A feature article from our U.S. partners

Business Cycle Update

For Now, the Risks of Trade Protectionism Are Offset by Global Reacceleration

Global equities and inflation-resistant assets favored, though smaller asset allocation tilts warranted

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Key Takeaways

- The global economic upturn has become increasingly synchronized during the past several months.
- The U.S. economy continues to experience a mix of mid- and late-cycle dynamics with a low risk of recession.
- The new Trump administration's more confrontational approach to trade relationships raises protectionist risks for the global economy and financial markets.
- An outright trade war between the U.S. and China could be devastating, but more nuanced policy changes would have varying impacts across a variety of countries, sectors, and companies.
- Relative to U.S. stocks, international equities offer cheaper valuations, currencies that are generally undervalued relative to the U.S. dollar, and some emerging markets that are in more attractive earlier phases of the business cycle.

The global economy entered 2017 on solid footing, with U.S. investor optimism high for pro-growth regulatory and tax policy changes from the new government in Washington. However, the risks of greater protectionism have risen with the ascension of Donald Trump to the U.S. presidency. This article investigates how these risks affect the outlook for the business cycles and financial markets in the U.S. and other countries.

Trade policy risks loom over global landscape

China and the U.S. at the epicenter of trade risk

Early statements from the Trump administration suggests a more confrontational approach to trade relationships, raising the prospects of policies that could inhibit global trade. In particular, China has been cited as a target for new U.S. measures due to its large trade surplus with the U.S. and perceived questionable commercial practices.

Over the long term, trade generally raises productivity potential because it facilitates international diffusion of knowledge and technology transfer, allows local companies to access global markets and benefit from economies of scale, and forces greater specialization by exposing firms to more intense competition. In the short

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term, an abrupt disruption of trade flows can create a negative cyclical shock to global growth.

From a systemic standpoint, a protectionist shock would likely reverberate throughout the global economy more easily if it was transmitted through a country or region of great importance to global trade. Using the strength of bilateral trade connections to display the global trade network, China and the U.S. are squarely at the center of the global system (see Exhibit 1). This centrality implies greater interdependence with the system overall. A trade war between China and the U.S. would be a worse-case scenario, a potentially devastating blow for global trade that might be powerful enough to provoke a global recession.

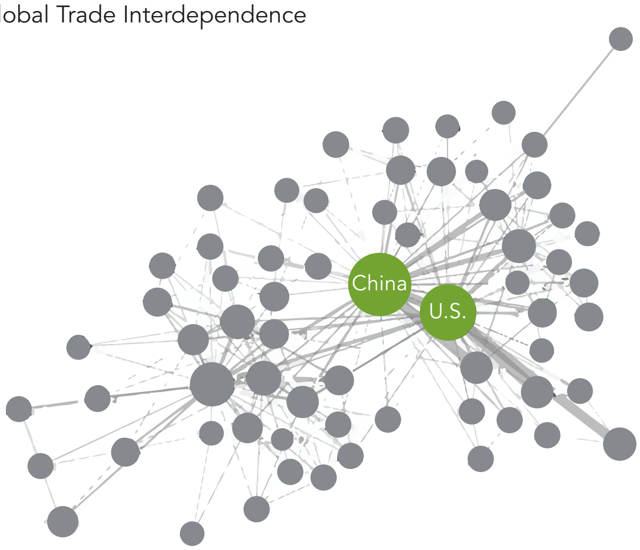
Winners and losers if protectionist risks continue to rise

Even if there is no explicit trade war, the creeping rise of protectionism has begun to impact the global economy and the financial markets. During the past several decades, rising globalization has facilitated free trade and cross-border flows of capital and labor. Most countries, including the vast majority of the world's major economies, experienced an increase in trade openness. While this generated benefits for the global economy, it also had negative by-products and created relative winners and losers across countries, industries, and companies. If protectionism rises, entities most at risk include:

- **Export-oriented economies:** Countries most dependent upon exports as a primary source of growth would be directly and negatively impacted by import tariffs or other protectionist policies. In particular, smaller open economies may have more at stake (e.g., Asian Tigers such as South Korea, European exporters such as the Netherlands), while larger, more closed economies (e.g., U.S., Brazil, India) may be relatively

EXHIBIT 1: The U.S. and China stand at the center of global trade.

