February 2013 Update

The “Balance Sheet Recession” and the Deleveraging Process

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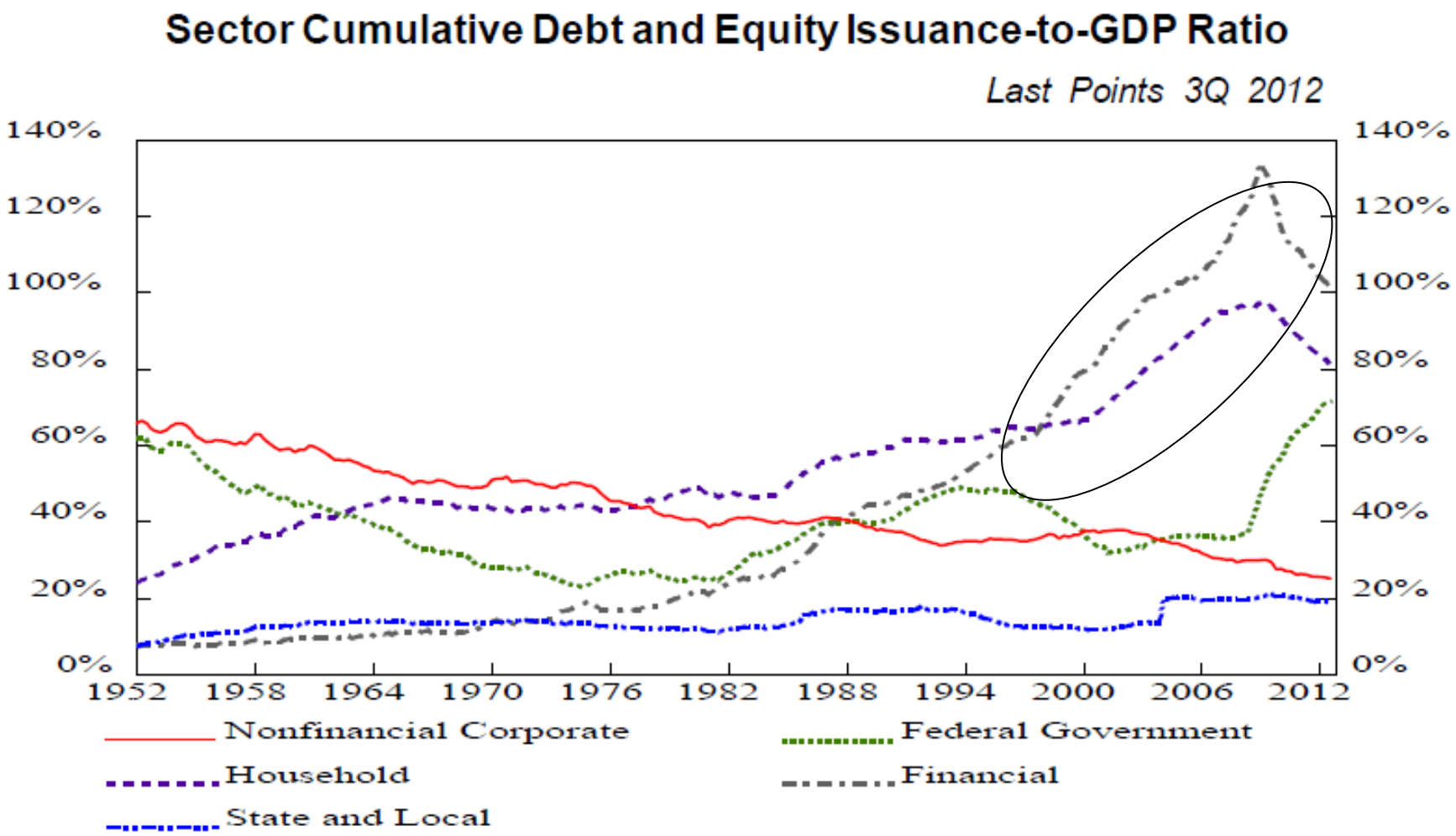
Origin of the balance sheet recession:

