



Mid-Year Outlook 2025

Research-powered investing

A global rewiring



This is for investment professionals only and should not be relied upon by private investors

Class perspectives

A more volatile policy and market environment puts a premium on expertise.

The investment teams we lead spent a long time at the start of 2025 debating valuations. That we were doing so with such vigour was some indication of where we found ourselves. Not necessarily at dotcom bust levels of overvaluation, but certainly at a point where there were real doubts over whether US tech stocks, or credit, could continue as they had.

Fast forward to early June, as we write this, and those instincts have been borne out, alongside a series of events which are arguably rewiring the world economic and security order. As uncertainty related to US policy reaches all-time highs, there has been movement in credit spreads, sharp shifts in currencies and long rates, and stock market volatility in which everyone has taken a good hard look at the underlying solidity of the businesses they invest in. Our bank of analysts do this all the time, and as an institution we've proved to be well positioned for the moves of recent months.

There is still substantial risk from here - by which we mean both for profit and for loss. As our macro team outlines, the outlook for the US economy has worsened significantly. Other economies look precarious too, and in global markets volatility has surged. The world's big investors are also naturally its big holders of mainstream assets for which the accepted wisdom is being questioned in ways not seen for a generation. We do not know yet where Treasuries or the dollar will end this year. But we can make projections, and we will make educated ones to shape investments across the various asset classes.

With that in mind we've packed this year's Mid-Year Outlook with a wide range of views, be they macro, asset-class, or sector specific. Right at the top of our minds is the fate of the US economy over the next few months, and you will find solid debate throughout this package of articles on the case for diversification - investors' chief defence in times of significant market and economic turbulence.

The case for Europe has clearly been strengthened, reflected in the market and our view of future earnings. More will be spent on defence and, whatever the domestic political arguments, a Germany that spends more is now a reality. Other central European economies are coming of age and are little exposed to US tariffs. China too, we believe, will flex its fiscal muscle to achieve its economic and policy targets.

Shifting to well-managed income strategies has been an attractive play for many. On the fixed income side, the simple option of cash has also proved popular amid the volatility but as rates come down there will be a tipping point where allocators look for more yield. Asian investors are looking more at European debt and there are signs of a recovery of interest in emerging markets as the structural dollar bull run in play since 2013 shows signs of turning.

Henk-Jan Rikkerink and Salman Ahmed discuss the deep-seated fragmentation of the global order that may arise from today's policy shifts and its macro and market implications; Lei Zhu and Matthew Quaife consider the implications for China and the rest of Asia; our latest survey of Fidelity International's company analysts digs into the impact of tariffs on the ground across regions; and in a new section, our experts dig into the implications for particular asset classes and investors' options in response.


We trust you'll be as stimulated by their ideas as we were.



Niamh Brodie-Machura
Chief Investment Officer, Equities



Andrew Wells
Co-Chief Investment Officer, Fixed
Income, Multi Asset and Real Estate

The background is a complex abstract composition. A large, dark blue circular area with a concentric ring pattern occupies the left and center. To the right, there are several overlapping geometric shapes in light blue, orange, and yellow. The overall style is modern and graphic.

"Accepted wisdom
is being questioned
in ways not seen for
a generation."

Contents

Part 1: Investment outlook	5
A global rewiring	6
Asia: The diversification trade	9
Analyst Survey: Winners and losers from new trade order	12
Part 2: Industry views	16
Foreword Wanted: New destinations for capital	17
Investment strategies to manage uncertainty	18
Four portfolio problems for insurers and how to solve them	22
Rise to the challenge: Income in 2025	25



Part 1:

Investment outlook



A global rewiring

The world is likely to fragment through the rest of 2025 and beyond. Investors may want to adjust their portfolios to reflect the new order.



Henk-Jan Rikkerink
Global Head of Multi Asset,
Real Estate, and Systematic



Salman Ahmed
Global Head of Macro
and Strategic Asset Allocation

- The first half of 2025 has shown rapid market changes, with ongoing volatility expected for the remainder of the year.
- The deep-seated fragmentation of the global order, driven by US and China policy shifts, will alter trade and capital flows, making diversification essential for investors.
- Private assets, real estate, and emerging markets like India and Latin America offer attractive opportunities with relatively cheap valuations.

Tariffs, trade deals, tantrums: the first six months of this year have shown us how quickly markets can move. Expect more jitters in what remains of 2025. More interesting for the long-term investor is the deep-seated fragmentation of the global order that will arise from today's policy shifts. The US is pushing for reliable allies in supply chains, while China is being pressured to orientate away from supply-side stimulus toward domestic consumption. A managed decoupling between both countries in strategic sectors will push trade and capital flows along new geostrategic lines.

This may confuse the picture for investors, who have long turned to the US as a relatively safe haven through previous bouts of volatility. Diversification into alternative regions will be paramount in this new age.

Here are some of our top convictions for the remainder of the year:

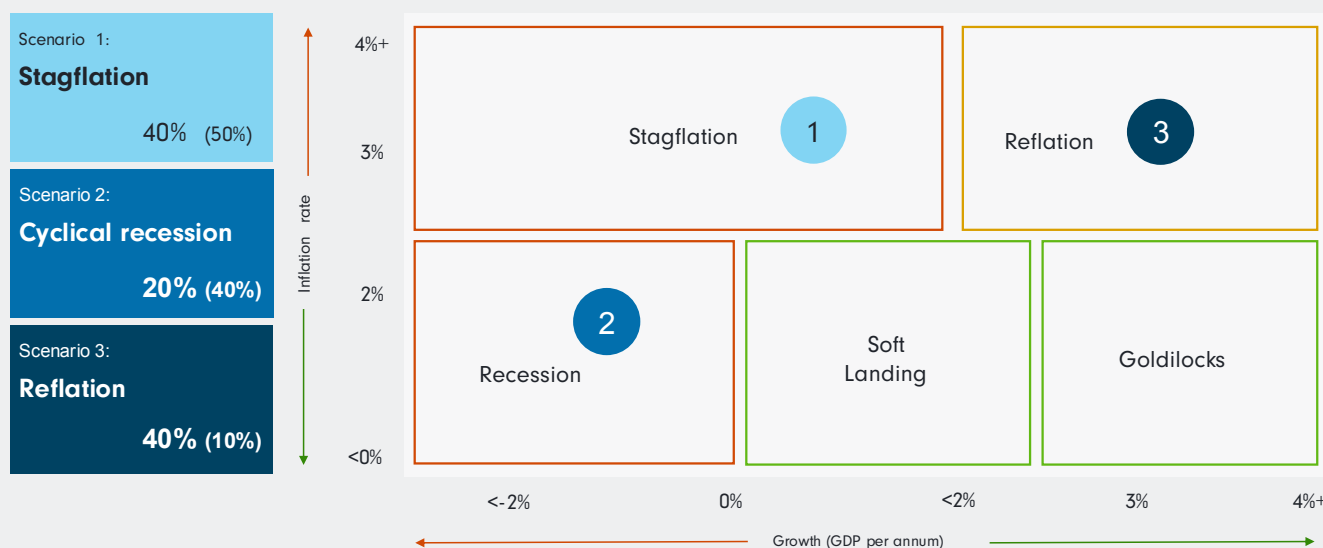
1. **Globally diversified portfolios:** Regional allocation will be more important as US assets experience heightened volatility.
2. **Hard currency and local currency EM bonds:** these stand to gain from a weak US dollar. Many are very cheap. Some, including Brazilian and Mexican bonds, boast attractive yields.
3. **The euro and Japanese yen:** these currencies should prove relatively stable and provide some of the defensive qualities lost from a turbulent dollar.
4. **Emerging market (EM) equities:** the rally in China is better supported by fundamentals than on previous occasions. Valuations are relatively cheap. China, India, and Latin America provide pockets of interest.
5. **Gold:** likely to play its traditional role as a preserver of value as the dollar depreciates.

