SPOTLIGHT | JUNE 2021

PREPARING FOR THE START OF A MINI-CYCLE

Key points

- The recovery phase of the US economic cycle is increasingly mature and looks set to transition to its next phase in the coming months, a 'mini-cycle' similar to those seen in the long expansions of the 1990s and in the post-Global Financial Crisis era.
- These 'mini-cycles' have coincided with changes in US Federal Reserve policy that we expect to see in the coming quarters. Typically lasting 4-5 quarters, mini-cycles result in shifts that occur within fixed income, equity and risk markets.
- As the cycle transitions, US government bond yields have typically stabilised or fallen, reducing the interest rate risk for investors. Credit spreads, in contrast, which tend to compress from their recovery phase peaks, widen during mini-cycles, jeopardising investor returns.
- In equities, mini-cycles see a transition from relatively high return and declining volatility to a comparatively modest (though usually positive) return with increasing volatility. This is a backdrop where investors can benefit from an increased stock-selection (alpha) rather than market focused (beta) bias.
- As importantly, these mini-cycles going back to the early-1990s have tended to coincide with an increase in volatility, more substantial drawdowns and exogenous shocks including the Mexican Crisis (1994), Asia/Russia Crises (1997-98), the Eurozone Crisis (2011-12), and the US high yield energy defaults (2015).
- As a result, pro-active risk management is an increasingly valuable asset in the mini-cycle phase of the economic cycle.

Global Investment Committee

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Navigating the final stages of the recovery phase

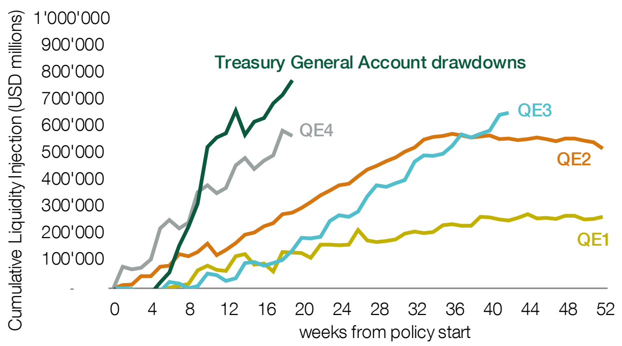
With 2020 witnessing not only the shortest and sharpest recession in history, but also its most rapid recovery as key US leading indicators reached their strongest levels since the early-1980s, the US economy appears to be entering the final stages of its recovery phase following the pandemic-induced lockdowns of 2020.

Indeed, that final phase of recovery should continue to present selective, but attractive return drivers for equities in particular. As upward revisions to earnings expectations continue, we expect second quarter earnings in both the US and Europe to represent the peak in earnings growth rates for this cycle.

Therefore, select global cyclical sectors as well as domestically sensitive sectors in Europe which continue to underprice this mature phase of recovery ahead of the start of earnings season in mid-July provide tactical opportunities.

Moreover, despite the speculation that the US Federal Reserve will soon slow its bond purchases, effectively tightening policy, the 2nd quarter has seen a liquidity surge coming from the US Treasury that exceeds any of the quantitative easing programmes of the Federal Reserve.

Recent liquidity injections from the US Treasury have been larger than ANY Fed quantitative easing program



Sources: Federal Reserve Bank of St. Louis and UBP

Indeed, these drawdowns, in combination with the Fed's own QE-related bond purchases, have injected as much as USD 1.6 trillion into the US economy in the first 5 months of 2021. With drawdowns set to finish by end-July, investors can expect another USD 500-700 billion in liquidity in the coming 2 months, a flow that should keep risk-assets well bid given the strong earnings backdrop we expect through mid-year.

Indeed, we believe that this combined liquidity surge from the US Treasury and Federal Reserve has been instrumental in restraining a more substantial rise in US 10-year yields since February. With benchmark yields retreating to as low as 1.5% in recent weeks, this has re-assured equity investors after a volatile February-March.

However, while catalysts for further strength in risks assets exist, investors should frame this in the context of an increasingly mature recovery phase.

