BUSINESS CYCLE UPDATE

Global Environment Poised to Stabilize as 2016 Progresses

Expect elevated volatility among financial assets as world digests the Fed's tightening

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KEY TAKEAWAYS

- Our 2016 outlook hinges on the ability of the U.S. economy to weather the global trade and commodity recession, while China and the rest of the world digest the initial U.S. monetary tightening.
- Our base-case scenario is that the beginning of the Fed tightening cycle will create a volatile environment entering 2016, but that the global economy will muddle through this choppy backdrop.
- The Fed is likely to proceed tightening at a gradual pace, and the step toward normalization may boost confidence in the U.S. economy.
- If such a scenario develops as 2016 progresses, the "base effect" of global stabilization may eventually lead to rising inflationary pressures and the possibility of an increase in late-cycle risk.
- Our 2016 outlook is supportive of equities, though the potential for elevated market volatility may warrant smaller asset allocation tilts than earlier in the cycle.

MORE IN THIS ISSUE

Fidelity's Asset Allocation Research Team employs a multi–time-horizon asset allocation approach that analyzes trends among three temporal segments: tactical (short term), business cycle (medium term), and secular (long term). This monthly report focuses primarily on the intermediate-term fluctuations in the business cycle, and the influence those changes could have on the outlook for various asset classes.

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The 2015 backdrop can be summarized by the economic and policy divergences between the world's two largest economies—the U.S. and China. Continued progress in the U.S. mid-cycle expansion during the first half of the year pushed the Federal Reserve (Fed) closer to a tightening stance, while China's growth recession created the need for even greater policy easing. When investors began to price in a Fed rate hike over the summer, it squeezed global dollar liquidity and prompted China into a surprise currency devaluation that roiled financial markets and sent another wave of deflationary pressures across the global economy.

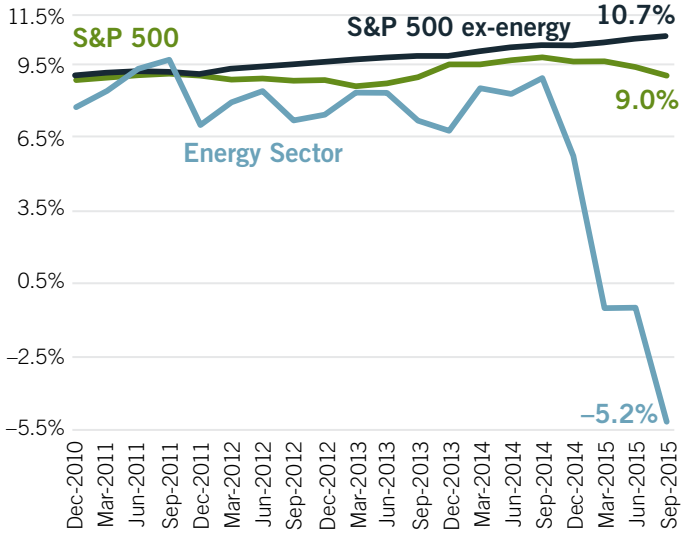
Base-case 2016 scenario: Muddle through

Our 2016 outlook hinges on the ability of the U.S. economy to weather the global trade and commodity recession while China and the rest of the world are digesting the start of U.S. monetary tightening. Our base-case scenario is that the beginning of the Fed tightening cycle will create a volatile environment entering 2016, but that the world will muddle through this choppy backdrop for the following reasons:

1. A single Fed hike is not disastrous (see "*Fed Ambiguity and the Road Map for Monetary Tightening, Business Cycle Update*," November 2015)

Exhibit 1 S&P 500 Profit Margins

Outside of energy, profit margins are still rising, which is a mid-cycle signal



Source: Standard & Poor's, FactSet, Fidelity Investments (AART), as of Sep. 30, 2015.

- Historically, most of the initial Fed rate hikes and the majority of monetary tightening occur during the mid-cycle phase, coinciding with a broadening U.S. expansion and generally solid performance from equity markets.
- Given weak global growth, low inflation, and low global bond yields, we anticipate a gradual pace of monetary tightening and no dramatic spike in long-term U.S. interest rates.
- Hiking rates may boost confidence in the U.S. economy, signaling a step toward normalization and providing tangible evidence that the economy is not dependent on extraordinary stimulus.

