Fidelity Roundtable: Top Investment Themes in 2016

Investment leaders discuss the implications of a Fed policy shift, a bear market in energy stocks, and the prospects for active managers

The presidents, chief investment officers, and other leaders within the asset management divisions at Fidelity Investments gather regularly to discuss market conditions, significant risk factors, and other dynamics driving the performance of the financial markets. In the Fidelity roundtable session that took place at year end, our investment professionals discussed the key factors shaping the outlook for the financial markets in 2016. Brian Hogan, president of Fidelity's Equity and High Yield Division, moderated the discussion. *[Note: The following views represent those of one or more individuals, and should not be considered as the collective view of either Fidelity Investments or any particular investment division.]*

BRIAN HOGAN (Moderator): Let's begin by talking about what is typically top of mind for most investors—investment opportunities. What assets are likely to be good investments in 2016, and why?

JOSEPH DESANTIS (Equities): There are some catalysts that make the financials sector attractive. For example, the prospect of higher interest rates—which improve banks' net interest margins—and the overall relatively cheaper valuations in this sector could make financials an area of relative strength. However, I don't see a big broad move higher for the overall stock market due to what I believe could be diminished revenue and earnings power given modest growth and already high profit margins.

MELISSA REILLY (Equities): In 2015, there was a narrowing of the market, in which there were a small number of strong-performing large-cap stocks that made a difference in whether or not a portfolio outperformed. Some people have made references to these stocks with an acronym—FANG-NOSH—referring to Facebook, Amazon, Netflix, Google, Nike, O'Reilly, Starbucks, and Home Depot, noting that they made up a significant portion of the S&P 500 Index's advance in 2015. These stocks did well because they have been leaders in their respective industries. Going forward, some of our portfolio managers have increased their exposure to financials, for the reason Joe mentioned. Elsewhere, we have had a lot of internal debate about health care. The sector has strong fundamentals, but some are concerned about the recent increase in political rhetoric and whether it will turn into legislative action. Overall, our growth managers are still favorably disposed to the technology sector, largely because of favorable growth prospects for leading companies in cloud computing and software as a service.

TIM COHEN (Equities): I agree there is an opportunity in financials with the Fed beginning a rate-tightening cycle. The sector also has valuation support, and I don't believe the impact of rising rates has been modeled entirely on all the business lines throughout the sector.

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HOGAN: What other thoughts do people have?

BRUCE HERRING (Strategic Advisers): I think leadership is going to continue to come from where it historically has—companies that can grow earnings faster than their competitors. Some of those faster-growing companies have been in the health care sector, but we still see good companies in all sectors. I continue to think that the backdrop next year will be a mid- to late-cycle, slow-growing U.S. economy. In that environment, faster earnings growth is harder to find, and there will likely be a premium put on the stocks of those companies that are growing earnings. I believe the financials sector is going to remain in an extended period of compression, due largely to a greater regulatory burden. And I don't see hard assets (e.g., commodities, such as crude oil and aluminum) as an attractive investment over the next year.

HOGAN: The Fed recently raised its short-term policy rate for the first time since 2006, and Fed policy is likely to be a major theme in 2016. The Fed has been very transparent about its thinking in recent months, in an effort to avoid any disruptive surprises to the markets. But from my perspective, the challenge for the Fed will be to determine and communicate how frequently and at what pace does it tighten going forward. Given concerns about uneven growth in the global economy and the strengthening of the U.S. dollar, a more thoughtful, deliberate, and slower rate-tightening pace may be needed during the next couple of years. What are your thoughts?

TIM HUYCK (Money Markets): I think you're right, Brian. In recent months, the Fed has really tried to communicate that the time has come to begin to normalize policy rates. Personally, I think the Fed should have acted sooner. The Fed has guided to basically 100 basis points (bps) a year after its initial tightening—100 bps next year, and 100 bps in 2017. But fed funds futures, a barometer of market expectations, is basically calling into question the Fed's guidance. The market's expectations have been well below the Fed's guidance for quite a bit of time, pricing policy rates at about half the pace of the Fed in 2016 and beyond.

