November 2024

Insight into Fidelity's capital market assumptions

H2 2024: A new fair-value based framework

Fidelity INTERNATIONAL

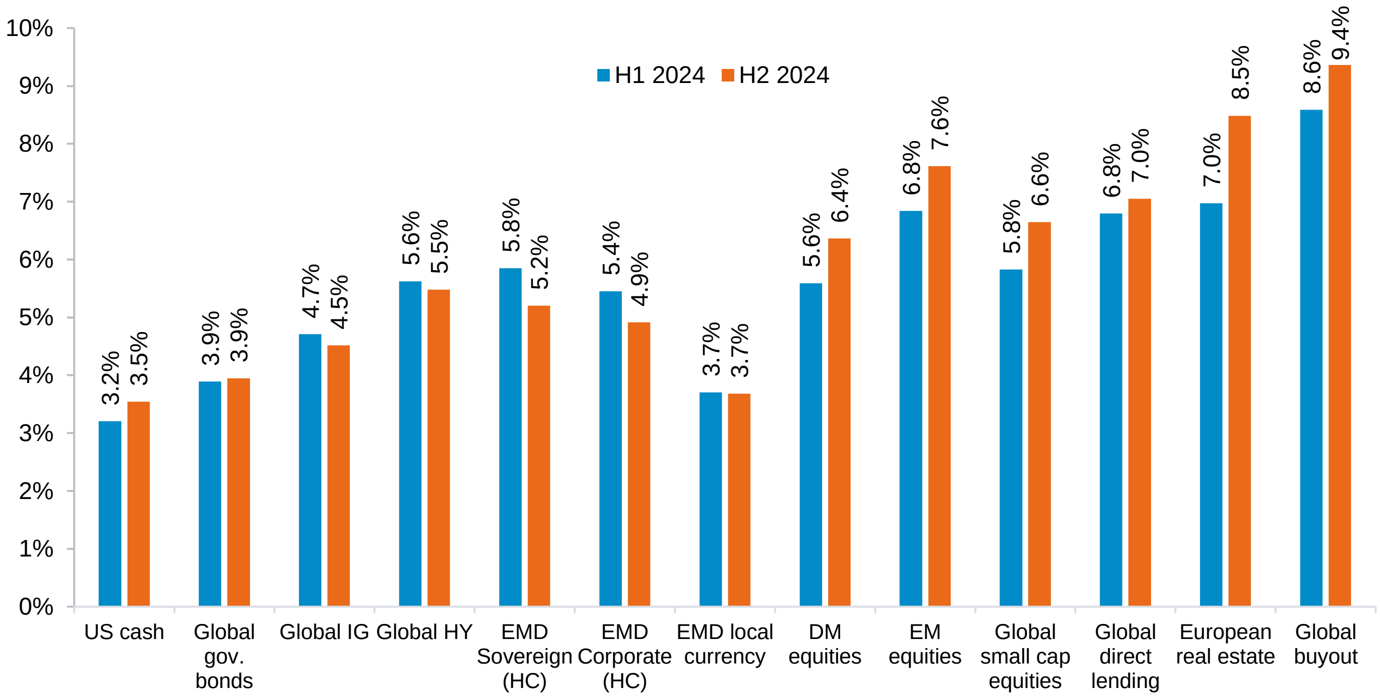
Executive Summary

Capital Market Assumptions H2 2024 update key points:

- **Macro trends:** Inflation and policy rates are likely to be structurally higher in the coming 10 years than in the previous decade.
- **Fixed income:** Bond yields are still relatively appealing; high yield is one of the most attractive parts of the fixed income universe though current volatility is subdued versus projections.
- **Equities:** Despite some markets being overvalued, a geographically diversified equity strategy will continue to remunerate investors over the long term.
- **Private assets:** Expected returns are still attractive for long-term investors willing to take on more illiquidity risk. That said, manager skill remains key when it comes to delivering portfolio outcomes.

Figure 1: Better short-term macroeconomic outlook raises expected equity returns relative to bonds

Average nominal return projections in USD, 10-year investment horizon



Source: Fidelity International, H2 2024. For illustrative purposes only. Global direct lending, European real estate and global buyout returns are net of fees.

Soft landing comes into view

The near-term macroeconomic outlook has improved since our last Capital Market Assumptions update in H1 2024. A soft landing has been our base case for much of 2024 and appears more likely than ever, which has led to an increase in our projections for equity returns and a decrease in our projections for fixed income returns over the next 10 years.

That said, economic cycles remain short and volatile, and financial markets are highly responsive to real-time data and revisions due to data-dependent central banks. Geopolitical risks including tensions in the Middle East and the US presidential election are adding to uncertainty and market volatility. We are monitoring these risks closely, particularly their effect on energy markets, trade, and fiscal policy.

Looking beyond 2024, the outcome of the US election, US Federal Reserve policy direction and the potential for additional stimulus in China will all be key determinants of macroeconomic trends and financial markets in 2025.

Over a longer time horizon, we still believe that inflation is likely to be higher than central bank targets and market consensus due to the ongoing structural forces of de-globalisation, de-carbonisation, and higher public debt, as detailed in our research in this paper. For this reason, we believe interest rates will also be higher than current central bank projections over the medium term.