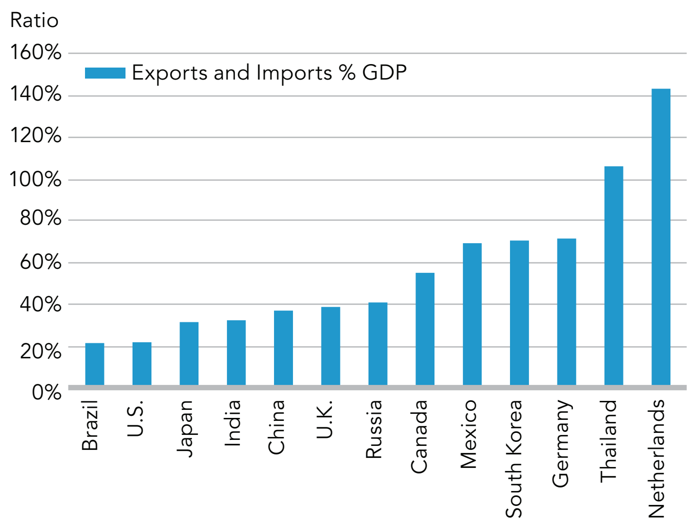
Global Trade Interdependence



The size of the circles represents total trade. The thickness of lines represents the volume of trade flows. Grey circles represent other countries. Source: International Monetary Fund, Haver Analytics, as of Dec. 31, 2015.

EXHIBIT 2: Protectionist trade policies could hurt smaller open economies and some emerging markets.

Trade Openness by Country



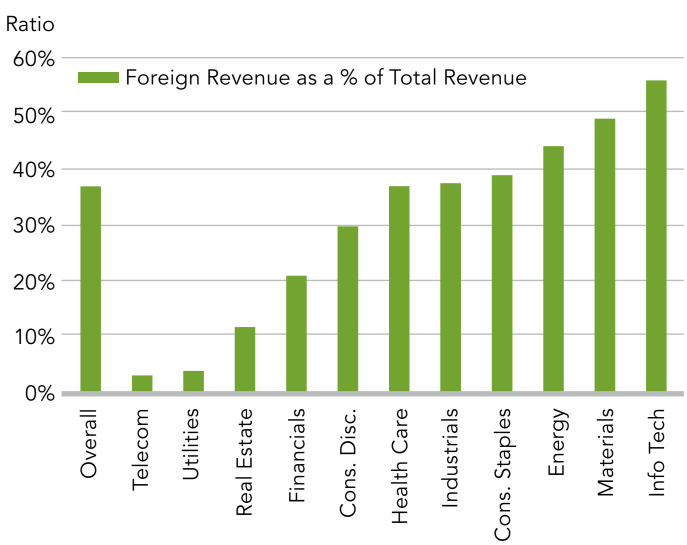
Source: World Bank, Haver Analytics, Fidelity Investments (AART), as of Dec. 31, 2015.

more insulated from protectionist trade pressures (see Exhibit 2). Emerging markets that have benefited from developed-country demand for manufactured goods over the past few decades, such as Mexico and China, may be more squarely in the crosshairs of U.S. policymakers, while commodity exporters may be somewhat more insulated due to the relatively less elastic nature of these goods.

- **Industries with foreign revenue exposure:** Within economies, industries that are more exposed to global trade have more to lose from protectionist policies. For example, half of the revenues for the U.S. information technology sector come from abroad. The utilities and financials sectors, however, earn 80%-100% of their revenues domestically, and are less likely to be impacted by anti-trade policies (see Exhibit 3).
- **Multinational companies with global supply chains:** Even within an industry, some companies are more externally-oriented in their businesses than others. Larger, multinational companies are more likely to sell goods abroad and be dependent on access to foreign markets. Many have global supply chains that could be disrupted by measures to discourage offshore production, which may also pressure profit margins by raising labor costs. Smaller companies tend to be more domestically oriented, and would be more insulated from protectionist measures.
- **Consumers and businesses reliant on imports:** As companies took advantage of cheaper labor abroad in recent decades, U.S. consumers and businesses benefited from less expensive imported goods. If more restrictive trade policies were to make imported goods costlier, it would at least initially put upward pressure on the prices of consumer goods.

