Executive Summary
Quarterly Market Update: Second Quarter 2017

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

Market summary: Global expansion offsets political uncertainty
The worldwide recovery in industrial activity continued to bolster the most synchronized global expansion in the past several years. While growing political uncertainty surrounding the prospects for U.S. economic policy changes caused a reversal in post-election, policy-related trades, stock market volatility remained at extremely low levels. Supported by a weaker dollar, non-U.S. equities led the Q1 global stock market rally; for the first time in years, emerging-market equities outperformed U.S. large-caps on a one-year basis.

Amid signs of moderate-but-not-overheating economic expansion, flattish bond yields helped support a solid backdrop for most asset categories. As inflation indicators firm, monetary policymakers turn less accommodative, and the U.S. business cycle becomes more mature, smaller allocation tilts are likely warranted.

As the year progresses, the uncertain outlook for U.S. economic legislation and upcoming elections in core European countries—including presidential elections in France during Q2—could boost market volatility.

Theme: Crosswinds for earnings
Corporate earnings growth continues to rebound off the profit-recession lows of early 2016, but a more moderate outlook in the growth trend could be likely, owing to a combination of factors. For example, companies may have difficulty expanding profit margins from elevated levels as they face a secular peak in globalization and a cyclical pick-up in wages. While government policies can boost cyclical growth that could help company sales, the multiplier tends to be higher for stimulus when there is a large amount of economic slack and monetary policy is accommodative—unlike the current backdrop. Moreover, boosting growth through fiscal stimulus may also be more difficult today following a sustained period of low investment. With the Federal Reserve (Fed) picking up the pace of monetary tightening, corporate interest expense may begin to rise, making it more difficult for corporations to continue to boost return-on-equity via higher levels of leverage. On the other hand, the possibility of a cut in the corporate tax rate could support further profit growth.

Economy/Macro: Continued global expansion supported by U.S. and China
The global economy continues to expand in a synchronized fashion, with most developed economies in more mature (mid to late) stages of the business cycle. China’s improved cyclical trajectory has helped boost many emerging-market economies and catalyzed a recovery in the global manufacturing, trade, and commodity industries. China’s broader activity has continued to stabilize and improve on the margin, but its policymakers’ shift to a less accommodative stance, amid continued excess capacity and corporate leverage, implies a ceiling to China’s cyclical upswing.

The U.S. economy remains a mix of mid- and late-cycle...
dynamics. U.S. manufacturing and other external-oriented sectors have rebounded alongside the global industrial recovery, and the post-election surge in positive business and consumer sentiment may represent potential upside for growth. The decline in unemployment claims suggests U.S. labor markets will continue to tighten, which provides a solid backdrop for the U.S. consumer and continued overall expansion. However, tighter labor markets are generating higher inflation, which is typically a key ingredient of transitions to the late-cycle phase. Although inflation remains relatively low, the recovery in commodity prices, including tighter supply-and-demand conditions for oil, further reinforces a firmer outlook for inflation relative to the past few years.

In terms of monetary policy, the market appears to have received Fed messaging and integrated it into expectations for more regular rate hikes ahead. While expectations for a normalization of monetary policy in Europe and Japan lag behind those for the U.S., improved growth and higher inflation have transformed the landscape from one dominated by extraordinary easing to a general drift toward less accommodation. With a growing number of industrialized countries no longer reducing government budget deficits after a multiyear period of austerity, policy action may be shifting from monetary to fiscal measures. In the U.S., the political path ahead remains highly uncertain with regard to changes in economic policy, but there is an upside risk to inflation in many potential scenarios. Globally, a key economic risk is the potential for more confrontational trade relations between China and the U.S., which would likely reverberate throughout the global system.