The significant changes in macro conditions over the past five years have also led us to make several improvements to our model for equity returns. First, we have built new fair-value models for forecasting long-term equity valuations and profit margins, both key determinants of equity returns. Second, for the first time we have included Fidelity's bottom-up analysts' expectations of aggregate earnings in our model. Drawing on our analysts' rich sector and stock expertise makes our model more robust at forecasting returns over the near term.

In addition, our decision to update our CMAs every six months rather than annually makes them better able to capture abrupt changes in the macro environment that can sometimes have long lasting effects. For example, climate change might be a long-term theme, but developments in regulations, public spending, and technology are likely to follow an uneven path with periods of significant change following periods of inertia. We believe our models are better equipped than ever to reflect the world we live in.

Full details of the improvements to our model can be found below, along with full details of our macroeconomic outlook and asset class return expectations over the next 10 years.

Updating our model: A new dynamic framework to manage regime shifts

Fidelity's Capital Market Assumptions are our expectations of financial assets' risk and return. They are primarily based on our top-down macroeconomic views, in particular the evolution of policy rates, GDP growth, and inflation across various horizons and regions, and this year we have enhanced them by including the earnings estimates of Fidelity's bottom-up analysts.

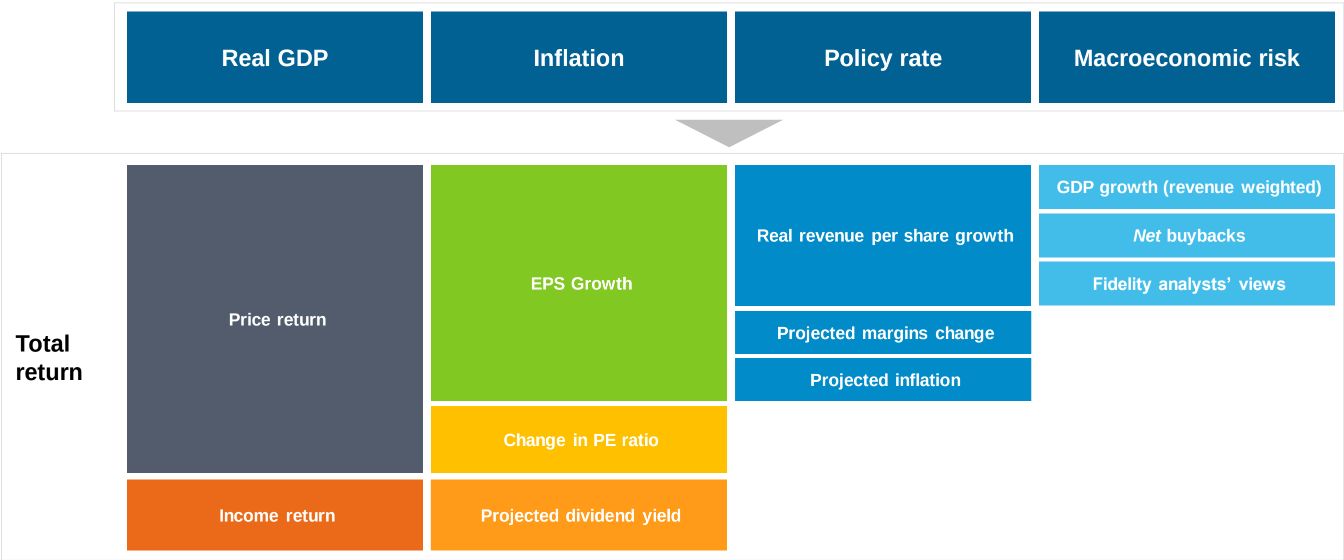
Of course, the real world never perfectly matches the models used to describe it, and the various macroeconomic inputs that we use fluctuate around our best estimates of their long-term equilibria. We use both quantitative and qualitative inputs to assess where these equilibria lie and how fast each variable will return there from its current state to build our long-term projections of asset returns.

In particular, our estimates for long-term equilibria are based on our views of key economic trends that we believe will change economies and markets over time, such as climate change, AI, and high debt-to-GDP ratios.

When building such models, it is natural to begin with the assumption of mean reversion and then adjust based on prevailing trends. However, the world has gone through so many profound changes in the past five years that we felt it was the correct time to perform an audit of our CMA model and its assumptions to consider if variables were likely to revert to their long-term averages or whether recent events and macroeconomic conditions had caused a regime shift that would likely lead to different long-term equilibria than previous periods.

Figure 2: A breakdown of equity returns in our CMAs

A combination of proprietary top-down and bottom-up forward-looking views



Source: Fidelity International, H2 2024. For illustrative purposes only.

From this research, it has become clear to us that two particular inputs into our model for equity returns - the calibration of equity valuations and corporate profit margins - require an updated framework. Both variables have remained above their long-term averages for some time and we believe that changing conditions mean they are unlikely to revert to their long-term historical means. We have therefore updated our model to account for this, making it more connected to the current macroeconomic environment and more dynamic in order to adapt to evolving future trends.

