



Market Analysis, Research & Education

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Soft Patch: Pause or Sign of Things to Come?

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At the beginning of May, the market abruptly shifted away from the pattern that had prevailed over the previous seven months. Riskier assets declined as stock markets dropped around the world, with the heaviest losses in emerging markets. Commodities from oil to silver experienced steep declines, and the dollar rallied against most foreign currencies. Treasury bond yields fell, and high-quality bond returns outpaced those of high-yield corporates.

Part of this move was likely due to technical factors and the normal ups and downs of market movements. After seven months of strong gains in commodity prices, stocks, and foreign currencies, these markets were probably overdue for some investor profit-taking and a pause in momentum.

Economic data has softened

Part of the explanation for the market reversal also lies in the underlying fundamentals of the global economy. Nearly two years after the end of the recession, it is still difficult for the overall trend in the world economy to run too hot or too cold in the aggregate. There has been too much monetary stimulus – low interest rates and high liquidity – not to have pushed prices and inflation expectations up from low levels, particularly in commodity markets where marginal prices are driven by demand in the fastest-growing

developing economies such as China and India. On the other hand, much of the developed world has been too weak for the global economy to overheat, with low wage growth in the U.S., Europe, and Japan ensuring that inflationary pressures did not break out into spiraling prices.

Most recently, economic data has broadly indicated decelerating economic activity – similar to what occurred at this point in 2010. In the U.S., leading indicators of economic activity have slowed, resulting in fewer positive economic surprises than during late 2010 and early 2011. In April, fewer than 4 of the 10 indicators that comprise the Conference Board's leading economic index strengthened on a one-month basis, down from 7 out of 10 in March and the lowest percentage since 2009. Housing activity remains moribund, while higher gasoline prices have siphoned off money from consumer discretionary purchases.

The data abroad has similarly softened. Leading economic indicators for developed countries (OECD) have decelerated to relatively low levels, punctuated by weakness in the UK and peripheral Euro-zone. Fiscal austerity programs in the UK, Greece, Portugal, Ireland and Spain have not led to a resumption of growth, leaving the outlook difficult. In Japan, lingering nuclear and other power problems have delayed reconstruction activity that offers hope for a reacceleration (see Exhibit 1, page 2).

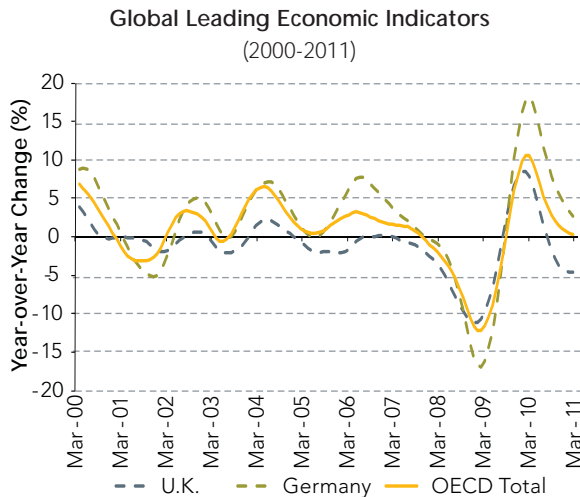
Mid-2010 redux?

The result is a backdrop that looks eerily similar to the one in late-spring 2010, when a growth scare caused a 15% world stock market decline in a swoon that lasted from April to August.¹ Now, as then, leading economic indicators for the U.S. and the developed world have softened. Worries about Greece's precarious sovereign debt position have again dominated the headlines, raising anxieties about the Euro-zone. Also similar is the concern that curtailing the Federal

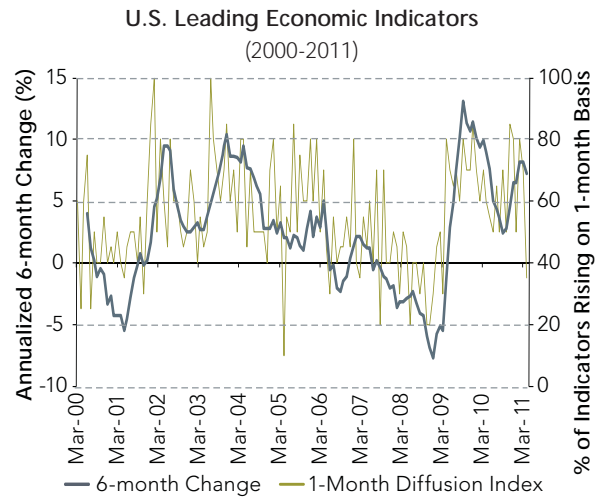
KEY TAKEAWAYS

- The May market reversal away from riskier assets such as stocks and commodities at least partially reflects concerns about decelerating economic growth, similar to the market correction during the spring of 2010.
- This soft patch suggests heightened risks to the global economic expansion, though cooling in commodity prices may provide a positive offset that could help make any slow-down transitory.

