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5 experts: 2011 outlook

FIDELITY VIEWPOINTS — 12/15/10

Our experts discuss what may shape the markets next year—and opportunities ahead.

Investors were taken on another roller coaster ride in 2010. After a robust beginning, U.S. stocks took a mid-summer swoon on fears of a double-dip recession in the United States and a debt crisis in Europe. Since then, the S&P 500® has bounced back more than 20% from its July lows and is up roughly 10% this year.[1]

But the real star performers in 2010 appear to be emerging markets, as well as commodities and gold. Among the equity sector leaders were consumer discretionary, industrials, and materials.

But what's ahead for 2011?

To answer that question, Viewpoints talked to five of Fidelity's top investment experts. As a group, they're upbeat on the U.S. economy and U.S. equities. Among the areas some find particularly attractive: consumer durables, capital goods, energy, insurance, technology, and small caps. But they are wary about bonds, particularly Treasuries.

- **Economy: "I think 2011 will feel better than 2010,"** by Lisa Emsbo-Mattingly
- **Markets: "The market is running on twin turbos,"** by Jurrien Timmer
- **Stocks: "Small-cap stocks tend to outperform in recoveries,"** by Joel Tillinghast
- **International: "Look for underappreciated stocks... and growth stories,"** by William Bower
- **Fixed Income: "Ratchet down return expectations,"** by Jeff Moore

On the economy:
Lisa Emsbo-Mattingly
Director of research for Fidelity's Global Asset Allocation team

"I think 2011 will feel better than 2010"

Usually when you exit a recession, you have pent up demand for consumer durables—like cars and washing machines—and housing. This is typically one of the first big drivers of a recovery. Not this time. Housing and autos are both well below their 2007 levels. But I believe there may be a silver lining in this slow recovery: consumer demand, rather than coming back with a bang, may have a longer fuse. So, I think 2011 will feel better than 2010—and certainly better than 2009.

Because incomes drive spending, I believe improvements in the labor market are still critical for the economy. Despite a worse-than-expected November unemployment number, we are getting lots of signs of a continued recovery in the job market. Private sector jobs are growing at a rate not seen since 2007. Weekly initial unemployment claims have declined to early 2008 levels according to the Labor Department. Hours worked in nearly every industry are rising rapidly, according to the Bureau of Labor Statistics. In my view, that indicates a building need to hire more workers.

Finally, one of the biggest drags on the labor market, construction and manufacturing, may finally be stabilizing. Over the past three years, the U.S. economy lost more than 7 million jobs. More than half of those jobs were in construction and manufacturing. Over the past year, the job losses in these sectors have slowed or even stopped. Going forward, the recent rise in pending home sales[2] and the continued strength of manufacturing surveys[3] indicate that jobs losses in the worst hit sectors of the economy may be behind us, and we may even see gains in 2011. As these key sectors normalize, I believe we'll continue to turn the jobs and income picture around.

Rebound ahead in hiring, capital spending

I think companies are beginning to realize they're losing business because they've held off hiring for so long. Now, I believe they actually have to push the button and make those hires.

I think the out-performers in this market are going to be companies that can grow their profits through revenues, because the margin expansion that we saw over the last couple of years is behind us. You're not going to get profit growth from cost cutting anymore. I believe the only way for most companies to get profit growth will be to increase top-line revenue. And I believe to grow top-line revenue, companies will need to hire and invest.

"I believe to grow top-line revenue, companies will need to hire and invest."

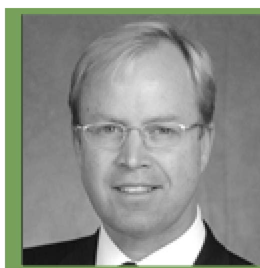
LISA EMSBO-MATTINGLY,
DIRECTOR OF ASSET ALLOCATION RESEARCH

Opportunities from more capital spending and hiring

I anticipate gains in sectors that benefit from this need to hire and invest. Among them: industrial and technology companies, which include everything from truck makers to machinery manufacturers to software developers. Companies that benefit from an improving jobs market – media and telecomm services – also should show good results. Typically at this part of the recovery, some of these sectors are starting to slow. But while we have seen them grow internationally, we're just beginning to see gains domestically.

