

Healthy Outlook: Year-End Business Cycle Update

By Dirk Hofschire, CFA, SVP, Asset Allocation Research, and Lisa Emsbo-Mattingly, Director of Asset Allocation Research. [Fidelity Viewpoints](#). 12/13/2013.

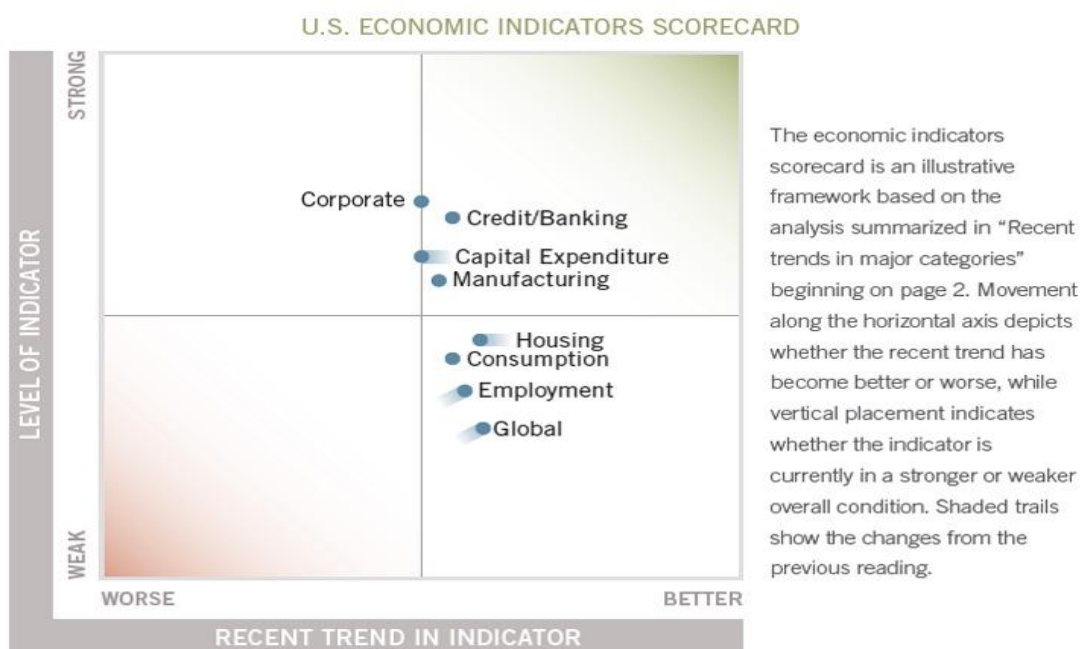
Key Takeaways

- The 2014 outlook for the U.S. economy looks healthy, with improving labor and low inflation supporting consumer spending.
- The global economy enters the year in a trend of modest improvement.
- Paring of the Fed's easy money policies and risks in Asia could trigger market volatility as 2014 progresses.
- Stocks in steady economies have favorable outlooks, but the ride may be bumpier and the upside more modest than in 2013.

The U.S. economy remains in mid-cycle expansion, supported by broad improvement across sectors. (See U.S. economic indicators scorecard, below.) Although the world's major economies are not completely synchronized, the general trend of the global business cycle is one of improvement. There are, however, several risks on the horizon that increase the likelihood of higher market volatility during the first half of 2014. As a result, we'll enter 2014 with a favorable outlook toward more economically sensitive asset classes such as stocks.

The following is a more detailed look at developments in major areas of the economy:

Outlook became more neutral amid an overall improving economic backdrop, accelerated employment gains, decelerated housing gains, and the capital expenditures.



For illustrative purposes only. Source: Fidelity Investments (Asset Allocation Research Team) as of Dec. 6, 2013.

Employment

Job quits and consumer perception of the job market have both been trending upward, indicating growing confidence in the employment market.



Job quits: Seasonally-adjusted estimate of workers voluntarily leaving jobs. Source: Bureau of Labor Statistics (job quits, through Oct. 31, 2013), The Conference Board (consumer perception, through Nov. 26, 2013), National Bureau of Economic Research, Haver Analytics, Fidelity Investments (AART).

