BUSINESS CYCLE UPDATE

U.S. Economy in Slow Roll Toward Full Late-Cycle Phase

Strengthening inflationary signals are directionally consistent with prior late-cycle phases

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KEY TAKEAWAYS

• The late-cycle phase can often be characterized as an overheating stage for the economy, when growth peaks and inflation accelerates.
• The low magnitude of growth and inflation has prolonged this U.S. cycle, but similarities in the direction of the cycle resemble historical late-cycle transitions.
• U.S. inflation is poised to accelerate amid tighter labor markets and higher oil prices.
• With the global trade recession of 2015 in the past, worldwide deflationary pressures are receding.
• The late-cycle phase historically has warranted smaller cyclical asset allocation tilts and has favored inflation-resistant assets.

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.
The U.S. cyclical backdrop has been defined by a tug-of-war between mid- and late-cycle dynamics throughout 2016. According to our business cycle framework, the cycle is progressing toward the late-cycle phase as recession risks remain low.

**The typical late-cycle phase is defined by moderating growth and rising inflation**

Fluctuations in the business cycle have historically tended to follow certain patterns. Shifts among different phases can be ascertained not by the magnitude of the indicators but by directional shifts in key factors. The late-cycle phase typically involves a rise in inflationary pressures and an economy that moves past the peak rate of economic growth. The evolution from mid to late cycle tends to be less well defined than during other phase shifts, but the following developments generally transpire during the late-cycle phase:

- **Corporate earnings pressured**—Rising input inflation generally causes profit margins to shrink and earnings growth to decelerate.
- **Credit slows**—Credit access usually tightens when lenders become overextended, causing borrowing rates to rise.
- **Inventories grow**—Inventories (relative to sales) rise as production outpaces moderating sales growth.
- **Monetary policy becomes restrictive**—The Federal Reserve (Fed) typically raises policy rates, leading to outright restrictive policy.
- **Labor markets peak**—Tightness in the employment markets tend to spur accelerating wage inflation.

For additional details on typical late-cycle patterns, see “U.S. Late-Cycle Indicators Rise, but Recession Risk Low,” (March 2016 Business Cycle Update).

**Similarities and differences with prior late cycles: Slow roll but in the same direction**

Historically, perhaps the single most important characteristic of the late cycle has been a pickup in inflationary pressures. During the nine late cycles since 1950, the level of the Consumer Price Index (CPI) has varied meaningfully; peak rates of inflation have ranged from 2% to 14%. However, headline CPI has accelerated during every late-cycle phase. Typically, the rise in inflation has been broad-based, with significant acceleration in both wages and commodity prices (Exhibit 1).

From a magnitude standpoint, inflation today has remained relatively subdued. Some of the key differences that have resulted in today’s lower inflationary backdrop include:

- **Sluggish aftermath following the “Great Recession”**—This expansion has been the slowest on record with real GDP peaking at a 3.3% (year-over-year) growth rate in Q1 2015—lower than any expansion since the Second World War. It has taken a long time to work through the excesses left from the Great Recession, including massive housing inventories and 10% unemployment.

- **Deflationary international backdrop**—Europe endured a weak recovery following its own debt crisis, Japan consumer demand suffered following its consumption tax hike, and China’s excess industrial capacity contributed to a global trade and industrial recession. The resulting weak demand helped precipitate a plunge in commodity

### Exhibit 1 Mid- and Late-Cycle Inflation (1966-2010)

Historically, accelerating inflation in wages and commodities drives the transition to the late-cycle phase.
prices during 2014-2015, further reinforcing global deflationary pressures.

- **Extraordinarily easy global monetary policy**—Typically as a cycle matures, central banks hike interest rates in a response to rising growth and inflation. However, the subdued level of growth and inflation has prompted global central banks to keep policy rates at extraordinarily low levels. The absence of more severe monetary tightening has allowed U.S. corporate borrowing costs to continue to decline deep into the cycle, blunting the tighter credit conditions that typically occur after a multiyear expansion (Exhibit 2).

These differences have caused the magnitude of growth and inflation to remain weak, and lengthened the duration of the current business cycle. But the similarities in the direction of the cycle rhyme with historical mid- to late-cycle transitions. The Fed has raised rates, credit standards have started to tighten (Exhibit 2), profit margins have peaked, and wages have accelerated (Exhibit 3). The full transition to late cycle may continue to drag on, but these developments suggest the U.S. is moving toward the late-cycle phase.

Our view of these key macro trends supports the outlook that late-cycle indicators are likely to rise in the coming months (see the Macro Update for more details):

- The Fed will continue to tighten incrementally, likely starting in December 2016.
- Tighter U.S. labor markets will continue to push up wages.
- China’s reacceleration will support global demand and commodity prices.
- With most major economies in expansion, global deflationary pressures will continue to abate.

