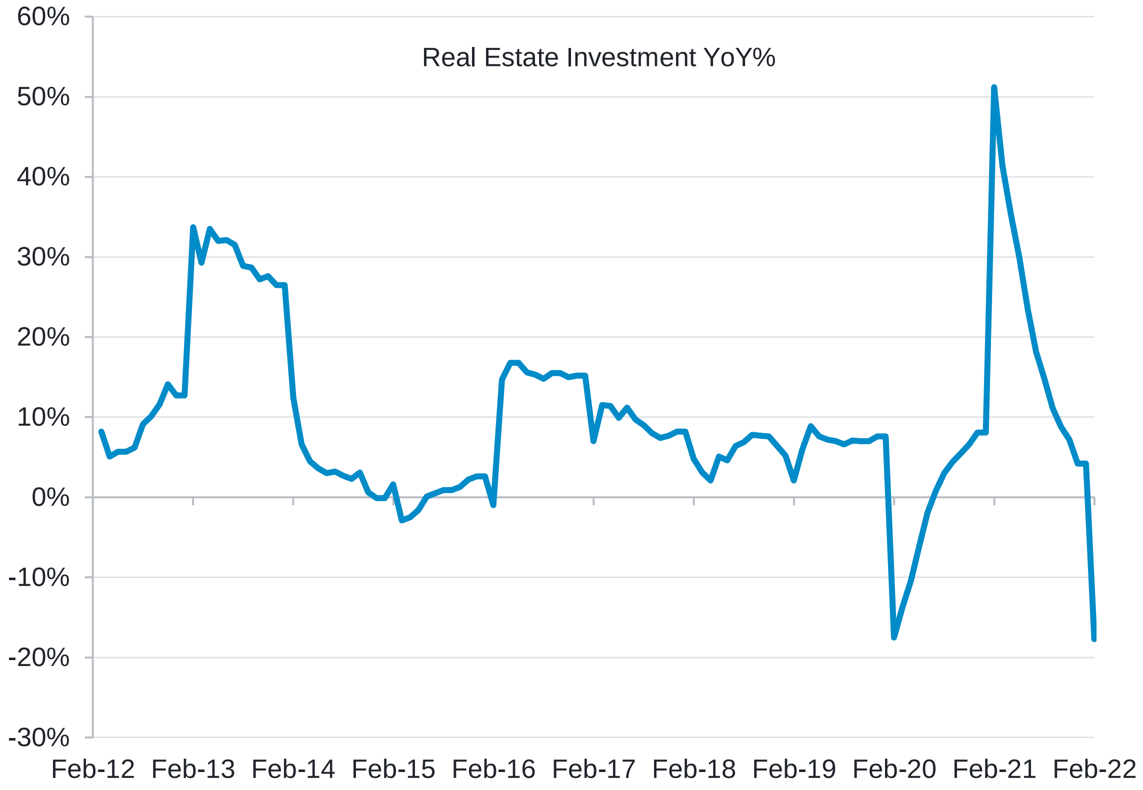


Source: Bloomberg, Fidelity International, March 2022.

China property: Near term weakness continues, bond prices remain depressed

- The war in Ukraine has had little impact on Asian credit fundamentals or growth expectations in China. However, it is affecting absolute returns of the asset class.
- China property remains a concern and we expect more volatility until there are concrete indications that the China property sector is on a path to recovery.
- In the rest of the Asia HY universe, top-down valuations are not quite as compelling, although selectively opportunities are beginning to appear.
- Lastly on China local currency duration, we hold a neutral view on the CGB term premium since the curve already normalised to its historical average from last month's relative steepness.
- We see the RMB holding steady in the near term, anchored by diversification flows amid the Russia/Ukraine war, but the currency may face headwinds in the long term given divergent US/China monetary policy paths
- Attractive yields and low correlations mean CGBs could offer diversification benefits.

China property remains a concern



Source: Refinitiv, Fidelity International, March 2022.

