

# INTERESTING TIMES LIE AHEAD IN 2008

DECEMBER 2007

*2007 has been an eventful year in world markets. Investor appetite for risk has dramatically re-rated as weakness in the US housing market has led to increased volatility in both equity and fixed income markets – as well as the inevitable impact it has had on property markets. Whilst the developed economies are bracing themselves for a US-led slowdown, the China bull story seems to continue apace. The Chinese market regularly strikes new highs and, in spite of tighter monetary policy, the economy goes from strength to strength. Chinese demand remains one of the main props to global commodity prices and a significant contributor to an oil price of almost \$100 per barrel.*

Given the increased levels of market uncertainty evident as we move into 2008, one message is clear: diversification will be essential. Investors should be considering the traditional means of diversification – by asset class and by geography – but consideration should also be given to more lateral means of spreading risk. We see moving away from leveraged asset classes as an important theme for successful investing in the new year. With that in mind, Asia may be one of the best places to build a market exposure as fewer companies – and consumers – in that region have embraced the concept of gearing in the same way as their western counterparts.

## HEADLINE THEMES

- Weak consumer confidence posing a tangible threat to global growth
- Inflation may emerge as a further threat to the global economy
- Diversification will be a key investment strategy
- Mixed outlook for global equity markets as credit conditions remain tight
- Asia likely to be a bright-spot on the back of continuing economic growth
- Eastern property markets expected to continue to outperform western counterparts
- Fixed income markets may be factoring in too much potential bad news
- Opportunities in credit markets exist on a selective basis

## ECONOMIC OVERVIEW

The global economic picture has changed dramatically during 2007. The year started off showing strong global growth and rising commodity prices but growth expectations have weakened since US sub-prime market concerns began to take hold in the summer months. The sudden contraction of credit has affected both markets and, perhaps most importantly, consumers. Consumer confidence could weaken as the value of financial assets comes under threat. House prices in the US are already falling; in the UK, they will at best level off, if not decline (albeit only slightly). It is unclear whether this has already had any impact on consumer confidence but the relationship between consumer confidence and property prices is undeniable – any bad news about the housing market is sure to dampen consumer spending which, in turn, could affect business confidence. We have already seen the most recent business confidence surveys show a downturn.

Labour markets are tight in many countries and the risk remains that a rising cost of living will trigger a wage price spiral. US firms have been hoarding labour despite the weak growth outlook and so may meet rising pay demands if that means they keep key workers. Wage demands may also become a problem in Europe, where strikes are already taking place. A convincing monetary easing cycle may have to wait for clear signs of disinflation.

Inflation, while not appearing a huge problem at the moment, could emerge as a real issue. There are already early signs that economic growth and corporate earnings are being eroded by inflation, thanks to the high demand for energy and commodities in Asia (especially in China). China could be argued to be exporting inflation to the west. With its rampant economy not showing any signs of slowing, as authorities take only limited steps to reign in growth ahead of the Olympics, China may play a major role in determining whether the US economy – and the rest of the developed western economies – faces a hard or a soft landing.

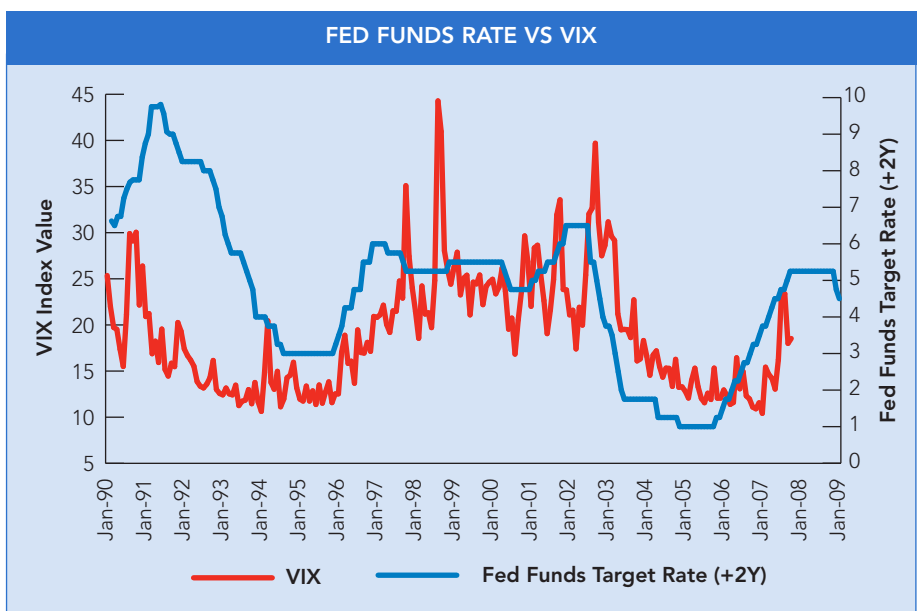
The rising inflationary threat means that central banks in the west may be limited in their response to slowing economic growth. Only the US Federal Reserve has stepped in to cut rates in response to a weak growth outlook and may be reluctant to cut further. The European Central Bank and Bank of England have remained firm with their monetary policy and held rates steady as they keep watch on this inflationary threat.

**EQUITY MARKETS**

Against an unsettled economic backdrop, Fidelity’s investment teams believe that 2008 could produce one of the most interesting years that equity markets have seen in a long time. With two of the three pillars that have supported equity markets since 2003 – leverage, consumer spending and corporate profits – unlikely to be as strong as in recent times, traditional investment fundamentals will be central to uncovering those stocks most likely to do well. No longer will investors be free to ride the positive wave that comes from leveraged private equity buyers keeping asset prices inflated.