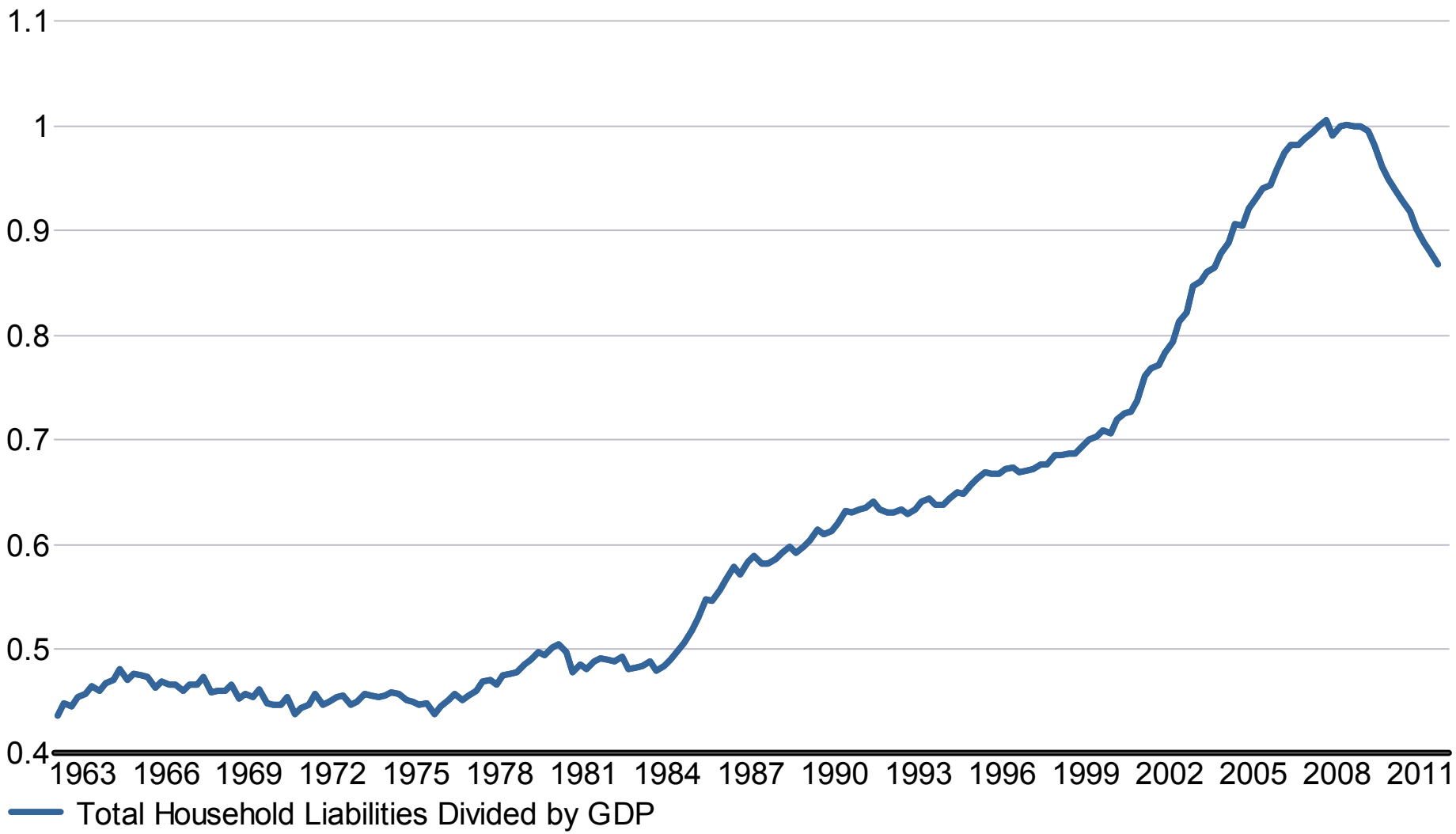
Leading up to the financial crisis in 2008, debt levels of the household and financial sectors grew to be quite excessive. This eventually became problematic for the economy because reducing debt back to normal levels cuts into consumer spending (with respect to the household sector) and access to credit (with respect to the financial sector).



Source: Federal Reserve

The household sector: where are we in the process?