Figure 3: Key variables in our new fair value models for valuations and profit margins

	Driver	Macro-financial explanatory variable
PE	**Real rates**	Real 10-year yield
	Equity risk premium	Macroeconomic volatility (real GDP and inflation)
	Earnings growth	Trend in real earnings growth

	Driver	Macro-financial explanatory variable
Profit margin	**Operating margin**	GDP growth
	Effective corporate tax rate	Effective corporate tax rate
	Interest coverage ratio	Real 10-year yield

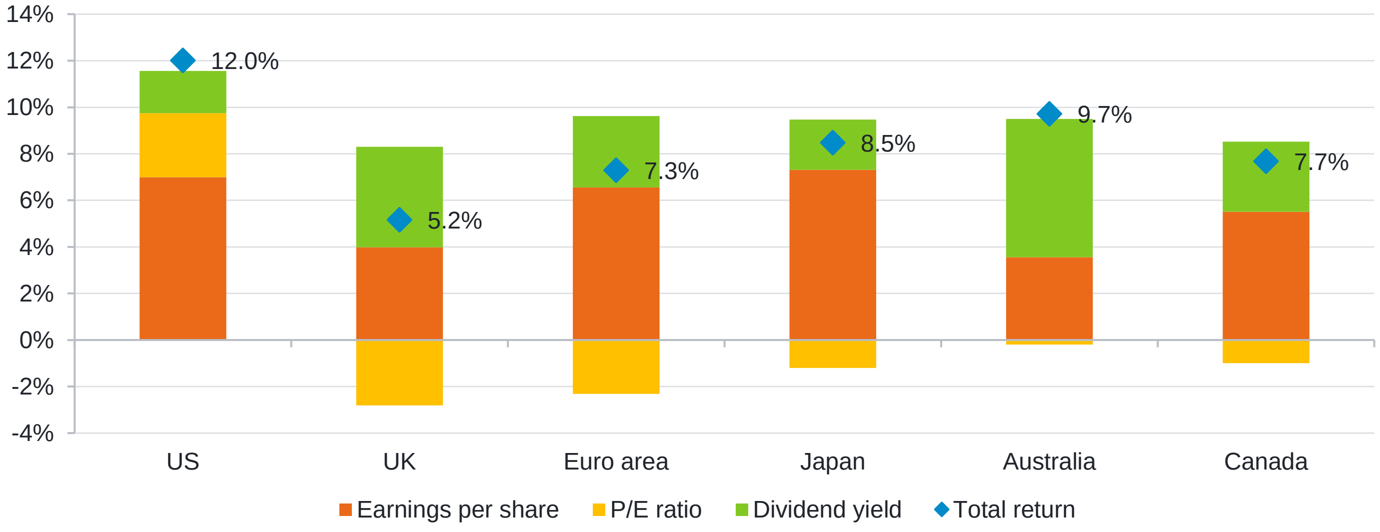
Below we discuss the reasons behind this shift and detail our new approach to modelling their equilibria.

Equity valuations

Equity returns are made up of dividends and price movements, which are themselves determined by changes in valuations and earnings growth. Therefore changes in valuations are crucial to forecasting equity returns. High equity valuations, especially in the US, have become a common market feature in recent years. Various explanations have been offered, from quantitative easing to the rise of the information technology sector.

Figure 4: Valuations changes have boosted US equity returns over the past 10 years

Equity return breakdown, past 10 years



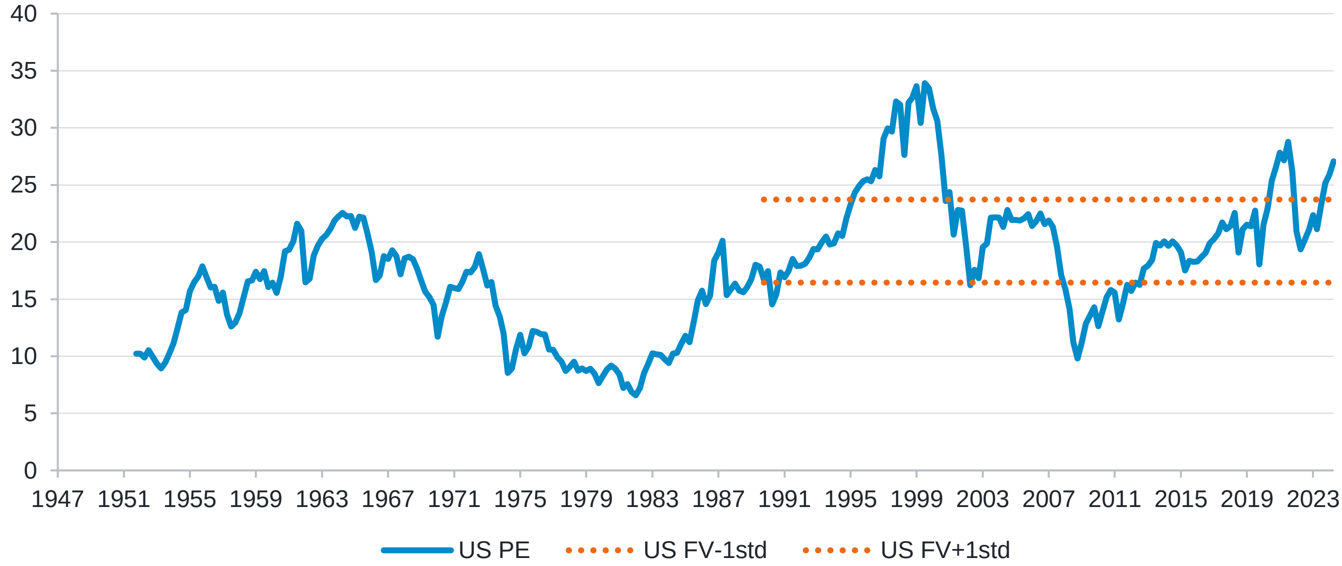
Source: Fidelity International, H2 2024. For illustrative purposes only. Data used is from December 2013 to December 2023.

