

Outlook 2021

Seizing the new reality

Fidelity International's outlook for the global economy,
multi asset, equities, fixed income and real estate

Executive summary

If you are reading this, then you've lived through one of the most volatile periods in market history. The year to come may prove to be as uncertain as the one just gone, but we believe the main themes discussed in this outlook will be the ones to drive the new reality - and the market response to it - in 2021.

First is the role of fiscal and monetary policy in preventing total economic collapse amid lockdowns and in driving the post-pandemic recovery. Second are the potential problems inherent in the record amounts of debt taken on by governments and corporates. These now exceed World War Two levels and have made the market more sensitive to inflation in a world of record low interest rates.

Third is the concern that some valuations reflect abundant central bank liquidity and sector trends accentuated by Covid-19, rather than economic reality. These may suddenly correct when vaccines are rolled out, amid broader market rotations. And finally, there is the extraordinary outperformance of environmental, social and governance (ESG) leaders across equities, fixed income and real estate that looks set to continue amid further shifts towards more sustainable forms of capitalism.

Getting to grips with this new reality will require a deep understanding of its implications for individual companies and the ability to move quickly when asset prices offer value.

Key takeaways from Outlook 2021:

- The scale of fiscal policy decisions will affect the speed of recovery in the real economy
- Vaccines could be a game-changer, but near-term economic damage is unavoidable
- Climate change looks set to be the key sustainability priority for 2021. Companies that behave sustainably outperform those that don't
- Money supply growth has jumped in response to Covid-19 and asset price inflation could feed through into consumer prices, causing market tantrums. Debt levels are a concern
- Equity valuations are stretched; there are opportunities beneath the surface, but watch out for sudden rotations
- Asian countries should benefit from a weaker dollar and their better handling of the virus
- Being truly diversified in 2021 may require looking beyond traditional asset classes to alternatives, currency pairs and long-volatility strategies - and to real estate for income

Foreword

After a year that few of us will forget, we have moved beyond the point where textbooks agree on what happens next.

In times like these, we must focus on what we do know. With a new president in the US, we can be sure that the Covid-19 and climate crises will climb the list of policy priorities. As regards tackling climate change, the wheels of regulation may turn slowly, but we expect companies to alter their behaviour in anticipation of a new approach.

Those that move early are likely to be rewarded in the capital markets. In 2020, we saw how companies that took environmental, social and governance issues seriously going into the crisis, outperformed those that didn't, both during periods of market volatility and relative calm. And those with the most comprehensive plans for dealing with disruption will be best placed to act creatively to take advantage of opportunities as they emerge.

These companies typically have three qualities. First, they acknowledge that their survival is not a given and are able to find a good balance between diversification and simplicity in their business. Second, they are focused on sustainability and work to maintain the basic environmental and social foundations that allow the business to perform year after year. And third, they show resilience, keeping a plan B ready to protect their long-term agenda when a crisis inevitably hits.

We witnessed a huge amount of change in a short space of time in 2020. These are just some of the trends that we believe will come to define not just the next 12 months, but the coming decade.

Wishing you a happy and healthy 2021.



Anne Richards

CEO Fidelity International

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Overview



Andrew McCaffery
Global CIO, Asset Management

Will the reality match the optimism?

2020 has been a year like no other in living memory. It serves as a reminder that crises can strike at any time, and that each one is different. So I am balancing the market's recent optimism with caution as we move into 2021.

The Covid-19 crisis prompted the fastest bear market in history followed by the swiftest rebound, propelled by an unprecedented monetary and fiscal response. On the threshold of 2021, the global recovery hangs in the balance. Central banks will continue to do most of the heavy lifting for the economy if fiscal stimulus proves relatively modest.

Vaccines draw closer, but the economic damage inflicted by the virus is becoming clearer. As this economic reality sets in, investors may start to question whether the policy response is adequate or has overshot, risking higher inflation than desired. If ever there was a time to be nimble and genuinely diversified across regions and asset classes, 2021 is likely to prove the value of this approach.

Market optimism and the economic reality

In 2020, investors consistently chose to believe the best-case scenario, buoyed by liquidity from the Fed and other major central banks. I am concerned that this optimism will not always be matched by the economic reality of 2021. A huge amount of investment has been brought forward to sustain shuttered economies and, given the likelihood of a divided US Congress, a limited fiscal stimulus package could mean a slower recovery. There is a risk in the near term of a double-dip recession in the US if more restrictions are imposed to tackle the virus while the world waits for vaccines to be delivered across populations.

Valuations of some US mega caps appear to be detached from reality, with some stocks trading at over 100 times their earnings. Unless earnings meet current expectations in 2020 and 2021, these stocks remain vulnerable. Any correction could have an outsized impact on the wider market, given the tech giants now account for over a fifth of the index.

Scratch beneath the surface, however, and there are a range of possibilities where valuations have diverged due to the pandemic and longer-term trends. Investors may need to act quickly to capture these bargains in what is still an 'on/off' market. Depending on the virus's evolution, a vaccine and any policy response, there may be sharp rotations from non-cyclicals to cyclicals or vice versa, though banks and oil companies will remain under structural pressure.

Increased sensitivity to inflation

Limits to fiscal stimulus appear so far to have reduced the risk of higher inflation. But the current disinflationary outlook could change rapidly if the velocity of money rises, there are shortages in the real economy, or there is better-than-expected growth, perhaps triggered by the swift rollout of vaccines.

Moreover, the Fed has signalled its intention to look through inflation that is moderately above target until the US is closer to full employment before considering tighter policy. Other developed market central banks, too, are veering towards a structurally easier policy stance.

