BUSINESS CYCLE UPDATE

Fed Ambiguity and the Road Map for Monetary Tightening

Despite slower global growth and profits, U.S. economy remains in mid-cycle expansion

Dirk Hofschire, CFA | Senior Vice President, Asset Allocation Research
Lisa Emsbo-Mattingly | Director, Asset Allocation Research
Joshua Lund-Wilde, CFA | Research Analyst, Asset Allocation Research
Austin Litvak | Senior Analyst, Asset Allocation Research

KEY TAKEAWAYS

- The Fed has held off raising rates, citing weak global growth and creating ambiguity about the monetary outlook.
- We expect improvement in U.S. labor markets will cause the Fed to hike rates in the coming months, though the tightening pace will likely be gradual.
- A move to U.S. monetary tightening could remove ambiguity and boost investor confidence in the U.S. economy and markets.
- Tepid global growth is still weighed down by China's growth recession, but more aggressive easing by policymakers has steadied markets and provides hope for stabilization.
- We continue to favor assets tied most closely to the solid mid-cycle outlook in the U.S. and Europe.

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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Anxiety about the weak global environment, along with the lack of inflationary pressure in the U.S. economy (see "Global Growth Risks Rise Amid Turmoil, but U.S. Economy Solidly Mid-Cycle," September 2015), resulted in the Federal Reserve (Fed) deciding to hold off raising interest rates at its September and October meetings. However, given the continued tightening in the U.S. labor market, the Fed is likely to begin raising rates during the next few months. We therefore examine what Fed tightening has historically implied for the U.S. economy and asset markets, along with how today's environment might be different.

First rate hike not typically the start of a downturn

It is important to note that the beginning of a Fed monetary tightening cycle historically has been a confirmation of U.S. economic progress, implying the Fed has enough confidence in the expansion's sustainability to feel comfortable raising rates. Looking back over the previous dozen Fed tightening cycles, the Fed typically implements both its initial rate hike and the majority of its tightening while the U.S. economy is in the benign mid-cycle phase. Moreover, after the Fed has implemented its initial rate hike, it has taken an average of roughly two years before the economy has entered the late cycle (see "Will Fed Tightening Pose a Late-Cycle Risk to the U.S. Economy?" September 2014).

History, therefore, suggests that the commencement of Fed tightening is typically not a signal of imminent late-cycle risk and is therefore too early to spur the implementation of an asset-allocation rotation toward late-cycle positioning. Economically sensitive assets, such as equities, tend to continue to perform well on a relative basis in the period immediately following an initial rate hike (see Exhibit 1). Even fixed-income returns have tended to remain modestly positive. As time moves further past the initial rate hike, there tends to be a shift in relative asset performance toward international equities and inflation-resistant assets, such as commodities.

Global weakness, low inflation point to gradual rate tightening pace

During the past three decades, the beginning of a tightening cycle has typically occurred in an environment of rising inflationary pressures and mounting global economic momentum (see Exhibit 2). However, inflation today is lower and the global economy weaker than during any previous start of a tightening cycle over the past 30 years. Headline consumer inflation has remained at roughly zero during the past year, and slightly less than half the world's 40 largest economies have experienced rising leading economic indicators during the past six months. Both trends suggest the pace of tightening going forward may be more gradual than typically occurs.

Market expectations: Rate hike needed to remove ambiguity

During the past two decades, the Fed has worked to increase the transparency of its policy decisions in an effort to avoid provoking abrupt disturbances in the financial markets. Historically, there have been a wide variety of market reactions to initial Fed tightening episodes.

In 1994, the Fed surprised investors by hiking aggressively, causing bond returns to suffer over the subsequent 12 months. In contrast, the predictably incremental pace of tightening during the 2004 cycle was largely in line with market expectations and coincided with solid performance across most bond categories (see Exhibit 3).