We believe that the shifting macroeconomic landscape means that valuations may indeed not return to long-term historical averages. This necessitates a more dynamic model to forecast valuations, one that is forward-looking and can adapt to secular trends. To that end, we built a proprietary fair value model based on the three variables (and their expectations) that drive valuations: real rates, the equity risk premium, and earnings growth.

Our fair value model reveals that price-earnings ratios (defined as real price divided by 5-year average real earnings) globally have indeed risen since 1990 in most of the largest markets. In addition, there are three long-term trends, based on the three variables that drive valuations, that explain this.

First, interest rates have broadly fallen since 1990. When interest rates are low, investors are willing to pay more for equity returns given a reduction in the discount rate (all else equal) and the lower returns available in fixed income assets. Second, the pace of earnings growth has increased since 1990, at least in the US. When companies are growing faster, investors are willing to pay higher prices today in the expectation of higher future returns. Finally, the equity risk premium has decreased since 1990. When macroeconomic volatility, a proxy for the equity risk premium is low, investors have greater certainty about future equity returns and are willing to pay a higher price for those returns. Of the three drivers, macroeconomic volatility is the most significant one in all developed equity markets.

Figure 5: US equity valuations have recently deviated from our forward-looking fair value estimate



Source: Fidelity International, H2 2024. For illustrative purposes only. Dotted lines are the +/-1 standard deviation levels from the fair value mean.

Current valuations in most equity regions that we cover in our CMAs are at or above fair value according to our model. In the US, valuations are higher than our fair value would suggest because equity price rises have outmatched the growth of earnings and investors have not adjusted for the increased macroeconomic volatility we have experienced recently.

But while it is interesting to analyse current valuations compared to their fair value, what matters for our CMAs is the equilibrium that valuations will converge on in future. To produce the forward-looking equilibria estimates, we made assumptions about the three key variables in our model over the next 10 years.

Our forecasts of real yields and earnings growth are a direct function of our views of policy rate, inflation, and real GDP in each region. Our forecast of macroeconomic volatility is based on our assumption that macro risk will decrease over time from its current elevated levels, although we think it will settle higher than the years directly preceding the Covid pandemic, which was among the least volatile periods since the 1980s. Weighing this all up, we believe that US valuations will fall from around 27 now to around 21 in 10 years' time.

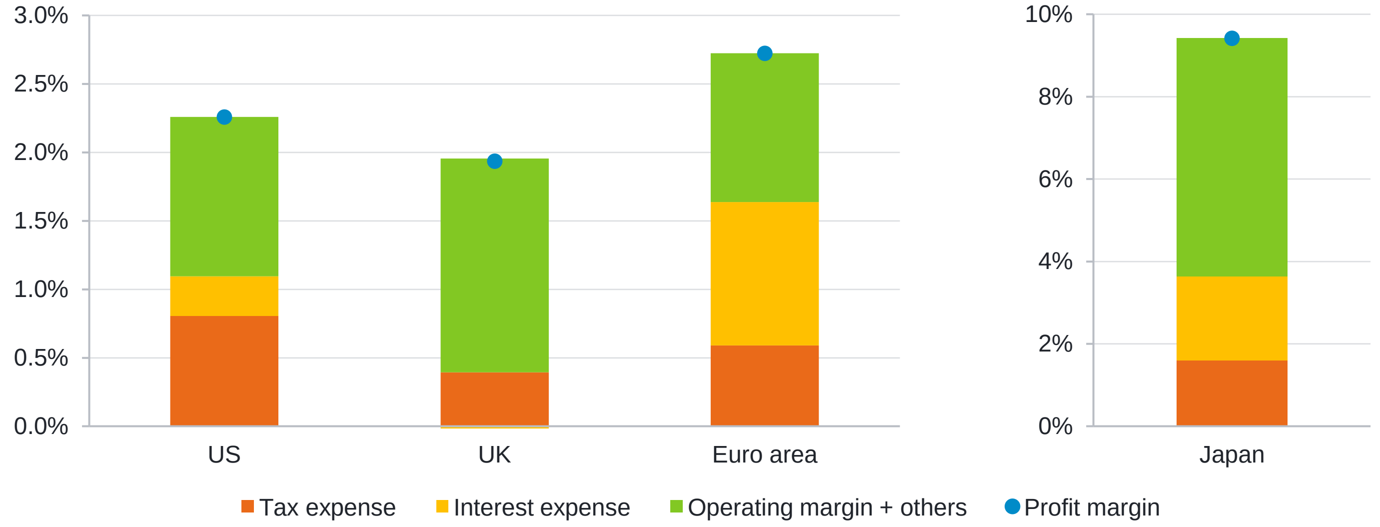
Profit margins

Expectations of the size of corporate profit margins are another key determinant of future equity returns. Like valuations, margins have been above their long-run averages for some time in some markets like the US, causing investors to wonder if they would mean revert or if the shifting macroeconomic landscape had set them on a lasting upward trend.

Again, we have updated our modelling process to account for changes in macroeconomic conditions to a dynamic fair value model based on the three key variables that determine profit margins: operating margin, the effective corporate tax rate, and the interest coverage ratio.

