2018 Outlook: Global Expansion to Continue, but Markets Likely More Volatile

Smaller asset allocation tilts may be warranted as the business cycle matures

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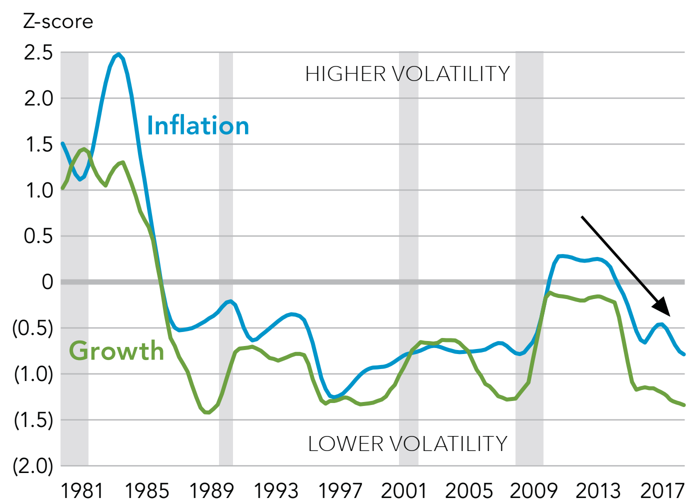
Key Takeaways

- We expect the global expansion to remain intact in 2018, but also foresee some fraying in the near-perfect backdrop that drove asset prices up and volatility down in 2017.
- U.S. recession probability is low, although we expect the business cycle to continue maturing and global activity to peak amid China's shift to less-supportive policies.
- Much higher inflation is unlikely, but global inflation trends appear firm enough to keep policymakers moving toward a reduction in monetary accommodation.
- Shifting monetary conditions will slow the liquidity growth that has provided extra fuel for asset prices in recent years, potentially resulting in higher market volatility.
- Our asset allocation view is generally constructive but prioritizes smaller cyclical tilts and portfolio diversification to guard against the increasing uncertainty of outcomes in 2018.

The year 2017 has been defined by a near-perfect combination of steady global growth, low inflation, and accommodative monetary policies. All major asset categories have experienced positive returns, and U.S. and global equity markets have registered stellar double-digit gains. Most notably, this all happened alongside plunging financial as-

EXHIBIT 1: U.S. economic fundamentals have grown more stable as this cycle has progressed.

U.S. Growth and Inflation Volatility



Source: Z-score is calculated from quarterly inflation and Real GDP data since 1947. Shaded areas represent U.S. recessions. Source: Bureau of Labor Statistics, National Bureau of Economic Research, Haver Analytics, Fidelity Investments (AART), as of Nov. 30, 2017.

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set price volatility, with the S&P 500 Index experiencing no calendar month of negative returns in 2017 and only one in the past 21 months. While easy global monetary conditions spurred robust liquidity growth and likely helped dampen asset-price fluctuations, economic fundamentals such as growth and inflation also registered surprisingly steady trends and falling volatility (Exhibit 1). In 2018, we expect some fraying in this picture-perfect backdrop that could raise volatility from extremely subdued levels.

Growth outlook: Synchronized global expansion continues

In 2017, almost all of the world's major economies were in some phase of expansion, leading to a self-reinforcing global acceleration and the most synchronized global upturn in at least several years (Exhibit 2). The primary driver of the pick-up in global activity was China's reacceleration over the past 18 months, which catalyzed a turnaround in global industrial production, exports, commodity industries, and the profits of multinational corporations.