Ways to diversify

In the medium term, we expect US dollar weakness to continue while the Fed remains accommodative. This will be positive for non-US markets, especially Asia. China is keeping monetary policy at a more neutral level, having encouraged its banks to show forbearance to companies suffering due to the virus, and is pressing ahead with domestic reforms. This could stabilise earnings in 2021 and may offer a level of diversification for global investors.

Commodities, currencies and use of private markets exposures, where the risk taken is potentially better rewarded, can also help diversify risk and boost returns if the recovery is uneven - especially if developed market government bonds wrong-foot expectations and behave more like a liability than an asset within traditional asset allocation frameworks.

Climate change looks set to be a priority

After a year in which social factors featured highly on government and corporate agendas, climate change looks set to be the sustainability priority in 2021, fortified by the EU's Green Deal and by US President-Elect Joe Biden's evident support. Expectations are high about what could be achieved to speed up decarbonisation at the UN climate change summit in late 2021.

At Fidelity International, environmental, social and governance (ESG) considerations are integral to our bottom-up investment approach and are expressed in the forward-looking ESG ratings we assign to companies. Those that take ESG seriously outperformed during the crisis and beyond. The more that firms do the right thing, the more they attract stable capital flows, which leads to better outcomes for the company, for investors, and for society.

To conclude, uncertainty over vaccine timings, the effects of monetary and fiscal stimulus, as well as earnings growth, may cause pockets of market volatility in 2021. Where there is crisis, there is also opportunity. But when markets price in overt optimism, I remain alert to reality having a great deal to prove.

Macro view



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The elephant in the room: Debt

Key takeaways

- Fiscal policy has been critical in generating an economic rebound but is likely to be less expansive than had the Democrats swept the board at the US election
- Debt levels are higher than after World War Two and will need to be confronted
- Climate change considerations are starting to affect macro policy

That was the easy part. Economies bounced back from the first wave of Covid-19 but many have moved into a tougher regime of further restrictions, eased only by hopes for the swift rollout of an effective vaccine.

As policymakers and investors grapple with the world, the elephant in the room they'll have to confront will be how to manage the heavy public debt racked up governments as they attempt to replace lost economic demand.

Fiscal policy has been critical in generating the rebound

Fiscal policy has proven to be the more critical support for economies during the initial lockdowns in spring 2020, compared with the Global

Financial Crisis in 2008 when governments relied more on monetary policy. This time governments in developed markets quickly deployed direct transfers to buffer household incomes as the global economy came to a screeching halt. Credit guarantees and direct lending to businesses meant that the full weight of the public balance sheet has been used to reduce the likelihood of permanent economic damage and to keep people employed.

More fiscal stimulus is likely in the coming months. But, in the US at least, a divided government could limit its size and reach. We expect the US government to provide a Covid relief package in H1 2021 of around \$1 trillion, but overall fiscal spending will be far lower than had the Democrats swept the board at the 2020 election. Amid a

second (and perhaps third) wave of Covid, this is unlikely to be enough to maintain strong economic momentum into 2021.

Our estimates suggest that total stimulus of around \$2 trillion, which includes the \$1 trillion of Covid relief as well as other measures, would add just 1.5 percentage points to GDP in 2021. This implies the Covid-induced output gap is unlikely to close before 2023. On the flip side, tax increases are less likely. This could help growth in the medium term, but worsen the sovereign debt burden in the long term.

Recovery is likely to be fitful

In Europe, new lockdowns to mitigate the second wave are capping the rebound from the first, and growth could be negative in the next couple of quarters. The US is likely to follow suit, given the worsening virus trajectory there. Further restrictions could hinder US economic momentum and make the global recovery fitful and unpredictable.

Beyond Q1 2021, however, activity should rebound as restrictions are lifted, though much depends on how quickly and widely any potential vaccine(s) can be deployed. China remains an exception, as the government's ability to contain the virus coupled with monetary and fiscal stimulus have already helped the economy to grow in 2020. We expect this growth to stabilise in China in 2021. Overall, we view risks to global growth forecasts (5.4 per cent according to the latest International Monetary Fund (IMF) projections) as balanced, but remain alert to the risk of a double-dip recession in the US.

Shift in the macro mindset: Austerity can wait

Despite the smaller size of US fiscal stimulus than some had hoped for, government spending is likely

to continue for some years to come. The IMF has called for sustained fiscal support in 2021 and beyond (a reversal of the austerity it preached in the aftermath of the 2008/9 crisis).

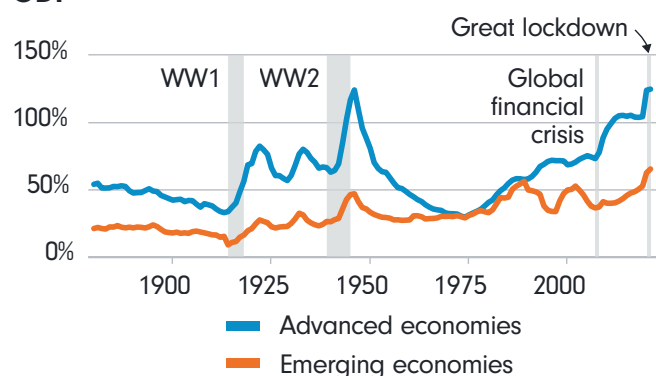
Indeed, the IMF has called on developed market countries to take advantage of the low rates put in place by central banks and to continue to borrow heavily. It has also recommended boosting public consumption and investment programmes to support a recovery. The shift in ideology is significant, especially given the fact that the spending spree so far has already pushed developed market public debt ratios beyond those seen after World War Two. In emerging markets too, government spending is on the rise.