US macro: Prepare for inflation

Effective tariff rates currently stand at around 14 per cent. This is likely to increase inflation in the US, to around 3.5 per cent this year. We believe there is a 40 per cent probability that this materialises as economic reflation, and a 40 per cent probability of stagflation (where prices rise even as growth falls). Meanwhile, foreign-produced goods will compete to find a home elsewhere as demand diminishes in the US. This should result in deflation in the rest of the world.

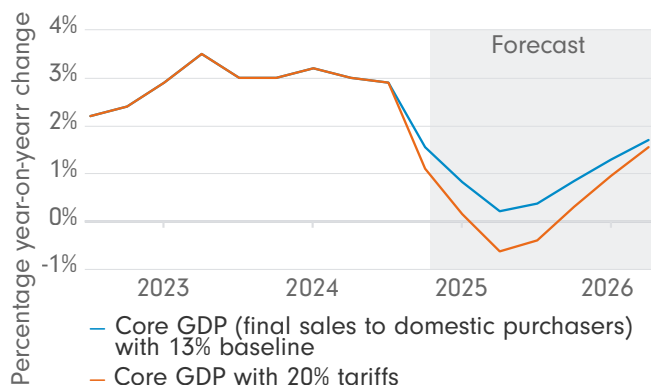
Scenarios for the US in 2025

Our combined probability of stagflation and recession has moved down, but remains high at 60%



Rising tariffs and volatile trade policy will also bring US growth down to around 1 per cent this year. While all-out recession is less likely if a de-escalation with China follows through, the picture remains uncertain. Were the effective tariff rate to rise to 20 per cent, recession would be back on the cards.

Chart 1: Effective tariff rates at 20% would push the US into recession



Source: Fidelity International, Fidelity International Global Macro Team calculations, macrobond, BEA. May 2025.

All this leaves the US Federal Reserve with a difficult balance to strike. We believe tariff relaxation and persistently sticky inflation mean the Fed is unlikely to cut rates this year (contrary to market expectations). But so long as the tariff picture remains unclear, so does the outlook for monetary policy.

Given the stagflationary risks in the US, investors will now look to alternative shores for growth hedges. Most other central banks - Japan and Brazil aside - are in a cutting cycle. We anticipate the European Central Bank will maintain its quarterly cutting cadence towards a policy rate of 1.5 per cent (and potentially lower if a trade war escalates), while improving inflation data amidst a softer labour market in the UK will facilitate further cuts for the Bank of England too.

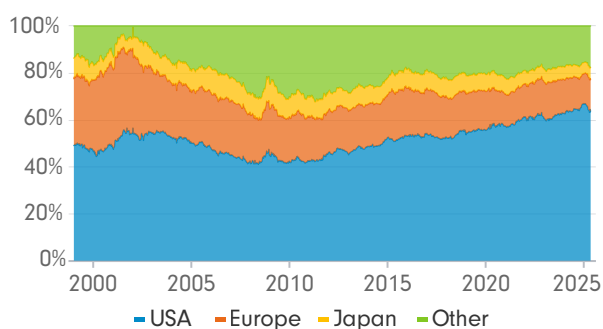
Broadening horizons

The diverging inflationary picture is symptomatic of a deeper-set, structural rewiring of the global economy. President Trump is determined to restore manufacturing to America and reduce the size of the US current account deficit by way of tariffs, while striking trade deals with friendly countries. China likewise is trying to support domestic consumption and increase the size of its service economy. Over the long term, we expect to see a fragmentation of the world's economic, technological, and security order, as both pursue more isolationist policies.

One likely consequence of these changes is a potential rebalancing of US assets in investors' portfolios. The US dollar is most obviously at risk, given its status as global reserve currency has fed into the twin deficits that Trump is now trying to reduce. The effectiveness of the US dollar as a hedge to equity risk is also coming under question, building on today's dollar depreciation as foreign investors lift hedge ratios.

Diversification has always been important. Now it is imperative for portfolios that have become increasingly reliant on US assets over the past 25 years. Capital outflows and a dollar depreciation mean index weightings will look very different in the future. Those who get ahead of these structural trends may stand to benefit as portfolios rebalance.

Chart 2: US assets dominate today's portfolios
MSCI all country world index



Source: Fidelity International, May 2025.

The euro could prove a significant beneficiary from the repatriation of flows, while newly expansive German fiscal policy signals the potential for a revival of the region. The valuation and defensive characteristics of the Japanese yen also make this currency appealing,

while gold should continue to respond well to any further geopolitical ruptures.

Emerging markets are attractive. Debt will be buoyed by dollar depreciation - some countries such as Brazil and Mexico already offer very attractive yields. EM equities look relatively cheap. The market is underpinned by Chinese stocks, which have turned a corner following AI breakthroughs in the country.

Private assets including real estate offer further diversification potential. That's particularly useful given their long-term investment horizon and active ownership in many strategies, providing investors with the ability to make adjustments to evolving market dynamics. Likewise, investors may find alternative opportunities in real estate, especially through higher income yielding European markets which can protect against inflation, and through the value-add of 'greening' previously unsustainable buildings.

And there is still room in a diversified portfolio for US equities. The S&P 500 comprises many of the world's biggest and most innovative companies, which are highly profitable and shareholder friendly. It would be unwise to bet against the US entirely; but equally it is not the only game in town.

Fickle fiscal

Fiscal policy also supports the case for portfolio rebalancing. It is impossible to ignore the US debt burden, and the country shows no sign of stabilising its trajectory. It is running wartime-level deficits at a time when the unemployment rate is at cyclical lows. High volumes of treasury issuance paired with today's volatility are creating a risk premium on long-term debt, as the imbalances between supply and demand become more prominent. This further erodes the appeal of US Treasuries as a safe haven and strengthens the case for diversification elsewhere.

One such area could be German bunds. US foreign policy and the need for Germany to boost internal investment in infrastructure and defence spurred the country to initiate a fiscal U-turn earlier this year. There is still ample room for more issuance given Germany's track record of fiscal rectitude.



Asia: The diversification trade

The ongoing divergence between economies presents a new reality for Asia. At the same time, it offers exciting diversification opportunities across the region.



Lei Zhu
Head of Asian Fixed Income



Matthew Quaife
Global Head of Multi Asset

- While Asia's reliance on trade makes it highly vulnerable to tariff tensions, many of the region's central banks have room to ease monetary policy, offering a buffer against their impact.
- Investors are reallocating funds from traditional safe havens towards Asia, drawn by its potential for growth, currency appreciation, and evolving consumer markets.
- Despite the near-term uncertainty caused by US tariffs, Asia's long-term growth prospects remain robust, supported by ongoing favourable structural shifts in China, Japan, and India, and strategic positions in the AI supply chain for countries like South Korea and Taiwan.

Asian markets breathed a sigh of relief after the US and China reached a temporary agreement on tariffs in May. But after all the surprises, twists, and turns, to say a great deal of uncertainty remains is fast becoming the clichéd understatement of the year.

One thing is for sure. We are in a new era of geoeconomic fragmentation. Neither the US nor China says it wants to fully decouple from the other, yet there is growing evidence of that happening in strategic areas. Asia's reliance on trade as an engine for growth leaves it particularly exposed to those tensions. Meanwhile frequent shifts and reversals in trade policy make it doubly challenging for governments to deliver timely fiscal and monetary policy responses.

However, compared with others, many Asian central banks have more monetary room to soften the impact of tariffs on their economies. While inflation remains sticky in the US, it is cooling in most of Asia,

and a recent surge in the region's currencies gives central banks more leeway. We expect to see more monetary easing through the second half of 2025. Investors looking to diversify their portfolios through this new era will find much to like in Asia.

