2019 Outlook: Maturing Cycle Heightens Uncertainties

Policy crosswinds add to potential volatility.

Dirk Hofschire, CFA l Senior Vice President, Asset Allocation Research
Lisa Emsbo-Mattingly l Director of Asset Allocation Research
Jacob Weinstein, CFA l Research Analyst, Asset Allocation Research
Cait Dourney, CFA l Research Analyst, Asset Allocation Research

Key Takeaways

- Global growth remains positive but has become more uneven, which is likely to continue to stir up market volatility.
- China has entered a growth recession and policymakers face a variety of challenges that make it more difficult to incite a sustained reacceleration.
- U.S. recession risks remain low, but late-cycle conditions are likely to prevail in 2019.
- The policy backdrop is likely to become more uncertain and less favorable in 2019, with monetary headwinds rising and trade policy remaining a source of uncertainty.
- Consistent with a maturing business cycle, asset-class patterns may become less reliable, warranting smaller cyclical tilts and a prioritization on portfolio diversification.

As we projected one year ago, 2018 will go in the books as the year the markets began to transition away from the low-volatility, mid-cycle environment that had generally persisted for several years (see *Leadership Series* article "2018 Outlook: Global Expansion to Continue, but Markets Likely More Volatile"). In 2019, further maturing in the U.S. and global business cycles is likely to heighten uncertainties and keep investors guessing about which of a variety of crosswinds will gain the upper hand.

Within that context, here is our outlook for major market themes in 2019 and their asset allocation implications.

Fidelity INVESTMENTS®

More uneven global growth

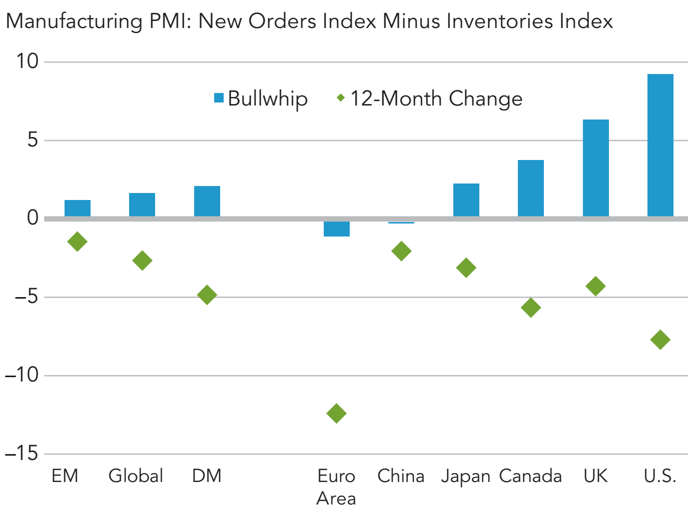
- The synchronized upswing in global trade and industrial activity has given way to a more uneven environment that is likely to persist in 2019.
- Global growth remains positive, but the growth rate has passed its peak and the outlooks for major economies are more varied.
- Industrial bullwhips (leading indicators of manufacturing activity that measure the difference between new orders and inventories) have declined materially over the past year, remaining solidly positive in North America while dipping negative in the Euro Area and China (Exhibit 1).

China slipped into a growth recession in late 2018 and its policy-easing measures so far seem insufficient to sustain a reacceleration.

- Chinese policymakers are caught in a difficult balancing act, facing weak growth but not wanting to over-stimulate after a decade-long credit boom that left private sector debt at worrisome levels.
- The mixed signals of more prudent debt management and growth stimulus have blunted the transmission mechanism for monetary policy easing, leaving credit growth stagnant (Exhibit 2).
- Policymaking challenges are further complicated by U.S. monetary tightening and uncertainty around U.S.-China trade policy.

EXHIBIT 1: Global manufacturing remains in expansion, but the outlook has deteriorated.

Global Manufacturing Bullwhips



Source: Institute for Supply Management, Markit, Haver Analytics, Fidelity Investments (AART), as of Nov. 30, 2018.

EXHIBIT 2: Monetary policy easing has not yet translated into faster credit growth.