Figure 6: Tax and interest expenses explain roughly 50% of profit margin increases since 1995

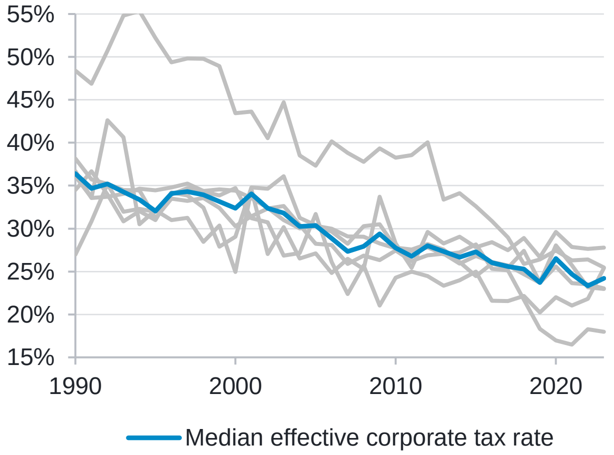
Breakdown of profit margins, December 1995-2023

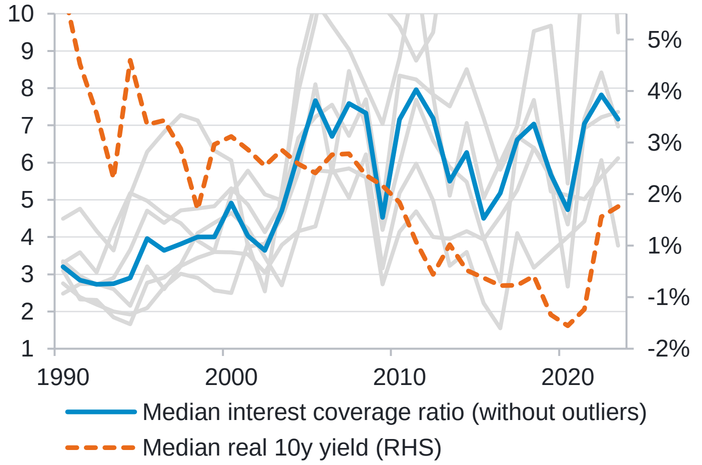


Source: Fidelity International, H2 2024. For illustrative purposes only.

Analysing the data, we find that rising profit margins historically have been caused by falling corporate tax rates and interest expenses, which themselves are a product of the falling interest rates witnessed in developed markets over the past 40 years.

Figure 7: Corporate tax cuts and lower rates have led to higher profit margins



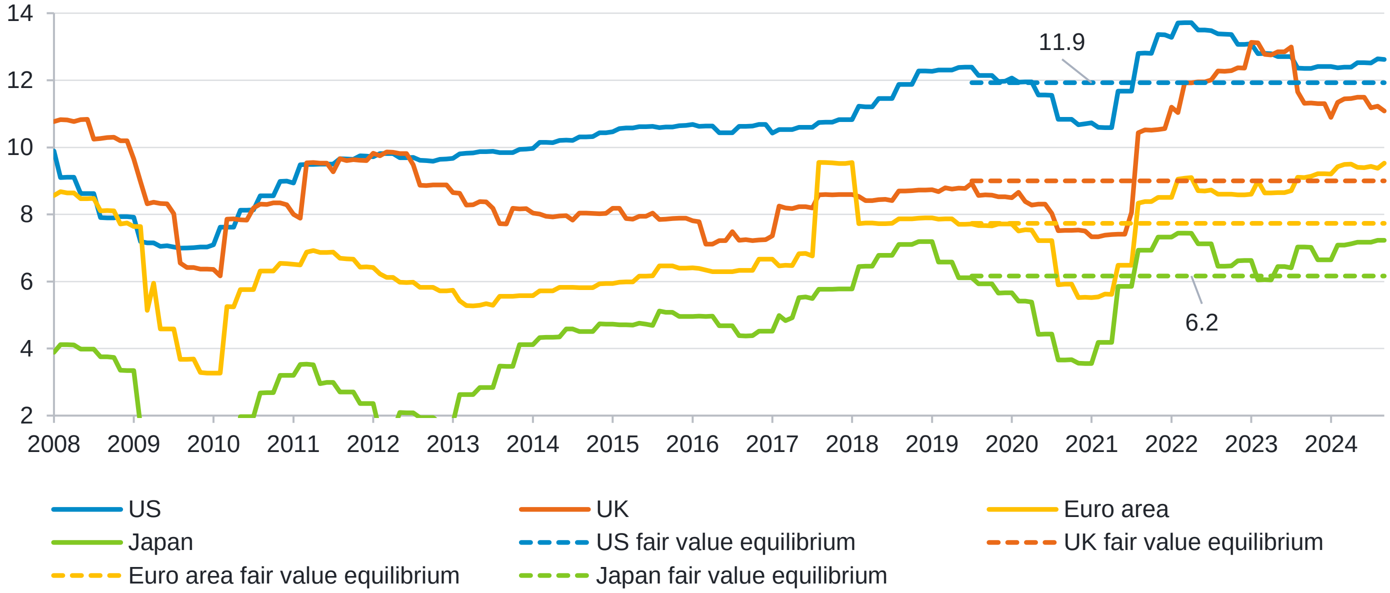


Source: Bloomberg, Refinitiv, Fidelity international calculations, October 2024. Median is computed for US, UK, Euro Area, Japan, Australia, Canada data.

