Executive Summary
Quarterly Market Update: First Quarter 2017

This Executive Summary should be reviewed with the accompanying presentation, “Quarterly Market Update: First Quarter 2017,” by Fidelity’s Asset Allocation Research Team.

Market summary: Stocks rally in Q4 while improved global economy sets tone for 2017
The global economic acceleration in 2016 provided a favorable backdrop for financial assets. The pickup in global economic activity was marked by a resurgence of growth in China, improved global industrial activity, abating deflationary pressures, and continued economic expansion in the United States. Global economic momentum set the stage for rising bond yields and inflation expectations in the U.S. during the second half of the year, which accelerated after the U.S. election results boosted hopes for a pro-growth change in U.S. economic policy. These hopes fueled a Q4 rally in U.S. stocks. The upward move in bond yields weighed on investment-grade bond returns. And the dollar surged to a 15-year high. We expect the global expansion to persist in 2017 and to set a positive tone to start the year. However, the wide distribution of potential policy outcomes poses uncertainty and may result in increased market volatility. We favor global equities and inflation-resistant assets, but smaller allocation tilts are merited at this point in the business cycle.

Theme: Rates and inflation—a secular shift?
There are several long-term (secular) factors that may indicate the multi-decade decline in interest and inflation rates may be ending. Over long periods of time, long-term government bond yields tend to have a tight positive relationship with GDP growth (yields generally have averaged the same rate as nominal growth). While government policies can induce a cyclical boost to higher economic growth rates, a substantial jump to much higher U.S. GDP growth on a secular basis would require some unlikely developments, particularly amid slower population growth and aging demographics. We expect interest rates to settle at a significantly lower level than their 20-year historical average (4.4%), but that they will rise over the long-term to an average closer to our 3.6% nominal GDP forecast. In addition, a rapid increase in globalization during the past few decades provided a secular disinflationary trend to U.S. prices. However, the secular rise in globalization may have hit a peak amid political pressures against integration, which would provide an incremental source of inflation going forward.

On a cyclical basis, there is also upside risk for both inflation and interest rates. The Federal Reserve continued its tightening cycle by hiking policy rates in December, marking progress toward greater monetary normalization. Major central banks in Japan and Europe did not lower policy rates further into negative territory during the second half of 2016, and steepening in yield curves may obviate the need for additional extraordinary monetary easing. Most major industrialized countries are experiencing the limits of monetary policy and shifting toward easier fiscal stances. The cyclical outlook for interest rates and inflation will be influenced by potential
changes in U.S. economic policy. Trump and the GOP Congress intersect on pro-growth policies, including deregulation and corporate tax cuts. However, the two sides have different views of fiscal and trade policy. Many of these policies tend to boost inflation, making an upside risk to prices the most likely outcome regardless of the policy mix.

Economy/Macro: Global expansion persists, policy outcomes are key

The global business cycle is in decent shape entering 2017, although it faces both a maturing profile and a staggering range of potential policy outcomes. Broadly speaking, most of the developed world is in the more mature phases (mid to late stages) of economic expansion, and China’s improved cyclical trajectory has helped boost many emerging-market economies. In 2016, China’s economic stabilization, fueled by accommodative fiscal and monetary policy, was a key factor in ending the steep global trade recession, and could continue to support global growth in the coming year. Europe’s industrial activity has recovered and economic expectations have risen across several large developed economies, although the political environment poses risks in 2017 with several core-country elections. The global economic outlook for 2017 is for modest cyclical traction, abating global deflationary pressures, and a low probability of global recession.

The U.S. economy remains a mix of mid- and late-cycle dynamics, with a low probability of recession. Tight labor markets are generating wage inflation, a trend that is consistent with historical later-cycle dynamics and a positive outlook for consumer spending. U.S. small business owner optimism rose meaningfully following the November elections, on hopes that the new administration will enact business-friendly changes. With core inflation in the U.S. already firm, a continued stabilization in energy prices will begin to push headline inflation higher on a year-over-year basis during Q1.

Given the details and timing of any U.S. policy changes are uncertain, two general flavors of the U.S. expansion appear likely. The first would be a material acceleration in growth, spearheaded by renewed business confidence, while the second may be a continued expansion at the 2016 pace. The most probable is a mix of these factors, with most combinations likely to create inflationary pressures and move the economy closer to the late-cycle phase as time progresses.