Here are some of our top convictions for the months ahead:

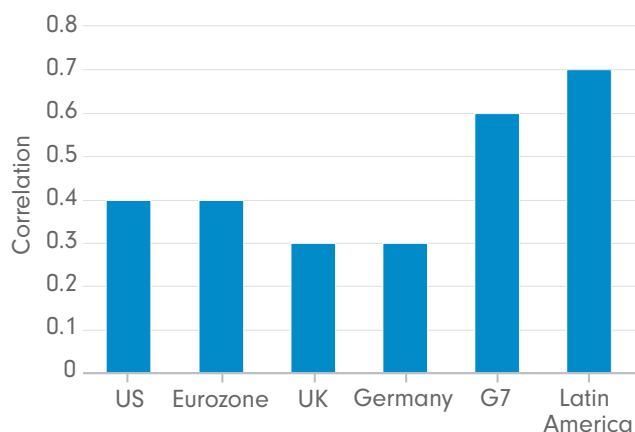
1. **Asia's investment grade local currency government bonds:** these are now an appealing diversification play, which will benefit from potential interest rate cuts.
2. **Currencies:** remain historically cheap even after the recent rally.
3. **China technology stocks:** China's ongoing shift from the world's factory to the world's innovator will further unlock the growth potential of tech firms.

Compelling grounds for diversification

Uncertainty around US trade policy combined with its growing debt burden is pushing global investors to reallocate funds away from the traditional safe havens of the dollar and long-duration Treasuries. There are a number of areas where Asia is set to benefit from the shift.

We like Asia's investment grade local currency government bonds. They exhibit low-to-moderate correlations with major global peers, which makes the asset class a good diversification tool. After years of development, the markets are far deeper than they once were, driven by growing economies and increasing support from regulators. More index providers have added the region's local currency bonds to their global indices, enhancing the appeal of the asset class. Central bank rate cuts and the potential for currency appreciation should lead to a boost in demand for the asset class.

Chart 3: 10-year correlation between Asia local currency government bonds and major global peers



Source: Bloomberg, Fidelity International, June 2025. Note: Correlation data is based on monthly returns (unhedged) of Bloomberg, ICE BofA, FTSE, and JP Morgan indices that focus on sovereign debt. Data as of March 31, 2025.

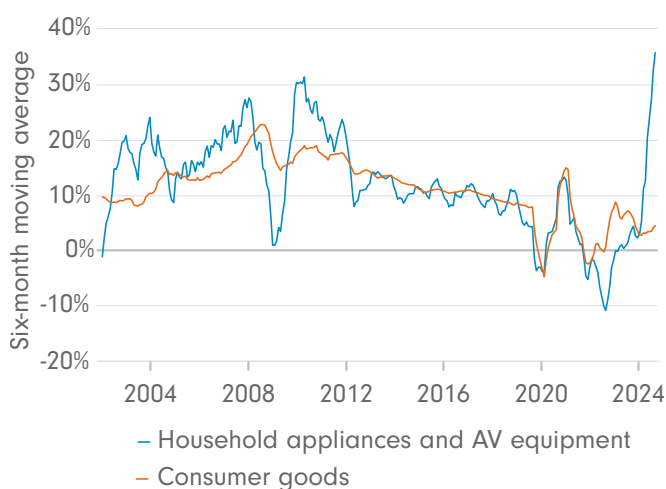
Despite the recent rally, Asian currencies still look cheap relative to their historical long-term averages, as measured by the real effective exchange rate. Demand for the region's currencies is likely to pick up further as investors seek dollar alternatives and position for ongoing tariff talks.

Change is afoot

Structural shifts in Asia's biggest economies are strengthening arguments for regional allocations too. Chinese policymakers have been focusing more on supporting domestic consumers as part of the country's moves to achieve its target of around 5 per cent growth this year. In March 2025, the government expanded a state subsidy programme that provides discounts on purchases of new consumer goods. The targeted approach is starting to help: the six-month moving average for sales of home appliances jumped in April by the most on record.

Chart 4: Stimulus is working

China home appliance sales spike on government support



Source: China National Bureau of Statistics, Macrobond, Fidelity International, June 2025.

There is still some way to go, however, for the country to rebalance its economy toward consumption-led growth, including building out its threadbare social safety net and funnelling more resources from factories to households.

The stratospheric rise of AI start-up DeepSeek earlier this year took the world by storm, marking a turning point for how global investors perceive the Chinese tech sector. No longer just the world's factory, it is now a worthy rival for the title of the world's innovator. Despite US export controls, advancements are being made across sectors, as the country embraces many new technologies at a faster rate than anywhere else. We think this momentum has further to run, with more growth potential in tech stocks.

Beyond China, Japan's reflation story remains intact. After decades of stagnation, the 'virtuous wage price cycle' policymakers have been aiming for is well under way. Major Japanese companies have promised large pay increases for their workers this year. The wage growth is expected to translate into a recovery in consumption. While export-oriented sectors are reeling from US tariffs, domestically-focused companies, such as banks, should fare better.

India, which has a large and young population and low dependence on exports, is well positioned to withstand uncertainties in a global trade slowdown. The policy backdrop, with monetary easing and fiscal consolidation, will help the economy pivot toward private sector-driven growth. Cuts to income tax will enhance the purchasing power of the country's rising middle class, helping to offset the weakening outlook for global demand.

Others stand to benefit from the developing AI story - for example, leading chip makers in South Korea and Taiwan, thanks to their strategic positions in the AI supply chain. Despite uncertainty surrounding potential tariffs, the robust AI demand will support their promising outlook.

The long view

There's no denying that the challenges posed by US trade policy for Asia more broadly are acute and could lead to a slowdown in export orders, while weighing on corporate confidence and delaying capex plans.

But while the region's economic outlook may be challenged in the near term, the reshaping of the world order in manufacturing, trade, and technology means global investors can't ignore Asia's diversification benefits and long-term structural growth potential.





Analyst Survey: Winners and losers from new trade order

Tariffs - and their knock-on effects - create fresh cost pressures for companies around the world. But the effects will not be distributed evenly.



Monica Li
Director of Research



Terry Raven
Director of Research



Rebecca Motta
Director of Research

- Analysts from Fidelity International highlight how companies with pricing power, particularly in sectors like information technology, consumer staples, healthcare, and industrials, may better manage tariff-induced cost pressures. However, weak demand in certain sub-sectors, like luxury goods, could constrain pricing power.
- Analysts suggest that shifting production locations might mitigate some tariff costs, though this could lead to further inflationary pressures, such as labour shortages.
- Companies in developed markets may be more affected by trade tensions than those in regions like Asia Pacific and China, where analysts report more positive or neutral effects from changing policies.

The topic of trade war looks set to dominate analyses for the remainder of 2025, dividing the corporate world into those who are bracing for it and those looking to jump on opportunities.

Investors will naturally want to identify who is who, taking account of second-order and relative effects, while also staying mindful of the macroeconomic context.

Cost inflation fears vary by region

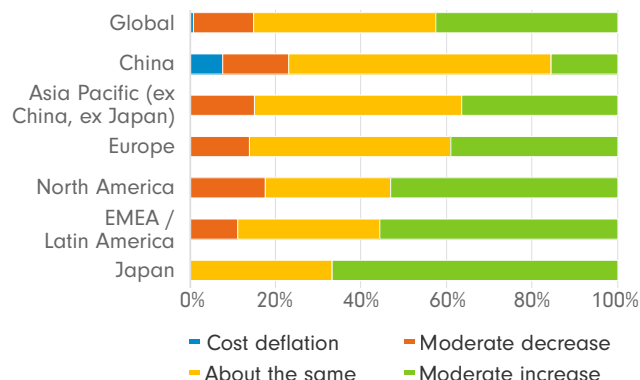
The bottom-up view from Fidelity International's analysts shows regional divergence when it comes to cost inflation expectations, echoing our overall mid-year outlook.

For example, 53 per cent of North America analysts expect moderate cost inflation increases, an expectation that's also shared by a majority of Japan and EMEA/Latin America-focused analysts.