These trends are unlikely to continue, however. We believe it will be difficult for corporate tax rates to be lowered much more than today, especially in light of ever-increasing debt-to-GDP ratios in most developed markets. In fact, the most likely direction for tax rates is up. Similarly, we believe that interest expenses will not continue to fall but are in fact likely to rise, in line with our view that interest rates will be higher over the next 10 years.

This would suggest that profit margins will indeed fall from their current levels. However, better operating margins could offset some of the impact of higher taxes and higher rates. Stronger GDP growth, perhaps from productivity gains, could help sustain higher operating margins.

Figure 8: Large- and mid-cap market profit margins still above our forward-looking fair value estimates



Source: Fidelity International, H2 2024. For illustrative purposes only.

A new process for a new environment

Apart from updating our forecasting process for valuation and profit margins, this year we have also included aggregates of Fidelity analysts' estimates of earnings for the first time. Drawing on the expertise of our bottom-up analysts enriches our forecasts with proprietary views on near-term market trends. Our estimates for the coming few years are based on our analysts' views before converging on our top-down derived long-term equilibria for earnings growth.

Climate change is the other key long-term trend likely to affect economies and markets. To estimate the impact of regulatory changes, physical risks, and the transition to a low-carbon economy we have produced CMAs for different climate change scenarios that integrate environmental risks and opportunities into economic and asset projections.

We are constantly looking for ways to improve our approach to buildings the CMAs. Ultimately, these updates give our CMA model greater depth and greater flexibility to react to changes in macroeconomic conditions.

CMA H2 2025 update details

Macro projections

Headline: Inflation and policy rates are likely to be structurally higher in the coming 10 years than in the previous decade.

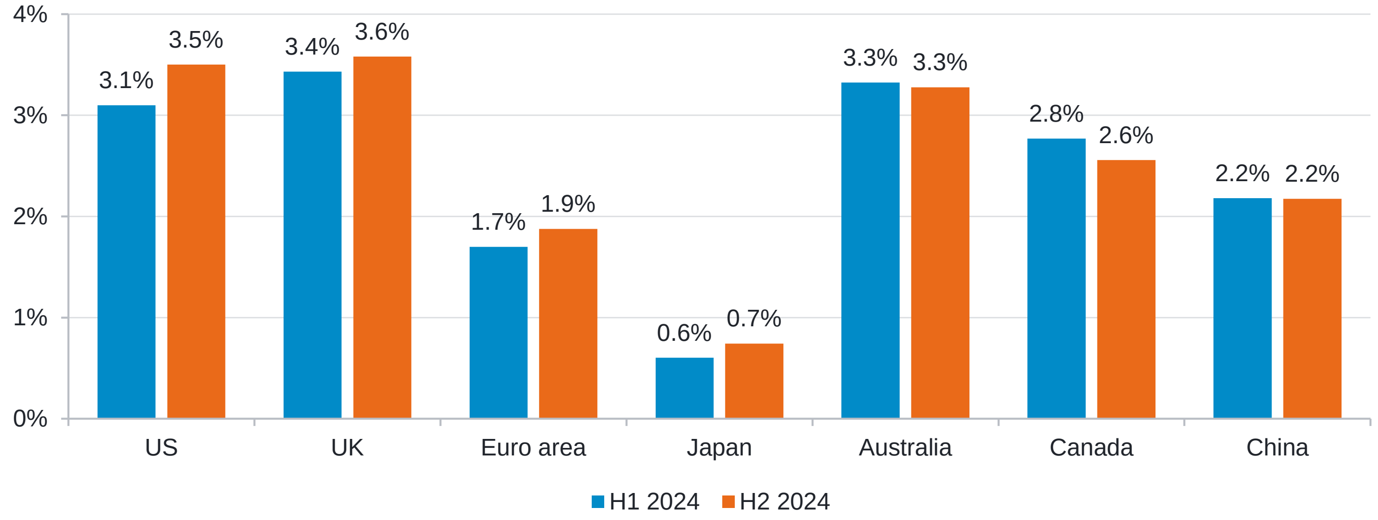
What has changed since our last CMA update in H1 2024? Our average long-term macroeconomic assumptions are broadly in line with our previous update. However, short-term uncertainty remains elevated as a result of data-dependent central banks and geopolitical risks.

Details:

- **GDP growth**: In the near term, recent data releases have supported our base case of a soft-landing and lowered the risk of a recession. The improved perception of economic health and wealth effects combined with continued easing in financial conditions have increased the risk of a no landing scenario that we are monitoring closely. Over a longer horizon, most of the developed market economies will experience an average growth below 2% over the next 10 years. Growth in China will continue to gradually moderate, with a 4% average over the next 10 years.
- **Inflation:** Inflation is moderating in most countries. However it is broadly still above target. In the short term, inflation will likely continue to be volatile, with economic cycles that remain short and uncertain. In countries such as the US and UK, we expect inflation to be structurally higher than central bank targets over the medium and long-term due to forces such as deglobalisation, net-zero transition and high debt burden.
- **Policy rates:** Our long-term projections of average policy rates have risen slightly in most regions to reflect continued risks. We believe central banks will continue to cut rates from current levels: the Fed has turned somewhat more cautious and will likely return to a more normal cutting pace of 25 bps; the ECB will likely deliver consecutive cuts until it is close to a neutral rate, while the BOE will continue to follow a more gradual easing path than the ECB and the Fed, as both inflation and wages remain stickier in the UK. We still assume most regions reach new, higher, steady state rates in late 2025 or later in 2026.