A higher stock market?

I think that profit growth is going to track gross domestic product (GDP) growth, which is nothing to write home about. But corporate profits are already extremely high; both U.S. total profits and S&P earnings are at or above their 2007 levels. I believe this implies that the market should be trading higher than it is.



On the markets:
Jurrien Timmer
Director of Global Macro and co-portfolio manager of the Fidelity Dynamic Strategies® Fund

"The market is running on twin turbos"

I'm bullish because I see a scenario unfolding over the next six months that echoes that of 2009. Recall that in March 2009, the markets were pricing in Armageddon, a severe depression. Instead, the Federal Reserve intervened on the order of $1.75 trillion in 2009, through its first quantitative easing (QE), and the recovery began. The S&P 500 shot up 80% from its March 2009 low.

Fast forward to 2010. In the spring of this year, fiscal stimulus was on the wane. The rebuilding of inventories, which had helped GDP, had run its course. So these drivers of recovery were ebbing just as the European debt crisis was threatening to spread contagion to the U.S. financial system. We had a mid-cycle slowdown, and the market started to fear a double-dip recession. It was a little like early 2009 though on a more modest scale.

But, as in 2009, the Fed stepped in with QE2 and injected $600 billion into the financial system. Once the Fed signaled this was going to happen, the stock market took off and had its best September since 1939.

A repeat of 2009

I'm looking for this process to continue in the first half of 2011. We're getting an organic economic recovery plus aggressive Fed monetary stimulus. So it's like the market is running on twin turbos.

I'm what I call "risk on" — bullish on traditionally riskier investments like stocks, corporate debt, commodities, gold and silver, non-U.S. dollar currencies and emerging market stocks. I am negative on the dollar and U.S. Treasury bonds.

Exodus from bonds?

Another reason I am bullish for 2011 is that investors might start to think about exiting bond funds. From October 2007 to October 2009 bond funds attracted $650 billion, which is a staggering amount. At the same time, $265 billion has been redeemed from stock funds since the October 2007 high, according to the Investment Company Institute.

With interest rates low, the bond market isn't providing much in terms of returns. Stocks, meanwhile, are up 20% from their July lows and up 10% year to date.[1] If $200 billion to $300 billion leaves the bond market and goes running after stocks, it could send interest rates higher and push up stocks. I don't know if that will happen, but we should not underestimate the impact if it does.

Down on Treasuries, up on corporates, high yield

I divide the bond market into two separate camps. I'm bearish on Treasuries, because the risk is that interest rates will move higher. Still, I am more positive on corporate and high-yield bonds, because an economic recovery should help the corporate side.

Bullish on gold, silver, foreign stocks and currencies

At the same time, I believe the dollar will continue to weaken because of the loose monetary policy being pursued by the Fed, and also by Europe, the UK, and Japan. Many other countries—China, Australia, and Brazil—are actually starting to tighten rates because growth and inflation have picked up.

Since gold and silver are priced in dollars, they will rise as the dollar falls. I would expect non-U.S. securities and non-U.S. currencies may also appreciate, reflecting the dollar's decline. This is why I'm also bullish on those investments.

QE3?

With fiscal stimulus waning, the Fed has to do nearly all the heavy lifting to keep a still fragile organic recovery alive. This reliance on monetary stimulus is actually more pronounced in Europe, where fiscal austerity is causing the European Central Bank to apply all the stimulus. Governments can't do it, because they are cutting spending

This may even play out in the U.S. municipal market, because local governments are facing budget pressures and cutting spending. If I were the Fed, the muni market would seem like an obvious choice to do QE3. But this is entirely my conjecture—the Fed has not said anything about it.