CHRISTINE THOMPSON (Bonds): Based on what is priced into the Treasury yield curve, the bond market does not believe the Fed's proclamations either. The curve suggests the Fed is going to move more slowly than it says it will. The markets are very exposed to the flow of economic data, and that's what our portfolio managers are watching as well to determine if there might be a shift in growth that would influence policy expectations. Meanwhile, though the Fed has been transparent, the market has been skeptical about that transparency, particularly with regard to guidance on what the trajectory and pace of tightening might be after the first move. The reality is that the Fed can only say so much, because it too is watching the economic data, and the data has been variable. So it's difficult to really ascertain what the actual pace of tightening will be.

TOM HENSE (Equities and High Yield): While the markets are expecting a tightening pace that is much slower than in prior tightening cycles, there is some risk that if forthcoming action by the Fed is not dovish but something more unexpected, there could be a negative reaction among various markets.

HOGAN: How are our fixed-income portfolio managers positioned in light of market expectations?

THOMPSON (Bonds): Our bond funds generally are positioned for a slow trajectory of tightening after the first move, to reflect positive, but slow economic growth. During the course of the past year, the most broadly diversified portfolios' positioning generally tilted toward an increased emphasis on the cheapened credit and corporate asset classes, and away from government duration positions that helped in the first half of 2015. Whether or not the Fed's pace is three or four separate moves of 25 bps, our positioning is unlikely to change dramatically unless the pace of economic growth changes, and our managers conclude that pace is going to cause a shift in Fed expectations.

HOGAN: So you don't believe an acceleration of economic growth is likely, and thus not likely to change the Fed's current guidance for a slow, measured rate-tightening pace?

THOMPSON (Bonds): Right. Significant growth and a pickup in inflation might hinder absolute returns for bonds, but it would not be entirely bad for the credit sectors of the bond market. The risk to credit sectors would be a downturn—perhaps fueled by a global crisis, for example—that forces the rate of economic activity to turn negative, and puts the economy back in a recessionary environment.

CHRIS SHELDON (Private Wealth Management): We've seen an improvement in the markets' consensus expectation for a Fed move compared to sentiment going into the Fed's September meeting. Back then, it was a "coin flip" as to whether the market thought the Fed was going to tighten, and the market volatility that occurred caused the Fed to wave off any serious consideration of a rate hike. I thought they lost an opportunity at the time. During the past couple of months, there has been more clarity around stronger jobs data and higher expectations that the Fed would tighten—and yet the equity markets have done pretty well. I think that's a good sign. There has been some wage growth and other positive economic data that have given the Fed more confidence to increase the current rate. Whether it's one and done or a series of gradual moves, at least the market debate is now around what's appropriate and how many, not whether the Fed should even start.

HOGAN (Moderator): What do others think about Fed policy?

HENSE (Equities and High Yield): The markets have taken comfort in the fact that inflation and inflation expectations have remained really low. However, assuming that the low current energy prices remain flat going forward in 2016, headline inflation may begin to move higher over the course of the next quarter, and it will be interesting to see how the markets react. Will the Fed maintain its shallow trajectory stance, and will markets still be comfortable with it? It's difficult to tell.

COHEN (Equities): What's interesting to me is that the overall U.S. equity market has been moving inversely to the historical patterns with respect to interest rate expectations during the past couple of months. Recently, when the Fed probability of a rate hike was going down, the S&P 500 Index went down. When it looked like a rate hike was more likely, the S&P has gone up. Unlike in the past, the equity market seems to be welcoming a Fed increase. Meanwhile, the movements of bond prices and the dollar have followed in sync with historical patterns.

HOGAN: Do you think the equity market has responded favorably due to the expectations of a Fed increase or because there's been more certainty in terms of policy direction?

COHEN (Equities): I think higher expectations of a new Fed rate tightening cycle have helped banks stocks rally because an increase in rates will help their net interest margins. But the increased clarity on policy—and now the Fed's initial rate hike—have certainly been a factor as well.

HENSE (Equities and High Yield): Don't underestimate the extent to which "Fed fatigue"—the long-running debate about when the Fed may begin normalizing policy rates—has weighed on the markets. So, greater certainty over Fed policy may have been helpful, and may continue to outweigh other factors.

