BUSINESS CYCLE UPDATE

Why Are Stocks Near All-Time Highs and Yields Near All-Time Lows?

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KEY TAKEAWAYS

- While not our view, record-high Treasury bond valuations imply a scenario of indefinite continuation of sluggish growth, non-existent inflation, and monetary easing outside the United States.
- Low interest rates have boosted equity prices as well, with high-dividend-paying bond proxies, such as utilities, trading at extreme valuations.
- Though post-Brexit data remain sparse, global growth and inflation trends appear to have gained momentum and could surpass subdued expectations over the next 6-12 months.
- Even a modest growth and inflation surprise could dampen the recent rallies in Treasuries and bond-proxy equities.
- Inflation-resistant assets may help diversify against the rise of U.S. late-cycle dynamics.

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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In early July, the yield on 10-year Treasuries fell to a record low. At the same time, the S&P 500 Index broke out to a new all-time high. This update will identify the drivers of this peculiar rally and discuss how the global business cycle may affect this dynamic going forward.

Ultra-low bond yields imply extreme valuations

Ten-year U.S. Treasury bond yields fell to 1.36% in July, the lowest level in history. Long-term Treasury yields are driven by three broad factors: expectations about the future pace of economic growth, expectations about the future pace of inflation, and something called a "term premium." Term premium is essentially the additional compensation investors require over short-term interest rates (e.g., cash) to be willing to lend money for a longer period of time and bear a higher level of interest rate risk.

Exhibit 1 (below) shows the long-term history of the additional compensation of the U.S. 10-year Treasury over cash. The blue line plots the cumulative excess return through time, and the green line is a measure of the underlying trend. Both lines go up over time, which means that Treasury investors have historically been compensated with extra returns for taking on term premium.

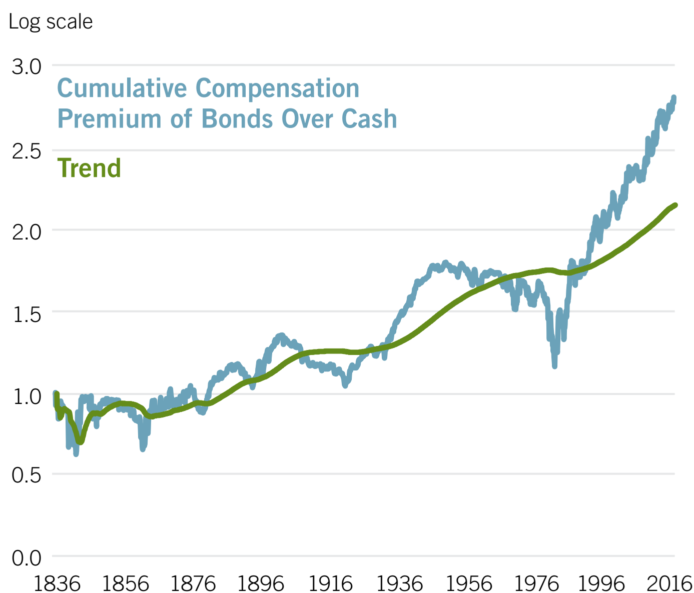
However, in recent years bonds have outperformed cash by a historically extreme amount (the blue line vs. the green line). The result is that there is very little term premium (additional compensation) for investing in bonds instead of cash, which implies that investors have never gotten so little yield in exchange for the duration risk they are assuming. Sovereign bond yields in Europe and Japan are even lower, with more than $10 trillion of debt trading in negative yield territory.

Why are bond yields so low?

There are several fundamental reasons that help explain these ultra-low bond yields, and it's important to remember that U.S. Treasuries are a global asset and not merely a reflection of the U.S. economy. The pace of global growth has been anemic, inflation has been subdued, and secular