Economic theory offers three ways to reduce debt burdens: 1) disruptive de-leveraging as happened during the Great Depression, 2) high inflation and 3) high nominal growth generated by stronger real growth. In our view, how the high debt load is managed will remain one of the biggest macro drivers of global economic progress and the policy cycle in the coming quarters.

Central banks may require other tools to mitigate a fiscal cliff

The jury is still out on how inflation will develop in 2021. But in the absence of a massive fiscal boost, it will be harder for the Fed alone to generate a sustainable increase in inflation, despite adopting a flexible average inflation targeting framework. Loosening an already loose policy is likely to have less impact than it did in 2020. Nonetheless, we expect the Fed to ease policy in the near term as it responds to changing market and economic conditions.

Chart 1: Government debt as a percentage of GDP



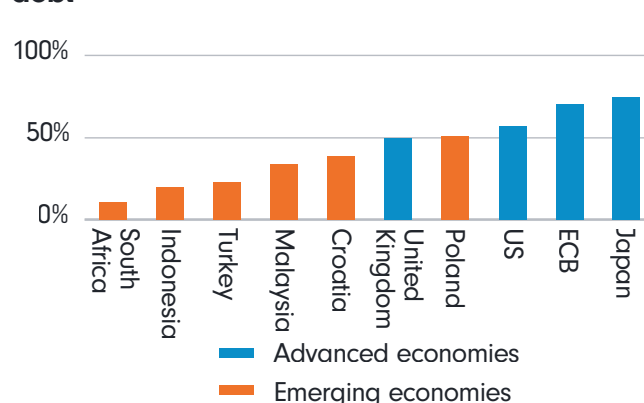
Source: IMF, World Economic Outlook, October 2020

As Covid-19 relief packages expire and to help mitigate the impact of a pending fiscal cliff, the Fed may also have to buy longer duration bonds, increase the pace of asset purchases and strengthen forward guidance. More easing is also likely in Europe given weaker growth and inflation expectations. Ever-easier monetary policy is therefore likely to become structural, especially in developed markets.

Climate change starting to affect macro policy

America voting for a president who accepts climate change exists and plans to do something about it, the Green Deal agreed by the European Union, and the net zero announcement from China has set the stage for climate in 2021. These events demonstrate the potential extent to which climate policies could alter the entire structure of the global economy and the impact they could have on the conduct of macroeconomic policy in the years to come. One example may be the introduction of a higher carbon price, given the trillions of dollars (\$16 trillion according to the International Energy Agency) that need to be invested in clean energy by 2030.

Chart 2: Central bank purchases of government debt



Source: IMF, World Economic Outlook, October 2020. (Percentage of central government marketable securities or debt issued since February 2020.)

Central banks are focused on the issue. Several are rapidly developing stronger analytical and policy machinery to help understand the implications of physical climate risks and how policymakers can facilitate the transition towards a zero-carbon future. In June 2021, the Bank of England will publish the results of climate-related stress tests of the financial system. This could provide a robust international framework for other central banks to follow.

Regaining debt sustainability

The path of recovery in 2021 is unlikely to be smooth. The rollout of a Covid-19 vaccine may come too late to stop another severe virus wave and the economic disruption may only be partially mitigated by a more modest fiscal impulse in the US. In the medium term, the recovery will depend on how well the sharp expansion of debt to deal with the Covid crisis is managed and which path countries take towards debt sustainability (voluntarily or involuntarily). Many of the transformational changes in macro policy and economic models triggered by the Covid crisis are yet to play out, including how we deal with the even bigger threat of climate change. In that context, the elephant has only just entered the room.

Multi asset



Henk-Jan Rikkerink
Global Head of Solutions and Multi Asset

Fiscal policy takes centre stage

Key takeaways

- Risks are finely balanced across markets, but opportunities in credit and equity will emerge alongside effective vaccines
- Sustainability factors are ever more critical to consider as capitalism evolves
- Being truly diversified may require looking beyond traditional asset classes to alternatives, currency pairs, and long volatility strategies

From the economic fallout of Covid-19 to the enormous fiscal and monetary response, markets have ridden an extraordinary 2020 that will inevitably shape the outlook for 2021. As highlighted by Fidelity International's global macro team, we are likely to be past the 'easy part' of the global economic recovery. Three main factors will now influence the investment backdrop for 2021.

- **Fiscal policy steps into the spotlight:** Both monetary and fiscal policy have been extremely supportive in 2020, and central banks appear willing to keep rates on hold

for some time. The focus for 2021 will be the extent to which fiscal policy can complement exceptionally accommodative monetary policy. In this regard, we will monitor the evolving US political backdrop closely.

- **Inflation remains a key question:** The jury is still out as to whether and by how much inflation will rise in 2021, given the economic backdrop. An important development is the Fed's average inflation targeting framework that allows for moderately above target inflation until US employment figures improve.

- **A new US presidential term:** After such a polarised election, the economic implications of the US electoral outcome will extend well into 2021 and beyond. Given the importance of fiscal policy to the medium-term economic outlook, the potential for a reduced stimulus poses a significant risk and, if the US Congress remains divided, the path of the recovery (across asset classes) could be more volatile.

Sustainability is critical

Sustainability factors are becoming ever more critical elements of investment risk. Unlike previous financial crises, the Covid-19 pandemic has disrupted far more than just asset markets: it has raised fundamental questions about the sustainability of industries, the responsibility of stakeholders, and the long-term prospects for capitalism as we know it.