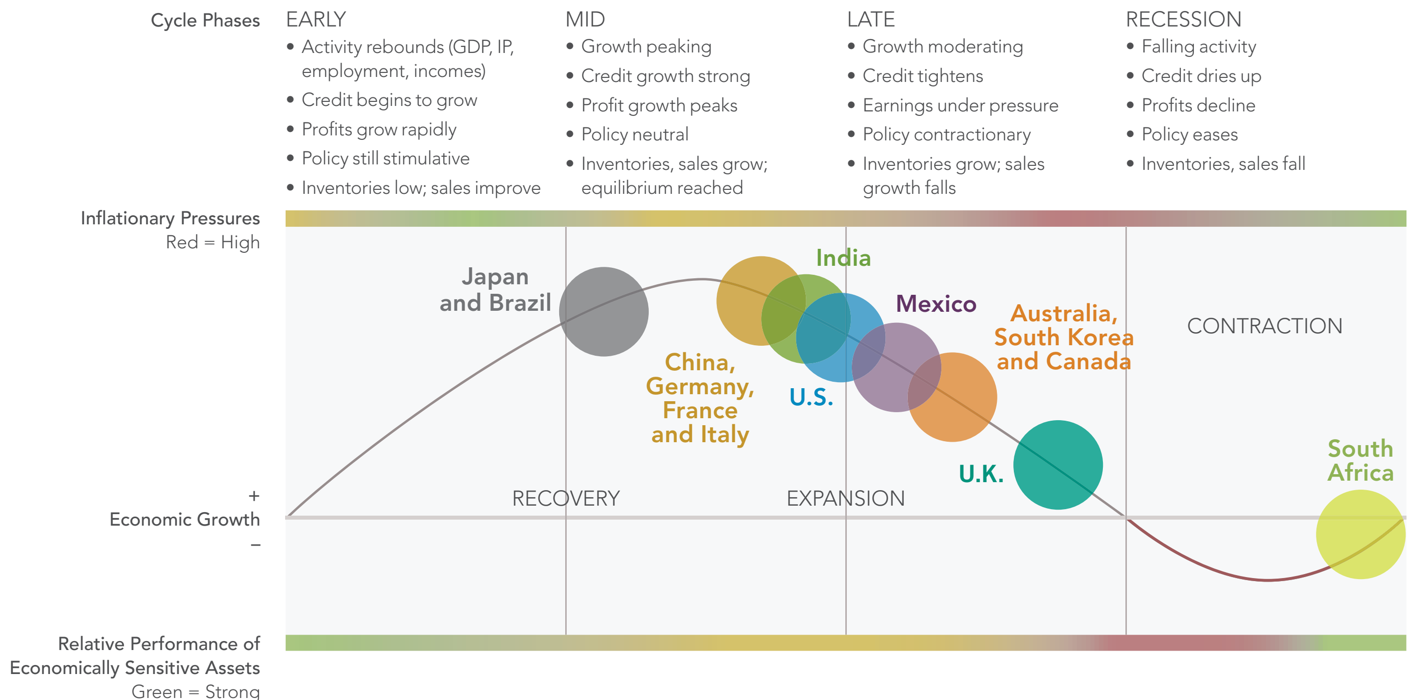
China

As we look into 2018, there are signs that China's policymakers are already removing stimulus from the economy, and it appears they may be more focused on addressing structural issues after Xi Jinping's power consolidation during October's National Party Congress.

- Policymakers are attempting to rein in China's credit boom and rapid increase in debt by tightening shadow financing and allowing short-term interest rates to rise. This has already resulted in credit growth falling to its lowest rate in almost a decade (Exhibit 3).

EXHIBIT 2: Most of the world's major economies remain in expansion.

Business Cycle Framework



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. Source: Fidelity Investments (AART), as of Dec. 15, 2017.

- Efforts have been made to restrain production in areas of overcapacity, including tighter restrictions on highly polluting industries such as steel, coal, and cement as well as policies to slow construction in housing and infrastructure.

Because China's business cycle is often driven more by state policy than private market indicators, the directional shift away from policy easing carries risks for its near-term growth outlook. Not only do we expect China's 2018 performance to be more uncertain, it contains significant downside risks for global activity given its outsized influence on global trade, manufacturing, and commodities.