China Credit Growth

Source: People's Bank of China, Haver Analytics, Fidelity Investments (AART), as of Oct. 31, 2018.

Late-cycle conditions in the U.S.

After a mid- to late-cycle transition phase over the past year, late-cycle dynamics are likely to dominate the U.S. landscape as we enter 2019.

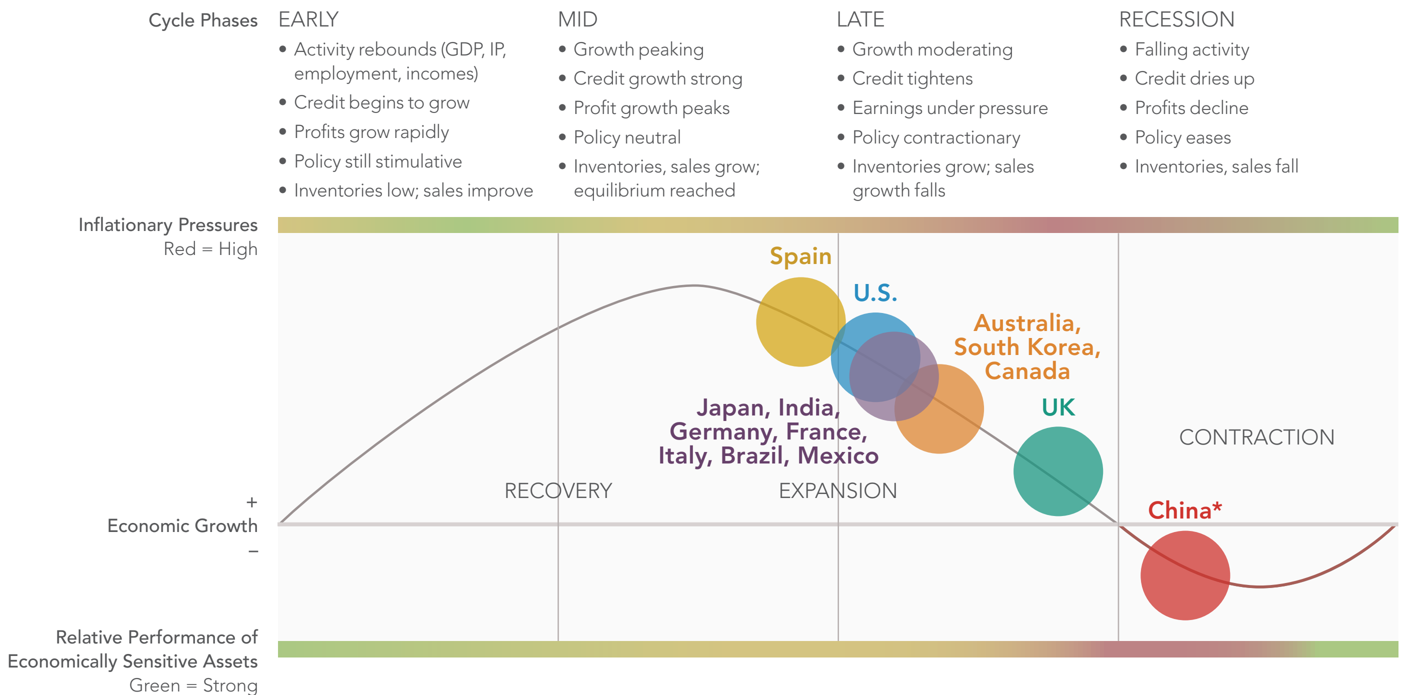
- Recession risks remain low, with U.S. consumers continuing to benefit from improved job conditions and repaired balance sheets.
- Tighter labor markets continue to put upward pressure on wages, which serves as a headwind for corporate profit margins and a motivation for the Federal Reserve (Fed) to focus on removing accomodation (Exhibit 4, page 4).
- Corporate profitability and cash flow should remain sturdy in 2019, but the pace of earnings growth will likely decelerate materially in the face of slower global growth, lower oil prices, a stronger dollar, and the fading impact of the 2018 tax cuts.