Exhibit 1 Asset Class Performance During Fed Tightening Cycles, 1950-2010

Most assets tended to perform well even after Fed tightening commenced

MEDIAN PERFORMANCE DURING FED TIGHTENING CYCLES, 1950-2010

Asset Class	3 Months Prior	6 Months After	12 Months After	24 Months After
U.S. Equities	7%	9%	10%	22%
International Equities	6%	7%	16%	38%
Commodities	3%	4%	7%	34%
High-Yield Bonds	1%	1%	3%	18%
Investment-Grade Bonds	0%	1%	3%	14%

Median asset class performance around the last 12 Fed tightening cycles. International Equities: MSCI All Country World Index ex U.S. Source: Bank of America Merrill Lynch, Barclays, Ibbotson, MSCI, Bloomberg Finance L.P., Fidelity Investments (AART), as of Sep. 30, 2015.

As of the end of October, market expectations (Fed funds futures) remained mixed as to whether the Fed would hike policy rates in 2015, and forecast an extremely gradual pace of tightening projected over the next two years.

Due to the Fed's extraordinary monetary policies in recent years, it is likely that some investors are feeling a sense of ambiguity because the environment deviates from their typical experience. In behavioral science, ambiguity aversion is different than normal risk aversion because investors perceive that outcomes and probabilities are difficult to specify, causing a paralyzing effect (see "Ambiguity Aversion–The Behavioral Risks of Fed Policy," June 2012). When this happens, investors tend to disregard additional information if it fails to eliminate the ambiguity.

We believe the Federal Reserve's recent communications have served to prolong and perhaps increase ambiguity by introducing new criteria such as global financial conditions into its decision-making process. As a result, an eventual move to hike interest rates may foster a sense of returning to a normal monetary cycle, which could remove the ambiguity and boost investor confidence in the U.S. economy.