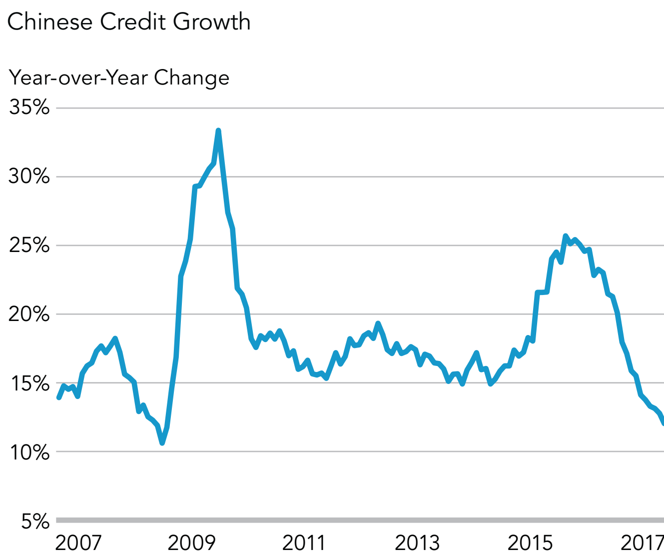
United States

The U.S. has remained on a very gradual progression through its business cycle, with mid-cycle dynamics remaining solid throughout 2017 and just a few hints of late-cycle trends along the way. Odds of recession are relatively low given today's tight labor market and broad-based expansion. We will be watching these key indicators that historically have marked the transition from the mid- to the late-cycle phase (Exhibit 4):

- Typically during a late-cycle phase, corporate profit growth decelerates and inventories build relative to new orders. So far, low inflation and robust global growth have supported a pickup in company profits and manufacturing new orders.
- Wage growth usually accelerates during the late-cycle phase and starts to crimp profit margins and slow the pace of hiring. This cycle, wages have risen and profit margins have declined off peak levels, but the process has been gradual, allowing margins to remain high and job gains strong.
- Historically, rising wages lead to broader inflationary pressures, causing the Federal Reserve to tighten monetary policy, which in the late cycle tends to lead to a flattening yield curve and tighter credit conditions. This time, wages have risen moderately but inflation is low. The Fed has hiked rates and the yield curve has become flatter, but it remains relatively steep and credit conditions remain supportive.

EXHIBIT 3: Tighter policies have resulted in the slowest rate of credit growth since the global financial crisis.

Chinese Credit Growth



Source: China National Bureau of Statistics, Haver Analytics, Fidelity Investments (AART), as of Oct. 31, 2017.

EXHIBIT 4: The U.S. features a mix of mid- and late-cycle characteristics.

Mid- to Late-Cycle Phase Transition

Indicator	Typical Late Cycle	Current Cycle (● Mid cycle / ■ Late cycle)
Corporate Profits*	Margins decline	● ■
Inventories	Rise relative to orders	●
Employment	Pace of hiring slows	●
Wage Growth*	Accelerates	● ■
Monetary Policy	Fed tightens, yield curve flattens	■
Credit	Lending standards tighten	●

*Listing of both green circle and orange square indicates evidence of both mid- and late-cycle traits. Source: Fidelity Investments (AART), as of Nov. 30, 2017.

Summary of global growth outlook:

- Less-supportive economic policies in China make the outlook more uncertain and a growth deceleration probable.
- Global activity has likely peaked and growth may slow in 2018.
- Today's U.S. recession probability remains low, but we expect the economy to continue its slow transition from the mid- to late-cycle phase.

Inflation outlook: Global inflation firm, with upside risk

The biggest surprise to us in 2017 was that the acceleration in global growth did not spur a bigger pickup in inflation. Nevertheless, there is evidence that global inflation trends have firmed:

- Purchasing manager surveys in almost all of the world's largest economies have reported rising prices paid and received, indicating firmer inflation in global goods.
- Core inflation in the eurozone has been on a steady rise during the past year, and we expect continued above-trend growth to keep this trend intact.
- Japan might be seeing early signs that tight labor markets are finally pushing core inflation toward a positive medium-term trend.
- Dissipating slack is pushing U.S. labor markets close to full employment, which should provide an upward bias to wages.
- Oil prices climbed to two-year highs, and even if they don't rise further, will start to add to headline inflation rates.

There are many reasons inflation has remained low—automation, globalization, the entrance of oligopolies into new industries, cheap funding for unprofitable companies—and it's likely they will continue to put a ceiling on price pressures. While we don't expect a jump to much higher inflation in 2018, global inflation appears firm and there are upside risks given low investor expectations.

