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Virus threatens global economic outlook

Late-cycle positioning remains appropriate as COVID-19 clouds outlook.

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Key takeaways

Dramatic market volatility has been accompanied by a combination of open-ended uncertainty surrounding the spread of the coronavirus and a vulnerable late-cycle backdrop.

The virus outbreak is both a supply and demand shock that adds a significant near-term headwind to global growth.

The US is destined for a near-term slowdown, and we are watching US leading indicators closely to ascertain how sustained and significant the impact is likely to be on the US economy.

We expect additional US and global policy stimulus, although monetary easing won't resolve the underlying disruption problems while the virus is still spreading.

Consistent with our outlook over the past 18 months, we expect the late-cycle environment to continue to provide more volatility that warrants a prioritization of portfolio diversification.

In February and early March, the spread of the coronavirus precipitated a sharp drop in the stock market and a historical plunge in bond yields. The question now is whether this is a short-term disruption or if it will lead to a lasting downshift in the global business cycle.

Entering 2020, the global cycle reflected hopeful signs of stabilization in trade and industrial activity after an 18-month downturn.

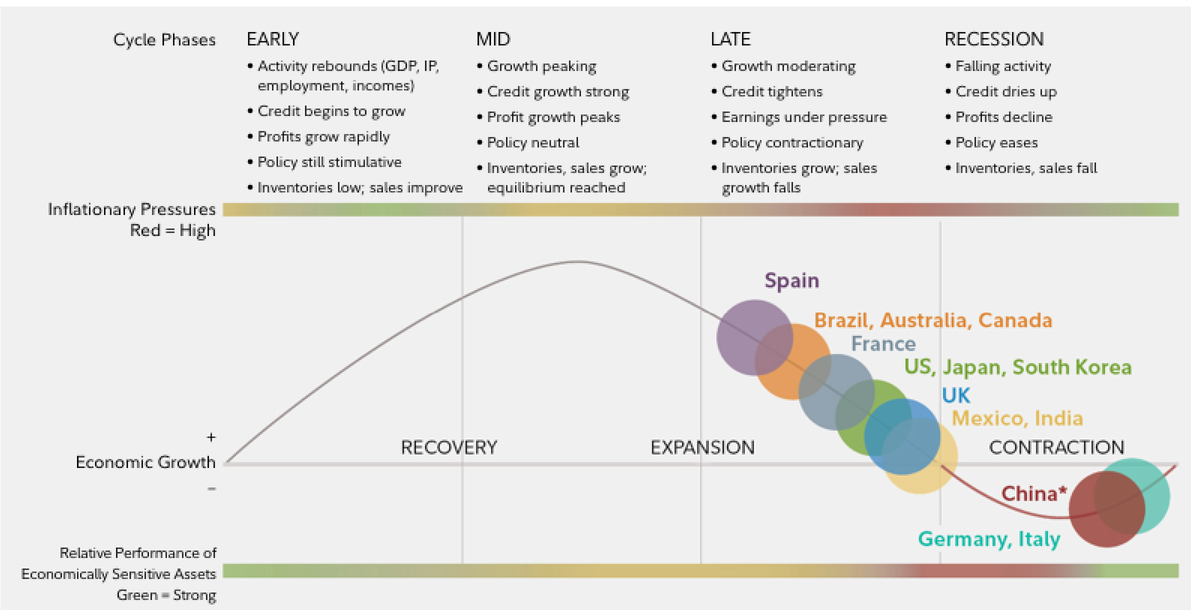
Hints of improvement in China and Germany bolstered the potential for a moderate recovery in global manufacturing.

The US late-cycle expansion continued, with near-term recession risks appearing relatively low.

Feedback

Heading into 2020, most global economies were already in mature stages of expansion; the spread of COVID-19 represents a significant near-term headwind

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 (Asset Allocation Research Team), as of February 29, 2020.

The coronavirus outbreak in China—and its subsequent spread throughout the world—is both a supply and demand shock that adds a significant near-term headwind to global growth.

There remains tremendous uncertainty about the virus, including how exactly it is transmitted and how far it will spread.

Thus far, it is clear the severe clampdown in China alone can have negative repercussions for global economic activity.

On the demand side, China is the world's second-largest economy and biggest consumer of commodities, implying weaker demand for industrial commodities as well as a litany of capital and consumer goods that is likely to result in rising global inventories.

