

Business Cycle Update

Global Expansion to Persist in 2017, with a Wide Distribution of Policy Outcomes

U.S. progression toward late-cycle phase to continue

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Key Takeaways

- The most likely path for the global economy in 2017 is one of modest cyclical traction, abating deflationary pressures, and low probability of recession.
- The U.S. cycle is maturing amid tighter labor markets and rising wages, which historically is consistent with late-cycle transitions.
- Changes in economic policy may have a significant influence over whether the U.S. passes into an overheating boom or continues rolling slowly toward the late-cycle phase.
- Post-election market performance indicates higher expectations for U.S. growth, but we have greater conviction that most potential policy mixes point to higher inflation risk.
- At this point in the cycle, asset allocation tilts should be smaller, and inflation-resistant assets may provide portfolio diversification in an environment of upward pressure on interest rates.

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.

In 2016, the U.S. economic expansion was characterized by an increasingly mixed combination of mid- and late-cycle dynamics. Three major trends drove those dynamics and will carry forward into 2017:

Tight labor markets are generating wage inflation and supporting consumption

The pace of hiring in the U.S. remained solid in 2016, and labor markets tightened further as the unemployment rate fell below 5%. As a result, wage growth accelerated from 3.1% on a year-over-year basis to 3.9% throughout 2016, according to the Atlanta Fed's Wage Growth Tracker (Exhibit 1). Consumers' perceptions of the labor market also continued to improve and drove a modest acceleration in the pace of consumption as the year progressed. Labor markets appear poised to continue tightening and to bolster consumer spending in 2017, with late-cycle dynamics likely to result in both a slower pace of job growth and improvement in wages.

Corporate fundamentals are a mixed bag

Corporate fundamentals were generally solid during the course of 2016, as abating headwinds from oil and the

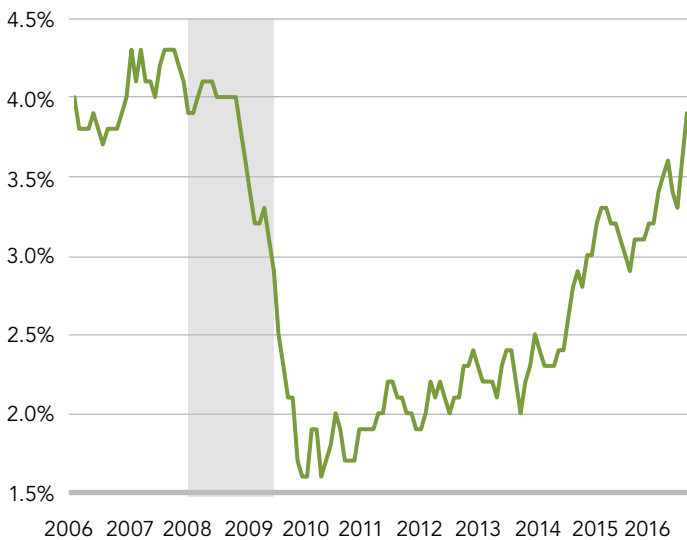
U.S. dollar allowed corporate earnings growth to rebound into positive territory. However, late-cycle signs began to emerge as the year progressed, including pressure on corporate profit margins due to stalling productivity and rising wages. While corporate borrowing costs fell significantly, banks reported that they began tightening lending standards to businesses for the first time since the financial crisis. Policy direction will be important in 2017, with possible tax cuts and deregulation representing potential tailwinds, while tighter monetary policy may challenge the credit cycle. This cross-current of mid- and late-cycle trends for businesses could persist well into 2017.

Inflation pressures are continuing to build

The acceleration in wage growth, coupled with the rebound in commodity prices, resulted in the Bureau of Labor Statistics' Consumer Price Index rising from just 0.1% to 1.6% year over year during the past 12 months ending in October. With core inflation firm and oil prices

EXHIBIT 1: Atlanta Fed Wage Growth Tracker

Wage growth has accelerated markedly during the past year
Year-over-Year Growth %



Shading represents U.S. economic recession as defined by the National Bureau of Economic Research (NBER). Source: Federal Reserve, NBER, Haver Analytics, Fidelity Investments (AART), as of Oct. 31, 2016.

poised to rise above early-2016 trough levels, headline inflation could approach 3% by the end of the first quarter of 2017.