Household sector debt is still elevated relative to GDP…



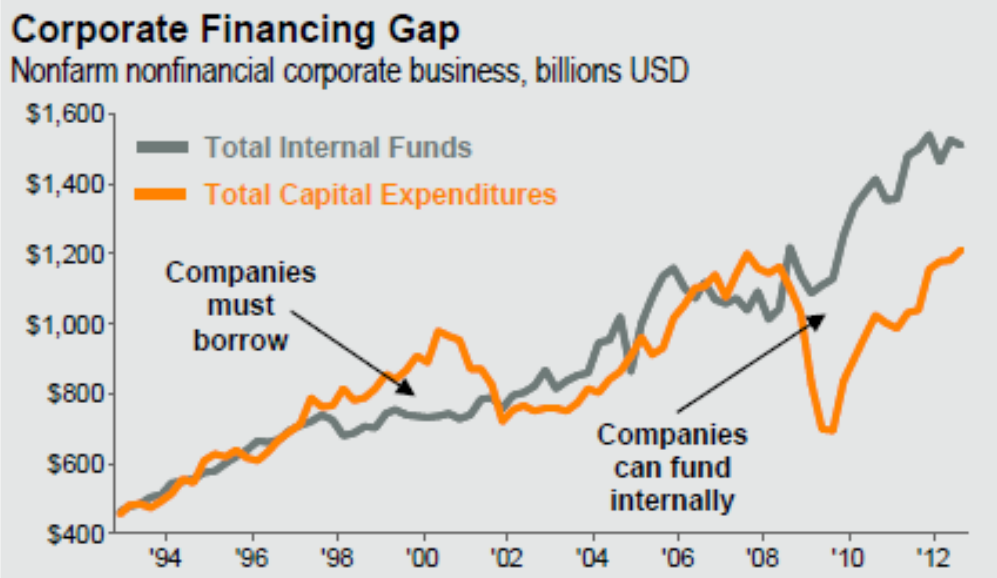
Source: FactSet

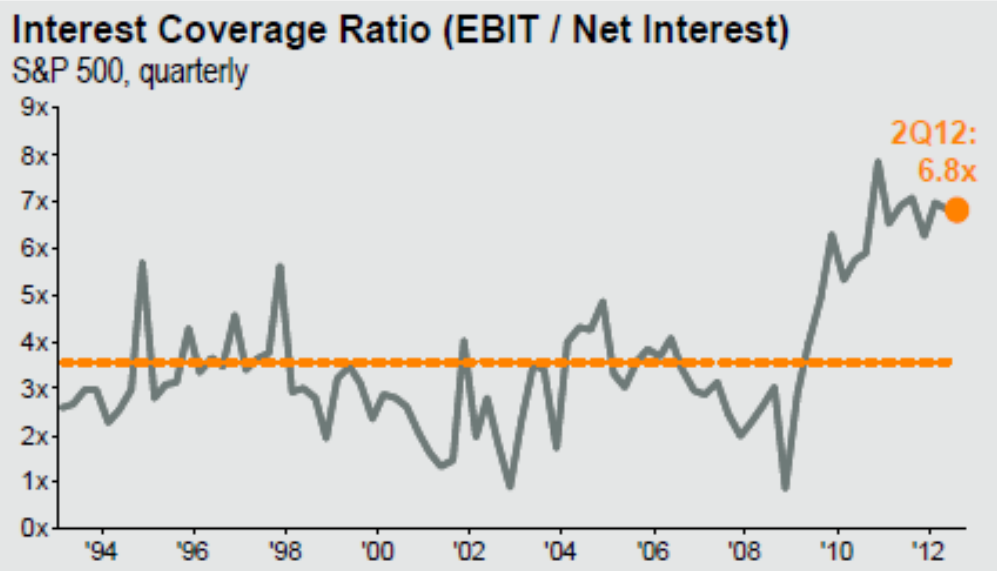
The household sector: where are we in the process?

…but debt service is very low, due to low interest rates. This makes the deleveraging process less painful in terms of its impact on consumer spending.

Source: JP Morgan Asset Management. Original Source(s): FRB

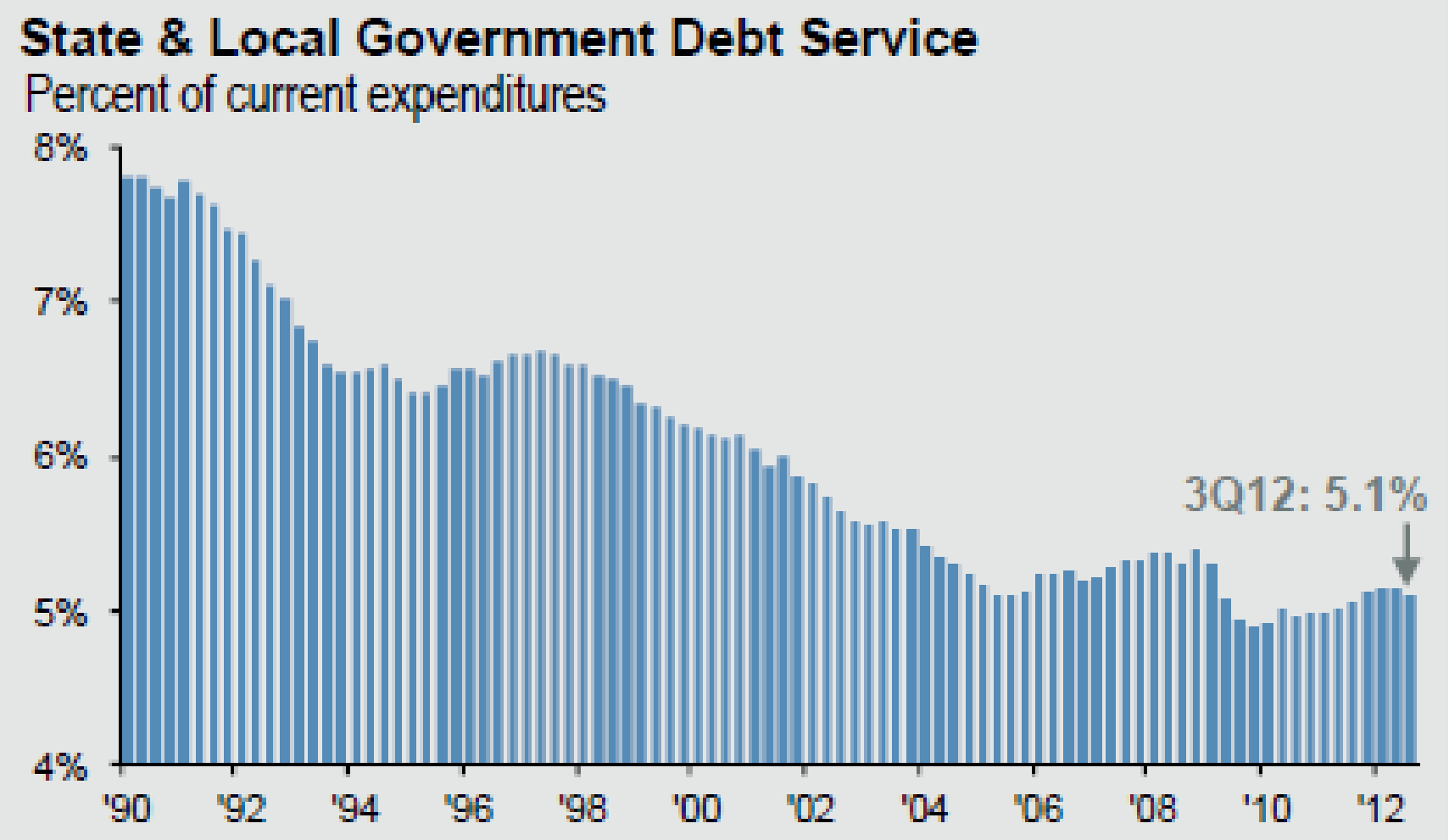
The corporate sector: where are we in the process?





