BUSINESS CYCLE UPDATE

Global Reflation vs. Deflation: The Battle Rages On

Despite risks, moderate global growth and low inflation likely to continue

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KEY TAKEAWAYS

• Despite divergent post-2008 fears about extreme inflation or deflationary collapse, the world has followed a path of moderate growth and low inflation.

• Our expectation is that ongoing refiational forces and deflationary pressures will continue to largely offset each other, keeping global growth on a path of modest improvement.

• Two risks to our balanced outlook: late-cycle inflationary pressures if U.S. wage growth is faster than expected, and a deflationary shock if China is unable to stabilize growth.

• Refiational forces are bolstered by the U.S. mid-cycle expansion, which is still underpinned by improving labor markets and the positive real income outlook for the consumer.

• The likely Federal Reserve move to raise policy rates may boost market volatility, implying smaller asset allocation bets may be warranted.

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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In the aftermath of the 2008 global financial crisis, investors were confronted with two polar opposite ongoing risks for the global economy. One extreme scenario was that the easy money triggered by extraordinary global monetary policies could eventually create an outbreak of high inflation. At the other extreme, some investors worried about a scenario in which slow economic growth and high debt levels could lead to a deflationary collapse. Several years later, neither extreme has come to fruition. Instead, the world has followed a moderate path of range-bound inflation expectations and low inflation, wherein reflationary forces and deflationary pressures have largely canceled out one another (see Exhibit 1).

Our base-case outlook
Although neither extreme has taken hold of the world economy, current global trends can be grouped into reflationary forces and deflationary pressures.

On the reflationary side:
- Monetary policy remains highly accommodative across much of the world
- Developed countries are generally experiencing cyclical improvements (see “Global,” page 6)

On the deflationary side:
- China’s economy remains in a slowing trend amid heightened overcapacity and declining corporate profitability (see “China,” page 6)
- Many emerging-market countries have experienced booms in private-sector credit growth in recent years but now face higher debt burdens at the same time that nominal GDP growth (the ability to service debt) has decelerated materially
- There are few willing and able drivers of global demand to bolster global trade by expanding imports
- Secular restraints on the U.S. consumer, including aging demographics, are likely to keep the rate of consumer spending well below the peak pace of prior expansions (see “Consumption and employment”)
- The strong dollar and weak oil prices have been powerful disinflationary forces in the U.S.

Our expectation is that these forces will continue to largely offset each other and keep the world on a moderate path over the intermediate term. This suggests a cyclical outlook that is somewhat down the middle and includes:
- Relatively low inflation
- Developed economies leading modest global improvement
- Federal Reserve (Fed) moves to tighten monetary policy but at gradual pace

The asset allocation implications of our cyclical outlook are:
- Higher market volatility
- Smaller bets warranted
- Favoring equities, especially in developed markets
- High-quality bond duration used to diversify risk
Risk 1: U.S. Wage Growth Is Faster than Anticipated

We expect U.S. labor-market tightening to continue to generate a modest rise in wage inflation, but there is a risk that wages experience a rapid acceleration that outpaces both our expectation and that of the market. Since the beginning of the year, the pace of hiring has remained relatively flat, while the job openings rate has risen rapidly (see Exhibit 2). This dynamic suggests that companies may be having difficulty finding qualified workers for their openings, perhaps implying that much of the remaining slack in the market may be due to structural factors such as a mismatch between worker skills and employer needs.

If companies are struggling to find qualified workers, they may be forced to raise wages at a much higher rate. A faster pace of wage gains is a double-edged sword: it boosts consumer spending, but it is also a primary driver of core inflationary pressures in the U.S. economy. Unexpectedly large increases in core inflation may prompt the Fed to raise interest rates faster and higher than investors currently anticipate. Wages are also the greatest expense for U.S. corporations, implying that faster wage growth may have an adverse impact on profit margins and, in turn, on earnings growth. Accelerating inflation, a deteriorating profit cycle, and tightening credit access would be signs that late-cycle pressures are rising in the U.S. economy. For a full discussion of the wage backdrop, see “The Implications of Mounting Wage Pressures in the U.S.” (May Business Cycle Update).