Elsewhere though, while a fair number predict greater inflationary pressures in the cost bases of the companies they cover, most analysts globally expect those pressures will stay the same or decrease.

"53 per cent of North America analysts expect moderate cost inflation increases."

Chart 5: Mixed expectations for companies' cost inflation



Question: How, if at all, do you expect inflationary pressures within your companies' cost bases to change over the next 12 months? Chart shows percentage of analysts. Source: Fidelity International, May 2025.

One factor that could keep rising costs in check is a decline in oil prices.

"OPEC+ are reinstating their supply faster than had previously been expected," notes **James Trafford**, an equity analyst who covers the sector. "For now, the oil price has been surprisingly resilient, but it may drop in the second half of the year once those barrels are actually starting to be produced."

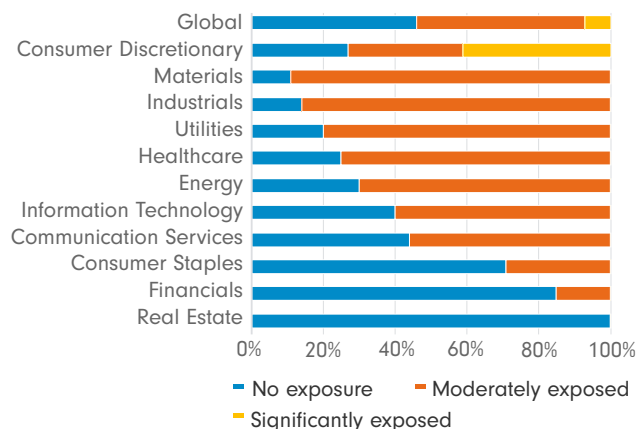
Of course, higher tariffs do represent an obvious source of one-time, cost-push inflation, with consumer discretionary firms looking particularly exposed.

"A significant proportion of my companies' goods are imported from Asia," says Cameron Ho, a North American retail analyst.

Zak Gibson, a consumer discretionary analyst for EMEA and Latin America, agrees: "Apparel is 90 per cent imports from China."

"Retailers passed through food inflation without issue during the 2022-23 inflation cycle, tariff inflation is likely to be smaller."

Chart 6: Tariff targets on their backs



Question: How exposed do you think your companies' costs are to any permanent changes in the level of tariffs they face? Chart shows percentage of analysts. Source: Fidelity International, May 2025.

By contrast, financials, real estate, and consumer staples are the sectors with the lowest proportions of analysts saying their companies' costs are exposed to tariff changes.

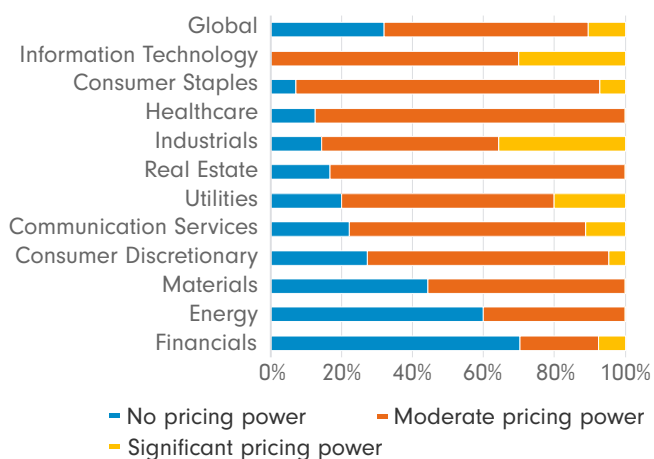
"Banks consume an immaterial amount of imported products," says Canadian financials analyst Thomas Goldthorpe, although he adds that a knock-on effect of tariffs could be lower loan growth if the economy weakens.

Which companies have pricing power to pass on costs?

For those businesses whose cost bases have higher exposure to tariffs, pricing power will be key in determining whether they can maintain margins. Here again the picture is mixed. Information technology, consumer staples, healthcare, and industrials are the sectors with the largest proportion of analysts who say their companies have moderate or significant pricing power.

"Retailers passed through food inflation without issue during the 2022-23 inflation cycle," says North America-focused consumer staples analyst Andrew Hall. "And the tariff inflation is likely to be smaller."

Chart 7: Power to (pass on costs to) the people



Question: To what extent do you think your companies have the pricing power to pass on the cost of tariff changes to their customers? Chart shows percentage of analysts. Source: Fidelity International, May 2025.

“Engine companies have the best pricing power of any industrials,” adds Oliver Trimmingham, who covers European aerospace. “They occupy monopoly or duopoly positions, with mammoth barriers to entry, and utterly captive customers.”

Jonathan Tseng argues similar dynamics grant significant pricing power to the semiconductor producers he covers: “It’s a consolidated industry. And it’s hard to make this stuff.”

“My companies are mostly high-quality businesses with pricing power and peers with similar supply chains,” says Dominic Hayes, an industrials sector equity analyst covering capital goods makers. “So, the main question is the degree of demand destruction.”

In some sub-sectors, weak demand is already imposing a constraint on pricing power.

“Historically I would have said my companies have significant pricing power,” says equity analyst Emma Cunningham. “However, luxury companies have pushed pricing too much since Covid, which puts them in a more difficult position to do so today. Consumer demand is choppy, with fatigue across vast portions of the consumer sector, including luxury.”

The case for - and costs of - relocating production

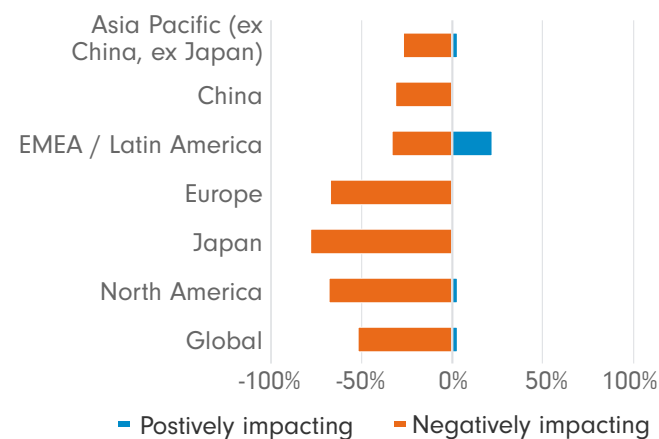
As things stand, most analysts say current trade policies are negatively affecting their companies.

Companies can respond to rising costs by shifting production to different locations depending on the level of tariffs.

“I think my companies can change their supply chain structure,” adds Penn Bowers, an equity analyst who covers Japanese gaming companies. “So on a short-term basis they may be exposed to tariff changes but on a longer-term view they can adjust fairly easily.”

For some sectors though, shifting production wouldn’t be a straightforward fix, especially if lots of businesses are trying to do the same thing all at once. While a reordering of global supply chains might well minimise tariff costs at the individual firm level, it could nonetheless represent a further inflationary impulse beyond the initial tariff shock.

Chart 8: Supply chains under strain



Question: To what extent are current trade policies affecting your companies’ supply chains relative to how they typically operate? Chart shows percentage of analysts. Analysts who responded ‘No impact’ are not shown. Source: Fidelity International, May 2025.

“If companies rapidly try to relocate to the US, that could lead to labour shortages and an increase in labour costs,” says automotive fixed income analyst Andras Karman.