Source: JP Morgan Asset Management. Original Source: FRB; S&P; Compustat; FactSet

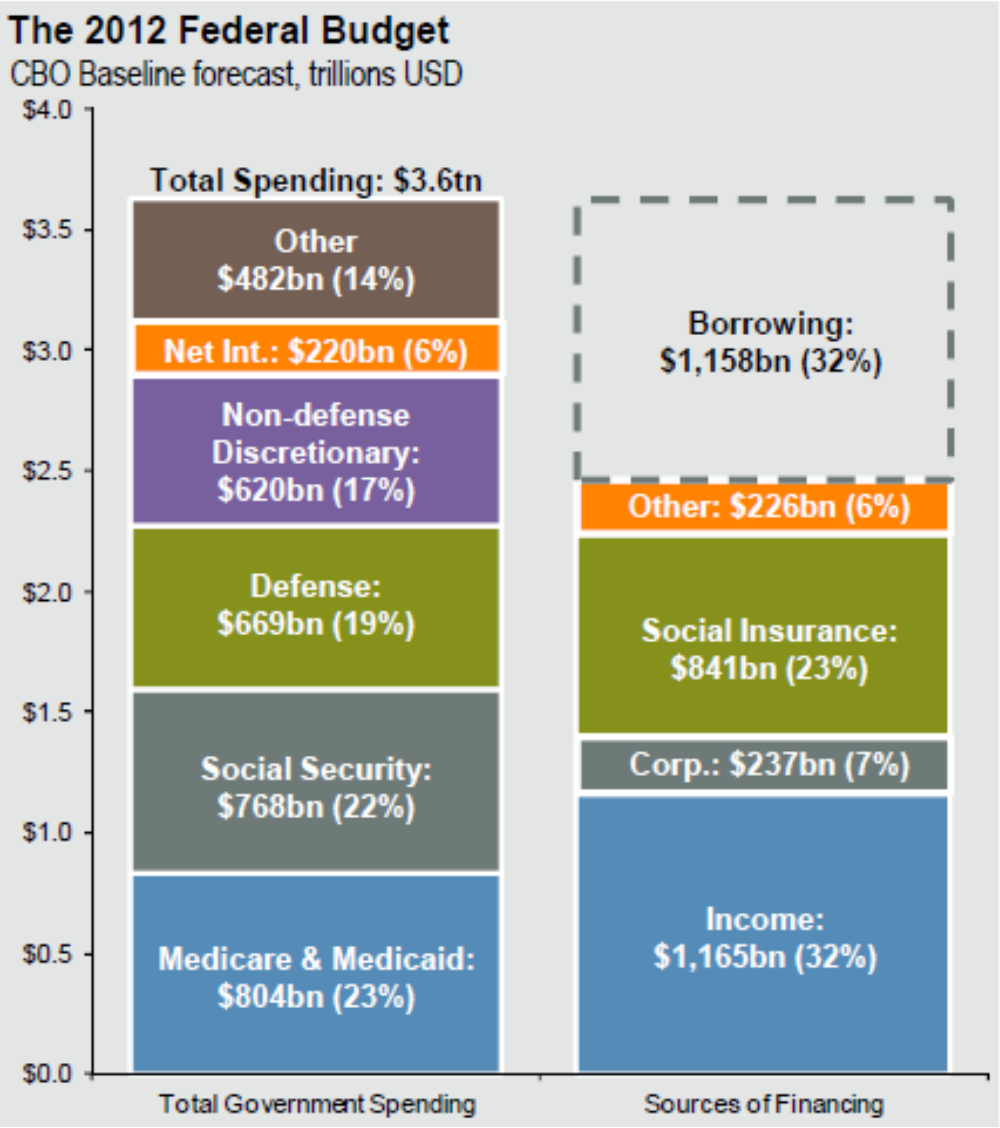
The state and local government sector: where are we in the process?