U.S. Equities: Technology powered broad-based gains across sectors
Technology shares led the broad-based gains across sectors with nine out of 11 posting solid positive returns. Health care was one of the better outperformers while bond-proxy sectors (e.g., utilities and consumer staples) bounced back as bond yields moved sideways. In a reversal of the trend seen late last year, energy and financial stocks lagged the broader market, as did value and small-cap stocks. Growth and large-caps outperformed, potentially signaling less investor conviction in the timing and direction of potential changes to economic policy.

From a valuation standpoint, U.S. large-cap price-to-earnings (P/E) ratios are somewhat above their long-term historical averages. However, we believe that over the long term, stocks will sustain a valuation level closer to the average of the past 20 years. While valuations have historically had a negative relationship with inflation, there is room for inflation to rise from today’s relatively low levels and still be generally supportive of high P/Es. Profits have rebounded after several consecutive quarters of negative earnings growth, helped by the recovery in energy prices. The rebound from the profit recession should continue and is supported by an increasing share of companies giving positive guidance, although the trend growth rate is likely to moderate in coming quarters.

International Equities and Global assets: Widespread gains helped by improving earnings
Non-U.S. equity markets generally posted strong returns during Q1, with currency appreciation enhancing gains in U.S.-dollar terms. International economies have shown renewed cyclical growth momentum relative to the U.S. in recent months. Accordingly, the gap in corporate earnings growth has also narrowed, making the cyclical outlook for international equities relatively more attractive after several years of underperformance. At the same time, the U.S. dollar remains at the upper end of historical ranges versus many currencies and price-to-earnings ratios for both developed and
emerging-market equities remain attractive versus the U.S. Both factors provide a favorable long-term valuation backdrop for international equity returns.

Over the past three decades, rising globalization has coincided with an increase in global equity correlations, but recently, anti-globalization pressures may be contributing to greater diversification benefits for non-U.S. equities and boosting opportunities for active management.

**Fixed Income: Credit categories boosted by further spread tightening**

Amid flattish interest rates, all fixed-income categories posted positive performance in Q1 and lower-credit-quality bonds led the way. Credit spreads compressed in emerging-market debt and corporate-high-yield debt, making them the most expensive categories relative to their own histories. During the past year, lower-credit-quality assets have performed far better than their interest-rate-sensitive counterparts.

Investment-grade bonds—the most interest-rate-sensitive bond category—have historically offered better downside protection than stocks, even when rates were rising. Bonds have had fewer instances of negative returns and less severe episodes of losses. Investment-grade bonds have posted positive returns during nearly all medium- and longer-term time horizons—even during rising-rate environments—as higher coupons countered price declines.

Most leveraged loans in recent years have included a LIBOR-floor provision to ensure a minimum rate paid to investors. During Q1, the 3-month LIBOR rose above the average floor for the first time in several years, thereby allowing the variable-rate feature to provide an upward coupon adjustment if short-term interest rates continue to rise.

Fixed-income strategies with designated allocations to both high-quality bonds and higher-yielding sectors have exhibited consistent downside protection. The diversification offered by “core-plus” and “multi-sector” portfolios has helped generate fewer periods of negative returns than any individual bond sector, while providing a lower magnitude of losses than lower-quality sectors.

**Asset Allocation**

Over long periods of time, GDP growth has a tight positive relationship with long-term government-bond yields. Although interest rates could rise further in the near term, we expect rates to settle close to our 3.6% nominal GDP forecast over the long term—a significantly lower level than their historical averages.

Cyclically, late cycles have had the most mixed performance of any business cycle phase, with more limited overall upside than mid-cycle phases.

From a long-term portfolio construction perspective, inflation erodes portfolio purchasing power and has been a headwind for equity and bond returns. Additionally, outright high inflation has coincided with a rise in the performance correlation between stocks and bonds.

Inflation-resistant asset classes—such as commodities, gold, commodity-producing equities, TIPS, and short-duration bonds—have held up relatively well when inflation is rising—both cyclically and secularly. In addition when inflation is high, these assets have been one of the few diversifiers for equities. A strategic allocation to a basket of such assets may help investors manage the risk that inflation could be higher than anticipated over the long term.
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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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