Policy crosswinds add to potential market volatility

While the Fed's rate hikes receive the most attention, the dominant policy theme for financial markets is the switch to global quantitative tightening that has reduced global liquidity growth.

EXHIBIT 3: The U.S. and global business cycles are maturing, and China has entered a growth recession.

Business Cycle Framework



The diagram above is a hypothetical illustration of the business cycle. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one. * A growth recession is a significant decline in activity relative to a country's long-term economic potential. We use 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 most for asset returns. We use the classic definition of recession, involving an outright contraction in economic activity, for developed economies. Source: Fidelity Investments (AART), as of Nov. 30, 2018.

- Major central bank balance sheets grew by nearly $2 trillion in 2017, a tremendous liquidity tailwind spurred by quantitative easing in Europe and Japan.
- In 2018, the Fed's balance sheet wind-down and the ECB's taper brought liquidity growth to near zero by the end of the year, and further reductions will turn this to an outright liquidity headwind in 2019 (Exhibit 5).

Overall, a relatively constructive policy backdrop for U.S. assets in 2018 is likely to become more uncertain and less favorable in 2019.

- The U.S. corporate and economic backdrops will likely continue to receive support from deregulatory policies and fiscal stimulus, but the one-time boost to corporate profit growth from tax cuts will continue to fade (Exhibit 6, page 5).
- The impact of global quantitative tightening and Fed rate hikes may move from a normalization phase to a more outright monetary headwind.
- U.S. trade policies are likely to continue to be a source of uncertainty for both businesses and financial markets and exacerbate late-cycle pressures on inflation and profit margins.

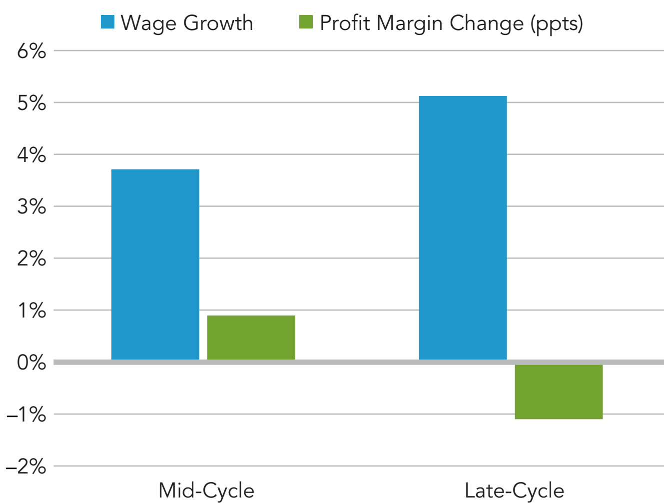
Asset allocation implications

The sum total of the major macro trends described above is likely to be elevated uncertainty and potentially higher market volatility throughout 2019.

- The net trend appears to be an accumulation of headwinds, but there is tremendous uncertainty around crosscurrents and timing. Meanwhile, low

EXHIBIT 4: Higher wage growth in the late-cycle phase often pressures corporate profit margins.

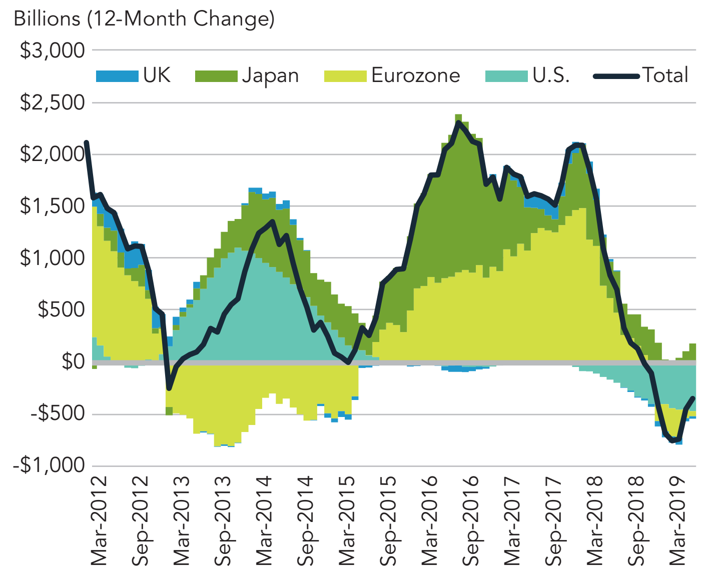
Wage Growth and Profit Margins in the Cycle (1950-2015)