The labor market continues to improve gradually. The pace of non-farm payroll growth has increased modestly, as job gains averaged nearly 200,000 per month for the past three months.¹ Total government employees have increased despite a reduction in federal workers, as stronger state and local tax receipts allowed municipal payrolls to expand.² In private sector hiring, the cyclical components, including manufacturing, construction, and retail, have trended higher, and more small businesses have recently increased payrolls.³ Leading indicators suggest expansion may continue. Jobless claims resumed their downward trend after a temporary spike during the government shutdown.⁴ Quit rates (which show worker confidence in finding new employment) and consumer perception of the employment market have both recently reached their highest post-recession levels (see chart, right). **The labor market upturn remains on a steady course, with leading indicators suggesting an improving outlook.**

Inflation

Inflation remains well anchored, balancing mild domestic inflationary trends with global disinflationary pressures. Headline inflation decelerated to 1.0% year over year, posting its lowest level since 2009, primarily due to a decline in energy prices.⁵ Core inflation (which excludes volatile food and energy categories) has remained near its current level of 1.7% since April.⁶ Leading indicators suggest wage growth could pick up modestly, which could offset global disinflationary pressures (energy and import prices) and hold overall inflation within a narrow range. This inflation mix would support the purchasing power of the U.S. consumer. **Modest wage growth amid global disinflationary trends may keep inflation relatively low and range-bound in 2014.**

Consumption

The outlook for real wages has improved amid tightening in the labor markets and lower inflation.



Bureau of Labor Statistics data on average weekly earnings of all employees includes both wages and salaries.

Source: Bureau of Labor Statistics, Haver Analytics, Fidelity Investments (AART) through Oct. 31, 2013.

Consumption activity has been modest but warrants a favorable outlook. Core retail sales grew at a 3.9% annualized rate in the three months through October, on par with the three-month average over the past year.⁷ The U.S. consumer has been supported by a low interest rate environment, which has provided affordable credit for durable goods and has helped reduce the ratio of financial obligations payments to disposable personal income to near the lowest level on record.⁸ The sector has held up reasonably well despite overall consumer confidence falling from its summer peak as weaker expectations followed the government shutdown. Higher housing and equity prices kept sentiment more buoyant among higher income earners.⁹ A sustained increase in real (inflation-adjusted) wages has been elusive during this recovery, but trends appear favorable and have the potential to support consumption broadly. Real wage growth, while modest, is at its highest pace since the early stage of the recovery as a result of rising nominal wages and lower inflation (see chart, right). **Though confidence measures remain tepid, low inflation and continued improvement in the labor market should provide a favorable backdrop for consumption.**

Credit and Banking

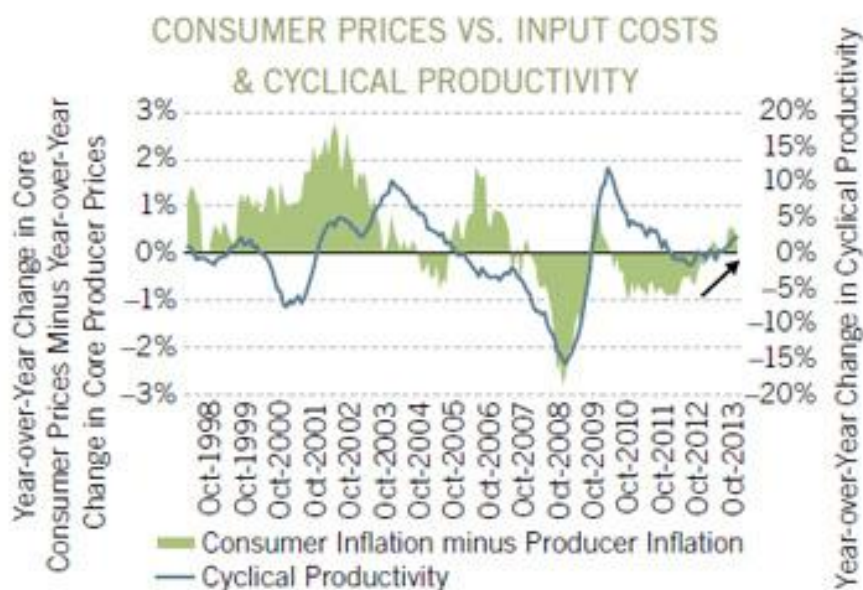
Credit and banking conditions in the U.S. remain supportive of economic expansion. The latest Senior Loan Officer Survey from the Federal Reserve (Fed) reports that banks have further eased lending standards across all categories.¹⁰ Sustained narrow credit spreads and easy access to markets continued to drive robust corporate debt issuance. The recent rise in real Treasury yields in anticipation of the Fed's potential tapering of quantitative easing (QE) has yet to create substantial volatility in credit markets. **Credit conditions remain accommodative and continue to provide broad support for the overall U.S. economy.**