Exhibit 1 Compensation Premium of Bonds over Cash

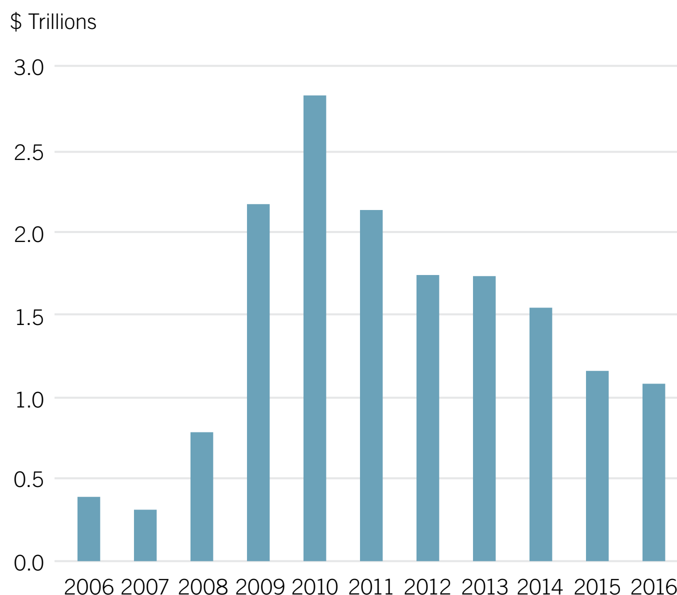
Bonds have dramatically outpaced cash, leaving little duration premium.



Source: Fidelity Investments (AART) calculation. Source: GFD, Fidelity Investments (AART), as of Jun. 30, 2016.

Exhibit 2 Developed Market Government Bond Issuance

2016 DM new government debt issuance has dropped to roughly one-third of the 2010 level.



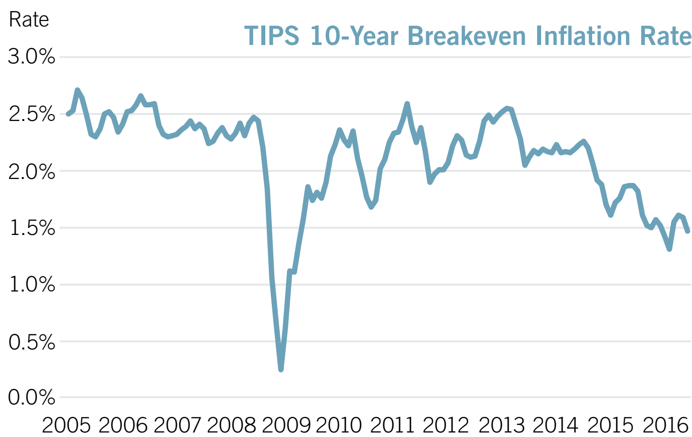
DM: Developed market. Source: Courtesy JPMorgan Research, Copyright 2016. Fidelity Investments (AART), as of Jun. 30, 2016.

issues such as high debt and aging demographics are long-term headwinds for growth. In response, monetary policy-makers have pushed down policy rates to ultra-low levels, including negative territory in Europe and Japan, and they have pledged to hold them there for a long time period.

Current yields also reflect formidable technical factors that have helped depress Treasury yields. On the supply side, quantitative easing programs by the four largest central banks have soaked up roughly the equivalent of $9 trillion in bonds. In addition, lower fiscal deficits have allowed new debt issuance by developed markets (DMs) to fall to an estimated equivalent of $1 trillion this year, just a third of the level issued in 2010 (see Exhibit 2). Meanwhile, demand for high-quality bonds has risen significantly. Regulatory changes have boosted demand among financial institutions in order to meet higher capital and liquidity requirements. Secular demand from pension plans and aging populations continues to rise. And zero and negative yields overseas have generated high foreign demand for comparatively high-yielding U.S. bonds.

Exhibit 3 TIPS Breakeven Inflation Rate

The Treasury market's 10-year inflation outlook is historically weak.



TIPS: Treasury Inflation-Protected Securities. TIPS breakeven inflation rate calculated as difference between real and nominal 10-year Treasury yields. Source: Federal Reserve, Bureau of Labor Statistics, Haver Analytics, Fidelity Investments (AART), as of Jun. 30, 2016

Bond yields are priced for one scenario: low growth, low inflation

The bond market today appears to be pricing in a continuance of the global environment that we have experienced over the past couple of years: sluggish growth, nonexistent inflation, and indefinite monetary policy easing outside the U.S. According to the Treasury market, investors anticipate inflation to average just 1.5% a year for the next decade (see Exhibit 3), the lowest at any point outside of the financial crisis. Bond yields imply that the market is pricing bonds at a level indicating not only that the market technical factors will continue but also that the most likely cyclical scenario is a global recession followed by secular stagnation in the long term. Such a scenario would likely not only justify current bond yield levels but potentially push them even lower.