Thus, as year-on-year earnings growth is set to peak in the 2Q21 reporting season, and the US Treasury is due to end its liquidity injections in July, possibly joined by the Federal Reserve later in the year, investors should use this final stage of the recovery phase to prepare portfolios for a transition to the next stage of the economic cycle.

Transitioning into the first 'mini-cycle' of the post-pandemic recovery

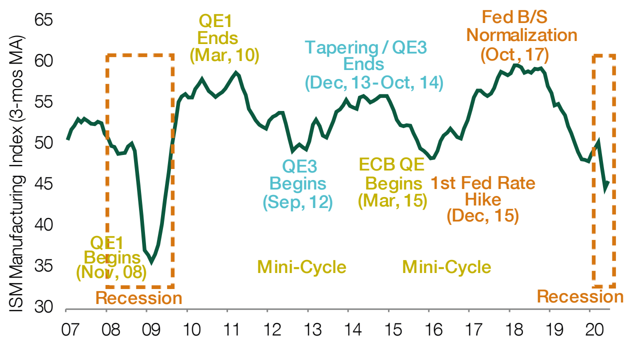
The economic recovery, as measured by the widely followed economic leading indicator, the Institute of Supply Management's Purchasing Managers' survey, has tracked the recovery seen following the 2008-09 Global Financial Crisis and in the early days showed parallels to the V-shaped recovery following the US recession of the 1990s.

What those two post-recession recoveries share is that they were the longest economic expansions in the history of the United States AND they both featured periodic 'mini-cycles', or periods of economic softness though not outright recession.

Indeed, both the 1990s expansion and its post-2008 counterpart each saw two mini-cycles, typically lasting 4-5 quarters which coincided with the withdrawal of central bank stimulus measures. Encouragingly for investors, returns over the duration of these mini-cycles are typically positive (though the 2014-16 mini-cycle delivered a modest loss of 1.3%)

More importantly, these mini-cycles triggered key shifts within fixed income, equity, and risk markets which are important for investors even in the context of an ongoing bull market.

Mini-cycles have followed post-recession recoveries in the two longest recoveries in US history



Sources: Institute of Supply Management, Bloomberg Finance L.P. and UBP

Fixed Income: focus on credit risk management during 'mini-cycles'

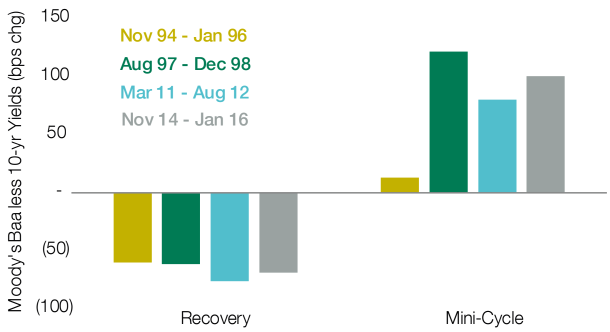
During recovery phases, unsurprisingly US Treasury yields reverse their declines and begin to rise in anticipation of the economic recovery. However, as the recovery transitions into a mini-cycle phase, benchmark Treasury yields tend to fall, or in the case of 2014-16, remain flat.

Indeed, the coming mini-cycle may resemble the 2014-16 episode when US bond buying slowed down (as markets expect the Fed to do in the months ahead) and growth in the Chinese economy weakened, as is the case currently.

More concerning for fixed income investors, however, is the implication of a mini-cycle in credit spreads. Having benefitted from tightening in spreads since March 2020, mini-cycles going back to the early-1990s tend to feature widening rather than narrowing spreads.

Indeed, with 75-100 bps in widening in Baa spreads in the past three mini-cycles, such moves have the potential to undermine total returns for fixed income investors, given the low absolute yields currently on offer.

Credit spreads shift from compressing to expanding during the 'mini-cycle' phase



Sources: Institute of Supply Management, Bloomberg Finance L.P. and UBP

Equities: Lower and more volatile returns in the mini-cycle phase

US equity investors have unsurprisingly realised strong returns during recovery phases of the economic cycle and indeed, 2020-21 has been no exception. The transition into the mini-cycle phase, however, typically results in not only a lower return profile for investors but also more significant drawdowns within the mini-cycle itself.