This has accelerated the shift towards using sustainability criteria in investment decision-making. With regard to strategic asset allocation, we are beginning to incorporate various temperature pathways into our models to help us understand the impact of different climate change scenarios on capital market assumptions, asset returns and risk profiles.

Cautious optimism across global equities, with regional preferences

Turning to asset markets, the team continues to balance caution with the need to take selective opportunities in equities and credit. Overall, we remain cautious about taking on investment risk against a backdrop of somewhat optimistic

valuations, given current economic conditions. Looking into 2021, we generally prefer credit over equity risk and assets higher up in the capital structure but vaccine news warrants greater optimism than before.

Equity markets as a whole may be bracing for slower economic growth, but the picture is nuanced across regions and sectors. So 2021 is likely to be more about capturing relative opportunities as investors price in economic and virus-related developments. From a regional perspective, the team is most positive about the prospects for emerging markets, specifically on emerging Asia (e.g. China, Korea and India), given attractive asset valuations, earnings revisions and technical market factors relating to broad investor positioning.

Looking into 2021, we generally prefer credit over equity risk and assets higher up in the capital structure but vaccine news warrants greater optimism than before.

Europe continues to face risks in terms of political developments (such as Brexit), headwinds from Covid-19 measures and the impact of these on economic data. That said, attractive valuations and further European Central Bank monetary policy easing are important factors to consider in the near term. Overall, we have a neutral outlook for US equities, given concentration risk at a market level and reverberations from the election.

The hunt for yield could intensify

Many of our team's strategies are designed to deliver consistent income across market cycles, so the combination of fixed income sub asset classes remains critical as 2021 rolls on. If monetary policy remains highly accommodative and fiscal support is relatively modest, the hunt for yield could intensify through 2021. With yields still at historic lows across the board, investors must strike a balance between tapping attractive income opportunities while avoiding any race up the risk spectrum.

From a tactical allocation perspective, an example of a pair trade that fits with our views for 2021 is a currency pair, with a long position in Japanese yen versus a short position in the US dollar.

From a risk-reward perspective, we expect decent compensation for exposure to high yield bonds and emerging market debt if the credit default cycle evolves in a moderately positive direction over the coming year. Within high yield bonds, we prefer Asian securities, given stronger underlying credit fundamentals and regional growth.

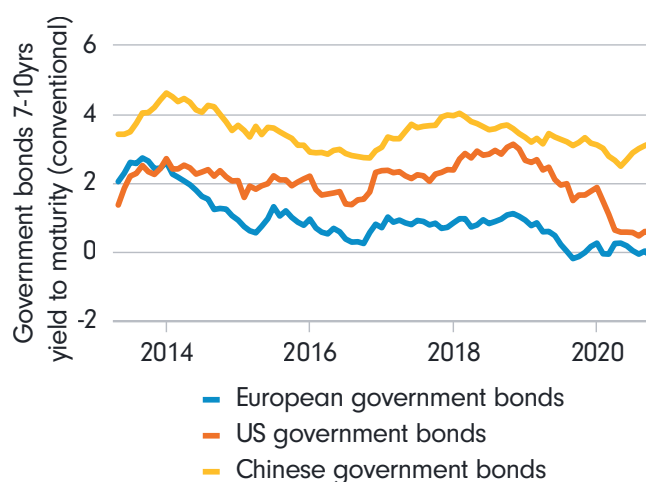
Finding defensiveness in a world of changing correlations

Perhaps one of the most pressing questions for investors as we enter 2021 is about how best to diversify investments for the long term. In the March 2020 crash, many of the traditional safe

haven asset classes failed to provide the level of protection that investors expected. US Treasuries and investment grade bonds, for example, provided less effective risk diversification in portfolios compared to previous crises.

With yields at historic lows, investors will need to search more widely for sources of defensiveness. In practice, this means looking beyond developed market government bonds and towards assets like Chinese government bonds, which offer compelling relative yields, or using pair trades with asymmetrical risk characteristics (where the upside potential is greater than the downside risk).

Chart 3: China government bonds offer attractive yields relative to other government bond markets



Source: Fidelity International and ICE BofA, as at 30 September 2020. European government bonds: ICE BofA 7-10Y Euro Government Index. US government bonds: ICE BofA 7-10Y US Treasury Index. China government bonds: ICE BofA 7-10Y China Government Index.

From a tactical allocation perspective, an example of a pair trade that fits with our views for 2021 is a currency pair, with a long position in Japanese yen versus a short position in the US dollar. At a time when reasonably priced defensive assets are becoming scarce, the yen is relatively cheap and offers risk-off

characteristics. At the same time, the team's view on the US dollar remains negative.

Alternatives such as 'long volatility' strategies could prove their worth

Alternatives offer another means of diversification. We continue to find opportunities in areas such as asset leasing, infrastructure and renewables. We tend to look for combinations of alternatives that have low correlations with traditional equity and bond markets.

Specifically, 'long volatility' strategies are explicitly designed to generate positive performance during periods of heightened market volatility. These types of strategies have cost investors in previous years as broad markets benefited from prolonged periods of growth, but performed well in 2020. We believe

they have an important long-term role to play in diversified portfolios, and 2021 is likely to throw up plenty of opportunities for them to prove their worth.