HERRING (Strategic Advisers): It's a tricky spot because everybody associates rising interest rates with the Fed trying to slow the economy. Now, the Fed's shift in policy is seen as confirmation that the economy is healthy, which is a good thing for stocks. And I think any subsequent rate increases will be further recognition of that the economy is healthier.

HOGAN: If that is the case, what is the level of rates that equates to normalized policy?

HUYCK (Money Markets): The Fed has indicated a level of 3.5% would represent long-term equilibrium, but clearly the markets (as indicated by fed funds futures) think the target level is much lower—probably in the neighborhood of 150 to 200 bps. However, the Fed has recently talked about how continued headwinds in the economy would argue for a lower neutral in the near term. Several recent Fed speeches and the post FOMC statement and press conference from December 16 mentioned tighter credit standards, household deleveraging, contractionary fiscal policy, and weak growth abroad as some factors, among others, that would create headwinds to growth that would necessitate a gradual and shallow path for rate hikes. I think this narrative has resulted in a fairly muted reaction in rates out the curve in the aftermath of the Fed tightening.

BRIAN ENYEART (Managed Accounts): One of the more interesting conversations is around what happens among long-term bond rates. Most market participants are myopically focused on what the Fed does regarding the short-term rate, but there seems to be enough technical pressure and demand for long bonds and yields that I think you're just going to see continued pressure to keep the long bond low. That could be as important as what happens to the short-term rate.

HOGAN: Turning to another theme, oil and natural gas prices have declined to generational lows, which have posed challenges for many energy companies. Will this difficult pricing environment persist in 2016?

COHEN (Equities): Demand for oil has remained steady in the U.S. and abroad, but the massive global oversupply needs to be worked off before crude, heating oil, and gasoline prices can stabilize and potentially recover. Low prices have been met with a significant decline in rig counts in the U.S., but the low prices have also made it unprofitable for many companies to produce oil. As a result, some exploration and production companies with higher debt obligations are likely to go out of business in this environment. The positive side of lower energy prices is that it puts more dollars in the pockets of consumers, which may help prop up other parts of the economy, such as consumer discretionary.

HOGAN: Did the market underestimate the technological drilling improvements that facilitated oil supply?

DESANTIS (Equities): It's possible. In retrospect, it has taken a longer time for production to come offline in the United States. During the past several months, we have just started to see the first decline in domestic production in years. But there has been no adjustment whatsoever out of the Organization of Petroleum Exporting Countries (OPEC) since a November 2014 decision not to cut production. OPEC has continued to produce more oil, which has kept the markets oversupplied. This combination has been a major reason there has been a longer-term period of low oil prices.

HOGAN: How have our diversified equity portfolio managers positioned their funds in this challenging environment for energy stocks?

REILLY (Equities): We did some research on prior oil price cycles, and concluded that it typically takes somewhere between 24 to 36 months until the economy can work through an oversupplied market. Recognizing this lag, and feeling that it may take longer for a business recovery given the excess in supply this time around, many of our managers have remained underweight the sector. These managers continue to monitor the supply and demand responses as they wait until it's a more attractive reentry point. I think they feel that it's not vital to catch the bottom [of the price cycle], but more important to see that there is an adequate supply response to ensure the outlook for profits is a bit more favorable. At the same time, a small number of managers have been willing to increase their positions given the extremely low stock valuations, believing it's already an attractive entry point.

COHEN (Equities): If you look back at a the oil price cycle in the 1990s, OPEC didn't make large production cuts until there were clear cuts in U.S. production and a significant decline in drilling rigs in operation. We've already seen this supply response in the U.S. In addition, many large oil companies don't develop their annual budgeting until this time of year, when they have some visibility into first-quarter earnings, and then typically cut production. So if this pattern repeats, it could be a near-term catalyst for a cyclical recovery. My guess is energy prices will be higher a year from now than they are today.

HOGAN: What about other raw materials?

COHEN (Equities): Energy typically has shorter up-and-down cycles than other materials, in large part because you see quicker supply-and-demand responses in energy (i.e., demand increases due to lower prices) that don't occur as quickly in other materials, such as copper.