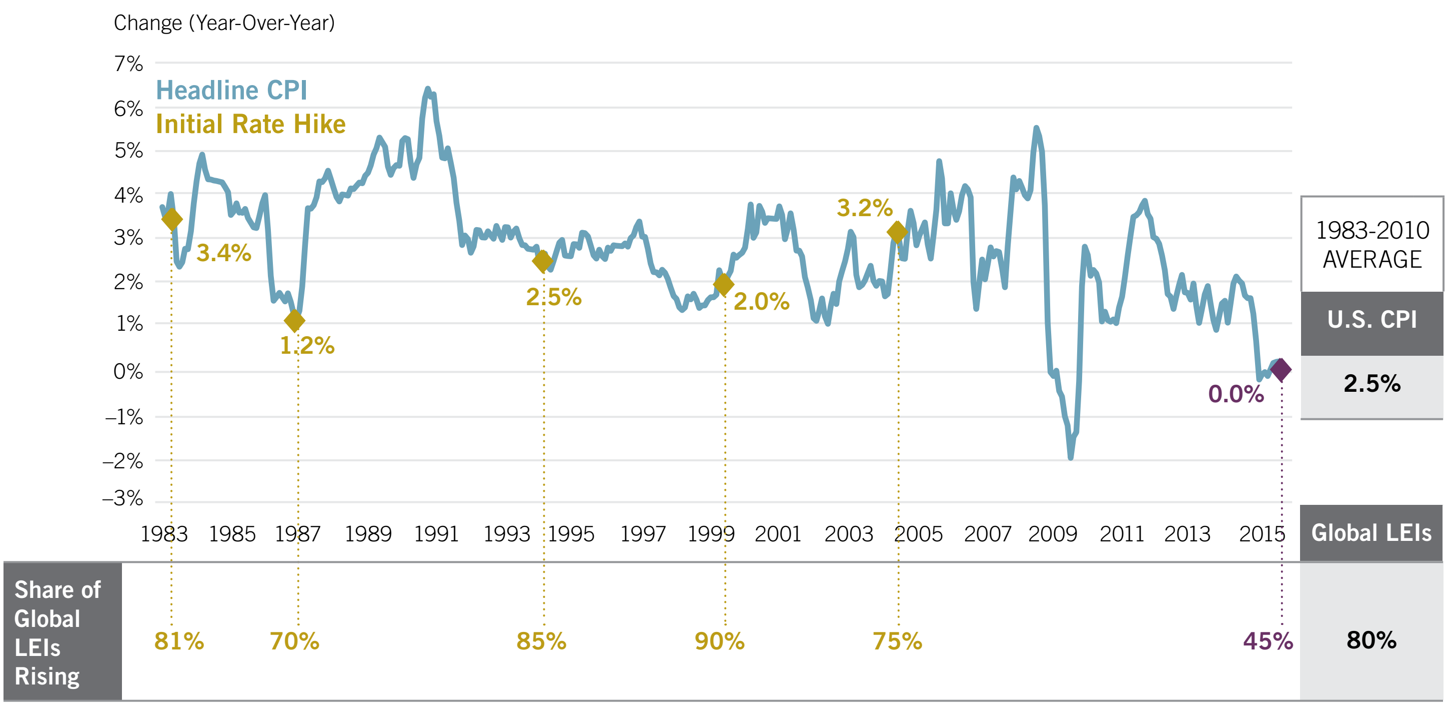
Asset implications of Fed outlook

In our view, the Fed is likely to raise interest rates during the next several months, with the following characteristics and asset allocation implications:

- ***Gradual pace of tightening:*** Continued tightening of the U.S. labor markets (see Consumption and employment section, Business Cycle: Macro Update) suggests that the Fed will have reason to initiate a tightening cycle in the coming months. However, the historically weak global growth and low-inflation backdrop suggests the initial pace of tightening is likely to be much more gradual than typically occurs.

Exhibit 2 Inflation and Global Growth During Initial Fed Rate Hikes

The global growth and inflation backdrop is weak compared to previous Fed tightenings

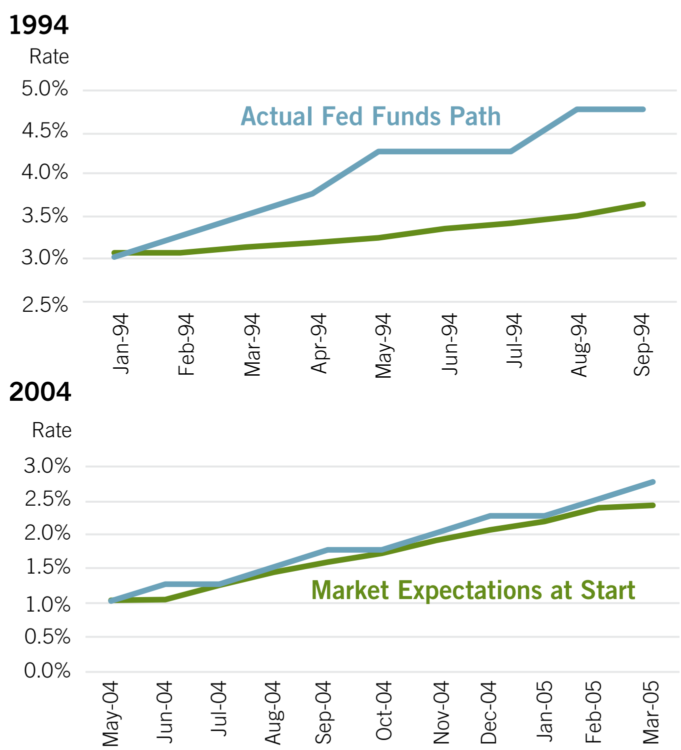


Global LEIs: leading economic indicators for world's 40-largest economies rising on a six-month basis. Fed: Federal Reserve. LEI: Leading Economic Indicators. CPI: Consumer Price Index. Source: Organisation for Economic Co-operation and Development (OECD), Foundation for International Business and Economic Research (FIBER), Bureau of Labor Statistics, Haver Analytics, Fidelity Investments (AART), as of Aug. 31, 2015.

