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Economic & Market Perspectives

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THIS IS WHAT LATE CYCLE LOOKS LIKE

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For most of the past decade, asset prices have risen with limited interruption. However, the investment environment has shifted over the past year and a half, and portfolios that served investors well during the steady ascent of risk assets could now be exposed and will have to work harder to generate returns than in previous years. This is what late-cycle investing looks like. More modest gains, with higher volatility, as investors grapple with uncertainty surrounding policy and mixed messages about the sustainability of the expansion.

KEY POINTS

Our base case is that the slowdown underway stabilizes, and another more modest growth cycle begins.

Our outlook is for the Fed to cut the federal funds rate one or two more times this year.

The pace of employment gains remains strong despite concerns over the weaker global economy and trade policy uncertainty.

The yearly change in core CPI is at 2.2%, slightly above the Fed's target rate of 2.0%.

Consumer spending is alive and well, with the monthly retail sales report posting six consecutive monthly gains.

In this context, recent market action is understandable. With relatively healthy domestic-driven data clashing with more troubling reports from overseas, and traditional recessionary signals like the yield curve sending warnings, investor sentiment has increasingly swung between two poles: Either the cycle is ending or there is nothing to worry about, and the cycle will continue to reach new highs.

Such a binary view, however, is too simplistic. An extended business cycle like the one we are currently experiencing can be properly understood as being composed of a series of mini-cycles, or alternating periods of accelerating and decelerating growth. We've had three such growth cycles thus far in what is now the longest expansion in history. The question is: Where do we go from here?

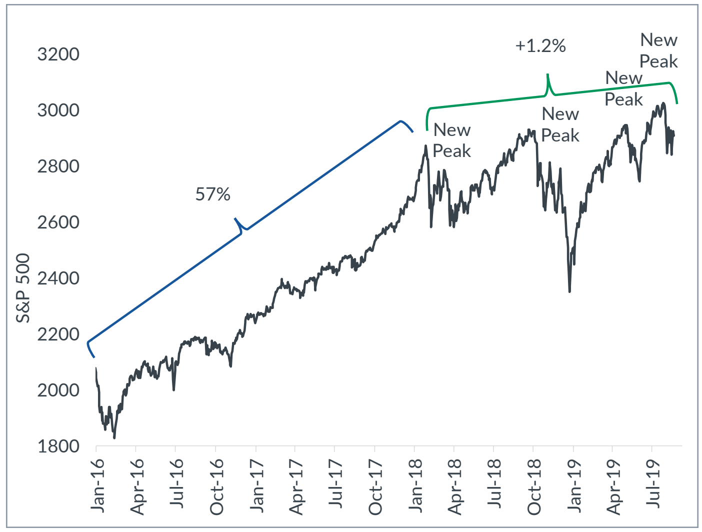
Our base case is that the slowdown underway stabilizes, and another more modest growth cycle begins. Certainly, the manufacturing sector is facing its share of challenges against a weakening global backdrop and trade tensions. Yet the broader U.S. economy has been mostly resilient. On rare occasions, like in 2008, troubles in one sector get so large that they take down the entire economy, especially when concentrated in the banking and consumer sectors. Usually, however, this is not the case.

In 2000, the tech sector came crashing down, but the spillover effects on the broader economy were barely noticed. In 2015, the same happened with oil. While we don't expect the broader economy to be unaffected by the current slowdown in the manufacturing sector, for now we have good reason to believe its impact will be limited as well. The U.S. economy is largely consumer driven, and here fundamentals continue to be strong: The labor market remains resilient, household balance sheets are healthy, and consumers are confident and spending. Manufacturing, in contrast, is a relatively small part of the overall economy, accounting for roughly 11% of GDP.

Moreover, despite the advanced age of this business cycle, we still see few signs of the excesses in the economy that jeopardized expansions in the past. The U.S. economy

FIGURE 1

S&P 500

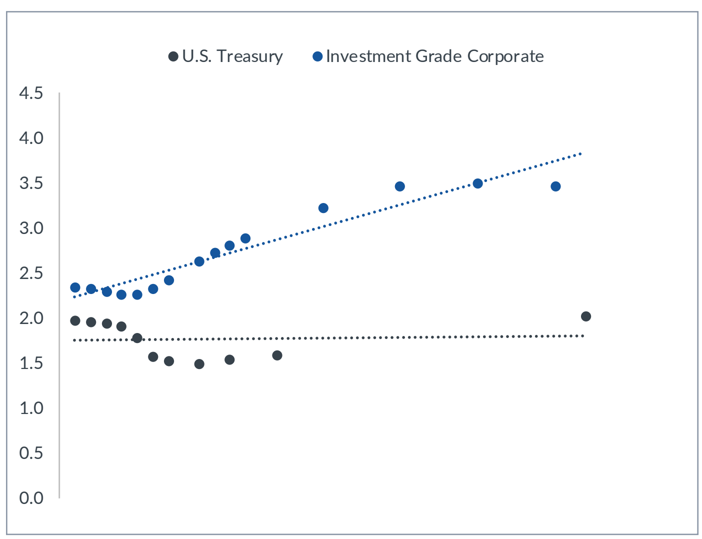


Source: FactSet as of 8/20/2019.

