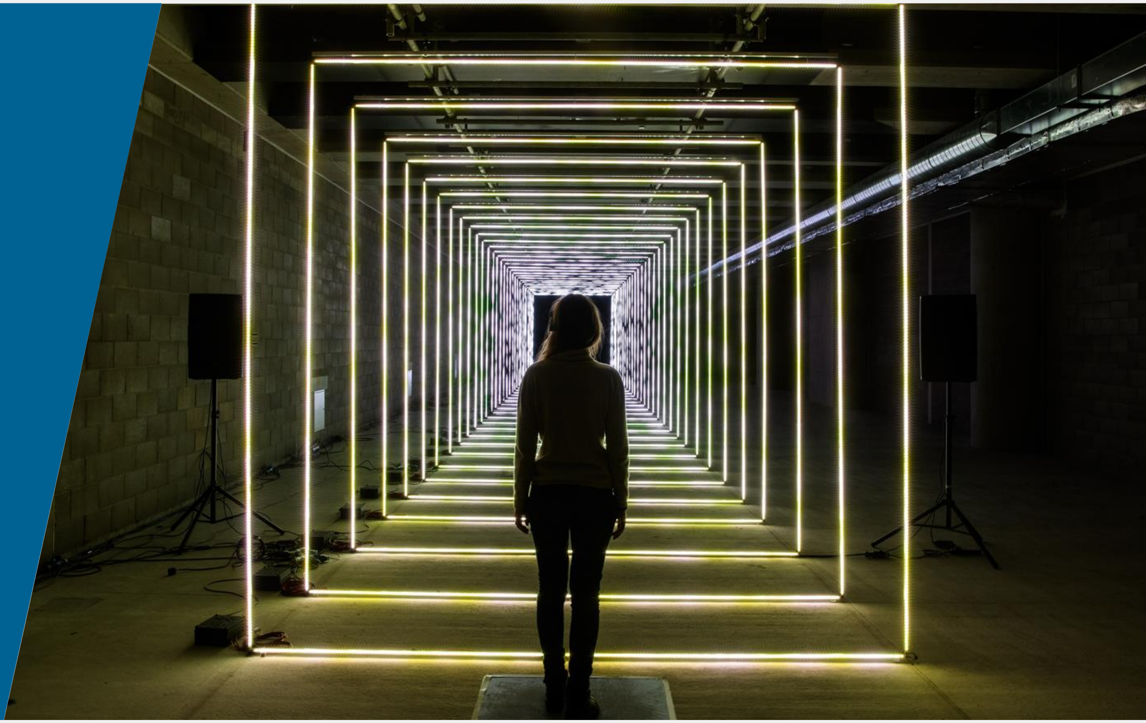
Fidelity INTERNATIONAL

Q2 2023 Investment Outlook

Navigating the polycrisis: Part II



FIL Investment Management

March 2023

Navigating the polycrisis: Part II

Three themes for Q2 2023

Hard vs. soft landing	▪ The aftershocks of Covid and the war in Ukraine continue to reverberate, with fissures in the global banking system opening on the back of the fastest rate hiking episode in history. DM financial stability risks return with a vengeance. ▪ With inflation having peaked, yet remaining well over target, the polycrisis continues to seriously challenge the Fed and other CBs. Every path in policymakers‘ decision tree entails trade-offs in managing growth, inflation, moral hazard risk, and more. ▪ The most extreme policy cycle since the 1980s has yet to conclude; we still see a hard landing recession in DM as the most logical outcome. Meanwhile, China’s reopening and Japan’s incoming policy regime introduces both risks and opportunities.
Risks and opportunities	▪ Up until March, the investment landscape showed a contrasting picture of near-term resilience and strong balance sheets, and risk of a recession eventually triggered by the higher cost of capital. This landscape has quickly darkened. ▪ In this context, our investment teams are focused on opportunities with resilient profiles. Sectors and regions with structural tailwinds and defensive characteristics, balanced with attractive valuations, present better risk-reward at this juncture. ▪ In the near-to-medium term, China’s re-opening is a boon for China and EM risk assets. Over the longer-term, the themes of sustainability, demographics, and reshoring/near-shoring continue to be sweet spots.
China reopening	▪ The message from China’s Two Sessions meeting is one of sustainable growth and a commitment to reopening. The government set a 5 per cent growth target in 2023 as an achievable goal, supported with moderate fiscal stimulus. ▪ Domestic mobility has rapidly returned, a positive sign. That said, stronger consumer confidence will be key as well as property sector activity. The latter is showing early signs of recovery. ▪ We are focused on second derivative reopening beneficiaries, onshore assets, and the strategically important digital economy. Growth spillovers to neighbouring Asian markets and EM offer additional opportunities for alpha generation.

Source: Fidelity International, March 2023.

Key themes and their investment implications for Q2 2023

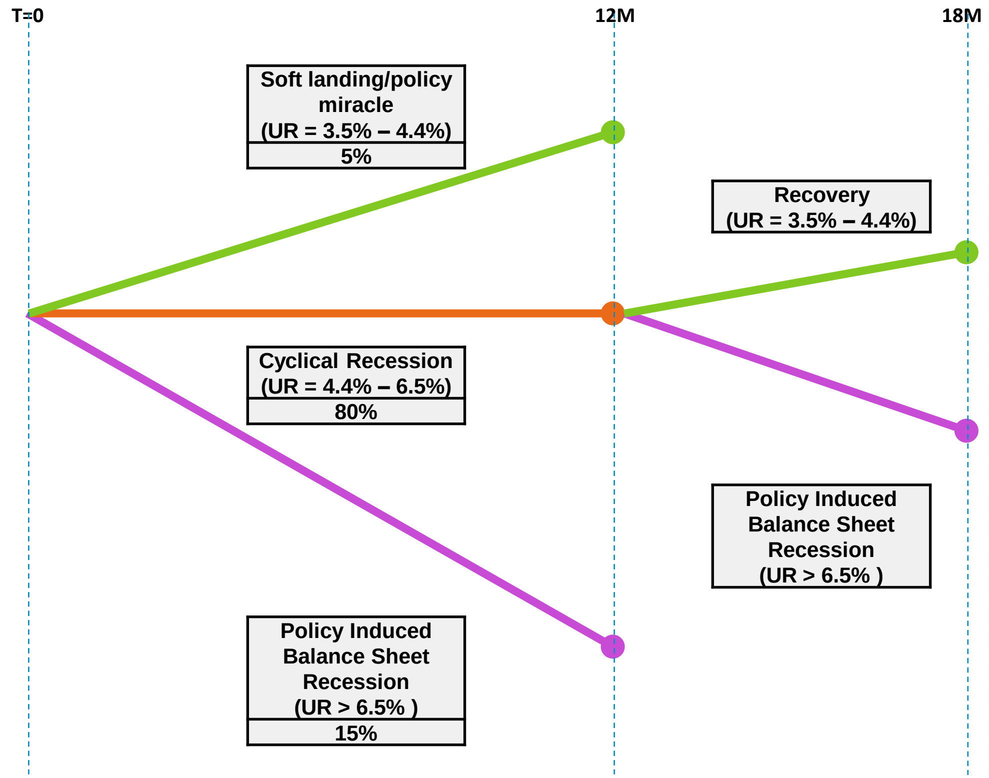
	Asset Allocation	Equities	Fixed income	Private markets	Real estate
Hard vs. soft landing	▪ Currently, the fallout from SVB has not changed our medium-term outlook. We still expect a hard landing but at a later date. We are defensively positioned, underweight credit and overweight cash. ▪ We think markets are under-pricing the risk of a recession in DM and that credit will be the first to come under pressure. Equities are supported by sentiment and strong labour markets for now. ▪ Within credit, we prefer IG for its higher quality, defensive characteristics.	▪ This quarter could be volatile amid issues in the banking sector alongside ongoing uncertainty over the future path of the global economy and interest rates. ▪ Equity markets are yet to fully reflect the potential hit to earnings from a faltering global economy. ▪ For companies, the near-term pain is evident in our survey's wide range of data points. Our analysts expect a rise in debt defaults over the next 12 months.	▪ The risk of a hard landing is not yet fully priced into HY spreads. Credit conditions are tightening, the weighted average cost of capital is increasing. High yield bonds offer high all-in yields, but spreads still don't provide adequate protection for a hard landing.	▪ Private debt less impacted by dichotomy of hard vs soft landing – both suggest challenges, but even in the hardest landing scenario, the private debt product retains protections at the most senior secured position of the capital structure, while floating rate nature mitigates impact of volatile rates backdrop.	▪ In a soft-landing scenario, the recent repricing in real estate should provide a good foundation for performance driven by a combination of rental growth and attractive yield. ▪ In a hard-landing, higher inflation and or interest rates could cause a further wave of repricing and reduced liquidity and reduced confidence. ▪ Real estate related debt and bond exposure could create a crisis in confidence in the broader sector.
Risks and opportunities	▪ SVB highlights the risks involved with today's fast pace of tightening. The Fed has been amongst the most aggressive – one reason why we favour a relative underweight in US equities. Now, the fallout looks to be contained but we will continue to monitor the situation as it unfolds. ▪ European small caps have lagged the broader recovery in Europe equities, creating the opportunity for a catch up. They are priced for a deep recession while the outlook is for a milder recession.	▪ We believe an earnings correction will occur this year. Corporate profit margins are under pressure, and rising funding costs are also adding risk. ▪ US earnings woes are likely to be extended, driven by multiples compression, with a strong labour market weighing on margins. ▪ China's re-opening is a significant boost for equities within Asia. Regional earnings for 2023 remain encouraging vs global markets.	▪ Refinancing is becoming more expensive for companies and rising interest rates are already having an effect on the residential mortgage market and auto loans. This is normally the time to gain duration exposure: government bonds typically outperform higher-risk assets at this point in the cycle. ▪ The next maturity wall occurs in 2025. However, at the margin there will be companies that do need to refinance and this will be expensive.	▪ The sectors that dominate the European private debt market are predominantly stable – services etc. – with limited exposure to Russia or inflated energy prices. ▪ Europe offers more mature market than U.S. with more experienced borrowers and fewer names from more stressed subsectors.	▪ Limited exposure to energy, banking, and tech sectors. ▪ Structural changes in supply chains continue to create demand for logistics. ▪ Acute shortage of supply and abundance of demand in sustainable buildings. Linked carbon ambitions.
China reopening	▪ We prefer EM equities to DM equities. We also expect EM currencies to be supported. ▪ Other beneficiaries of China's reopening include the Thai baht, the Australian dollar, and Indonesian and Chinese A-Shares equities. ▪ We prefer Asia high yield to that of Europe and the US.	▪ The rapid reopening has resulted in a spike in valuations among Chinese equities. The next stage will be a switch to earnings as the main driver for future gains. ▪ Earnings per share (EPS) still has a long way to go to catch up with the historical average peak increase. ▪ Chinese corporates enjoy favourable tailwinds. Monetary and fiscal policies are both accommodative and inflation remains benign.	▪ The macroeconomic backdrop remains supportive in China, with Covid cases having peaked, easing monetary policy from the People's Bank of China (PBOC), and increasing fiscal support. This will be expensive.	▪ Europe currently enjoying the economic tailwind from China reopening, but this is likely to have postponed any expected recession rather than resolving the risk completely. ▪ Economic buoyancy seen in borrowers' input costs decreasing, but wage pressures persist and this continues to weigh on operating cash flow.	

Global Macro

The scenario probability tree

Recent banking stresses in the US strengthen our conviction that a hard landing is ahead

Scenario probability tree over the next 12-18 months



Note: Probabilities are shown for each branch.
Source: Fidelity International, March 2023.

Cumulative scenario probabilities

	Probabilities after 12 months
Soft landing	5% (30%)
Cyclical recession	80% (55%)
Balance sheet recession	15% (0%)
Sum of recession probs.	95% (55%)

Note: Previous probabilities shown in brackets
Source: Fidelity International, March 2023.

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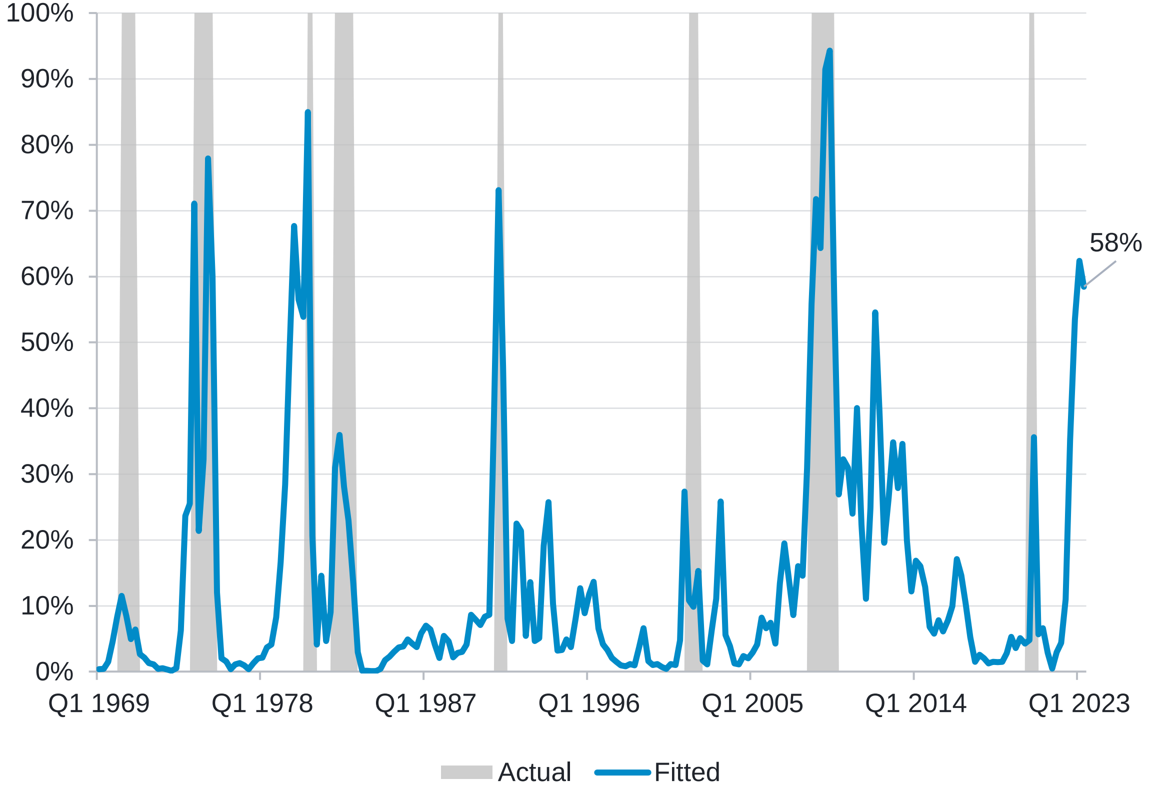
Our quant models have been signalling a high probability of US recession…

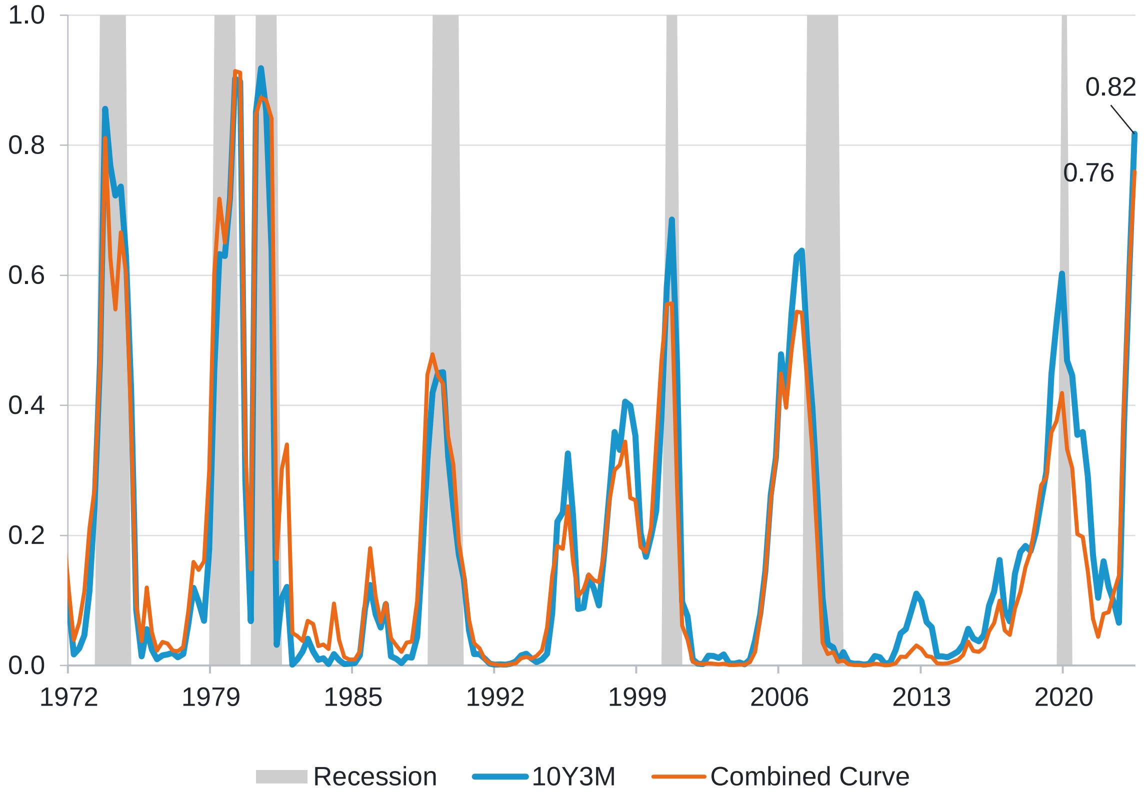
…even before the rise in banking stress. Now it's becoming even more likely

Recession prob. from US future activity trackers (1Q ahead)



Source: Fidelity International, Fidelity Global Macro Team calculations, March 2023.

Recession prob. from various yield curve inversions (2Q ahead)



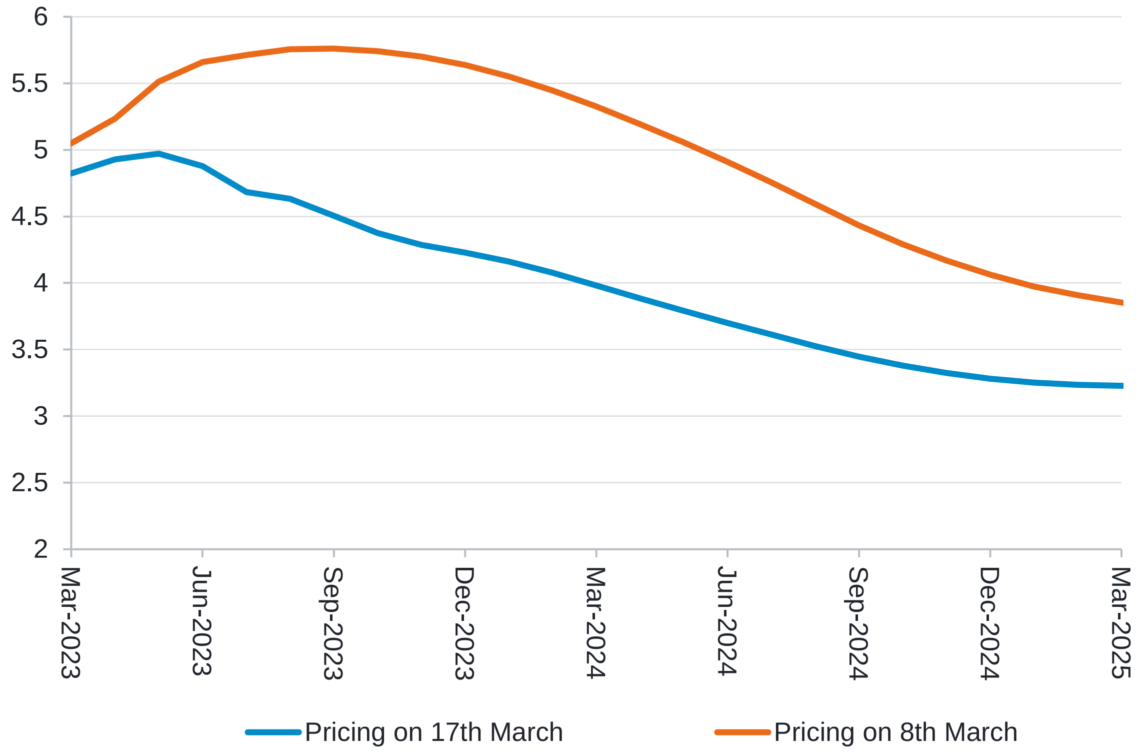
Note: combined curves looks at the spread of 28 different nominal curves which gives us the best success rate of predicting a recession historically. Data as on end December 2022
Source: Fidelity International, Fidelity Global Macro Team calculations, March 2023.

