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BUSINESS CYCLE UPDATE

U.S. Late-Cycle Indicators Rise, but Recession Risk Low

Beaten-down asset prices leave room for upside surprises

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KEY TAKEAWAYS

- Deteriorating financial and business conditions have boosted late-cycle indicators in recent months, but U.S. recession risks remain low.
- As 2016 progresses, we expect the global economy to gradually stabilize and provide support to global equities, oil prices, and inflation.
- The late-cycle phase traditionally marks a peaking economic environment that includes rising inflationary pressures.
- Historically, the late cycle has the most mixed asset performance of any phase, but it is distinct from recession, which typically features a decline in equities.
- The increase in late-cycle indicators implies assets with inflation-resistant properties—including TIPS, shorter-duration bonds, commodities, and commodity stocks—may provide important portfolio diversification.

Fidelity's Asset Allocation Research Team (AART) 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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The market sell-off and deteriorating financial conditions in early 2016 have generated headline worries about U.S. recession. According to our business cycle framework, U.S. recession risks remain low, although late-cycle indicators have been rising during the past few months.

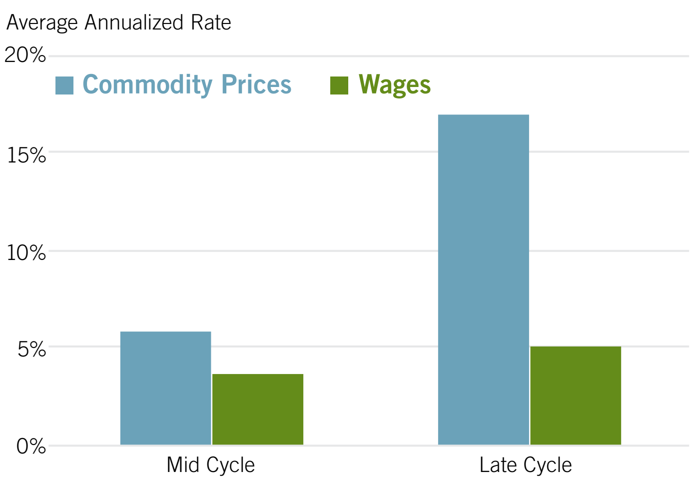
Every business cycle is different, but our historical analysis suggests that the rhythm of cyclical fluctuations in the economy has tended to follow similar patterns. Because shifts in the business cycle phases influence relative asset performance patterns, they can be used to create portfolio allocation tilts over the intermediate term. This update will highlight the key factors to consider as we monitor the outlook for the U.S. business cycle over the course of 2016.

Phase transitions: Key macro factors to watch

Fluctuations in the business cycle are essentially distinct changes in the rate of growth in economic activity, particularly changes in three key mini cycles—the corporate profit cycle, the credit cycle, and the inventory cycle—as well as changes in the employment backdrop and monetary policy.

Exhibit 1 Mid and Late-Cycle Inflation

Historically, accelerating inflation in wages and commodities drives the transition to the late cycle



Fidelity Investments proprietary analysis of historical commodity performance, using data from BP Statistical Review of World Energy, U.S. Department of Agriculture, U.S. Geological Survey, and U.S. Foreign Agricultural Service. Wages = Average Hourly Earnings. Source: Bureau of Labor Statistics, Haver Analytics, Fidelity Investments (AART), as of Jan. 31, 2016.

While the economy expands in both the mid- and late-cycle phases, the transition to the late cycle typically moves the economy past the peak rate of economic growth. It's important to note that the evolution from mid to late cycle tends to be less well defined than during other phase shifts, which may lead to an extended transition period. The following is a current review of major factors that demonstrates a mix of mid- and late-cycle dynamics:

- **Corporate profits**—During the typical mid-cycle phase, corporate revenues and profit margins expand. In contrast, rising input inflation during the late-cycle phase generally causes profit margins to shrink and earnings growth to decelerate. In recent months, profit margins have moderated as cyclical productivity has decelerated. However, the most acute pressure on earnings has come from falling commodity prices, as earnings excluding energy have held up much better (see Macro/Corporate and credit).