2. U.S. economy remains in sturdy mid-cycle phase, despite external weakness

- Employment markets continue to tighten, underpinning the solid outlook for real (inflation-adjusted) income growth for the all-important consumer sector (see Macro Update/Consumer).
- Weakness persists in external-oriented sectors of the economy such as manufacturing and the oil industry, but the worst of the inventory correction may be fading (see Macro Update/Corporate).[1]
- Outside of energy, corporate profitability is steady and indicative of a continued mid-cycle expansion, with near-record profit margins and limited wage pressures (Exhibit 1, Macro Update/Corporate).[2]

3. China to emphasize fiscal stimulus and stability

- China continues to face massive cyclical challenges, with a dire need for restructuring its overbuilt and overleveraged industrial and corporate sectors (see "China's Economy: Stuck in the Cyclical Mud, Business Cycle Update," June 2015).
- Nevertheless, policymakers appear to be placing structural reform on the back burner, and intensifying the flow of stimulus measures in an effort to stabilize the economy (see Macro Update/China).

1 *Source: Census Bureau, Haver Analytics, Fidelity Investments (AART), as of Oct. 31, 2015.*

2 *Source: Standard & Poor's, FactSet, Fidelity Investments (AART), as of Dec. 10, 2015.*

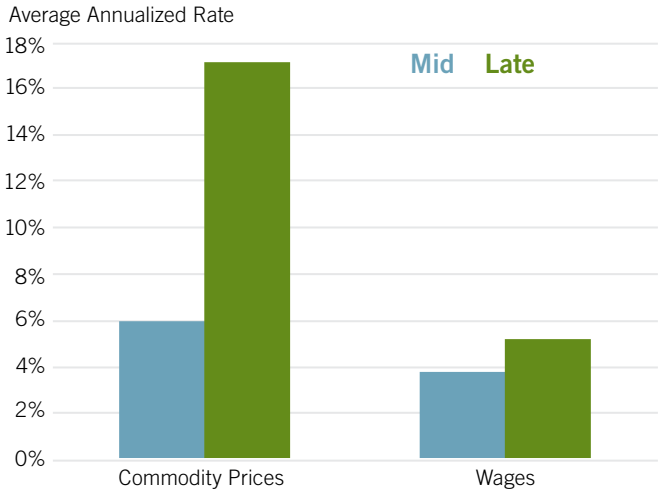
- China's ability to weather increased volatility in its currency markets as a result of Fed tightening is again being tested, with the renminbi (RMB) depreciating to new multiyear lows in December; however, we expect the authorities to continue to closely manage the RMB to keep it from dropping sharply.
- While China's growth recession remains the biggest risk to our muddle-through scenario for the global economy, policymaker willingness to emphasize near-term stability should be enough to steady the Chinese economy in 2016 (albeit at a subdued pace).

4. Global business cycle likely to stabilize

- Led by mid-cycle expansions in the U.S. and in Europe, many advanced economies enjoy healthy cyclical domestic conditions, including low oil prices and low interest rates for their consumer sectors (see Macro Update/Global).
- Any stabilization in China would go a long way toward mitigating the downward spiral in commodities and global trade that has weighed heavily on export- and commodity-dependent economies, as well as toward mollifying recessionary pressures in other emerging markets, such as Brazil and Russia (see Macro Update/Global).
- An outright reversal of recent global trends does not appear imminent, but our view is that we may be approaching the final innings of sharp declines in commodity prices, emerging-market economies, and non-U.S. currencies.

Exhibit 2 Mid- and Late-Cycle Inflation (1966-2010)

Historically, accelerating inflation in wages and commodities drives the transition to the late cycle



Fidelity Investments proprietary analysis of historical commodity performance, using data from BP Statistical Review of World Energy 2015, U.S. Department of Agriculture, U.S. Geological Survey, and U.S. Foreign Agricultural Service. Wages = Average Hourly Earnings. Source: Bureau of Labor Statistics, Haver Analytics, Fidelity Investments (AART), as of Oct. 31, 2015.

