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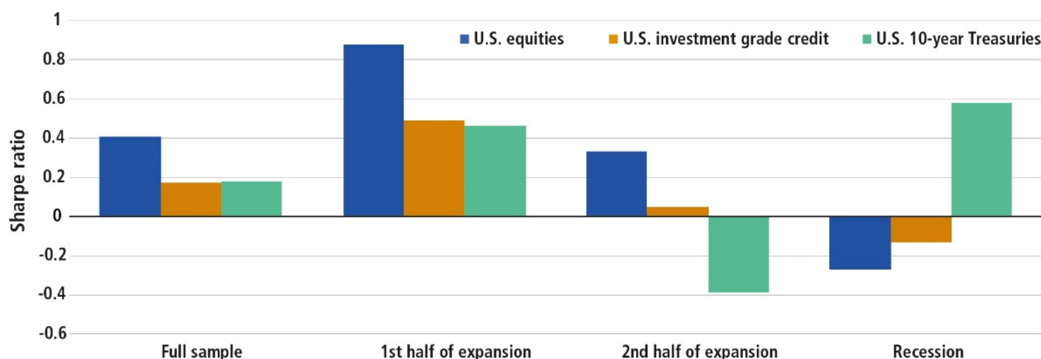
MARKET INSIGHTS: SHOULD INVESTORS POSITION FOR "LATE CYCLE" OR "RECESSION"?

Economic cycles don't always follow a predetermined path, but after 10 years of expansion it seems prudent for investors to plan for the cycle's eventual end. For a brief time, it was hoped that tax-package stimulus might reset the economy back to a recovery/expansion phase, allowing several more years of economic growth above potential. However, the stimulus has been short-lived. Even with lower taxes, incentives for business investment, and historically low interest rates, the economy seems destined for slower growth – and a slower global economy only reinforces this path.

Investors need to decide whether to position portfolios for the late part of the economic cycle or for the recession phase. The difference is important, as asset performance varies significantly between late-cycle and recession, especially relative to volatility. During the late stage of an economic cycle, stocks generally provide attractive risk-adjusted returns while fixed income performs poorly. In recession, the opposite is true: equities underperform while high-quality debt (not to be confused with "investment-grade corporate bonds") enjoys its best performance of the entire economic cycle (see chart below).

Risk factor returns over the business cycle, 1955–2018



Source: PIMCO; Gurkaynak, R., Sack, B., and Wright, J. paper "The U.S. Treasury Yield Curve: 1961 to the Present," Federal Reserve Board Finance and Economics Discussion Series (FEDS), 2006; Kenneth R. French database; National Bureau of Economic Research (NBER).

Past performance is not a guarantee or a reliable indicator of future results. *The Sharpe ratio measures the risk-adjusted performance. The risk-free rate is subtracted from the rate of return for a portfolio and the result is divided by the standard deviation of the portfolio returns.*

Recessions and expansions are as defined by the NBER. We divide expansions into two equal calendar halves and present Sharpe ratios in these sub-periods as well. See http://www.nber.org/cycles.html

From 1955–1969, U.S. equities total returns are taken to be that of the market factor from the Kenneth French database. From 1970–1987, U.S. equities total returns correspond to that of the MSCI USA Index. After 1988, U.S. equities are the excess returns to the S&P 500.

U.S. credit excess returns are measured over duration-matched U.S. Treasuries (all others are measured over cash), per year of spread duration. The history of U.S. credit excess returns begins in 1973.

Historical excess returns to the Treasury series are estimated from par rates provided by Gurkaynak, Sack, and Wright from the "H15" series of constant-maturity yields from the Federal Reserve, and Ibbotson Associates. After 1988, the series is spliced with excess returns to the Bloomberg Barclays US Treasury 7-10 Year Index. Returns are per year of duration.