EXHIBIT 3: Industries more exposed to global trade have more to lose from protectionist policies.

U.S. Company Foreign Revenue Exposure



S&P 500 company data. Source: FactSet, Fidelity Investments (AART), as of Dec. 31, 2016.

There is a wide range of potential changes to trade policies, and it is too early to know how the Trump administration will proceed and what the results may be. Given the interconnected nature of the global economy, the potential impact of greater restrictions will be a risk across a variety of economic and market sectors.

Tax policy changes may be aimed at trade, and could affect the U.S. dollar

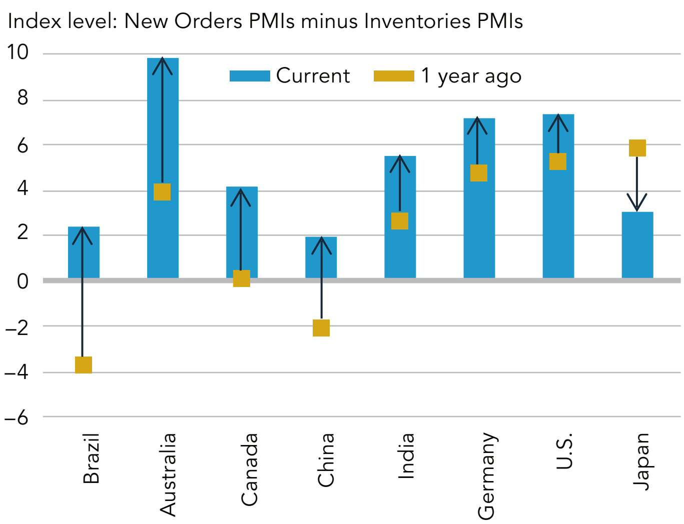
A change to U.S. tax policy is another possible way to attempt to influence trade flows. Both the administration and the GOP Congress have highlighted corporate tax cuts and reform as ways to incentivize U.S. businesses to import less, export more, and increase onshore production. While it's too early to know what form such tax policy changes may ultimately take, certain changes could put upward pressure on the U.S. dollar as a result of less demand (either real or perceived) for foreign currency to buy imported goods. For example, the border adjustment tax, included in the House GOP tax proposal, theoretically stimulates an upward adjustment in the currency that may match the size of the tax incentive. Thus, a policy-induced stronger U.S. dollar looms as a risk for U.S. investors in international equities.

Despite risks, global cyclical acceleration has become more synchronized

Although trade policies represent a risk to the economic outlook, the global expansion continues to gain traction and provides fundamental support for the outlook for international equities. Around 75% of the world's largest countries' leading economic indicators are rising on a six-month basis, up from 40% one year ago.[1] The lagged effects of China's 2016 stimulus-induced reacceleration are showing up in global trade and industrial data, as well as the recovery in global commodity prices. Purchasing manager surveys show positive bullwhips (i.e., new orders less inventories) in around 80% of the world's largest countries, almost all of which have risen during the past year (see Exhibit 4). Low interest rates, accommodative

EXHIBIT 4: Most countries manufacturing sectors have improved and signal continued expansion.

Country Bullwhips



PMI: Purchasing Managers' Index. Source: IHS Markit, Institute for Supply Management, Haver Analytics, Fidelity Investments (AART), as of Dec. 31, 2016.

global monetary policies, and the shift to easier fiscal stances remain generally supportive of growth. Global economic growth remains slow, but cyclical traction keeps the odds of global recession low.

A closer look at business cycles around the world

The global economy's cyclical acceleration has been driven by the collective economic influences of multiple countries. The following commentary provides some insight into the business cycles of the world's major economies (see Exhibit 6).