Private Assets: Private Credit and Real Estate

Private Markets: Key takeaways

Inflation supportive of floating rate leveraged loans, but stock picking critical given heightened stagflation / downturn risks

A cautious approach appears appropriate.

Stock picking ability continues to be paramount as idiosyncratic risk increases. A dynamic approach to markets is required to capture the significant opportunities. This is a time active managers can differentiate themselves and add significant alpha. We are looking for:

- Positive cashflow businesses with sticky revenues and strong enterprise value coverage
- Strong balance sheets, low leverage, ratings, default risk
- Sectors with cost inflation pass through, demand inelasticity
- Covid recovery sectors (highly selective)

Private credit offers high current income with low volatility, while senior secured nature and floating rate protects against downside risks.

Market remains orderly, with no expectation of disorderly movement assuming no further exogenous shocks. Limited direct Russia exposure and sticky capital makes loans resilient.

Most favoured sectors: Telcos, healthcare, software, selected chemicals (e.g. distribution, fertilisers), defence.

Least favoured sectors: Paper & packaging, food, consumer discretionary, retail, building materials, autos.

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Private credit: The impact of the war

- **Limited impact on portfolios:** The direct impacts on portfolio risk profile/leverage will be minimal.
  - 26% of portfolio has some direct exposure to RUS/UKR i.e. people on the ground. 36% of our portfolio trades with Russian and Ukrainian counterparts, but largely <2% of group revenues/purchases attributable to the region
  - Only 4 names have material exposure (>5% of revenues/COGS). Only 3 names where trapped cash is a material concern
- **Supply chain analysis is key:** Even those not directly involved in supply chain issues could be affected. This means thorough research of a company’s entire supply chain is paramount and could add significant value.

Sector Impact

Negative for sectors with high exposure to energy / agricultural commodities - paper & packaging, chemicals (+/-), autos, food	Neutral for various sectors, including telcos, gaming, software (+/-)	Supply chain disruption remains a concern across all sectors

Market positioning: Are downside risks priced in?

- **Default risks not priced in:** HY market has recently repriced to account for tightening financial conditions and outflows associated with hawkish central banks and the Ukraine war. However, implied default rates are improbably low – risk of recession/downturn is not yet priced in, so there could be more downside to come. Spreads are still tight by historical standards.
- **Credit picking ability is key in the current environment.** There is no obvious blanket, cross-industry approach.
- **Margin pressure:** High inflation means we are concerned about margin pressure and cashflows.
- **Looking for quality:** we are looking for companies that can withstand cashflow pressure, have stable revenues, offer low loan to value, and have plenty of ratings headroom.
- **Bank CDS:** We are watching these as an indicator of tightening financial conditions

Private markets tightening/defaults chart

Forward yield default expectations	With c. 5% yields, high yield market similar to October 2020 levels with distressed ratio of bonds close to 7%; and 2020 default rate ended at 3.5%. Default rate in 2021 was just 0.75%
Distressed levels HY / loan index	1.74% of loans CS Western European Ex USD and 1.15% of bonds ICE BofA Euro HY constrained trading <80c
Liquidity concerns	Repricing, and spread widening so far due to planning for tightening liquidity conditions and Ukraine conflict (outflows) As recession becomes more widely expected, higher default rates likely to be priced in
CCC-B spreads	Spread remains tight (tighter <25% of time) – reflects liquidity concerns over default concerns Expect widening of riskier names / refinancing conditions to worsen
Bank CDS	Successful hedge – good indicator for tightening financial conditions

