# OUTLOOK 2008 FROM FIDELITY INTERNATIONAL

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- **Mixed outlook for global equity markets as easy credit conditions tighten, but Asia to remain buoyant on the back of continuing economic growth**
- **Gains still to be had in equities for those willing to pay less heed to the benchmark indices. Avoid banks and look for well-financed companies**
- **Interest rates to remain low by historic standards although higher inflation could emerge as a serious threat**
- **Diversification away from the leveraged markets of the West will be key to good returns in 2008**

**December 2007** – Commenting on the outlook for markets in 2008, **Michael Gordon, Head of investment strategy at Fidelity International,** says: "Next year could be one of the most interesting for equity markets this decade. At least two of the three pillars that have propped up the equity bull markets of the West since March 2003 – leverage, consumer spending and corporate earnings – could be missing in 2008.

"Leverage, which has underpinned so much of the rise in all markets over the last couple of years, is no longer readily available on attractive terms. The era of easy credit is over. As a result, the private equity houses are in retreat. Their absence from the market – and more particularly, their willingness to buy assets – means that the traditional investment fundamentals such as earnings growth will need to take centre stage next year.

"In developed countries, consumer confidence could weaken, too, as the value of financial assets comes under threat. Falling US house prices have begun to have an impact on consumer confidence and 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.

"The economic backdrop is less than rosy. 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 rampant consumption of energy and commodities in Asia. The big question is whether central banks in the West will be hamstrung in their response to slowing growth by a rising rate of inflation. Financial institutions might well push for lower rates, but will the banks oblige?

"How will this play out for investors? Well, they may want to avoid banks for a little while yet. Banks, one of the largest sectors in some markets, have begun to see their earnings forecasts downgraded. Typically this cycle takes around 18 months and it's hard to see the overall market moving ahead while forecast earnings are being cut.

"Aftershocks from the Great Credit Crunch of 2007 will continue to be felt in the banking sector. Securitisation and off-balance sheet activities will quickly become a distant memory, leaving banks to rediscover a less profitable banking model. In 2008, it is difficult to see how the domestic banks – those heavily reliant on mortgage business – will keep up with the rest of the market.

"That said, I believe that investors in the equity markets of the West will be able to make gains in 2008, provided that they are careful about stock selection and are willing not to be led by the main stock market indices. Avoiding banks might well play an important role in the pursuit of returns, but so will the identification of companies with strong cashflow and solid balance sheets.

"Indeed, if the market does become choppy, then investors might be best off in well-financed companies. More broadly, given the increased levels of uncertainty, diversification will be essential. Investors will need to consider the traditional ways of diversification – by asset and by geography – but they will also need to think laterally. Moving away from leveraged asset classes will be important. My view is that Asia is the best place to see market exposure without leverage.

"Sure, share prices in Asia have risen sharply in some markets such as China, but the story for investors there has been one of pure growth, not leverage. Put bluntly, we expect the region's rising importance in global economic terms – and the continued growth there – to be reflected more in equity markets.

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"Moreover, Hong Kong and China come with a free currency "option" for investors. At present, both the Hong Kong dollar and the Chinese Renminbi are pegged to the US dollar. Should the authorities remove the peg, there would be a one-off currency boost for foreign equity investors. That may not happen in 2008, but one day it will.

"On the other side of the world, the US looks problematic. Leverage is greatest there: it will take time for the structural excesses in credit markets to unwind, perhaps a year or two. The dollar is weak and it is hard to see what will cause that trend to reverse. In 2008, New York will remain a destination for shoppers, not investors I'm afraid.

"By the second half of the year, investors willing to roam the credit markets might find some very interesting opportunities. Asset backed securities – bonds underpinned by the cashflows from financial products such as mortgages – should, by then, begin to provide very interesting yields for funds that can capture them

"Globally, monetary conditions are likely to remain supportive. Interest rates continue to be low by historical standards and central banks are more likely to cut the cost of borrowing than raise it, particularly if economic growth does stutter. I believe shares will offer positive returns – provided that investors are choosy about stocks and are less influenced by the make-up of benchmark indices."

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