"Late Cycle" More Likely Than "Recession"

While the economy is showing some signs of slowing, recession does not seem imminent. Recession anxiety is fueled by declines in economic indicators, such as industrial production and business credit. During the first quarter of 2019, industrial production fell from an annualized rate of 3.5 percent to 2.8 percent – certainly not a recession, but not headed in the right direction, either. Optimistically, the decline was substantially driven by data in motor vehicles and parts, and an offsetting hope may be found in retail sales: U.S. retail sales jumped in March, driven by a 3.1 percent increase in motor vehicle sales and parts, which could lead to a subsequent pick-up in industrial production. Likely related to trade uncertainty, business credit applications also slowed in the first quarter; this uncertainty could shift with a resolution of NAFTA, a trade pact with China, and clarity on EU auto tariffs, but the slowdown can be disconcerting until then. In the meantime, consecutive monthly improvements in U.S. small-business optimism offers hope that credit growth can improve regardless of trade issues.

In contrast to the above potential reasons for caution, some other indicators argue against recession. For instance, weekly jobless claims are down to the lowest level since the 1960s, and mortgage applications for home purchases have also improved. Economic fundamentals, driven by strong employment, continued wage growth, corporate earnings, and a pause in tighter monetary policy suggest a recession is not poised to unfold in the near future.

Although a recession may not be imminent, a more challenging environment than we have enjoyed over much of the last 10 years should be expected, with the main differentiator stemming from less stimulus. The Fed has pivoted to pause rates, but rate reductions do not seem necessary. From a fiscal standpoint, another round of tax-cuts is unlikely – thus removing the likelihood of government stimulus – and slow global growth is of little help to the U.S. economy. In the absence of domestic stimulus, and with little help from the global economy, investors should plan for a late-cycle environment.

An Atypical Late Cycle?

The atypical nature of this cycle may not permit formulaic investing that worked in previous cycles. Late cycles are typically characterized by high inflation and often by a sense of investor euphoria – especially if the economy is showing signs of overheating. Typically, stocks perform relatively well, as do assets that benefit from inflation, including commodities and real estate. However, this 2019 late-cycle environment has so-far been characterized more by skepticism than euphoria and relatively low inflation (not high inflation). In fact, with the exception of perhaps January of 2018, euphoria has been noticeably absent this entire cycle and seems unlikely to emerge soon, leaving stocks without their late-cycle boost. Inflation, though, could yet reveal itself. With only the unemployable left unemployed, wages could rise relatively quickly, as companies compete for qualified labor, and resulting wage growth would contribute to higher inflation. A delay in the Fed's response – a classic mistake made in past cycles – would allow

inflation to gain some foothold before eventual tighter monetary policy is pursued. In this scenario, inflation-protected investments such as commodities or real estate could perform relatively well. But, again, without investor euphoria, stocks seem less likely to follow their historic late-cycle pattern.

Keeping an open mind, a more unusual scenario could also develop to bring about the demise of the current cycle. Low levels of inflation and a stable Fed policy suggest that this late cycle could evolve with continued stable rates – not higher ones. If this stable-rate scenario unfolds, interest-rate sensitive sectors such as housing and autos may struggle to improve, since: a) higher home prices and stable rates translate into reduced affordability and, therefore, slower home sales; and b) strong auto sales over the past several years should translate into little pent-up need for new cars, and this low demand could combine with potential EU tariffs to further restrict auto sales. Late-cycle growth could therefore plod along, or deteriorate slowly, until a catalyst other than the usual suspects of higher inflation and higher interest rates emerges to bring about its end.

That cycle-ending catalyst could be lack of earnings growth, which may pressure U.S. equity prices lower; in turn, lower equity prices could impact the U.S. wealth-effect, potentially contributing to a decline in economic growth. Another possibility is that the catalyst could emerge as rising concerns about excessive U.S. Government and corporate debt produce redemptions of debt holdings; the resulting higher interest rates could be especially punishing to lower quality credits, leading to increased bankruptcies and an economic slowdown. Yet another catalyst could come in the form of a more socialist political agenda. Managed care stocks have recently underperformed, as the probability of Bernie Sanders winning the Democratic nomination has increased. Such a reaction suggests investors might respond quickly to fears of increased regulation and new corporate taxes that could reduce profits or provide incentive for companies to expand outside the United States; U.S. equities would likely decline as a general de-risking of portfolios unfolds.

In any scenario, late-cycle behavior still seems likely before recession. However, unlike past cycles, recession could come without high inflation or the investor euphoria that pushes stock prices higher.

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