Slowdown or recession?
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Recession risks rise, though mid-cycle slowdown may be the most likely scenario.

The U.S. debt-ceiling debate and government credit rating downgrade have dominated recent headlines. But it’s the deterioration in the eurozone and the outlook for the global economy that have likely provided a more fundamental impetus for the dramatic sell-off in worldwide stock markets. The risks of worldwide recession have risen in recent days, and the trajectory of the financial markets likely depends in large part on how damaging these developments have been to the underlying trends in the global economy.

Turmoil dampens already slowing global economy

Recent financial turbulence—including the eurozone debt crisis, the U.S. credit downgrade, and the worldwide stock market sell-off—has raised the risks to the U.S. and global economic outlooks. Here in the U.S., the economy is perhaps more susceptible than usual to a stock market reversal. Stock losses create a negative wealth effect that disproportionately impacts higher income U.S. households, which have accounted for the bulk of consumer spending growth during the economic recovery. In addition, the U.S. corporate sector has been a key bright spot for the economy. Falling stock prices could inhibit business confidence, potentially delaying further employment gains.

Overseas, the near-term risks to some regions may be even greater than in the U.S. The eurozone sovereign debt crisis has contributed to rising risk aversion in global credit markets. Even more fundamentally, the crisis has reinforced the increasingly weak outlook for European economic growth. Europe accounts for roughly one-fifth of the global economy. Weaker European demand will likely further damage already decelerating export growth in Asia and other regions. China's economy has moderated substantially in recent months amid significant monetary tightening. A slowdown in exports raises the near-term risks of a hard landing there. Japan has been unable to fully regain its footing after its nuclear and natural disasters. With Europe, China, and Japan accounting for 50% of non-U.S. economic activity, the world’s three largest economies outside the U.S. may be stalling.1

There are silver linings

There are, however, some positive offsets resulting from recent events, which are mostly associated with taming of some the same headwinds that helped create the growth deceleration to begin with.

First, commodity prices have declined substantially, with crude-oil prices falling nearly 30% from their peak in the spring.2 This provides a significant boost to real consumer incomes, particularly to struggling low- and middle-income U.S. households that have cut back on discretionary spending to fund gasoline purchases in recent months. Lower commodity prices also provide relief to business profit margins, and generally reduce the cost pressures that have pushed up headline inflation rates around the world.

Second, such obvious growth concerns and lower inflationary pressures are likely to effectively end the current round of global monetary tightening. Freed from inflation concerns, emerging markets including China, Brazil, and India, along with a few healthy developed economies such as Australia, have the wherewithal to end their recent tightening cycles. Perhaps they will even provide additional monetary or fiscal stimulus. Europe and the U.S. are clearly more constrained in their policy responses because of fiscal limitations and other factors. Even here, monetary policies still have the potential to become more accommodative.

Highlighted by political inertia and the inability to grapple with government debt problems, the sovereign policy risks in Europe and the U.S. are unlikely to be resolved overnight. Thus they continue to be dark clouds that may overshadow these silver linings. Yet amid widespread investor perceptions that U.S. and European policymakers have appeared largely ineffective in restoring confidence, there is a low bar for policy expectations. At the same time, financial markets are sending the clearest signals since late 2008 that more forceful and coherent action must be taken. In this environment, any progress on fiscal and sovereign policies in the
U.S. or Europe could be a positive surprise.

**Muddle-through economic scenario still appears most likely**

The outlook has become cloudier, and the psychological impact of severe financial turbulence is always difficult to gauge. Nevertheless, my assessment is still that the U.S. economy has a higher probability of remaining in a mid-cycle slowdown than heading to an imminent recession. As events continue to be fluid, I am monitoring the following key areas that could change that outlook.

**Leading indicators not in danger territory**

U.S. leading indicators have yet to deteriorate to a level consistent with impending recession (see chart below). U.S. GDP growth did fall close to a stall speed during the first half of 2011, decelerating during the second quarter to less than 2% on a year-over-year basis. Such a low growth rate has often preceded recessions in recent decades. During June, however, five of the components of the Conference Board’s leading economic indicators index remained positive on a six-month basis. This is more consistent with a mid-cycle slowdown. Every recent recession was preceded by a period when no more than two leading indicators pointed up.