Figure 9: Inflation and policy rates will normalise but will settle at higher level compared to the past

Average expected central bank policy rate p.a., 10 year horizon



Source: Fidelity International, H2 2024. For illustrative purposes only.

Fixed income

Headline: Bond yields are still relatively appealing; high yield is one of the most attractive parts of the fixed income universe though current volatility is subdued vs projections.

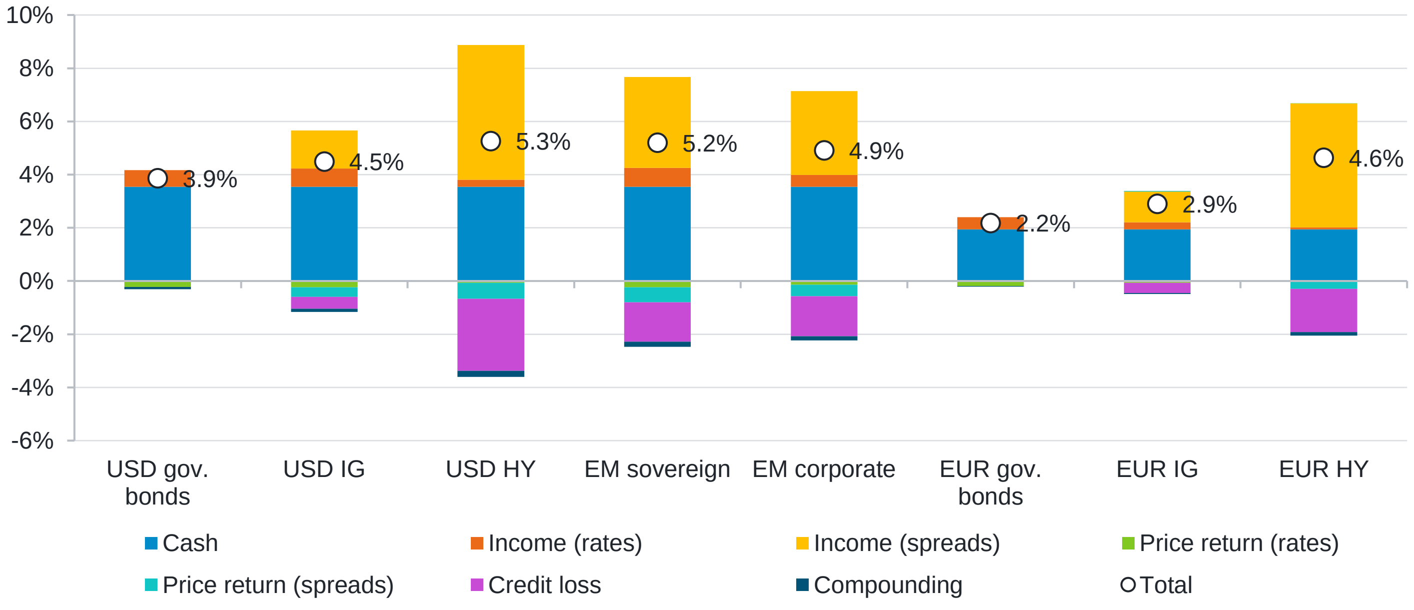
What has changed since our last CMA update in H1 2024? Our expectations of bond returns are marginally lower than those in our last update. Overall yields remain attractive compared to a few years ago and we still expect long-term rates to settle at a higher level than the pre-pandemic era. High yield remains the most attractive fixed income asset class.

Details:

- Yield curves in the largest DMs have now 'un-inverted', driven by falling short-end rates. The 10Y-2Y spread turned positive in September for the first time since late 2022 in the US, UK, and Europe. We expect this yield curve normalisation to continue, which marginally increases our expectations of the income component of bond returns over the next 10 years.
- Overall yields are still attractive relative to a few years ago, however we expect these to fall over the coming years as inflationary pressure recedes and central banks lower interest rates in response. That said, we still expect policy rates to settle at a higher level than the pre-pandemic equilibria.
- Credit spreads are still tight, but we expect these to widen over the next few years, which, along with relatively high government yields, make high yield one of the most attractive asset classes in the bond space. However, attractive average returns need to be carefully assessed alongside the risk profile of high yield bonds.
- It is important to note that from a long-term perspective, investing in diversified bonds is highly likely to remunerate investors more than cash, especially in light of central banks gradually lowering interest rates.

Figure 10: Higher cash and credit spreads will continue to drive long-term fixed income returns

Fixed income average return breakdown in local currency p.a., 10-year horizon



Source: Fidelity International, H1 2024. For illustrative purposes only.

Equities

Headline: Despite some markets being overvalued, a geographically diversified equity strategy will continue to remunerate investors over the long term.

