BUSINESS CYCLE UPDATE

Global Growth Risks Rise Amid Turmoil, but U.S. Economy Solidly Mid-Cycle

Instability in China raises the risks of global deflation

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KEY TAKEAWAYS

- Market volatility spiked due to rising global deflationary pressures, stirred by China’s flagging growth and visible policy struggles.
- The U.S. economy remains relatively insulated, with lower inflation potentially prolonging the mid-cycle expansion.
- Mid-cycle environments have historically coincided with stock market corrections rather than prolonged bear markets.
- The Federal Reserve may pursue an even more gradual path of monetary tightening.
- U.S. and Europe offer more favorable cyclical conditions for equities, while high-quality bonds provide protection against the likelihood of elevated volatility.

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.
Recent financial market turmoil has not altered the major tenets of our global economic outlook, as they were expressed in last month’s update, “Global Reflation vs. Deflation: The Battle Rages On” (August Business Cycle Update). We expect an environment of low inflation, elevated market volatility, cyclical leadership from mid-cycle expansions in the U.S. and Europe, weakness from recessionary pressures in many emerging markets, and a gradual pace of Federal Reserve (Fed) tightening. The events in recent weeks have raised the risk of a more deflationary global environment, a scenario that could be precipitated if China is unable to stabilize the growth trajectory of its economy.

**Market volatility spiked on increased global deflationary risk**
As we have noted over the past four years, a China deflationary shock represented the biggest threat to the global economy. Over the past several weeks, additional evidence has become visible of the massive challenges the Chinese economy faces after an extended credit and investment boom. Most indicators of economic activity point to multiyear weakness, despite the renewed emphasis on policy easing (see “China,” page 6). Moreover, for perhaps the first time after decades of high growth rates and strong economic management, the perceived aura of infallibility surrounding China’s policy responses has been punctured. The failed attempt by policymakers to prop up a faltering equity market, and the currency devaluation in August, caught many investors by surprise.

The result of continuously rising risks in China has been a risk-off market in August that punished assets and entities most linked to China’s growth trajectory. As the world’s second-largest economy, biggest trader, and largest consumer of commodities, China’s visible struggles have led to a large drop in commodity prices, the equities of commodity producers, and emerging-market (EM) equities and currencies (see Exhibit 1). Global trade has slumped (see Exhibit 2), with negative effects on the countries and companies that are most dependent on exports and foreign demand.

The risks to China, including the risk of a larger devaluation, remain elevated as policymakers try to balance greater policy easing with the increase in capital outflows. As a result, recessionary pressures in many emerging-market
and commodity-producing economies are likely to intensify in the near term, with deflationary pressures emanating from China continuing to negatively affect commodities, trade demand, and currency values (see “Global,” page 6).

U.S. economy still in mid-cycle

The outlook for the U.S. mid-cycle economic expansion remains solid despite global weakness. The story remains a tale of two sides of the economy. The more externally oriented sectors—such as exports, manufacturing, and energy production—are likely to soften further due to the additional strengthening in the U.S. dollar, weaker global demand, and lower oil prices. However, the more domestic side of the economy—including the larger household and services sectors—is likely to experience only minor impact from recent global developments. In fact, the increased deflationary pressures may have a silver lining for U.S. households and businesses, pushing down the prices for gasoline and other commodities and making imported goods cheaper.

Because the exit from mid-cycle expansion is typically caused by a rise in inflationary pressures, the latest developments have actually lowered the near-term risk of a move to the late-cycle phase. The Fed may become even more cautious and gradual in its approach to raising interest rates. While we still expect that continued improvement in U.S. labor markets will prompt the Fed to begin a tightening cycle in the coming months, global deflationary pressures are likely to help keep interest rates and inflation relatively low. The most likely result is a more prolonged slow, low-inflation, mid-cycle expansion led by strength in the U.S. consumer sector (see “U.S. economic sectors,” page 5).