![Leading Economic Indicators (1959-2011)](chart)

**Some transitory weakness dissipating**

Several indicators may have been temporarily depressed by transitory developments during the second quarter. This suggests the potential for improvement during the third quarter. Real consumer spending slumped to nearly flat growth in the second quarter as households paid more for gasoline and other goods with higher prices. Falling commodity inflation may restore some stability in consumer spending patterns. Industrial production, particularly in auto manufacturing, looks to pick up after the disruptions created by the Japanese supply chain problems.

**Some areas not yet deteriorating**

Several areas of the economy have yet to exhibit the severe deterioration typically associated with a pre-recession decline. These are the areas to watch in the weeks ahead.

First, steadily rising initial unemployment claims have traditionally been one of the best leading indicators of every recession since 1959. Since reversing their downward trend and rising to a peak of 440,000 claims in mid-May, new claims have declined in recent weeks to 400,000. This level is widely associated with net employment creation (see chart below).
Second, the Bloomberg Financial Conditions Index, a broad barometer of conditions in credit and other financial markets, has deteriorated markedly but remains, as of August 8, much closer to the levels of the mid-2010 market correction than the 2008 financial crisis (see chart below).
Third, corporations posted operating earnings growth of 12% in the second quarter, despite meager U.S. economic results. Slowing global economic activity will undoubtedly take an even greater toll on profits during the second half of 2011, but profit growth is far from recessionary territory. And corporations have proven adept at maintaining profitability in a weak economic climate. Although corporate earnings guidance deteriorated dramatically in July, negative guidance remains far below levels previously associated with negative profit growth in outright earnings recessions (see chart below).
Investment implications

The recent financial turmoil has prompted negative headlines about U.S. government debt. Yet the U.S. Treasury bond market has resumed its role as a beneficiary of the global flight to safety. Bond prices have risen and 10-year Treasury yields have dropped to their lowest levels since late 2008. By contrast, the worsening outlook for global growth has caused stocks, commodities, and other riskier asset categories to suffer the brunt of the fallout.

Severe, sustained bear markets (stock market declines of 20% or more) have historically coincided with recessions in economic activity and in corporate earnings. Of the 14 U.S. bear markets since 1926, 10 have been accompanied by recessions in both the economy and earnings (described as negative year-over-year profit growth). The four bear markets that did not coincide with economic and profit recessions tended to be less severe, averaging a 26% decline compared to the 44% average for recessionary bear markets (see chart right). While economic uncertainty and financial volatility are likely to remain high, earnings and economic recessions in the U.S. are not foregone conclusions. This implies that the degree of fundamental economic and corporate damage resulting from the current financial turmoil will be a key factor determining the depth of the current market downturn.

Bear markets not accompanied by economic and earnings recessions historically have fallen less than bear markets accompanied by recessions.

Source: Standard and Poor’s, Haver Analytics, Bloomberg, FAM (AART) as of 7/31/11.
The Asset Allocation Research Team (AART) conducts economic, fundamental, and quantitative research to develop dynamic asset allocation recommendations for the Asset Allocation Division of Fidelity Asset Management (FAM).

Views and opinions expressed are as of August 10, 2011 and may change based on market and other conditions.

Investment decisions should be based on an individual’s own goals, time horizon, and tolerance for risk.

**Past performance is no guarantee of future results.**

Investing involves risk, including risk of loss.

Diversification does not ensure a profit or guarantee against loss.

All indices are unmanaged and performance of the indices include reinvestment of dividends and interest income, unless otherwise noted, are not illustrative of any particular investment and an investment cannot be made in any index.

1. Share of global GDP on purchasing-power-parity basis. Source: International Monetary Fund, FAM (AART) as of 4/11/11.

2. Oil prices represented by West Texas Intermediate light sweet crude oil first expiring futures contract price. Source: Haver Analytics, FAM (AART) as of 8/8/11.

3. Source: Bureau of Economic Analysis, Haver Analytics, FAM (AART) as of 6/30/11.

4. Source: FactSet Estimates, FAM (AART) as of 8/8/11.

The S&P 500® Index, a market capitalization-weighted index of common stocks, is a registered service mark of the McGraw-Hill Companies, Inc. and has been licensed for use by Fidelity Distributors Corporation.

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.

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