Renewables offer opportunities: Burbo Bank off-shore wind farm. (Photo by: Christopher Furlong / Staff Images via Getty Images)

Equities



Romain Boscher
Global CIO, Equities

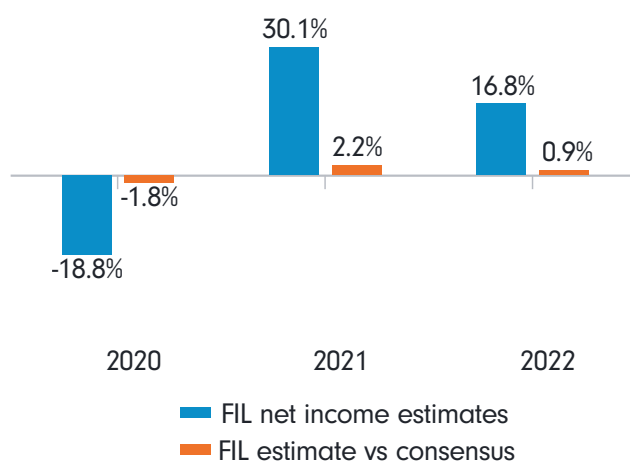
A delicate balancing act

Key takeaways

- Earnings will continue to recover but at an uneven pace that may test valuations
- Certain value areas appear attractive but no wholesale switch to value expected given structural challenges among banks and oil
- Sustainability characteristics help drive financial performance but important to understand which firms are taking real action

Asset prices shot ahead of earnings expectations for much of 2020, thanks to the enormous fiscal and monetary response to the economic damage caused by Covid-19. As we enter 2021, earnings are likely to continue to recover, but at an uneven pace that may test valuations. Sector divergence, extended valuations at market level and the increased risk of sudden rotations mean that 2021 will require a delicate balancing act between risks and opportunities and an ability to move swiftly as conditions change.

Chart 4: Fidelity aggregated earnings forecasts



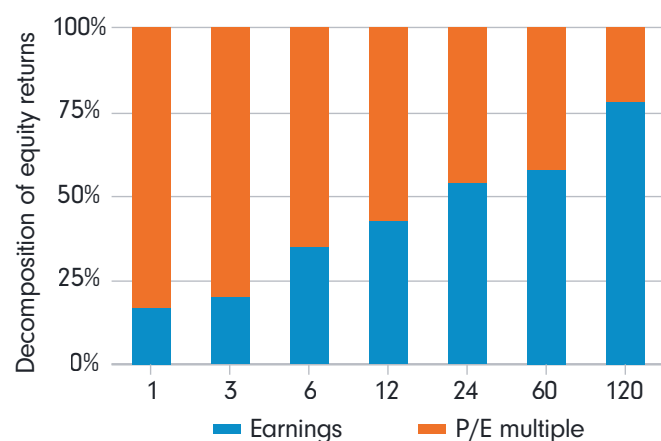
Source: Aggregate of Fidelity International's global analysts' forecasts for full calendar years. IBES MSCI World forecasts used as consensus. Source: IBES, Fidelity International, November 2020.

Earnings matter in the long term

For much of 2020, investors banked on a best-case economic scenario and a V-shaped recovery, given confidence by the level of monetary and fiscal stimulus that followed the first wave of the virus. For example, the \$600 paid every week to US citizens kept consumption higher than it might have been in the first half of the year. However, if the new US government finds that it cannot fully replace demand with more stimulus in the coming months, there is a higher chance of a double-dip recession.

But there is another letter in this alphabet economics: a possible K-shaped outcome where valuations diverge sharply between those sectors and stocks perceived to be winners and those spurned as losers. Markets may also whipsaw between the competing forces of abundant liquidity and economic damage, but earnings will be the yardstick to measure corporate performance in the long term. Despite dividend cuts in certain sectors, equities continue to offer a yield cushion of around 2-3 per cent that still looks attractive in a world of near-zero rates.

Chart 5: Over longer periods earnings have a higher impact on returns



Source: Credit Suisse, 2019. NTM P/E and NTM EPS; Median contribution to return; Since 1964. S&P, Thomson Reuters, FactSet. (NTM = next twelve months).

Headwinds facing banking and oil

The long-awaited rotation in style factors failed again to materialise in 2020. Brief forays into value were swiftly displaced by a return to growth names, despite the valuation differential between the two styles being at an all-time high. The failure of value as a whole to maintain leadership may be due to structural headwinds in two sectors: banks and oil.

Despite dividend cuts in certain sectors, equities continue to offer a yield cushion of around 2-3 per cent that still looks attractive in a world of near-zero rates.

Banks face the prospect of low interest rates for an extended period in much of the developed world. They make their money by arbitraging the difference between long and short-term interest rates and investing deposits into securities; wherever they put their money at present, their return is extremely small. While they went into this crisis in better shape than they did the last, the number of non-performing loans could rise if the pandemic continues throughout 2021.

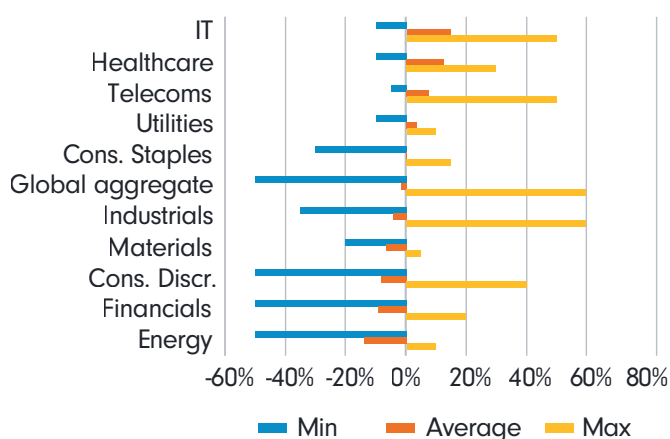
Oil companies, meanwhile, face numerous challenges. In past crises, low oil prices have stimulated economies, but Covid has hampered the travel and leisure companies that might otherwise have benefited from cheaper fuel. The fiscal environment is changing too, with policy likely to be greener than in the past, favouring

renewable energy. At the height of the pandemic, when oil prices fell 40 per cent, renewable energy prices plateaued. Major oil companies are taking note. Giants such as BP, Shell and Total have cut their dividends and reallocated capital to invest in green energy. Companies that get left behind in the transition to a low-carbon economy look increasingly at risk.