The volatility that has swept back into markets through 2007 is unlikely to go away in 2008. History shows a clear link between equity market volatility and the actions of the Fed. Generally, there is a two-year lag between the Fed raising rates and increased equity market volatility. The Fed ended its last tightening cycle in mid 2006, suggesting it could be the latter part of 2008 before we start to see market volatility settle down again.

*"...volatility is unlikely to go away in 2008..."*



Source: Datastream, 31.10.07

Aftershocks from the credit crunch will continue to be felt in the banking sector. A tighter appraisal of risk in the securitisation markets is likely to leave banks to rediscover a less profitable business model. In 2008, it is difficult to see how the banks that are heavily reliant on mortgage business will keep up with the rest of the market. With that in mind, avoiding banks might well play an important role in the pursuit of returns.

Consumer stocks may also continue to suffer. They have already struggled to keep pace with the market in the second half of 2007 as markets anticipate a consumer slowdown. Unless these fears prove unfounded, it is hard to see how the sector will not continue to feel the pain of the credit squeeze next year.

However, investors in western equity markets should still be able to make gains, provided that they are careful about stock selection and are willing not to simply follow the benchmark. We believe that successful investing in 2008 will lie in the large cap space, with the identification of companies with strong cash flow, solid balance sheets and attractive risk/ return profiles.

Against the turbulent backdrop of the west, one of the most likely places to find such companies is Asia. Share prices in Asia have risen sharply – especially in markets such as China – but the story for investors there has been one of pure growth, not leverage. That provides a very solid base for growth whilst the rest of the world is suffering from the aftermath of a period of over-leverage. So we expect the region to rise in importance in global economic terms and for the continued growth there to be increasingly reflected in equity markets.

#### **PROPERTY MARKETS**

As in other equity sectors, investors in property securities should expect further volatility in 2008 and, as markets return to the fundamentals of equity investing, focus should be on those REITs and property companies that actively manage their property portfolios to maximise returns and offset any falls in asset prices and income that may come with a global slowdown.

The proliferation of REIT markets globally is an important structural change which we expect to continue regardless of how well the underlying property markets may be faring. The REIT market in Asia has developed quickly, whilst the UK and Europe have been much slower to adopt this model. That degree of imbalance may well correct in some part through 2008. Italian REITs are expected to begin trading on the Milan stock exchange in spring 2008, where it is believed that there are approximately 50 potential groups that could list as Italian REITs (or SIIQs). Newspaper articles also suggest that Spain's ruling Socialist Workers Party will include a proposal to introduce REITs in its campaign for re-election in March 2008. It is also said that Denmark is to get a REIT structure in the not-too-distant future.

*"...the markets of Asia continue to show signs of growth..."*

Looking to the fundamentals of the sector, as has been the case this year, it is likely that the world can again be divided into two hemispheres: east and west. The principle risk to the performance of property assets is a US-led recession. Any slowdown brings inevitable downside risk to the earnings of property companies. Lower rental growth, potentially lower levels of occupancy, increased downtime and increased incentives to release properties, as well as slowing any development pipeline roll-out, would all start to chip away at company profits. On the expectation of slowing growth in the west, market commentators have been paring back expectations for performance in the new year but the markets of Asia continue to show signs of growth. Demand in China and Hong Kong remains high and the resilience of the other economies in the region poses an equally attractive backdrop to the region's property sector.

### FIXED INCOME MARKETS

Late summer 2007 marked a significant re-pricing of risk in global fixed income markets. Investors sought refuge away from the fall-out of the US sub-prime market and its relationship with structured debt products such as collateralised debt obligations (CDOs) through a flight to quality, in particular into government bonds. Government bond markets have strengthened and yields have fallen a long way since then and are now discounting a series of interest rate cuts that Fidelity's fixed income team believes may come through more slowly than the market expects, due to the inflationary concerns mentioned previously.

As investors moved into safer assets, credit spreads – the additional yield investors demand for taking on the extra risk of investing in non-government debt – have widened a long way in 2007. However, we do not believe that, even if global economies slow, corporate bond default rates (which remain low) will rise to the levels seen in the last credit bear market of 2001 and 2002. Over the medium term, credit looks good value, although good analysis and strong stock selection is of vital importance in this volatile environment. By the second half of 2008, investors willing to roam the credit markets again might find some very interesting opportunities. In particular, asset backed securities – bonds underpinned by the cash flows from long term businesses, including mortgages – should begin to provide very interesting yields for funds that can capture them.

Whilst economies will slow and the evolving US housing problems and tighter credit conditions will have an impact on bond markets, the general perception about growth prospects may be too gloomy. Yields already seem to factor in a lot of potential bad news. Selective issuer and credit selection should still offer fixed income investors attractive opportunities in the coming year.

### CONCLUSION

The increased market volatility which has been in evidence since summer 2007 is likely to continue. Volatility is not necessarily a bad thing. Oftentimes it makes it easier to uncover quality investments. However, volatility also highlights the importance of building a diversified portfolio of assets. In 2007, we have seen evidence of the inverted relationship between equities and fixed income, government bonds especially. Property and commodity markets have also shown their own, distinct investment traits. These distinctions are likely to be equally important in 2008 as markets grapple with an uncertain economic backdrop and the ongoing troubles of the financial sector. Good, solid, fundamentally sound investment opportunities do still exist in such a market. Good, solid, fundamentally driven research will be the key to finding them.



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