Source: JP Morgan Asset Management. Original Source: BEA

The federal government: where are we in the process?

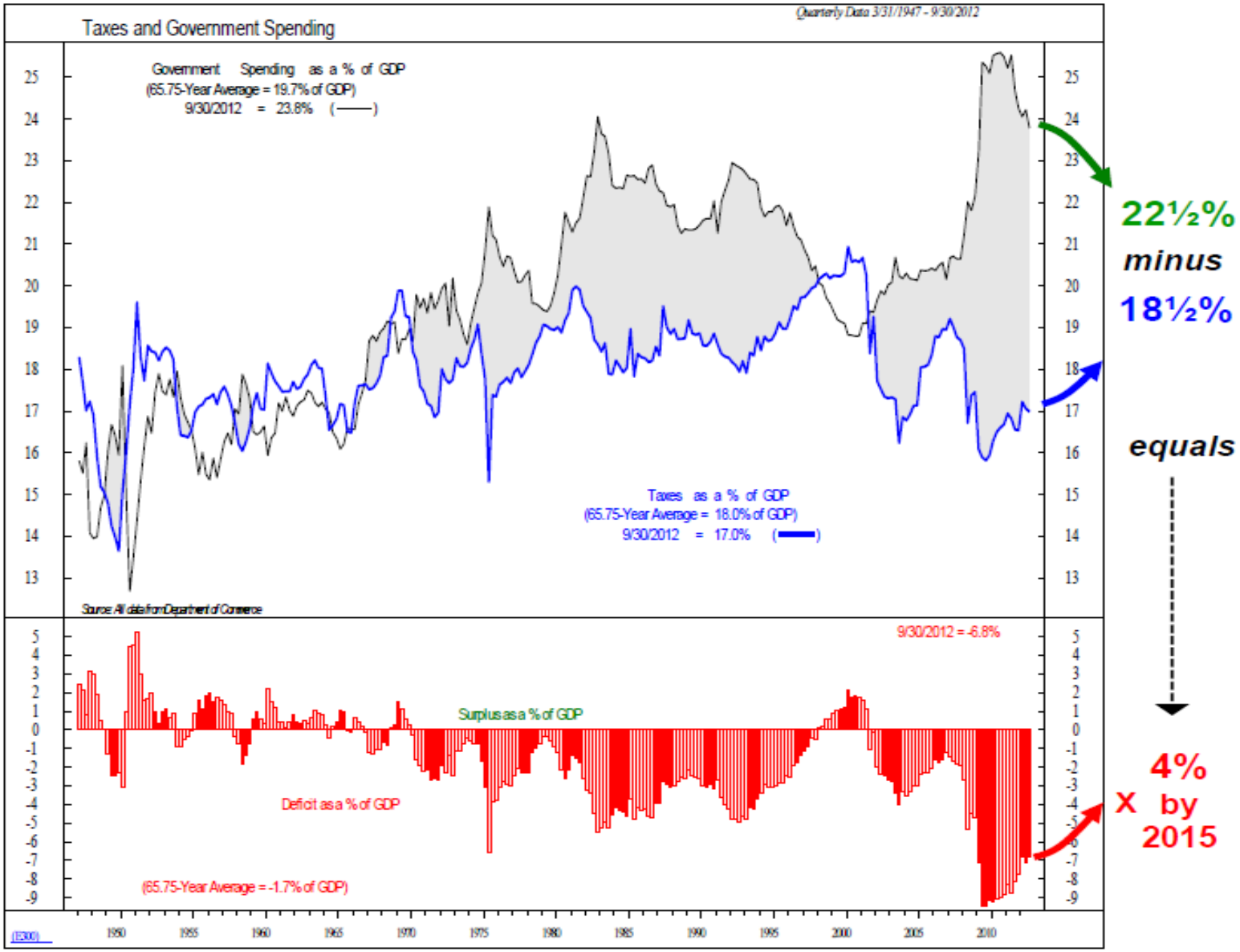
Current borrowing is still quite significant…



Source: JP Morgan Asset Management. Original Source: Treasury; BEA; OMB; CBO

The federal government: where are we in the process?

