May Market Update Podcast

Schuster: In the most recent month, risk assets, many of which have experienced double-digit gains year-to-date, remain generally positive, despite perceptions of slowing global growth. Indeed, more cyclical areas of investment, such as commodities, posted weaker returns as hopes of a more robust recovery in emerging market economies disappointed investors.

Hello, I'm Lars Schuster, institutional portfolio manager with Fidelity Strategic Advisers, Incorporated. Welcome to the Fidelity investment insight podcast series. To help us understand the current market environment, I'm joined today by Dirk Hofschire, senior vice president of Asset Allocation Research with Fidelity Investments. Welcome to the program, Dirk.

Schuster: Please review the last month here in the markets, April 2013.

Hofschire: Sure. The last few weeks have generally been pretty calm. We've had low volatility and generally positive results out of many asset categories. So some of the leaders so far in 2013: Japanese stocks have continued to go up. We've also seen a slight decline in interest rates from where we were a month or two ago, so many bond categories have turned positive recently for the year as well. And we still do have those laggards, and they tend to be more tied to the global economy, things like commodities, things like emerging market stocks. But overall, we've had a pretty calm back drop here and fairly solid investment results so far.

Schuster: Well, let’s go back to the beginning of the year.

Individuals, I think, generally felt like the U.S. economy was expanding; sentiment was improving; housing was doing well; and some of that perception is that the US economy may be a bit weaker, now. Is this true or is it just misperception?

Hofschire: I think the tone of the numbers has been softer here recently, and part of that is probably due to some of the fiscal drag that we've been talking about, some of those payroll and tax increases that started at the beginning of the year, but now, we also have the sequestration cuts coming in. But the other part is there is some artificial aspect to this, that some of this might be seasonal adjustments. Ever since we went through 2008 and had the really weak economic results at the end of the year and the beginning of 2009, we've been thrown off and things have sometimes seemed better during the winter and worse during the summer because of those seasonal adjustments. So part of this could be just due to usual ups and downs. And consumer numbers, for instance, were stronger than expected in January and February, and have been a little weaker than expected in March and April. What we think though, is that the underlying trends are mostly still fairly solid. Employment markets are healing very slowly, but they're still healing. Credit conditions, in general, are very supportive of growth. Housing recovery is still very much under way, and so in general, we would still characterize what we're seeing here in the US as a slow mid-cycle expansion.

Schuster: Well, let's look outside the US. Last month, we talked about a bit of resurgence in policy risk coming outside of Europe, with situations in Cyprus and other areas. What's the economic conditions within Europe, and broadly, across other international economies?

Hofschire: Well globally, I think maybe the data recently has been even more disappointing, so it's not so much that we're seeing a global downturn, in our opinion, but I think what we're seeing is people are expecting the global economy to be in the better recovery mode than it's shown over the past couple of months, but it's really mixed when you look around the world. So if you start with Japan, that's been a real bright spot. We've talked about Prime Minister Abe's policies in the past, and in particular, the monetary policies, extremely accommodative, quantitative easing policies by the Central Bank, have done a number of things, and they're targeting higher positive inflation in Japan. That's boosted consumer sentiment, household sentiment. The stock market has gone up there. The yen has depreciated. That helps the competitiveness of their exporters, so the early cycle recovery in Japan has really been gaining steam. On the other hand, you look in Europe, and really very lackluster conditions there. The good news is that the financial conditions have remained calm, despite the bailout in Cyprus, despite some political noise around Italian elections, but there really hasn't been much traction, and so most of those economies are still in sort of a recessionary mode. Then, you look at the developing world of emerging markets. There is a recovery in China, but haven't really been getting as much bang for the buck as you might expect, given all the credit that's poured in to their economy. Other big emerging markets, like India and Brazil, are not growing at near the pace that they were a couple of years ago. So overall, global growth is uneven. It's probably getting better, but it has recently been kind of disappointing, relative to people's expectations.

Schuster: So the disappointment versus expectations, would this be a meaningful explanation of why commodities have had some weakness more recently?

Hofschire: Yes, I think it's definitely part of it. You know, commodities, when you think back, have really been in this long-term sort of supercycle since maybe around the year 2000. Where prices have just continuously gone up. And now, recently, you've seen, whether you talking about energy, industrial metals, or agriculture, most of these prices are now kind of at the low end of the range of where they've been the past couple of years, and just as an example, copper prices, for instance, dropped here recently to the lowest level since we've seen since 2011. So part of it probably is demand, that weaker global economy than people expected, especially in China, especially in developing markets where there's still a fair amount of demand for commodities in general, but part of it is probably also supply. You know, after a decade or so of rising prices, you're now starting to see more supply coming back online, particularly in areas like industrial metals. So this could be a time where we have more of a trading range for commodities going forward than this continuous supercycle that we've been accustomed to.

Schuster: Right, well if we could, let's look at one specific precious metal within this whole spectrum, gold. Gold has been very publicized more recently for some of the volatility in the pricing of it.In fact, the first half of April, we saw some historic declines that we have not experienced in many decades, and then subsequently, some rebound. Where are we with the direction of gold right now?

Hofschire: Yes, very large drop, here recently in gold, again back to lows that we haven't seen for a couple of years. Gold is kind of hard to pin down. It's not really like other commodities. You know, most commodities, you dig them up from the ground, you produce them, and it becomes a supply-demand issue. What are you going to use, for instance, copper for, to build a home or other construction? Then once you use it, it's gone from supply. Gold is very different than that. It does have some demand, of course, for jewelry, but really, a lot of the incremental demand for gold comes from investment purposes. So there is no cash flow to gold, and it's a hard thing, sometimes, to value versus other assets, so it's also sometimes hard to figure out why it moves up and down.

When you think about the reasons people like to hold gold as an asset class, a lot of times, it's sort of an alternative currency to paper currency, so the times that have been beneficial in the past to own it is when people are worried about the value of paper currencies, perhaps when inflation expectations are going up, or when the dollar is weak, or when there is risk to the global financial system. And now recently, a lot of these things haven't been particularly supportive of gold, so systemic risk has kind of been falling as the risk in Europe and other places hasn't been in the headlines as much. The dollar has actually been relatively strong. Inflation expectations have been very subdued. So that, along with probably some technical trading issues we've seen here recently, have really caused this slump. However, I think when you look out here, going forward, central banks are still easing. We mentioned Japan, but certainly, it's the Federal Reserve here, and other central banks around the world, so real interest rates are still very, very low. There's a lot of liquidity out there, a lot of this, then needs—we are sort of seeing some attempts to depreciate paper currencies, so it may be too soon to really claim that this gold run that has been going on for so long has completely reversed, but I think it's certainly a reminder that gold can be a very volatile asset class in the near term.

Schuster: Right. So when we put all this together today, we have a US economy slow mid-cycle expansion, some disappointment outside of the US, economically speaking, commodity weakness, volatile gold prices, what's an investor to kind of think around some of the more recent news?

Hofschire: I think one question investors have been having recently is, have some of these markets come too far too fast, given the fundamentals? Are we going to be in for another sort of summer swoon like we've seen in some of the recent years? And at this point in the cycle, after we've had four years or so of a bull market in many equities, I think it does make sense that you have to be careful about your expectations. You shouldn't really be expecting outsized gains at this point. However, when you look at the basic conditions, we have pretty low inflation. We have a lot of monetary support, and we have a global economy that's not particularly robust, but it's also not weakening. So these things, together, you know, are a pretty decent backdrop overall, and so what it means, as always, is sort of try to stick to your guns, in terms of what you're thinking for your overall investment strategy, but it's not a terrible backdrop, from my perspective.

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