U.S. stocks: correction more likely than deep bear market

Although global developments may have a limited impact on the U.S. economy, their influence on the profit outlook for U.S. public corporations may be greater. The stronger dollar, weaker global demand, and lower commodity prices are likely to negatively weigh on the earnings of multinationals and commodity producers. The stocks of energy, materials, and globally exposed industrial companies have been among the worst performers so far in 2015. Nevertheless, mid-cycle backdrops have generally experienced fewer extended bear markets (declines of 20% or more), with moderate equity market corrections (declines of 10% to 20%) a more frequent outcome. Historically, the large price drops associated with equity bear markets have coincided with severe double-digit contractions in corporate profits, which typically occur during economic recessions. Corrections have occurred more frequently than bear markets, and have been more short-lived and shallow, because profit growth has tended to remain positive or to only slightly decline (see Exhibit 3). If our outlook proves accurate—if the U.S. remains in a mid-cycle expansion and does not move toward recession—profit growth should stabilize over time, averting the fundamental catalyst for a severe bear market in equities (see “Corporate and credit,” page 5).

Exhibit 3 Bear Markets vs. Corrections Since 1980

Unlike U.S. market corrections, bear markets are typically associated with steep earnings recessions.

**Outlook/asset allocation implications**

Seven years ago, the global financial crisis devastated the overleveraged U.S. household sector, leaving China to spur global demand. Today, the U.S. consumer is perhaps the world’s brightest growth story, but financial pressures are weighing heavily on China after its extended credit boom.

### Outlook Summary

The risk of a China deflationary shock is the greatest threat to our base case outlook. As a result of this about-face and China’s most recent struggles, the risks of global deflation have risen in recent weeks and now outweigh the potential inflationary risk of a tightening U.S. labor market. The small devaluation and relative stability of China’s currency (through the end of August) do not evoke the worst-case deflationary scenario we outlined as a risk to our base case outlook last month, which would likely involve an even greater abrupt devaluation and perhaps higher financial instability in China. Greater deflationary pressures have lowered the inflation outlook in the U.S., implying an even greater likelihood of a prolonged mid-cycle phase (and less probability of an inflation-driven late cycle in the near term). As a result, the market sell-off may potentially provide a buying opportunity for U.S. equities in the coming weeks.

Our base case cyclical outlook and asset implications are the following:

- **Cyclical leadership** by the U.S. and Europe, favoring those equities over emerging markets and commodities
- **Low inflation**
- **The Fed is likely to tighten monetary policy at a gradual pace**
- **Elevated market volatility**
- **Smaller asset-allocation bets warranted**
- **Maintain exposure to high-quality bond duration, to diversify and to guard against deflation risk**

**Source:** Fidelity Investments (AART).
Business Cycle: Macro Update

The latest bout of global volatility will likely further soften activity for external-oriented sectors in the U.S. (exports, manufacturing, oil production), which are negatively influenced by the weaker global environment, stronger dollar, and drop in oil prices. However, the 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 (see Exhibit A).

U.S. economic sectors

Inflation. The headline consumer price index, which has fallen close to 0% year over year, will likely remain weak following the recent downturn in commodity prices. However, wage pressures— and, by extension, core inflation (excluding food and energy)—are still trending modestly higher, and are likely to continue to rise as the labor market tightens further. Wage gains support a modest pickup in inflation, but late-cycle inflationary pressures remain absent amid renewed weakness in commodity and import prices.

Consumption and employment. Conditions facing U.S. consumers continue to improve amid tightening labor market conditions and lower oil prices. Unemployment claims remain near historic lows, while the job openings rate is near historic highs. However, weak secular trends (such as an aging population) are likely to prevent consumer spending from matching the pace of previous cycle peaks. 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. Improvement in leading indicators provides evidence that the slow housing expansion is gaining greater traction. Underlying fundamentals, such as increased bank willingness to make mortgage loans, rising mortgage originations, solid employment, growing household formations, and high home affordability, suggest that this improvement in demand could continue. Several activity metrics signal that the sector is gaining momentum, with new single-family home construction rising in July to the highest level since 2007. The outlook for the housing sector is solid, supported by the tightening labor market, an uptick in household formations, still-low mortgage rates, and easing lending conditions.