Housing

The housing market recovery has slowed in the past six months, showing mixed recent data but a balanced supply-and-demand outlook. With home prices up 13% over the past year and mortgage rates almost a full percentage point higher since May, housing affordability is down significantly from its peak at the end of last year though still high relative to historical levels.¹¹ The drop in affordability has dampened sales activity and lowered the near-term outlook for housing price appreciation, suggesting a transition from the fast-paced recovery of the past year to a more mature housing expansion, where conditions remain supportive of an upward trend in activity. Housing supply remains relatively tight at five months, the average over the two decades before the housing crisis.¹² October building permits, boosted by multifamily permits, rebounded after several months of softness to show the biggest monthly gain since the crisis.¹³ **The near-term pace of housing activity will likely continue to slow, but balanced supply-demand conditions should provide a sustainable tailwind to the housing cycle and the overall economy.**

Corporate

Corporate profit margins, already high, have been bolstered by improved productivity and a favorable inflation environment.



Source: Bureau of Labor Statistics, Haver Analytics, Fidelity Investments (AART) through Oct. 31, 2013.

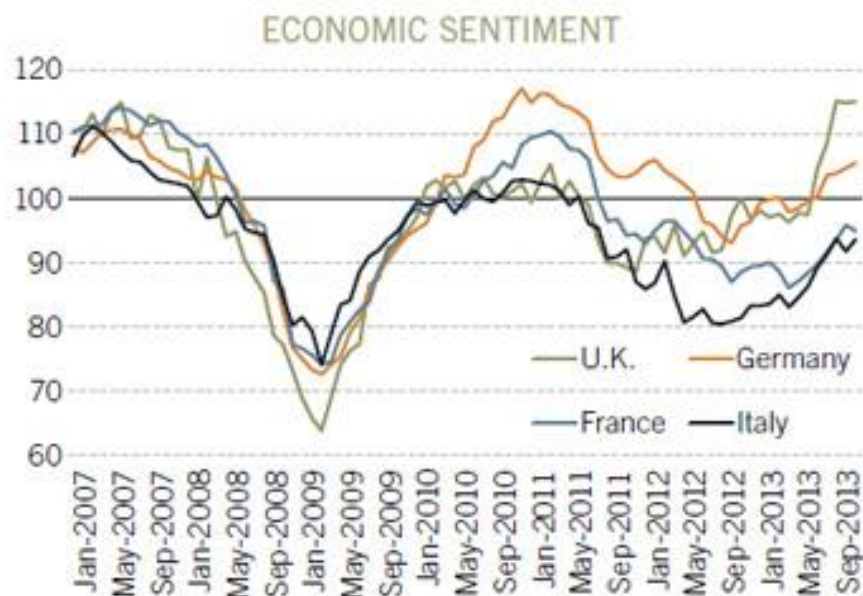
The corporate sector remains a bright spot for the U.S. economy as manufacturing steadily improved and profitability remained high. The manufacturing Purchasing Managers' Index indicated the most robust expansion in two years amid firming international and domestic demand, and November new orders expanded at the fastest rate since April 2011, outpacing inventory expansion.¹⁴ Meanwhile, corporate capital expenditure data remained mixed and was likely negatively impacted by uncertainty amid the government shutdown.¹⁵ Continuing its slow and steady pace of low-single-digit growth, year-over-year corporate earnings growth was 3.5% in the third quarter of 2013.¹⁶ The fundamental backdrop for margin expansion is still constructive: U.S. companies are benefiting from a shift in relative pricing power, as producer prices (i.e., input costs) have recently been growing

more slowly than prices paid by consumers, reversing the trend since the recession and relieving downward pressure on margins. Additionally, healthy net income margins continue to be boosted by cyclical productivity gains due to low borrowing rates and increased efficiencies (see chart, right). **Solid outlooks for manufacturing and corporate earnings contribute to a constructive backdrop for the corporate sector overall.**

Global

The global economy continues to exhibit modest improvement, with cyclical progress in developed nations driving the trend. Leading indicators have improved over the past six months in approximately three-quarters of the world's largest economies, with nearly all developed countries demonstrating broad strength. The improving global backdrop has provided a boost to many nations' external sectors, as illustrated by the indication of rising manufacturing activity in 82% of economies.¹⁷

Amid a general trend of improvement, recent economic sentiment indicators for developed European economies have been mixed.