- ***No dramatic spike in interest rates:*** The low-global-growth, low-yield environment will likely continue to lead to strong demand for U.S. Treasury bonds. Therefore, high-quality bond duration remains useful to diversify against any further risk-off equity volatility going forward.
- ***Boost of confidence for the U.S.:*** The first rate hike is not synonymous with an economic downturn, nor the start of the late-cycle phase, but it could go a long way toward removing investor ambiguity about U.S. monetary policy and the economy.

Exhibit 3 Fed Tightening vs. Market Expectations

The market impact of Fed action depends partly on expectations



Source: Market Expectations derived from fed funds futures. Source: Bloomberg Finance L.P., Haver Analytics, Fidelity Investments (AART), as of Sep. 30, 2015.

Business Cycle: Macro Update

Activity has softened for external-oriented sectors in the U.S. (exports, manufacturing, crude-oil production) that are negatively influenced by the weaker global environment, stronger dollar, and drop 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. Conditions facing U.S. consumers remain solid amid tightening labor market conditions and lower crude oil prices. Although payroll growth has leveled off in recent months, leading indicators suggest the labor market will continue to improve as unemployment claims remain near historic lows and the job openings rate is near historic highs. Consumption measures, such as core retail sales, display modest nominal growth of around 3.5%,[1] with weak secular trends (such as an aging population) likely preventing U.S. consumption growth from matching the pace of previous cycles. **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 economic indicators provides evidence that the slow housing expansion has sustainable traction. Underlying fundamentals, such as increased bank willingness to make mortgage loans, rising mortgage originations, solid employment, higher construction activity, and growing household formations suggest that a gradual improvement in demand should continue. **The outlook for the housing sector is solid, supported by the tightening labor market and gradually easing of lending conditions.**

Inflation. Global deflationary pressures and the plunge in commodity prices have left the consumer price index (CPI) unchanged year over year. However, core inflation (excluding food and energy) is still trending modestly higher, having increased 1.9% year over year due to the rising prices of shelter and services. Wage inflation remains steady but has yet to accelerate meaningfully; average hourly earnings remains at a 2.2% year-over-year growth rate, and the Atlanta Fed's wage tracker has slightly decelerated in recent months to a 3% growth rate. **The continued tightening of labor markets supports a modest pickup in inflation, but late-cycle inflationary pressures remain absent.**

Corporate and credit. A strong dollar and weak global demand have weighed on manufacturing, business investment, and

1 Census Bureau, Haver Analytics, Fidelity Investments (AART) as of Sep. 30, 2015.

corporate profits. Corporate earnings growth dipped negative (-3% on a four-quarter trailing basis) in the second quarter, and is expected to stay modestly negative for 2015 overall (-2%). However, earnings weakness was driven by a 60% profit decline in the energy sector, while earnings in the rest of the market were still up 2% in Q3 and are expected to rise about 7% in 2015.[2] Although credit spreads of investment-grade and high-yield corporate bonds have widened somewhat in recent months, bank lending and overall credit conditions are still supportive of expansion.[3] **Global weakness has taken some steam out of business activity, but credit availability and the corporate sector remain generally healthy.**

Global

China. A downshift in growth at the end of a credit boom has left China in a growth recession. The country remains mired in a credit overhang, excess capacity in the property and industrial sectors, and declining corporate profitability. Policy makers 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. **Support from policy makers is helping to stabilize conditions in the near term, but a sustainable reacceleration remains elusive absent greater structural reforms.**

Europe. Europe remains in a mid-cycle expansion phase, supported by a renewed commitment to monetary stimulus and pent-up demand in the periphery. Some German business sentiment indicators have softened due to recent external weakness, but the eurozone's Purchasing Manager's Index (PMI) has remained in stable expansionary territory.[4] **Despite weakness in external-oriented sectors, accommodative monetary policy, a competitive euro, and credit availability 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. Japan's economy continues to benefit from extraordinarily easy monetary policy, but has begun to show signs of slowdown as a result of ties to China and Southeast Asia. **Dampened by a weak external environment, Japan's economy has entered the late-cycle phase, as broad activity indicators have moderated and inventories have continued to build.**