Based on the historical cyclical patterns across asset classes, rising late-cycle pressures could have important asset allocation implications, including:

- An even greater rise in equity market volatility
- Lower absolute returns across asset classes
- Faltering leadership of cyclical asset classes (equities, credit-sensitive fixed income)
- Improved relative performance of inflation-resistant assets (commodities, TIPS)
- Improved relative performance of shorter-duration bonds and cash

Risk 2: China Deflationary Shock

We expect that China’s ratcheting up of policy stimulus will help to stabilize growth somewhat, albeit within a decelerating medium-term trajectory. The risk to this outlook is if the deflationary forces of China’s post-boom landscape prove too powerful and lead to an outright economic contraction and rising financial instability. For a full discussion of China’s outlook, see “China’s Economy: Stuck in the Cyclical Mud” (June Business Cycle Update).

After growing around 10% annually for the past several decades, we believe China’s economy has entered a growth recession and that actual growth is well below the reported 7% GDP growth rate. China’s already challenging transition to slower growth is aggravated by the end of cyclical credit, real estate, and investment booms that have left the economy with industrial overcapacity and severe imbalances. Authorities have responded with increasingly stimulative monetary and other measures, but several indicators suggest that the real economy is struggling to respond to the more accommodative policy environment.

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**Exhibit 2 Job Openings Rate vs. Hires Rate**

A rising openings rate and a steady hires rate suggests companies may be struggling to find qualified workers.
While the government is encouraging bank lending, the demand for loans has fallen to the lowest level in at least a decade, signaling that the traditional monetary policy transmission mechanisms are impaired (see Exhibit 3). Meanwhile, economic concerns and lower interest rates have spurred foreign capital outflows amounting to hundreds of billions of dollars over the past few quarters.¹

A Chinese economy that fails to stabilize would have even greater negative implications for the global economy than the current path of slow and disappointing growth. First, China’s trading partners in Asia—such as South Korea and Japan—would experience even tougher conditions for their export industries. Second, China is one of the largest consumers of commodities, so commodity prices and producers—such as Brazil and Australia—would likely suffer even greater headwinds.

Further, potential financial instability in China could have global repercussions. If deteriorating conditions prompted even heavier capital outflows, policymakers could become either unable or unwilling to defend the value of the renminbi through drawing down foreign exchange reserves. A currency devaluation would represent a substantial deflationary shock to the global economy.

The risk that China is unable to stabilize its economy would have significant asset allocation implications, including:

- Risk-off tone to the global financial markets, including even greater volatility
- Defensive assets would likely hold up better, especially long-duration Treasuries
- Assets with linkages to China’s economy may suffer the most, including close Asian trading partners, commodity prices and producers, and emerging-market equities
- On a relative basis, U.S. equities in more defensive, domestically oriented sectors may fare better

Outlook Summary

Exhibit 3 China Loan Demand
Demand for credit has plummeted, blunting the effectiveness of policy easing.

Index Level

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¹ International Monetary Fund, Haver Analytics, Fidelity Investments (AART), as of Jun. 30, 2015.
Business Cycle: Macro Update
Recent U.S. data releases have been less disappointing relative to market expectations, due in part to stabilization in external-oriented sectors following a sharp deceleration caused by the stronger dollar, weaker external environment, and plunge in oil prices. The mid-cycle expansion continues to be bolstered by a healthy domestic backdrop underpinned by the positive real income outlook for the U.S. consumer.

U.S. economic sectors
Consumption and employment. Conditions facing U.S. consumers continue to improve substantially. Although weak secular trends, such as aging demographics, have restrained consumer spending relative to past cycles, cyclical headwinds continue to dissipate. For a full discussion of consumer spending, see "The U.S. Consumer: Outlook Bright But Not Off to the Races" (July Business Cycle Update). Consumers are benefiting from much-improved balance sheets, tightening labor-market conditions, and modest increases in worker compensation. In July, new unemployment claims reached a multi-decade low. 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 indicators provides more evidence that the slow housing expansion is gaining greater traction. Single-family sales have emerged from their weather-induced first-quarter slowdown and are now growing at a double-digit pace over the past year. Underlying fundamentals, such as increased bank willingness to make mortgage loans, rising mortgage originations, solid employment, growing household formations, and high home affordability suggest that this improvement in demand could continue (see Exhibit A). Growth in single-unit supply has remained relatively restrained despite the pickup in demand. The outlook for the housing sector is solid, underpinned by the tightening labor market, a rebound in household formations, still-low mortgage rates, and easing lending conditions.

