April 2013

EXECUTIVE SUMMARY

Quarterly Market Update: Second Quarter 2013

This Executive Summary should be reviewed with the accompanying presentation, "Quarterly Market Update: Second Quarter 2013," by Fidelity's Asset Allocation Research Team.

Market Summary

Spurred by the sharp rally in U.S. and Japanese equities, most riskier asset categories posted strong returns during the first quarter. Emerging-market assets and commodities performed the worst, while U.S. investment-grade bonds posted their first negative quarterly returns since 2010.

Global markets have generally enjoyed a positive backdrop of incremental economic improvement, modest inflation, highly accommodative monetary policies, and low volatility. Systemic policy risk continued to ebb, though bank failure in Cyprus and sequestration cuts in the U.S. may provide ongoing headwinds. U.S. and global business cycles still provide a solid backdrop for economically sensitive assets, though the risk-return outlook is less favorable after the asset rally.

Economy/Macro Backdrop

Global growth continues to show signs of improvement. After two years of sluggishness, leading indicators in the world's largest economies are on an upswing. With the new government in Japan focusing on fiscal and monetary stimulus, as well as structural reform, optimism about the Japanese economy has increased. China's ongoing early-cycle reacceleration has boosted the rest of Asia, and rising trade volumes bode well for continued global expansion. Germany's export-oriented economy is picking up, but most of Europe remains in recession. Core countries like France are still frail, while peripheral countries have been stymied by weak banks and high unemployment.

The U.S. economy has been solidly in a mid-cycle expansion since the late-cycle risks at the end of 2012 abated. Firmer domestic demand and a better global backdrop have boosted the U.S. manufacturing sector. Lower energy and unit labor costs have enhanced competitiveness, supported by renewed growth in capital expenditures. The U.S. sequester will limit federal government employment, but the automatic spending cuts—and the revenue increases from this year's legislation—are providing fiscal savings and tax-code visibility, and layoffs at the state and local level have slowed. The housing recovery and easing lending standards are also helping to offset the impact of fiscal austerity measures on consumers. However, sequestration will likely remain an economic headwind in 2013.

The Federal Reserve (Fed) continues to add $85 billion in monthly quantitative easing, though there is little evidence of inflationary pressure. Recent purchases of government debt by the newly aggressive Bank of Japan (BoJ) have caused the yen to plunge. Core inflation has been rising with wage growth in many emerging economies, but kept in check by wage weakness in the developed world. Range-bound commodity prices have also limited headline inflation, at least so far.

Theme: Emerging Opportunities in Global Markets

While working-age populations in some developed countries are contracting, most developing economies continue to benefit from positive demographic trends. Rapidly expanding credit has also underpinned recent growth in many emerging markets, especially in China; further increases in leverage may need to be more modest. Relative to the size of their economies, most developing countries have stock markets that are still small, with substantial weights in state-owned firms. Rising per capita income and wealth, along with low household debt, have made the emerging-market consumer a larger contributor to global growth. Active strategies may be necessary to gain significant exposure to this theme.

U.S. Equity Markets

U.S. equities experienced strong, broad-based returns in the first quarter. Reflecting income-oriented investors' ongoing focus on steady, dividend-paying stocks, defensive sectors did especially well. Current valuations are near average, suggesting average intermediate-term return expectations. U.S. corporations have returned value to shareholders as both dividends and share buybacks, thus boosting total yields. Companies whose stocks have low payout ratios could benefit from raising their dividends. Investors are again rewarding earnings growth fundamentals. More potential for active returns may come from a disciplined business cycle approach to sector allocation.

International Equity & Global Assets

Japanese stocks surged on rising confidence that new pro-growth government policies would boost corporate results, while emerging market equities faltered, and commodity prices declined. The currency impact was generally negative for U.S. investors, particularly the steep drop in the yen. During the quarter, analysts' 2013 earnings expectations were lowered for most world regions other than Japan. Earnings multiples ticked up on positive price momentum in developed countries, yet remain well below long-term averages in both developed and developing markets. With the improved credit quality of many emerging economies, allocating to their equity and debt securities may offer diversification benefits.

Fixed Income Markets

Investment-grade bond categories posted modest negative returns as interest rates rose slightly. High-yield corporate bonds and leveraged loans benefited from spread tightening and solid corporate fundamentals. The Fed's efforts to keep nominal interest rates low have pushed Treasury yields below current inflation rates—a challenging environment for bond investors. Macroeconomic uncertainty and sovereign indebtedness have also made active management of fixed income risk exposures more important. Yield spreads on most categories widened modestly during the quarter, but remained below historical averages. During 40 years of rising interest rates from 1941 to 1981, Treasury bonds offered better downside protection than U.S. stocks, exhibiting less severe losses and fewer periods of negative returns.

Asset Allocation Themes

In the current low-yield and low-inflation environment, diversifying a portfolio across fixed income sectors and non-bond sources of income with varied risk exposures may lower volatility and raise the expected risk-adjusted return. When inflation is rising, fixed-rate bonds have struggled, particularly when interest rates have been low, while equities have tended to hold up better as their real (inflation-adjusted) returns have remained positive. Investments with hard-asset or income-adjusting characteristics may also increase the frequency of outpacing inflation.

Outlook: Market Assessment

The U.S. business cycle remains in expansion, and several non-U.S. developed and emerging countries have begun to positively inflect. Export-oriented economies in particular appear to be improving, with Japan pursuing a range of stimulus measures and structural reforms. Policy also remains crucial to the cyclical course in China and Europe. Cyprus is a reminder that signs of recovery remain vulnerable to potential policy errors. From an asset allocation perspective, equity markets may have already reflected the improving growth story. Although the economic cycle is still generally improving, the asset market outlook is more mixed.

Primary contributors include Lisa Emsbo-Mattingly (Director of Asset Allocation Research), Dirk Hofschire (Senior Vice President, Asset Allocation Research), Miles Betro (Senior Analyst, Asset Allocation Research), and Craig Blackwell (Analyst, Asset Allocation Research).

This report is a product of the Asset Allocation Research Team (AART), which conducts economic, fundamental, and quantitative research to develop asset allocation recommendations for Fidelity's portfolio managers and investment teams. AART is responsible for analyzing and synthesizing investment perspectives across Fidelity's asset management unit to generate insights on macroeconomic and financial market trends and their implications for asset allocation.

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Past performance and dividend rates are historical and do not guarantee future results.

Payout ratio is the dividend paid out over the year divided by the earnings over the year. A low payout ratio indicates dividend growth potential, while a high payout ratio indicates less cash to increase dividends.

Diversification/Asset Allocation does not ensure a profit or guarantee against a loss.

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

Foreign markets can be more volatile than U.S. markets due to increased risks of adverse issuer, political, market or economic developments, all of which are magnified in emerging markets.

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

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, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Unlike individual bonds, most bond funds do not have a maturity date, so avoiding losses caused by price volatility by holding them until maturity 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.

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