Asset allocation implications of a "muddle-through" scenario for the global economy

Should our base-case scenario for the global economy play out, the following are some asset allocation considerations to keep in mind:

- Favor equities over bonds for an eventual reassertion of U.S. mid-cycle trends
- Expect elevated volatility
- Maintain relatively small asset allocation tilts
- A dramatic spike in interest rates remains unlikely

Late-cycle risks may rise as year progresses

The U.S. remains in a steady mid-cycle expansion as we highlighted above, and near-term, late-cycle risks remain generally low. However, if our base-case scenario plays out—China stabilizes and the global economy muddles through—we anticipate that the odds of the U.S. transitioning to a late-cycle phase may rise as the year progresses. As a result, the following are some factors we expect to be monitoring closely before the end of 2016.

1. Late-cycle phases generally feature rising inflation

- The transition from a mid-cycle phase to a late-cycle phase typically involves a pickup in inflationary pressures; in particular, commodity prices and wages tend to accelerate (Exhibit 2).
- Rising input cost inflation during the late-cycle phase generally pressures corporate earnings by causing profit margins to decline, leading to tighter credit conditions and more restrictive monetary policy (see Business Cycle Framework).

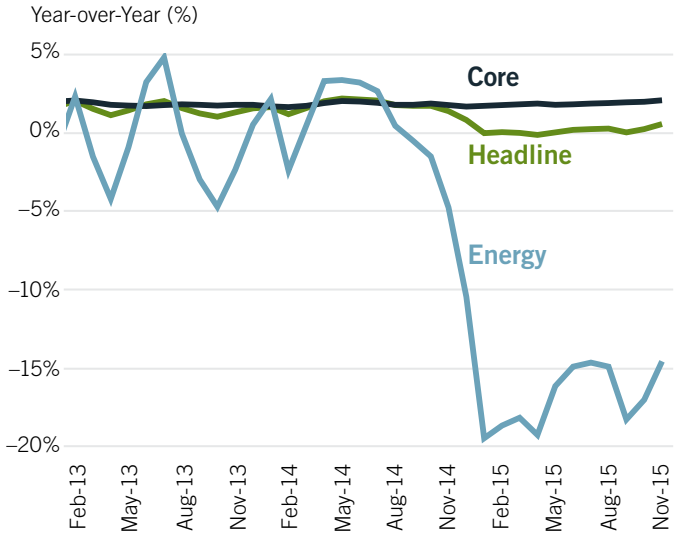
- However, our historical analysis of the late-cycle phase indicates that corporate sales growth has tended to remain solid, a recession typically didn't occur for a year and a half after the start of the phase, and the global environment has tended to hold up well, with 87% of countries, on average, seeing their leading economic indicators (LEIs) rise.

2. A global "base effect" may eventually help lift commodities, inflation

- Tightening U.S. labor markets should continue to put modest upward pressure on wages, and U.S. core consumer inflation has already ticked up to nearly 2% amid the strength in domestic service industries (see Macro Update/Inflation).
- With headline consumer inflation still hovering around 0% due to the plunge in oil prices, any stability in commodity prices over the next year could cause U.S. inflation to rise from a low base.

Exhibit 3 Consumer Price Index

Any stabilization in energy prices would cause headline inflation to rise toward core inflation



Headline inflation: A measure of the total inflation that is experienced throughout an entire economy. Core inflation: An inflation measure that excludes temporary price volatility of some commodities, such as food and energy products. Source: Bureau of Labor Statistics, Haver Analytics, Fidelity Investments (AART) as of Nov. 30, 2015.

> "The U.S. remains in a steady mid-cycle expansion, and near-term, late-cycle risks remain generally low. However, if our base-case scenario plays out—China stabilizes and the global economy muddles through—we anticipate that the odds of the U.S. transitioning to a late-cycle phase may rise as the year progresses."

