The Latest "Mini Cycle" Appears to Be Over–What Now?

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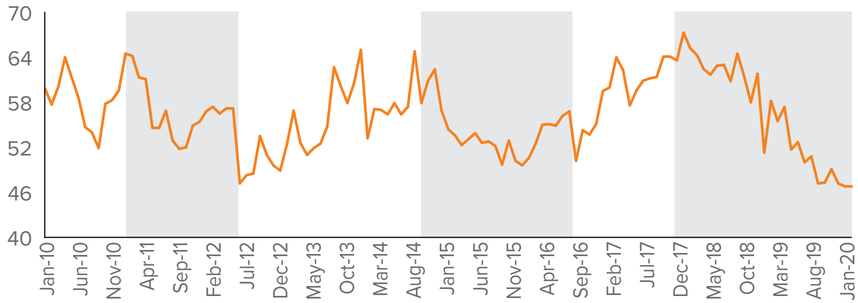
The Ebb and Flow of 2019: A Microcosm of the Last Decade

2019 was a year characterized by slowing economic fundamentals but outsized returns for risk assets, with the latter coming largely because of the Fed's dovish pivot and extremely oversold readings of investor sentiment. Early in the fourth quarter of 2019, we started to see signs that slowing economic data outside of the U.S. was nearing a bottom. Of course, this ebb and flow of economic data is consistent with the three-year manufacturing cycles that have been persistent since the economic recovery began in 2009. Prior to the most recent "mini manufacturing cycle" (that started in 2018), 2011 and 2015 also marked the beginning of three-year periods characterized by 18 months of manufacturing strength followed by 18 months of weakness.

There have been 3 "mini cycles" since 2009

ISM Manufacturing New Orders



Source: Bloomberg and ISM. As of 12/31/19

Manufacturing weakness usually morphs into a recession when there is a sufficient degree of imbalance in the economy and monetary policy is restrictive. With accommodative monetary policy and no significant household or corporate balance sheet excesses, we see no obvious signs of a U.S. led recession in 2020. However, social upheaval and push-backs against globalization in certain countries create risks and uncertainties that we expect will hinder growth.

Outside of the United States, the Slowdown is Abating

The global growth downturn that began in the second half of 2018 is showing signs of abating. The easier monetary policies delivered by central banks in 2019 are now at an inflection point, primed to feed through to a growth upturn in 2020. Outside of the U.S., we believe the most upside resides in China and Europe. In China, the combined credit and fiscal impulse has turned positive, an indicator that has historically led economic activity by roughly nine months. Also, the drag on European export growth related to Brexit uncertainty and the recession in Turkey should ease. Wildcards remain renewed trade escalations and rising social unrest due to populism, authoritarian regimes and inequality, all of which could provide enough of a shock to derail this nascent recovery.

Investment implication: Positive for risk assets

The combination of monetary stimulus and softer (ex U.S. demand) caused money creation to accelerate relative to bank lending. This is happening again with excess liquidity going into risk assets rather than credit creation.

Stability on the Path of U.S. Monetary Policy for 2020

Chairman Jerome (Jay) Powell’s “tightening on auto-pilot” language humbled the Fed in the fourth quarter of 2018, as the perception of a policy error raised concerns about weakness in credit and housing markets. Since that time, the stance of U.S. monetary policy has become more accommodative. Today, the bar for the Fed to tighten interest rates is relatively high. Consensus estimates for U.S. GDP are around trend growth for 2020, which we believe to be too low due to strong labor market, labor income, and the wealth effect.

Investment implication: U.S. monetary policy provides “margin of safety”

Economic data is at an inflection point where the effects of easier monetary policy feed through to better data. We expect this to be the case at least through mid-2020.

The Upside for Interest Rates is Capped

Yields for 10 Year Treasuries are likely to be contained in their recent range since mid-2019 with upside limited to 2.0 – 2.5%. Real yields in excess of 1% have had the propensity to slow U.S. housing, causing uncertainty for U.S. consumer net worth and spending. Bonds also become a more competitive asset class at 3% versus equities, which spurs demand. Germany has been the global driver of bond yields. We believe that expectations of improved growth will push German Bund yields closer to fair value at 0% over the course of 2020 dragging global bond yields modestly higher.

Investment implication: Rates unlikely to approach long-term estimates of fair value

Our 10-year fair value for U.S. rates (10-Yr Treasury) is 3.25%. However, rates are unlikely to get anywhere near that level as yields in the U.S. are still relatively high enough to draw in global capital.

The Credit Cycle Continues to Age, But is Still Too Early to Trigger a Recession

Broad measures of U.S. corporate health such as interest coverage ratios and non-financial corporate debt to assets are converging toward their long-term averages from very high levels. However, non-financial corporate free cash flow remains positive and historically a U.S. recession has never started with that measure in surplus. The credit cycle continues to age but it is too early to trigger a recession.

Investment implication: It’s a bond picker’s world

2020 is likely to be a coupon-clipping year in credit with no significant rise in defaults. However, given the relatively limited upside from current asset valuations, we believe the path to future investment success will be paved by security selection as this backdrop favors idiosyncratic opportunities over broad market risk taking. When volatility does strike, perceived “losers” will be excessively punished and avoiding these investments will be critical.

Inflation is a Longer-Term Concern

Inflation is a lagging indicator. Many structural deflationary forces, such as the world support ratio[1] since 1990, are past their peak. Productivity, has been unusually low for a long time and is unlikely to support deflationary expectations going forward. This will lead to a gradual increase in inflationary pressure as unemployment falls well-below the revised estimates of NAIRU over the course of 2020. We expect inflation to become more of a concern in late 2021 or 2022.

Investment implication: Inflation comes to the forefront in two to three years

While price inflation remains tame, we expect that diminishing spare capacity (of appropriately skilled labor) and populist forces, will support wage growth. Limited ability to pass through higher costs poses a threat to corporate profit margins in the near term.

The Path Ahead: Prepare for a Low Return World

Many asset class returns have had an extraordinary return over the last decade. For example, on a 10 year look, the return for a 60/40 stock/fixed income portfolio ranks in the 90th percentile of all observations since 1947.[2] Returns going forward will be driven by earnings growth alone and very little expectation for P/E multiple expansion. Long-term valuation measures such as Equities/Gross Domestic income are in the top quintile of all readings since 1926, which portends low single digit returns on a five-year view.

[1] The world support ratio is the number of workers relative to number of consumers, number of workers incorporates age-specific variation in labor force participation, unemployment, hours worked and productivity. Number of consumers incorporates age specific variation in needs or wants based on age-specific consumption data. They are also referred to as ‘effective workers and ‘effective consumers’ shown as a GDP-weighted aggregate of 46 countries. Source: National transfer accounts.
[2] As of 12/31/19. Source: MSCI, Morgan Stanley Research, Duff & Phelps

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