EXHIBIT 1:
Leading economic indicators in developed economies have decelerated in recent months, though activity remains solid in the U.S.



Source: Organization for Economic Cooperation and Development (OECD), Haver Analytics, FMRCo. (MARE) as of 5/20/11.



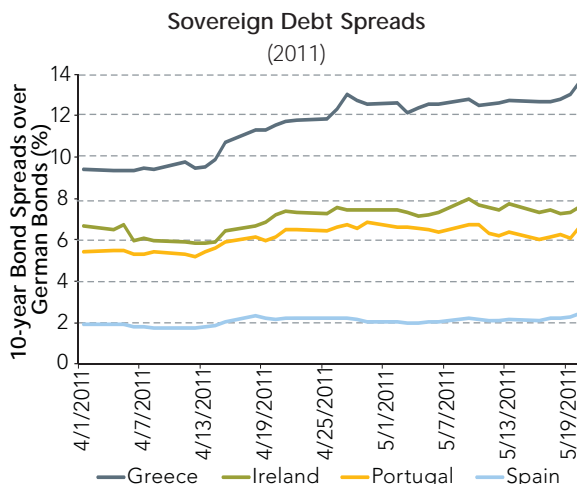
Source: The Conference Board, Haver Analytics, FMRCo. (MARE) as of 5/20/11.

Reserve's extraordinary monetary easing (first quantitative easing last spring and QE2 today) may leave the U.S. economy without enough juice to power through. Of course, the world bounced back after the soft patch and market correction in mid-2010. The Fed instituted a new round of quantitative easing, Euro-zone concerns faded from the front page, and the U.S. and global economies reaccelerated, leading to the sharp rally in riskier assets.

Will the markets follow a similar pattern this time? So far, there is some basis for hope that the current soft patch may not be as severe as in mid-2010. Greek debt

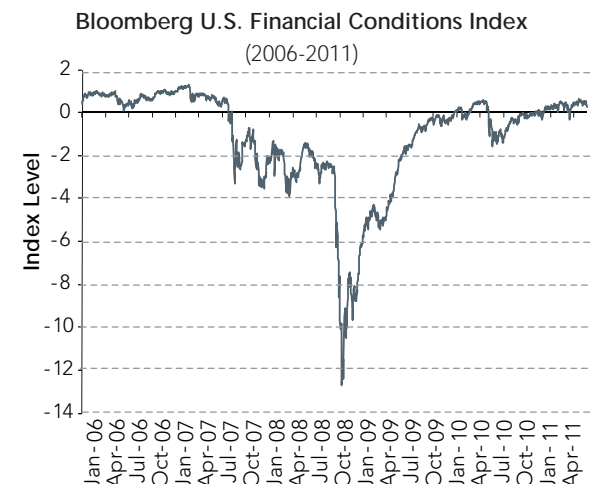
restructuring rumors have failed to produce the same widespread financial contagion that occurred last year. U.S. financial conditions have not deteriorated as much, since corporations have continued to find funding cheap and plentiful. Despite distress in the Greek debt markets, larger Euro-zone periphery countries such as Spain have not seen borrowing costs rise through the first few months of 2011, although growing anxieties in recent days have pushed up Spanish bond yields in an increasingly worrisome trend (see Exhibits 2 and 3). In addition, the magnitude of the U.S. economic deceleration may be less severe: 70% of leading economic indicators are still higher than they were

EXHIBIT 2: Distressed conditions in Greece had limited impact on other Euro sovereign countries until recently, when borrowing costs for Spain have risen.



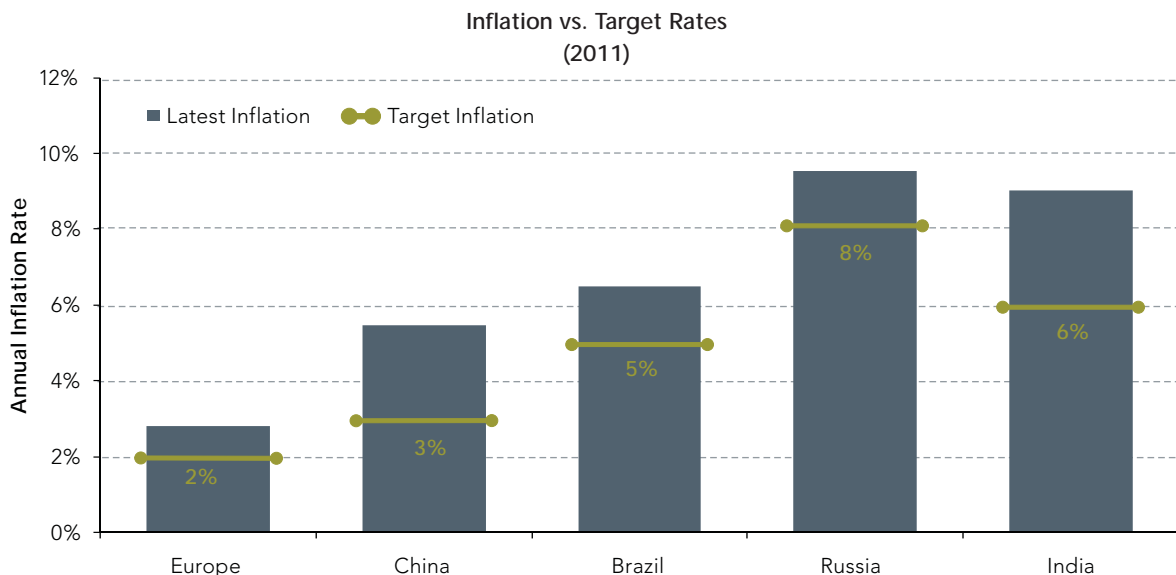
Source: Source: Financial Times, Haver Analytics, FMRCo. (MARE) as of 5/20/11.