Our base-case U.S. economic outlook for 2017:

- The odds of recession are likely to remain low given the positive consumer backdrop.
- Mid- and late-cycle dynamics should persist, with the potential to tilt toward the late-cycle as the year progresses.
- Inflation pressures are likely to continue rising, which historically has been a key to late-cycle transitions.

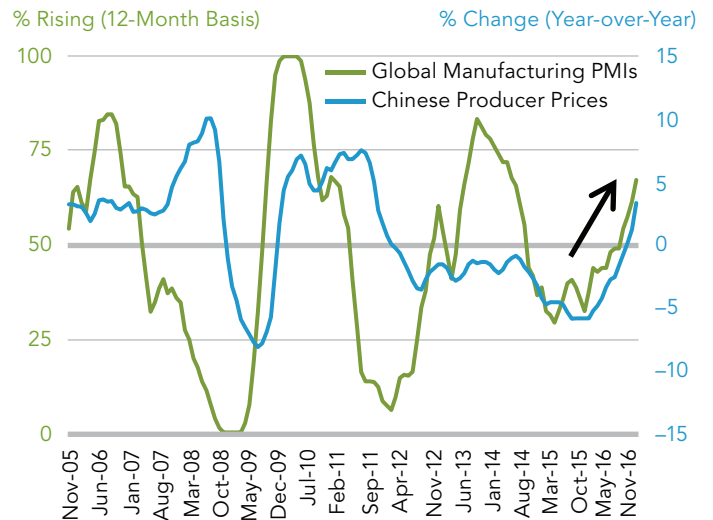
At the global level, economic conditions stabilized during 2016 and will enter 2017 on a more solid foundation than a year ago. Important trends include:

The end of the steep global trade and industrial recession led to a reacceleration in global growth

As 2016 comes to an end, around 80% of the world's

EXHIBIT 2: Global Manufacturing and Chinese Producer Price Inflation

Global industrial activity and Chinese producer prices rose in 2016



Source: Markit, Institute for Supply Management, China Business Support, Haver Analytics, Fidelity Investments (AART), as of Nov. 30, 2016.

largest countries' leading economic indicators are rising on a six-month basis, up from 40% one year ago. Much of the improvement came from the industrial sector, with around 75% of the manufacturing Purchasing Managers' Indexes (PMIs) at higher levels compared to the prior year—up from around 30% a year ago (Exhibit 2). China's stimulus-induced reacceleration was a key driver of the global improvement. Low interest rates and accommodative monetary policies have remained generally supportive of growth.

Global deflationary pressures have abated

After a steep plunge during the past two years, commodity prices inflected higher in 2016. Raw industrial commodity prices are experiencing their first sustained increase since 2011, rising 25% year to date. Energy prices also trended higher as a result of contracting global oil production, coupled with the recent production