Digitisation is another trend that has accelerated due to the pandemic. Companies with existing infrastructure, such as cloud storage, that could absorb additional demand on their systems are the main beneficiaries. At the other end of the scale are the 'old world' bricks-and-mortar companies such as retailers. So it is less a question of value versus growth, and more of a generational shift between old and new sectors.

Chart 6: Wide divergence in outcomes within and across sectors

Answers to: "How do you expect full year 2021 earnings to compare to full year 2019 earnings?"



Source: Fidelity Analyst Survey, Fidelity International, June 2020. NB. Min refers to minimum analyst estimate, likewise max to maximum analyst estimate.

Trees hiding in the woods

As discussed above, there may not be a wholesale switch to value in 2021. But there

are plenty of value trees hiding in the woods, particularly among cyclical sectors such as industrials and durable goods, that investors can seek to capitalise on, especially in the event of an effective vaccine in 2021 and a pick-up in demand. Investors need to be careful of zombie firms, however, even if they appear to be good value. As witnessed in Japan, these firms can go on for years, being continuously refinanced without actually entering a formal default, and offering little or no increase in valuation.

Investors seeking to play the technology growth trend could still find growth stocks with more reasonable valuations outside the US, especially among German and Japanese corporations.

On the growth side, sectors such as technology appear expensive at a headline level. But beneath the surface we continue to find quality growth names that should do well as economies recover, albeit slowly, from Covid-19. In this context, we believe there are more opportunities among mid- and large-caps, and fewer among the mega caps. Investors seeking to play the technology growth trend, for example, could still find growth stocks with more reasonable valuations outside the US, especially among German and Japanese corporations.

Asia drives the recovery

Valuation is also critical within regions. While European markets as a whole may not outperform

the US, Germany, for example, is a cyclical, export-led economy that is benefiting from the faster recovery in Asia, especially in China. China has rebounded quickly in the wake of Covid-19 and continues to act swiftly to contain further outbreaks. At the same time, Europe and the US have entered periods of big fiscal expansion that are widening their trade deficits with China, despite attempts to close them. In previous recessions, export-led economies such as those in Asia have suffered from a decline in global trade. This time, many Asian economies appear more robust and some, such as Indonesia, have been able to implement extraordinary policy measures to mitigate the economic impact of the virus.

Stars align for ESG

One of the most dramatic trends in 2020 has been the alignment of the twin stars of environmental, social and governance (ESG)

considerations and financial performance, both during and after the March crash. Our [research](#) shows that companies with the highest ESG ratings collectively outperformed over that period, exhibiting a higher Sharpe ratio and risk-adjusted return. As a result, we believe ESG adoption will only accelerate in 2021, especially as climate change moves up the agenda in the US.

To be considered a high-quality company now requires not only a strong balance sheet, a good business model and stable earnings, but also a high ESG rating. Across the world, companies wishing to attract capital are engaging ever more readily with a range of themes from employee welfare to achieving net zero. Many companies are promoting their green credentials, but it is important to get an inside view and understand which firms are taking real action.

¹Putting sustainability to the test:: <https://www.fidelityinternational.com/editorial/article/putting-sustainability-to-the-test-esg-outperformance-903013-en5/>



Employee massages and fitness services may form part of post-pandemic welfare trends. (Photo by: View Pictures / Contributor Images via Getty Images)

Fixed income



Steve Ellis
Global CIO, Fixed Income

Monetary policy to the rescue, but duration tantrums are possible

Key takeaways

- Money supply growth has jumped in response to Covid-19 and asset price inflation could feed through into consumer prices
- Central banks need to keep refinancing costs low given high debt levels but may not act until there is a duration tantrum
- ESG funds have outperformed in 2020 and sustainable credit names could offer smoother return profiles

Central banks have been on the front line of the Covid-19 crisis and will remain the biggest game in town if US fiscal support proves limited. There is little sign of balance sheet tapering or rate rises on the horizon. However, the possibility of a vaccine emerging in 2021 and the huge monetary and fiscal response to the crisis in an era of ultra-low rates means the risk of 'duration tantrums' (i.e. spikes in longer-dated bond yields) persists.

Immense stimulus feeds through into risk asset prices

Central banks in the G6 countries have almost doubled their balance sheets since the start of the Covid crisis. While a divided US Congress could bring a more modest fiscal stimulus than might have been expected under a 'blue wave' Democratic sweep at the US election, we expect the Covid-related support that has bipartisan

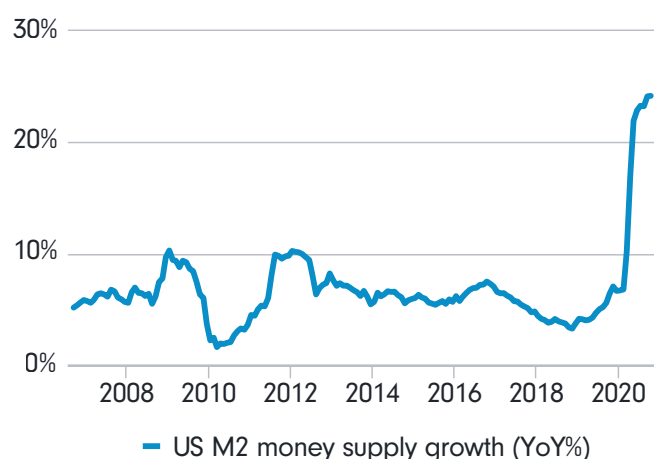
approval will come through. The influx of monetary stimulus in 2020 has already fed into higher risk asset prices, and this could continue into 2021. Credit spreads have tightened across many areas, though remain wider in certain sectors most affected by the pandemic such as energy.