Wage growth: average hourly earnings for production and non-supervisory employees since 1966. Profit margins for all private non-financial corporations in U.S. GDP calculations. Ppts: percentage points. Profit margin change: the median percentage-point change of non-financial corporations' after-tax profit margins for historical mid- and late-cycle periods. Profits sourced from National Income and Product Accounts (NIPA). Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Haver Analytics, Fidelity Investments (AART), as of Sep. 30, 2018.

EXHIBIT 5: Central bank liquidity will turn negative in Q1 2019, and may contribute to elevated market volatility.

Fed, ECB, BOJ, BOE Balance Sheets



Estimates for 2019 include the following assumptions: Fed to roll off balance sheet assets by lesser of stated caps or total bonds maturing each month; ECB and BOE to maintain constant balance sheets in 2019; BOJ to purchase at annualized rate of average purchases over last 12 months. Source: Fed, Bank of England (BOE), European Central Bank (ECB), Bank of Japan (BOJ), Haver Analytics, Fidelity Investments (AART), as of Nov. 30, 2018.

recession risk implies it's too early to have high conviction in extremely bearish scenarios.

- Overall, our expectation is for this late-cycle environment to provide a less favorable risk-return profile for asset markets than during recent years.
- The historical business cycle road map suggests that relative performance among asset classes is much less consistent during the late cycle compared with the mid cycle.
- This implies less confidence that riskier assets such as equities will outperform more defensive assets like investment-grade bonds, due to their lower historical frequency of outperforming during the late cycle (Exhibit 7).
- For a more detailed description of the late-cycle playbook, see *Leadership Series* article "Investing Strategies for a Maturing Business Cycle."

A maturing business cycle may influence relative asset performance patterns and can be used to help create portfolio tilts over the intermediate term, but it's important to remember that cyclical allocation tilts are only one investment tool.

- Any adjustments should be considered within the context of long-term portfolio positioning, driven by the risk-return objectives of the overall investment strategy.
- Understanding the dynamics of a maturing business cycle may help investors manage and monitor risks, but cyclical tilts are typically not effective tools for rapid market timing or making wholesale changes to a portfolio.
- At this point, smaller cyclical tilts are warranted and diversification should be prioritized—stick closer to strategic portfolio weights (long-term asset allocation mix).

EXHIBIT 6: Policy may provide less of a tailwind in 2019.

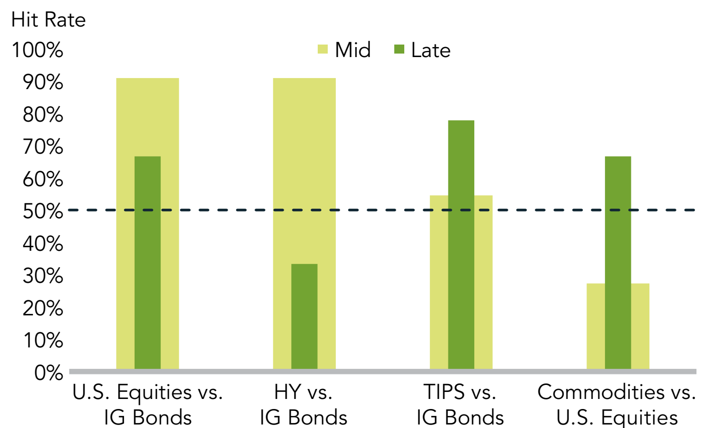
Economic Policy Scorecard

	2018	2019	Potential Trend Change
Deregulation	+	+	
Tax cuts	+++	+	Fading effect
Fiscal spending	+	+	
Monetary policy		–	From normalization to tightening?
Trade	–	– –	From small headwind to bigger one?

Source: Fidelity Investments (AART), as of Sep. 30, 2018.