United States

- **Consumers support continued expansion:** Favorable employment conditions contributed to a significant amount of tightening in the labor markets. Hiring has remained solid, albeit at a slower pace than last year, and wage growth continues to accelerate. These trends are consistent with historical late-cycle dynamics. Consumer sentiment has improved post-election, particularly for consumers who don't possess a college degree,[2] but has yet to translate into an acceleration of consumer spending. *Tight labor markets and rising income suggest that the U.S. consumer is providing a solid foundation for continued U.S. expansion.*
- **Inflation is accelerating:** As we have expected for several quarters, continued wage growth—along with higher oil prices—is generating a meaningful rise in inflation in early 2017. Prices paid by the manufacturing sector have surged to their highest level since 2011[3] and commodity prices for consumers are rising on an annual basis for the first time in more than two years.[4] In response, the Treasury market's long-term inflation expectations have drifted above 2%. *With core inflation firm and oil prices poised to rise above early-2016 trough levels, headline inflation could approach 3% by the end of the first quarter of 2017.*

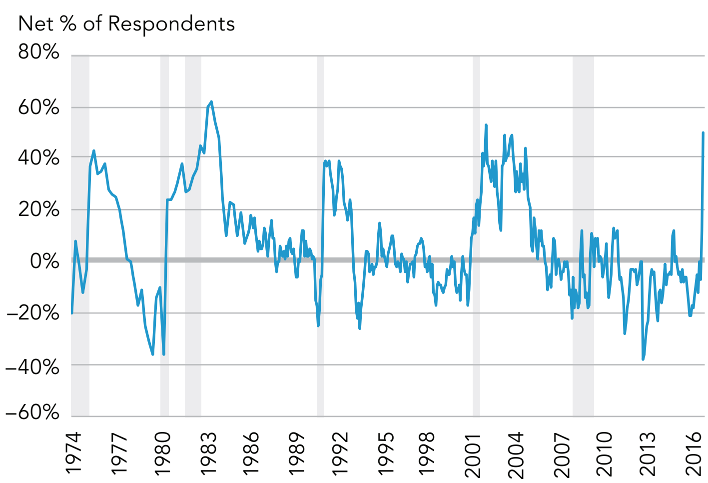
- **Mixed outlook for business sector:** The U.S. business sector is experiencing a mix of mid- and late-cycle dynamics. The manufacturing sector continues to reaccelerate in tandem with the global expansion. However, the upside potential for earnings growth is limited by rising corporate profit margin pressures from both accelerating wages and rising interest expense.[5] Small business sentiment has surged on hopes of deregulation and other policy changes (see Exhibit 5), which have the potential to spur a recovery in business investment if they come to fruition. *The corporate sector is boosted by the global industrial recovery and optimism about policy changes, although a maturing cycle is likely to cap the potential upside.*

China

The Chinese economy continues to experience an early-cycle recovery on the back of an industrial recovery boosted by last year's dramatic increase in government stimulus. Manufacturing PMIs have remained in expansion for six consecutive months, but further acceleration may be limited as policymakers have already reined in support for the housing market. The rise in short-term interbank rates and the renewed pressure on capital outflows reflect continued risks to China's overleveraged corporate sector, but policymakers thus far have appeared willing and able to calm financial conditions when necessary. China remains in an early-cycle phase, but typical early-cycle upside may be absent given continued industrial overcapacity and an overextended credit boom.

EXHIBIT 5: The economic expectations of small businesses have surged to a 15-year high.

Share of Independent U.S. Businesses Expecting Economy to Improve



NFIB: National Federation of Independent Business. Shading represents U.S. economic recession as defined by the National Bureau of Economic Research (NBER). Source: NFIB, NBER, Haver Analytics, Fidelity Investments (AART), as of Dec. 31, 2016.