Money supply is growing this time

In contrast to the financial crisis over a decade ago, the growth rate of money supply is on the rise in the US, and consumer prices could follow. Back in 2008, banks were in such an impaired state, they deposited reserves with the Fed almost as fast as money was being created for them to lend to the real economy. This time, bank balance sheets are in better shape and the consequences of unprecedented stimulus could be inflationary.

For years, money supply (M2) growth has averaged at around 7 per cent a year. It is currently running at around 23 per cent - a level not seen since the 1960s. While the velocity of money has yet to increase, circulation has been in a downward structural trend for several years; this could now reverse as further (albeit moderated) fiscal stimulus comes through.

Chart 7: Money supply jumps in response to Covid-19



Source: Refinitiv, Fidelity International, November 2020.

The big debt problem

A key issue for investors is that while monetary policy is loose, debt is high - and getting higher to finance the response to Covid. The International Monetary Fund estimates global public debt to be almost 100 per cent at the start of 2021, while JPMorgan estimates total public and private sector debt to be 280 per cent of global GDP. By the end of 2020, headline fiscal deficits in advanced economies look set to be five times higher than they were the year before.

For this debt to be rolled over and to avoid a negative spiral of defaults, central banks must keep refinancing costs low. So far, they have managed to do so: real yields on the 10-year Treasury started 2019 at 50 basis points and are now around -110 basis points. However, this makes the financial system more vulnerable to a sudden increase in yields, whether triggered by signs of inflation, better growth prospects or a policy mistake similar to the reduction in the Fed's balance sheet that triggered a market tantrum towards the end of 2018.

Duration tantrums are a risk

While inflation risk is not as great as it might have been under a 'blue wave' scenario, it hasn't gone away. And the risk may increase if an effective vaccine is rolled out more quickly than anticipated or if total social financing in China jumps. Central banks could be deliberately slow to respond to signs of inflation and higher yields, as they attempt to keep nominal rates anchored at low levels. In fact, we could see as much as a 150 basis point move in yields before central banks intervene to push them back down.

The closest historical parallel to this could be the 2013 'taper tantrum' when the Fed's tightening

of policy led to a sharp withdrawal from assets such as emerging markets. This time it would be more of a 'duration tantrum', as the 'risk-free' rate implied by Treasuries would suddenly jump higher. In this kind of environment, growth companies (such as the tech mega caps) that have done well in 2020 could see a reversal, amid a switch to value.

A higher risk-free rate would also hurt emerging market debt and longer-dated investment grade bonds, and credit spreads could widen. Lower duration assets in some high yield areas would be less affected, and short duration assets with income characteristics would outperform. Such a dislocation could also create opportunities in sectors where spreads had become overly tight. In the meantime, a selective and nimble approach, with a focus on valuations, will remain crucial in the months ahead.

Excess dollar liquidity could prolong currency weakness

After several years of an upward dollar trend, the US currency weakened in 2020 as a result of huge monetary stimulus from the Fed and increased dollar liquidity to the rest of the world. We expect dollar weakness will persist, amid further borrowing to fund the fiscal deficit. Once again, much depends on the virus trajectory in the next few months and on how soon global economic growth can recover and inflation re-emerge as Covid restrictions eventually ease.

ESG becomes ever more integral to issuer selection

ESG and climate funds have outperformed conventional funds throughout 2020 and are likely to continue to do so in 2021 following President-Elect Biden's declared intention that the US re-join the Paris agreement and China's ambition to get to net zero carbon emissions by 2060.

Funds like these are able to provide more secure income streams over the long term, meaning their overall Sharpe ratio is higher even if their yield characteristics may initially appear more modest. With volatility now likely to persist at higher levels than the last decade, quality credit issuers with high ESG ratings can offer a smoother return profile over the coming years than those with weaker ESG credentials.

Real estate



Neil Cable

Head of European Real Estate Investments

Unique challenges will accelerate structural trends

Key takeaways

- Pandemic pushes retail online; hospitality remains under pressure
- Offices will continue to be in demand post-Covid, but their usage will evolve
- Environmental attributes of buildings now rank alongside, and sometimes above, yield and performance in terms of investment priorities

Social distancing, low retail footfall, working from home: the Covid-19 pandemic has presented a unique set of challenges for the real estate sector in 2020 and the effects will continue in 2021, accelerating some trends and disrupting others.

European retail under pressure

Most noticeably, the crisis has accelerated structural changes in how people shop, increasing online retail spending at the expense of the High Street. Continental European consumers had been slower than

their counterparts in the UK, the US and China in embracing online shopping. But they made up some of this ground in 2020, increasing online sales 20.6 per cent year on year between February and May, and could continue to do so amid a second wave and further lockdowns.

We expect European retailers to reduce their store numbers and switch their focus to online portals, increasing vacancy rates in second-tier high streets and shopping centres, and putting even more pressure on values. This will discourage short-term investment in the sector, reducing market liquidity

and further reducing prices, but also perhaps prompting a longer-term rethink of how these spaces will be used in the future.

