EXECUTIVE SUMMARY

Quarterly Market Update: Fourth Quarter 2015

This Executive Summary should be reviewed with the accompanying presentation, “Quarterly Market Update: Fourth Quarter 2015,” by Fidelity’s Asset Allocation Research Team.

Market summary: Global deflation fears stoke market turbulence
Global growth concerns dominated the financial markets during the third quarter of 2015. Additional evidence of China’s economic slowing, as well as surprising clumsiness in its management of equity and foreign-exchange market fluctuations, was a primary trigger for the jump in market volatility. Riskier assets posted their worst quarter since 2011, with emerging-market equities and commodities suffering the greatest losses due to concerns centered on China’s growth trajectory. A lack of clarity in the Federal Reserve’s messaging may also have created ambiguity about the U.S. economic and monetary outlook. Government bond yields fell during the flight to quality in Q3, and a dramatic spike in interest rates remains unlikely. We believe global deflation risks have risen, but modest cyclical improvement will continue to be led by the U.S. and European economies. Elevated market volatility may continue until greater policy clarity in both the U.S. and China is forthcoming.

Theme: Fed policy outlook—clarity needed
Historically, the first interest-rate hike in a Federal Reserve tightening cycle is not the start of a market or economic downturn. Typically, economically sensitive assets, such as equities, have performed well during the period immediately after the initial hike, as the economy gathers strength in the mid-cycle phase. However, the current environment contrasts with previous periods of initial Fed tightening, as inflation is lower and the global economy weaker than during any previous period within the past three decades when the Fed first began a tightening cycle. As a result, the pace of Fed tightening is likely to be gradual. An initial Fed hike, likely in the coming months, may tighten global financial conditions and put pressure on less liquid asset classes. However, a Fed hike might also remove the ambiguous feeling that some investors may have about monetary policy and the U.S. economy, which may have the offsetting impact of boosting investor confidence.

Economy/Macro: Developed markets lead in slow global environment
Most of the developed world continues in mid-cycle expansion, led by steady improvement in the U.S. and Europe. However, global growth remains tepid, as China and many other emerging markets face recessionary pressures. Policy easing in China is likely to become even more aggressive, but increased traction is difficult amid industrial overcapacity, declining corporate profitability, and weak loan demand. As the world’s biggest trader and largest consumer of commodities, China’s faltering growth has had an outsized impact on global trade, with the value of global exports declining at one of its fastest paces in decades. Countries and companies that direct more exports toward North America and Europe are faring better than those more reliant on import demand from China and the rest of Asia.
Leading economic indicators suggest the U.S. is likely to remain in a modest mid-cycle expansion in the near-term. Global weakness will likely further soften activity for external-oriented sectors of the U.S., but the much larger consumer sector continues to benefit from tightening of labor markets and an increasingly positive real income outlook. Europe’s domestic recovery continues amid supportive monetary policy and pent-up demand, and the majority of the eurozone’s exports go to other European economies.

As China’s growth prospects have deteriorated, capital outflows and market pressures on its currency have caused policy makers to sell Treasuries to keep the renminbi from depreciating too markedly. Although China’s Treasury selling puts upward pressure on yields, there are many other factors influencing interest rates over the near-term, some of which are applying offsetting downward pressure. Over the long-term, we expect yields to rise somewhat, but to a level that is well below historical averages. Meanwhile, the drop in oil prices is beginning to stimulate global demand, but with supply growth still strong a greater demand response from emerging markets is likely needed to generate a sustainable increase in oil prices.

U.S. Equities: Negative Q2, but fundamental outlook still positive
Most equity styles and market caps sold off into correction territory during the third quarter, pushing returns negative on a year-to-date basis. Utilities were the strongest performing stocks and the only sector in positive territory, while commodity-linked sectors such as materials and energy posted the biggest losses. Corporate profits declined slightly in Q2 and are expected to fall again in Q3, but the earnings slowdown has largely been the result of declines in energy sector profits. Historically, a modest slowdown in earnings growth has coincided more often with market corrections than bear markets, implying our outlook for solid domestic profits would avert the fundamental catalyst for a severe bear market. U.S. equity valuations are elevated but within fair-value range. Energy sector valuations relative to the market have become historically cheap but free cash flows continue to deteriorate, implying active security selection may help investors identify the potential winners and losers.