- **Credit**—Credit growth is generally strong during the mid-cycle phase, as demand rises while credit availability improves. During the late-cycle phase, credit access usually tightens when lenders become overextended. Financial conditions have deteriorated in recent months alongside the financial-market turmoil, but banks remain well capitalized and lending standards to households continue to ease (see Macro/Corporate and credit).

- **Inventories**—Typically, inventories (relative to sales) remain lean during the mid-cycle phase and then rise as production outpaces moderating sales growth during the late cycle. Manufacturing inventories did rise during the first half of 2015 amid the global trade recession, but recent data indicate the worst of the inventory correction may be over (see Macro/Corporate and credit).

- **Monetary policy**—The Federal Reserve (Fed) typically begins hiking rates and neutralizes monetary policy during the mid-cycle phase, with additional tightening leading to outright restrictive policy during the late cycle. Though the Fed has moved to monetary tightening, its policies have yet to become overly punishing.

- **Labor markets**—Unemployment typically declines the most during the mid-cycle phase, leading to a late-cycle tightness in the employment markets that tends to spur accelerating wage inflation. Improvement in the labor markets has tightened employment conditions and led to greater wage pressures, although the upward move in wage inflation has remained incremental, not rapid (see Macro/Employment and consumption).

Transition to late-cycle phase: Typically need more inflation

Historically, perhaps the single most important driver of the transition from mid cycle to late cycle has been a pickup in inflationary pressures. The late-cycle phase can often be characterized as an overheating stage for the economy, in which rising inflation tends to crimp profit margins and lead to tight monetary policy. Historically, the rise in inflation has been broad-based, with significant acceleration in both wages and commodity prices (Exhibit 1). Today, wage inflation does seem to be gaining traction, but commodity inflation remains notably absent. Our view is that the stabilization in the global economy over the course of the next year may cause commodity prices and inflation rates to rise (see Macro/Inflation).

Late cycle is not synonymous with recession

It's important to note that while the late-cycle phase typically coincides with peak economic activity, it is distinct from the recession phase that usually follows it. Recessions are characterized by outright and broad-based declines in economic activity, contractions that typically unwind the excesses built up during the expansionary upturn. On average, late cycles typically last a year and a half. However, the character of late cycles tends to be less homogenous than other phases, and historically has ranged in length from less than a year to more than two years before the beginning of recession.

Asset implications of late cycle: Less upside, no disaster

Our multi-time-horizon framework posits that asset allocation decisions should be made by taking into account the confluence of short (tactical), medium (business cycle), and long-term (secular) time horizons (Exhibit 2). Long-term portfolio construction principles should generally serve as the foundation for most investment strategies, while shifts in business cycle phases may be utilized to create portfolio tilts over the intermediate term. It's important to remember that cyclical allocation tilts are only one investment tool, and

Exhibit 2 Multi-Time-Horizon Asset Allocation Framework

The business cycle is the intermediate-term time horizon that affects asset performance, in addition to short- and long-term factors.

Source: Asset Allocation Research Team (AART), Fidelity Investments.