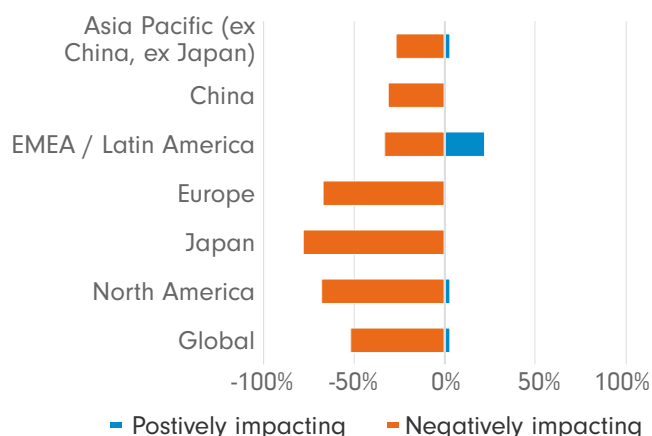
Asia-focused analysts are relatively sanguine

Interestingly, as Chart 8 above shows, most analysts who cover Asia Pacific, China, and EMEA/Latin America say current trade policies have either no impact or a positive impact on how their companies currently operate. This suggests that if trade tensions persist, it's companies in developed markets that could feel the brunt.

Chart 9 tells a similar story, where a notably smaller proportion of analysts covering Apac and China expect supply chain issues to adversely affect their companies' earnings compared with other regions.

"There's no big direct impact from tariffs to domestic consumption," says China-focused consumer staples and sportswear analyst Alex Dong, although he adds that the overall picture is gradually weakening, against a current backdrop of limited fiscal stimulus to spur consumption.

Chart 9: Relative calm in Asia around supply shortages



Question: How, if at all, could (non-labour) supply shortages / issues impact your companies' earnings over the next 12 months? Chart shows percentage of analysts. Analysts who responded 'No impact' are not shown. Source: Fidelity International, May 2025.

Evan Delaney, a fixed income telecoms analyst covering North America, sees more direct tariff-related consumption headwinds in his sector: "Tariffs are likely to make handsets like iPhones more expensive. All else being equal, this will make a

consumer less likely to upgrade their plan, slowing subscriber and pricing growth."

But it's not just the absolute effect of tariffs that investors should consider. Relative impacts will have a big part to play in deciding who the winners and losers are.

"The current base case is that Indian textile players may see relatively better tariffs versus peers," says equity analyst Priyadarshree Dasmohapatra who covers the space. "If that happens, they will end up having better bargaining power."

"A consumer is less likely to upgrade their [phone] plan, slowing subscriber and pricing growth."

There are also, as always, second-order effects to consider. If we do, as expected, see persistent inflation in the US economy for the rest of the year, this too will create winners as well as losers.

"Given the probability of US Federal Reserve interest rate cuts has decreased since the tariffs, I expect banks to maintain relatively healthy net interest margins in the next 12 months," says Sukhy Kaur, a financials fixed income analyst. "High inflation is also generally good for the insurance broker sector."

To end on a positive note, though, whatever further challenges tariffs may or may not create, they will not be the first big tests that management teams have faced this decade.

"I think managing through the Covid supply chain disruptions has left business models better prepared to handle this situation," says European industrials analyst Abhishek Dhawan. "So, we should not underappreciate the ability of cyclical to be able to navigate this better than in the past."



Part 2: Industry views

Wanted: New destinations for capital

Events of recent months are a significant change for investors in Asia and beyond and demand the examination of alternative distributions of capital going forward.

From an Asian perspective there is no question that the opening months of 2025 have delivered a regime change. It is a term that is oft-used and oft-devalued, but I believe firmly we will look back on this period and say that the events of the first half of 2025 were a turning point. Trends begun over the past two months may well prove definitive for the next decade.

Some hard truths are emerging: the big money investors we deal with in Asia are unlikely to be allocating 70 per cent of their money to the US equity market for too much longer; allocations to US Treasuries similarly deserve close examination; and we should think carefully about where else that money might go.

Hedging is a big question for the Asian investors we talk to every day and de-dollarisation is being actively discussed. The orthodoxy of the 60-40 portfolio has long been undergoing a rethink, as has how we all deal with currency exposure.

The United States will not be entirely left behind. It is still the world's biggest market and one that demands allocation. But markets are never a business of black and white, big moves happen because of a shift at the margins.


All of that has profound implications for our clients. Our job is to deliver the thought and action that allow them to see through the immediate uncertainty and define where markets are headed in the longer term and what it means for the construction of portfolios.

That is no small job and this section of our mid-year outlook includes a detailed examination of two pieces of the industry landscape: income strategies and the insurance market, as well as a preview of our new Investor Toolkit - a guide from our asset class experts on how to deal with the different scenarios ahead.

We will need all the tools we can lay our hands on for the months to come, because the first half of 2025 has made one thing clear: high tariffs or not, it will not be business as usual at all.



Damien Mooney
Head of Asia Pacific
Ex Japan



Investment strategies to manage uncertainty

Here, we lay out a preview of a new investor toolkit from Fidelity that offers solutions to deal with the challenges presented by an era of global fragmentation.

- Fragmentation has the potential to disrupt established performance trends across asset classes and geographies.
- After years of US exceptionalism, asset allocators must assess whether their geographic exposures remain appropriate.
- Evolving correlation patterns across asset classes demand a rethink of risk management and diversification processes.

Investors are facing uncertainty on multiple fronts: economic growth, fiscal policy, monetary policy, inflation, geopolitics, and international capital flows. Against this backdrop, asset class behaviours are fluctuating as macro dynamics shift, while certain traditional safe havens are becoming less reliable. Time-tested diversification techniques are therefore becoming less reliable, challenging investors' ability to balance investment opportunity and risk. Geographic allocation has become an area of concern, particularly for non-US investors, given the country's elevated weighting in global indices. The high level of concentration that has developed within the US equity market as a result of tech dominance also requires further consideration, given shifting market dynamics.

“Against this backdrop, asset class behaviours are fluctuating as macro dynamics shift, while certain traditional safe havens are becoming less reliable.”

How shifting macro dynamics impact asset class returns – an inflation example

		Key indicators				Market impact	
	Economic conditions	Inflation	Monetary policy	Bond-equity correlation	Commodity-equity correlation	Equities	Bonds
Inflationary shock	Surging inflation requires dramatic policy tightening Growth needs to weaken to solve the inflation problem	Very high, rising	Strong tightening	Positive	Negative	Weaken ▼	Weaken ▼
Deflationary shock	Economic policy struggles to stimulate very weak activity and inflation	Very low, falling	Strong easing	Negative	Positive	Weaken ▼	Strengthen ▲
Inflationary	Inflation risks are a key market and economic concern Growth may be robust, but limited room for policy support	Upward pressure	Concerned about inflation	Positive	Negative/Neutral	Strengthen ▲	Weaken ▼
Disinflationary	Inflation pressure is low or consistently declining Economic policy can focus on supporting growth, markets	Stable/declining	Able to support growth	Negative	Positive	Strengthen ▲	Strengthen ▲

Source: Fidelity International, June 2025.

The investment challenges – and solutions

There is a lot to digest, but we see a number of persistent market dynamics that can act as a guide for investor decision-making over the coming years, as illustrated below:

Key investment challenges

Search for safety	Uncorrelated exposure	Macro-driven markets	Fading US market dominance	Long-term growth in uncertainty
Investors looking for wealth preservation as traditional safe havens are being tested	Positive equity/bond correlations push investors beyond the 60/40 approach	Inflation remains sticky in some areas, as growth concerns and recession risks rise	US dominance has faded since 2024, calling for a more global approach	Investors still need long-term growth, and those prepared to look-through current volatility can capture upside

Source: Fidelity International, June 2025.

Whatever an investor's view, one thing is clear - what has worked in the past may no longer work in the future. Asset allocators should therefore approach their decisions with a forward-looking perspective, backing their strategies with in-depth research and recognising that asset class behaviours can change through time. With that in mind, there are several actions worth considering:

1. Consider diversification across regions

Perhaps most obviously, global investors who believe that US market dominance has peaked (or even plateaued) should seek to increase the international diversification of their exposures. To achieve this, they might construct their portfolios using regional building blocks, improving flexibility to react to structural changes in the geopolitical backdrop as/when they reassess their regional exposures, including potential structural home biases versus global exposure.