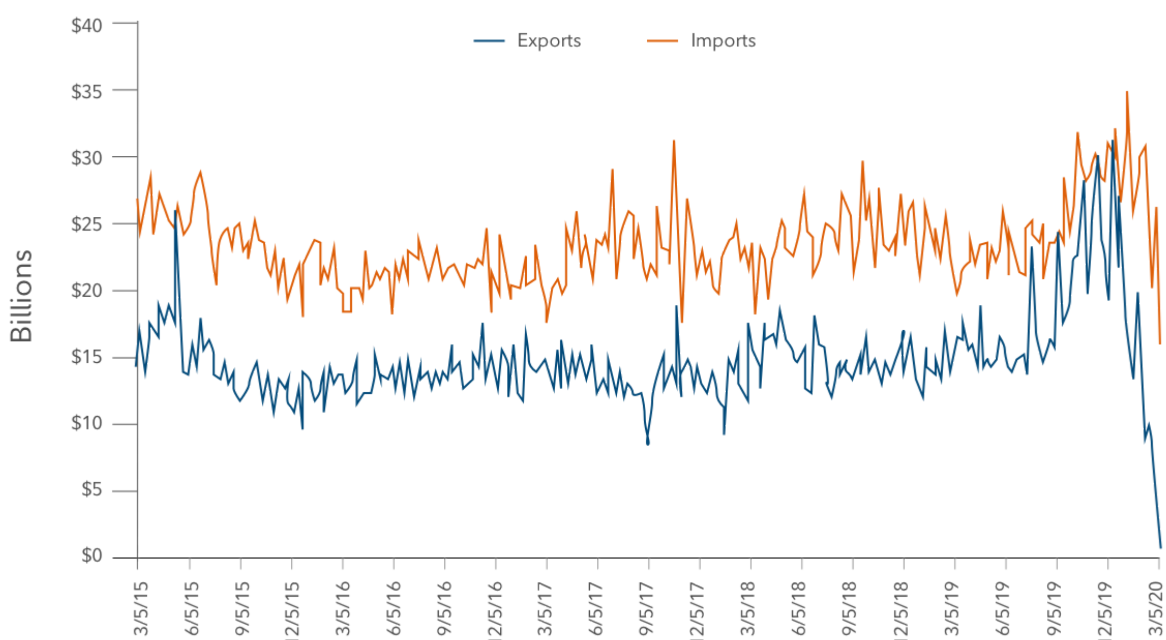
On the supply side, the integrated nature of China's factories points to significant disruptions in global supply chains for everything from consumer electronics to intermediate inputs for manufacturing production in other countries.

The virus outbreak in other major economies such as South Korea, Japan, and Italy is decimating global travel and exacerbating these supply and demand trends.

It is likely that China's economy and global industrial data will demonstrate extreme weakness over at least the next month or two.

Import and export activity has declined sharply amid the outbreak of the coronavirus

Weekly US port activity



Source: US Customs and Border Protection, Bloomberg Finance L.P., Fidelity Investments (AART), as of March 5, 2020.

We're watching US leading indicators closely to ascertain the significance of impact on the US economy.

Tight labor markets, challenged profit margins, and a flat yield curve already provided the US with a late-cycle backdrop.

Severe near-term disruption in US manufacturing and retail goods markets is likely, as bills of lading for imported goods have plummeted over the past month amid China's shutdown.

US exports will likely suffer as well due to weaker worldwide demand and significant global supply-chain disruptions.

Credit conditions remained reasonably favorable to begin 2020, but we're watching corporate-bond spreads, bank lending standards, and other indicators to gauge whether a typical late-cycle tightening phase is taking shape.

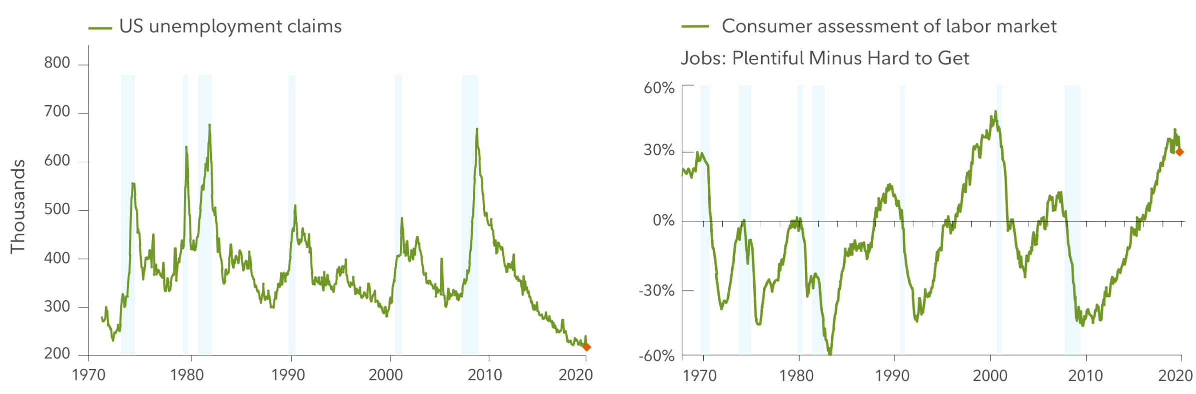
US labor markets remain tight, but leading indicators have been more mixed.