Bank lending channel and Fed policy implications

Focus now on the bank lending channel which is the key transmission mechanism for ongoing stress

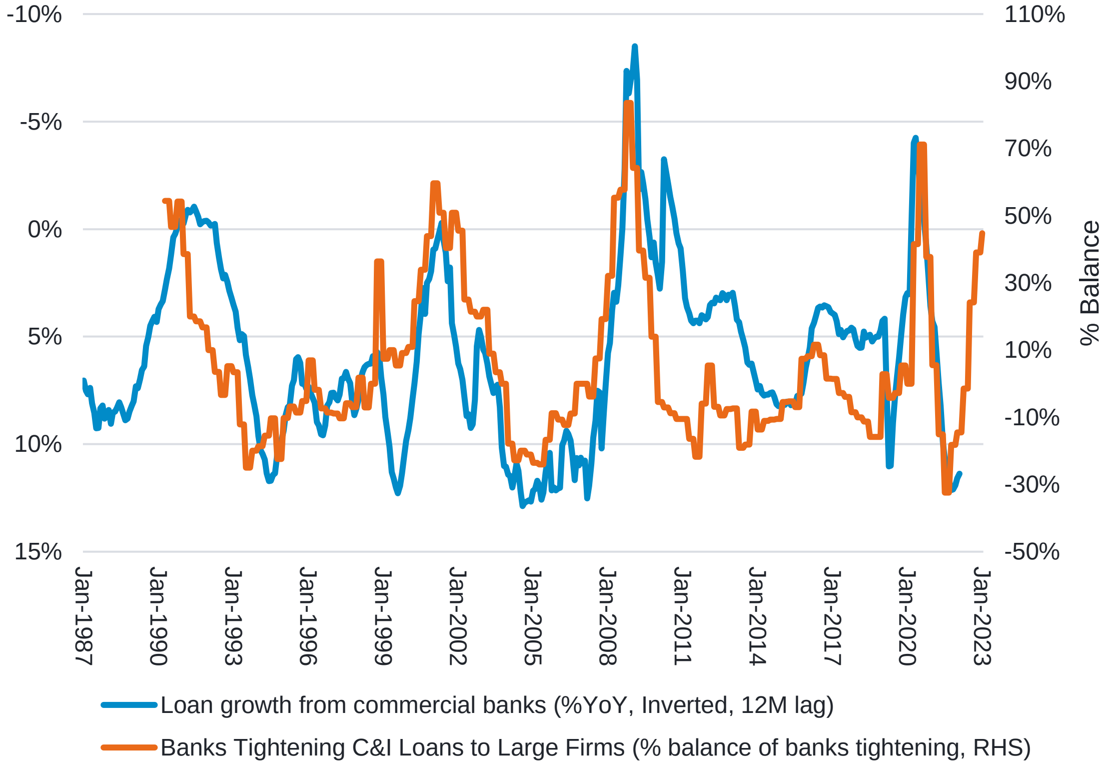
Market now pricing in significant *cuts* by year end

USD OIS 1M implied forward rates



Source: Fidelity International, Bloomberg, March 2023.

Credit standards have *already* tightened meaningfully, implying flat credit growth going forwards

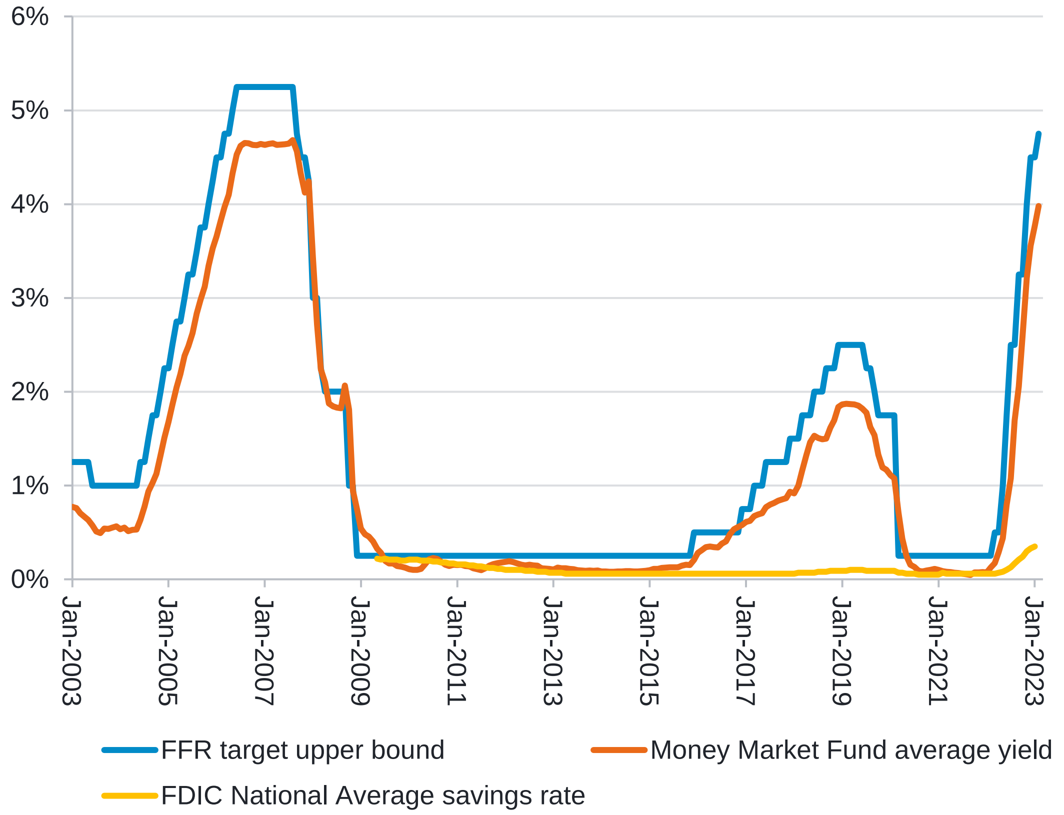


Source: Fidelity International, Haver Analytics, March 2023.

Bank lending channel and Fed policy implications

Falling bank deposits, market turmoil will lead to further tightening in financing conditions

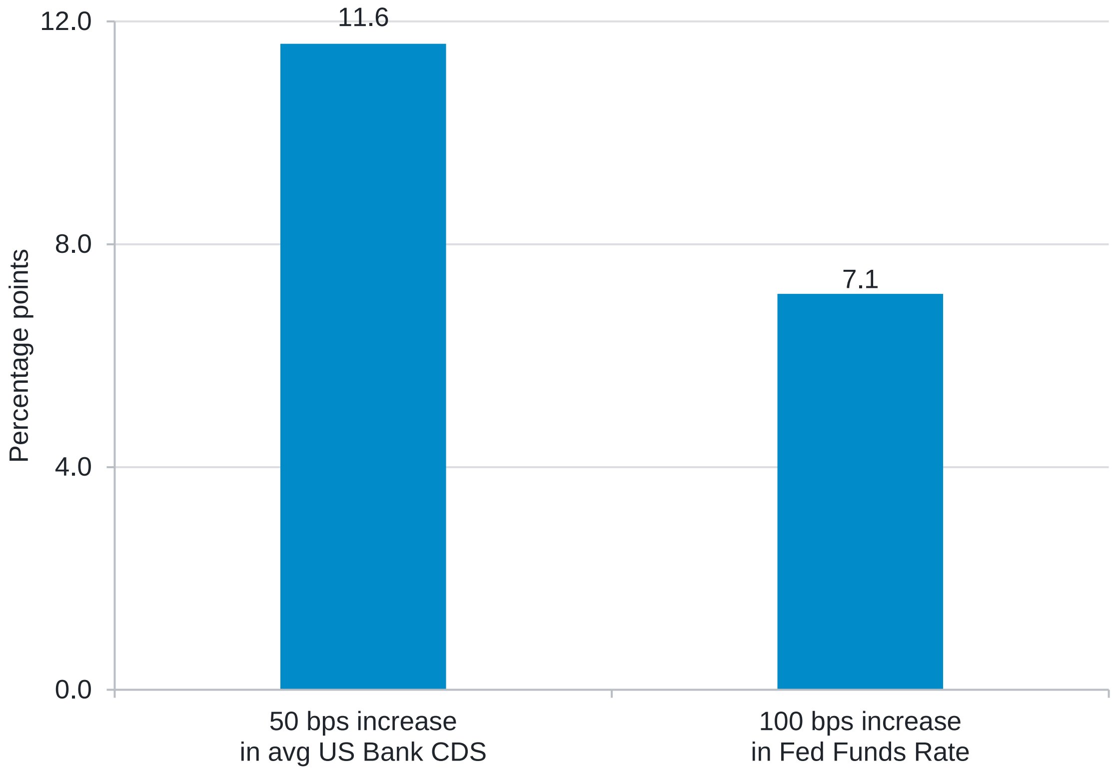
Gap between money market fund yields and bank deposit rates highlights deposit flight risk



Note: MMF yields are approximated via an average of 4 US money market fund yields.

Source: Fidelity International, Bloomberg, Haver Analytics, March 2023.

Impact on lending standards for large/med sized firms from regressing lending standard



Note: Above are estimates based on regressing lending standards on Fed funds rate and average US Bank 5Y CDS spreads.

Equal weighted average of six US Bank 5Y CDS spreads are used for calculating average US bank CDS (MS, GS, JPM, BofA, WF and Citi). Lending standards are net % of tightening standards from the Senior Loan Officer Opinion Survey. All the independent variables are statistically significant at < 5% and the model R^2 is 40%.

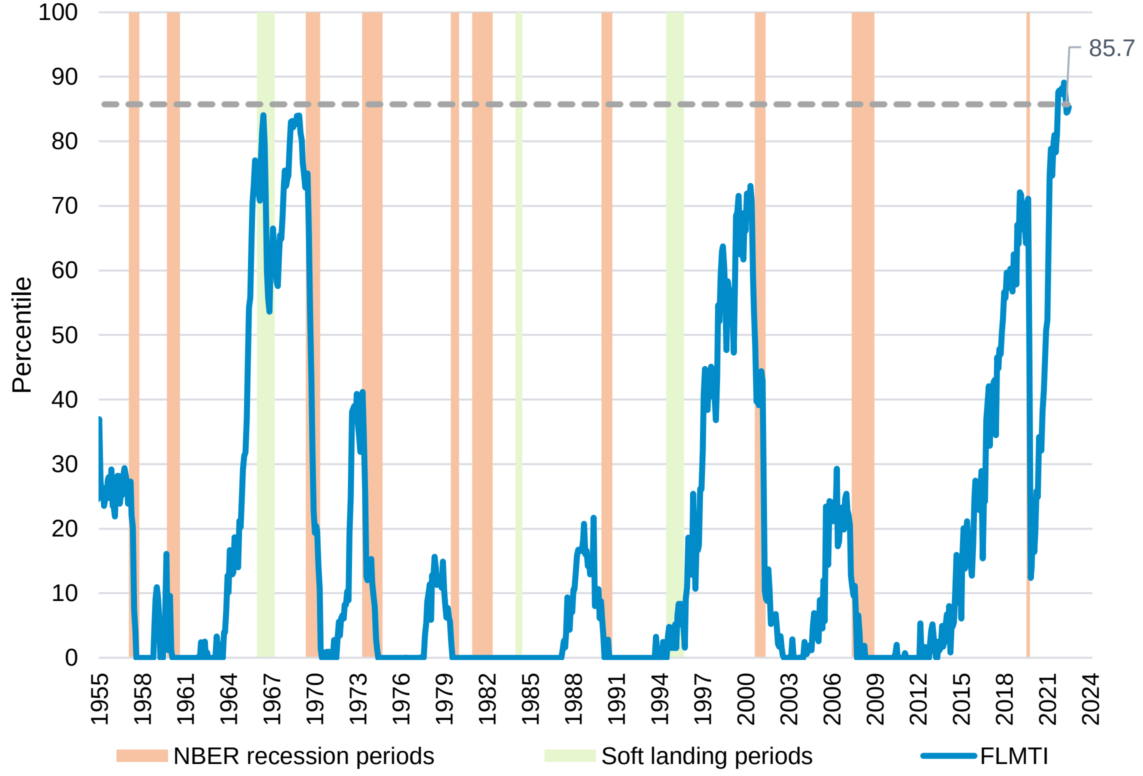
Source: Fidelity International, Fidelity Global Macro Team calculations, Bloomberg, Haver Analytics, March 2023.

US labour market remains at its tightest levels in decades

The Fed is pursuing tool separation to address financial stability and inflation targeting but the trade-off is getting sharper

Labour market tightness inconsistent with soft landing…

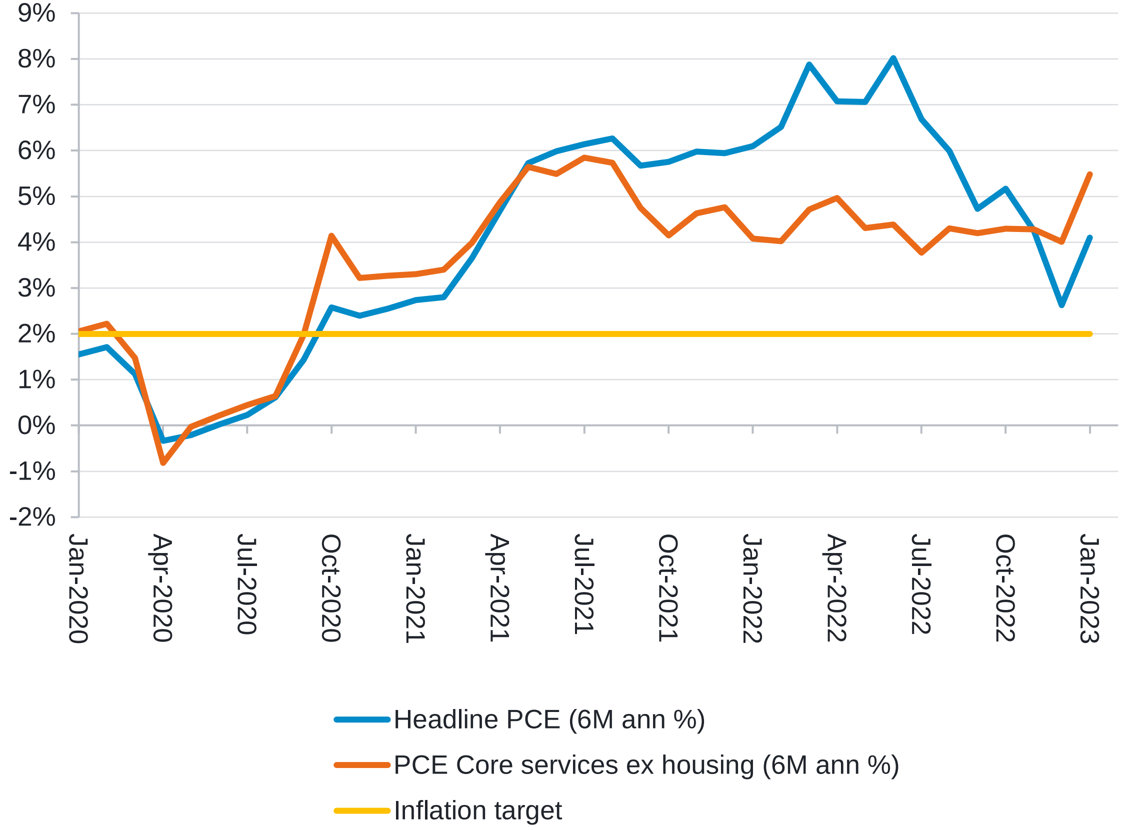
Fidelity Labour Market Tightness Indicator (FLMTI)



Note: Calculated as the average percentile of indicators above their median.

Source: Fidelity International, Fidelity Global Macro Team calculations, March 2023.

… and keeping underlying inflation high and sticky.



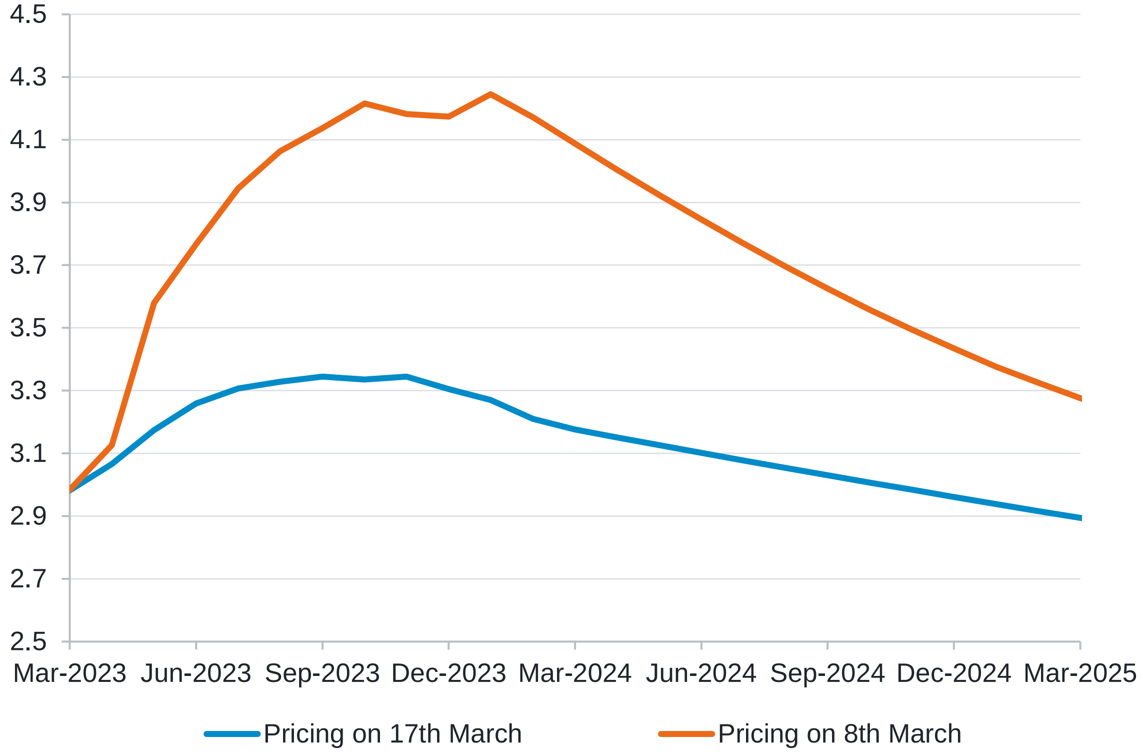
Source: Fidelity International, Haver Analytics, March 2023.

ECB policy implications

Bank lending channel plays an even more important role in the policy transmission in Europe vs US

Markets still pricing rate hikes

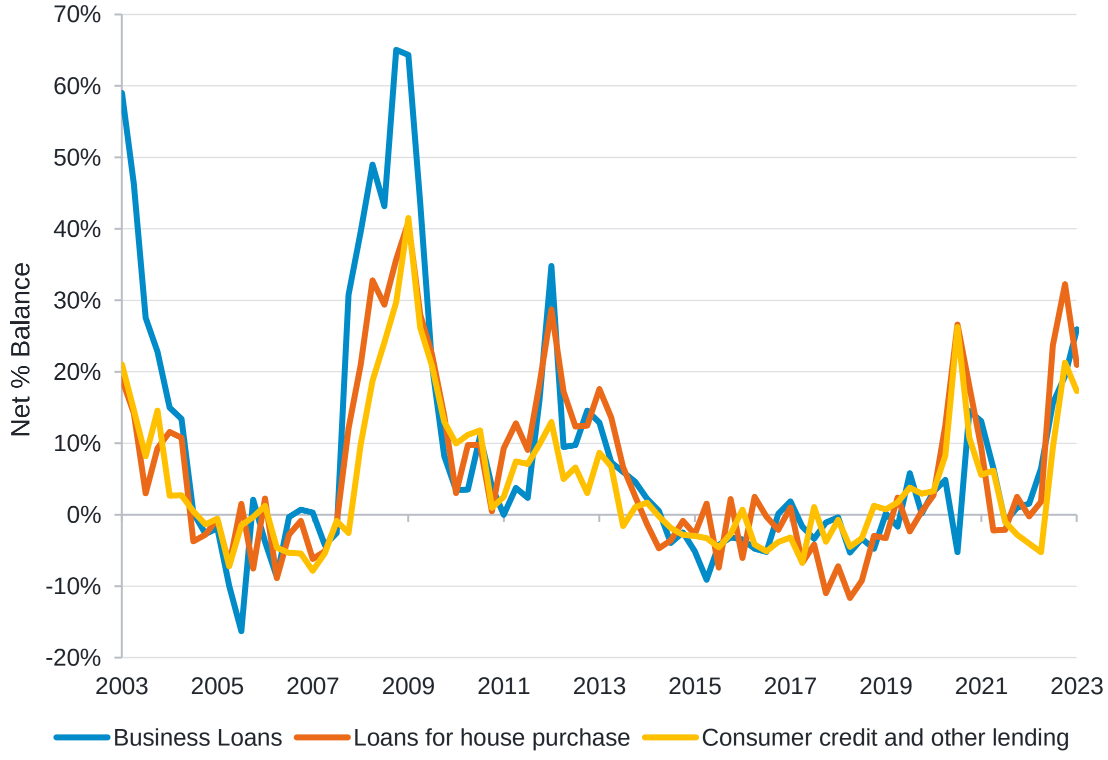
EUR OIS 1M implied forward rates



Source: Fidelity International, Bloomberg, March 2023.