In equities, attractive bottom-up opportunities are being presented across Europe in markets like the Nordics and the UK. Across Asia, smaller companies look attractive, while China continues to offer compelling investments on an idiosyncratic basis. Emerging markets also look appealing, particularly opportunities in Latin America. In every case, selectivity will be important as investors assess structural exposures and tactical opportunities. Meanwhile, the dislocation of policy regimes around the world is likely to present opportunities across the credit spectrum at different points through the investment cycle, which can be captured through regional or active global aggregate strategies.

2. Capture future drivers of return

If we have entered a new era in which elevated uncertainty stifles growth, income could become a more important driver of overall returns. This will be especially true within equities if the mega-cap companies which have driven valuations higher see their exceptional earnings growth rates of recent years moderate.

Such risks support the use of dividend-based total return strategies focused on high-quality companies with pricing power, such as diversified equity income and enhanced income. Strategies which can offer all-in yields are attractive, such as diversified global fixed income or high yield.

3. Ensure portfolio flexibility

Increased volatility requires a broader and more flexible toolkit. Over the coming months, it will be critical to increase the precision of portfolio construction through a wider range of investment ideas, including actively managed strategies which can target more consistent investment outcomes. In equity allocations, this could mean taking exposure to specific styles or factors, such as quality or value.

For example, focusing on specific segments of the capitalisation spectrum, such as small or mid-cap companies, can help avoid concentration risks within the US market. Meanwhile, those who want to maintain exposure to the enduring technology theme might also consider a more value-orientated approach that can mitigate idiosyncratic risks associated with some of the mega-cap tech names.

Beyond equities, portfolio optimisation can benefit from a more dynamic approach across a wider range of asset classes, including alternatives. This can include the use of diversified investment approaches within asset classes, for example active duration management within fixed income allocations.

4. Uncover uncorrelated sources of return

The necessity to preserve capital during periods of market turbulence supports a revitalised role for strategies that can deliver uncorrelated returns relative to equity and bond markets. In this regard, investors still have a broad toolkit of potential options at their disposal, including absolute return and market neutral strategies across asset classes, as well as contrarian, special situation, and multi asset options, which each have the ability to deliver differentiated returns. Private assets are also an increasingly important asset class for investors able to sacrifice liquidity.

5. Balance bonds differently

While there remains a role for Treasuries in portfolios within risk-off environments, recent bond and currency market turbulence might lead investors to diversify their geographic fixed income exposures and take a more flexible active approach across the capital structure. The context of each investor's objectives and risks is key in such considerations, given the impact that variables like foreign exchange rates can have on overall portfolio risk and returns.

Bunds were a key beneficiary of recent volatility in treasury markets, a dynamic which endorses an increased role for unconstrained active strategic bond strategies. Finally, with cash rates still elevated, short duration and liquidity strategies can perform well at the lower end of the risk spectrum.





Four portfolio problems for insurers and how to solve them

Insurers can no longer rely on traditional assumptions about risk and return drivers. Adaptation will be critical to meeting their investment goals.



Ghislain Perisse
Global Head of Insurance Solutions

- Changes in the macro environment have complicated risk management and regulatory alignment for insurers, demanding a reappraisal of strategies.
- Insurers are adapting by diversifying, such as adopting a barbell approach to optimise yield while managing risk, rebalancing portfolios in response to inflationary risks, and seeking stability through diversification into Asia's corporate and quasi-sovereign bonds.
- The increasing importance of private markets, including private equity and direct real estate, presents opportunities for insurers to achieve capital efficiency and resilience amidst market uncertainties.

An era of relatively modest inflation, a predictable interest rate environment, and stable geopolitics has given way to geopolitical and macroeconomic fragmentation, through events such as the US-China tariff disputes, the Russia-Ukraine war, and broader realignments of alliances.

As a consequence, risk management and regulatory alignment have become more complex. Specifically, we identify four challenges insurers face, each of which requires its own set of responses.

Challenge 1: Volatility is now structural

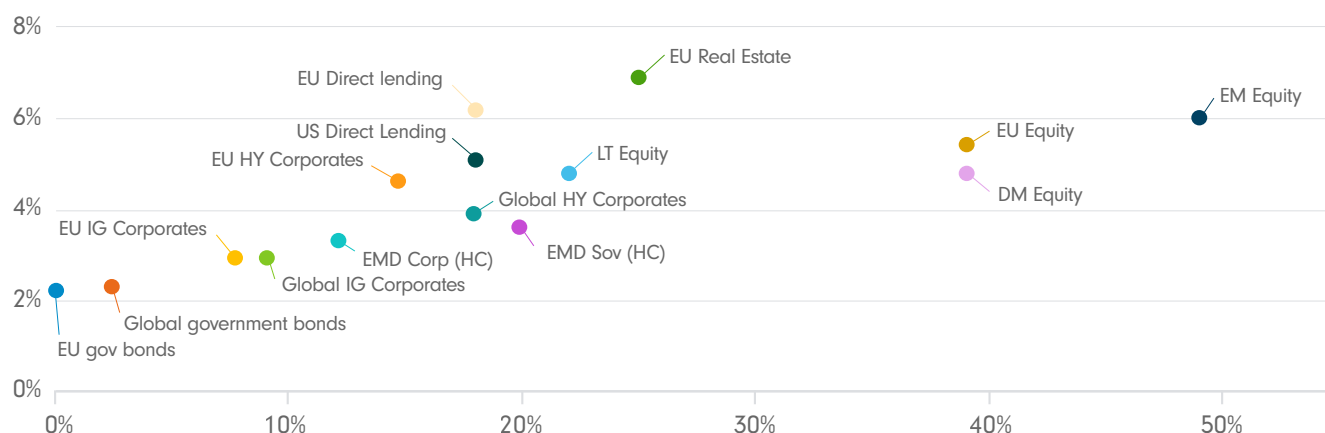
Elevated uncertainty leads to higher volatility, making diversification even more necessary. In addition, the current investment landscape means the way insurers diversify also needs to evolve.

Insurers typically split their investment strategy into two parts. The first is a liability-driven portfolio and the other a surplus portfolio. In the liability-driven portfolio, particularly for life insurers with longer time horizons, asset classes such as high-quality government and investment grade bonds dominate.

Under current market conditions, a more nuanced approach to calibrating risk within both portfolios is needed. For example, the lower end of investment grade, particularly BBB-rated issues, is increasingly viewed with caution as regions like the UK or certain parts of Europe risk downgrades. Insurers therefore need to assess whether they're being appropriately compensated for the risk taken, which potentially includes not only higher losses but also higher capital charges.

Chart 10: Expected return vs. spread risk SCR*, by asset class

Expected returns (10 years)



Source: Fidelity International, February 2025. Asset class expectations are based on Fidelity's Capital Market Assumptions as of June 30, 2024. Currency: EUR. Notes: EM HC sovereign bonds are treated as corporates, given that they are denominated in foreign currency. Sovereign index duration is longer than corporates, which results in a higher spread risk solvency capital requirement (SCR). All fixed income asset classes considered as fully hedged. *Spread risk SCR calculations based on Fidelity's calculations.

How insurers can respond

Some are shifting to a barbell strategy, combining safer government bonds with high-yield credit, particularly with issuers that are more likely to be upgraded. European high yield, for example, may offer more rising stars than their counterparts in the US, where fallen angels have recently dominated. This approach can offer a way for insurers to optimise yield while managing risk with more predictability.

In surplus portfolios, multi-asset, equity income, and equity market-neutral strategies are able to serve more of a core role in portfolio construction. These strategies have built-in capabilities to reduce downside risk and improve the potential for cash flow stability, helping to mitigate portfolio volatility. Importantly, in a more uncertain environment, active risk management can respond more quickly to market disruptions.