The thing to remember is that so much is at stake for the Fed. It has thrown all its political capital into the fight against recession. So I don't think the Fed is going to just sit there now and let it all its work be destroyed. I think the Fed is going to do whatever it takes to keep the recovery alive, even if it means very unconventional measures.

> "The Fed is going to do whatever it takes to keep the recovery alive."
>
> JURRIEN TIMMER
> DIRECTOR OF GLOBAL MACRO

On Stocks:
Joel Tillinghast
Manager of Fidelity Low-Priced Stock Fund

"Small stocks tend to outperform in recoveries."

In the last two years, demand in the United States has abruptly fallen off a cliff and companies have had to make adjustments in their costs. I've been surprised how fast companies have reacted and how large the cost cuts have been. As a result, profits have bounced back and I think they will probably continue to improve, although at a much slower pace.

When companies feel comfortable enough to invest those earnings back into their businesses, in the way of capital expenditures, demand should return and support top-line growth.

Stocks should trump bonds

With interest rates artificially low, I think stocks are priced to give a better return potential than bonds. In fact, I'm not sure that bonds are priced to give any kind of material return at all. I worry that most categories of fixed income could produce capital losses over the next couple of years. While I think stock returns may not be too exciting in absolute terms, I expect they may look very attractive when compared with those of bonds.

Small-cap stocks have led in recoveries

Historically, small-cap stocks tend to outperform in recoveries because those companies have more volatile business models. Improvements in economic activity generally lead to higher rates of growth in sales and earnings for smaller firms, relative to large companies.

As of November 30, small-cap stocks traded at a premium to large-cap companies based on valuation metrics, such as the price-to–earnings ratio.[4] However, the small-cap universe is quite broad, and I believe there is still an array of good companies trading at attractive valuations.

Avoiding banks, targeting insurance

For several years, I have felt banks were taking on more risky loans and they were getting paid less for them. I'm still concerned about the sector. Since the financial crisis of 2008, the Fed has encouraged banks to hold Treasuries and other lower yielding paper. When interest rates go back up, this could potentially hurt them.

Insurance companies have looked attractive, in my view, because they have fairly good profitability and are selling for less than book value. Most have also written down their non-performing securities, so I don't expect big surprises ahead. What I prefer about insurance companies is that their funding base is more stable than that of banks.

Technology stocks "quite reasonable"

One of the results of a mediocre decade for equities is that stocks that were overpriced in 2000 have tended to become quite reasonable. Among them are technology and high-quality growth companies. Technology services have recurring revenues and may provide more visibility into the future. However, the more cyclical nature of components and hardware may have an advantage now, and some have very compelling valuations.

Upbeat on consumer stocks

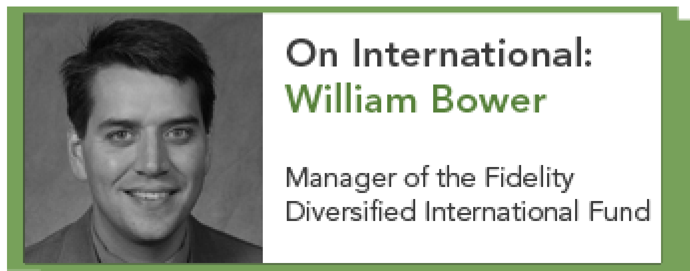
I'm looking for companies that can outgrow their markets and be more profitable than average. So I believe that while consumer spending probably will continue to be somewhat sluggish, some companies appear poised to deliver more profitability than others. I look for companies with strong brands and that exhibit uniqueness against their competitors.

> "I'm looking for companies that can outgrow their markets and be more profitable than average."
>
> JOEL TILLINGHAST
> FIDELITY LOW-PRICED STOCK FUND

A stock-picker's market

It's been a challenging time for stock pickers of late, because almost everything has gone up together. However, looking ahead, I don't think the market will continue to exhibit such high correlations. Once you have more dispersion in returns—when investors start to make the distinction between good companies and bad ones—I

believe the market will favor stock pickers again.