Credit standards in the Euro area have tightened meaningfully

Change in credit standards, past 3M



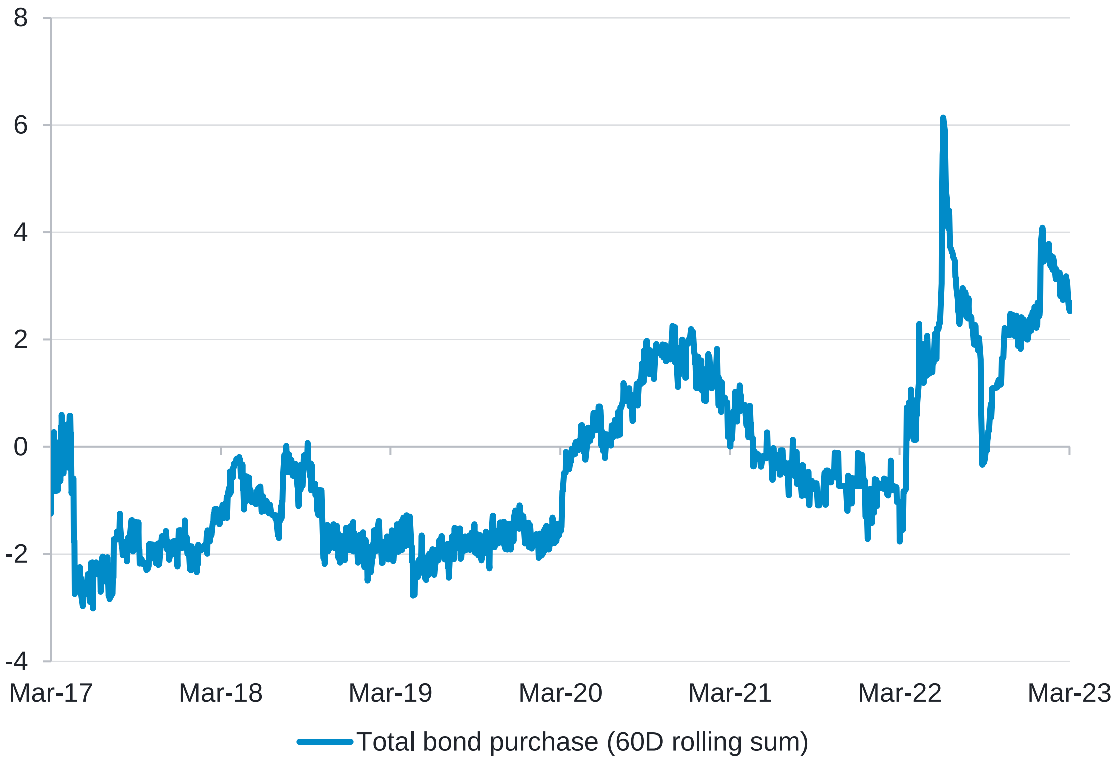
Source: Fidelity International, Haver Analytics, March 2023.

Waiting for the BOJ exit

Annual wage negotiations surprised on the upside but market turmoil puts near-term YCC exit in question

BOJ interventions to defend YCC have started falling back from previously very elevated levels

Rolling 2yr Z-score of JGB purchases by the BOJ



Source: Fidelity International, Bloomberg, March 2023.

Japan is the world's largest creditor with a positive net international investment position (NIIP) of $3.5 trillion

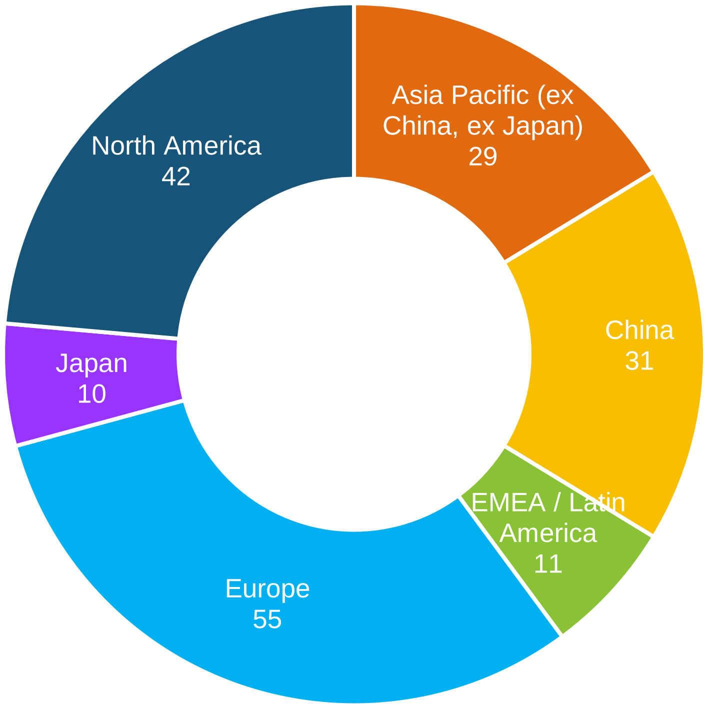
International holdings of US Treasuries

Source: Fidelity International, Bloomberg, March 2023.

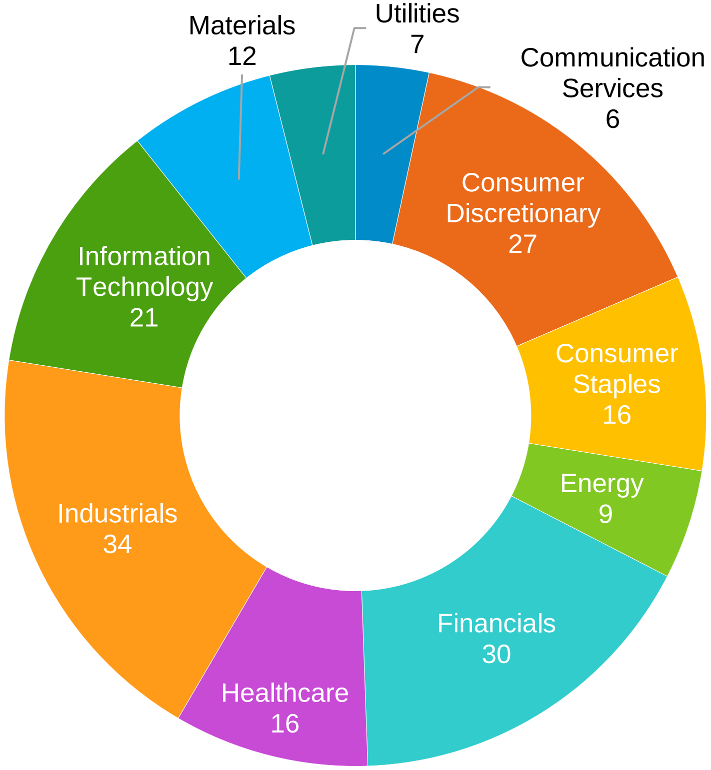
Global Investment Research

178 responses from 151 analysts

Region



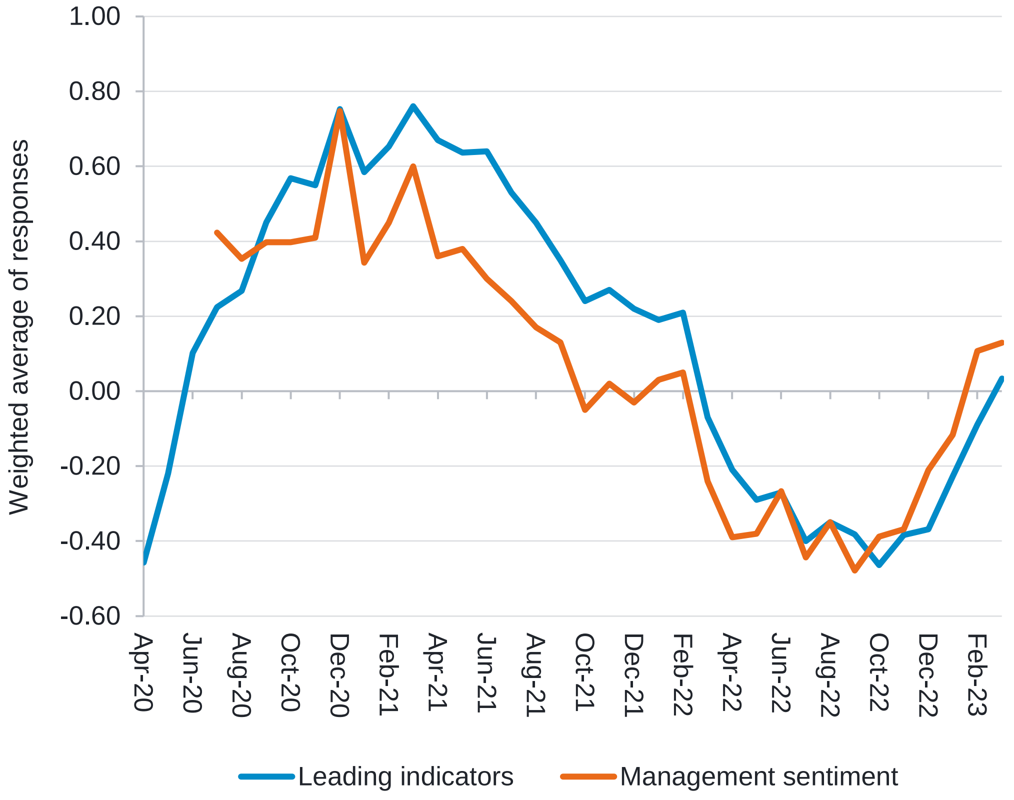
Sector



Analysts that cover more than once sector, or whose sectors have significant variation between subsectors, answer the survey more than once to provide greater granularity. Charts show number of responses.
Source: Fidelity International, March 2023

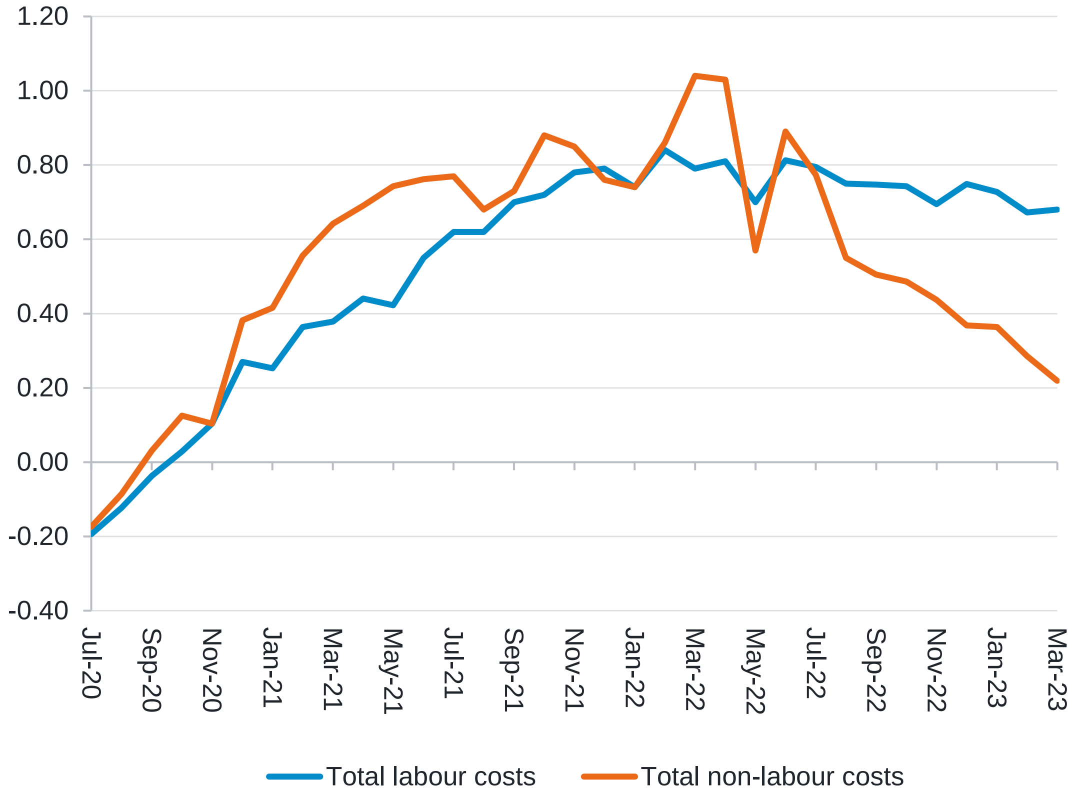
Both management sentiment and leading indicators turned up, driven by China's reopening; labour costs remain sticky while non-labour cost pressures ease

FIL analyst survey corporate leading indicators and management sentiment, March 2023



Source: Fidelity International Global Investment Research, March 2023

FIL analyst survey corporate leading indicators and management sentiment, March 2023



Source: Fidelity International Global Investment Research, March 2023

Sentiment and leading indicators diverging between DM and China

The picture elsewhere remains split

Management Sentiment by region

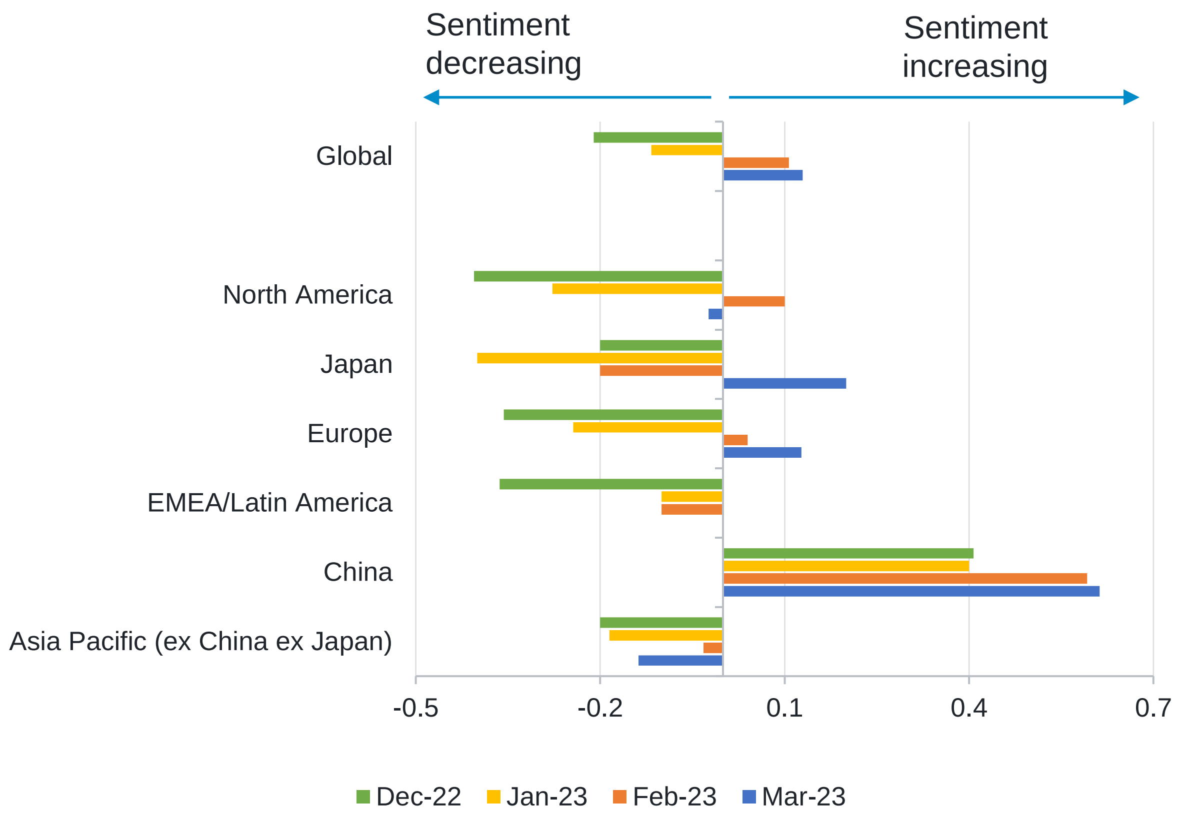


Chart shows proportion of responses reporting management sentiment is positive minus those reporting management sentiment is negative; strong negative and strong positive receive a higher weighting. Question: "Based on your recent research and interactions with companies, to what extent, if at all, has your perception of management sentiment over the next 6 months changed?"

Source: Fidelity International Global Investment Research, March 2023

Leading Indicators by region

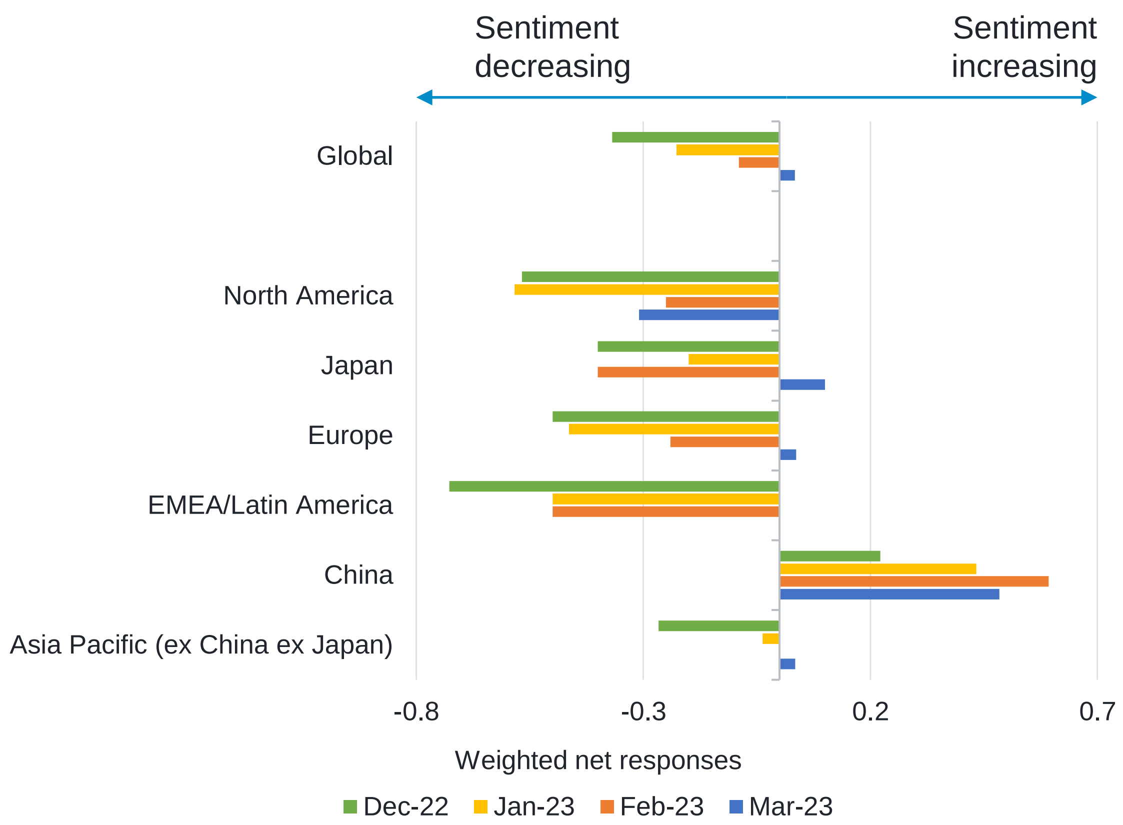
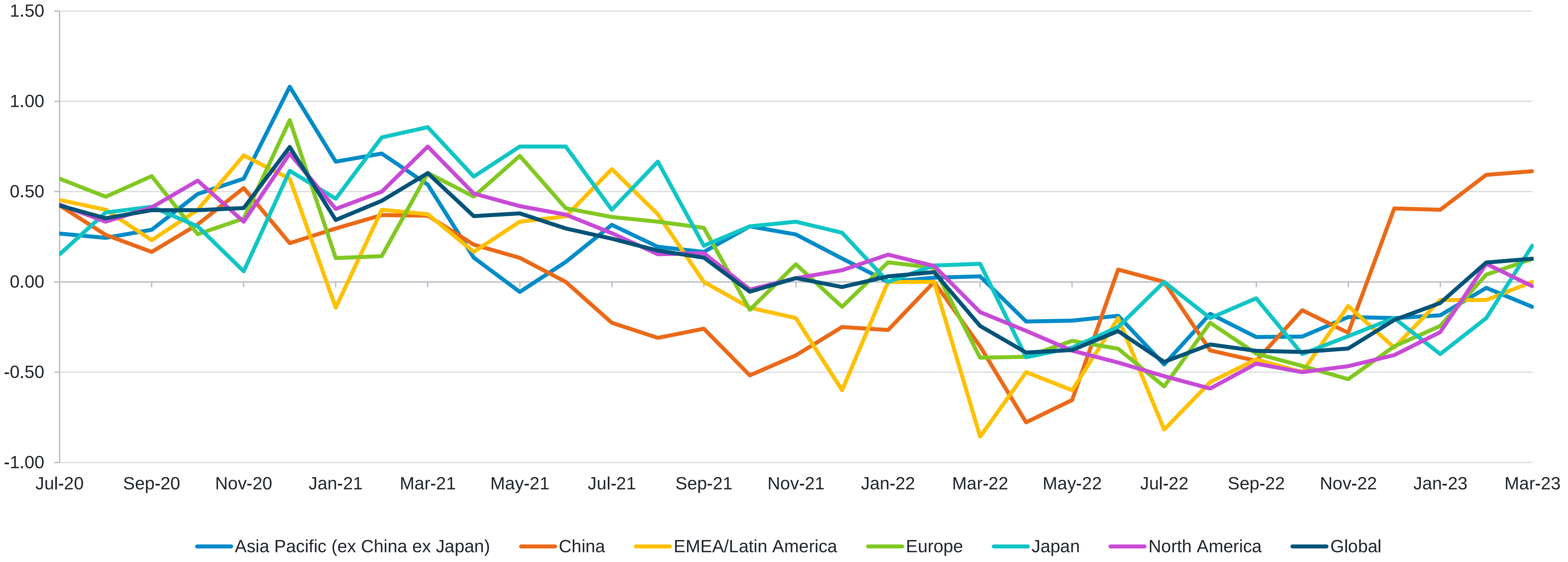


Chart shows proportion of responses reporting leading indicators are positive minus those reporting leading indicators are negative; strong negative and strong positive receive a higher weighting. Question: "What is the outlook for leading indicators over the next 6 months at your companies?"