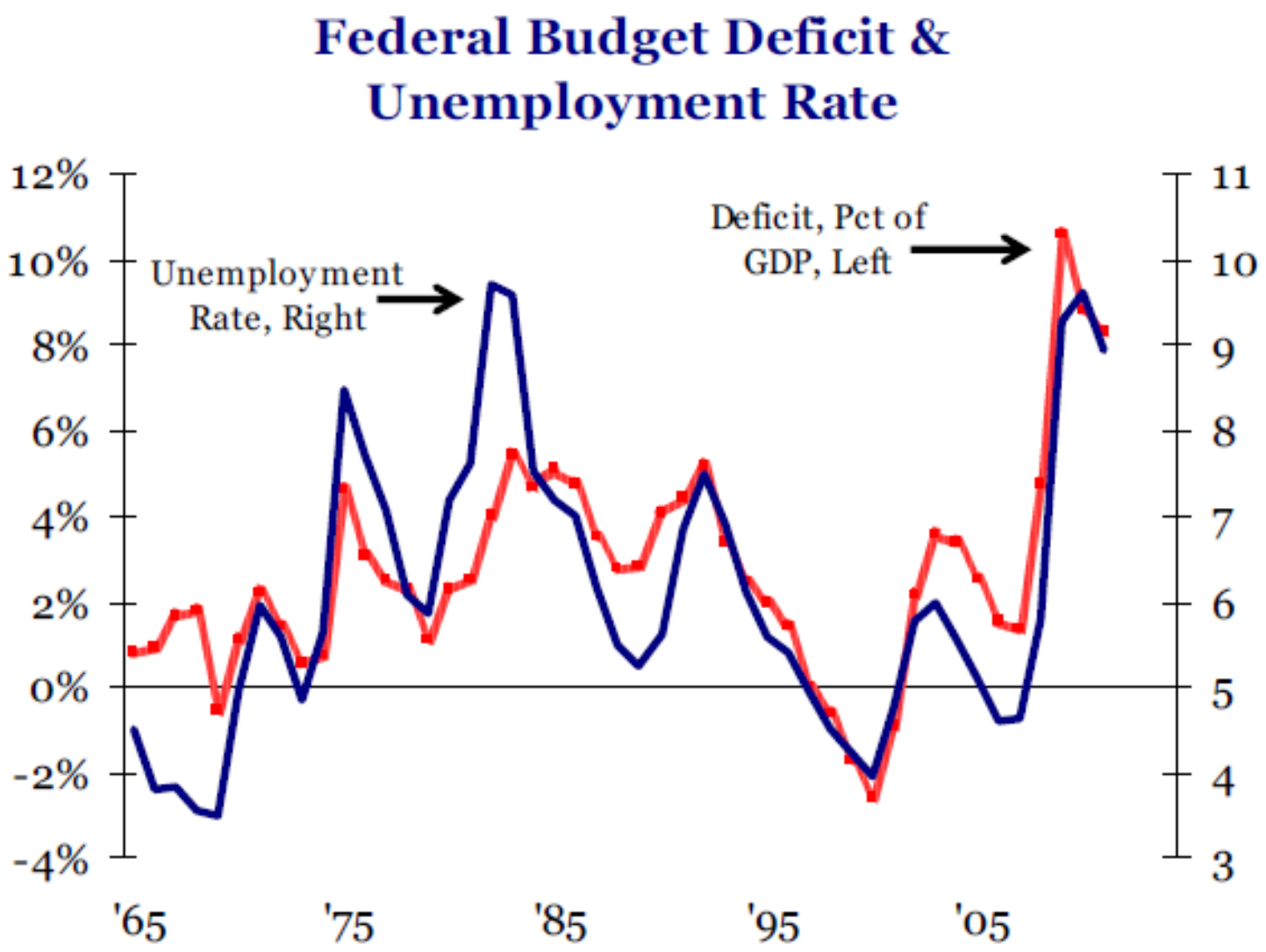
…but the deficit appears to be moving back to more normal levels…



Source: Ned Davis Research, with annotations from Barry Bannister (Stifel Nicholaus).

The federal government: where are we in the process?