> "Our base case is that the slowdown underway stabilizes, and another more modest growth cycle begins.

FIGURE 2

Corporate vs. Treasury Curve
Corporate Curve Remains Steep



Source: Bloomberg as of 8/16/2019.

has only recently hit full capacity, and history has shown that the late cycle of an expansion can last a long time before vulnerabilities build up. While the yield curve is flashing yellow, and sometimes red, credit markets are also signaling stability ahead. Indeed, we think the yield curve currently is saying more about the global state of affairs and that the credit markets are the more relevant indicator of U.S. economic health.

From this perspective, recent market reactions appear again to be driven more by psychology than fundamentals. We are not dismissive, though, of investor concerns altogether. Risks have risen somewhat, as an aging expansion is more vulnerable to policy missteps and other shocks. Brexit and instability in Europe, auto tariffs, an escalation of tensions with our key trading partners and weakness in China, all number among the many expected or potential challenges that loom ahead for the global economy, to which the U.S. will not be completely immune. Equity valuations too are beginning to look high, which is typical of late cycle. Bear markets historically have rarely been linked to high valuations alone. Usually, one needs a combination of other factors, such as a recession or aggressive Fed tightening. However, the higher valuations are, the higher the perch is from which to fall.

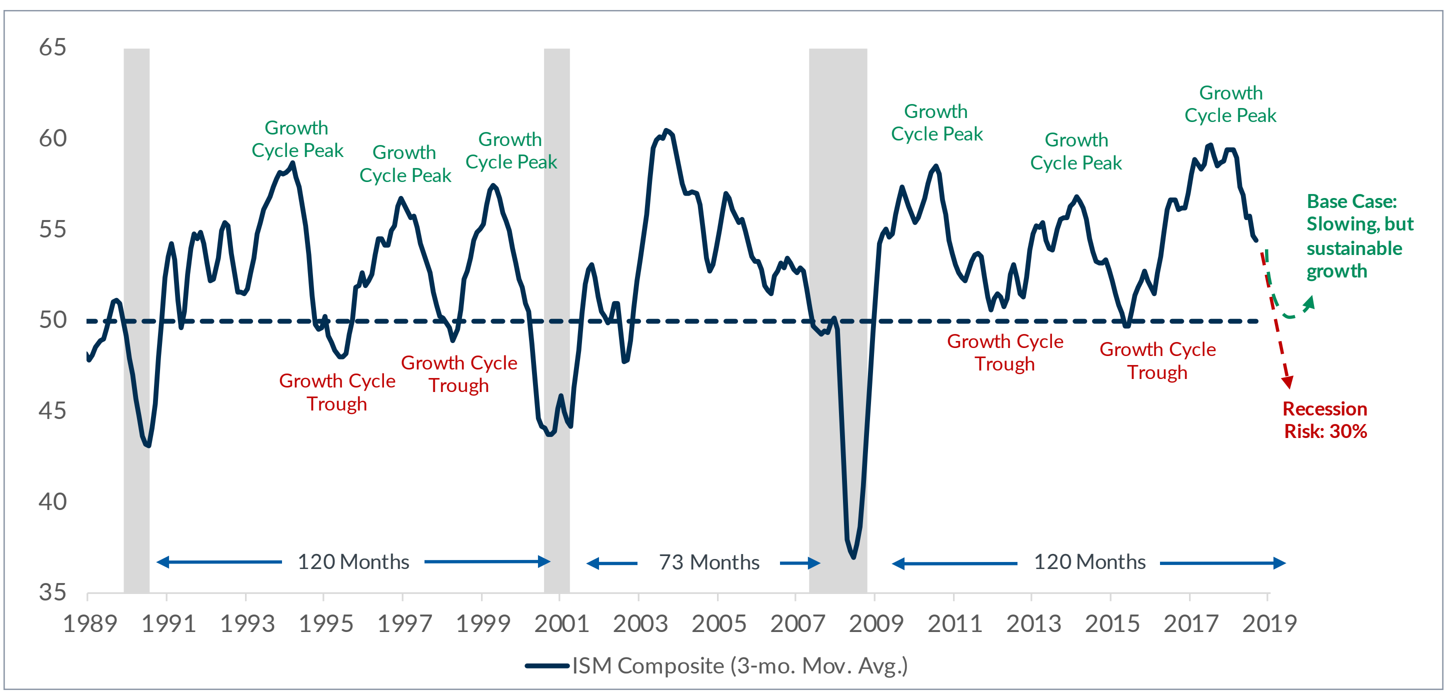
The good news is that we are not entirely in uncharted waters here. Over the past year and a half, trade and global growth fears have surfaced frequently, as have worries over the yield curve and falling interest rates, leading to several sizeable pullbacks in stock prices. In each instance, the market reacted in a similar fashion, pulling back initially before reconnecting to the broader fundamentals.