Corporate and credit. Corporate earnings were modestly negative in the second quarter of the year, down ~3% on a four-quarter trailing basis. This decline was driven largely by the energy and materials sectors; excluding these sectors, earnings rose 6%. The renewed slump in commodity prices will likely create further profit weakness for those sectors, but profitability remains solid among more domestically oriented sectors. Credit conditions remain generally favorable, although credit spreads of investment-grade and high-yield corporate bonds have widened somewhat in recent weeks. Manufacturing and business investment have softened amid a weaker energy sector and a strong U.S. dollar, but credit availability and the corporate sector remain generally healthy.

Exhibit A Components of U.S. GDP

The U.S. economy is driven more by domestic factors than by global ones.

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3 Source: U.S. Census Bureau, Haver Analytics, Fidelity Investments (AART), as of Jul. 31, 2015.
4 Source: Standard & Poor’s, Fidelity Investments (AART), as of Aug. 21, 2015.
Global

China. A downshift in growth at the end of a credit boom has left China with a credit overhang, excess capacity in the property and industrial sectors, and declining corporate profitability. In an effort to stimulate the slowing domestic economy, the People’s Bank of China cut the required reserve ratio and the benchmark interest rate for a third and fourth time this year, respectively. Economic weakness is centered in the industrial and property sectors, as industrial activity metrics have fallen to 2008 levels and construction activity remains moribund. China remains in a growth recession, with more policy easing likely but a sustainable reacceleration improbable absent greater structural reforms.

Europe. Europe continues to regain cyclical traction amid improved credit and monetary conditions and pent-up household demand in the periphery. Though some European exporters such as Germany may be affected by weak Chinese demand, domestic conditions continue to improve in many countries after a multiyear slump. Accommodative monetary policy, a competitive euro, and a healthy credit cycle 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. With more than half of Japan’s exports going to Asia, the regional reverberations from China’s recession and currency devaluation pressures represent a threat to the corporate profit recovery in Japan’s manufacturing and export sectors. Japan’s economy has matured into a mid-cycle expansion, as broad activity indicators have moderated and external conditions deteriorated.

Global summary. The latest global financial turmoil has driven an even wider divergence between the outlook for economies that can generate internal demand versus economies that are most exposed to global conditions (particularly China’s downturn). In general, developed economies are in better shape, led by steady mid-cycle expansions in the U.S. and Europe that are bolstered by a recovery in household demand after years of subdued activity. These economies are net beneficiaries of lower commodity prices and cheaper imports. Leading economic indicators (LEIs) for 70% of developed markets are positive on a six-month basis. The exceptions are Australia and Canada, which are experiencing rising recessionary risks due to their reliance on commodity exports.

In contrast, many emerging-market economies are experiencing late-cycle or recessionary pressures, and only one-third of LEIs are positive on a six-month basis. Weaker commodity prices have caused many EM commodity-dependent countries, including Brazil and Russia, to fall into recession. The recent bout of currency weakness serves as an additional cyclical headwind for many EM economies. Currency depreciation spurs inflationary pressures, which often compels policymakers to maintain tighter monetary conditions than might be warranted by a weakening domestic economy. Also, weaker currencies tend to raise the debt-service burden of EM countries, and companies that borrowed heavily in U.S. dollars must now repay with weaker currencies. Global economic expansion is likely to remain sluggish, as positive trends in major developed economies barely offset deteriorating conditions in many emerging markets.

1 Source: Bloomberg Finance L.P., Fidelity Investments (AART), as of Aug. 26, 2015.
3 Source: MSCI Indices, FactSet, Fidelity Investments (AART), as of Jul. 31, 2015.
Business Cycle Framework

Japan, Germany, and the U.S. are in the mid-cycle expansion phase, 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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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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