**How could this time be different?**
The late-cycle phase can often be characterized as an overheating stage for the economy, in which growth tends to peak and then decelerate in the months and/or years prior to recession. But the path of late-cycle transition has not always

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**Exhibit 2 Credit Standards and Borrowing Costs**
Bank standards for business loans have tightened, but corporate borrowing costs have declined

![Credit Standards and Borrowing Costs Graph](image)

**Exhibit 3 Average Hourly Earnings**
Although the pace is subdued, wage growth has accelerated in the past year

![Average Hourly Earnings Graph](image)

*C&I: commercial and industrial. Sources: Federal Reserve, Haver Analytics, Fidelity Investments (AART), as of Sep. 30, 2016.*
been smooth or precise, making it important to consider a variety of alternate scenarios for the U.S. economy:

- **Could the U.S. return to the mid-cycle phase?** This scenario would require an acceleration of growth and employment without feeding through to inflation. The deflationary global shock in 2015 extended the mid-cycle in the U.S. through plunging oil prices and weaker industrial growth, but domestic labor markets continued to tighten. With even tighter employment conditions today, any pickup in growth would likely create even higher wage pressures, implying a boost to inflation that would likely move the economy fully into the late-cycle phase.

- **Could the U.S. skip the late-cycle phase and enter recession?** There also exists the possibility of a shock strong enough to move the U.S. into recession, but this scenario is unlikely due to the size of the U.S. domestic household sector. Neither the European sovereign debt crisis nor the global trade recession in 2015 was enough to cause a U.S. recession, so any shock would need to be of deeper proportions.

- **Could the U.S. enter the late-cycle phase without higher wage inflation?** Wage inflation typically accompanies improving labor markets, so it’s difficult to have a full-blown late-cycle phase without wage acceleration. However, during the stagflationary 1970s, oil supply shocks caused commodity prices to spike, crimped the economy, and led to a slowdown in wages—even while overall inflation rates hit double-digit levels. A commodity supply shock could presumably once again result in a similar scenario, but it has been much more common for wage and commodity inflation to rise in tandem.

**Conclusion: Moving toward the late-cycle playbook**

Late cycles are not recessions. Late cycles historically have had 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, and although stocks have typically outperformed bonds, small bet sizes are warranted given lower return potential (Exhibit 4). Given that the market’s inflation expectations are near multi-year lows, inflation-resistant assets are generally attractively priced. The following is a summary of the late-cycle asset allocation playbook:

- Smaller cyclical tilts are warranted (stick closer to strategic portfolio weights).
- Favor inflation-resistant assets to diversify the portfolio against inflation risk.
  - For riskier assets, consider commodities, energy and materials stocks, and emerging-market equities.
  - For fixed income, consider Treasury Inflation-Protected Securities and shorter-duration bonds; tighter credit conditions tend to favor higher-credit-quality bonds.

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**Exhibit 4 Asset Class Performance During Mid and Late Cycles (1950-2010)**

The relative performance among inflation-resistant assets improves during late cycles.

<table>
<thead>
<tr>
<th>Annual Absolute Return (Average)</th>
<th>Stocks</th>
<th>High Yield</th>
<th>Commodities</th>
<th>Investment-Grade Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mid</td>
<td>0%</td>
<td>10%</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>Late</td>
<td>0%</td>
<td>10%</td>
<td>20%</td>
<td>20%</td>
</tr>
</tbody>
</table>

Past performance is no guarantee of future results. Asset class total returns are represented by indexes from the following sources: Fidelity Investments, Morningstar, and Bloomberg Index Services Ltd. Source: Fidelity Investments proprietary analysis of historical asset class performance. Source: Fidelity Investments (AART) as of Sep. 30, 2016.
BUSINESS CYCLE UPDATE: U.S. ECONOMY IN SLOW ROLL TOWARD FULL LATE-CYCLE PHASE

Business Cycle: Macro Update
The global economic expansion continues at a slow, steady pace and deflationary pressures have been abating. The U.S. continues to experience a mix of mid- and late-cycle dynamics, with low odds of recession.

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

U.S. consumers support continued expansion
Favorable employment conditions have helped soak up a significant amount of excess slack in the labor markets. Hiring has remained solid, albeit at a slower pace than last year, and wage growth is at post-recession highs across a variety of measures. These trends are consistent with historical late-cycle dynamics. Consumer sentiment and spending have weakened slightly of late, but the tight labor market and rising compensation continue to keep the odds of recession low. Tight labor markets and rising income suggest that the U.S. consumer is providing a solid foundation for continued U.S. expansion.

Inflation poised to accelerate
Higher oil prices and continued wage growth are primed to generate a more meaningful rise in inflation. During the past year, headline CPI has accelerated from 0.0% to 1.5% year-over-year, while core inflation (excludes food and energy) has risen from 1.9% to 2.2%. The Treasury market’s long-term inflation expectations have begun to drift higher, although they remain subdued relative to history and the Fed’s inflation target. With core inflation firm and oil prices poised to rise above early-2016 trough levels, headline inflation could approach 3% by the end of the first quarter of 2017.