EXHIBIT 7: Late-cycle playbook: less consistent patterns for riskier assets; inflation protection helpful.

Relative Asset Performance by Cycle Phase (1950–2015)



Past performance is no guarantee of future results. HY: high yield. IG: investment grade. Hit Rate: frequency of an asset class outperforming another. Results are the difference between total returns of the respective periods represented by indexes from the following sources: Fidelity Investments, Morningstar, and Bloomberg Barclays. Fidelity Investments source: proprietary analysis of historical asset class performance, which is not indicative of future performance, as of Sep. 30, 2018.

Authors

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

Lisa Emsbo-Mattingly | Director of Asset Allocation Research

Jacob Weinstein, CFA | Research Analyst, Asset Allocation Research

Cait Dourney, CFA | Research Analyst, Asset Allocation Research

The Asset Allocation Research Team (AART) conducts economic, fundamental, and quantitative research to develop asset allocation recommendations for Fidelity's portfolio managers and investment teams. AART is responsible for analyzing and synthesizing investment perspectives across Fidelity's asset management unit to generate insights on macroeconomic and financial market trends and their implications for asset allocation.

AART Research Analyst Ryan Carrigan and Research Associate Tyler Earle also contributed to this article. Fidelity Thought Leadership Vice President Christie Myers provided editorial direction.

Unless otherwise disclosed to you, any investment or management recommendation in this document is not meant to be impartial investment advice or advice in a fiduciary capacity, is intended to be educational, and is not tailored to the investment needs of any specific individual. Fidelity and its representatives have a financial interest in any investment alternatives or transactions described in this document. Fidelity receives compensation from Fidelity funds and products, certain third-party funds and products, and certain investment services. The compensation that is received, either directly or indirectly, by Fidelity may vary based on such funds, products, and services, which can create a conflict of interest for Fidelity and its representatives. Fiduciaries are solely responsible for exercising independent judgment in evaluating any transaction(s) and are assumed to be capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies.

Information presented herein is for discussion and illustrative purposes only and is not a recommendation or an offer or solicitation to buy or sell any securities. Views expressed are as of December 2018, 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.

Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk. Nothing in this content should be considered to be legal or tax advice, and you are encouraged to consult your own lawyer, accountant, or other advisor before making any financial decision.

Fixed income securities carry inflation, credit, and default risks for both issuers and counterparties.

Although bonds generally present less short-term risk and volatility than stocks, bonds do contain interest rate risk (as interest rates rise, bond prices usually fall, and vice versa) and the risk of default, or the risk that an issuer will be unable to make income or principal payments. Additionally, bonds and short-term investments entail greater inflation risk—or the risk that the return of an investment will not keep up with increases in the prices of goods and services—than stocks. Increases in real interest rates can cause the price of inflation-protected debt securities to decrease.

Stock markets, especially non-U.S. markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Foreign securities are subject to interest rate, currency exchange rate, economic, and political risks, all of which are magnified in emerging markets.

Investing involves risk, including risk of loss.

Past performance is no guarantee of future results.

Diversification and asset allocation do not ensure a profit or guarantee against loss.

All indices are unmanaged. You cannot invest directly in an index.

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

The Chartered Financial Analyst (CFA) designation is offered by the CFA Institute. To obtain the CFA charter, candidates must pass three exams demonstrating their competence, integrity, and extensive knowledge in accounting, ethical and professional standards, economics, portfolio management, and security analysis, and must also have at least four years of qualifying work experience, among other requirements.

If receiving this piece through your relationship with Fidelity Institutional Asset Management® (FIAM), this publication may be provided by Fidelity Investments Institutional Services Company, Inc., Fidelity Institutional Asset Management Trust Company, or FIAM LLC, depending on your relationship.

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

If receiving this piece through your relationship with Fidelity Clearing and Custody Solutions® or Fidelity Capital Markets, this publication is for institutional investor or investment professional use only. Clearing, custody, or other brokerage services are provided through National Financial Services LLC or Fidelity Brokerage Services LLC, Members NYSE, SIPC.

© 2018 FMR LLC. All rights reserved.

869946.1.0