International equities/global assets: Earlier year-to-date gains erased
Global weakness took a toll on global equities, commodities, and currencies in the third quarter, and the stronger U.S. dollar detracted from most non-U.S. equity returns. The worst performers included commodity producers such as Latin America and Canada, as well as China-linked trading partners in Asian emerging markets. Nevertheless, the dollar’s six-month flat movement versus the euro and the yen highlights the challenge in timing and hedging short-term currency movements. Since the early 1990’s, actively managed international equity funds have on average significantly exceeded benchmark performance by taking advantage of company exposures that drive most of stock-price variance. In terms of the long-term outlook, the low valuations of most international equity markets and our expectation for faster relative economic growth in emerging markets offer attractive underpinnings for global-oriented portfolios.

Fixed Income: Higher quality, longer duration outperformed
Falling interest rates and rising spreads resulted in the outperformance of higher quality and longer duration fixed-income categories during the third quarter. High-yield corporate spreads are now above their recent historical averages, implying the market has already priced in an elevated default rate despite still-positive corporate fundamentals. Managing both interest-rate and credit risk is critical at this juncture of the business cycle, and a multi-sector fixed-income strategy with a foundation of high-quality bonds may provide consistent downside protection. Finally, although fiscal challenges exist for many municipalities, state revenues have continued to improve the fundamental backdrop for municipal bonds.

Asset allocation themes
Historically, a portfolio consisting of 70% U.S. and 30% international equities has provided higher returns, lower volatility, and better risk-adjusted returns than the S&P 500 Index over the long run. Meanwhile, although the U.S. economy remains in a mid-cycle expansion, investors should keep in mind that a shift to the late-cycle phase has typically resulted in a shift in asset performance. The late-cycle phase has the most mixed performance of any business cycle phase, with the leadership of economically sensitive assets typically faltering, and relative and absolute returns becoming more mixed.
Views expressed are as of the date indicated, based on the information available at that time, and may change based on market and other conditions. Unless otherwise noted, the opinions provided are those of the authors and not necessarily those of Fidelity Investments or its affiliates. Fidelity does not assume any duty to update any of the information. Past performance and dividend rates are historical and do not guarantee future results.

Investing involves risk, including risk of loss.

It is not possible to invest directly in an index. All indices are unmanaged.

Diversification/asset allocation does not ensure a profit or guarantee against a loss.

Stock markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments.

Changes in real estate values or economic downturns can have a significant negative effect on issuers in the real estate industry.

The securities of smaller, less well-known companies can be more volatile than those of larger companies.

The commodities industries can be significantly affected by commodity prices, world events, import controls, worldwide competition, government regulations, and economic conditions.

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.

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 also carry inflation risk, liquidity risk, call risk, and credit and default risks for both issuers and counterparties.

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 due to potential changes in the credit quality of the issuer.

Third-party marks are the property of their respective owners; all other marks are the property of FMR LLC.

The S&P 500® Index is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. S&P 500 is a registered service mark of The McGraw-Hill Companies, Inc., and has been licensed for use by Fidelity Distributors Corporation and its affiliates.

If receiving this piece through your relationship with Fidelity Financial Advisor Solutions (FFAS), this publication is provided to investment professionals, plan sponsors, institutional investors, and individual investors by Fidelity Investments Institutional Services Company, Inc.

If receiving this piece through your relationship with Fidelity Personal & Workplace Investing (PWI), Fidelity Family Office Services (FFOS), or Fidelity Institutional Wealth Services (IWS), this publication is provided through Fidelity Brokerage Services LLC, Member NYSE, SIPC.

If receiving this piece through your relationship with National Financial or Fidelity Capital Markets, this publication is for institutional investor use only. Clearing and custody services are provided through National Financial Services LLC, Member NYSE, SIPC.

AUTHORS

Lisa Emsbo-Mattingly  I  Director, Asset Allocation Research

Dirk Hofschire, CFA  I  Senior Vice President, Asset Allocation Research

Jake Weinstein, CFA  I  Senior Analyst, Asset Allocation Research

Austin Litvak  I  Senior Analyst, Asset Allocation Research

Caitlin Dourney  I  Analyst, Asset Allocation Research

Fidelity Thought Leadership Vice President Kevin Lavelle provided editorial direction.