

## What the market did and why: October

**Lars Schuster:** Investors continue to be confronted by grim economic, political, and financial headlines on a daily basis. Offsetting this news are highly accommodative monetary policies enacted by central banks around the world, which has helped lift global asset prices. However, entering the final quarter of the year, investors continue to remain concerned about a wide variety of economic and fiscal policy risks.

**Schuster:** Hello I'm Lars Schuster, institutional portfolio manager with Fidelity Strategic Advisors Incorporated, and welcome to the Fidelity Investment Insight Podcast series. To help us understand the current market environment, I'm joined today by Dirk Hofschire, senior vice president of asset allocation research with Fidelity Investments. Welcome to the program Dirk.

**Dirk Hofschire:** Good to be here.

**Schuster:** Well Dirk, let's review the past month in the markets across the globe. This would be September 2012.

**Hofschire:** Sure. In September we've had a continuation really of a lot of the themes that we've been talking about through the course of the summer, been pretty calm, a little bit quiet in the markets, and in general risk assets have continued to add to their gains, and we've seen some categories, some sort of global categories, European stocks, merging market stocks, some commodities -- things that had been under-performing for much of the year, they've actually been some of the better performers. So when you look down year to date here through almost nine months of the year, most asset categories have shown some positive gains, and this has come really despite what's been weak economic data across the board, and I think a big part of it really has to do with the expectations, and really now the launch of new monetary stimulus.

**Schuster:** Yeah, let's talk about that particular point in a little bit more detail. There have been several policy announcements across the globe from various central banks. It almost feels like an open-ended type of alphabet soup of different acronyms. Can you help break this down just a little bit?

**Hofschire:** Sure, let's start with the Federal Reserve here in the United States, and they announced in September a new package of what's called quantitative easing, and it's not so much a surprise to the markets that they did something, because that's been anticipated as we've talked about in the last two or three months, but I think what they announced was really at the high end of people's expectations. They said that this was going to an open-ended commitment to quantitative easing. So they're going to start off doing about \$40 billion of purchases, mortgage-backed security purchases to start, but they extended their language for zero interest rates out into 2015, and they essentially said there's no end to this program, there's no specific deadline. So they're going to keep going about it based on economic conditions, and not let up until after the labor market improves and after they see significant signs of strengthening in the economy. So this is really a different type of commitment. It's an indefinite commitment, it doesn't have deadlines like the previous rounds, and now it's very clear that the Fed is much more concerned, much more focused on bringing down

unemployment, and less so on inflation which to them is not a big deal. Now, the other thing, you look around the world as you just mentioned and so you've got the Federal Reserve but you've got the European Central Bank as well, Draghi, the head of the European Central Bank had articulated over the summer his intent to make purchases of government bonds for peripheral Euro-zone countries. We got more details about that program in September as well - those have some conditionality, countries have to apply for it -- but what he's really done by outlining the policy is he's succeeded in helping to drive down some of those borrowing costs, even though it hasn't been fully implemented yet and there are still some risks. But when you add all this up to what the Fed did, what Europe has done, Japan instituted a new round of quantitative easing, emerging markets in many countries have been easing as well -- that adds up to a lot of global liquidity, a promise of more, and generally when you see positive monetary stimulus, it is a net incremental positive for the psychology of asset markets.

**Schuster:** So, maybe in the near term here, it's offered some form of stimulus or a positive environment for risk assets, as you noted earlier. But it's not a panacea, right, it -- this doesn't solve all ills, there are still other economic and other fundamental issues that still need to be solved, correct?

**Hofschire:** Certainly true, and, you know in general you think about that stimulus coming in, and it gives you a hope that things might get better down the line but, you of course have to remember why all of that extraordinary stimulus is needed and, the fact of the matter is the global economy is very very weak, we have severe financial problems in places like the Euro zone, so, you start off with that backdrop -- you look at Europe, it's in a deepening recession, it's becoming even more difficult for countries like Spain and Greece to meet their fiscal targets. And it's even weighing on countries like Germany which were really the strength of the European economy, and we think Germany now has moved into a late cycle phase of their economy and may even be in danger of tipping into recession in the coming months. You look in Asia -- emerging Asia, which has been a big engine of growth for the rest of the world, and China has now, still experiencing very lackluster growth, they're burdened really by over-capacity. So, you look around the world and we have this sort of synchronized slowdown in manufacturing, synchronized slowdown in trade, so more monetary easing helps, in that context, but it's important to remember that certainly that's not going to be sufficient to fix all of these problems alone.