"Look for underappreciated stocks… and growth stories"

Looking at Europe and Japan, developed market economies have some very similar problems to those we are seeing in the United States: slow recovery and slow job growth. While the United States seems to be aggressively trying to restructure its banking system, Europe, in particular, has struggled to produce a concerted response. I think the outlook for developed markets at the moment is challenging.

Globally, the only place that seems to have had meaningful growth recently has been the emerging markets. Brazil, China, and India have shown their mettle despite the broad slowdown in developed market economies. Their domestic economies have grown large enough that they've been able to grow on their own rather than rely solely on exports. It used to be that when the United States slowed down, emerging markets got crushed. That's just not the case anymore.

But there is no free lunch here. You have to look at the valuations. If you want to own growth in emerging markets, you're going to have to pay for it. I wouldn't say it's a crowded trade, but the merits at this point are well known.

From a top-down view, I think the outlook for the United States is marginally better than for other developed nations, but they all face very similar problems. And the emerging markets are a place where you can get growth, but you have to consider the valuations very carefully.

Follow the growth

The valuations are cheapest in those parts of the world where you have the greatest problems-the developed countries. So, if Europe and the United States really improve, if job growth kicks in and the developed world recovers, that's probably a better place to be in terms of investments. On the other hand, if we limp along and have a pedestrian recovery, investors probably want to have some exposure to emerging markets.

BILL BOWER
FIDELITY DIVERSIFIED INTERNATIONAL FUND

I don't know how the recovery will unfold, so I have owned both. I think international investing is like casting a net; it's just a much bigger net.

Think energy, emerging market consumers, technology

There are a couple of long-term investment themes that I find appealing. One has to do with energy. Because oil is one of the few commodities in the world that tends to operate at high capacity utilization, there isn't a lot of excess in the supply chain. As emerging markets grow and develop, I think oil is going to get tighter.

China currently consumes about 13% of the world's oil. But when you look at other commodities, such as copper and iron ore, demand from China can be as high as 50% of the world's total. I think oil may follow that trend. Over the next five to ten years, I believe oil consumption in China could double.

Emerging market demand doesn't just show up in commodities, however. Major consumer product companies have achieved 30% to 40% of their revenues from emerging markets, which is tempering slow growth in developed world markets. I am also interested in technology.

The bottom line

Relative to fixed income, stocks seem like a good position to me, especially if the global recovery is better than expected. When you look at the United States and Europe, I feel valuations are generally inexpensive, particularly when you think of other alternatives like bonds. But I think it's possible to find attractive stocks in both the developed and the emerging markets. I look for underappreciated stocks and companies with compounding growth stories that will be really resilient in challenging economic environments.

"Ratchet down return expectations"

The tepid pace of recovery and low-yield environment should signal investors to consider keeping some cash and liquid short-term securities on the sidelines for future investment opportunities, and to stay well diversified within their fixed income portfolio.

United States: Low rates for the foreseeable future

In the United States, we are seeing positive but slow growth. The consumer has retrenched, and corporate America, while flush with cash, has been reluctant to invest heavily for the future. Meanwhile, durable growth that delivers job creation is difficult to envision in the United States anytime soon.

In this environment, I think the Federal Reserve will stay the course of "low for long," attempting to keep interest rates and bond yields down for the foreseeable future. Because yield makes up a large percentage of a fixed income investment's total return, I believe fixed income investors need to ratchet down return expectations.

A two-speed world

The global economy today is a two speed world. We are seeing growth in emerging economies and slow to no growth in the developed world. In the emerging markets, China, the engine of growth over the past few years, has begun tightening monetary policy to counteract inflationary pressure. The potential of a slowdown in China makes me concerned about the knock-on effects elsewhere, including in commodity-rich countries.

Risks in Europe and emerging markets

On the slow-growth side, the slow pace of growth in Europe is manifesting itself as a factor in the sovereign debt crises. I think many European countries will face significant fiscal retrenchment and labor cost adjustments, which will be painful for labor. If these countries don't address their fiscal problems, the sustainability of the euro may be called into question. In peripheral Europe, there is a clear need to take measures to restructure economies in order to be competitive. Possible scenarios include a debt restructuring that would hurt investor returns. Investors need to be mindful of risk in this sector and, consequently, to realize that current yields may not be sufficient compensation for holding these investments. You may want to consider other options.