As a result, a stock/sector approach is more prudent during the mini-cycle phase compared to a market-oriented approach which leads during the early, recovery phase.

In the past, earnings growth has been the key driver to returns for equity investors in the mini-cycle phase, which has historically benefitted growth-oriented companies over their value counterparts.

However, 2020-21 offers an important contrast to previous cycles. First, earnings growth for 2021-22 of growth-oriented companies is forecast to lag earnings growth among value-oriented companies (21% vs. 26% CAGR). Moreover, a key risk to 2022 earnings – rising taxes – appears to place a disproportionate burden on growth-focused, multinational tech and healthcare companies opening up the potential of risks to forecasts in 2022.

With fiscal spending to transform industries via IT investment, some offset to a potential increased tax burden is possible. Thus, investors should take a more balance approach between growth and value stocks in the coming mini-cycle and place a premium upon 'quality' equities in both the growth and value segments that can deliver visible earnings growth combined with durable valuation floors.

Beware of a rising volatility regime and exogenous shocks in the mini-cycle

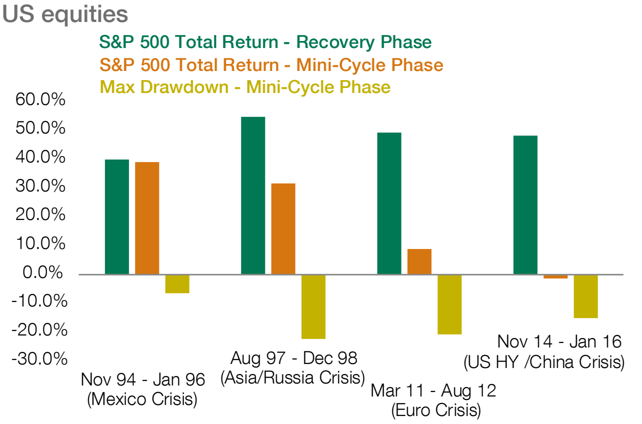
With widening credit spreads and increased equity drawdowns common during mini-cycles, rising volatility in this phase of the economic cycle is unsurprising.

However, the context of this increased volatility is important for investors. Each of the mini-cycles going back to the early-1990s has coincided with not just an increase in volatility but meaningful exogenous shocks including the Mexican Crisis (1994), Asia/Russia Crises (1997-98), the Eurozone Crisis (2011-12), the US high yield energy defaults and Chinese currency devaluation (2015).

Indeed, with the desynchronised recovery between China, the US, Europe, and much of the emerging world, the prospect of instability if US policy makers seek to tighten the reigns on policy support should not be underestimated, as seen in previous mini-cycles.

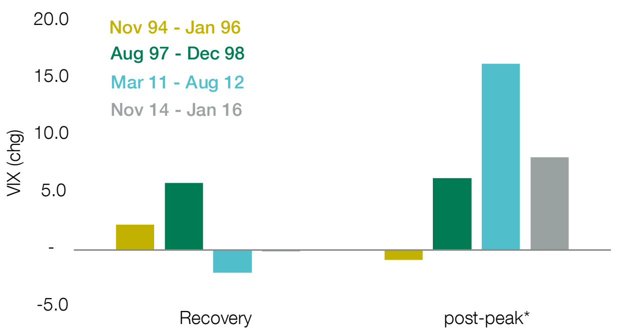
As a result, investors should not only increase their risk management vigilance but also move to a more pro-active risk management stance while volatility remains low and while the economy transitions into the next phase of its cycle.

Mini-cycles lead to lower returns and larger drawdowns in US equities



Sources: Standard & Poors, Bloomberg Finance L.P. and UBP

Mini-cycles translate into high and rising equity volatility



Sources: CBOE, Bloomberg Finance L.P. and UBP

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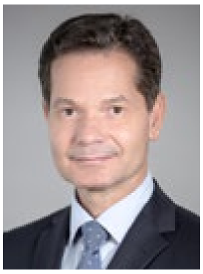

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