Mixed outlook for business sector
The U.S. business sector remains steady, but it continues to experience a mix of both mid- and late-cycle dynamics. With fewer headwinds from oil prices and the dollar, corporate earnings appear on track to post their first quarter of positive growth since mid-2015. However, the upside for earnings growth is limited by rising corporate profit margin pressures, as productivity continues to slow and wages accelerate. In addition, corporate borrowing costs have continued to decline, but banks continue to incrementally tighten lending standards for businesses. Finally, the overall business inventory-to-sales ratio remains at elevated levels, although the reacceleration in industrial activity may signal an easing of the inventory overhang.

The corporate sector is experiencing a crosscurrent of mid- and late-cycle trends in

Exhibit A Global Leading Indicators vs. Chinese Inflation
China’s emergence from deflation has bolstered global economic momentum

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2 Source: Standard and Poor’s, Fidelity Investments (AART), as of Oct. 24, 2016.
3 Source: Productivity is measured by a proprietary proxy of U.S. economic productivity that tracks cyclical corporate productivity. Sources: Haver Analytics, Fidelity Investments (AART), as of Sep. 30, 2016.
4 Sources: Federal Reserve, Haver Analytics, Fidelity Investments (AART), as of Aug. 1, 2016.
5 Source: Census Bureau, Haver Analytics, Fidelity Investments (AART), as of Aug. 31, 2016.
profits, credit, and inventories, with a maturing cycle likely to cap the potential upside.

Global: Slow growth, deflationary pressures abating

Europe: Expansion on track despite Brexit headwinds
The Euro Area remains in a mature, sluggish mid-cycle expansion phase, and so far has weathered the initial impact of Brexit better than expected. Recession risks remain low across European countries, as they benefit from an improving manufacturing sector and relatively easy credit conditions. However, political uncertainty may increasingly weigh on business sentiment indicators, particularly in the U.K. and Italy, due to Brexit and the upcoming Italian referendum. Europe’s domestic economy appears strong enough to continue its tepid cyclical expansion despite rising political uncertainty.

China: Reacceleration amid fiscal response
Driven by substantial fiscal policy stimulus and other easing measures, China has emerged from its growth recession and is experiencing a broad-based pickup in economic activity. Industrial production has recovered meaningfully since bottoming in late 2015, and industrial company profit growth has turned positive for the past eight months after declining through 2015. Additionally, producer prices in China rose on a year-over-year basis for the first time since early 2012, suggesting deflationary forces have receded. Mortgage lending restrictions have been enacted to cool the overheating property sector. China has entered the early-cycle phase on the back of sustained policy stimulus, but typical early-cycle upside may be absent given continued industrial overcapacity and an overextended credit boom.

Global summary: Stabilization continues, deflationary pressures recede
After the steep global trade and industrial recession in 2015, the global economy continues to gain traction. Nearly 70% of countries’ leading economic indicators are rising on a six-month basis, a level seen only once since early 2014 (Exhibit A). Improvement has been led by emerging markets and Asian economies closely tied to China, as inventory-to-shipment ratios in South Korea and Taiwan have begun to move toward more benign territory. Japan has recovered from a mild recession and is experiencing early-cycle dynamics, underpinned by improvements in the consumer sector. Commodity-exporting countries, such as Canada and Australia, are also benefiting from the recovery in global trade and commodity prices, and show marginal improvements. The global economy remains slow and many advanced economies are in maturing phases of the cycle, but cyclical traction continues and global deflationary pressures are abating.

Outlook/Asset allocation implications
As 2016 draws nearer to a close, all eyes will be on U.S. politics and policymakers. Regardless of the election results in November, we anticipate the populist forces of discontent to spur a directional easing of U.S. fiscal policy over the course of the next year. Meanwhile, investors expect the Fed to hike rates for a second time, in December. Unlike during the Fed’s move to tighten in 2015, the global business cycle is in better shape to withstand the effects. With time, it’s possible that policymakers in Europe and Japan will move closer to the U.S. by providing slightly less monetary accommodation and slightly more fiscal relief. The mix of receding deflationary pressures, still-easy global monetary policies, easier fiscal stances, and underlying global cyclical stability would indicate a potential upside surprise in inflation.

We remain positively disposed toward global equities, although the rising probability of a U.S. shift into the late-cycle phase suggests market volatility could return and that smaller cyclical asset allocation tilts may be warranted. As noted above (see page 4), inflation-resistant assets may be useful in diversifying a portfolio against a cyclical acceleration in inflation.
Business Cycle Framework
The world's largest economies are in 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).
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.

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