Source: Fidelity International Global Investment Research, March 2023

Sentiment by Region

China takes off



Source: Fidelity International, March 2023

Supply chain disruptions easing but labour costs will keep pressure on services

Labour costs by region

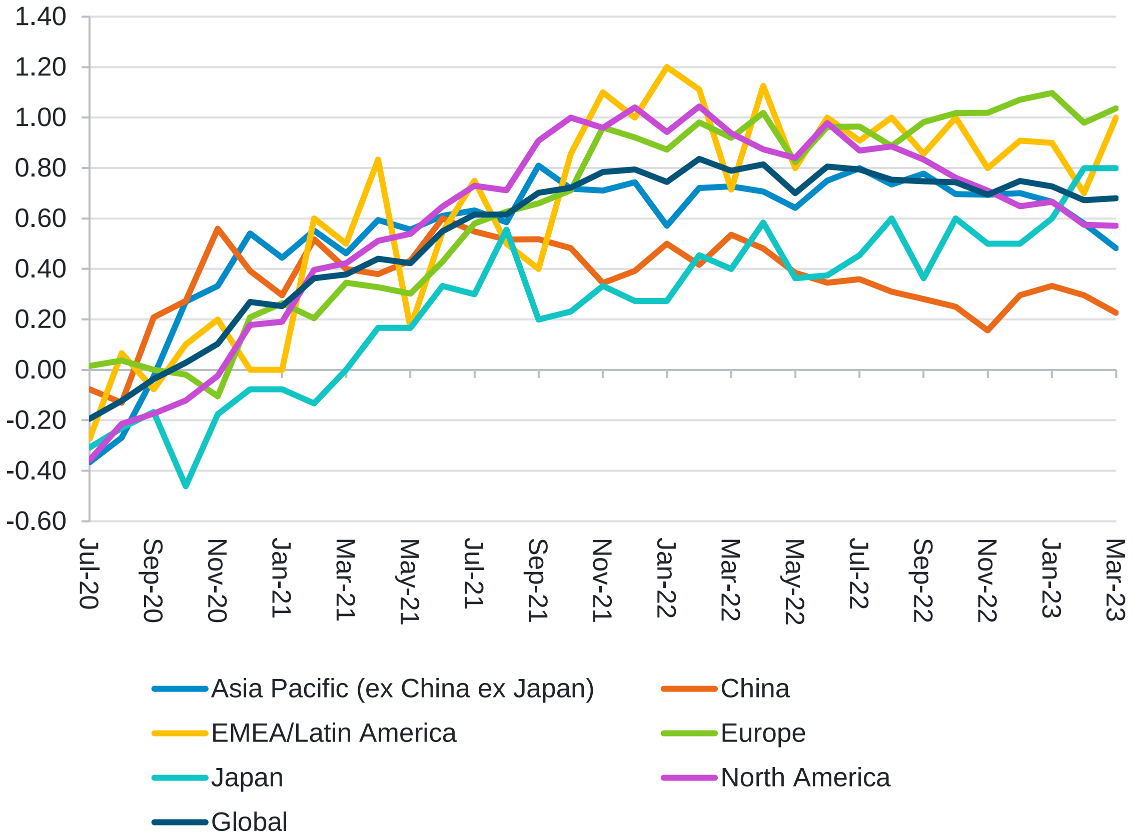


Chart shows proportion of responses reporting costs are increasing minus those reporting costs are decreasing; significant increases and significant decreases receive a higher weighting. Question: "What are your expectations for total labour costs over the next 6 months compared to current levels?"

Source; Fidelity International, March 2023

Non-labour costs by region

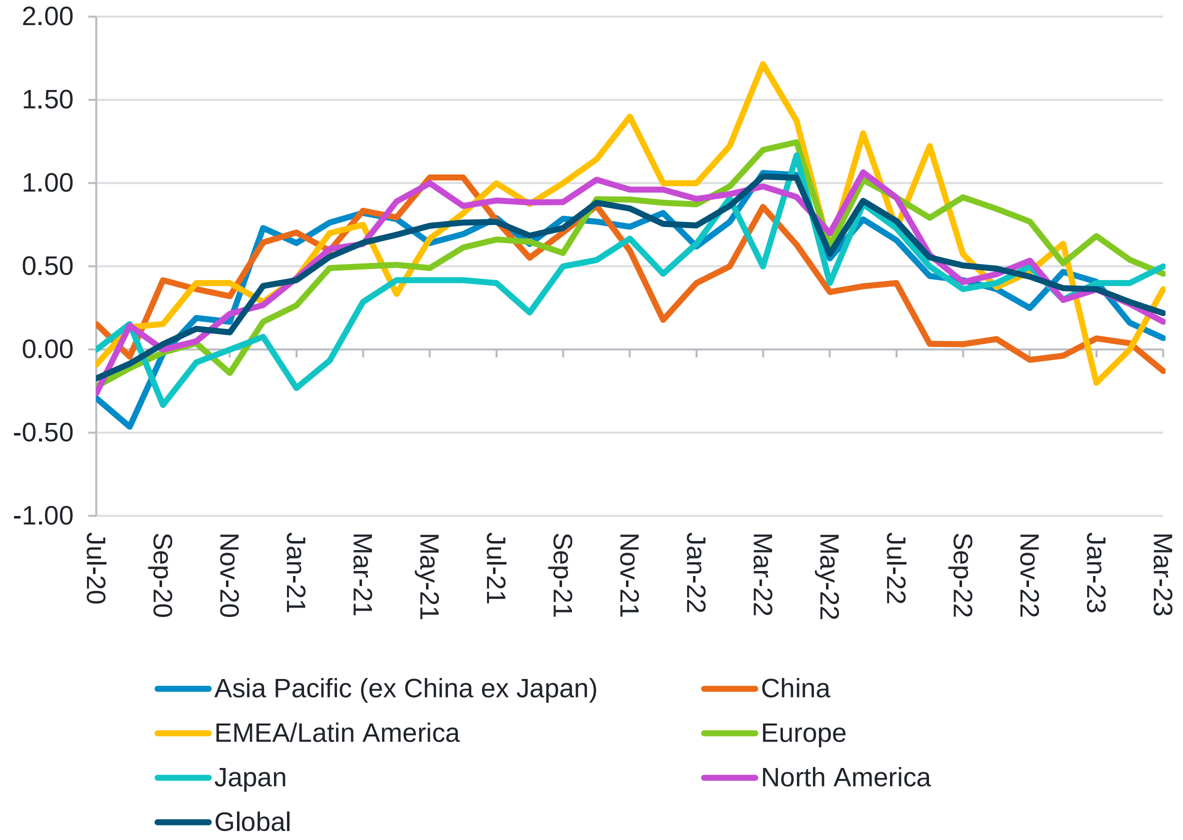


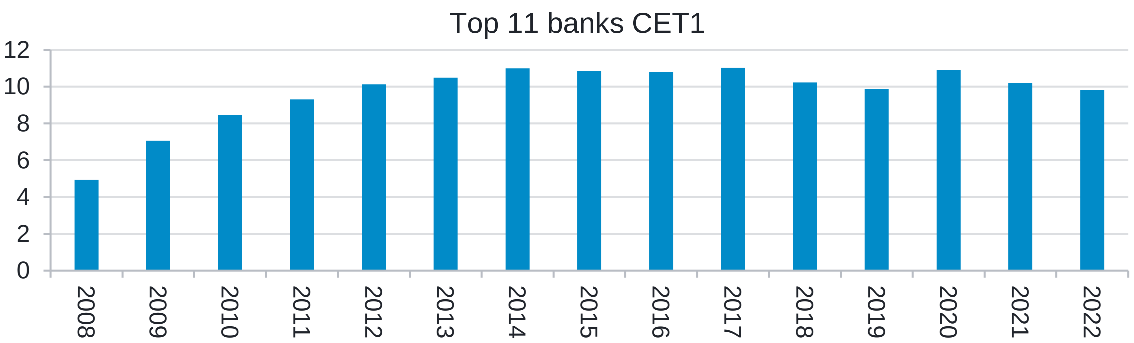
Chart shows proportion of responses reporting costs are increasing minus those reporting costs are decreasing; significant increases and significant decreases receive a higher weighting. Question: "What are your expectations for total non-labour costs over the next 6 months compared to current levels?"

Source; Fidelity International, March 2023

Is this Global Financial Crisis 2.0?

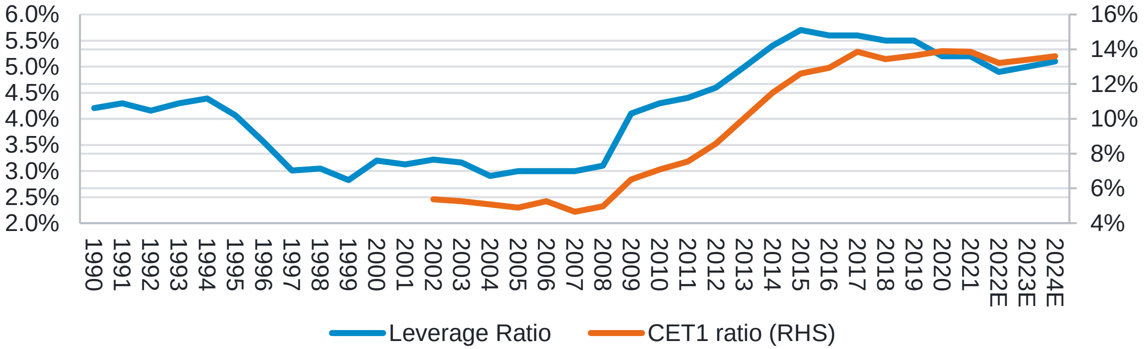
…..we don't think so, but the situation could deteriorate further

US banks' capital levels are twice those in 2008



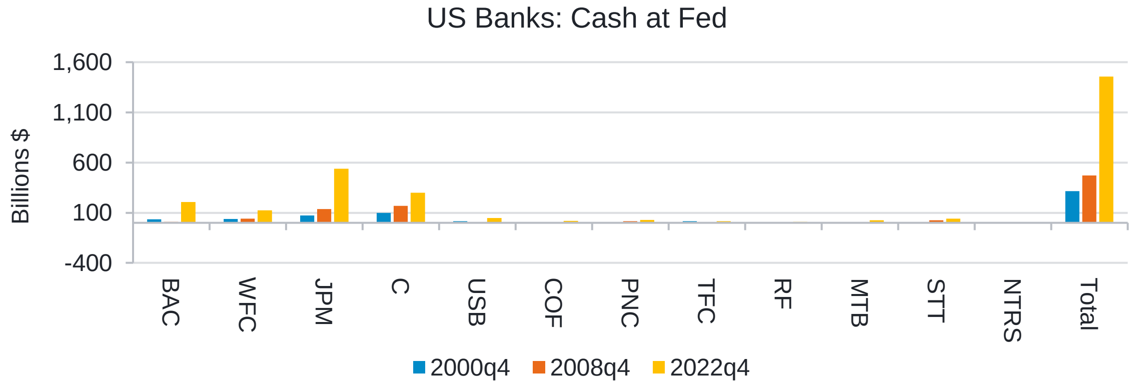
Source SNL Financial, 31st December 2022

European banks also exhibit stronger capital levels



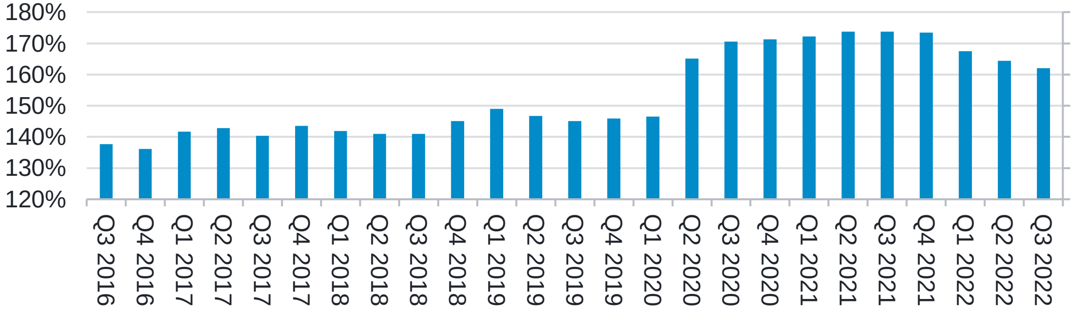
Source: SNL Financial, JP Morgan, 31st December 2022

US banks are much more liquid than before



Source: SNL Financial, JP Morgan, 31st December 2022

And liquidity... as illustrated by liquidity coverage ratios



Source: ECB, December 2022

Multi Asset

Multi Asset: Key takeaways

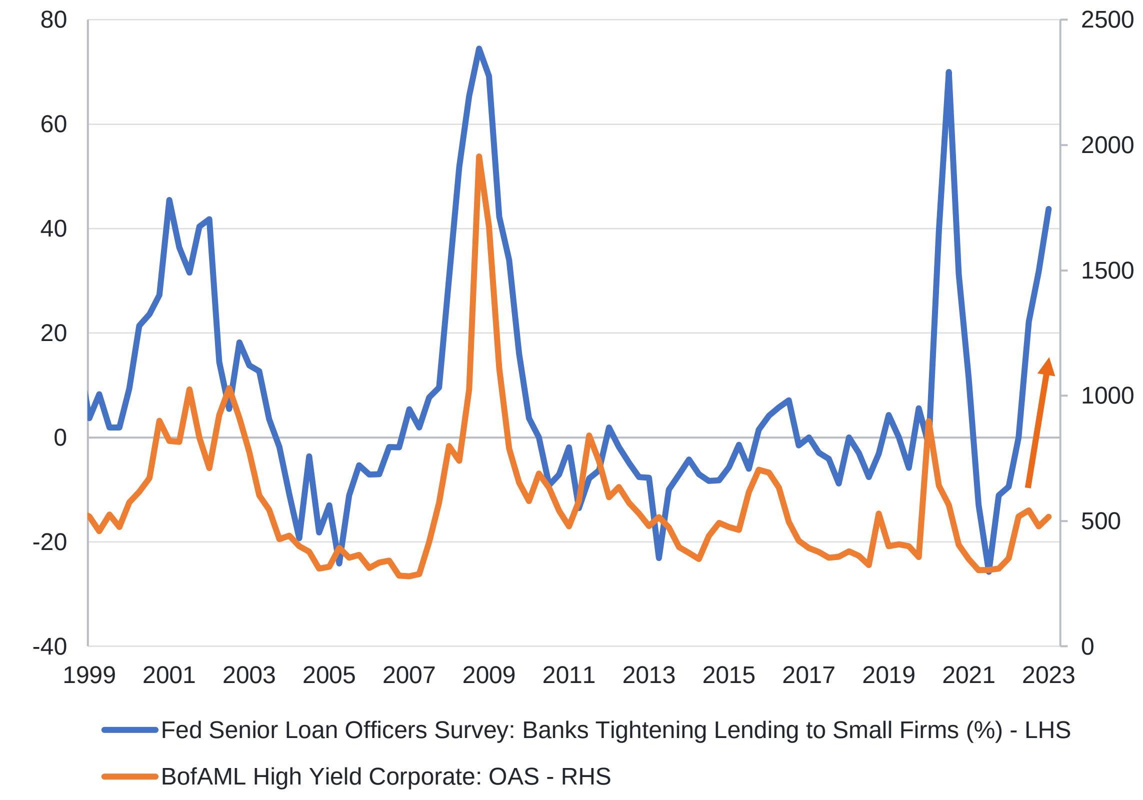
Solutions & Multi Asset key view	Reasoning	Investment implications
No 'Goldilocks': The inflation battle will continue but with growing divergence	Central banks are facing an increasingly high stakes trade-off between financial stability and controlling inflation. There is a growing divergence between different central bank policy that may present opportunities.	▪ Allocate away from corporate credit ▪ Maintain overall neutral duration across portfolio ▪ Prefer Gilts over Bunds and JGBs ▪ Avoid GBP ▪ Allocate to South African and Brazil local rates ▪ Tilt to US Renewables equities ▪ Avoid US Homebuilders equities
Banking crisis: Tighter financial conditions, possible credit crunch	Higher bank funding costs will accelerate the withdrawal of credit from the economy, raising the risks of a hard landing in the next 12-months. The regional banking crisis in the US is not yet contained and could still become a systemic problem.	▪ Cautious on US due to on-going banking stress ▪ Higher dollar funding costs are a headwind for EM FX ▪ Move up in quality across equities and credit ▪ Prefer IG over HY ▪ Allocate to min-vol equities ▪ Allocate to 'long equity volatility' strategies
China is resurgent	China is emerging from Zero Covid far faster than expected, accompanied by a broadening package of growth-positive policy announcements. Many other Emerging Markets are benefitting from falling inflation, peak monetary tightening, and attractive valuations. This may prove a potent mix.	▪ Allocate to EM equities over DM equities ▪ Allocate to local currency EM debt (currency hedged) over hard currency ▪ Allocate to Asia High Yield out of Europe, US HY ▪ Buy Thai Baht ▪ Buy Indonesia and China A-Shares equities

Source: Fidelity International, as of March 2023. 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.

The inflation battle will continue but with growing divergence

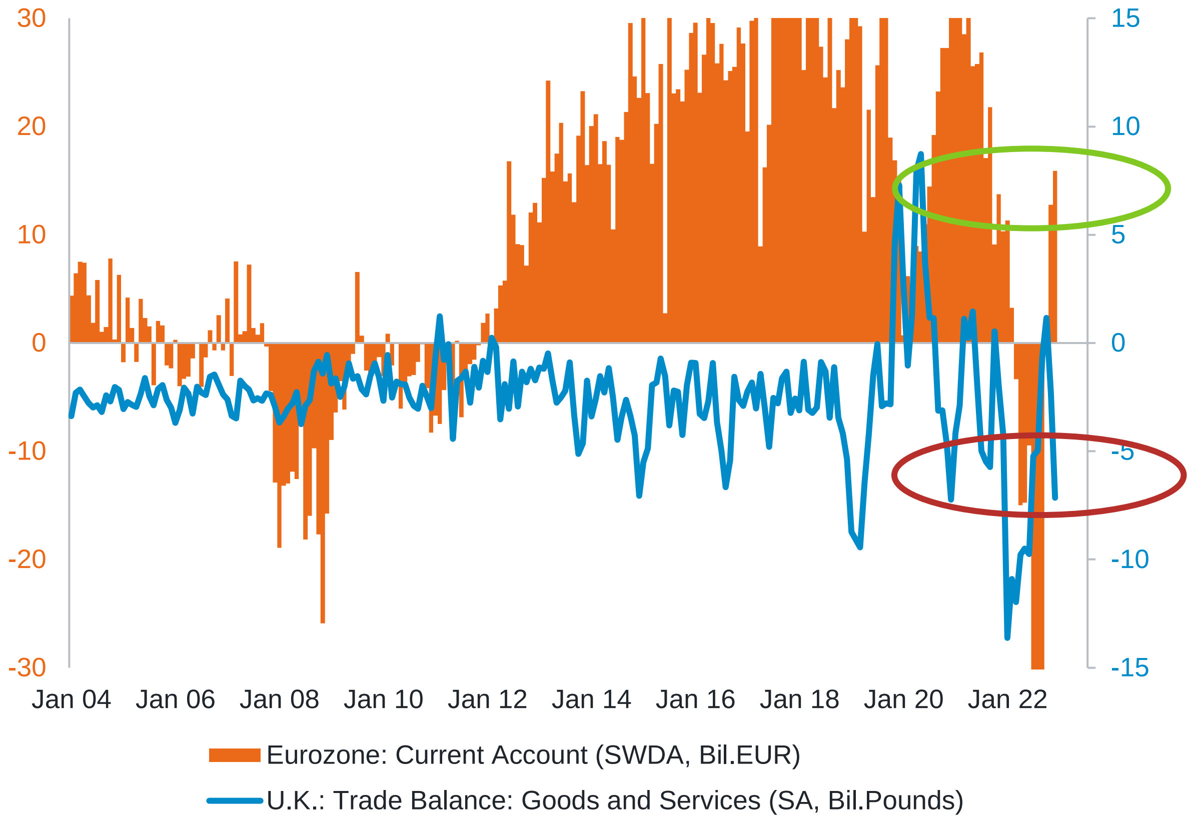
Remain cautious, expect credit to come under pressure before equities; avoid GBP

Allocate away from corporate credit: HY spreads not yet pricing the required tightening in financial conditions



Source: Haver Analytics, March 2023.

Avoid GBP: UK's chronic deficit remains, whereas the Eurozone's current account reverting back into surplus

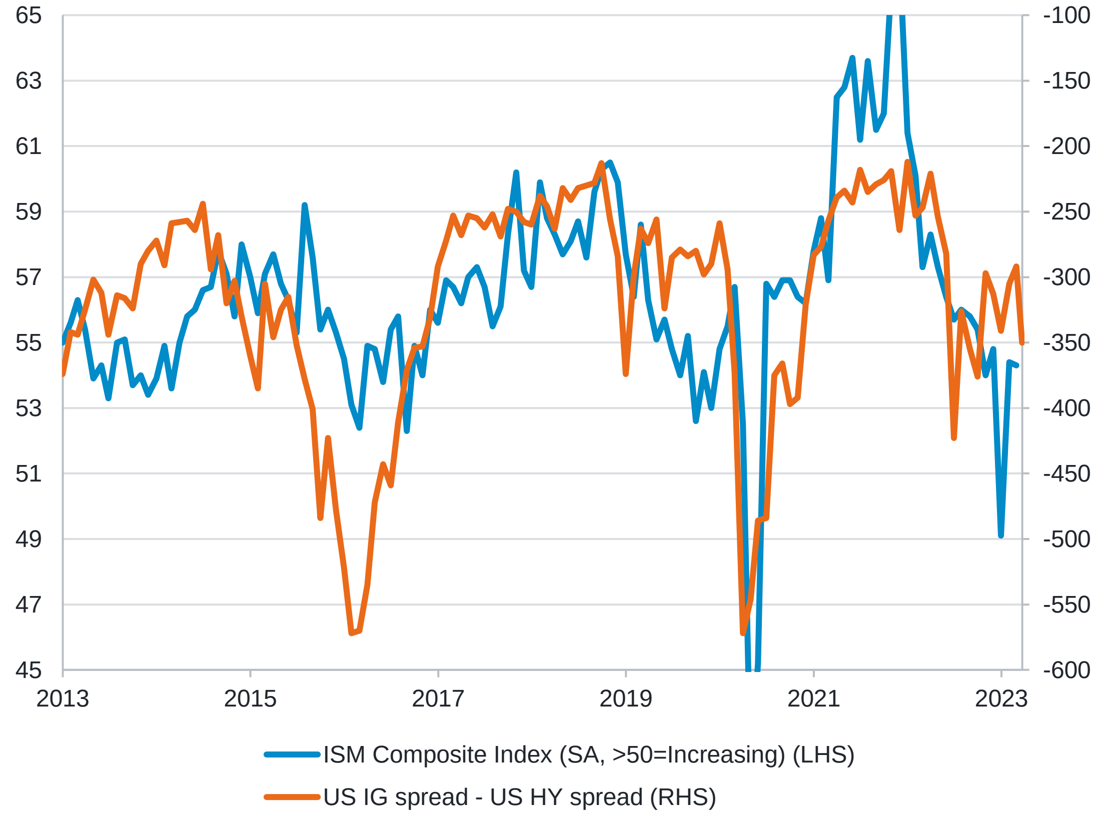


Source: National sources; Haver Analytics, February 2023.