Inflation. Inflationary pressures remain low but have exhibited modest upward momentum. Although falling commodity prices have pushed headline inflation toward 0% year over year, core inflation (excluding food and energy) has started to trend higher, increasing at a 2.3% annualized rate over the past six months. We expect the continued decline in labor-market slack will translate into accelerating wages and service prices, causing core inflation to accelerate modestly through the end of the year. Although hourly earnings have yet to signal acceleration in wage growth, other measures, including consumer surveys of wage expectations and the Atlanta Fed wage growth tracker point to the beginning stages of wage inflation. Wage gains support a modest pickup in inflation, but late-cycle inflationary pressures remain absent.

Corporate and credit. The U.S. corporate and credit backdrops generally remain solid. Credit conditions are favorable, and there are signs that industrial activity is stabilizing after a sizable deceleration during the first quarter. Manufacturing and business investment have softened amid a weaker energy sector and a strong U.S. dollar, but ample credit availability and solid non-energy corporate profitability continue to be supportive of the mid-cycle expansion.

Exhibit A Change in U.S. Household Formations
Increases in household formations have historically led to a pickup in housing construction

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1 Data include new and existing single-family home sales. Source: National Association of Realtors, Census Bureau, Haver Analytics, Fidelity Investments (AART), as of Jun. 30, 2015.
3 Source: University of Michigan, Federal Reserve Bank of Atlanta, Fidelity Investments (AART), as of Jun. 30, 2015.
Global
China. A downshift in growth at the end of a cyclical boom has left China with a credit overhang and excess capacity, which has stirred deflationary pressures. Producer prices have decelerated over the past three years, falling to nearly -5% year over year in June. Industrial production has slumped and profitability has declined. **China’s economy remains in a growth recession, but increasingly aggressive policy easing is helping stabilize near-term conditions.**

Europe. Europe continues to regain cyclical traction amid improving credit and monetary conditions, pent-up household demand, and abating deflationary fears. **The showdown in Greece did little to thwart economic momentum in the rest of the eurozone, as consumer and business sentiment remain above their 2014 troughs, loan demand continues to rise, and labor markets continue to gradually tighten. Accommodative monetary policy, a weaker euro, and a healthy credit cycle continue to serve as significant tailwinds for the eurozone’s mid-cycle reacceleration.**

Japan. The Japanese economy continues to experience an uneven recovery, supported by extensive monetary easing. While the consumer is showing signs of strength, with confidence ticking higher in each of the past seven months, wage growth remains tepid. Furthermore, weak external demand—including that from China—has kept the inventory-to-shipments ratio elevated. **Japan is experiencing a tepid early cycle alongside renewed monetary stimulus and a boost to corporate profits from a weaker yen.**

Global summary. The global economy remains on a slow, steady growth trend balanced by reflationary and deflationary forces. Leading economic indicators (LEIs) for the world’s 40-largest economies suggest incremental progress is likely to persist, with roughly 60% of those countries reporting a rise in their LEIs on a six-month trailing basis. This progress is driven heavily by developed economies, with almost 90% exhibiting growth in their LEIs as a result of cheaper commodity prices, weaker currencies, and ultra-low interest rates. Conversely, many emerging markets are experiencing late-cycle or recessionary conditions, particularly commodity exporters that have been weighed down by lower commodity prices. Large developed-country commodity exporters, such as Canada and Australia, are also experiencing weaker growth trends. **The global expansion remains sluggish, but better conditions in several major developed economies underpin a modestly improving economic outlook.**

Outlook/asset allocation implications
The multiyear U.S. mid-cycle expansion has likely been prolonged by soft global economic conditions that have tempered domestic growth and inflationary pressures. Our expectation is that this relatively benign, low-inflation environment will continue. As articulated above, we expect that the Fed’s move to raise rates will generate greater market volatility, which warrants smaller asset allocation bets than would have been appropriate earlier in the business cycle. With the downside risk in China still substantial, we continue to favor developed equity markets in Europe and the U.S. over assets—such as commodities—that are dependent on the cyclical prospects for emerging-market economies.

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2 Cabinet Office of Japan, Haver Analytics, Fidelity Investments (AART), as of May 31, 2015.
Business Cycle Framework

Japan is in an early-cycle recovery, while the U.S. and Germany remain in the mid-cycle phase, and China is 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).
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.

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