- After steep 2015 plunges in commodity prices, global inflation, non-U.S. currencies, and economic growth in emerging markets, a generally lower base has been established, making it more difficult for further declines of such magnitude.
- If global activity stabilizes in 2016, the "base effect" could push up global inflation without a significant reacceleration in growth or a return to high commodity prices; for instance, if oil prices just stop dropping, U.S. headline inflation will move closer to core levels (Exhibit 3).

Typical late-cycle performance patterns for financial assets

It's too early to shift to a late-cycle playbook approach, but these are some of the historical asset return patterns to keep in mind (see "The Business Cycle Approach to Asset Allocation," September 2014):

- Mixed asset class performance with more limited overall upside
- Less confidence in equity performance, though stocks typically have outperformed bonds
- On average, core bonds outperformed credit as spreads widen
- Higher conviction in inflation-resistant assets, including commodities, energy stocks, and shorter-duration bonds

Past performance is no guarantee of future results. Asset class performance referenced above is represented by indexes from the following sources: Fidelity Investments, Ibbotson Associates, Barclays, as of Jul. 31, 2014. Source: Fidelity Investments proprietary analysis of historical asset class performance from 1950-2010, which is not indicative of future performance. Late-cycle phase average duration: roughly 18 months.

Business Cycle: Macro Update

Activity has softened for external-oriented sectors in the U.S. (e.g., exports, manufacturing, crude-oil production) that are negatively influenced by the weaker global environment, the stronger U.S. dollar, and the decline in oil prices. However, the U.S. mid-cycle expansion continues to be bolstered by a healthy and much larger domestic sector, underpinned by the positive real income outlook for U.S. households.

U.S. economic sectors

Consumption and employment. The backdrop for the U.S. consumer remains solid entering 2016 amid improving labor-market conditions and lower oil prices. Payroll growth remains positive, although the pace of labor-market tightening may begin to slow as leading employment indicators, such as unemployment claims and hours worked, has softened recently. Tighter labor markets are incrementally boosting wage growth, with plans for raising worker compensation at small businesses back to pre-crisis levels (Exhibit A). Consumption measures, such as core retail sales, are still trending modestly higher. **Labor-market improvements, muted inflation, and a strong dollar continue to support the purchasing power and real income outlook of the U.S. consumer.**

Housing. The slow housing market expansion appears poised to continue into 2016. Underlying fundamentals remain positive: mortgage rates are low; bank willingness to make mortgage loans continues to improve; single-family permit issuance continues to grow at an upper-single-digit annual pace; and employment and new household formation trends are moving in the right direction. **The outlook for the housing sector remains positive, supported by the tightening labor market and a gradual easing of lending conditions.**

Inflation. Global deflationary pressures and the plunge in commodity prices have continued to weigh on headline inflation in the U.S. Year-over-year headline inflation remained near 0% in November, with core inflation (excluding food and energy) still trending modestly higher to 2% on the back of rising shelter and services prices. The absolute level of wage inflation remains generally modest. **The continued tightening of labor markets supports a modest pickup in core inflation, while headline inflation is likely to rise over the course of 2016.**

Corporate and credit. A strong dollar and weak global demand continue to hamper manufacturing, business investment, and corporate profits. The build-up in business inventories created a major drag on third-quarter GDP growth. However, the healthy ratio of new orders to inventories in November's manufacturing Purchasing Manager's Index (PMI), as well as broad improvement in inventory-to-sales ratios in recent months, suggests that the worst of the inventory correction may be over (Exhibit B). Corporate earnings are expected to decline 5.7% year over year in 2015 due to the steep drop in energy-sector profits, but profit margins outside energy have continued to rise (Exhibit 1).[3] We expect mid-single-digit earnings growth in 2016. Financial conditions have tightened some during the past few months, with high-yield spreads continuing to widen, and banks reporting a tightening of lending standards for commercial and industrial loans for the first time in four years. **Global weakness has taken some steam out of business activity, but credit availability and the corporate sector remain generally healthy.**