Banking crisis: Tighter financial conditions, possible credit crunch

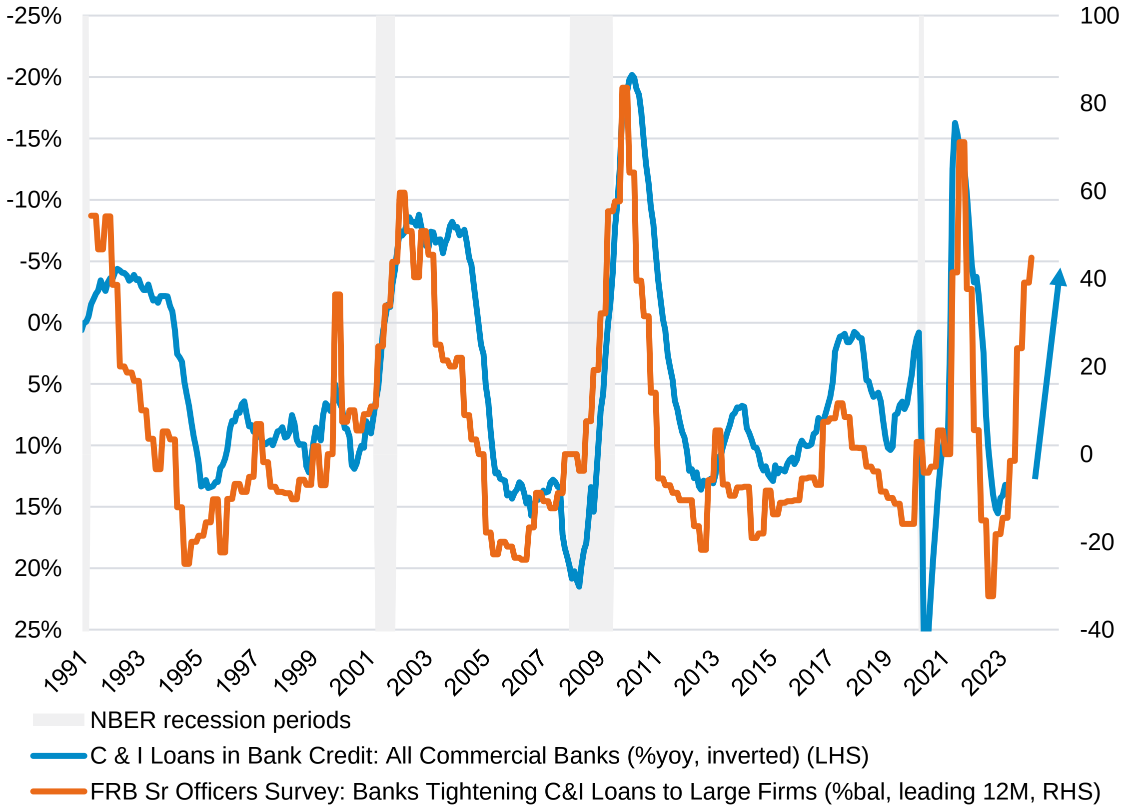
Prefer IG to HY for defensiveness; cautious on the US as lending likely to contract

Difference between US HY and IG spreads will likely widen further given higher risk of hard landing



Ice BofA indices. Source: Refinitiv, Fidelity International, March 2023.

Tighter lending standards in the US are likely to significantly reduce bank loans

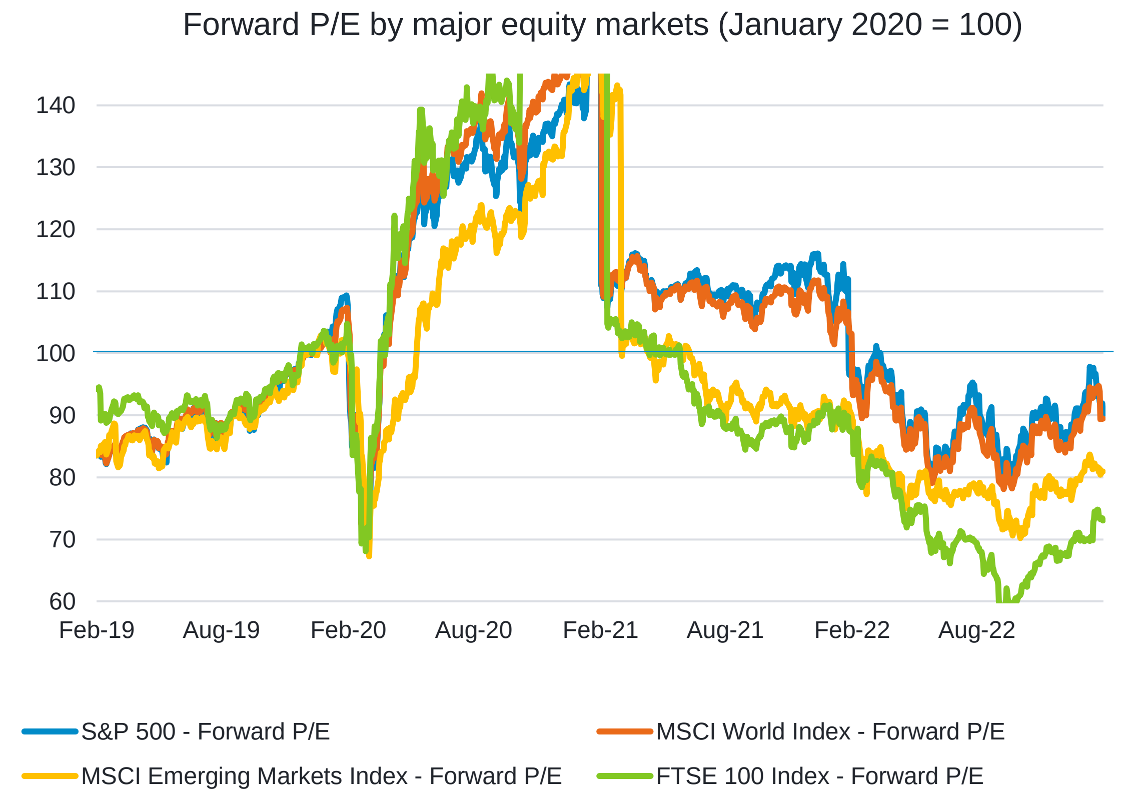


Source: National sources; Haver Analytics, February 2023.

China is resurgent

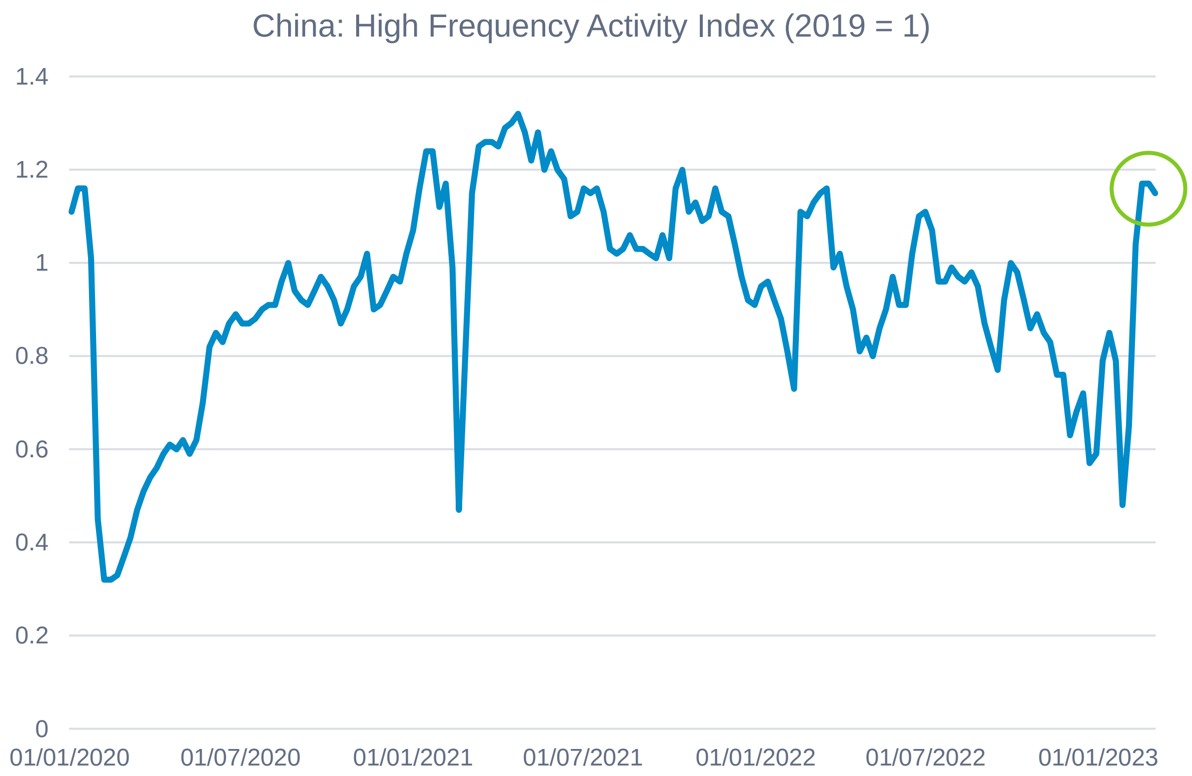
Prefer EM equities to DM equities, especially the US

The de-rating in US and DM equities is now very small compared to pre-COVID, leaving EM and FTSE 100 more attractive



Source: Bloomberg, January 2023.

China's rapid normalisation and stimulative policy stance makes us positive on cheap Emerging Market equities



Source: Haver Analytics, March 2023. The Yicai HFEAI tracks congestion, subway usage, home sales etc.

Our asset allocation views at a glance

Equity region

	View	Change	Rationale
US	○●○○○	–	The US economy is slowing from a high level. However, the recent banking sector turmoil could further tighten financial conditions.
Europe ex. UK	○○●○○	–	Activity continues to recover. However inflation is still high and sticky. Banking sector uncertainty could tighten credit conditions.
UK	○○○●○	–	The internationally focused large cap index is cheap on a range of valuation metrics.
Japan	○○●○○	–	Manufacturing activities are impacted by slowing global activity and cost pressures, albeit the service sectors are supported by tourism related reopening demand.
Emerging markets	○○○●○	–	The China re-opening should continue to support the region. However, USD flows could impact short-term EM performance.
Asia-Pacific ex. Japan	○○●○○	–	The region could benefit from China reopening and the associated trade and commodity demand in 2023.

Credit

	View	Change	Rationale
Investment grade (IG) bonds	○○○●○	–	Given the recent banking stress, we prefer to stick to our defensive bias, even though spreads have widened meaningfully.
Global high yield	○●○○○	–	We maintain our cautious view on HY vs IG given deteriorating rating trends and tightening lending standards.
Emerging market debt (EMD, hard currency)	○○●○○	–	China reopening helps with EM fundamentals, but recent risk-off sentiment and tightening dollar liquidity could hurt near-term performance.

Government bonds

	View	Change	Rationale
US Treasuries	○○○●○	▲	Tighter lending standards mean that US hard landing risks have increased. We therefore prefer nominal rates to TIPS.
Euro core (Bund)	○●○○○	–	Fundamentally, the Euroarea is likely to end up with higher inflation and a more hawkish central bank than either the US or UK.
UK Gilts	○○○●○	–	Recent data has provided some positive news on inflation and there are signs of labour market slock. The BoE has a dovish bias despite the recent hike.
Japan govt bonds	○●○○○	–	A new era dawns at the BoJ. We continue to believe that the current YCC policy is unsustainable.
Inflation linked bonds (US TIPS)	○○●○○	▼	The banking crisis has raised the risks of a disinflationary hard landing coming sooner and being more severe than previously expected.

FX

	View	Change	Rationale
USD	○○●○○	–	USD is typically a risk-off asset. However the banking sector stress means the outlook is mixed.
EUR	○○○●○	–	Rate differentials look positive for the euro given the relatively hawkish outlook for the ECB, although things have been complicated by banking stress.
JPY	○○○●○	–	JPY is cheap and we see optionality from hard landing risks as global rate differentials compress.
GBP	○●○○○	–	The BOE remains one of the more dovish central banks, despite the hike in March.
EM FX	○○●○○	▼	Tighter financial conditions as a result of banking stress are a headwind for EM FX.

Source: Fidelity International, as of March 2023. Change reflects directional difference in view versus previous month. Views reflect a typical time horizon of 12–18 months and provide a broad starting point for asset allocation decisions. However, they do not reflect current positions for investment strategies, which will be implemented according to specific objectives and parameters.

Equities

Equities: Key takeaways

We remain cautious on global equities

- Market volatility remains high amid ongoing uncertainty over the future path of the global economy/interest rates.
- Potential tail risks could send markets even lower if left unchecked. Silicon Valley Bank's collapse has led to deposit outflows from regional banks and tighter financial conditions. The crash of Credit Suisse has increased fragility in the European banking sector.

Earnings are set for a correction

- Expect an inflection point in earnings this year amid recessionary fallout for top line earnings growth, an inflationary hit on costs and higher borrowing rates resulting in greater interest expense.
- Companies have begun to give more cautious guidance, with sectors, like consumer discretionary, beginning to issue profit warnings.
- However, readjustment of earnings expectations in the months ahead can turn caution into opportunity.

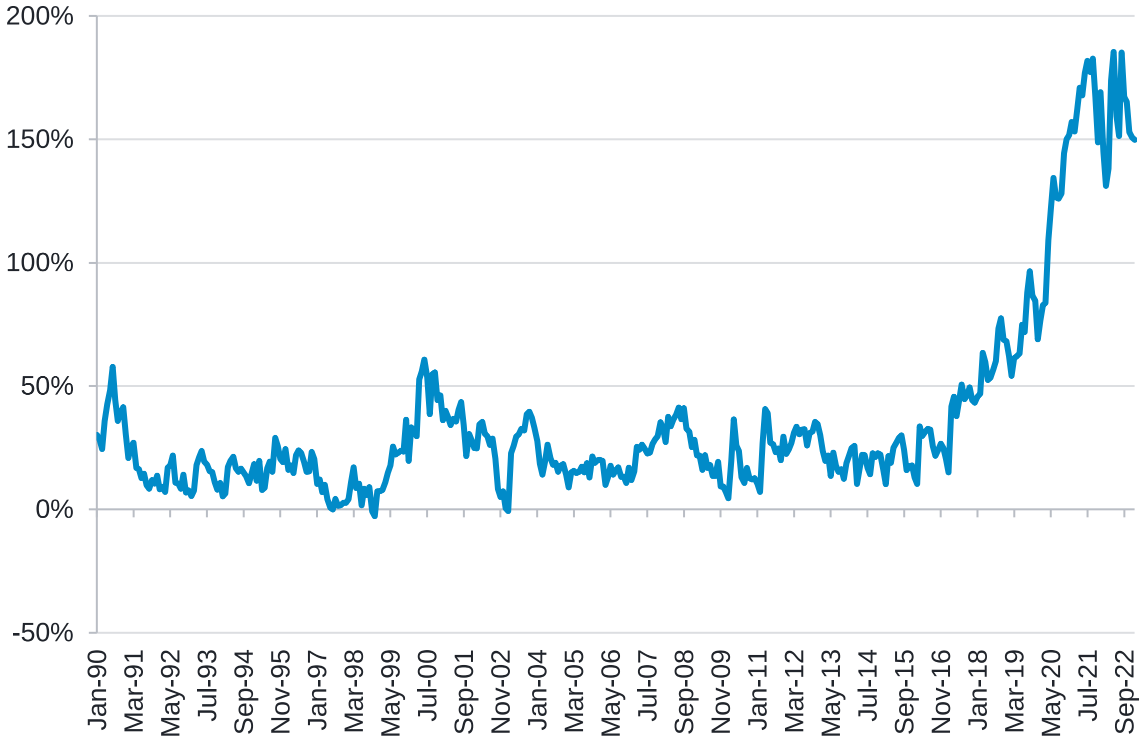
Diverging regions create selective entry points

- US - earnings woes remain, driven by multiple compression, with a strong labour market weighing on margins. However, corporates remain higher return prospects, given the effects of a strong domestic competitive environment.
- Europe - tightening financial conditions to have a negative impact on earnings prospects for European companies as well.
- China - improving corporate earnings are likely to take over from cheap valuations as the main driver in the next stage of the rebound.

Valuation gaps leave ample room for stock picking once volatility calms down

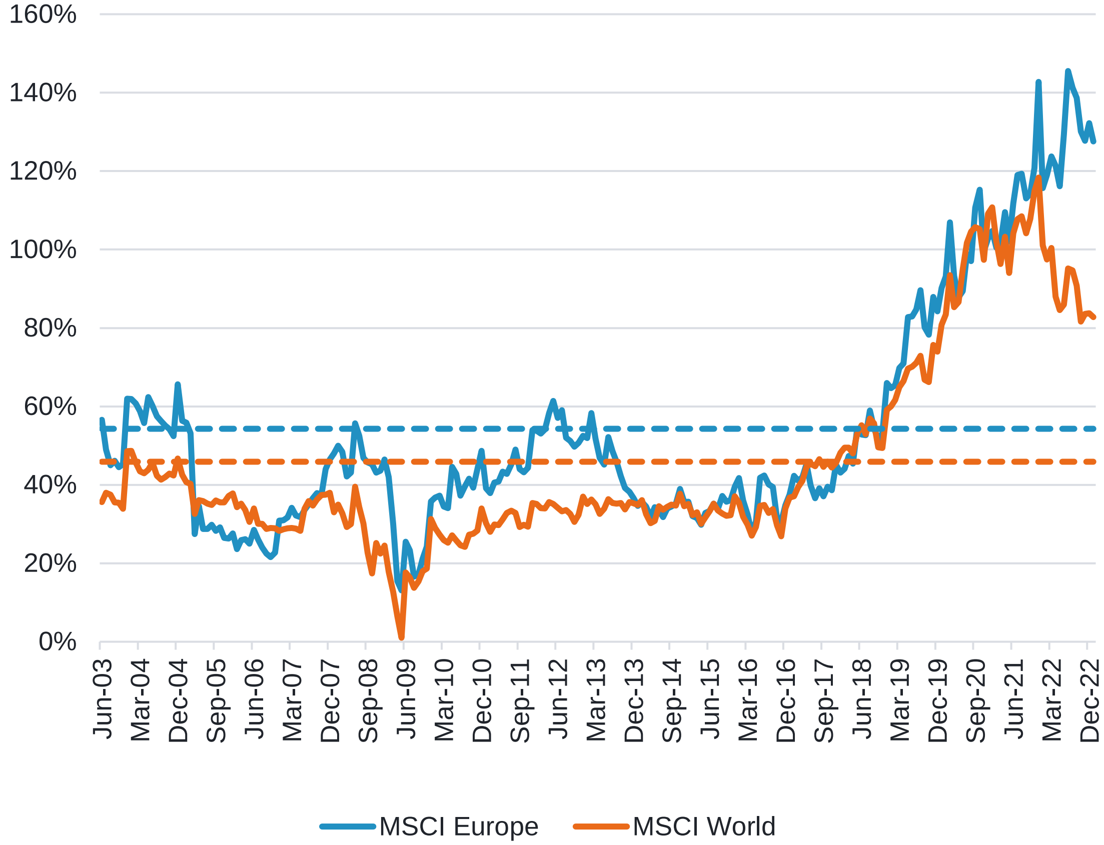
Valuation gaps already narrowing globally (US) but still near peak in Europe

Premium of most vs least expensive (based on FCF, sector neutral basis)



Source: Exane BNP Paribas estimates, January 2023

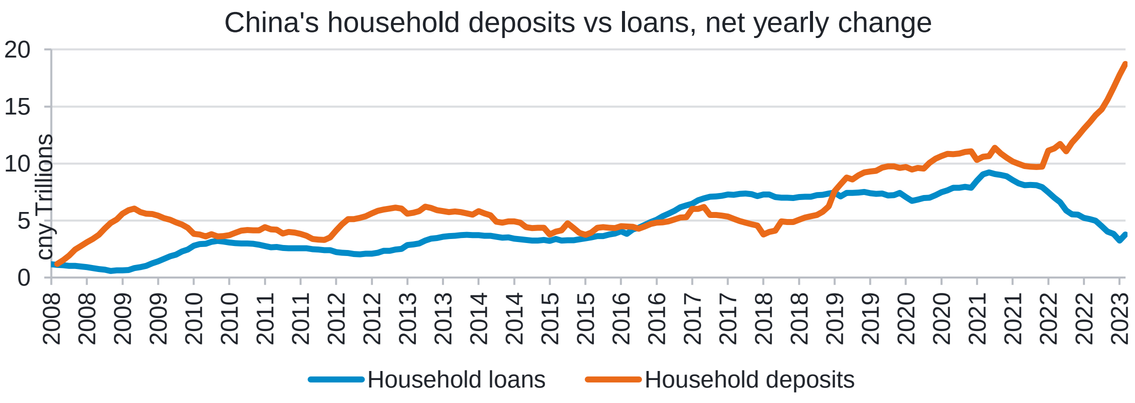
12m forward P/E premium (Growth vs Value)