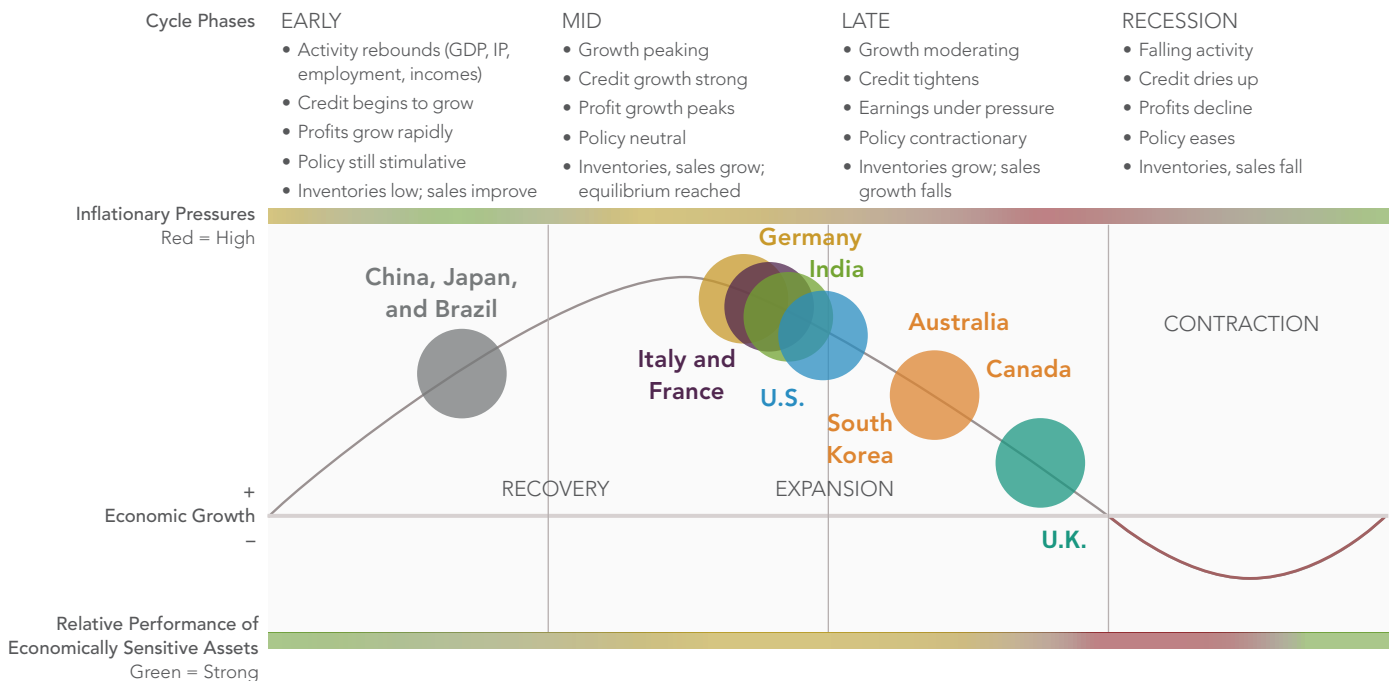
cut announcement by the Organization of Petroleum Exporting Countries (OPEC) and Russia. Furthermore, China's producer price inflation turned positive on a year-over-year basis for the first time since 2012 (Exhibit 2). Improved supply/demand fundamentals for commodity prices and the reacceleration in global growth should continue to put upward pressure on global inflation through next year.

Developed markets overview: Most developed economies are in a mature phase of their cyclical expansions

The U.K. and European Union have thus far been able to shrug off post-Brexit headwinds, as improving manufacturing and global trade have helped reduce the probability of recession. However, the European expansion remains slow as unemployment remains high and political risks weigh on business sentiment (see

EXHIBIT 3: Business Cycle Framework

The world's largest economies are all in expansion, though at various phases of the business cycle



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. Please see endnotes for a complete discussion. Source: Fidelity Investments (AART).

“Politics and policy: Wide range of potential outcomes in 2017,” page 5). Outside Europe, countries remain in various phases of the business cycle. Late-cycle commodity exporters, such as Canada and Australia, have benefited from higher commodity prices but their housing sectors are vulnerable to rising interest rates. Meanwhile, Japan is experiencing early-cycle dynamics, helped by increased export demand. Overall, we expect growth across developed economies to remain slow, with most countries entering more mature phases of their cycles as 2017 progresses (Exhibit 3).

Emerging markets overview: China’s uncertain outlook is key to whether emerging markets can sustain momentum

Emerging markets, particularly commodity exporters and Asian economies closely tied to China, reaped the greatest benefits of the 2016 recovery in China’s growth and in commodity prices. For example, Brazil exited a painful recession and entered the early-cycle phase. Although we are categorizing China in an early-cycle expansion, a sustained acceleration may remain elusive due to continued industrial overcapacity and an overextended credit boom. Given the massive buildup of corporate leverage, Federal Reserve (Fed) interest rate hikes and the pace of capital outflows remain a risk to the renminbi and China’s financial stability. Because China’s successful reacceleration was largely policy induced, China’s policymakers face a difficult balancing act between maintaining growth while addressing imbalances in the housing and credit markets.

Our base-case global economic outlook for 2017:

- Global economic growth remains slow, with most advanced economies in maturing phases of the cycle.
- The most likely path is one of modest cyclical traction, abating global deflationary pressures, and a low probability of global recession.