**Schuster:** Well you gave some specific remarks with regards to Europe and China, but what about here at home, in the United States, what are some of the current trends in the economy that you're all seeing?

**Hofschire:** Well we've talked for quite some time now that we think the US is still at a better place in the economic cycle -- that sort of mid-cycle expansion -- than many other countries around the world and that hasn't changed. Some things that have gotten even better, in particular in the housing market -- and you're seeing a lot more self-sustaining momentum in housing activity. You think back -- we actually peaked in 2005, 2006 in the housing market in terms of prices and activity, so we're now six or seven years later and we've worked off much of the excess that was brought about by that bubble. So prices are back to sort of average -levels,

and with really low mortgage rates today affordability has never been higher; new construction has been so low for so long that a lot of the supply has been restrained. And so you're now seeing prices start to perk up around the country, activity -- construction activity definitely perking up, and this is a big positive for households, for consumers, for the balance sheets of banks, for construction jobs, so has the potential really to help those areas of the economy a lot in the coming months. The problem though is we're also starting to see a little bit of late cycle dynamics, little bit of deterioration in some sectors including a slowdown in manufacturing -- which we think is probably related most to the global slowdown I alluded to a moment ago -- but also a slowing in some business investment. And, this may be related to the global slowdown as well, but we're also increasingly thinking that this has something to do with the uncertainty that we're facing on the fiscal front, going into the potential fiscal cliff uncertainty in the end of the year. So the US is doing OK, but we still have a number of risks out there.

**Schuster:** You mentioned the fiscal cliff. I'd like just to spend a few moments if you would, talking a little bit about what that is, and where do we stand within the context of the fiscal cliff, as well, and sometimes it may get confused for investors out there is the upcoming election cycle, here in early November. They are separate and distinct events, but they do get kind of combined together -- could you provide us some comments there?

**Hofschire:** Sure. So the fiscal cliff is essentially all of the tax cuts are going to expire at the end of the year under current legislation as well as some automatic and other spending cuts that are currently legislated. So, if nothing happens, legislatively, going into 2013, we're going to hit a very big cliff of money that's going to come out of government expenditures, it's worth about 5% of our gross domestic product, which means it's very likely it would -- if we hit it -- push the economy off-course, and into recession. So, what you'd be rooting for here then, from a market perspective or economic perspective, a better pattern would be if we start to address our fiscal challenges over a medium term, but make it gradual and not experience that cliff all at once. So our concern on this -- you alluded to the election -- is, it doesn't seem that people are overly concerned in the market right now about the potential for some uncertainty and some volatility around this, and one of the reasons it's a problem to us, is when you look at the elections in November, nothing's going to get done with this fiscal cliff before the elections. So you have sort of a small window of opportunity before the end of the year that they're going to be able to come to some sort of agreement, and they may be able to do something immediately after the elections, but they also may not. And so, our base case when you look at this is that at bare minimum, it's going to add a certain amount of uncertainty as we go into the fourth quarter and along toward the end of the year. That could further weigh on economic sentiment, as I mentioned with business investment a moment ago, and it could also create more market volatility.

**Schuster:** Right so you have two offsetting sentiment issues there: improving housing prices, and the potential of uncertainty with the fiscal cliff. Certainly interesting dynamics there, combine all of that with some of you're earlier comments regarding global growth slowdown -- what's an investor to do?

**Hofschire:** Great question! Obviously a lot of cross-currents here, you also throw in you know the positive monetary support, but all of these economic and other risks. So it is very hard to figure out near term. We're somewhat cautious still on a tactical basis given all these risks, moving into the end of the year. But we're also trying to focus more on the intermediate term as well. Because we do expect, when you look forward into 2013, that one way or another, we are likely to get some progress on the fiscal front, some improvement of at least transparency, or visibility into the fiscal picture over the next several years, and if that happens then, perhaps if we get some other uncertainties cleared up around the world, it could really be very very positive for the economy, positive for risk-asset markets and stocks on a basis maybe setting us up for several years, but we need to go through potentially some uncertainty before that. So, it's a lot to digest, but the one thing we're trying not to do is become so overly focused about the near term that we forget about those potential possibilities in the intermediate term.

**Schuster:** Well thanks very much for your comments today, Dirk.

**Hofschire:** My pleasure.

**Schuster:** We appreciate your insight regarding the current market environment, and look forward to speaking with you in the very near future.

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