U.S. Equities: Mostly positive gains across style, cap, and sectors in 2016

All major equity categories posted positive gains in the fourth quarter and throughout 2016, with a significant percentage of these gains realized in the weeks following the U.S. presidential election. The Q4 outperformance of small-cap stocks relative to large caps may in part be attributed to their lower exposure to the post-election rise in the dollar and concerns about protectionism. Among sectors, energy stocks led the way in 2016 as oil prices recovered. Financials climbed sharply after the election thanks to a steeper yield curve and greater prospects for deregulation. Industrials rose on hopes for fiscal stimulus. Health care lagged due to a more uncertain policy environment. Bond proxies, such as real estate and consumer staples, reversed from leaders to laggards during the year’s second-half rise in interest rates.

The decline in U.S. corporate earnings since mid-2015 appears to be inflecting positively as the energy and manufacturing sectors recover from the steep drop in oil prices and the end of the global industrial recession. Pro-growth policies could benefit top-line growth, but profit margins will likely remain pressured from rising employment costs and higher interest rates, making mid-single-digit earnings growth appear achievable for 2017. Although the pace of inflation may rise it remains relatively low on a historical basis, indicating there may
still be room for inflation to increase without causing significant damage to stock valuation multiples.

**International Equities and Global assets: Despite weak Q4, emerging markets led 2016 gains**

Emerging-market equities rallied until the U.S. elections, then retraced some of their gains but still ended the year in double-digit positive territory. Commodity prices rebounded during the year, which benefited commodity-exporters, including those in Canada and Latin America. Overall, the rising U.S. dollar detracted from returns, particularly in developed markets and during the post-election period.

After several years of negative earnings growth, the fundamental backdrop may be improving on the margins for developed and emerging markets. In developed markets, earnings expectations have begun to stabilize at relatively low levels. In emerging markets, the pace of profit decline has moderated during the past several quarters, with earnings growth in countries, including India and Brazil, even entering positive territory. On a secular horizon, emerging markets are attractive from both a fundamental and a valuation perspective. Price-to-earnings multiples in most EM countries’ equity markets remain at the lower end of their 20-year averages, and we expect growth of emerging countries to outpace that of developed markets over the long term.

**Fixed Income: Credit-sensitive assets outperformed in 2016**

The rapid narrowing of credit spreads during 2016 resulted in the significant outperformance of lower-credit-quality categories, such as high yield, emerging-market debt and leveraged loans. Looking ahead to 2017, with inflation expectations at around 2% and inflationary pressures rising, TIPS may prove useful as an inflation hedge. On a relative basis, TIPS tend to experience a better price return than nominal Treasuries when inflation expectations rise, as they did in the third and fourth quarters of 2016.

Underlying fundamentals remain solid for municipal bonds. Even if personal income taxes for the top bracket are reduced to the 33% level suggested in the Trump and GOP plans, munis would retain a significant tax-equivalent advantage over comparable Treasuries. Throughout all cycle phases, diversification is the key to downside protection in a bond portfolio. Historically, fixed-income strategies with designated allocations in both high-quality bonds and higher-yielding sectors have helped mitigate downside risk.

**Asset Allocation**

Keep in mind that late cycles historically have the most mixed asset performance of any business cycle phase. Stocks have typically outperformed bonds, and inflation-resistant assets such as commodities, energy stocks, short-duration bonds, and TIPS have typically performed relatively well in the late-cycle phase. Combining inflation-resistant assets historically has increased the frequency of outpacing inflation, a difficult task for cash in today’s low-rate environment.

Meanwhile, one of the keys to long-term investing success is to create and maintain a well-diversified portfolio with an asset mix that reflects one’s investment horizon, risk tolerance, and financial situation. If market volatility increases in 2017 due to uncertainty around new potential policies, remember that investors who review their portfolios more often have tended to shift toward more conservative exposures. Increased portfolio monitoring raises the likelihood of seeing (and reacting to) a loss. Loss aversion and excessive emphasis on short-term market volatility can cause investors to make asset allocation changes that deviate from their long-term plans. Outsourcing asset allocation to a professional investment manager may help investors identify and maintain an appropriate amount of portfolio risk, keeping their portfolios aligned with long-term goals.
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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.

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