Real Estate: Key takeaways

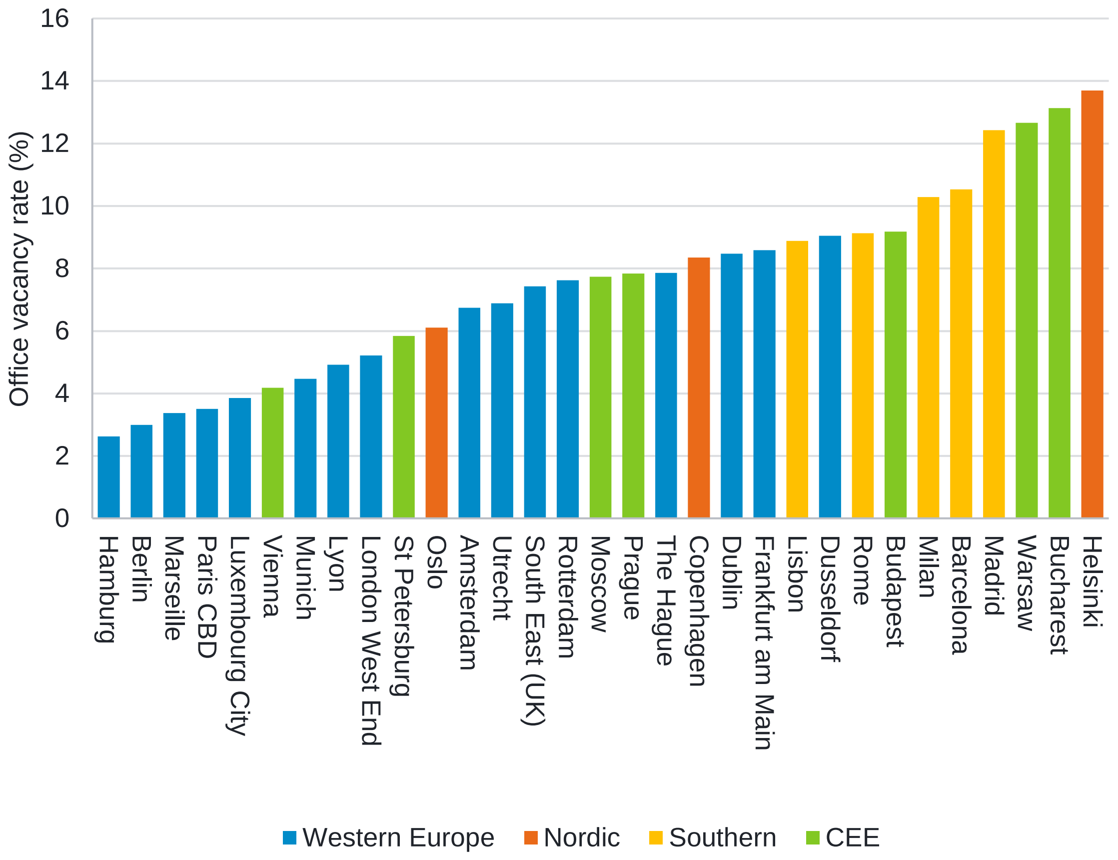
Caution required given recession risk in Europe

- **Markets have reacted slowly and have yet to fully price in the higher level of risk.**
- **This is a time for caution.** Real estate can be a good hedge against inflation, however, the asset class does relatively poorly in times of low growth. Discerning how sharp and how long the hit to growth is will be key.
- **Disruptive trends suggest demand for ‘green’ buildings may be more resilient.**

Historically stagflation points to weak demand and falling rents; but supply side factors could support pricing

- **Real estate and inflation:** Short periods of inflation are typically good for real estate.
- **Inflation protection:** Index-linked leases provide some protection from current inflation and we are seeking to increase the duration of our index-linked leases.
- **Stagflation is a worry though:** Capital values are linked to growth, so longer periods of inflation that require tightening to reduce demand or periods of stagflation are a worry, although real estate may still perform well relative to other asset classes.
- **Landlords should still have pricing power:** Vacancy rates remain very low in Europe. Not only does this indicate a serious market shock is unlikely, even if demand is impacted by worsening economic conditions, but also that landlords should have some ability to raise rents.
    - Markets with higher vacancy rates are largely in Central and Southern Europe, which we have little exposure to and will remain cautious on for the time being

Vacancy rates remain low in Western Europe (even post-Covid)