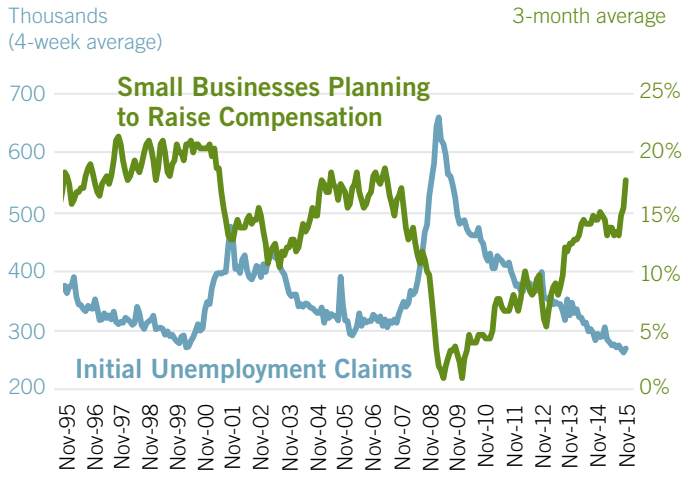
Global

Europe. Europe remains in a mid-cycle expansion, despite the negative impact of the weak global environment on exports. Several surveys point to positive trends in domestically-oriented sectors, which continue to be underpinned by pent-up demand in

3 *Source: FactSet, Fidelity Investments (AART), as of Nov. 30, 2015.*

Exhibit A U.S. Labor and Wage Trends

Tighter labor markets and low inflation are boosting real wage growth



Source: Department of Labor, National Federation of Independent Business, Haver Analytics, Fidelity Investments (AART), as of Nov. 30, 2015.

the periphery and low unemployment in Germany.[4] The extension of quantitative easing by the European Central Bank, while disappointing from an expectations standpoint, will still be a net positive for the region. **Despite weakness in external-oriented sectors, positive trends in accommodative monetary policy, a competitive euro, and solid service sectors continue to underpin the eurozone's mid-cycle expansion.**

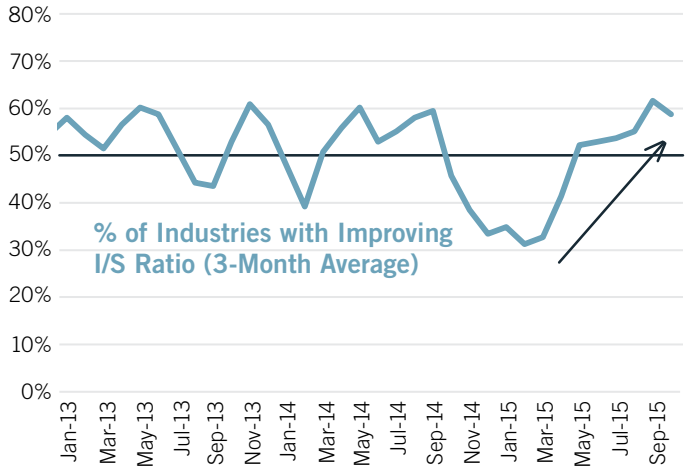
Japan. As a slow-growing economy heavily reliant on trade, Japan's business cycle is particularly susceptible to changes in the external growth environment. Despite profit- and inventory-cycle headwinds due in part to slowdowns in China and Southeast Asia, it's encouraging to see that the composite Purchasing Manager's Index for Japan has moved incrementally further into expansionary territory during the past few months.[5] **Japan's economy remains in the late-cycle phase, as broad activity indicators have moderated and external demand from the rest of Asia remains soft.**

4 *Source: The British Chamber of Commerce, Haver Analytics, Fidelity Investments (AART), as of Sep. 30, 2015.*

5 *Source: Institut für Wirtschaftsforschung, Haver Analytics, Fidelity Investments (AART), as of Nov. 30, 2015.*

Exhibit B U.S. Durable Goods Inventory-to-Shipments Ratio

Rising U.S. inventories amid the global trade recession weighed on U.S. manufacturing in 2015, but the worst appears to be over



Source: Census, Haver Analytics, Fidelity Investments (AART), as of Oct. 31, 2015.