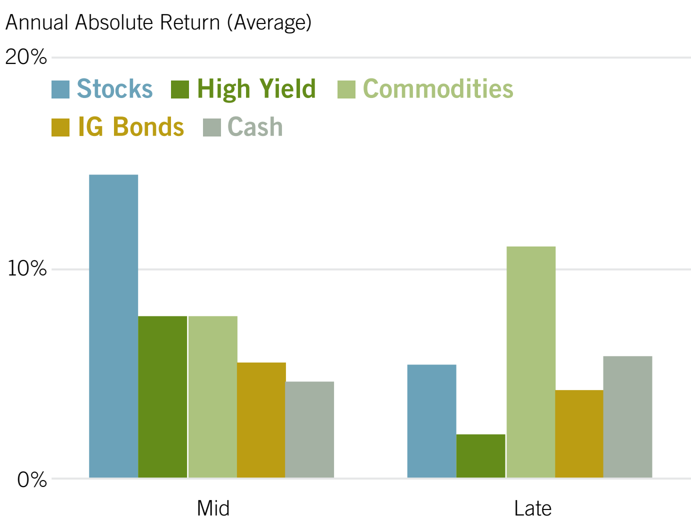
any adjustments should be considered within the context of long-term investment objectives and principles.

As mentioned above, it may be too early to shift fully to a late-cycle playbook approach (see the Outlook on p. 6 for our current asset allocation views). However, because we anticipate the odds of a U.S. late-cycle phase may continue to rise as the year progresses, the following are some of the historical asset-class return patterns to keep in mind for an eventual change in positioning (Exhibit 3). Traditional late-cycle performance patterns include:

- The most-mixed asset performance of any phase, with generally more limited overall upside for returns
- Less reliable relative asset performance patterns generally warrant smaller cyclical tilts
- Higher conviction in inflation-resistant assets, including commodities, energy and materials stocks, shorter-duration bonds, and TIPS
- Less confidence in equity performance, though stocks typically have outperformed bonds
- On average, core bonds outperformed credit as spreads widened

Exhibit 3 Asset Class Performance Between Mid and Late Cycles

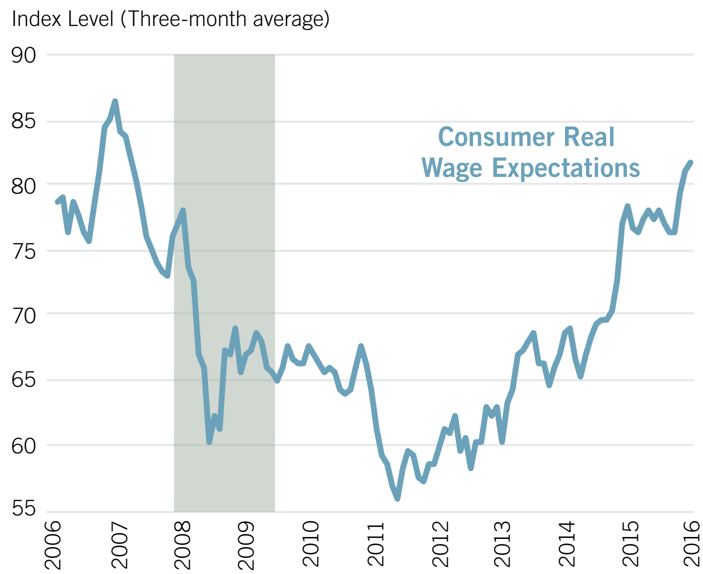
The relative performance of inflation-resistant assets improves in late cycles



Past performance is no guarantee of future results. Asset class total returns are represented by indexes from the following sources: Fidelity Investments, Ibbotson Associates, Barclays. Source: Fidelity Investments proprietary analysis of historical asset class performance, which is not indicative of future performance.

Exhibit 4 Consumer One-Year Real Wage Expectations

Rising real wage expectations bode well for consumer demand



Grey area represents U.S. recession as defined by National Bureau of Economic Research (NBER). Source: University of Michigan, NBER, Haver Analytics, Fidelity Investments (AART), as of Feb. 26, 2016.

Business Cycle: Macro Update

Late-cycle indicators have risen because of the negative effect of the weak global environment on the U.S. external-oriented sectors that are most exposed to global trends, including oil investment, manufacturing, and exports. However, with U.S. households in solid shape and consumption accounting for nearly 70% of U.S. output, the broad economy is not nearing a recession.