However, there are other scenarios for the U.S. and global economic outlook. In our opinion, the most likely alternative is that continued expansion in the U.S. and stabilization in the global economy leads to a growth and inflation environment that surpasses extremely subdued market expectations. One possibility within this context is that governments increase deficit spending to further stimulate growth, a trend already apparent in China, recently announced in Japan, and becoming increasingly likely in the U.K. and in the U.S. (see China, Macro section, page 6). Any improvement in macroeconomic trends would likely obviate the need for monetary policy-makers to endlessly expand easing programs, particularly at a time when the limitations of ultra-low and negative policy rates are becoming more apparent (see Leadership Series paper "Potential Pitfalls of Negative Policy Rates," May 2016).

Such a scenario does not necessarily suggest a powerful global expansion, rampant inflation, or an overnight reversal in accommodative monetary policies. However, low yields and inflation expectations appear to be pricing in such a dire outcome that even a modest surprise in the other direction may have the ability to move asset valuations away from such a defensive-oriented outlook.

We believe growth is stabilizing and inflation is accelerating

What matters most is whether the outlook justifies the pessimism implied by record-low bond yields. To us, steadying trends in China and continued expansion in the U.S. make a modest positive surprise in both growth and inflation expectations the most likely scenario over the next 6-12 months. Trends in most of the recent economic data support this outlook (see Macro section, page 5):

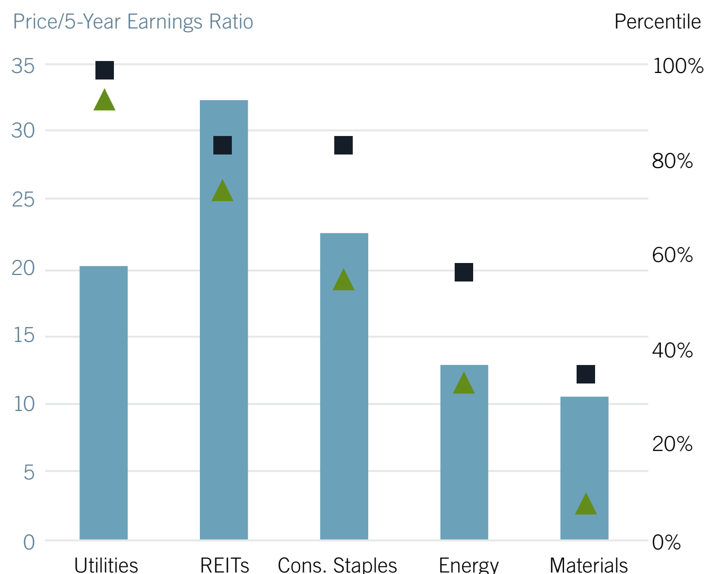
- U.S. wage pressures are accelerating (see U.S. consumer section).
- Despite recent weakness, oil prices have significantly rebounded off their Q1 trough (see U.S. inflation section).
- The global manufacturing and trade recession is receding (see Global section).

Exhibit 4 Equity Sector Valuations, 1976-2016

Bond proxies are expensive historically on both an absolute and relative basis.

■ Current P/E ■ Percentile vs. History (Sector)

▲ Percentile vs. History (Rel. to Market)



Percentile vs. history (sector) refers to the sector's historical P/E ratios. Percentile vs. history (relative to market) refers to sector's historical premium/discount to the broader stock market. Source: Fidelity Investments (AART), as of Jun. 30, 2016.

Modest upward surprises to both growth and inflation expectations would likely put upward pressure on interest rates. It's important to note, however, that many of the strong secular and technical factors outlined above may serve to moderate the magnitude and pace of any increase in yields.

Stock valuations helped by yields; bond proxies at extremes

As Treasury yields have fallen to such low levels, it has spurred investors to search for higher-yielding assets in other markets. One area in particular that has benefitted has been bond-proxy, or high-dividend yielding equities, including stocks in the utilities, REITs, and consumer staples sectors. During the past year, bond-proxy sectors such as REITs and utilities have attracted a net $11 billion in inflows, while the overall equity market has seen a net outflow of $96 billion.[1] The surge in demand has pushed high-dividend-yielding stock valuations to historically high levels relative to their own past, as well as to the broader equity market (see Exhibit 4).