2 Source: Standard & Poor's, FactSet, Fidelity Investments (AART), as of Oct. 27, 2015.

3 Source: Bloomberg Finance L.P., Fidelity Investments (AART), as of Oct. 27, 2015.

4 Source: Markit, Fidelity Investments (AART), as of Oct. 23, 2015.

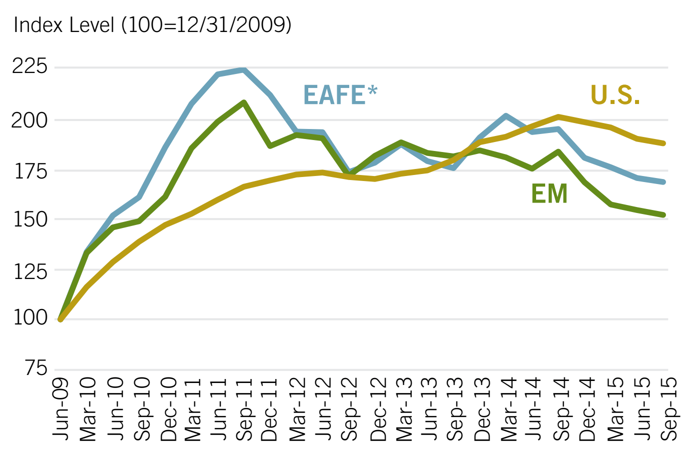
Global summary. The deceleration in global growth in recent months is weighing on exports, the industrial sectors, and the corporate profits of most major economies (see Exhibit A). Fewer than half the 40 largest economies in the world have exhibited positive growth in LEIs on a six-month basis, down from about two-thirds during the first quarter of 2015. The weakness is centered in emerging-market (EM) 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.[5] Currency depreciation and capital flight in many emerging markets is constraining the ability of policy makers to ease monetary conditions, and EM corporate earnings have sunk back to 2010 levels (Exhibit A).

The outlook for most developed markets remains better, underpinned by steady household sectors in the U.S. and Europe. Low inflation and weakness in external-oriented industries have boosted expectations for even greater monetary accommodation. **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.**

5 Source: Export value in USD, adjusted for changes in currency. Source: International Monetary Fund, Haver Analytics, Fidelity Investments (AART), as of Aug. 31, 2015.

Exhibit A Global earnings slowdown

Global earnings have stagnated, with profits outside the U.S. back to 2010 levels



* EAFE: Countries represented by the MSCI Europe, Australasia, Far East Index (EAFE). Source: FactSet, Fidelity Investments (AART), as of Sep. 30, 2015.

Outlook / asset allocation implications

Policy divergences between the world's two largest economies sit at the fulcrum of the outlook for global asset markets. When the U.S. mid-cycle expansion pushed monetary authorities closer to a tightening posture over the summer, it squeezed global U.S.-dollar liquidity and pressured China into a small devaluation in August. China's slowdown has weighed on the global economy, but financial markets regained their footing in October as renewed weakness precipitated greater easing by Chinese policy makers, hopes for additional accommodation from other countries, and greater patience from the Fed. The ultimate solution to this policy dichotomy is for China (and the global economy) to stabilize sufficiently to both spur a turnaround in global corporate profitability and allow the U.S. to begin to normalize its monetary policy.

Our base-case scenario remains that the global economy will muddle through, with China's increasingly aggressive policy stance doing just enough to stabilize conditions. From an asset allocation perspective, we continue to favor equities tied to cyclical leadership in the U.S. and Europe. Exposure to high-quality bonds and restrained asset allocation bets may provide some protection against a potential increase in volatility due to Fed tightening or a worse-than-expected downturn in China.