China. A downshift in growth at the end of a credit boom pushed China into a growth recession in early 2015, although recent trends have been somewhat mixed. Policymakers have stepped up the pace of stimulus measures in recent months, including a tax cut on small-engine cars, a lower required down payment for homes, increased infrastructure expenditures, and additional cuts in interest rates and bank-required reserve ratios. Headline industrial data remain weak, but an increasing number of individual industries are reporting stabilization in activity over the past six months,[6] while property market activity has continued to weaken. **Support from policymakers is helping to stabilize conditions in the near term, but a sustainable reacceleration remains elusive absent greater structural reforms.**

Global summary. The global economy has remained weak in recent months, with just 45% of the largest economies in the world exhibiting positive growth in leading economic indicators (LEIs) on a six-month basis.[7] The weakness is centered in emerging-market economies, where China's downturn and the resulting plunge in commodity prices have led to a 26% year-over-year decline in the value of global exports. Global corporate earnings have stagnated, with profits outside the U.S. back to 2010 levels. Nevertheless, policy stimulus has picked up in recent months, including in Europe and China, and a correction in global manufacturing inventories may signal the bottom of the global trade recession. **The global economic expansion is likely to remain sluggish, as steady trends in major developed economies are countered by challenging conditions in many emerging markets.**

6 *Source: China Statistical Information Network (www.stats.gov.cn), Haver Analytics, Fidelity Investments (AART), as of Oct. 31, 2015.*

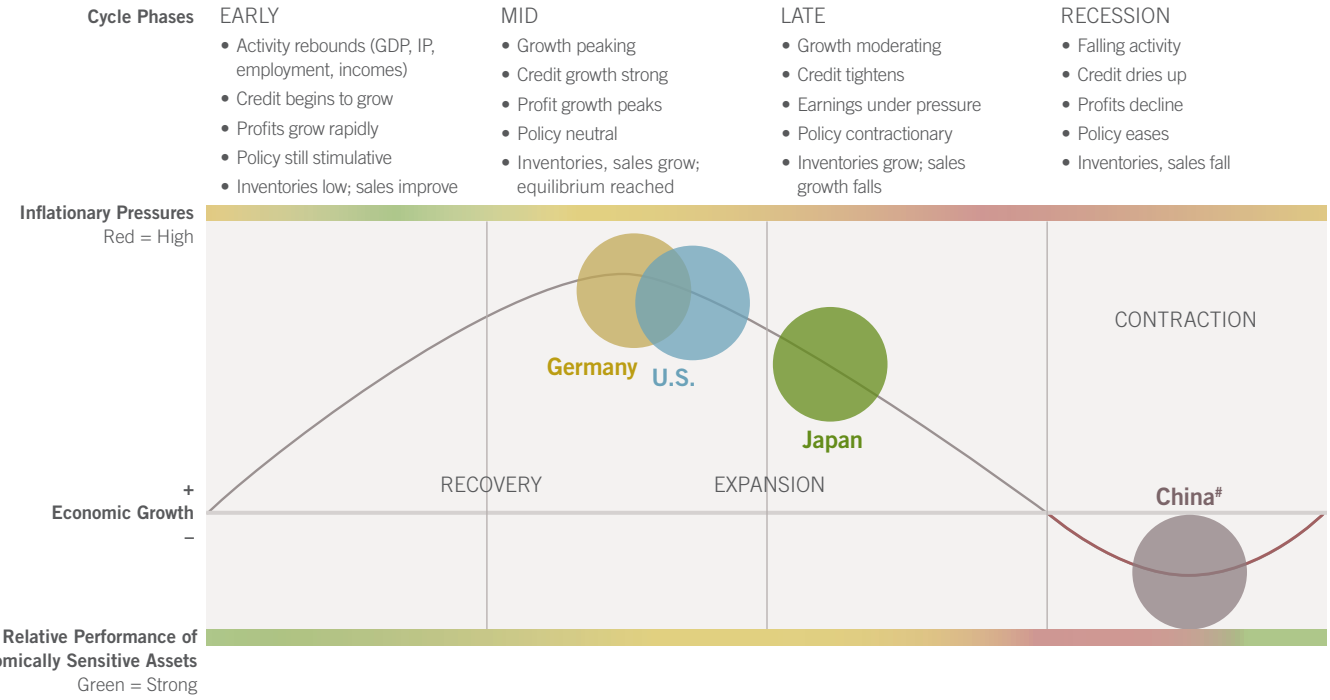
7 *Thirty-eight of the world's major economies. Source: Organisation for Economic Co-operation and Development (OECD), Foundation for International Business and Economic Research (FIBER), Haver Analytics, Fidelity Investments (AART), as of Oct. 31, 2015.*