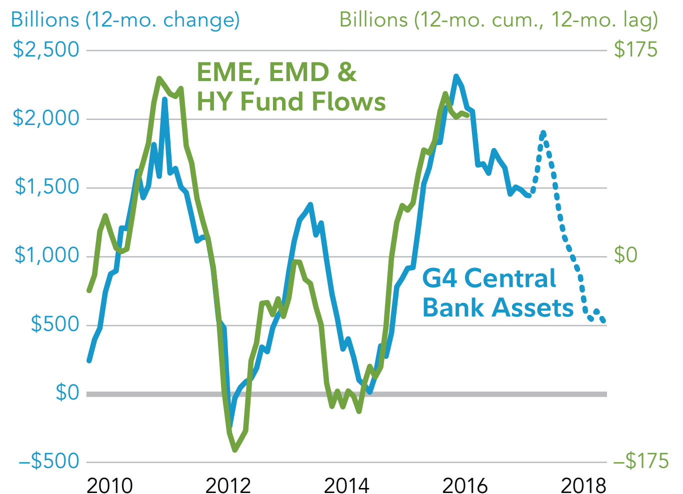
Monetary policy outlook: Move toward normalization to spur higher market volatility

We believe growth and inflation are firm enough to keep global policymakers moving toward a reduction in monetary accommodation. While this process is likely to happen gradually, 2018 may experience a neutralization of extra liquidity growth that has provided fuel for asset prices in recent years.

- Growth in major central bank balance sheets is set to drop by $1.4 trillion over the next 12 months as the Fed winds down its balance sheet and the European Central Bank (ECB) pares back on quantitative easing (QE)—Exhibit 5.

EXHIBIT 5: The quantitative easing unwind will challenge global liquidity growth.

Central Bank (Fed, ECB, BOJ, BOE) Balance Sheets and Asset Flows



G4 Central Banks: Federal Reserve (Fed), European Central Bank (ECB), Bank of Japan (BOJ), Bank of England (BOE). Fund Flows: Mutual funds and ETFs. EME: Emerging Market Equity. EMD: Emerging Market Debt. HY: High Yield. Dotted line estimates future central bank assets: Fed to roll-off balance sheet assets by lesser of stated caps or total bonds maturing each month. ECB to begin tapering in January 2018 to EUR30B of monthly purchases for nine months. BOJ to purchase at annualized rate of JPY 60T going forward. BOE to keep balance sheet constant. Source: Federal Reserve, Bank of England, European Central Bank, EPFR, Haver Analytics, Fidelity Investments (AART), as of Sep. 30, 2017.

- The deceleration in liquidity growth may first affect the prices of riskier assets, especially smaller, more liquidity-driven categories of credit.
- As the primary driver of global liquidity over the past two years, the ECB's QE program has been particularly important to some markets, as European holdings of corporate bonds increased sharply during the QE upturn.
- In general, slower global liquidity growth may translate into higher market volatility.

Will the "Goldilocks" market backdrop persist?

There are many other potential scenarios for 2018, and perhaps the foremost question is whether the "Goldilocks" conditions can continue and whether asset prices can continue to climb in a broad-based manner with little volatility. Here are some developments that could support that scenario:

- If inflation slows further and monetary policymakers tighten less than the market expects.
- If economic policies (deregulation, tax legislation) spur business confidence and productivity-enhancing capital investments.