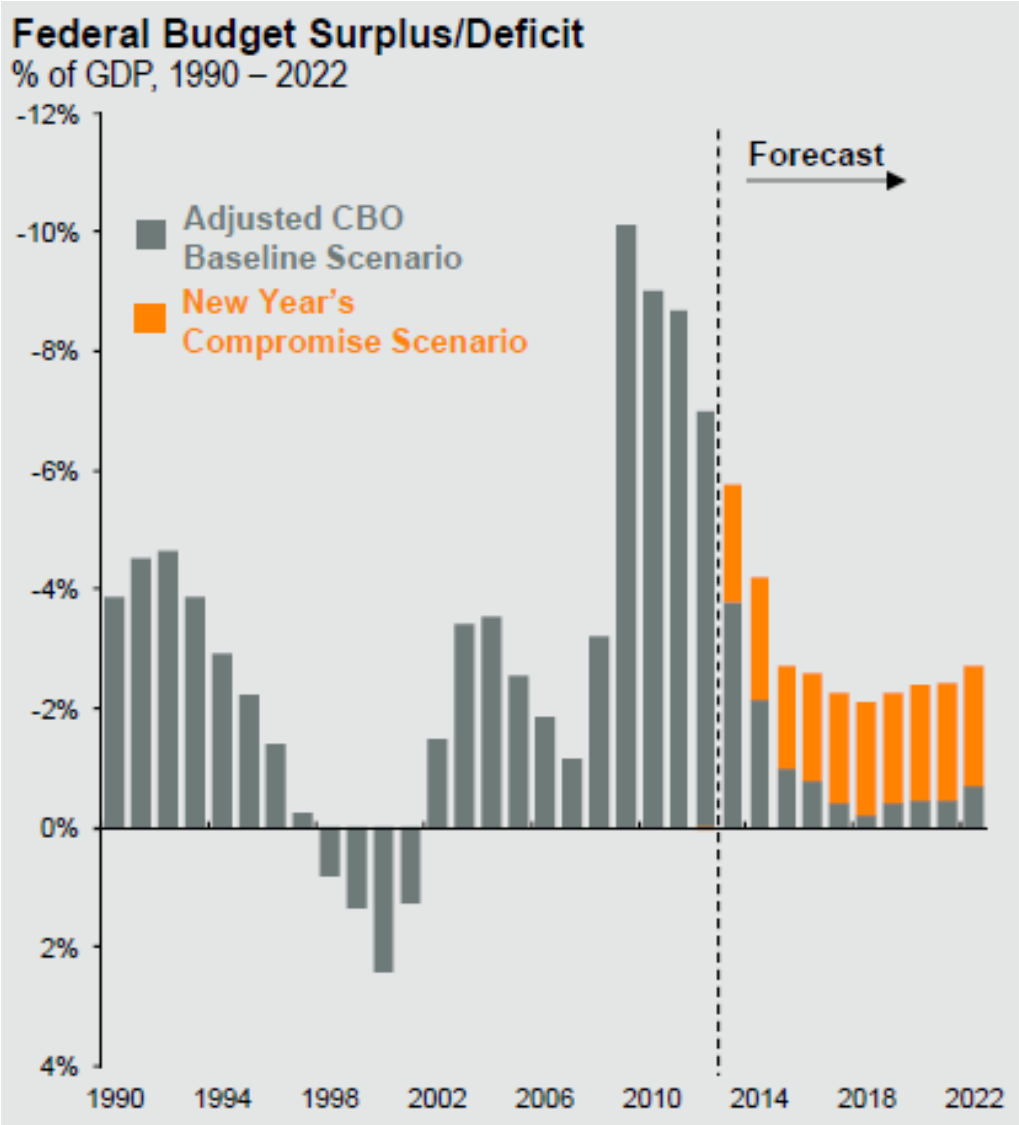
…which is aided by a recovery in U.S. employment…



Source: Strategas

The federal government: where are we in the process?

…and is consistent with CBO forecasts (which account for the January tax deal)…



Source: JP Morgan Asset Management. Original Source: Treasury; BEA; CBO.

The federal government: where are we in the process?