Low bond yields have also contributed to rising valuations for the equity market as a whole, as they provide lower interest rates to discount the present value of future corporate earnings. However, the somewhat above-average market valuations are still within a historically reasonable range.

Moreover, equities in general may benefit from a modest surprise in growth. As we've highlighted the past several months, the U.S. economy continues to experience a mix of mid- and late-cycle indicators (see U.S. macro section), with our expectation that late-cycle indicators will continue to rise in the coming months. Inflation-resistant sectors, such as energy and materials—which are trading at historically low relative valuations (Exhibit 4)—tend to benefit from the inflationary dynamics of late cycles. Stretched valuations may make utilities and other bond proxies less helpful than usual in a late-cycle environment, particularly if interest rates rise.

1 Flows include mutual funds and ETFs. Source: EPFR Global, Haver Analytics, Fidelity Investments (AART), as of Jul. 13, 2016.

Business Cycle: Macro Update

Though post-Brexit data remain sparse, the U.S. and global economies appear to have gained momentum in recent months. The U.S. continues to experience a mix of mid- and late-cycle dynamics with low odds of recession, while the global economic expansion continues at a slow but steady pace.

United States: Late-cycle indicators elevated, recession odds remain low

Consumer supports continued expansion

Favorable employment conditions have helped soak up a significant amount of excess slack in the labor markets. As the cycle continues to mature, wage growth has begun to pick up and job gains have moderated, as is consistent with historical late-cycle dynamics. Better wage growth has helped consumer spending inflect higher in the first half of the year, as evidenced by improved core retail sales and improved growth in spending on services.[2] **Tight labor markets and rising income suggest that the U.S. consumer is providing a solid foundation for continued U.S. expansion.**

Inflation firm, likely to rise from higher crude oil

We expect inflation to remain firm as oil prices stabilize and continued labor-market tightening supports wage growth and service prices. During the past year, headline CPI has accelerated from 0.2% to 1.0%, while core inflation (ex-food and energy) has expanded from 1.8% to 2.3% despite a stronger dollar keeping a lid on import prices. **With core inflation firm and oil prices poised to rise above late 2015's subdued levels, headline inflation will likely rise to at least 2% by the end of the year.**

Earnings and industrial activity moving off bottom

Stabilizing external conditions have helped the U.S. business sector regain footing from a recent slowdown. All components of the ISM manufacturing index outside of inventories have accelerated during the first six months of this year and are now signaling a solid expansion. Energy-led earnings declines have weighed on market sentiment in recent quarters, but earnings expectations stabilized during Q2, and the earnings reporting season thus far has suggested a better tone of positive surprises. **Late-cycle trends such as rising wages may cap profit growth, but fewer headwinds from oil prices and the dollar suggest an opportunity for earnings to surprise to the upside.**

2 *Excludes autos, buildings supplies. Source: Census, Haver Analytics, as of Jun. 30, 2016.*

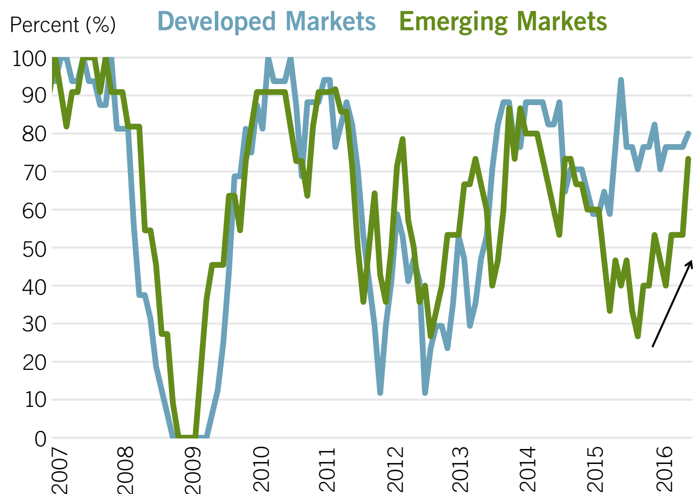
Global: stabilization continues, despite Brexit headwinds