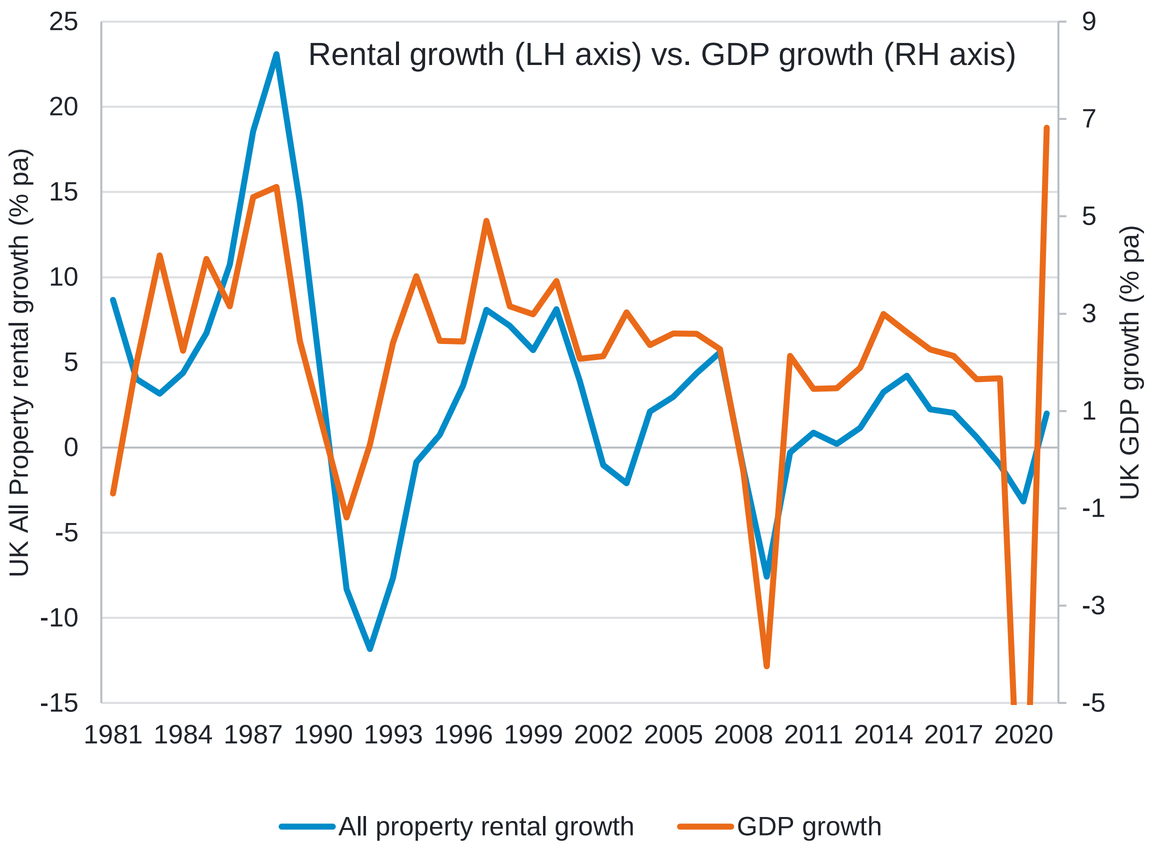


Source: CBRE, Q4 2021.

Real estate capital growth highly correlated with economic growth; focus is on delivering stable income

- **Recession risk:** The main risk to the real estate sector from the conflict is of a recession. The longer it continues, the greater the chance of a recession in Europe and the greater the potential knock on effects on real estate
- We are yet to see the real estate market react to the war. There is very little sign of concern at the moment
- **Themes of interest:** Healthcare, residential data centres. The chronic shortage of green buildings provides opportunities irrespective of the economic cycle.
- **Quality of income:** We are monitoring existing tenant base for increased risk, and carefully scrutinising new tenants
- We are also have a preference for 'core' over 'prime' assets and opportunities with good ESG credentials/potential to upgrade, providing some protection against cyclical risks

Rental growth depends on GDP growth



Source: Fidelity International, March 2022; MSCI UK Annual Property Index, 2022; Oxford Economics, December 2021

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