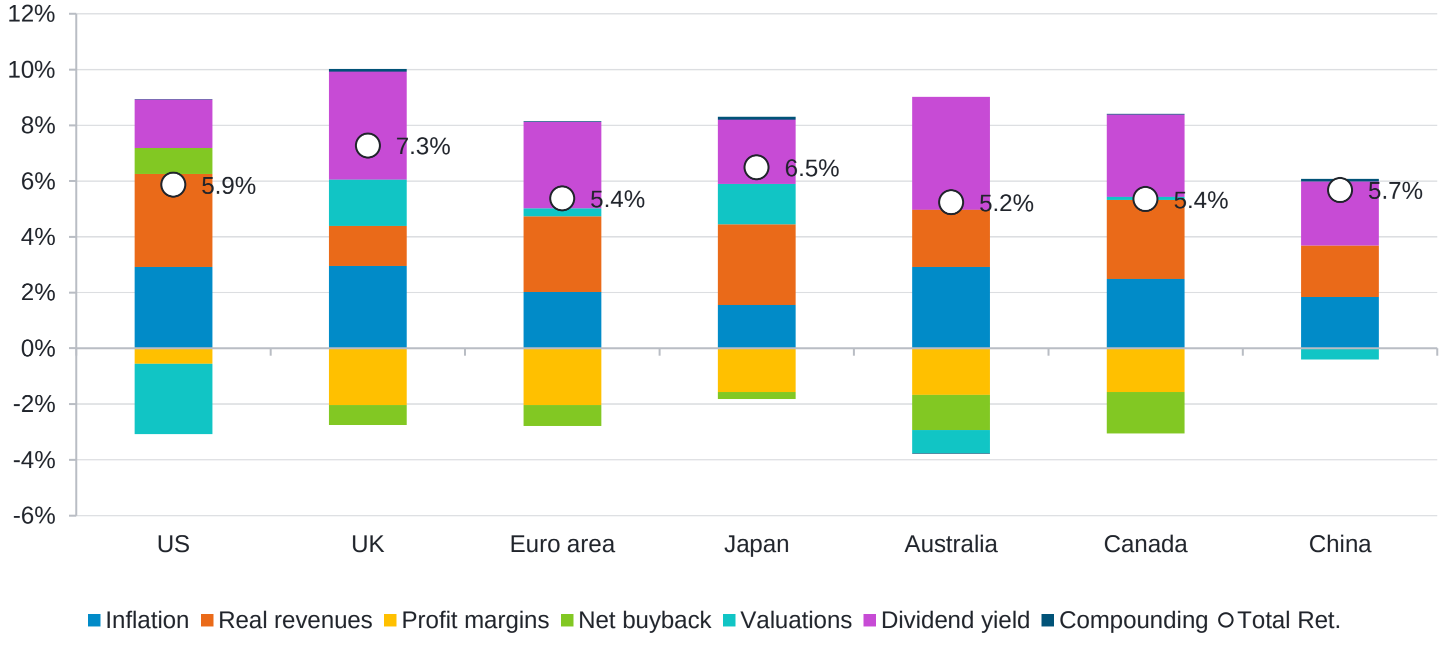
What has changed since our last CMA update in H1 2024? A better near-term macro outlook and enhancements to our equity model mean that we expect equity returns over the next 10 years to be higher than we did in our last update.

Details:

- The enhancements to our model for equity returns, especially for valuations and profit margins, have contributed to higher expected returns compared to our previous forecasts.
- Although our expectations of inflation are in line with our previous update, we expect real revenue to be an important driver of returns, especially in the US and Japan, driven by more positive expectations of the sustainability of recent trends in companies' profitability.
- Our forecasts of profit margins haven't changed in most regions, given our macro-based fair-value equilibrium is in line with our previous expectations in most regions apart from Japan, where the estimate equilibrium is lower (while still significantly higher than historical average) than previously assumed, driven by our top-down estimates of real rates, corporate taxes, and GDP growth.
- Despite PE ratios rising in most countries, the contribution of valuations to returns is not significantly different from our last estimates in H1 this year in most regions. In the UK and Japan we continue to expect a positive contribution to future returns from increasing PE ratios, because our newly introduced fair-value model projections of equilibrium PE are higher than current valuations.
- Overall, we expect total equity returns over the next 10 years to be higher than we did in our last update.

Figure 11: Earnings growth and dividend yields remain key drivers of equity returns

Equity average return breakdown in local currency p.a., 10 year horizon



Source: Fidelity International, H2 2024. For illustrative purposes only.

Private assets

Headline: Returns are still attractive for long-term investors willing to take on more illiquidity risk. That said, manager skill remains key when it comes to delivering portfolio outcomes.

What has changed since our last CMA update in H1 2024? Private markets continue to be attractive from a risk-return perspective. Long-term expected private equity returns have increased slightly in line with public markets. Real estate remains relatively attractive but dependent on the macroeconomic landscape as well as supply and demand dynamics.

Details:

- **European (ex-UK) real estate:**
  - Both inflation and economic growth affect nominal rental value growth, which are broadly in line with our last CMA update. We expect rental growth to average 1.8% over the next 10 years, with a total return (net of managers' fees, in Euros) of 6.9%.
  - Less restrictive monetary policy could be a tailwind for property prices in the future, however a lot will depend on the path of economic growth, inflation, and supply and demand over the next years. In addition, an increase in demand for green real estate could represent a long-term opportunity.
- **Direct lending:**
  - Returns are still attractive for long-term investors willing to take on more illiquidity risk.
  - Starting spreads are in line with our previous CMA update, and we expect 6.2% annual return (net of managers' fees, in Euros) for European direct lending over the next 10 years.
- **Private equity (global buyout):**
  - The 10-year return prospects look slightly better this year at 9.4% (net of managers' fees, in US dollars) because expected returns are based on those of public markets (plus an asset-specific risk premium), which have increased.
  - The cost of capital has risen (particularly relevant for more leveraged strategies in the private equity space) and the amount of dry powder is still high. On the one hand this could stimulate capital market activity while, on the other, it will require skilled managers to pick the right deals.

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Important information