United States: Recession risks remain low

Employment and consumption on a durable path

Favorable labor-market conditions continue to support consumer activity. Job growth may proceed at a more moderate pace, but leading indicators such as initial unemployment claims are near 40-year lows and suggest labor market tightening will continue. Consumer confidence has held up well, bolstered by real (inflation-adjusted) income growth that has remained above 3% on a year-over-year basis for the past 14 months, the longest streak since the late 1990s. Moreover, expectations for real income growth continue to rise as labor market slack falls (Exhibit 4). The pace of consumer spending has remained moderate as some consumers have used the gasoline savings to pay down debt and shore up their balance sheets. **Tighter labor markets and rising income expectations suggest the U.S. consumer is providing a solid foundation for continued U.S. expansion.**

Corporate and credit outlook impacted by global and financial-market headwinds

The strong U.S. dollar, falling oil prices, and weak global demand weighed on corporate profit margins and earnings growth in 2015. However, excluding energy, profit margins remain near all-time highs and earnings are expected to grow in the mid-single digits for 2015.[1] Weak global demand also generated a significant inventory build during the first half of 2015, but non-oil inventory-to-sales ratios have begun to improve in recent months. Financial conditions have continued to tighten, with banks restricting business lending for a second consecutive quarter and corporate bond spreads remaining above long-term averages. However, overall credit conditions are still not tight, and corporate fundamentals remain generally healthy. Mortgage lending standards continue to ease, cash flows to cover corporate debt service obligations remain at the upper end of their historic range, and overall borrowing rates remain low. **Headwinds to the profit, inventory, and credit cycles have risen, but any stabilization in the global economy and financial markets should help mitigate those pressures.**

1 Source: FactSet, Fidelity Investments (AART), as of Jan. 31, 2016.

Inflation pressures likely to rise

Inflation pressures remain mixed, but are on track to rise over the next year. Labor-market tightening has pushed average hourly earnings growth to its fastest pace since 2010, although the 2.5% absolute level of growth remains historically subdued.[2] These incremental wage pressures are pushing core inflation measures higher, with core CPI rising to 2.2% year over year in January, the highest it's been in more than three years.[3] Tumbling commodity prices have been a deflationary counterbalance to these pressures, leaving overall inflation relatively muted (see Macro/Global). **With domestic core prices rising incrementally on the strength of labor markets, any stabilization in commodity prices is likely to push inflation higher over the course of the next year.**

Global: Weak, but signs of stabilization

Europe holding slow but steady

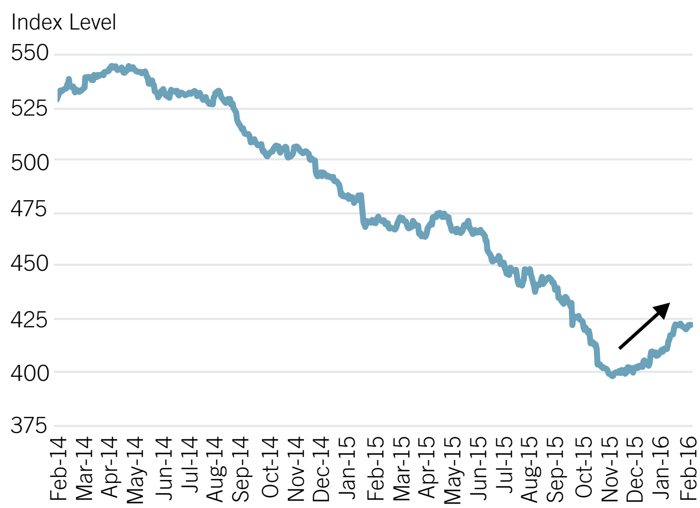
Europe remains in a mid-cycle expansion, despite the negative impact of the weak global environment. Consumer sentiment continues to improve in several peripheral countries; in Italy,

2 Source: Bureau of Labor Statistics, Haver Analytics, Fidelity Investments (AART), as of Jan. 31, 2016.

3 Source: Bureau of Labor Statistics, Haver Analytics, Fidelity Investments, AART, as of Jan. 31, 2016.

Exhibit 5 Raw Industrial Commodity Prices

Raw Industrial prices, a coincident indicator of global growth, may have stabilized.