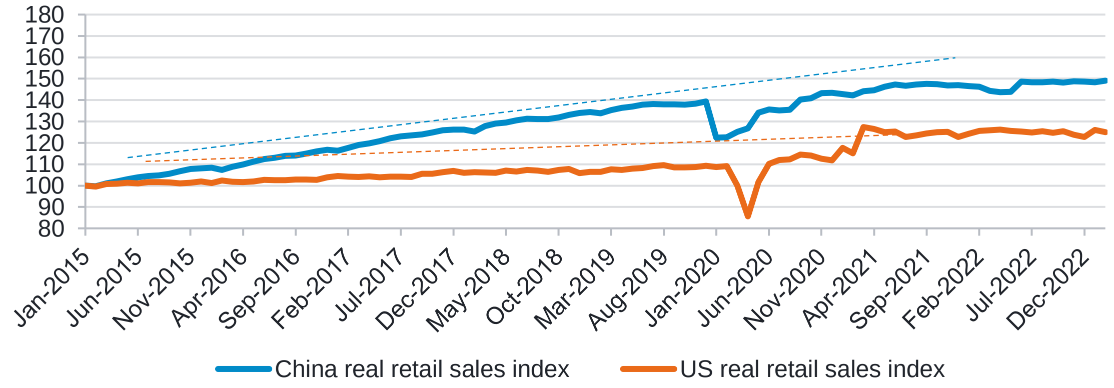
Source: FactSet, January 2023

China - Consumption will likely continue to lead recovery

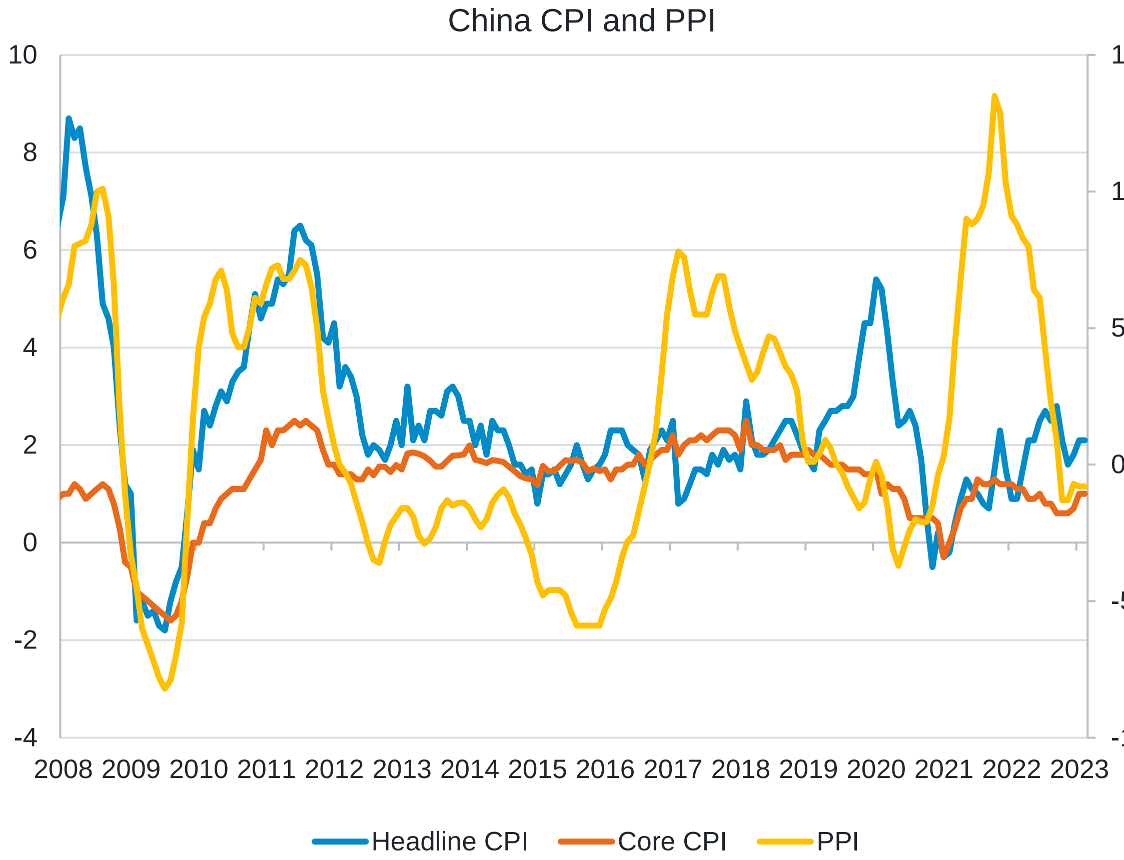
Consumption recovery will stay strong in H1, supported by savings and possible policy easing, but long-term sustainability of the recovery depends on the policy settings and households' income expectations



Source: Bloomberg, Fidelity International, March 2023



Source: Bloomberg, Fidelity International, March 2023

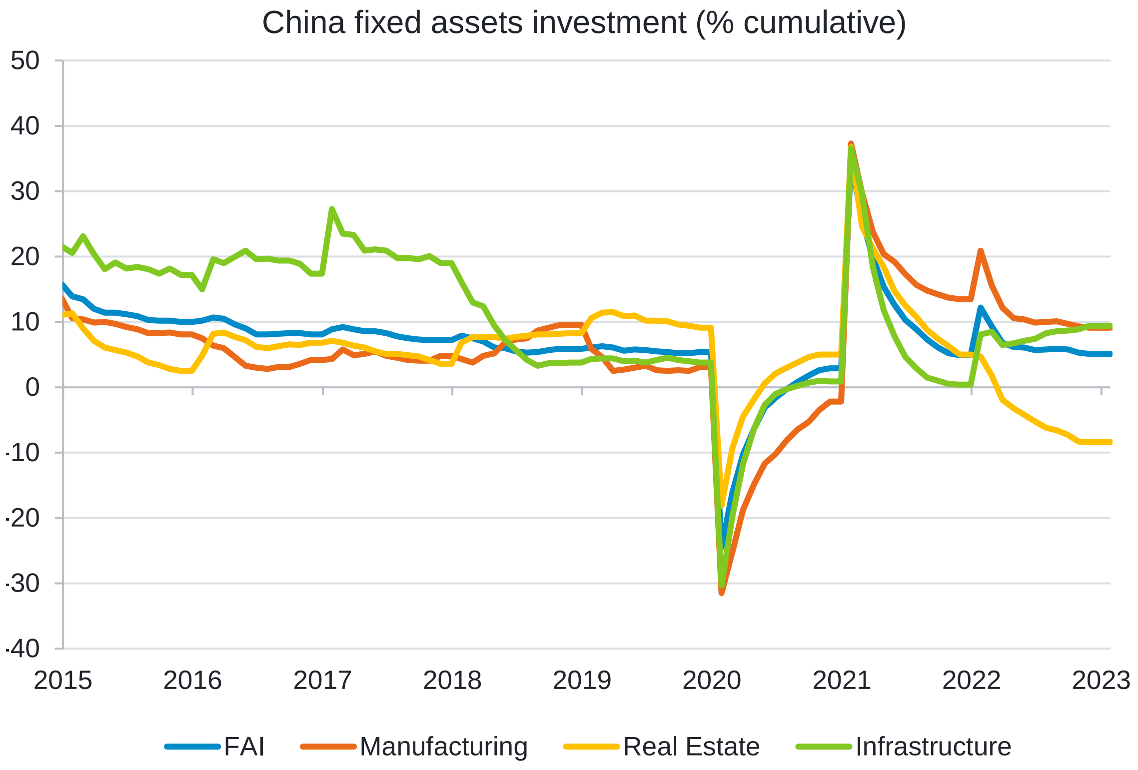


Source: Bloomberg, Fidelity International, March 2023

China - Long term growth will pivot from property-driven to “high-quality growth”

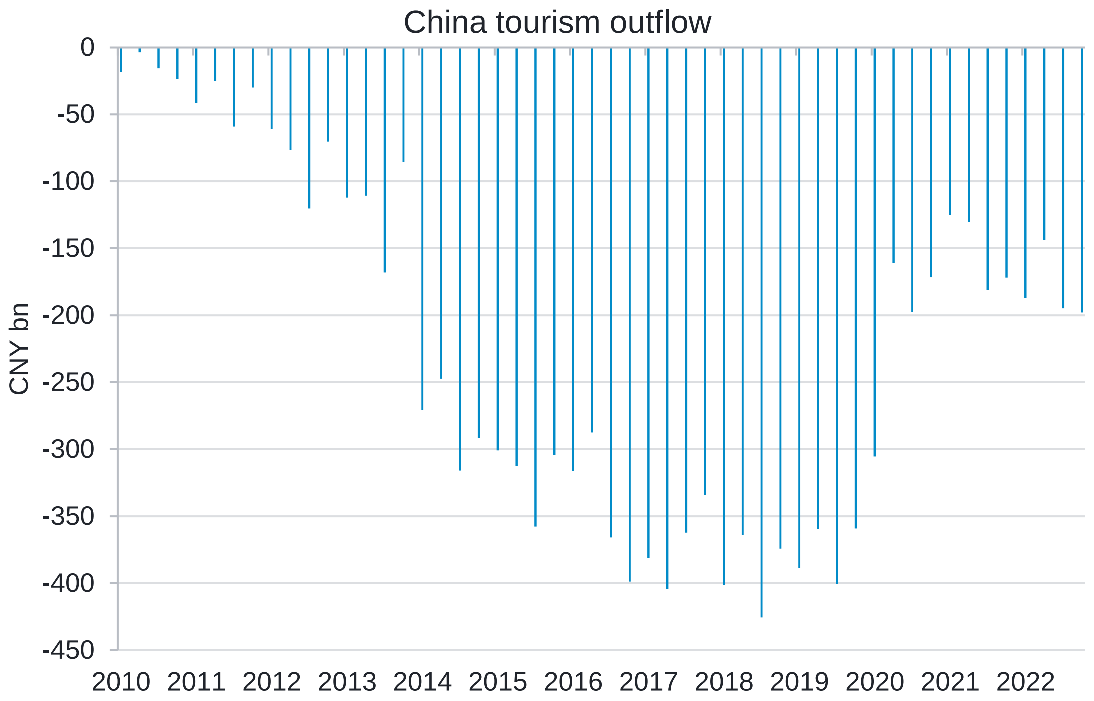
The shift away from relying on property sector to boost growth is clear, but in the short-term property sector stabilisation is still crucial for China to move towards the new growth model.

Fixed assets investments indicate the shift in growth priorities



Source: Bloomberg, Fidelity International, March 2023

Global implications will be different: less commodities driven, more consumer and manufacturing sectors growth



Source: Bloomberg, Fidelity International, March 2023

Fixed Income

Fixed Income: Key takeaways

Time to be defensive

- Investors should prioritise protection in this recessionary environment. We favour IG bonds, where investors at least get some risk premium as protection for any default risk.

Long US and EU duration

- Europe and the US are on the brink of recession. We believe the Fed and the ECB will need to pivot at some stage (which includes ending QT), meaning US Treasuries and Bunds should find support. Now is the time to add interest rate risk by adding duration.

High yield (HY) not offering enough recession protection

- The risk of a hard landing is not yet fully priced into HY spreads. Credit conditions are tightening, the weighted average cost of capital is increasing. High yield bonds offer high all-in yields, but spreads still don’t provide adequate protection for a hard landing.

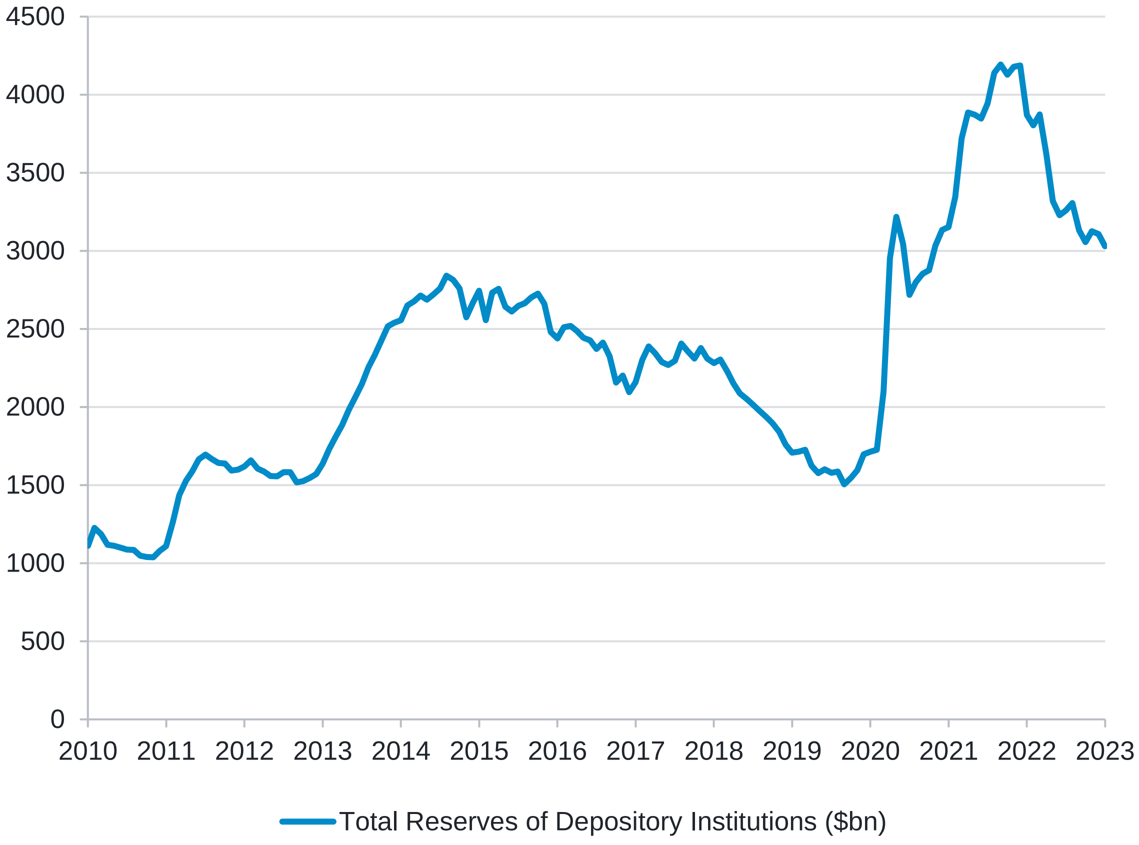
The saving grace is that there is no immediate refinancing cliff

- Companies termed out their debt and refinanced at low rates, so there is no immediate refinancing cliff before 2025. However, at the margin there will be companies that do need to refinance and this will be expensive.

Bank reserves have fallen significantly

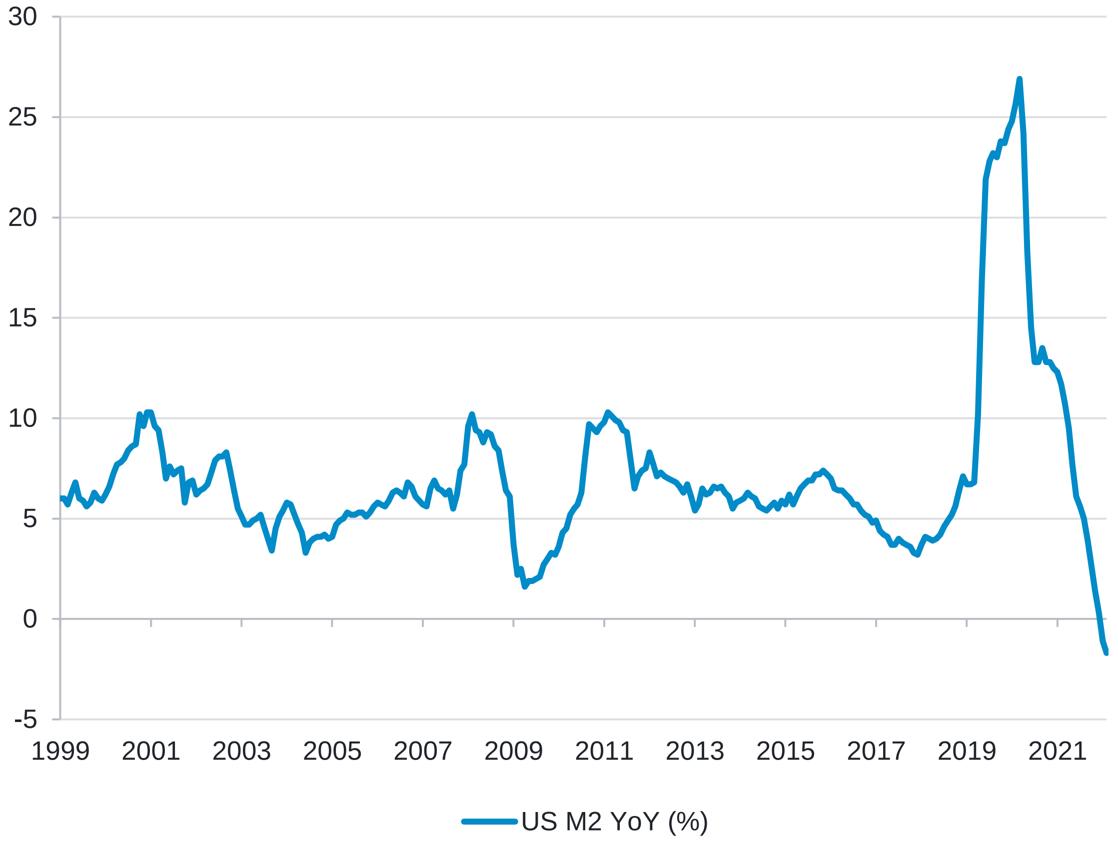
High powered money is declining as deposits have fallen. Meanwhile the cost of capital in increasing.

Falling trend in US bank reserves



Source: Fidelity International, Federal Reserve, as of 1 January 2023.

US M2 growth is now in negative territory

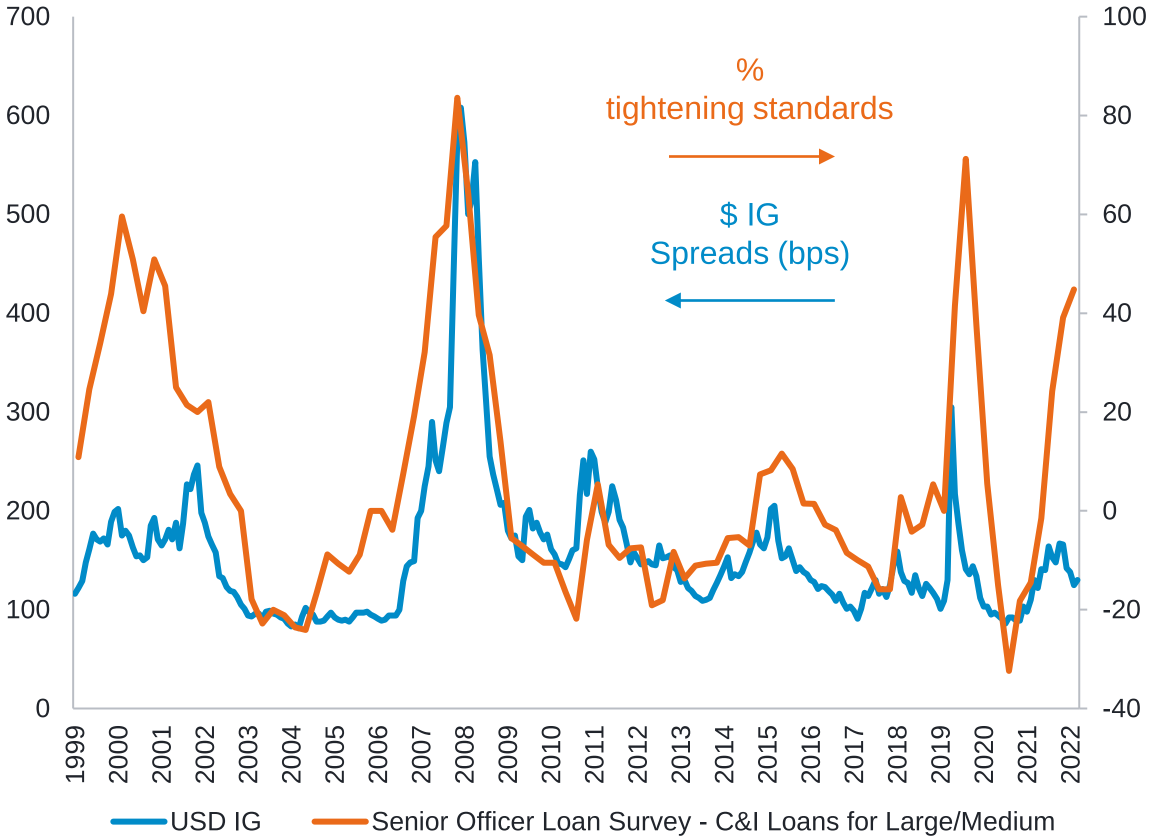


Source: Fidelity International, Bloomberg, 31 January 2023.