Europe: Headwinds from Brexit, Italian banks, but expansion likely to continue

Pre-Brexit data indicate that much of Europe remained in a mid-cycle expansion phase, benefiting from a recovering manufacturing sector and improving credit conditions, particularly in Germany. Post-Brexit data show a drop in German business sentiment, but eurozone industrial expansion continued. While it will take at least several more weeks of data to gauge the negative impact of Brexit on sentiment and activity, we do think the uncertainty will serve as more of a headwind than a force strong enough to derail Europe's expansion. Additionally, concerns about under-capitalized Italian banks represent another sentiment overhang, but we believe these risks are not systemic and that European bank fundamentals in general are notably stronger than prior years. **We expect Europe's domestic economy is strong enough to continue its tepid cyclical expansion despite rising political uncertainty.**

Exhibit A Share of Countries' Manufacturing Sectors in Expansion

After bottoming in late 2015, the global manufacturing sector appeared to have rebounded pre-Brexit, with recent strength driven by emerging markets.



Data include manufacturing PMIs for 32 countries. Source: Markit, Haver Analytics, Fidelity Investments (AART), as of Jun. 30, 2016.

U.K. sentiment falls, recession risk rises post-Brexit
Brexit is already weighing on cyclical growth. In the near term, uncertainty surrounding the time frame and substance of the negotiations with the EU are likely weighing on sentiment, business investment, and hiring. This has already begun to be reflected in the data, with the Lloyds Bank survey of current and forward-looking business expectations declining sharply in July. **Brexit substantially raises the risk of recession in the U.K., with political uncertainty a big wild card.**

Japan slipped into modest recession, but new stimulus may provide a positive impact on economy
As a slow-growing economy heavily reliant on trade, Japan's business cycle is particularly susceptible to changes in the external growth environment. Japan has slipped into a mild recession on the back of a stronger yen hurting the export sector's competitiveness and profitability. Responding to this weakness, policymakers announced a large stimulus package at the end of July, though the impact will depend on the structure of the package. We believe fiscal expansion will be more meaningful for the real economy, as monetary policy has begun to show its limits. **Fiscal expansion and continued stabilization in China could potentially provide tailwinds for Japan to move back into positive growth territory.**

China stabilization continues amid policy support
A downshift in growth at the end of an overextended credit boom has caused China to remain in a growth recession for the past year, but the economy appears to have steadied over the past several months. Stabilization is largely due to monetary and especially fiscal stimulus, as policymakers ramp up infrastructure projects, leading to stabilization in the industrial and property sectors. **Rising fiscal support and improved global financial conditions have stabilized growth in the near term, although greater structural reforms will be needed for a sustainable reacceleration.**

Global summary: tentative improvement in PMIs, EMs, and commodity-exporting countries
Most pre-Brexit data show a global economy that was exhibiting tentative signs of reacceleration across a variety of metrics. More than 75% of countries' manufacturing sectors were in expansionary territory during June, featuring a dramatic improvement in emerging markets, rising from 50% of countries in expansion in May to more than 70% in June (see Exhibit A, page 5). The global trade recession appears to have receded, with global export growth recovering notably after dropping more than 20% in 2015. Raw industrials prices—a proxy for global growth—are positive year-over-year for the first time in nearly two years. Several commodity-exporting countries such as Brazil, Canada, and Australia are improving on the margins. **Despite Brexit headwinds, the tepid global economy appears to be gaining cyclical traction.**