Markets’ response: Big move in bond yields altered the landscape

During 2016, asset prices shifted from under-appreciating the improving global economic backdrop to sharply reacting to the turnabout in policy expectations after the U.S. elections:

Investors initially didn’t respond to the reacceleration in global growth

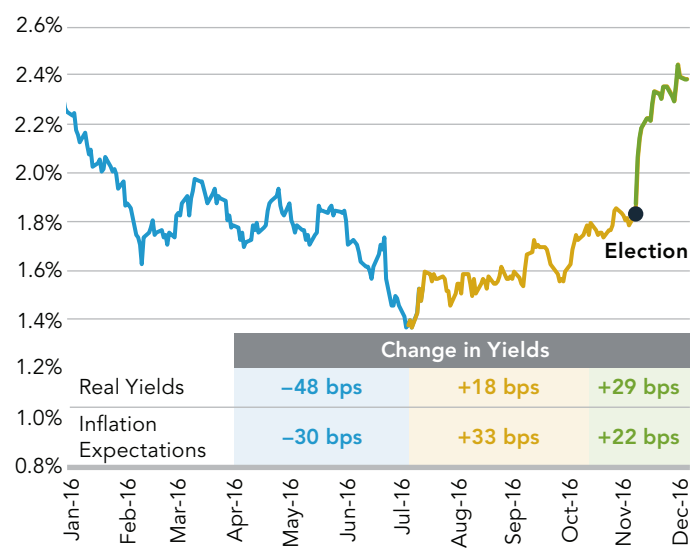
- In the mid-year aftermath of Brexit, global bond yields plunged to all-time lows.
- The performance of “bond-proxy” equities, such as utilities, consumer staples, REITs, and telecommunication services, surged as investors sought higher-yielding assets.

From July through early November, sentiment turned more positive for the cyclical outlook

- The 10-year U.S. Treasury bond yield rose 50 basis points from early July to the November election, as both economic and inflation expectations improved.

EXHIBIT 4: U.S. 10-Year Treasury Bond Yield

U.S. 10-year Treasury bond yields have surged roughly 100 basis points since hitting an all-time low in July



Source: Federal Reserve, Haver Analytics, Fidelity Investments (AART), as of Dec. 7, 2016.

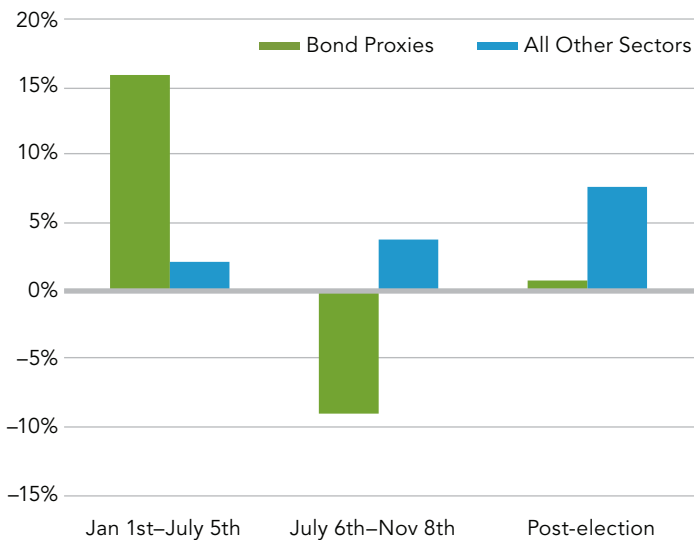
- The performance of bond-proxy equities turned negative, while the overall market posted modest gains.

Big performance changes after U.S. elections

- The 10-year U.S. Treasury bond yield rose an additional 50 basis points (through December 7), due slightly more to improving growth than inflation expectations (Exhibit 4).
- While U.S. stocks rose, the underperformance of bond-proxy equities relative to the broad U.S. equity market became even more pronounced (Exhibit 5).
- The U.S. dollar surged amid rising U.S. bond yields, acting as a drag on non-U.S. stocks (in dollar terms).
- U.S. small-cap equities significantly outperformed large caps, due to perceptions that large caps will be more negatively impacted by the strong U.S. dollar and benefit less from potential corporate tax reform.

EXHIBIT 5: U.S. Equity Sectors 2016 Performance

Bond-proxy equity sectors have significantly underperformed since Treasury yields bottomed in mid-2016



Bond Proxies: S&P 500 Consumer Staples, REITs, Telecom, Utilities. Other sectors: S&P 500 Consumer Discretionary, Energy, Financials, Health Care, Industrials, Technology, and Materials. Source: Standard and Poor's, Bloomberg Finance L.P., Fidelity Investments (AART), as of Dec. 7, 2016.