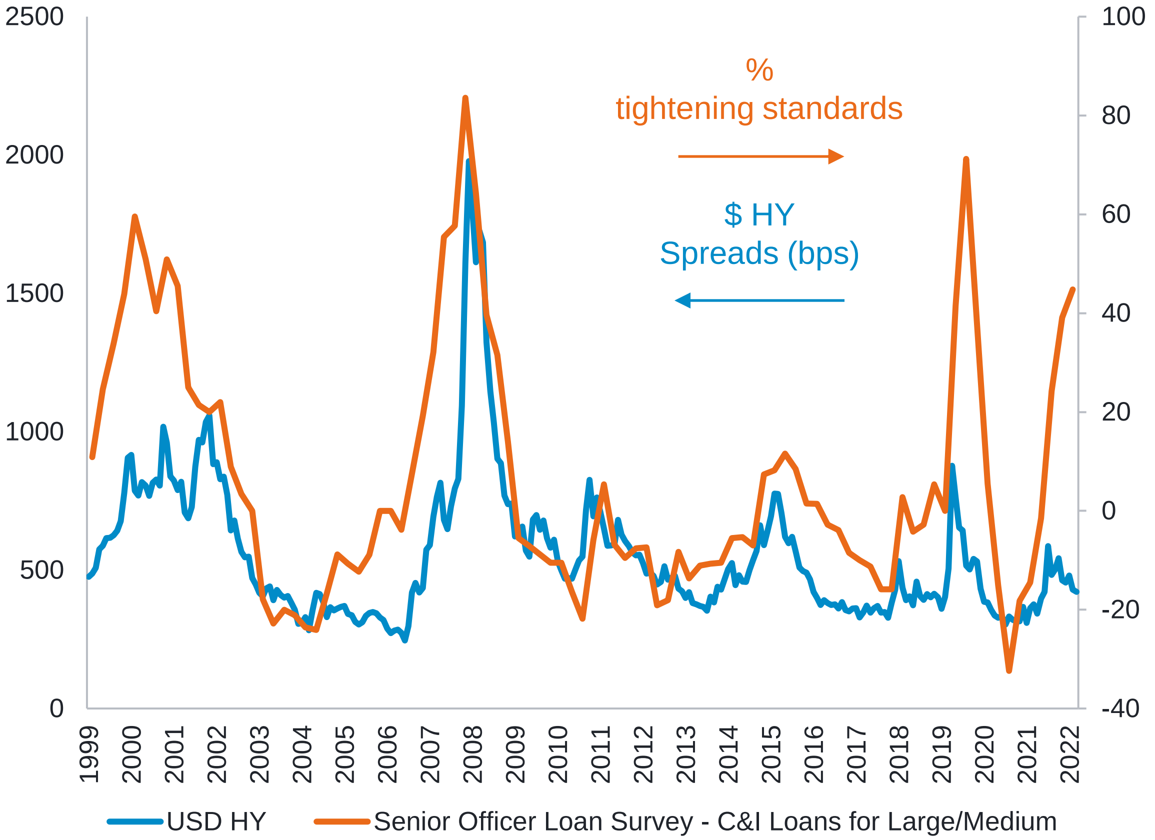
Senior Officer Loan Survey shows tightening credit conditions

Yet spreads across IG & HY indices show no sign of widening

US senior loan officer survey for large corps vs US IG spreads



US senior loan officer survey for large corps vs US HY spreads

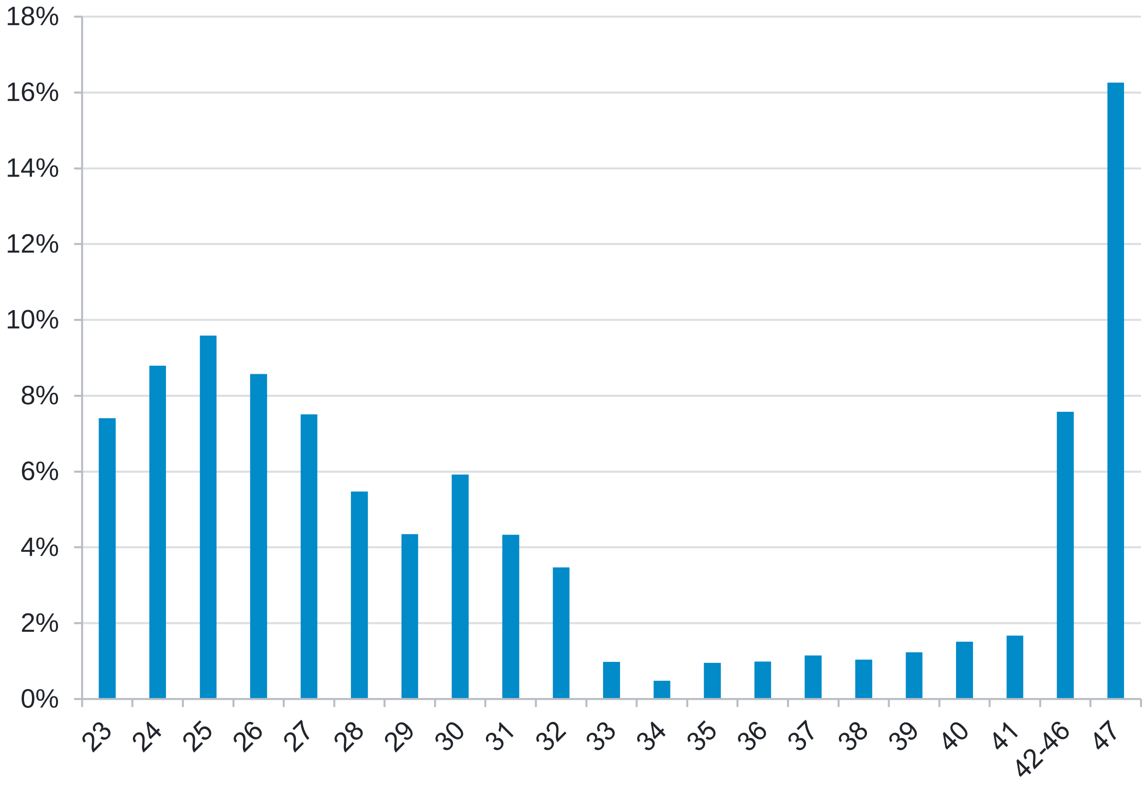


Source: Fidelity International, Bloomberg, 28 February 2023. USD IG = C0A0, USD HY = H0A0. Net % of domestic respondents tightening standards for C&I Loans for Large/Medium used.

The maturity wall for US corporates starts hitting from 2023-25 – but thankfully no immediate refinancing cliff

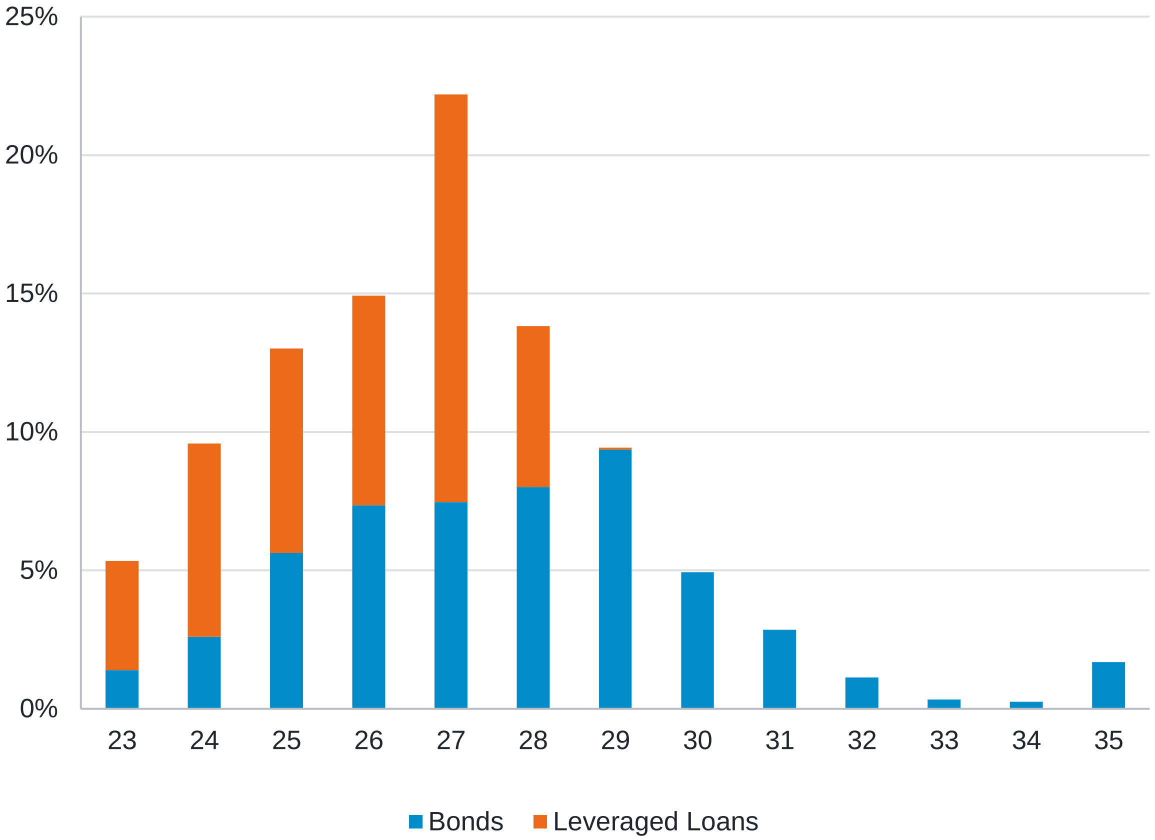
The maturity wall for HY corporates reaches its nadir in 2027

USD IG bond maturity wall % total market value



Source: Fidelity International, GS, 31 December 2022.

USD HY bond maturity wall % total market value



Source: Fidelity International, GS, 31 December 2022.

Private Credit

Private Credit: Key Takeaways

Valuations suggest longstanding resilience

- Private debt less impacted by dichotomy of hard vs soft landing – both suggest challenges, but even in the hardest landing scenario, product retains protections at the most senior secured position of the capital structure, while floating rate nature mitigates impact of a volatile rates backdrop
- Market technicals suggest there's no steep uptick in returns for taking an aggressive position – rather cautious credit selection remains key

Under pressure, but not to breaking point

- While we anticipate default rates will increase, these are likely to be limited. Ratings downgrades - and therefore a greater dispersion of ratings – expected
- Borrowers facing higher debt servicing costs than typical, and even as input costs have fallen, wage pressures persist to weigh on earnings
- Competing against an increasingly attractive cash market

Strong, well-positioned market fundamentals

- Refinancing wall in the near term is being chipped away. The loan market has found solutions for some of the chunkier and more complex upcoming maturities. Around €47.8B of debt maturing before 2026, of which €19.5B is rated single B or below
- Sectors that dominate private debt have limited exposure to Russia or inflated energy prices
- Europe enjoying economic tailwinds from China reopening and remains attractive for long term investors given current valuation entry point, more mature borrower profile, and reduced exposure to subsectors now undergoing stress

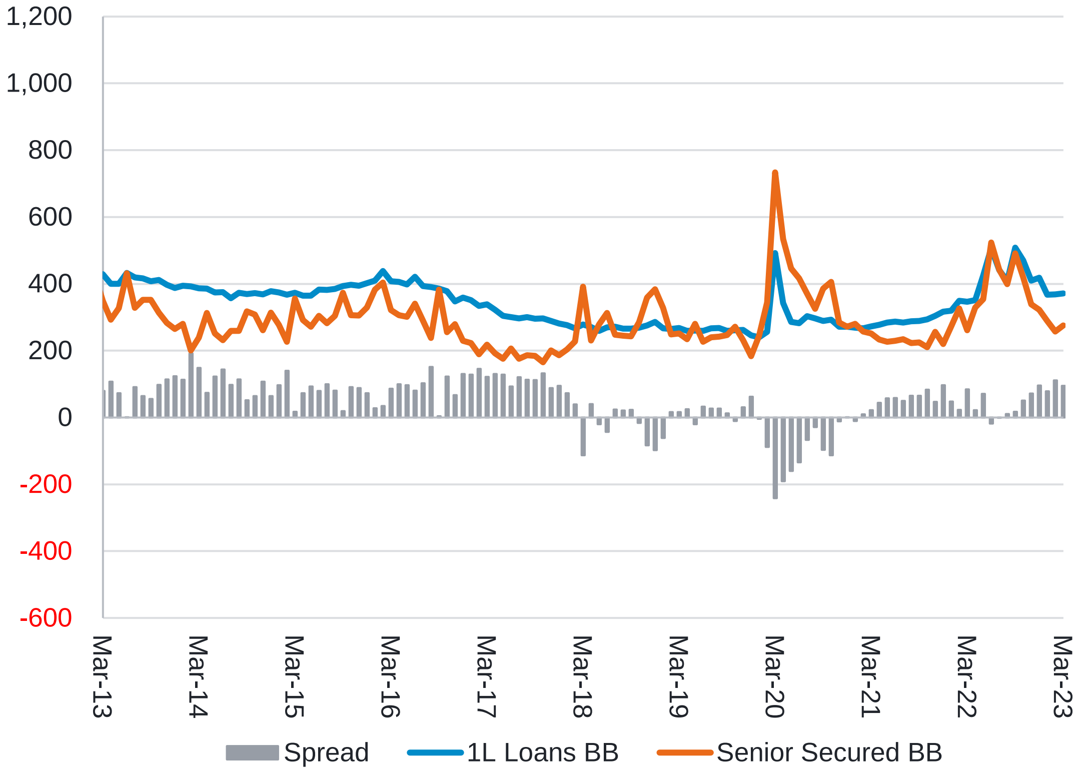
Outlook only limited by supply

- Pipeline of largescale leveraged buyouts curtailed primarily by the mismatch in valuations between buyers and sellers
- This limits the new issue supply available to ramping CLOs, which in turn rely upon the secondary market to source assets.

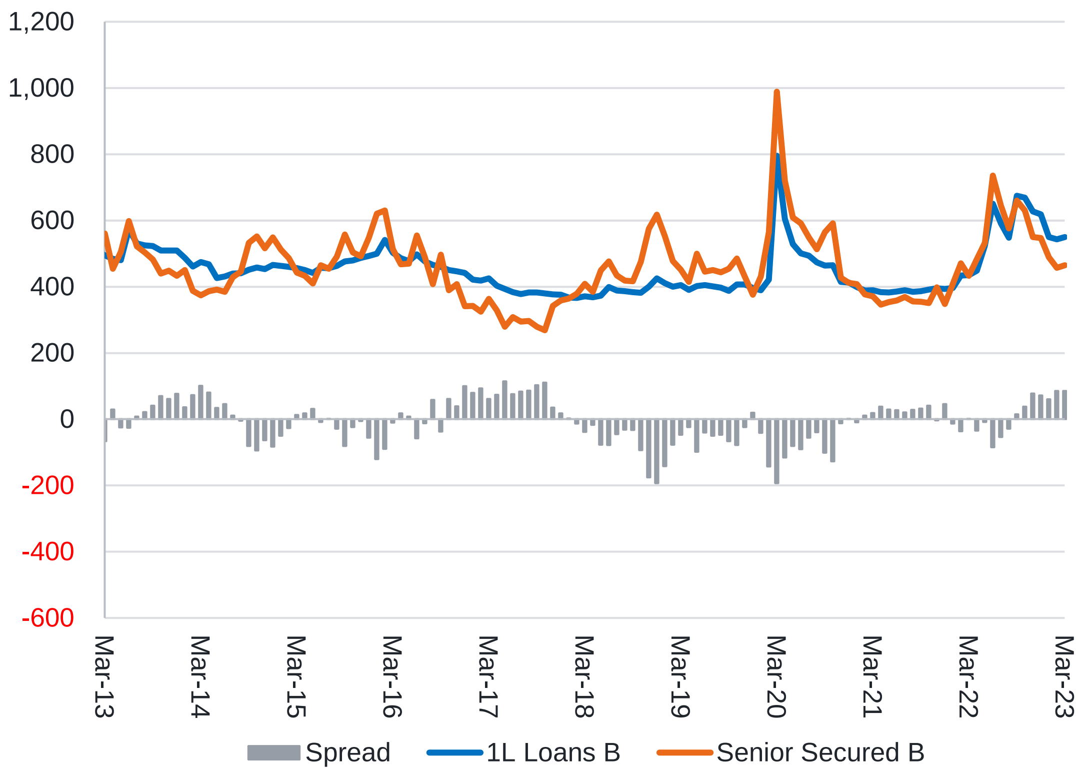
Loans continue to offer a premium to high-yield bonds

Adjusted for ratings and seniority, loans continue to be more attractive on a relative basis. But the story goes further than just the margin on offer: the loan market is less volatile, more likely to be covenanted (in the case of direct lending), and PE sponsors have demonstrated willingness to support stressed borrowers

EUR Loans vs HY - Senior Secured - BB



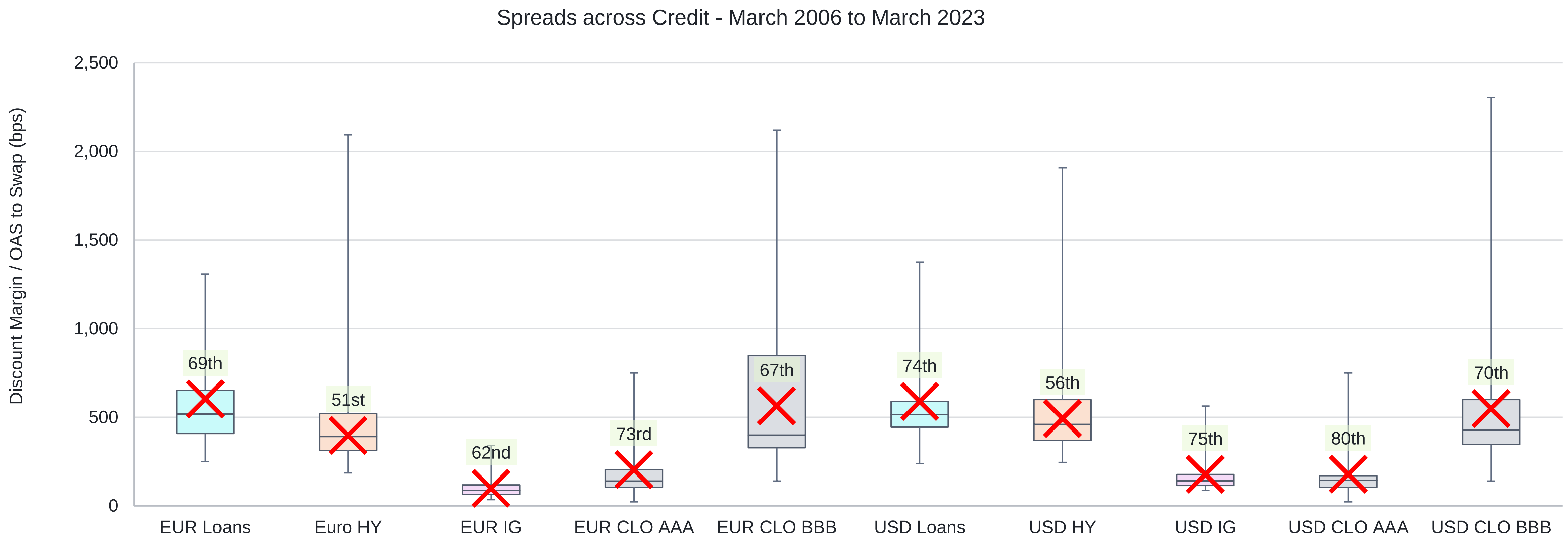
EUR Loans vs HY - Senior Secured - B



Source: Credit Suisse Western European Leveraged Loan Index, EUR only; ICE BofA High Yield; Bloomberg; Fidelity International, March 2023

Spreads across European loans attractive versus other asset classes

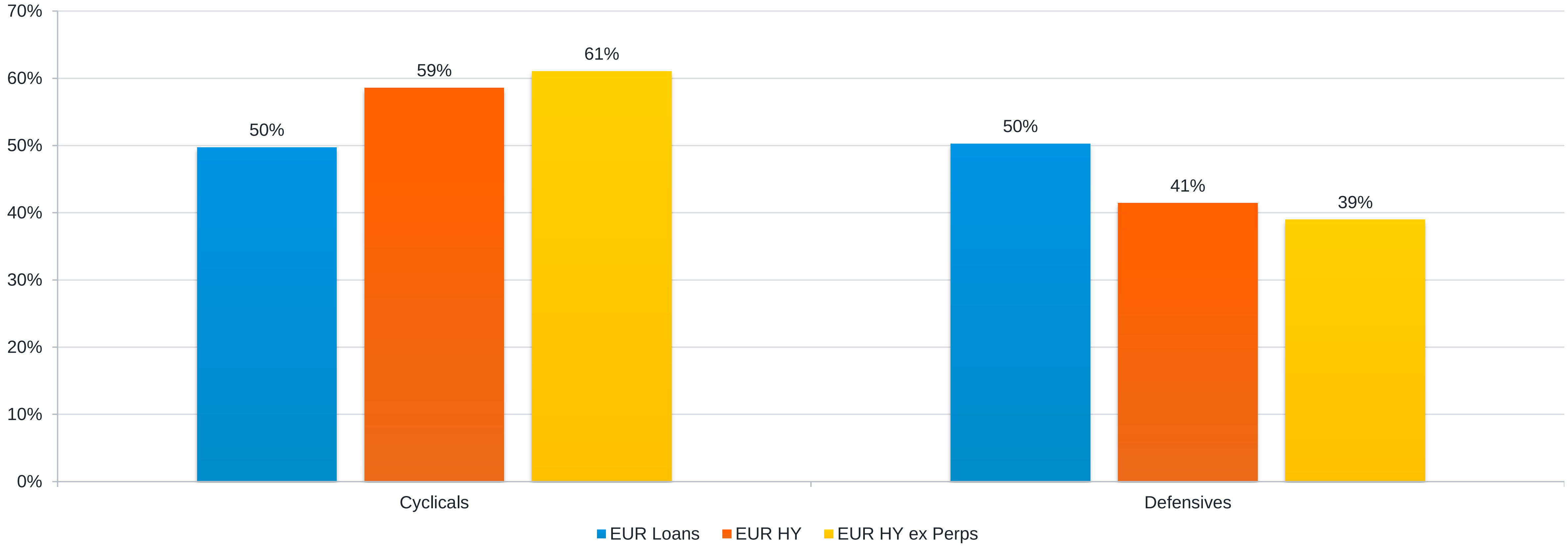
With current discount margin in the European loan product current around the 69th percentile, the product offers a great deal of value versus historical averages



Source: Credit Suisse Western European Leveraged Loan Index, Eur only, discount margin to maturity; Credit Suisse Leveraged Loan Index, discount margin to maturity; ICE BofA Euro High Yield, OAS to Swap (OAS to Gov for 2006 & 2007); ICE BofA US High Yield, OAS to Swap (OAS to Gov for 2006 & 2007); ICE BofA Euro Corporate Index, OAS to Swap (OAS to Gov for 2006 & 2007); ICE BofA US Corporate Index, OAS to Swap (OAS to Gov for 2006 & 2007); JPM Secondary Discount Margins for pre-crisis CLOs; Citi Secondary Discount Margins for post-crisis CLOs; Fidelity International, March 2023

Underlying sectors of private debt world relatively strong

Euro loans remain defensively titled compared to High Yield



Source: Credit Suisse Western European Leveraged Loan Index, Eur only; ICE BofA Euro High Yield. Defensive/Cyclical split based on Credit Suisse sector type classifications; Fidelity International, March 2023

Real Estate

Real Estate: Key takeaways

H2 22 re-pricing provides good foundation for sector

- A soft landing scenario is a 'goldilocks' scenario for real estate. The recent re-pricing should provide a good foundation for attractive performance, driven by a combination of attractive yields (now at least 100 bps higher than in Q2 22), rental value growth and ongoing indexation of rents.