Challenge 2: A resurgence of inflationary risk

Inflation is another concern for insurers. Here, the baseline macroeconomic reality in the US is one of entrenched inflation. With fiscal policy remaining expansionary, we do not expect any rate cuts from the Federal Reserve this year. In Europe, inflation has been stabilising. However, investors should not be

complacent; inflation can be imported from the US through energy prices and supply chain pressures among other channels. That may lead to hesitation by the European Central Bank and the Bank of England on further cuts in rates, even if growth stalls.

How insurers can respond

Some insurers previously extended duration in expectation of more US rate cuts, and may now be exposed. They will need to rebalance their portfolios to align with liabilities, maintain cash buffers, and refocus on shorter-duration, higher-quality credit. The takeaway is that duration is a tool, not a trade in this environment. Prudence is required.

Challenge 3: The reappraisal of sovereign credit

Since sovereign bonds are no longer viewed as the safe havens they once were, insurers are re-evaluating their role in portfolio construction. Some, including those in the UK and France, are diversifying away from domestic government bonds where high debt burdens are raising questions about long-term sustainability.

As spreads widen in riskier developed market government bonds, the implications for capital charges become more significant. Interestingly,

Portugal, Greece and Italy - once sidelined at the riskier fringes of sovereign debt - now appear more stable, a dramatic reversal underscoring how relative risk is being reinterpreted in the new investment regime.

How insurers can respond

Asia offers diversification. In comparison to the more indebted countries in Europe and North America, many in Asia are relatively insulated from fiscal excess. For example, Japan, India, and other Asean economies are viewed as more stable from a credit perspective. Building exposure to Asia's corporate and quasi-sovereign bonds, with their attractive spreads and solid fundamentals, could help build portfolio resilience.

Challenge 4: The shift away from public markets is intensifying

This one is perhaps less of a challenge and more of an opportunity. One of the most notable trends in insurance portfolios is the role of private markets. Asset classes such as private equity, private credit, and direct real estate are increasingly foundational.

How insurers can respond

Direct lending, which supports private equity, offers contractual yields with lower mark-to-market

sensitivity than publicly traded credit along with higher resilience to interest rate uncertainty. And because direct lending is unrated, it's more capital efficient if structured correctly to reduce volatility-based capital charges.

In Europe, real estate is gaining traction following a reset in valuations. However, investors exploring this asset class must look beyond pricing to the environmental and regulatory implications of their investments. Tenants are demanding ever higher environmental standards. Therefore, assets that support the low carbon transition such as sustainable logistics and office retrofits may offer higher risk-adjusted return opportunities.

Adding ballast to portfolios

Insurers are adapting to the new investment regime by sharpening their asset-liability management discipline, embracing active risk management, and reassessing exposures not just by asset class, but also by sector, liquidity premium, complexity premium, geography, capital efficiency, and volatility sensitivity. Adding exposure to Asia, global equity, quality credit, and private markets can all help build ballast in portfolios that are increasingly tested by real-world complexity.



Rise to the challenge: Income in 2025

Interest in income investing is booming



Jochen Breuer
Portfolio Manager



James Durance
Portfolio Manager



Belinda Liao
Portfolio Manager



Becky Qin
Portfolio Manager



Talib Sheikh
Portfolio Manager



Fred Sykes
Portfolio Manager

Do you want income from your capital? How much do you want and what are you prepared to sacrifice for it?

Less than two decades ago, retirement for most of the population of the western world just meant waiting for a pension cheque to arrive every month. That has changed. People have more control over their pensions and investments, and the conversations they have with their providers or investment advisors have grown more sophisticated and demanding. They are the same ones those institutions then have with us.

As ever, if you understand what has changed, and why, then you have more chance of understanding what comes next.

Broadly, more people want income from their investments as well as some growth in its overall value. But there are interesting dynamics behind that change that demand more thought and a greater variety of solutions from big asset managers like Fidelity.

We talked to a group of six Fidelity portfolio managers who deal with one or other brand of the income universe about what clients are asking, how their responses are changing, and how they should change further.

I want a predictable income, with low risk

In Asia, where wealth in general is growing faster than in the West, there is often less concern from investors about holding onto the original capital of their savings - a strong distribution, backed by a solid return, is more important and can usually come at the expense of the underlying pot.

Belinda Liao runs fixed income strategies out of Asia that, besides the plain-vanilla bond investment, use rates and currency arbitrage to add extra percentage points of return for Chinese investors willing to look beyond their domestic market for bond returns.

Last year, she says, short duration and money market plays dominated institutional investors' thinking, but in 2025 many began to go further out the curve.

"People have refocused on income again, to a large degree because the rates differential between countries has changed," she says.

The question-marks US trade policy has provoked about US Treasuries again raise the case for allocating to a wider spread of bond markets, and this time Asian markets look far more mature than in past shakeouts, she argues.

"Asian investors, especially in China, like USD-denominated Asian investment grade (IG) because everything's relative. China rates are low, therefore, from a Chinese investor's perspective, if they can invest across the border in a dollar bond issued by an Asian company, they feel good with yields elsewhere in Asia instead of going to Europe or the US, with which they are less familiar. Here they are getting a 5.2 per cent yield versus say a five-year credit bond in China that yields less than 2 per cent. Why not?"

Another important aspect to her strategies is that they can benefit from a chunky return pick-up from hedging the currency risk and profiting from the carry on the dollar exposure held under the hedge.

"We are a dollar investor," says Liao. "But Japanese rates are getting higher. So, say, we get 1.5 per cent yield from holding yen bonds. Then we hedge back from yen to US dollar to gain an additional carry from the advantage in US rates, which leaves us with above 5 to 6 per cent total yield. This is attractive if we can manage the duration risk well."

There is a similar play in China. "Now that China rates are lower than US rates, we get about 2.5 per cent yield from holding RMB bonds. Then we hedge back from RMB to US dollar to gain an additional carry from the advantage in US rates. That leaves us with above 5 per cent total yield. On top of that, we will get capital gain from the declining China rates."

Chart 13: Hedging back from RMB to dollar now provides a positive gain



Source: Bloomberg; Fidelity International, as of 28 February 2025.

But I want more for my money

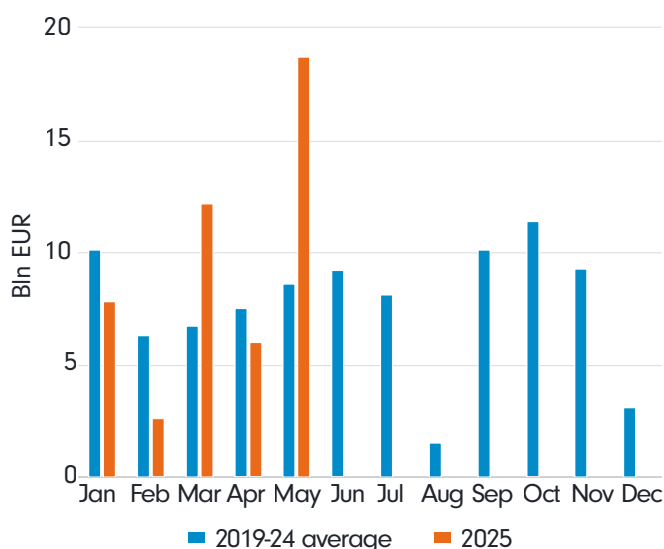
A higher yielding world, however, means that investors also want more percentage points in that overall return. Investment grade bonds carry more risk than government bonds or money market instruments and have been spectacularly popular over the last two years as a provider of solid long-term returns.

"The outright level of yields in the fixed income market is as high or as close to as high as it's been in two decades and that has drawn both retail and institutional investors into the space," says fixed income fund manager **James Durance**.

"There is a terrific amount of institutional demand for bonds from people like ourselves, from alternative asset management, from CLOs, from the private credit market, and so on."

Chart 14: Credit market technicals supported markets earlier in 2025

Issuance in March and May shows how much market can swallow



Source: Fidelity International, Bloomberg Finance LP, JP Morgan, June 2025. Data is for EUR HY non-financial bonds.