Source: European Commission, Haver Analytics, Fidelity Investments (AART) through Nov. 30, 2013.

Most developed economies are in early- or mid-cycle phases of the business cycle. Economic sentiment indicators—encompassing both business and consumer attitudes—in most major European nations are reflecting a diversity of underlying economic circumstances (see chart, right). The rebound in U.K. confidence has been strong, while results in the eurozone have varied: Germany has stabilized, but the recovery in France still appears weak. The economies in Italy and other peripheral countries have improved, but remain structurally weak. Japan remains in mid-cycle expansion, as fiscal and monetary accommodations help support growth in the manufacturing sector, improvements in the labor market, and stronger corporate profits and exports bolstered by a weaker yen.

The majority of emerging market economies remain in late-cycle expansion, showing signs of stability, but many face various headwinds from structural challenges. Stagflation continues to threaten several large emerging economies, especially those with current account deficits. Brazil, India, and Indonesia have countered rising

inflation by raising policy rates, which may also dampen growth momentum. The near-term outlook for China remains positive, driven by strong credit growth as well as manufacturing and infrastructure-related activity. However, the sustainability of the current recovery is uncertain, as credit conditions become frothier and funds are diverted to less productive assets. **The global economy remains in a modest upward trend, led by better cyclical momentum in developed economies.**

Summary and Outlook

Although the world's major economies are not completely synchronized, the general trend of the global business cycle is one of improvement. In fact, global recession risks are lower and near-term global momentum is more favorable than at any point since 2010. Europe remains in a favorable early-cycle recovery, Japan enters 2014 in a solid mid-cycle expansion, and an improving employment outlook in the U.S. supports a potential modest mid-cycle acceleration next year. While China and several other large emerging markets continue to display late-cycle dynamics, developing economies as a group have stabilized, with their export sectors aided by improved demand in the developed world. The pace of global growth remains relatively slow, but the world economy enters 2014 on reasonably sound footing.

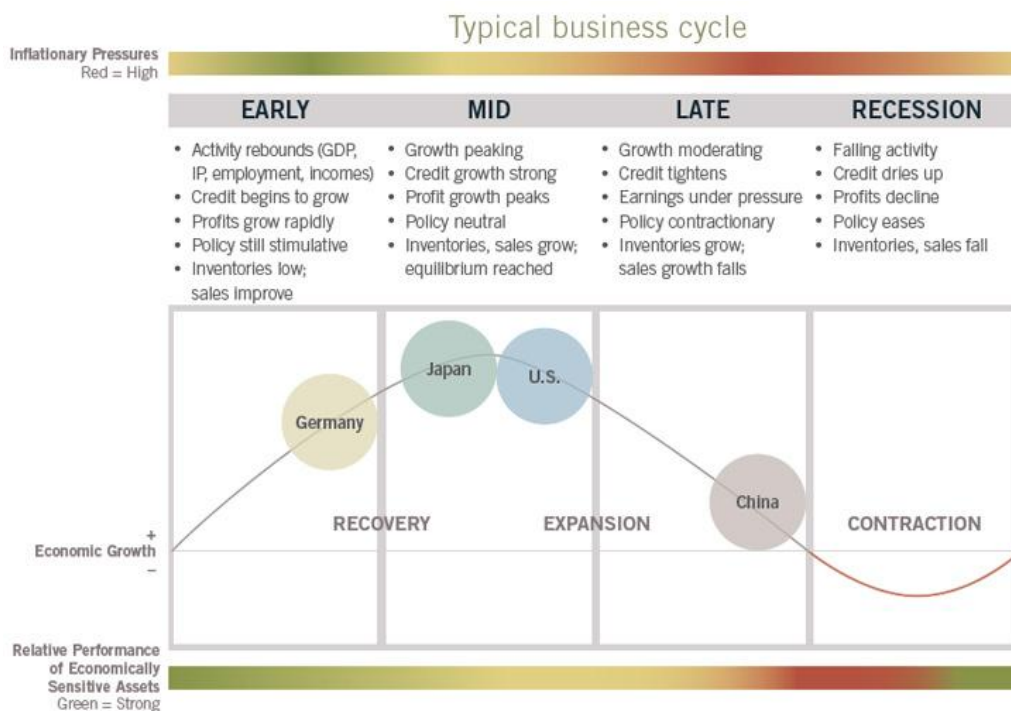
There are, however, several risks on the horizon that increase the likelihood of higher market volatility during the first half of 2014. Equity markets in advanced economies have experienced significant gains in 2013 with little volatility, benefiting from high liquidity, low inflation, and improving economic data. After these relatively uninterrupted gains, markets may be more susceptible to a disruption, and there are a number of potential catalysts that could upset this benign trend, including:

- **Tapering of QE.** We believe current trends in U.S. employment and global growth, as well as the Fed's apparent desire to downplay quantitative easing in favor of forward guidance, make it likely bond purchase tapering will begin in the coming months. This action will be a positive acknowledgement of more sustainable growth trends, but it will result in lower dollar liquidity globally, causing a tightening that could affect asset categories such as emerging-market bonds that have benefited from this easy-money policy.
- **Liquidity challenges in China.** China's policymakers are attempting to balance the desire to maintain stable growth with the need to tame the rapid credit expansion that is raising risks within its financial system. China's dwindling current account surplus has left it more reliant on short-term capital inflows from abroad than is generally recognized, such that any tightening in global liquidity conditions (possibly as a result of Fed tapering) could create tightening pressures and more volatility in China's outlook.
- **Sustainability of Japan's expansion.** Japan's economic acceleration during 2013 was largely a product of accommodative fiscal and monetary policies, the latter of which helped devalue the yen and boost exports and corporate earnings. In April 2014, a rise in the sales tax is likely to cause consumer spending to plunge temporarily, which may severely challenge the momentum of the broader economy. An economic slowdown may create yet another risk for Asian demand, and may spur volatility in Japan's large government-bond markets.

As a result, we enter 2014 with a favorable outlook toward more economically sensitive asset classes such as stocks, based on the improving global business cycle backdrop. However, we anticipate the following conditions for next year:

- **Being more nimble may be advantageous.** The prospect for greater market volatility, even without dramatic changes in the underlying business cycle, may reward tactical maneuvers during the year.
- **Countries with steadier outlooks may offer better risk-adjusted returns.** Developed markets generally remain in a less perilous stage of the business cycle, and the U.S. in particular appears to be in the midst of a stable (if unspectacular) upward trend. By and large, economies that experienced a financial crisis and since deleveraged (e.g., the U.S. and much of Europe) offer lower-risk backdrops than those that have seen rapid increases in credit and real-estate booms in recent years (e.g., China, Hong Kong, Canada, and Australia). While the upside to the U.S. equity market may be less attractive than a year ago due to fuller valuations, the U.S. may offer a more favorable risk-reward proposition.
- **A spike in interest rates is unlikely.** Although anticipation of Fed tapering may create some upward pressure on U.S. bond yields, greater market volatility and the potential for a risk-off move could reverse that trend. Return potential for bonds remains relatively muted, but high-quality fixed-income exposure could offer an important diversification benefit as 2014 unfolds.
- **Commodity disinflation may continue.** A range-bound outlook for commodity prices, with potential downside primarily from demand risk, suggests that entities benefiting from muted inflation—such as the U.S. consumer—may provide better relative opportunities in 2014.

China remains in the late cycle, while developed economies generally occupy more favorable phases of the business cycle, with Germany progressing further into the early cycle, and Japan and the U.S. firmly in the mid-cycle phase.



Note: This is a hypothetical illustration of a typical business cycle. There is not always a chronological progression in this order, and there have been cycles when the economy has skipped a phase or retraced an earlier one. Economically sensitive assets include stocks and high-yield corporate bonds, while less economically sensitive assets include Treasury bonds and cash. 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).