“Global economic growth remains slow, with most advanced economies in maturing phases of the cycle. The most likely path is one of modest cyclical traction, abating global deflationary pressures, and a low probability of global recession.”

- The strengthening U.S. dollar and fear of rising protectionism led to the significant underperformance of emerging-market equities.

Summary

- In the back half of 2016, investors began to price in expectations for better economic growth and higher inflation in the United States.

Politics and policy: Wide range of potential outcomes in 2017

The last several weeks of 2016 provided a clue about how the markets had repriced expectations for future policy changes, but there remains tremendous uncertainty about how the complex array of potential policy actions will actually come to fruition in 2017. Here are a few things to watch:

Trump/Republicans share some big objectives, but many questions remain unanswered

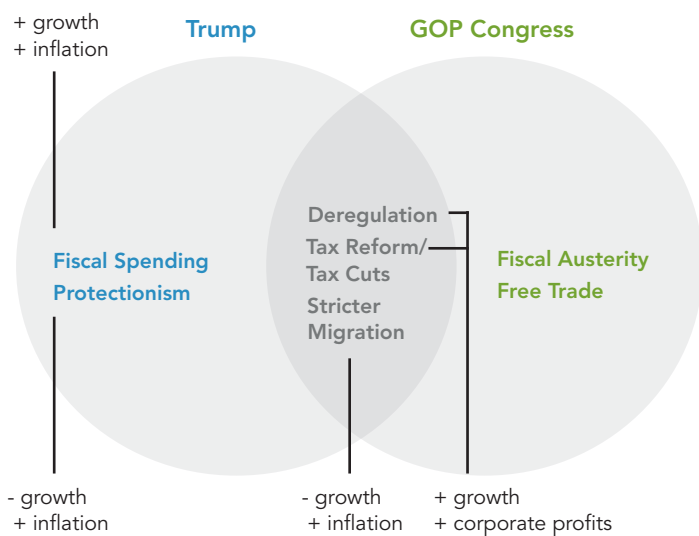
Investor optimism about a boost to cyclical growth centers on the areas of alignment between President-elect Trump’s agenda and the traditionally business-friendly GOP Congress: tax cuts, corporate tax reform, and a lighter touch on business regulation. On the other hand, more restrictive immigration policies could hamper

growth and spur inflation (Exhibit 6). In other areas where there is less agreement between the two sides, Trump's plan for big spending on infrastructure could spur both growth and inflation, while his anti-trade rhetoric raises the risk of protectionist actions that could hurt growth and incite inflation. Putting it all together, it seems reasonable that some aspects of the growth agenda are likely to be implemented and could boost cyclical growth during 2017, but it's also possible the impact might be partially offset if there is a greater-than-expected protectionist tone in the policy mix. Many of these policies tend to boost inflation, making an upside risk to prices perhaps the most likely outcome, regardless of the policy mix.

A maturing cycle and tightening Fed act as counterweights to stimulative policies

Stimulative fiscal policies, such as tax cuts and infrastructure spending, typically have the greatest multiplier effect on growth at the beginning of an

EXHIBIT 6: The Impact of Potential Public Policies in 2017
 Various policies are likely to have different implications for U.S. growth and inflation



Source: Fidelity Investments, as of Dec 12, 2016.

economic cycle when there is considerable excess capacity in the labor markets and the broader economy. With the U.S. expansion more than seven years old and unemployment below 5%, a large policy stimulus might cause the economy to hit capacity constraints relatively quickly and give an upward boost to inflation. The Fed hiked policy rates in December for the second time this cycle even before any new stimulus, so a boost from fiscal policy may give the Fed confidence to normalize rates at a faster pace than expected.

The rest of the world still has accommodative policies, but heightened political risk in Europe

Outside the U.S., policy and political uncertainty is also likely to remain high in 2017. After the triumph of anti-establishment views in the Brexit and U.S. presidential votes, national elections in France, Germany, and the Netherlands (and maybe Italy) will likely keep investors on edge. A clear victory by nationalist, populist parties in any of these areas could immediately raise investor concerns about the integrity of the euro area currency union. Meanwhile, the European and Japanese central banks will try to navigate an environment where negative rates and additional monetary accommodation have hit the limits of usefulness, and are arguably doing more harm than good. At a high level, some major economies may be recognizing the limits of monetary easing and shifting toward easier fiscal stances, which would be an incrementally positive development for growth.

