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SPOTLIGHT

Navigating the coming 'mini-cycle' in the US Economy

Recession concerns appear overblown, though we do expect a 'mini-cycle' in the US economy in the months ahead. This 'mini-cycle' should signal a peak in US 10-year yields between 3-3.5% and push corporate credit spreads wider keeping the focus on risk management for fixed income investors. While PE multiples will have difficulty expanding in this 'mini-cycle', strong earnings growth should be sufficient to drive an 8-10% return in US equities through year end.

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UBP
Union Bancaire Privée

Key points

- *Economic, earnings and market dynamics appear consistent with a 'mini-cycle' in the US economy rather than portending economic recession*
- *Historical mini-cycles where the Fed pursued tightening or stayed on the sidelines resulted in only modest equity returns*
- *We expect US equities to return 8-10% in 2018, though volatility will be high. Tactical rotation, hedge funds, and capital protected strategies can complement active stock selection to drive returns.*
- *Across mini-cycles since 1983, 10-year yields peaked and declined while corporate spreads widened*
- *We have begun lengthening government bond duration and continue to reduce levels of corporate credit exposure in our bond portfolios*

With global equities having dipped into correction territory on two occasions from their 2018 peaks, the debate grows about whether this is simply a necessary correction following the bull market of 2017 or whether the declines to date indicate something more worrisome for investors.

We believe the current economic, earnings and market dynamics suggest a peak in growth and evidence of deceleration – a 'mini-cycle' – in the context of a mature economic expansion. With concerns rising about the flattening of the US yield curve giving rise to concerns about the prospect of a US recession, our UBP Recession Watch framework (see table) does not indicate any signs of imminent recession on the horizon.

As eight of the 12 bear markets (decline of < 20%) in the US since the end of the Great Depression occurred as the US economy fell into recession, we do not believe that a recession-induced bear market lies ahead.

Of the remaining four periods, a combination of economic growth scares, tightening credit and above average valuations were seen in the bear markets of 1946, 1962 and 1966 while the indicators present before the stock market crash of 1987 were only tightening credit and above average valuations.

Lacking data for 1946, and even with the limited data available for 1962 and 1966 bear markets seem to support the anecdotal descriptions provided by the Federal Reserve Bank of Richmond suggesting that these too were mini-cycles. Such periods have occurred frequently since the 1980s – characterised by a decelerating manufacturing sector but firm consumer/employment markets supporting the broader economy. Interestingly, in 1962 and 1966, the mini-cycles were accompanied by a US bear market (decline of > 20%).

With the UBP Economics team expecting US growth to peak in the first half of 2018 before decelerating through to year-end, a mini-cycle in the US economy does appears to lie ahead. The recent rise and expected drawdowns in inventories and the prospect of less buoyant consumption than in past cycles are expected to be the drivers of this

UBP Recession Watch Indicators – No signs of US recession on the horizon…

		1960-61 Recession	1969-70 Recession	1973-75 Recession	1980 Recession	1981-82 Recession	1990-91 Recession	2000-01 Recession	2008-09 Recession	2018 Mini-cycle?
Manufacturing	ISM Mfg <50	NA	YES	YES	YES	YES	YES	YES	YES	NO
	Industrials Sales Growth (< 0% YoY)	NA	YES	YES	YES	YES	YES	YES	YES	NO
	IP Growth (< 0% YoY)	YES	YES	YES	YES	YES	YES	YES	YES	NO
Employment/ Consumption	Non-Farm Payrolls (< 0% YoY)	YES	NO	YES	YES	YES	YES	YES	YES	NO
	Jobless Claims (YoY chg > + 60k)	NA	NO	YES	YES	YES	YES	YES	YES	NO
	Retail Sales Growth (< 2.5% YoY)	NA	NA	NA	NA	NA	YES	YES	YES	NO
Credit	Tightening Lending Conditions	NA	NA	NA	NA	NA	YES	YES	YES	NO

Source(s): Federal Reserve Bank of St. Louis and UBP 'mini-cycle'. However, as the UBP Recession Watch indicators highlight, the economy as a whole remains very much in expansion territory and is still a significant distance away from the threshold of a recession.

Should the coming mini-cycle mimic those seen over the previous three decades, investors should expect it to last for between 12-18 months:

- Long-term bond yields should reach a high point and then begin to decline as inflation is expected to peak in 2Q18
- Credit spreads should continue their widening begun earlier this year
- 20%+ earnings growth and dividends should offset multiple compression to drive moderate total returns in equities

Fixed Income Outlook

With US 10-year yields having risen from 2.1% in mid-2017 to nearly 3% in 2018, concern that US 10-year yields will continue to track higher is now weighing on investors. However, we believe that a number of factors suggest that the primarily upside risk in 10-year yields that investors faced in 2017 has now given way to two-way risk in 2018.

