

CIO PERSPECTIVE: EQUITIES

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December 2011

2012: Another year of living dangerously



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AT A GLANCE

- 2012 should see us enter the final phase of the eurozone debt crisis.
- Investors should proceed with caution. The prospect for capital appreciation in most developed equity markets is low.
- Within equities, investors should focus on income-generating stocks. High-quality companies with high dividend yields are attractive on a total return basis and offer a measure of downside protection in volatile markets.
- The attractions of emerging markets will become even more conspicuous in 2012. Investors should take advantage of buying opportunities to increase exposure to an asset class with superior long-term fundamentals.

2012 will be a difficult year for equity investors - another year of living dangerously. The prospects for capital appreciation in most developed equity markets are low, and the imperative to consider the income-generating aspects of equities has never been greater. Emerging markets will not be immune from eurozone-inspired volatility but their attractions will become more conspicuous as the developed world's problems are laid bare during the final, volatile phase of the sovereign debt crisis.

The eurozone sovereign crisis is entering a new, and most likely final phase. The locus of the crisis is spreading from the periphery to the core, threatening to engulf all of continental Europe, including France and even Germany. While it is not yet a global sovereign crisis for developed economies, this is not something that investors should rule out as financial transmission mechanisms could quickly send contagion towards the UK, the US and beyond. Indeed, given the political deadlock in the US, there is the potential for their credit rating to come under further threat if we do not see credible fiscal consolidation plans in 2012.

The theme that drove bond markets in 2011 was the reappraisal and re-pricing of peripheral sovereign bond debt. In 2012, the theme driving markets is likely to be a more general re-pricing of core, AAA rated sovereign debt. We have started to see the beginnings of this process and the markets are ahead of the rating agencies once again.

Funding conditions in the inter-bank lending markets have weakened recently, and are likely to deteriorate further. As a result, the capacity of the ECB to purchase bonds could quickly become exhausted, as its purchases drain reserves from the inter-bank lending market. The subsequent reduction in liquidity raises the prospect of a funding crisis in the global banking sector which will lead to weaker economic conditions everywhere.

In response, central banks will ease monetary policy. The US and UK are likely to undertake further quantitative easing. The pressure will build on the ECB to do the same given the need to support an enlarged group of sovereigns, but I fear German opposition to quantitative easing will be very difficult to break down.

At the moment, the ECB is merely buying time for peripheral countries to make the necessary internal adjustments, however, that adjustment process is becoming more and more difficult. I believe investors must give some weight in their thoughts to the possibility of a eurozone break-up as markets, and peripheral governments, realise that a combination of austerity, deteriorating fiscal dynamics and economic contraction is locking the periphery into a vicious downward spiral.

The immediate implication of such a break-up scenario would be the imposition of a foreign exchange crisis onto the present sovereign, banking, and economic crisis via several significant devaluations in the eurozone periphery. While these devaluations would enable peripheral nations to set about the process of restoring their economic competitiveness, in the short-term they would create a significant foreign exchange crisis that would exacerbate the problems within an already fragile financial sector.

Economic weakness and financial contagion in Europe will inevitably impact on global growth, although, the prospect of a recession in the US is still relatively low. We will also see slower growth in emerging markets, however, that will be considerably in excess of the developed world. A slowdown in emerging markets is not a huge concern as these markets face inflationary pressures to which slower growth is a partial solution. This allows monetary policy in emerging markets to become more accommodative.

So 2012 is likely to be a troubled year for developed economies and Europe in particular, however, the attendant volatility that we see in financial markets may also mark the last down-leg of the debt crisis as equity markets are excellent discounting mechanisms. While the prospect of capital appreciation is very low in developed equity markets, there are opportunities in income and in emerging markets.

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Within equities, investors should focus on high-quality, defensive companies with stable and reliable earnings streams, which pay high and sustainable dividends. In Europe, dividend yields are considerably in excess of their 15-year average and there are a number of equity funds which are targeted towards this particular income-yielding section of the market; the income offers a measure of protection to investors against further market volatility. These companies are typically large, robust household names like Unilever, which may well prove to be a relatively safe place for investors to park some of their cash, when consideration is given to the mounting stresses in the banking system.

The contrast between emerging and developed markets will become even more conspicuous in 2012. Investors should be alert to buying opportunities in emerging markets that allow them to increase exposure at attractive prices. The long-term case for emerging markets is intact and the fact we are in a 'two-speed world' in economic growth terms will only become more obvious.

In episodes of heightened volatility, emerging markets will not offer near-term respite as equity correlations converge. However, I do believe over the course of 2012, investors will begin to reward their superior economic fundamentals and their better ability to recover from the slowdown in global growth. The headwinds in emerging markets are cyclical in nature rather than structural, so the case for investment is robust on a medium- to long-term view. I believe emerging markets will ultimately deliver better economic and stock market performance in 2012 than their overly indebted developed counterparts.



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