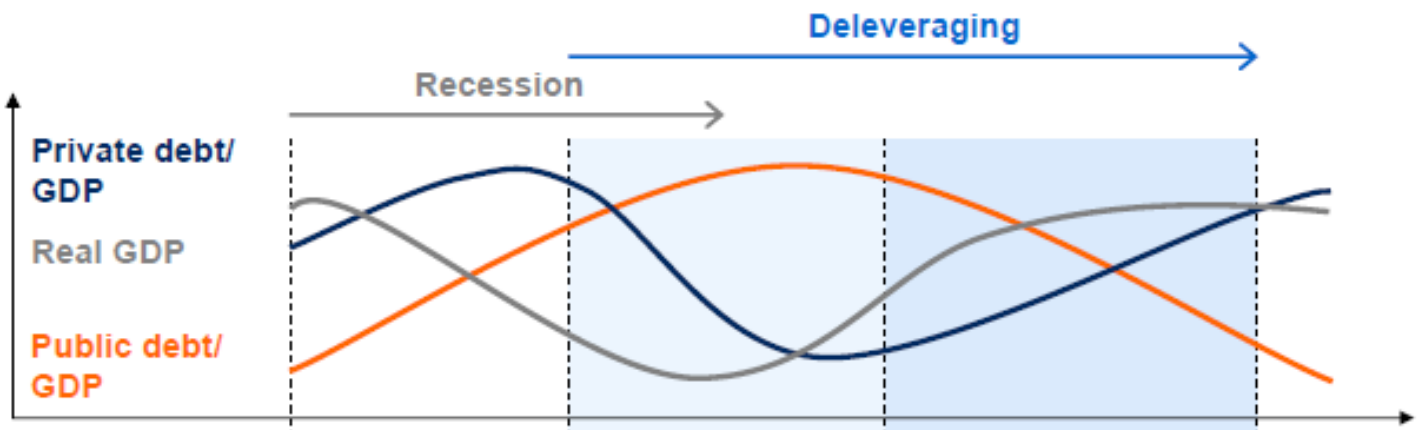
…which ultimately results in a stabilization of debt to GDP below key levels. A debt to GDP ratio of 80% has been identified by Rogoff and Reinhart as an important level to stay below.

Source: JP Morgan Asset Management. Original Source: Treasury; BEA; CBO

History as a guide

<u>The last 5 years in the U.S. have closely traced the Swedish and Finnish deleveraging episodes from the 1990's</u>, which offer a useful historical analog that shows the private sector must deleverage first and that the government sector can follow once GDP growth reaccelerates. The flow is logical given the government's capacity to deficit-spend and control monetary policy.

Average of Swedish and Finnish deleveraging episodes



	Pre-crisis period	Early stage of recession	Private-sector deleveraging	Rebound and public-sector deleveraging
	10 years	1–2 years	4–6 years	~10 years
Real GDP growth Annual average (%)	3%	-3%	1%	3%
Change in debt/GDP Percentage points				
▪ **Private sector**	60	8	-26	87
▪ **Public sector**	3	15	21	-30

Source: IMF, Haver Analytics, McKinsey Global Institute

Concluding thoughts: Why only five more years?

Sweden Government Bond 10 year yield [January 1989-January 2013]
Date: 1-29-13 - Source: Trading Economics

Finland Government Bond 10 year yield [January 1991 - January 2013]
Date: 1-29-13 - Source: Trading Economics

United States Government Bond 10 year yield [January 2006 - January 2013]
Date: 1-29-13 - Source: Trading Economics

Appendix: Important Information

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.

Although bonds generally present less short-term risk and volatility than stocks, bonds do contain interest rate risk (as interest rate rise, bond prices usually fall and vice versa) and the risk of default, or the risk that an issuer will be unable to make income or principal payments. Additionally, bonds and short-term investments entail greater inflation risk, or the risk that the return of an investment will not keep up with increases in the prices of goods and services, than stocks.

Increases in real interest rates can cause the price of inflation-protected debt securities to decrease.

Stock markets, especially foreign markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Foreign securities are subject to interest-rate, currency-exchange-rate, economic, and political risks, all of which are magnified in emerging markets.

Lower-quality debt securities generally offer higher yields, but also involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Any fixed income security sold or redeemed prior to maturity may be subject to loss

The municipal market is volatile and can be significantly affected by adverse tax, legislative or political changes and the financial condition of the issuers of municipal securities. Interest rate increases can cause the price of a debt security to decrease. A portion of the dividends you receive may be subject to federal, state, or local income tax or may be subject to the federal alternative minimum tax.

The commodities industry can be significantly affected by commodity prices, world events, import controls, worldwide competition, government regulations, and economic conditions.

The gold industry can be significantly affected by international monetary and political developments such as currency devaluations or revaluations, central bank movements, economic and social conditions within a country, trade imbalances, or trade or currency.

Changes in real estate values or economic conditions can have a positive or negative effect on issuers in the real estate industry, which may affect your investment.

Appendix: Important Information

The Organization for Economic Co-operation and Development (OECD) countries include: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States.

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 S&P 500®, 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.

BC U.S. Corporate Bond Index—Publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements.

The Bank of America Merrill Lynch High-Yield Bond Master II Index is an unmanaged index that tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

The CBOE Volatility Index (VIX) is based on the prices of eight S&P 500 index put and call options.

The Merrill Lynch Option Volatility Estimate (MOVE) Index is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options.

The Daily Sentiment Index gathers the opinions of futures traders and is expressed as a percentage number of bullish opinions.

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.

The Bloomberg United States Exchange Market Capitalization Index is an unmanaged index that tracks the market capitalization of all U.S. listed companies.

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Before investing, have your client consider the funds' investment objectives, risks, charges, and expenses. Contact Fidelity for a prospectus, or summary prospectus, if available, containing this information. Have your client read it carefully.

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