Source: Commodity Research Bureau, Haver Analytics, Fidelity Investments (AART), as of Feb. 22, 2016.

consumers' expectations of their financial situation over the next twelve months stands at a five-year high. Negative interest rate fears have sparked concern about the banking sector, which works against the European Central Bank's easing efforts. **Despite weakness in external-oriented sectors, supportive monetary policy and positive trends in the household and service sectors underpin the eurozone's slow, mid-cycle expansion.**

Japan's outlook mixed

As a slow-growing economy heavily reliant on trade, Japan's business cycle is particularly susceptible to changes in the external growth environment. In addition to weakness in external-oriented sectors tied to China, the recent introduction of negative interest rates by the Bank of Japan and the strengthening yen may provide a headwind to the banking sector and corporate profitability more generally. **The trajectory of Japan's late-cycle economy may depend most on trends in the global economy.**

China fragile but may be bottoming

A downshift in growth at the end of an overextended credit boom pushed China into a growth recession in early 2015. Policymakers have stepped up the pace of stimulus measures in recent months, including targeted measures for autos and housing, leading to tepid signs of stabilization. Capital outflows have remained elevated and represent a major risk to China's outlook, but policymakers have renewed their commitment to stabilizing the currency during February (see "China's Stability Key to Global Improvement," February 2016 Business Cycle Update). **Support from policymakers should help stabilize conditions in the near term, although greater structural reforms will be needed for a sustainable reacceleration.**

Global summary: Financial headwinds, but real economy stabilizing

The global economy is struggling, but there are some signs of stabilization. About half the world's largest economies posted positive growth in leading economic indicators (LEIs) on a six-month basis, with emerging-market LEIs on a multi-month uptrend.[4] The CRB raw industrials index, historically a coincident indicator of global growth, has been rising since late 2015 despite the plunge in oil futures prices (Exhibit 5).[5] We expect oil supply-demand conditions to tighten over the course of 2016 and recover alongside a stabilizing global economy.

Tighter financial conditions represent a risk to global growth. Low and negative interest rates in Europe and Japan have cast a shadow over bank profitability, and global corporate credit spreads have remained in a widening trend. Tighter U.S. dollar liquidity precipitated by the Fed's tightening continues to pressure the commodity industries and emerging markets that had enjoyed extended credit bonanzas. **Deteriorating global financial conditions represent a formidable risk, but underlying measures of real activity suggest the world economy may be stabilizing.**

4 *Source: Organisation for Economic Co-operation and Development (OECD), Foundation for International Business and Economic Research (FIBER), Haver Analytics, Fidelity Investments (AART), as of Dec. 31, 2015.*

5 *Source: Commodity Research Bureau, Bloomberg Finance L.P., Fidelity Investments (AART), as of Feb. 24, 2016.*