Europe

The Euro Area remains in a mature and somewhat sluggish mid-cycle expansion phase. As global trade reaccelerates along with Asian growth, both the German industrial and service sectors are the healthiest they have been during this cycle. The outlook for the greater Euro Area, however, remains mixed amid still-elevated unemployment in the periphery and the potential for political risk to weigh on sentiment. Several major 2017 elections in core countries and the uncertain outcome of the U.K. leaving the European Union may pose risks, but overall, Europe's cyclical expansion remains steady.

Brazil

Brazil is in the early-cycle recovery phase, though some leading indicators have stagnated amid heightened political uncertainty. Growth should be helped by falling inflation and easing monetary conditions.

India

India's underlying mid-cycle trends remain positive despite the recent decision to discontinue widely utilized large-denominated bank notes as legal tender. The demonetization has had some negative effects on the industrial and consumer sectors, but positive cyclical tailwinds are still dominating.

Japan and South Korea

Both countries have experienced positive spillover effects from large-trading partner China, which has helped lower recession probabilities. The cyclical paths of these countries are heavily dependent on China's growth trajectory.

Canada and Australia

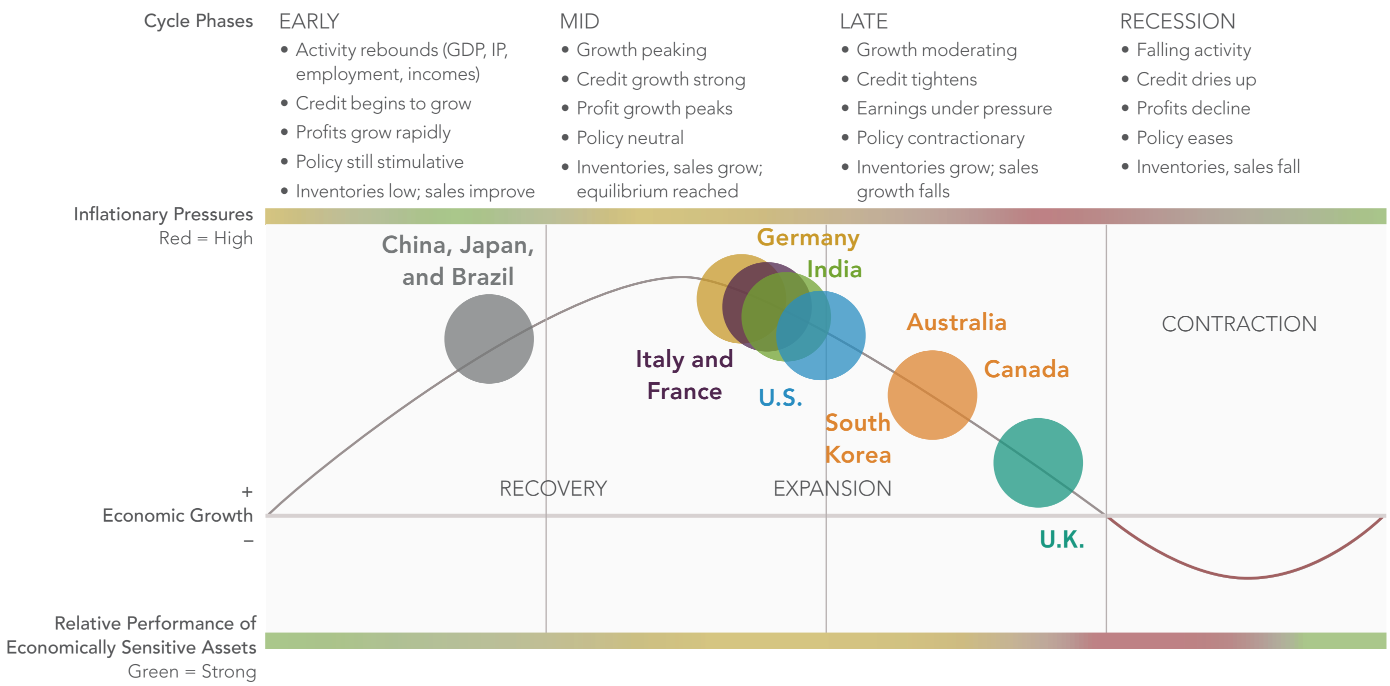
Both countries remain in late-cycle phases with potentially peaking housing markets. The rise in commodity prices has helped reduce the probability of these countries entering recession.