HOGAN: Does the world simply have too much stuff coming out of the ground?

COHEN (Equities): That is the biggest bear argument—that we've reached an inflection point, whereby global demand may just not grow the way it has in the past, and supply remains plentiful given new technology. For example, demand in Western Europe has shrunk for three or four years in a row just because of advances in fuel efficiency. However, U.S. demand has been growing, and the oil industry has always been self-correcting [i.e., lower prices spur higher demand, lower supply, and eventually, higher oil prices]. I think the better managed companies will always make money, and our energy sector managers have been largely positioned in the most profitable exploration and production companies—those with the strongest balance sheets and the best access to key oil basins.

HERRING (Strategic Advisers): My concern for energy stocks in 2016 is that the sector is going through a super cycle right now, and one that may indeed take much longer

for a recovery than most people think. I don't see the typical behaviors going on right now in energy that have occurred at the troughs of prior cycles. We haven't yet seen a wave of bankruptcies or oil fields being shut down. The industry may only be near the start of such events. And while there is a lot of energy being focused on when the asset class is going to bounce, such a bounce may not occur for well beyond another year. Semiconductor companies went through a super cycle, and what happened for about a decade was that stocks rallied some, then collapsed to new lows, then rallied again, and collapsed again. This went on until most of the world forgot about the asset class and had given up on it. It is possible energy could be experiencing an extended period like that now, with lower highs and lower lows.

DESANTIS (Equities): I tend to agree with that, Bruce. I believe the only way that prices go up in a sustainable fashion is when OPEC reduces actual production, and that may not occur for some time. Many countries continue to produce oil because it's a primary source of revenue to support their budgets. There is also an organized terrorist group that has taken over more oil fields in Syria and Iraq, and this group is producing oil to generate revenue to fund its operations.

DEREK YOUNG (Asset Allocation): Many Middle East countries are very dependent on producing oil for income, and thus are much less sensitive to supply and demand issues than they have been historically.

COHEN (Equities): I definitely hear your point, Bruce, because it doesn't feel like the oil industry has gone through five to seven years of pain to the point where no one cares anymore. At the same time, the amount spent on new drilling today is lower than it was a year ago. Many oil producers have slashed costs dramatically and are cutting projects. So I think there'll be enough supply response in the U.S. to provide support for prices, at least on the margin.

HOGAN: The past year has generally been a good one for the performances of active managers. Are there any signs that it will continue?

HENSE (Equities and High Yield): Our business cycle research indicates that the late stage of the cycle typically includes greater dispersion of asset class returns and higher volatility—two factors that historically have provided a better backdrop for active managers. That's something we are keeping an eye on, but we are not there yet; our asset allocation team believes the U.S. economy is still firmly in the more mature phase of a mid-cycle expansion. Our research has also showed that active managers tend to perform better during periods of higher stock return dispersion, and during rising interest rate environments, which historically have started in the mid-cycle phase. As we've discussed, the Fed has begun a rate-tightening cycle, so it's very possible an environment conducive to active management continues.

BRIAN: Well that would bode well for Fidelity's customers. This has been an informative discussion. Thank you all for your time.

Fidelity Thought Leadership Vice President Kevin Lavelle provided editorial direction for this article.

The following participated in Fidelity Investments' December roundtable session:

Tim Cohen | Chief Investment Officer, Equities

Joseph DeSantis | Chief Investment Officer, Equities

Brian Enyeart | Chief Investment Officer, Strategic Advisers, Inc

Tom Hense | Group Chief Investment Officer, High Yield and Equities

Bruce Herring | President, Strategic Advisers, Inc.

Brian Hogan | President, Equity Group

Tim Huyck | Chief Investment Officer, Money Markets

Angelo Manioudakis | Chief Investment Officer, Global Asset Allocation

Charlie Morrison | President, Asset Management

Stephanie Pierce | Executive Vice President, Investment Product Development

Melissa Reilly | Chief Investment Officer, Equities

Chris Sheldon | Chief Investment Officer, Private Wealth Management

Christine Thompson | Chief Investment Officer, Bonds

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