Our base-case outlook for public policy/politics in 2017:

- The probability of growth-friendly U.S. fiscal and regulatory policies has risen significantly with the Republicans' takeover of the White House and Congress, implying that the outlook for U.S. growth may have shifted upward.
- However, the distribution of outcomes is likely to

be extremely wide, and the surest bet appears to be that most potential policy mixes point to higher inflation risk.

- In combination with the election risk and monetary policy uncertainty in Europe, policy direction is likely to profoundly influence the U.S. and global business cycles during 2017.

Outlook/asset allocation implications for 2017

As we enter 2017, the global business cycle is in decent shape, although it faces both a maturing profile and a staggering range of potential policy outcomes. The general shape of the outlook is highly dependent on the direction of the world's largest economy, and we posit there are two broad scenarios for the U.S. economy over the next year:

- The first is that U.S. growth accelerates materially over the course of 2017, presumably boosted by fiscal stimulus and business-friendly policies, pushing the economy into an overheating phase. Historically, overheating booms have occurred fairly frequently late in the cycle. This faster-growth scenario would likely be accompanied by higher inflation, a pickup in global growth, higher commodity prices, and a Fed that hikes rates (but stays patient) and is generally perceived as behind the curve.
- The second scenario is that U.S. growth is stable but does not meaningfully accelerate, presumably because the mix of Republican policies is not as effective or growth-oriented as hoped, which leaves the U.S. economy rolling slowly toward late cycle. This pattern is arguably where things were headed absent a major

policy change, and it might feel similar to much of what occurred in 2016. The Fed may still hike patiently but would be perceived as even with or ahead of the curve, the stronger U.S. dollar would tighten global financial conditions and put pressure on China and others, and inflationary pressures would rise but at a more moderate pace (see "U.S. Economy in Slow Roll Toward Late-Cycle Phase, Business Cycle Update," November 2016).

Given the difficulty in predicting U.S. economic policies in advance of the presidential Inauguration, we do not have a high degree of confidence in projecting which flavor of U.S. expansion is more likely in 2017 (and it could likely end up somewhere in between). From an asset allocation standpoint, we enter 2017 still favoring equities, and see the potential for bond yields to rise further, as we have during the past 12 months. However, what matters most is that either U.S. scenario is likely to push up the odds of a full move into the late-cycle phase as 2017 progresses. An overheating boom would presumably—for a while—provide more upside to stocks and downside for bonds, similar to post-election patterns. But either way, the current mature U.S. cycle implies fuller asset valuations, less stock market upside, and higher policy uncertainty than earlier in the cycle. These characteristics imply cyclical tilts should be smaller at this phase of the cycle, and closer to strategic weights. In addition, the upside risk to inflation implies more inflation-resistant assets (e.g., Treasury Inflation-Protected Securities, energy stocks, and commodities) may provide portfolio diversification. The next year should be an interesting one for investors, and we believe the business cycle framework may be useful in keeping a focus on the intermediate term.

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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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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. Increases in real interest rates can cause the price of inflation-protected debt securities to decrease.

The commodities industries can be significantly affected by commodity prices, world events, import controls, worldwide competition, government regulations, and economic conditions. 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. Please note that there is no uniformity of time among phases, nor is there always a chronological progression in this order. For example, business cycles have varied between one and 10 years in the U.S., and there have been examples when the economy has skipped a phase or retraced an earlier one.

Index definitions

A Purchasing Managers' Index (PMI) is a survey of purchasing managers in a certain economic sector. A PMI over 50 represents expansion of the sector compared to the previous month, while a reading under 50 represents a contraction, and a reading of 50 indicates no change. The Institute for Supply Management® reports the U.S. manufacturing PMI®. Markit compiles non-U.S. PMIs. The Consumer Price Index (CPI) is a monthly inflation indicator that measures the change in the cost of a fixed basket of products and services, including housing, electricity, food, and transportation. The S&P 500® Index is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. S&P 500 is a registered service mark of The McGraw-Hill Companies, Inc., and has been licensed for use by Fidelity Distributors Corporation and its affiliates. The S&P 500® Sector Indices include the standard GICS® sectors that make up the S&P 500® Index.

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