Outlook / asset allocation implications

The global economy and financial markets wobbled during the final months of 2015, underscoring the downside deflationary risks emanating from China's growth recession and tighter global financial conditions related to the Fed's move toward a rate hike. The coming weeks and months will be a test of whether the global economy can digest U.S. monetary tightening. Our base-case scenario is that the world will muddle through, supported by U.S. and European household sectors, and perhaps endure the final innings of sharp declines in commodity prices, EM economies, and non-U.S. currencies. If such a scenario develops during 2016, the "base effect" of global stabilization may eventually lead to rising inflationary pressures and the possibility of an increase in late-cycle risk. For now, we foresee a favorable outlook for equities, supported by a mid-cycle revival in the U.S. and Europe, stabilization in China, and beaten-down investor sentiment. Market volatility may remain more elevated than during recent years, indicating that smaller asset allocation tilts and the inclusion of high-quality bonds to diversify equity risk may be worthwhile strategies.

Business Cycle Framework

Germany and the U.S. are in the mid-cycle expansion phase; Japan has slipped into the late cycle, while China remains in a growth recession.



Note: The diagram above is a hypothetical illustration of the business cycle. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one. #A growth recession is a significant decline in activity relative to a country's long-term economic potential. We have adopted the "growth cycle" definition for most developing economies, such as China, because they tend to exhibit strong trend performance driven by rapid factor accumulation and increases in productivity, and the deviation from the trend tends to matter the most for asset returns. We use the classic definition of recession, involving an outright contraction in economic activity, for developed economies. Please see endnotes for a complete discussion. Source: Fidelity Investments (AART).

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The Asset Allocation Research Team (AART) conducts economic, fundamental, and quantitative research to develop asset allocation recommendations for Fidelity's portfolio managers and investment teams. AART is responsible for analyzing and synthesizing investment perspectives across Fidelity's asset management unit to generate insights on macroeconomic and financial market trends and their implications for asset allocation.

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Generally, among asset classes, stocks are more volatile than bonds or short-term instruments and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Although the bond market is also volatile, lower-quality debt securities, including leveraged loans, generally offer higher yields compared to investment-grade securities, but also involve greater risk of default or price changes. Foreign markets can be more volatile than U.S. markets due to increased risks of adverse issuer, political, market, or economic developments, all of which are magnified in emerging markets.

Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

Fixed-income securities carry inflation, credit, and default risks for both issuers and counterparties.

Investing involves risk, including risk of loss.

Past performance is no guarantee of future results.

Diversification and asset allocation do not ensure a profit or guarantee against loss.

All indices are unmanaged. You cannot invest directly in an index.

The Business Cycle Framework depicts the general pattern of economic cycles throughout history, though each cycle is different; specific commentary on the current stage is provided in the main body of the text. In general, the typical business cycle demonstrates the following:

During the typical early-cycle phase, the economy bottoms out and picks up steam until it exits recession then begins the recovery as activity accelerates. Inflationary pressures are typically low, monetary policy is accommodative, and the yield curve is steep. Economically sensitive asset classes such as stocks tend to experience their best performance of the cycle.

During the typical mid-cycle phase, the economy exits recovery and enters into expansion, characterized by broader and more self-sustaining economic momentum but a more moderate pace of growth. Inflationary pressures typically begin to rise, monetary policy becomes tighter, and the yield curve experiences some flattening. Economically sensitive asset classes tend to continue benefiting from a growing economy, but their relative advantage narrows.

During the typical late-cycle phase, the economic expansion matures, inflationary pressures continue to rise, and the yield curve may eventually become flat or inverted. Eventually, the economy contracts and enters recession, with monetary policy shifting from tightening to easing. Less economically sensitive asset categories tend to hold up better, particularly right before and upon entering recession.

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