EXHIBIT 3: So far, there has been little financial contagion in the U.S., where borrowing conditions remain favorable.



Source: Bloomberg, FMRCo. (MARE) as of 5/20/11.

EXHIBIT 4: Inflation rates in many countries remain higher than central-bank targets, implying that more rate hikes are likely in emerging economies in the months ahead.



Source: Haver Analytics, Country statistical organizations, FMRCo (MARE) as of 4/30/11. India inflation data as of 3/31/11.

six months ago.ⁱⁱ Initial unemployment claims could have exaggerated the weakness in the labor markets caused by weather effects and Japanese supply-chain disruptions. The pace of manufacturing has remained solid, though cooling slightly over the past month, and recent declines in oil prices should take some pressure off consumers. While an additional round of quantitative easing from the Federal Reserve is unlikely, the Fed has clearly indicated that it has no imminent plans to tighten either by shrinking its balance sheet or raising interest rates, which implies that relatively supportive monetary conditions should continue.

On the other hand, perhaps the biggest difference between today and one year ago is that many of the world's fastest growing economies in the developing world are now in a later stage of the economic cycle, with rising inflationary pressures and tightening monetary policies. The largest of these, China, has experienced slowing in its leading indicators, including softening money growth and bank lending. The good news is that the breadth of emerging-market growth remains solid: more than 70% of countries continue to show improvements in their leading economic indicators.ⁱⁱⁱ With inflation still running above the maximum rates targeted by most central banks, however, tightening in China and many other emerging economies is

likely to persist (see Exhibit 4). Managing a soft landing amid high commodity prices and domestic imbalances will be a challenge, which makes the medium-term outlook for global growth less certain.

Investment implications

The risks to the global economic outlook have clearly risen so far in 2011. Crucial factors to monitor are whether the deterioration in European credit markets will begin to contaminate U.S. financial conditions, in addition to signs of slowing in China that may raise the risk of a hard landing. With many more uncertainties – political noise surrounding the U.S. debt ceiling, potential instability in the Middle East, and the end of QE2 – it may be difficult for riskier asset categories to find their footing in the near term. However, the silver lining of recent market activity is that cooling commodity prices may provide relief from the inflationary and anti-growth pressures that had been building for several months. If this trend continues, it could keep interest rates low, which would benefit bond markets. This could also renew the solid backdrop for U.S. stock prices in particular, where strong corporate fundamentals, supportive credit markets, and steady (albeit slow) repair in the economy have provided an auspicious environment for more economically sensitive asset prices. ■

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The Conference Board Leading Economic Indicators (LEI) is a composite of 10 leading indicators designed to signal peaks and troughs in the business cycle. The weighted LEI Index gives each component a certain weight based on the perceived importance as a leading indicator. The LEI Diffusion Index measures the proportion of the components that are rising to those that are falling.

The Bloomberg Financial Conditions Index combines yield spreads and indices from the Money Markets, Equity Markets, and Bond Markets into a normalized index. The values of this index are z-scores, which represent the number of standard deviations that current financial conditions lie above or below the average of the 1992-June 2008 period.

[i] The Morgan Stanley Capital International (MSCI) All Country World Index (ACWI) fell 15% from 4/15/2010 to 5/25/2010. Source: FactSet, FMRCo. (MARE) as of 5/23/11.

[ii] Source: The Conference Board, Haver Analytics, FMRCo. (MARE) as of 5/20/11.

[iii] Includes Turkey, South Africa, Brazil, India, Indonesia, Russia, China, Czech Republic, Slovakia, Hungary, South Korea, Malaysia, Mexico, Poland, Thailand, and Taiwan. Source: Haver Analytics, FMRCo (MARE) as of 3/31/11.

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