Executive Summary
Quarterly Market Update: Third Quarter 2017

Market summary: Low inflation and global expansion continued
The continued synchronized expansion in global activity provided a steady backdrop for asset markets. With inflation decelerating amid weaker oil prices, most asset markets experienced unusually low volatility during Q2, even compared to the relatively calm levels of the past five years. This steady economic backdrop, combined with ample global monetary accommodation, supported a relatively tranquil environment for the past three months. Bolstered by a weaker U.S. dollar, non-U.S. equities led the global stock market rally for the second quarter in a row, with particular strength among small-caps. In fixed income, most categories posted low single-digit positive returns for the second quarter. Falling commodity prices dampened inflation expectations and boosted longer-duration bonds. The yield curve flattened modestly as shorter-term interest rates rose, while tightening spreads again boosted the returns to corporate and other credit-bond categories.

While flagging oil prices and muted inflation pressures mitigated any concerns about potential overheating, a major question for the markets going forward is whether the growth and inflation backdrop will remain firm enough for global monetary policymakers to move toward normalization. Changes to monetary policy will be critical to the outlook, as a broad directional move toward reducing accommodation raises the potential to provoke greater market volatility amid maturing business cycles in many major economies, including the U.S.

Theme: Global liquidity poised to tighten?
The balance sheets of the four major advanced-economy central banks—the U.S. Federal Reserve (Fed), European Central Bank, Bank of Japan, and Bank of England—have more than quadrupled since the global financial crisis due to trillions of dollars of quantitative-easing asset purchases. Firming inflation and global growth have given the Fed confidence to continue gradually hiking its short-term policy rate, although both are weaker than during prior periods of Fed tightening. Europe’s progress toward policy normalization may occur sooner than the markets anticipate, with short-term yields implying negative yields for nearly five years and a slower pace of normalization relative to the U.S.

After converging on the 2017 outlook over the past year, investor expectations for Fed tightening have once again diverged materially from the Fed’s forecasts for the next 12 to 18 months. Markets are anticipating the Fed will hike rates only twice through December 2018, instead of the four times the Fed projects. The Fed also announced the outlines of a plan to begin shrinking its balance sheet that would imply additional tightening. Historically, the yield curve typically flattens as the Fed hikes rates and the business cycle matures, with inversions occurring prior to each of the last seven recessions. However, the yield curve remains relatively steep, and a move toward global monetary normalization might boost longer-term rates more than usual at this point in the cycle.
Economy/macro: Growth and inflation firm but not accelerating

The global economy continues to expand in a synchronized fashion, with most developed economies in more mature (mid-to-late) stages of the business cycle. Relatively steady economic growth has been underpinned by a turnaround in export-oriented sectors and manufacturing activity. Nearly 90% of countries are reporting higher new export orders, and global trade growth has risen to its highest level since 2011.

China’s reacceleration supported these trends, although late in 2016 policymakers began to rein in policy stimulus. China’s economy remains broadly steady, but signs of slowing momentum in industrial activity and housing suggest most of the upside has already occurred. Elsewhere, the eurozone is on a mid-cycle upswing, with consumer and industrial-sector confidence at multiyear highs and rebounding core inflation.

The U.S. economy remains a mix of late-cycle dynamics. Manufacturing activity has reaccelerated over the past year amid strengthening global demand, but rising wages are crimping profit margins and banks have tightened their lending standards for potentially overextended segments of the economy such as commercial real estate and autos. Inflation may be range-bound as moderating shelter costs and lower oil prices act as headwinds, but tighter labor markets and a possible rise in food prices present upside pressures.

Overall, recession risks remain low globally, although less accommodative policy in several countries, including China, may constrain any upside to growth going forward.

U.S. equities: Growth stocks, large-caps continued to lead

Growth and large-cap stocks continued to outpace other U.S. equity categories in 2Q due to their exposure to the improving international economic backdrop.

Sector performance was varied, though mostly positive, with only energy and telecommunication services experiencing outright declines—due to falling crude oil prices and price competition, respectively.

The continued outperformance of so-called “FANG” tech stocks—Facebook, Amazon, Netflix, and Google (now Alphabet)—has raised concerns that the market has become overly dependent on a small number of stocks. While the breadth of companies driving S&P 500® price returns was somewhat narrow in 2Q, this level was not far below the historical median breadth during rising markets. Corporate earnings are still inflecting positively in 2017, and while potential pro-growth policies could boost top-line growth in 2018, margins will likely remain under pressure, suggesting more modest earnings growth ahead. U.S. large-cap valuations are higher than their long-term historical average, but valuations are a more meaningful indicator of long-term future returns, and are therefore more of a headwind for the secular outlook than the cyclical one.

International equities and global assets: Broad gains helped by weaker U.S. dollar, acceleration in corporate earnings

Non-U.S. equities posted strong gains for a second quarter in a row. A weaker U.S. dollar in Q2 boosted returns in most developed markets, but was a minor detractor from emerging markets. Both developed- and emerging-markets equities benefited as international corporate earnings accelerated into positive territory, following several years of profit recession. Attractive valuations are favorable for international equities—P/E ratios for most equity markets are lower than those in the U.S. and the U.S. dollar remains at the upper end of historical ranges versus major currencies.

On a secular basis, we expect GDP growth of emerging countries to outpace that of developed markets over the long term, providing a relatively favorable long-term
backdrop for emerging-markets equity returns. The recent flattening of globalization trends could reduce the correlation between U.S. and international equities from such elevated levels, a secular shift that would likely provide greater diversification benefits for non-U.S. equities within a global portfolio.