AUTHORS

Dirk Hofschire, CFA I Senior Vice President, Asset Allocation Research

Joshua Lund-Wilde, CFA I Research Analyst, Asset Allocation Research

Lisa Emsbo-Mattingly I Director, Asset Allocation Research

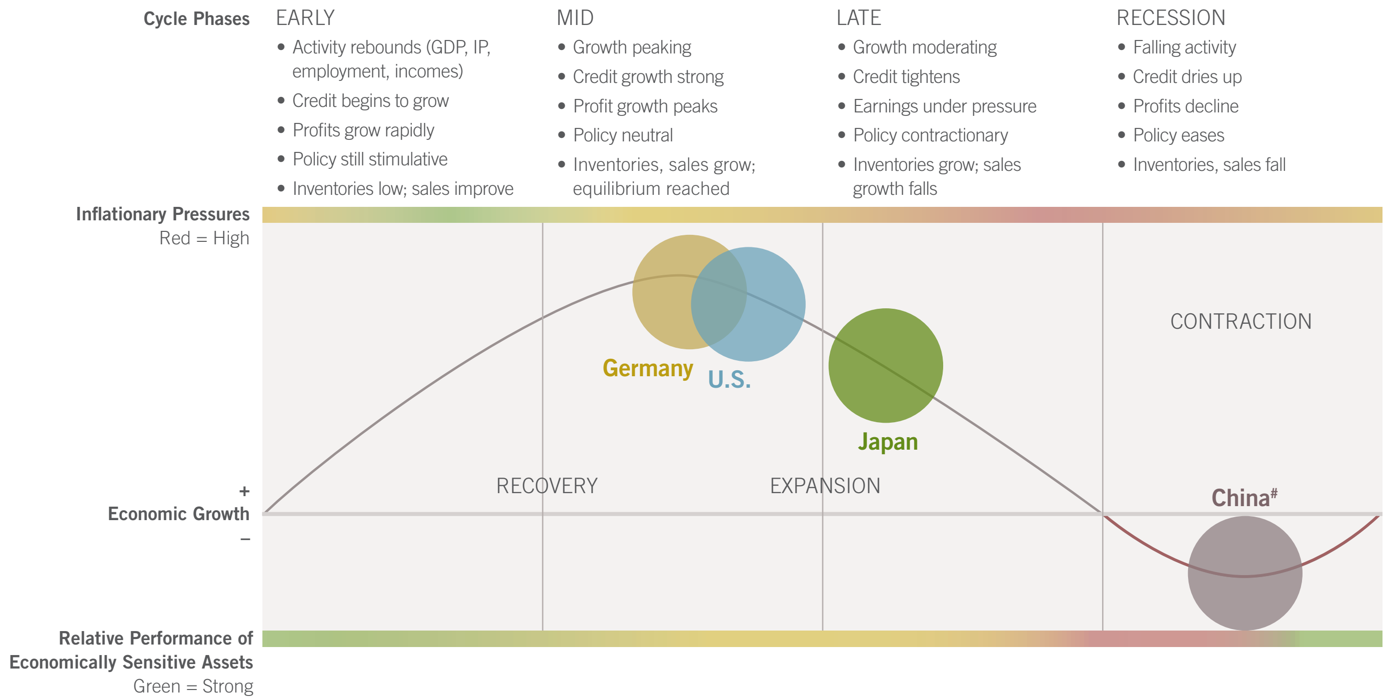
Austin Litvak I Senior Analyst, Asset Allocation Research

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.

Asset Allocation Senior Research Analyst Jordan Alexiev, CFA; Senior Analyst Jake Weinstein, CFA; Research Analyst Ilan Kolet; and Analyst Caitlin Dourney also contributed to this article. Fidelity Thought Leadership Vice President Kevin Lavelle provided editorial direction.

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).

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.

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.

MSCI Europe, Australasia, Far East Index (EAFE) is a market capitalization-weighted index that is designed to measure the investable equity market performance for global investors in developed markets, excluding the U.S. & Canada.

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