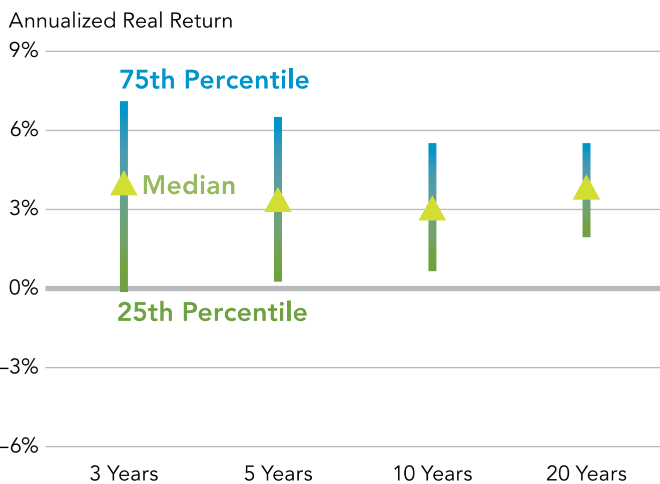
While we don't consider it the most likely sustained scenario over the next 12–18 months, an extension of disinflationary mid-cycle conditions could spur a market "melt-up" scenario for risk assets.

Asset allocation outlook

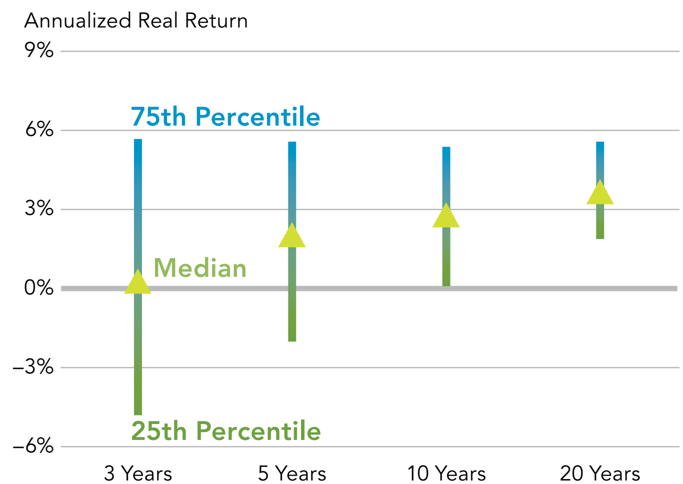
Financial markets will enter 2018 with positive momentum and a solid global corporate and economic environment. Nevertheless, our business cycle framework suggests the more mature an expansion becomes, the greater the

EXHIBIT 6: Cyclical risk turns asymmetrical in the late-cycle phase.
Sample Returns for a Diversified Global Equity and Bond Portfolio in Various Business Cycle Phases

Starting in Mid-cycle Phase



Starting in Late-cycle Phase



For illustrative purposes only. Portfolio returns based on an asset allocation of 40% U.S. equities, 20% international equities, 35% U.S. investment grade bonds, and 5% U.S. high yield bonds from the following indices: Dow Jones U.S. Total Stock Market Index, MSCI World Ex-U.S. Index, Bloomberg Barclays Aggregate Index, ICE U.S. High Yield Index. **Past performance is no guarantee of future results. You can not invest directly in an index. Index performance is not meant to represent that of any Fidelity fund.** Source: Fidelity Investments (AART), as of Nov. 30, 2017.

downside risks for asset returns on an intermediate-term basis. For instance, using historical patterns as a guide, the performance of a diversified portfolio beginning in the mid-cycle phase typically experiences steadier, positive returns over the subsequent three- and five-year periods. If the performance of the same portfolio begins in the late-cycle phase, there is a broader range of return possibilities and a generally less attractive risk-reward profile (Exhibit 6).

In addition to a maturing U.S. business cycle and the shift toward global monetary tightening, there are a number of other factors that make us less confident about making large asset allocation tilts at this point compared to earlier stages of the cycle. Elevated valuations across most asset categories imply more positive expectations have been priced into the markets. Geopolitical risks, particularly North Korea's pursuit of long-range nuclear capabilities, are in a rising trend. In addition, other political risks, including the potential for protectionist policies, cannot be discounted.

As a result, our cyclical asset allocation view is to prioritize diversification in order to guard against the increasing uncertainty of outcomes and potential pickup in volatility that we expect during the course of 2018. Within the context of smaller cyclical tilts, we remain favorably disposed toward international equities and inflation-resistant assets.

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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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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.

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Diversification and asset allocation do not ensure a profit or guarantee against loss.

All indices are unmanaged. You cannot invest directly in an index.

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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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