Initial unemployment claims are extremely low and have yet to show signs of rising.

Falling job openings and deteriorating consumer attitudes about the labor-market outlook point to a potential peak in employment markets.

As businesses face tight profit margins and greater uncertainty about the outlook for global growth, the employment decision—whether to hire less or lay workers off —is the epicenter of potential risk for the US economy.

Initial unemployment claims remain at extremely low levels, but consumer attitudes about the job market have deteriorated over the past 6 months



Shading represents US economic recession as defined by the National Bureau of Economic Research (NBER). Source: US Department of Labor, NBER, The Conference Board, Haver Analytics, Fidelity Investments (AART), as of February 29, 2020.

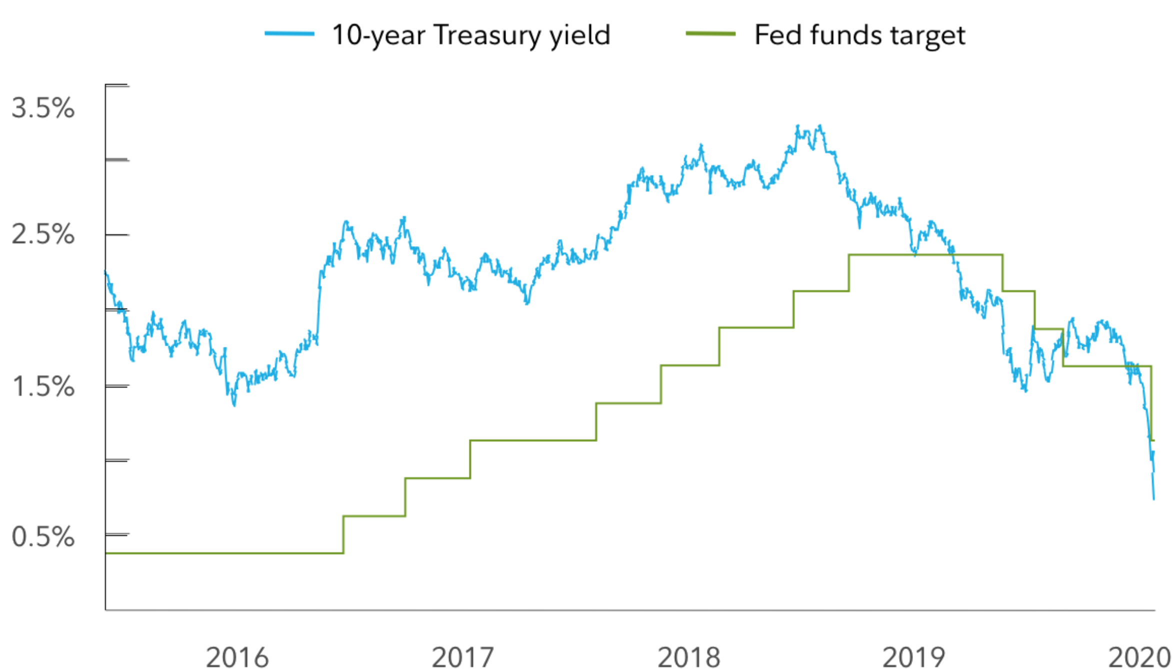
There has been a growing worldwide policy response to attempt to counteract the economic damage precipitated by the virus outbreak.

- China introduced targeted fiscal and monetary stimulus, debt repayment relief for businesses, and other measures.
- The US Federal Reserve (Fed) cut its short-term interest rate by half a percentage point—an act of extraordinary intra-meeting monetary easing.
- Low rates and stimulus efforts will have only a limited impact on economic activity in the near term, as anti-virus measures (e.g., restricted travel and limitations on group activity) blunt their efficacy.
- Monetary easing can mitigate liquidity challenges and ameliorate headwinds. However, monetary easing was already experiencing a diminished ability to stimulate the real economy even before the virus outbreak. Further, monetary (and even fiscal) easing won't resolve the underlying disruption problems as long as the virus continues to spread.

Feedback

In an effort to stem the economic impact of the virus, the Fed cut its benchmark rate in early March; long-term US Treasury yields also recently fell to historic lows

Federal funds target rate and 10-Year Treasury yield



Source: Bloomberg Finance L.P., Fidelity Investments (AART), as of February 29, 2020.

Late-cycle asset allocation positioning remains appropriate in this highly uncertain environment.

Consistent with our outlook over the past 18 months, it is likely that the late-cycle environment will continue to provide more volatility and a less favorable risk-return profile for asset markets.

Since the beginning of this late-cycle phase, US stocks have now underperformed bonds, underscoring that asset return patterns tend to be less reliable and volatility typically rises during the late cycle.

We continue to believe this environment warrants smaller cyclical tilts and prioritization of diversification, including exposure to non-US equities and inflation-sensitive assets that have more attractive valuations.

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