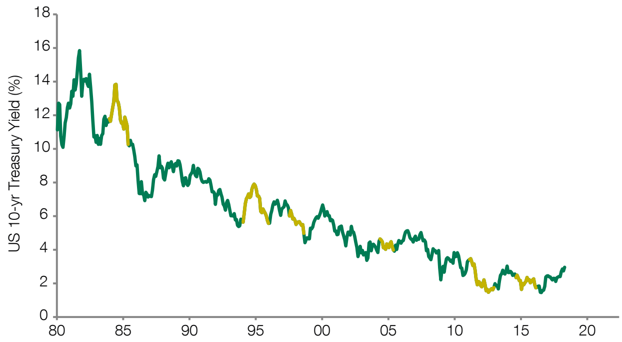
As highlighted in our 2018 Investment Outlook, we feel that movements in 10-year yields will be driven by both the normalisation of inflation-adjusted yields as well as cyclical factors such as growth and inflation. Indeed, the 'mini-cycle' of 2015-16 highlights the important role that two-way risk in 10-year yields still plays in cushioning slowdowns in the US economy.

The recovery in the US economy in 2017 has resulted in the pronounced back-up in yields in recent months, returning them to the lower end of what we expect will be a new range for the Fed in the coming cycle.

Widening government budget deficits are the key catalyst for continued upward pressure on 10-year yields while a peak in growth and inflation in coming months should present the primary headwinds. As a result, investors should not be surprised to see US 10-year yields peak in the weeks ahead in the 3-3.5% range.

A peak and decline in 10-year yields would be consistent with what was seen during previous 'mini-cycles' where 10-year yields fell by an average of 126 bps. As a result, investors who had previously been focused on floating rate strategies may benefit from shifting towards fixed rate fixed income strategies as well as extending duration in portfolios as we have begun to do in portfolios.

US Government bond yields tend to fall during mini-cycles



Source(s): Federal Reserve Bank of St. Louis and UBP

Bond investors who had previously sought refuge from low government bond yields by moving into corporate credit would be wise to become more cautious. In five of the six mini-cycles observed since the 1980s, bond investors experienced a widening in corporate credit spreads by an average of 55-60 bps compared to the 15 bps widening seen from their troughs of 2018.

As a result, having already moderated our high yielding corporate credit exposure in 2017, we are now taking steps to manage exposure to widening investment grade corporate credit spreads actively by looking selectively at government and mortgage opportunities.

Equity Outlook

In contrast to bond markets where falling yields and rising spreads were consistent across the mini-cycles previously observed, US equity returns saw less consistent return profiles, ranging from +39% in 1994-95 to -0.3% in 2015-16. Encouragingly, total returns delivered in five of the six observed 'mini-cycles' since 1980 have remained positive (see table).

Mini-Cycles bring tradeable volatility and still positive returns for equity investors

	S&P 500 Contribution to Total Return				Peak to Trough
Mini-Cycle	PE	EPS	Div	Total Return	Rise/Fall
1984-85	-11.4%	29.7%	7.7%	22.6%	0-19%
1994-95	-6.1%	42.4%	4.9%	38.7%	-7% to +31%
1997-98	6.6%	-0.7%	2.0%	8.6%	-12% to +39%
2004-05	-8.6%	16.4%	1.9%	8.2%	-5% to +10%
2011-12	-10.0%	18.6%	4.2%	10.9%	-19% to +32%
2015-16	-1.1%	-2.1%	2.8%	-0.3%	-15% + 11%
Average	-5.1%	17.4%	3.9%	14.8%	
Median	-7.4%	17.5%	3.5%	9.7%	

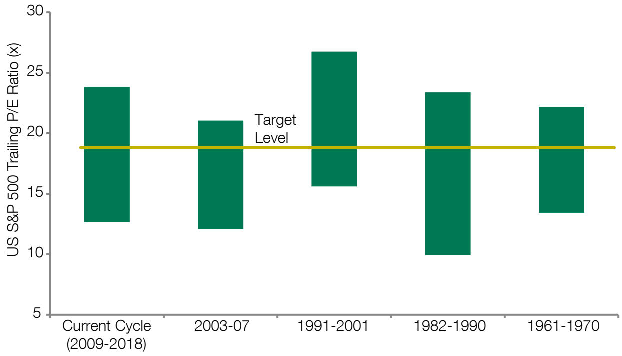
Source(s): UBP

In addition, in five of the six of the observed mini-cycles since 1980, investors saw PE multiples contract, sometimes only modestly (1% in 2015-16) though on occasion by as much as 11% as happened in 1984-85. Where earnings grow was robust, earnings and dividends were sufficient to drive an 8-11% total return in equities in the mini-cycles since 1997. However, strong earnings growth in 1984-85 and 1994-95 allowed for total returns of 23% and 39%, respectively.

In light of the potential for earnings growth of 20%+ in the US for 2018 even assuming a further 5-10% compression in PE multiples, we expect moderate, though attractive positive total returns as we look towards the rest of this year.

We expect US equities to return 8-10% in 2018, though volatility will be high. Indeed, in previous mini-cycles, investors experienced drawdowns of as much as 19% only to see markets rebound as much as 30-40% from the mini-cycle lows (see table). This supports the case for investors to stay invested during 'mini-cycles' and look at volatility as an opportunity to rotate positions in and risk exposure to markets. Hedge fund exposure and capital protected strategies can complement an active approach to stock and sector selection to manage risk.

Look for a de-rating to return valuations back to cycle averages



Source(s): UBP

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