Sustainability provides opportunities

- An acute shortage of supply and an abundance of demand for sustainable buildings is supporting a large 'green' premium. High energy costs and corporate Net Zero Carbon targets are focusing occupiers attention on the energy efficiency and carbon footprint of their real estate, while SFDR is focusing investors attention on the environmental qualities of their portfolios

A hard landing exposes a number of ongoing risks

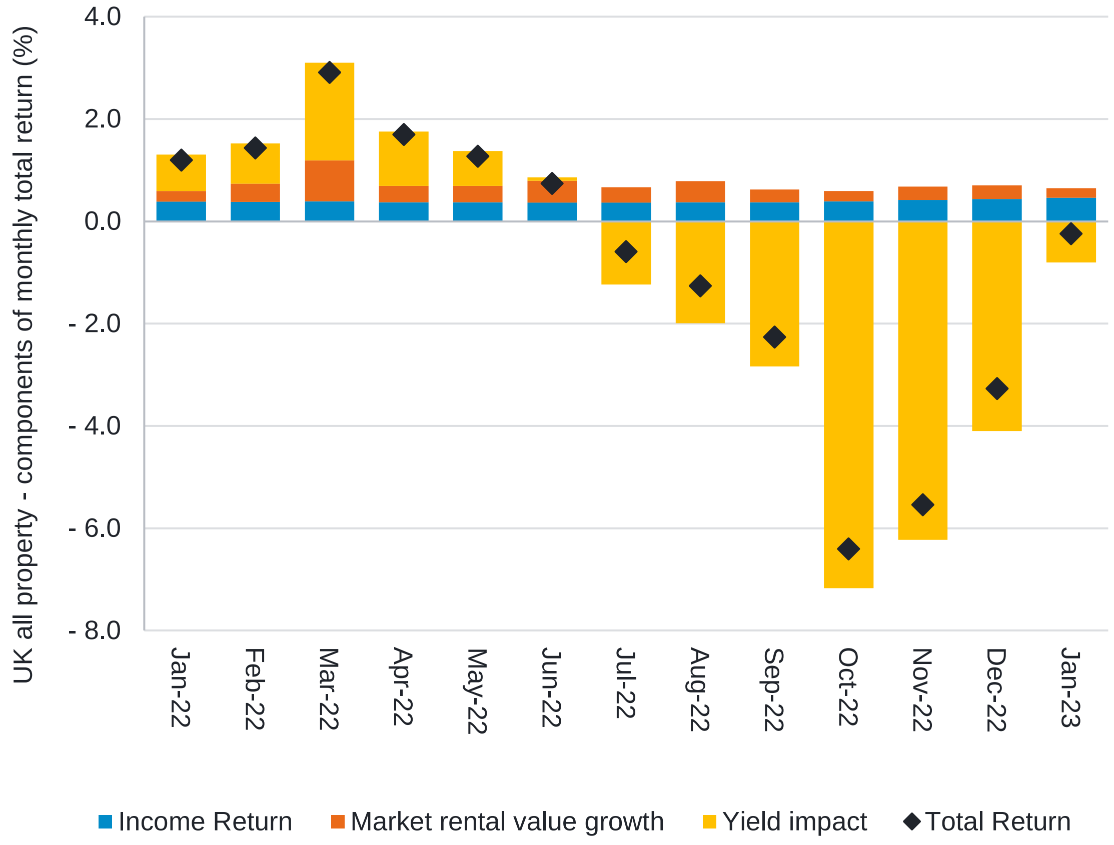
- Higher interest rates and/or higher inflation could cause another wave of re-pricing, reduce liquidity and further damage confidence in the sector, particularly if there are further headlines around closure of funds to redemptions or defaults on CMBS. Tenant failures could also damage income returns.

Exposure to higher risk sectors could hit income

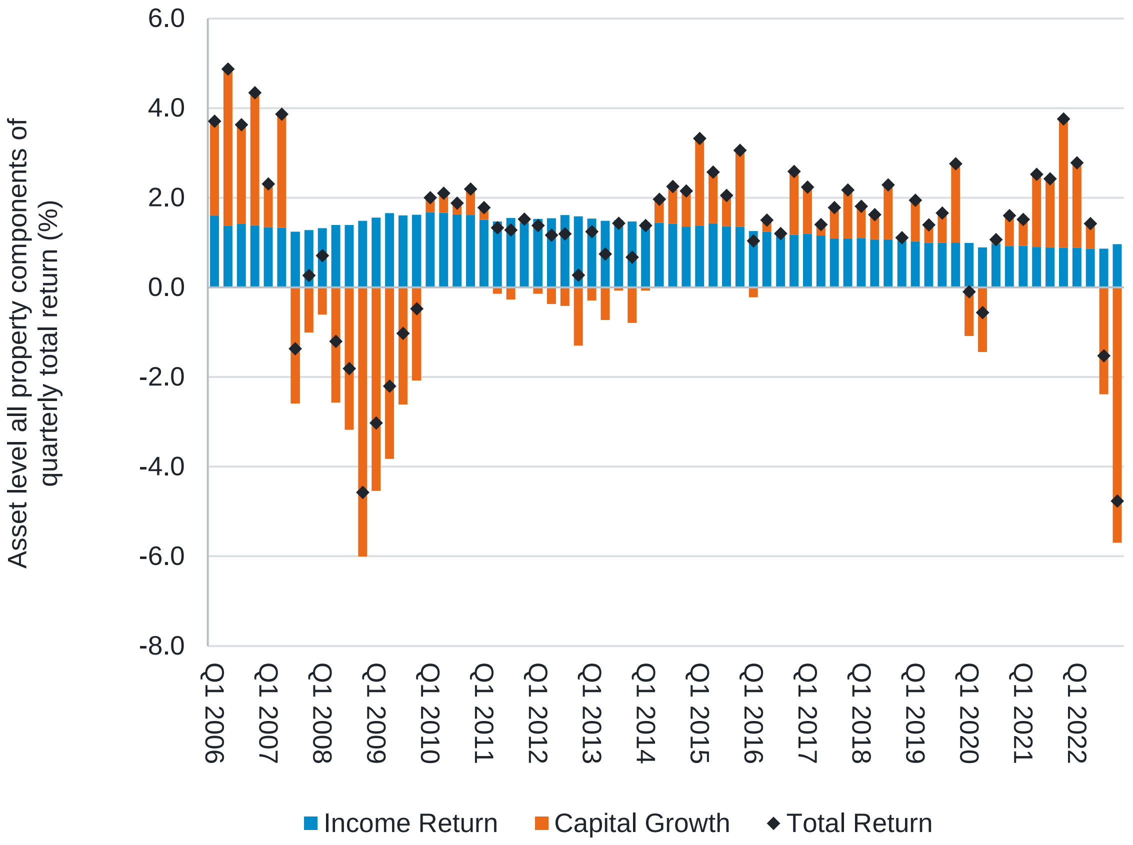
- High levels of exposure to tenants in sectors such as energy, banking and technology where volatility is high and there are increased default risks, could be damaging to performance. Within the FIL real estate portfolios we only have 7.5% of income exposed to these sectors.

UK well placed for recovery; Eurozone more vulnerable to further corrections in hard landing scenario

UK values down 20% since July; pace of correction slowing



European values also down, but correction (so far) more modest

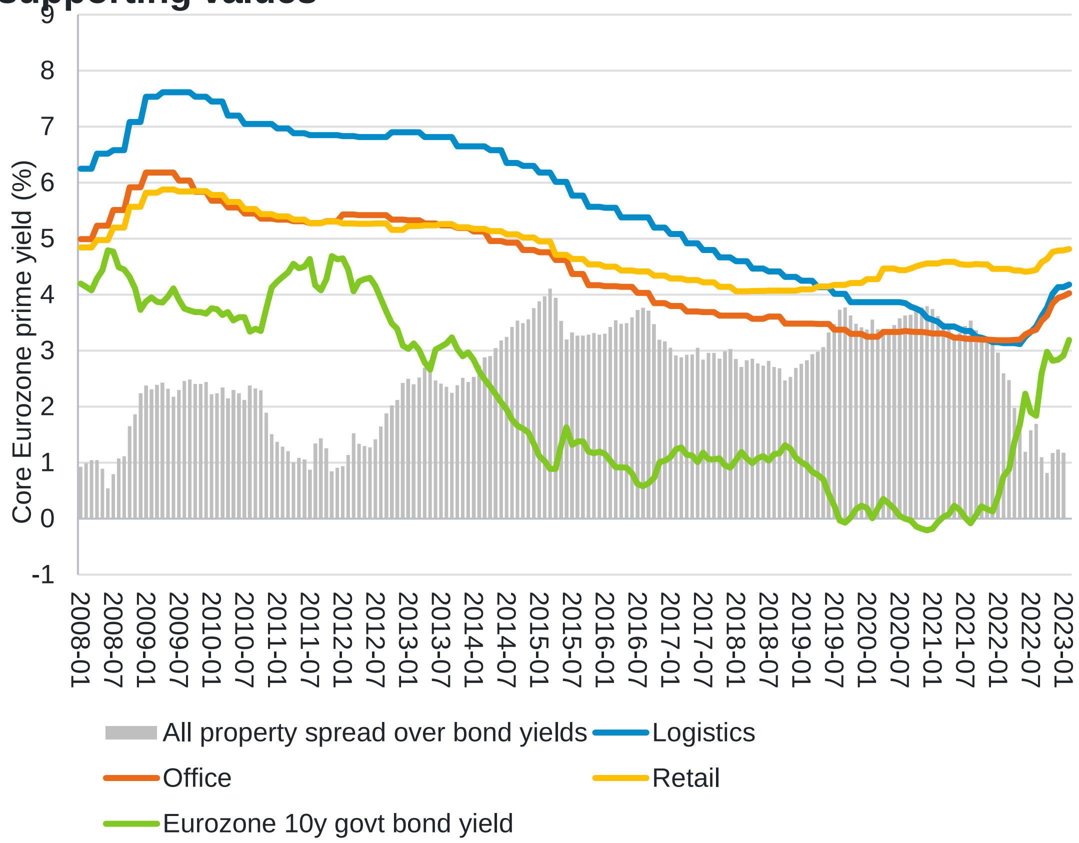


Source: MSCI UK Monthly Index, February 2023; MSCI Pan-European Balanced Property Fund Index, Q4 2022.

Source: MSCI Pan-European Balanced Property Fund Index, Q4 2022.

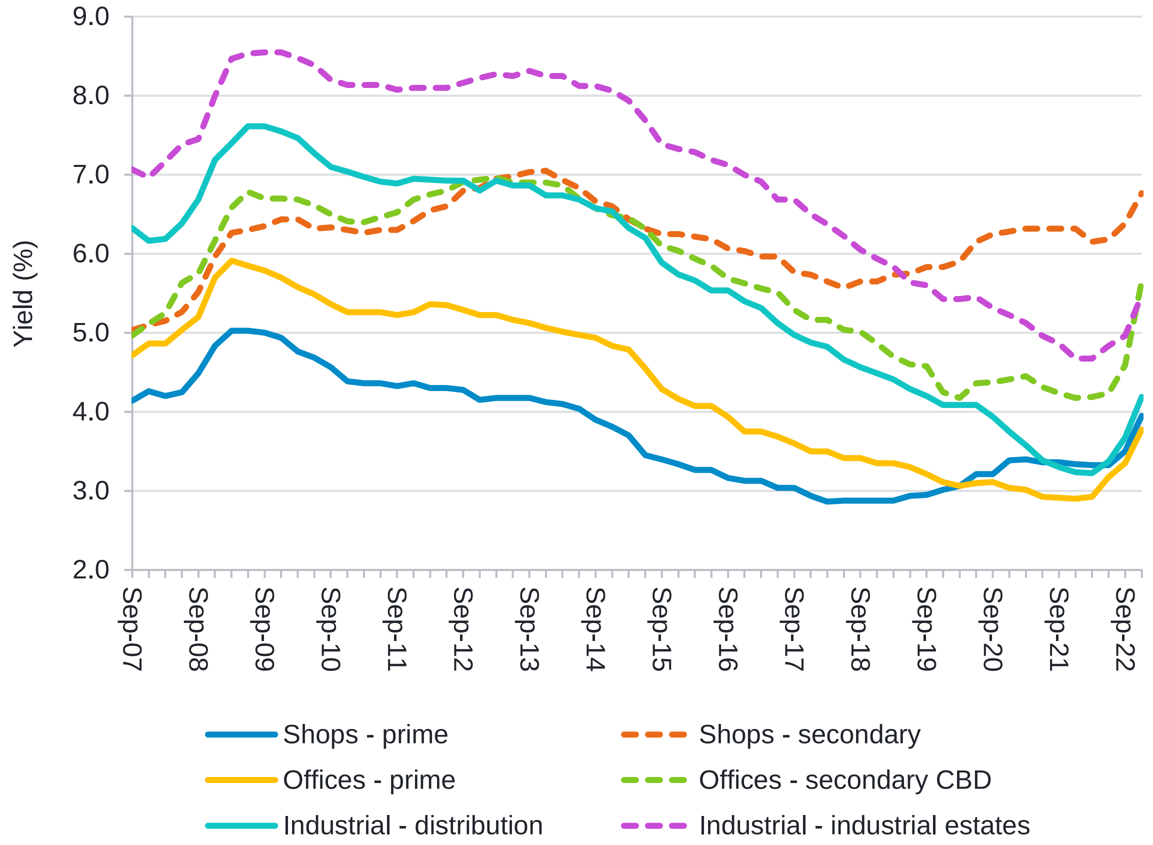
Repricing reflects more than interest rate moves – structural headwinds impacting secondary offices and retail

Relative pricing looks tight, but rental growth and indexation are supporting values



Source: Fidelity International, CBRE, February 2023.

Repricing has been particularly sharp for secondary offices

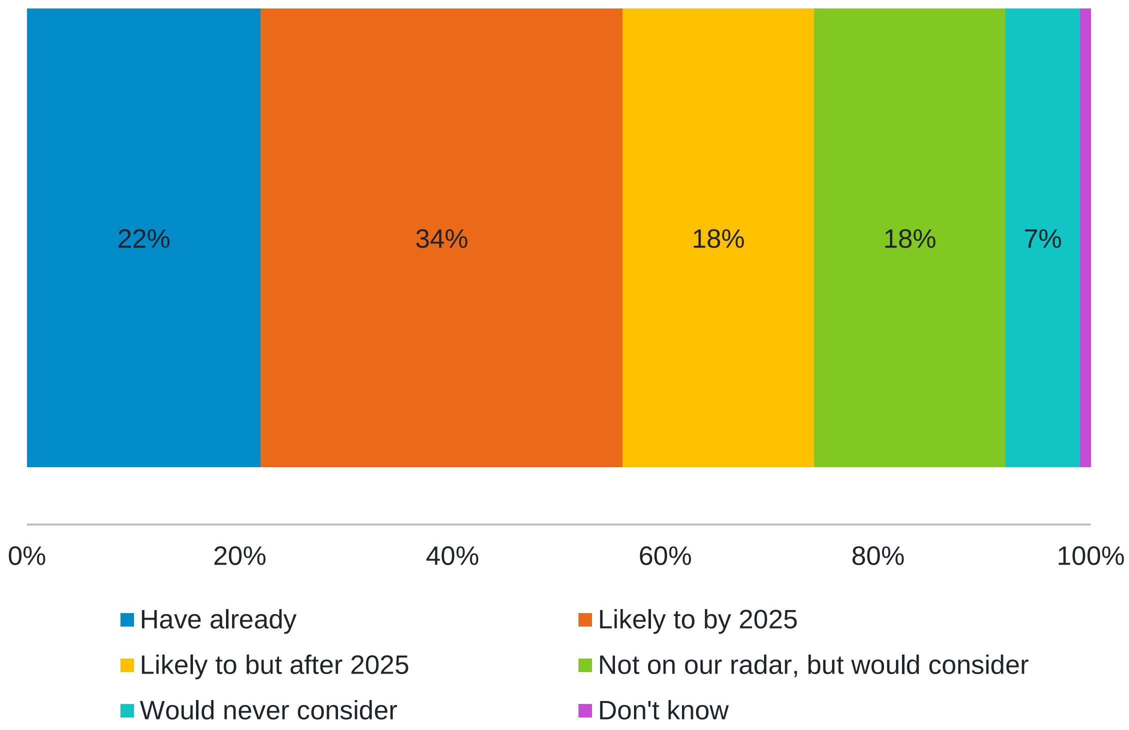


Source: Refinitiv Eikon, March 2023.

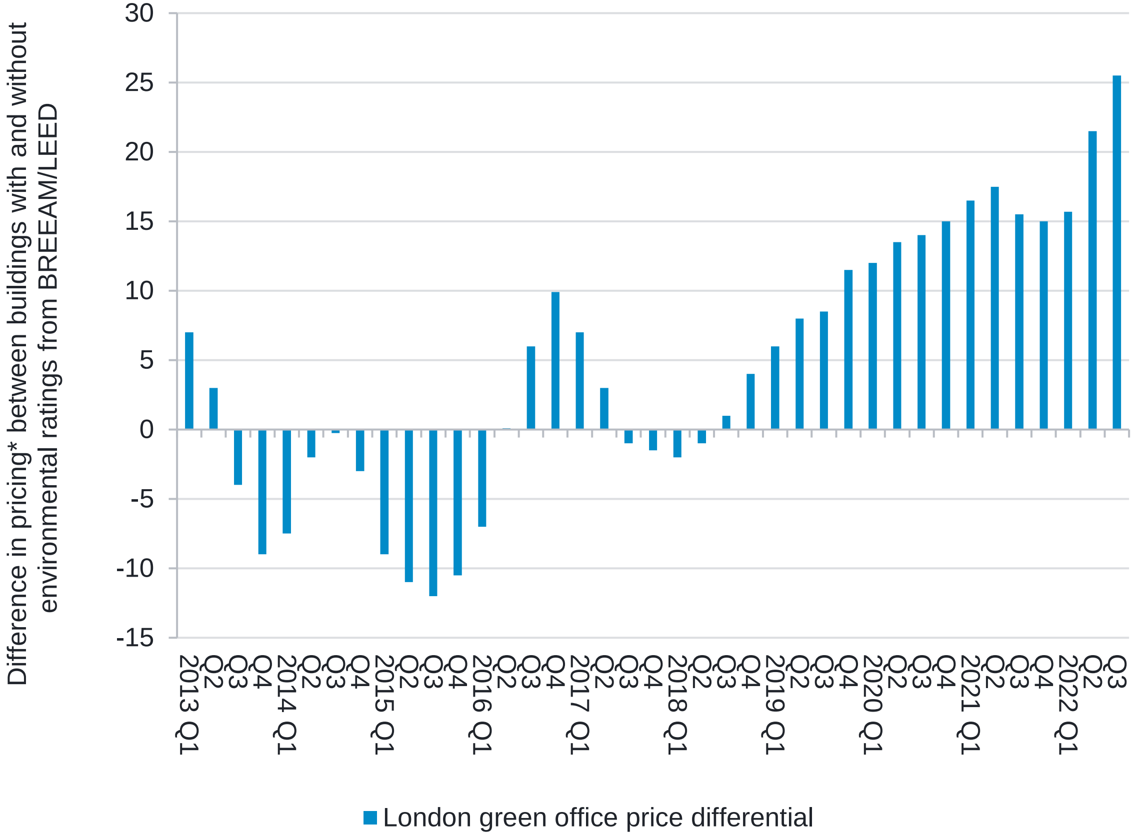
Focus on sustainability – green premium set to provide downside protection and considerable upside

Office occupiers show willingness to pay a green premium

Q: how open is your organisation to paying a premium to occupy space with leading sustainability and green credentials?



Investors are paying an increasing premium for green offices



* Pricing difference is based on hedonic analysis of London office prices, controlling for factors that impact building value such as age, size and sub-market

Source: Fidelity International; JLL, The Future of Work Survey, July 2022.

Source: Real Capital Analytics, October 2022.

Important Information