Fixed income: Falling yields, narrowing spreads supported returns
Most fixed-income categories posted low single-digit positive returns this quarter. Long bonds were the strongest-performing category, benefiting from a drop in long-term yields, while most credit-sensitive categories enjoyed a boost from the continued narrowing in credit spreads. Treasury Inflation-Protected Securities (TIPS) were the worst performer because market expectations for inflation waned. Despite a fourth policy rate hike from the Fed in Q2, bond yields moved even lower across categories the past three months. Yields remain extremely low relative to history, with high-yield corporate bonds approaching all-time lows. Credit spreads also compressed further for most categories, making all sectors expensive relative to their own histories. Investment-grade bonds—the most interest rate-sensitive bond category—have historically offered better downside protection than stocks, even when rates were rising. During the four decades of rising rates from 1941 to 1981, high-quality investment-grade bonds provided positive nominal returns as increasing coupons helped offset the negative impact of price declines.

Most leveraged loans in recent years have included a LIBOR floor provision to ensure a minimum rate paid to investors. During Q2, 3-month LIBOR continued to rise above the average floor for the first time in several years, thereby allowing the variable-rate feature to provide an upward coupon adjustment if short-term interest rates continue to rise.

Fixed-income strategies with designated allocations in both high-quality bonds and higher-yielding sectors have exhibited consistent downside protection. The diversification offered by “core-plus” and “multi-sector” portfolios have helped generate fewer periods of negative returns than any individual bond sector, while providing a lower magnitude of losses than lower-quality sectors.

Asset Allocation
Late cycles have the most mixed performance of any business-cycle phase, with more limited overall upside than mid-cycle phases. There is less confidence in equity performance, though stocks have typically outperformed bonds. Inflation-resistant assets, such as commodities, energy stocks, short-duration bonds, and TIPS, have typically performed relatively well.

Any inflation erodes the purchasing power of portfolios. In addition, equity and bond returns have historically experienced headwinds during periods of rising inflation. Further, when inflation has been higher and more volatile—as it was in the 1970s—the performance correlation between stocks and bonds increased, leaving inflation-resistant assets such as commodities as one of the few diversifiers for stocks during these periods.

Even though the performance of the major asset classes tends to deteriorate when inflation is rising, inflation-resistant asset classes—such as commodities, gold, commodity-producing equities, and short-duration bonds—have historically held up better in such environments. A strategic allocation to a basket of such assets may help investors manage the risk that inflation could be higher than anticipated over the long term.
For Canadian investors
For Canadian prospects and/or Canadian institutional investors only. Offered in each province of Canada by Fidelity Investments Canada ULC in accordance with applicable securities laws.

Unless otherwise disclosed to you, any investment or management recommendation in this document is not meant to be impartial investment advice or advice in a fiduciary capacity, is intended to be educational and is not tailored to the investment needs of any specific individual. Fidelity and its representatives have a financial interest in any investment alternatives or transactions described in this document. Fidelity receives compensation from Fidelity funds and products, certain third-party funds and products, and certain investment services. The compensation that is received, either directly or indirectly, by Fidelity may vary based on such funds, products and services, which can create a conflict of interest for Fidelity and its representatives. Fiduciaries are solely responsible for exercising independent judgment in evaluating any transaction(s) and are assumed to be capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies.

Information presented herein is for discussion and illustrative purposes only and is not a recommendation or an offer or solicitation to buy or sell any securities. Views expressed are as of the date indicated, based on the information available at that time, and may change based on market and other conditions. Unless otherwise noted, the opinions provided are those of the authors and not necessarily those of Fidelity Investments or its affiliates. Fidelity does not assume any duty to update any of the information.

Investment decisions should be based on an individual’s own goals, time horizon, and tolerance for risk. Nothing in this content should be considered to be legal or tax advice and you are encouraged to consult your own lawyer, accountant, or other advisor before making any financial decision.

In general the bond market is volatile, and fixed-income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.)

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.

Third-party marks are the property of their respective owners; all other marks are the property of Fidelity Investments Canada ULC.

If receiving this piece through your relationship with Fidelity Institutional Asset Management® (FIAM), this publication may be provided by Fidelity Investments Institutional Services Company, Inc., Fidelity Institutional Asset Management Trust Company, or FIAM LLC, depending on your relationship.

If receiving this piece through your relationship with Fidelity Personal & Workplace Investing (PWI) or Fidelity Family Office Services (FFOS) this publication is provided through Fidelity Brokerage Services LLC, Member NYSE, SIPC.

If receiving this piece through your relationship with Fidelity Clearing & Custody Solutions™ or Fidelity Capital Markets, this publication is for institutional investor or investment professional use only. Clearing, custody or other brokerage services are provided through National Financial Services LLC or Fidelity Brokerage Services LLC, Member NYSE, SIPC.

© 2017 Fidelity Investments Canada ULC. All rights reserved.

US: 807109.1.0   CAN: 810018.1.0

Authors

Lisa Emsbo-Mattingly  I  Director, Asset Allocation Research
Dirk Hofschire, CFA  I  Senior Vice President, Asset Allocation Research
Jake Weinstein, CFA  I  Senior Analyst, Asset Allocation Research
Austin Litvak  I  Senior Analyst, Asset Allocation Research
Caitlin Dourney  I  Analyst, Asset Allocation Research

Fidelity Thought Leadership Vice President Kevin Lavelle provided editorial direction for this article.