As an example, Inditex, the company behind names like Zara and Massimo Dutti, recently announced its intention to achieve 25 per cent of total sales from online (up from 14 per cent in 2019). It also plans to close 1,000-2,000 stores over the next two years. As part of this strategy, it is investing in stores that are 'fully-integrated, digital and eco-efficient', and closing smaller stores reaching the end of their life cycle.

Despite this acute crisis, we believe offices are central to collaborative work and corporate growth as well as employee well-being, and will remain with us for many years to come.

Elsewhere, the hospitality sector is facing increasingly difficult times. The European Commission estimates revenue losses of 50 per cent for restaurants and cafes in 2020. Areas dependent on tourism, such as France, Spain and Italy, are likely to be the worst hit.

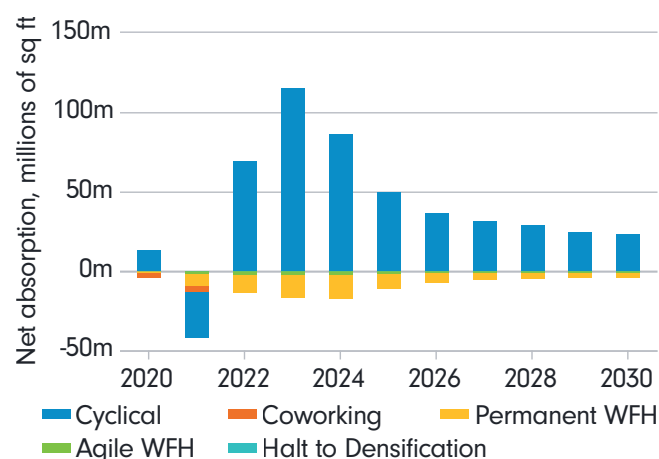
Prices in the market are yet to reflect fully the Covid crisis, with government and monetary support for the economy helping to buoy values, alongside the weight of global capital hungry for yield. This is having some strange effects. For example, in Germany, commercial real estate is already more expensive than before the pandemic, while in the UK, the price adjustments have been modest and are perhaps more a reflection of Brexit risk.

The death and rebirth of the office

The outbreak has also had a huge impact on office usage, accelerating a work-from-home trend that had been increasing at around 3 to 4 percent a year before the crisis. In the UK, remote working hit a high of 38 per cent in June 2020, according to the Office for National Statistics.

Despite this acute crisis, we believe offices are central to collaborative work and corporate growth as well as employee well-being, and will remain with us for many years to come.

Chart 8: Factors driving office demand over the next decade



Source: Cushman & Wakefield Research, Fidelity International, September 2020.

Office usage may be different of course. The layout and facilities offered may change in the future, with fewer desks crammed in and a greater emphasis on imaginative and collaborative spaces. Even if in-person office work drops from five days a week to four or three, aggregate demand for offices may still increase as other purposes are found for the space and the economy recovers from this crisis. These trends will not be evenly distributed, meaning that analyst research, active asset selection

and careful portfolio management will be more important than ever.

While there is no doubt that 2020 has been a challenging year for commercial real estate, we are mindful that, with the extraordinary global efforts to develop a vaccine to combat the virus, we could see a return to a more normal way of working and shopping in 2021.

Better data collection leads to increased focus on sustainability

Investors are planning for the longer term when it comes to refurbishment of properties to improve the performance of energy and social factors. We believe 'green leases' are fast becoming the new norm, where the tenant and landlord will be obliged to fulfil respective environmental commitments, such as providing energy use data. This will improve transparency for investors.

Improved data collection on energy usage and increased certification, such as the Global Real Estate Sustainability Benchmark, are driving environmental and social factors to the forefront of investors' minds. The environmental sustainability of an asset is now both more measurable and more desirable, to the extent that it ranks alongside, and sometimes above, yield and performance in the list of priorities for clients.

New buildings are subject to ever more stringent regulations, particularly in the era of sustainability and energy conservation. Increasingly, a building without the best environmental characteristics will struggle to find tenants. This trend is leading to an increased focus on refurbishing existing stock as the real estate industry aims to play its part in minimising carbon emissions. We have observed

that only around 1 per cent of building stock is replaced each year, which means that the majority of buildings that will be with us in 2050 have already been constructed. We therefore believe that retrofitting older buildings will be better for the environment than focusing on the characteristics of new builds.

In the land of low income, real estate is royalty

The monetary policy response to the Covid-19 crisis has further repressed traditional sources of income such as government bonds and has lowered real yields to rock-bottom levels. Real estate is attractive in such an environment and remains popular with income-seeking investors despite being less liquid than other asset classes. Yields may be historically low for property, but 3.5 per cent a year still beats most government bonds.

Different sectors are reflecting the alternative impacts of the crisis in their prices. Growth in online retail is spurring demand for logistics and warehouse assets, which are starting to look expensive. On the other side, High Street retail is starting to look quite cheap and may present opportunities in the medium term as conditions settle. Meanwhile, data centres, healthcare and mixed-use properties are embedding themselves in long-term portfolios to an extent that we haven't seen before.

While there is room for rents to fall further as the crisis grinds on into 2021, real estate remains an attractive option for investors seeking a sustainable source of high-quality income over the longer term.

Additional media

Video

Outlook 2021: Seizing the new reality

<https://video.fidelity.tv/view/wibilJzkhp2>



Podcast

Outlook 2021 CIO special

<https://video.fidelity.tv/view/ckkWybKwYoW#/>



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