At the start of 2025 that investor interest in credit meant there was less spread on investment grade credit over government bonds compared with history, offering investors lower remuneration for the risk of holding them.

Historically, however, credit tends to deliver over time. In the 2008 financial crisis, for example,

coupon income from bonds accounted for over 80 per cent of total returns in the Barclays Aggregate Bond Index.

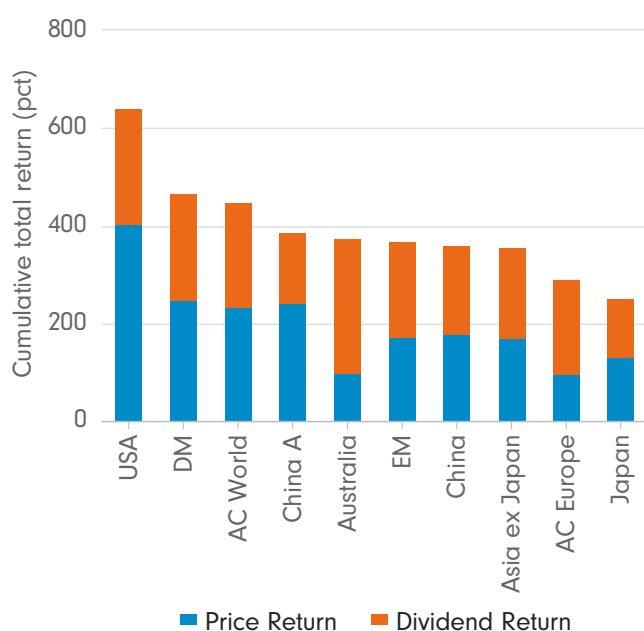
Dividends win

All the arbitraging aside, fixed income is still what it says on the tin - a fixed, unvarying income that can be undermined by inflation. In contrast, high quality dividend paying equities can increase the income they pay over time, which historically has meant that they are able to protect dividend income in real, not just nominal, terms.

“The people who want income-paying equities are people who will accept a lower level of income today in the knowledge it will keep its purchasing power.”

Chart 15: Paying dividends pays

Reinvested dividends account for around 50% of returns since 2004



Source: Refinitiv, Fidelity International, March 2025. MSCI Regional Total Return vs Price Indices in local currency terms.

Growth stocks, which rise on the promise of significant earnings in the future from trends like AI, have provided all the headlines of the past decade and normalised the idea of constantly rising equity markets. But over long periods of time, reinvesting the dividends that many of the market’s more traditional companies pay out can also deliver - and without the same level of risk.

“The people who want income-paying equities are people who will accept a lower level of income today in the knowledge it will keep its purchasing power,” says **Fred Sykes**, a portfolio manager who runs strategies focused on dividend paying equities.

“That is a long-term approach. Warren Buffett said inflation swindles the equity investor. In general terms this may well be true, but there is an opportunity if you invest in the right type of equities. To my mind there are two attributes to look for: firstly, companies that have pricing power, and secondly, not paying a high multiple.”

With the US market wobbling, Sykes’ strategies benefit from a European focus. In previous years that looked unexciting, but it puts him in a strong position if narratives change.

“The US has been the safest place in the world to invest for many years, but this has driven up equity valuations and expectations which makes it sensitive to even small disappointments,” he says. “It is led by a narrow group of stocks. If they are faltering, there is a long way down on momentum.”

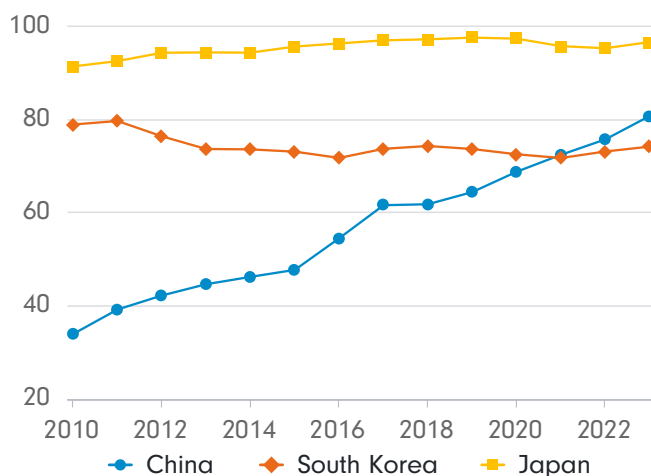
His colleague **Jochen Breuer** focuses on Asian dividend strategies, which are benefitting from corporate governance reforms to up shareholder returns in the continent’s biggest markets.

“Australia has always been a country where investors cared about dividends,” he says. “Over the last few years we have also seen increasing demand for dividend income from Chinese investors as domestic interest rates have come down. Companies in Asia are getting better: we’ve seen increasing dividend payouts and buybacks in Japan, China, and South Korea, partly driven by government pushes for

enhanced corporate governance and capital allocation in those countries.”

Chart 16: More Chinese companies are paying dividends

Percentage of Asian companies paying dividends



Source: Company filings, Fidelity International, March 2025.

I want sustainable income and access to the best opportunities in markets

A fourth strand to the income world looks ever more relevant after the appearance of cracks in the US economy and stock market in March.

Savers’ best defence against volatility is diversification, and the original alternative provider of income in this light was real estate. While the trade-off is illiquid underlying assets, property offers contracted guarantees of income that are not changed by short-term movements in market pricing.

An alternative response, therefore, is multi-asset investing that allows more flexibility when credit, stock or bond markets are in flux.

Fidelity portfolio manager **Talib Sheikh** has been running multi-asset strategies since they started to boom around the time of the Great Financial Crisis. “After the GFC,” he says, “anything that could provide a regular income above the zero bound was an appealing prospect. That became less the case as interest rates rose, coupled with a US-led equity bull market. But we may be at the moment where that dynamic has changed.”

The sorts of strategies Sheikh now runs with colleagues **Becky Qin** and **George Efstathopoulos** have had to work hard through an era of one way stock market growth, but that is not what they’re designed for.

“We appeal to lower-risk investors looking for a smoother ride, with volatility less than half that of the equity market,” Sheikh says. “We blend global income assets (equities, bonds, credit, and real assets) according to our asset allocation views. If, as currently, I can get my clients a dividend cheque of 5 or 6 per cent once a quarter and keep the value of their initial investment steady or generating some growth, then mostly I will have delivered what they need.

“We think about balancing three objectives: regular income, capital growth and risk control. Growth in the income and the initial investment shields your initial investment from the effects of inflation. And, importantly, we want to make sure we do it in a risk-controlled manner.”

Multi-asset was originally based on the 60-40 basket of equities and bonds that made up a traditional pension fund portfolio. The past decade, in which the two asset classes have risen and fallen together, has challenged that idea.

“You have to work harder to build a diversified portfolio that deals with market volatility. We have to look beyond just government or investment grade fixed income,” says Qin.

“That leads to alternatives, which we have significantly ticked up over the past year. We want the income generation to be quite diversified and we want to make sure that our portfolio is very liquid.”

Popular changes

Income investing after 2009 seemed to be a simple game: at a time when markets were going up, guaranteeing returns from consistent dividend payers, or solid corporate bond issuers, felt like a good defensive play, and one that - unlike cash - did deliver a return.

But the world has changed, and with inflation and potentially structural change to the global trading system back in play, things are not so simple. What investors want from income investments has grown more varied and more complicated, depending on which markets, economic backdrops, or required returns they are working with. Indeed, even the definition of income can vary from one investor to the next.

Different strategies will suit different demands.

Luckily, the variety and sophistication of the strategies our industry offers has also grown.

Successful and systematic absolute return strategies are now a reality; high yield is not always as low rent as its 'junk' moniker suggests; and dividend investing does not always have to be boring. And all, in the right combination, can deliver.

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