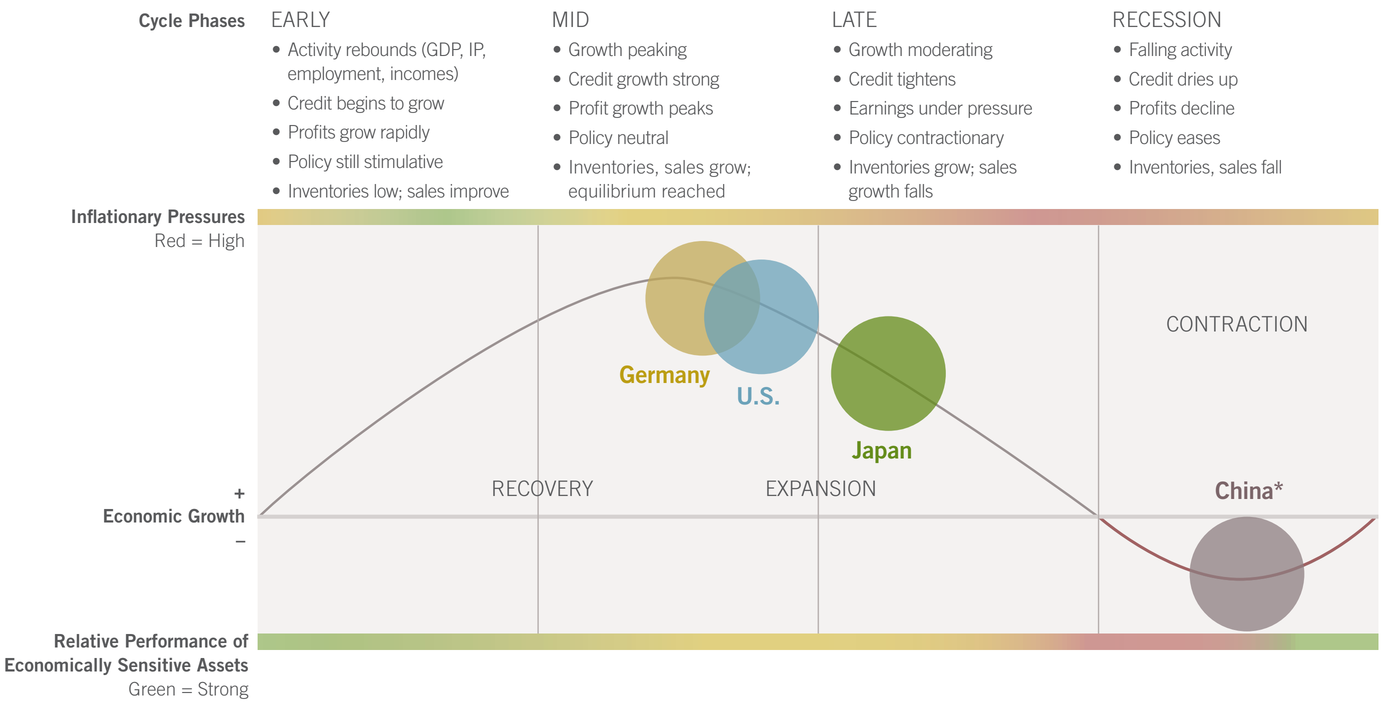
Outlook/asset allocation implications

Rising U.S. late-cycle indicators, China's difficulties, tightening global financial conditions, and the unwinding of the commodity and EM boom present formidable challenges to global asset markets. These issues will not be resolved quickly or easily, and flagging investor confidence raises the risk of generating a negative feedback loop. Nevertheless, a fair amount of bad news is now reflected in asset prices. Using our business cycle framework, we think the risk of U.S. recession is low and China's growth recession trends are likely to moderate, combining to provide a gradual stabilization of the global economy.

From an asset allocation perspective, economic stabilization should provide support for U.S. and global equities as 2016 progresses. There now appear to be selective opportunities in a number of the most beaten-down asset categories, and we may be approaching the final innings of sharp declines in commodity prices, EM equities, and non-U.S. currencies. The increase in late-cycle indicators implies assets with inflation-resistant properties—including TIPS, shorter-duration bonds, commodities, and commodity equities—may provide important portfolio diversification if cyclical inflation accelerates and outpaces current low expectations. Market volatility may remain more elevated than during recent years, indicating that smaller cyclical asset allocation tilts may be warranted.

Business Cycle Framework

The world's four 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.

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

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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 in¬vestment-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 develop¬ments, 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.

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.

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.

In general the bond market is volatile, and fixed-income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.)

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.

Increases in real interest rates can cause the price of inflation-protected debt securities to decrease.

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