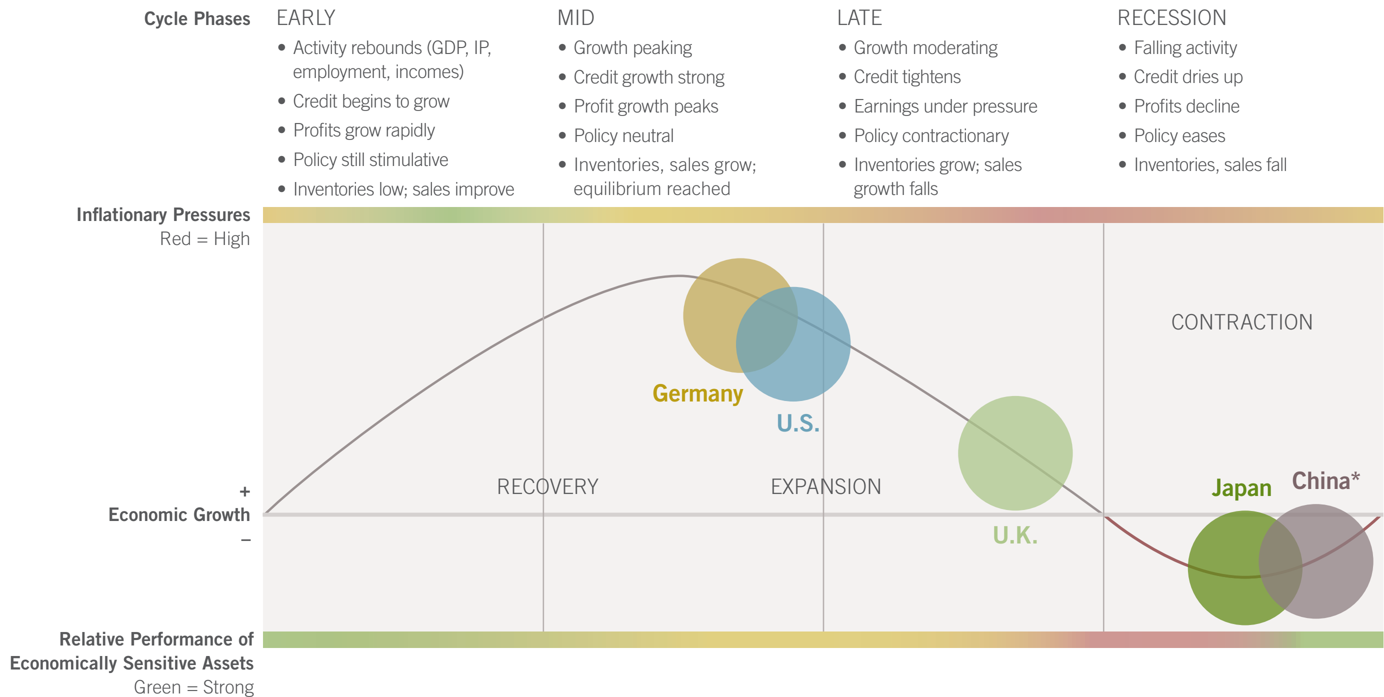
Outlook / asset allocation implications

The slow-growth, low-inflation business cycle has been weak enough to justify low bond yields but not bad enough to disrupt the multiyear bull market in U.S. stocks. Perhaps the abundance of cheap money worldwide has allowed everyone to be right for a moment in time. However, if Brexit uncertainty is not enough to dislodge the trend toward global stabilization—which is our base case—then growth measures, inflationary pressures, and late-cycle indicators are likely to rise. Historically high valuations for bonds and bond proxies offer little support for this scenario.

If that's the case, the investment question is not about whether activity will become vibrant or inflation-rampant, but simply whether they will outpace beaten-down expectations. High-quality bonds are still a necessary component of a diversified portfolio, but at these yield levels, there are cyclical and secular risks that suggest a difficult return profile ahead. From an asset allocation perspective, we still favor global equities, though smaller cyclical tilts may be warranted at this phase of the cycle. Inflation-resistant assets may help diversify against the rise in U.S. late-cycle dynamics.

Business Cycle Framework

The world's five largest economies are in various stages 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. *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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Fixed-income securities carry inflation, credit, and default risks for both issuers and counterparties.

Although bonds generally present less short-term risk and volatility than stocks, bonds do contain interest rate risk (as interest rates rise, bond prices usually fall, and vice versa) and the risk of default, or the risk that an issuer will be unable to make income or principal payments. Additionally, bonds and short-term investments entail greater inflation risk—or the risk that the return of an investment will not keep up with increases in the prices of goods and services—than stocks. Increases in real interest rates can cause the price of inflation-protected debt securities to decrease.

Stock markets, especially non-U.S. markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Foreign securities are subject to interest rate, currency exchange rate, economic, and political risks, all of which are magnified in emerging markets.

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 commen¬tary 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 accel¬erates. Inflationary pressures are typically low, monetary policy is accom¬modative, 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.

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.

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