The risk of a two speed world is that we drop down to a single speed—slow. I think this could happen for a number of reasons, including a growth shock in China or in other overheating emerging economies. Emerging economies may well have to tighten monetary policy to counter inflationary pressures. A tightening would drive local currency yields higher, reducing the returns to investors in the short term. I don't think the market is pricing in this risk.

Opportunities in high yield, CMBS, corporates

In the current and very likely persistent low-yield environment, I think the highest expected returns for the risk will likely be in shorter-maturity securities. I've been paying lots of attention to shorter securities from various sectors, including U.S. Treasuries, corporate bonds, and commercial mortgage-backed securities (CMBS). The combination of yield and pull to maturity—which is the tendency of a bond's price to move toward its par value as it nears maturity—is a powerful force for affecting returns from these investments.

Looking out for slightly longer-term opportunities over the next 18-24 months, I think high-yield bonds may

JEFF MOORE
FIDELITY INVESTMENT GRADE BOND FUND

potentially be a source of additional yield for investors with a longer horizon and ability to take more risk. This sector has benefited from improved corporate balance sheets and cash flow, and from likely consolidation in the industry. My view that the U.S. economy will grow, albeit slowly, is also supportive. However, these investments aren't without risk. In my view, high-yield valuations are fair today and will not necessarily compensate investors if global growth sags. In a slowing global economy, you may see high-yield bond prices fall, and investors could face losses.

The importance of diversification

I think you may want to view the low-yield environment as a signal to diversify across asset classes and sectors. The many government and market uncertainties and risks that exist can be mitigated and dampened by diversification. It is important to think about investing in shorter-term securities and maintaining liquidity to position yourself for opportunistic return investments, which often become available in this type of market environment. For example, if we see a backup in the spreads or the yield pickup in corporate bonds over Treasuries, that could be an opportunity to add credit exposure as the risk-reward trade-off becomes more attractive.

Related funds

- Jurrien Timmer is co-manager of the Dynamic Strategies Fund (**FDYSX**).
- Joel Tillinghast manages the Low-Priced Stock Fund (**FLPSX**).
- William Bower is portfolio manager of the Fidelity Diversified International Fund (**FDIVX**).
- Jeff Moore is the manager of the Fidelity Investment Grade Bond Fund (**FBNDX**).

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- Use our Portfolio Review to see if your investment mix is in line with your long-term goals.
- Research stock and bond mutual funds.
- Research stock and bond exchange-traded funds (ETFs).

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1. Based on the S&P 500® Index, data through December 9, 2010. The S&P 500 Index is a market capitalization–weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.

2. National Association of Realtors.

3. Institute for Supply Management.

4. As of November 30, 2010, the Russell 2000® Index had a P/E of 18.6, while the Russell 1000® Index (large cap benchmark) was at 15.2.

The Russell 2000 Index is a market capitalization–weighted index of 2,000 small company stocks of U.S.-domiciled companies. The Russell 1000 Index is a market capitalization–weighted index of 1,000 large U.S.-domiciled company stocks.

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In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.) Fixed income securities also carry inflation risk and credit and default risks for both issuers and counterparties. Unlike individual bonds, most bond funds do not have a maturity date, so holding them until maturity to avoid losses caused by price volatility is not possible. Lower-quality debt securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer.

Stock markets, especially foreign markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments.

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The gold industry can be significantly affected by international monetary and political developments.

Because of their narrow focus, sector funds tend to be more volatile than funds that diversify across many sectors and companies. The fund is considered non-diversified and can invest a greater portion of assets in securities of individual issuers than a diversified fund. Thus, changes in the market value of a single investment could cause greater fluctuations in share price than would occur in a more diversified fund.

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