Asset allocation implications

In the aftermath of the U.S. election, asset performance and conventional wisdom suggested that new U.S. policies would raise growth relative to the rest of the world, boost the U.S. dollar, and damage the prospects of emerging markets via trade protectionism. Our view is that while such scenarios are plausible, the rapid market response priced in a much higher probability than warranted. In contrast, we believe the global economic upturn is becoming more synchronized, with some emerging markets in more attractive earlier phases of the business cycle than the United States. In addition,

EXHIBIT 6: The world's largest economies are in expansion, though at various phases of the business cycle.

Business Cycle Framework



Note: 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. Please see endnotes for a complete discussion. Source: Fidelity Investments (AART).

international equities have cheaper valuations than U.S. stocks, and the U.S. dollar is now fully or over-valued relative to many currencies on a fundamental basis.

On an asset allocation basis, we continue to favor global equities. However, smaller asset allocation tilts are warranted due to the advanced stage of the U.S. business cycle, the wide distribution of policy outcomes, and rising geopolitical risk. As the U.S. proceeds further toward the late-cycle phase, exposure to inflation-resistant assets may become even more valuable to provide portfolio diversification.

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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 employs a multi–time-horizon asset allocation approach that analyzes trends among three temporal segments: tactical (short term), business cycle (medium term), and secular (long term). This monthly report focuses primarily on the intermediate-term fluctuations in the business cycle, and the influence those changes could have on the outlook for various asset classes.

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Endnotes
[1] Source: OECD, Foundation for International Business and Economic Research (FIBER), Haver Analytics, Fidelity Investments (AART), as of Nov. 30, 2016.

[2] Source: University of Michigan, Haver Analytics, Fidelity Investments (AART), as of Jan. 13, 2017.

[3] Source: Institute for Supply Management, Haver Analytics, Fidelity Investments (AART), as of Dec. 31, 2016.

[4] Source: Bureau of Labor Statistics, Haver Analytics, Fidelity Investments (AART), as of Dec. 31, 2016.

[5] Source: Bureau of Economic Analysis, Haver Analytics, Fidelity Investments (AART), as of Sep. 30, 2016.

The Business Cycle Framework depicts the general pattern of economic cycles throughout history, though each cycle is different; specific commentary on the current stage is provided in the main body of the text. In general, the typical business cycle demonstrates the following:

During the typical early-cycle phase, the economy bottoms out and picks up steam until it exits recession then begins the recovery as activity accelerates. Inflationary pressures are typically low, monetary policy is accommodative, and the yield curve is steep. Economically sensitive asset classes such as stocks tend to experience their best performance of the cycle.

During the typical mid-cycle phase, the economy exits recovery and enters into expansion, characterized by broader and more self-sustaining economic momentum but a more moderate pace of growth. Inflationary pressures typically begin to rise, monetary policy becomes tighter, and the yield curve experiences some flattening. Economically sensitive asset classes tend to continue benefiting from a growing economy, but their relative advantage narrows.

During the typical late-cycle phase, the economic expansion matures, inflationary pressures continue to rise, and the yield curve may eventually become flat or inverted. Eventually, the economy contracts and enters recession, with monetary policy shifting from tightening to easing. Less economically sensitive asset categories tend to hold up better, particularly right before and upon entering recession.

Index definitions
A Purchasing Managers' Index (PMI) is a survey of purchasing managers in a certain economic sector. A PMI over 50 represents expansion of the sector compared to the previous month, while a reading under 50 represents a contraction, and a reading of 50 indicates no change. The Institute for Supply Management® reports the U.S. manufacturing PMI®. Markit compiles non-U.S. PMIs.

The Consumer Price Index (CPI) is a monthly inflation indicator that measures the change in the cost of a fixed basket of products and services, including housing, electricity, food, and transportation.

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