Navigating financial markets will require more thought and selectivity as we continue to move later in the cycle, and risks to the expansion rise further. Per our late-cycle playbook, we continue to focus on quality and yield through an emphasis on more stable asset classes. In our equity portfolios, our focus is on higher-quality domestic companies as well as dividend payers, which provide income and can help bolster returns in times of market stress.

At the same time, we have recently lowered exposure to MidSmall Cap equities, which tend to be more vulnerable

FIGURE 3

Cycle Within a Cycle



Source: FactSet as of 7/2019.

in a downturn, and are underweight export-oriented sectors and international regions most affected by trade and global headwinds. In our fixed income portfolios, we think opportunistic income still offers attractive opportunities but have nudged quality higher across our various strategies in response to late-cycle indicators, and we prefer asset classes with more seniority in the capital structure.

Late-cycle investing can be stressful but also rewarding for investors willing to take a more prudent approach. By focusing on high-quality U.S. stocks, select credit areas, and alternatives, we believe we have positioned our portfolios to help withstand late-cycle volatility and minimize risk yet continue to participate in future gains.

THE FED

The Fed has made two distinctive pivots this year. Back in January, the Fed stated that it would sit on the sidelines for the foreseeable future, a remarkable change in direction from just a few weeks earlier, in late December, when it hiked interest rates and planned on several more hikes in 2019. Then, at its July 31 meeting, the Fed cut the median federal funds rate from 2.375% to 2.125%. This was the first reduction in that rate in over a decade and follows nine hikes (225 basis points) over a three-and-a-half-year period.

The Fed cited concerns about the global economy and muted U.S. inflation and left open the door for further

FIGURE 4

Historically, Bear Markets Have Rarely Been Linked to High Valuations Alone

Bear Markets	Market Peak	Return	Duration (Months)	Macro Environment			
				Recession	Commodity Spike	Aggressive Fed	Extreme Valuations
Crash of 1929 – Excessive leverage, irrational exuberance	September 1929	-86%	32				
1937 Fed Tightening – Premature policy tightening	March 1937	-60%	61				
Post-WWII Crash – Postwar demobilization, recession fears	May 1946	-30%	36				
Flash Crash of 1962 – Flash crash, Cuban Missile Crisis	December 1961	-28%	6				
Tech Crash of 1970 – Economic overheating, civil unrest	November 1968	-36%	17				
Stagflation – OPEC oil embargo	January 1973	-48%	20				
Volcker Tightening – Whip Inflation Now	November 1980	-27%	20				
1987 Crash – Program trading, overheating markets	August 1987	-34%	3				
Tech Bubble – Extreme valuations, dot-com boom/bust	March 2000	-49%	30				
Global Financial Crisis – Leverage/housing, Lehman collapse	October 2007	-57%	17				
Current Cycle	-	-	-				
Average		**-46%**	**24**	**80%**	**40%**	**40%**	**50%**

Bear markets outside recessions are rare.

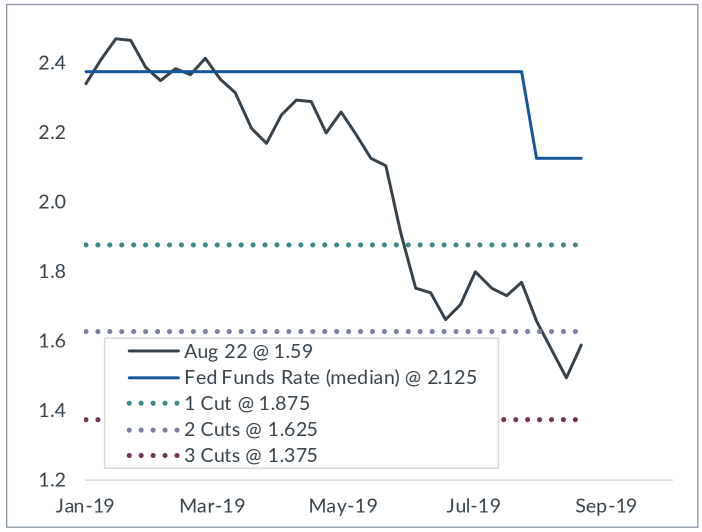
Source: J.P. Morgan, FactSet as of 7/2019.

rate reductions. Powell described the move as a "mid-term policy adjustment." We have seen this before. Back in the 1990s, the Greenspan Fed lowered interest rates in 1995 and 1998 to help extend the economic expansion. It worked. That expansion lasted 120 months, the longest expansion in U.S. history up until that time (it was just surpassed by this expansion, which is now in its 122nd month).

Our outlook is for the Fed to cut the federal funds rate one or two more times this year. It has three meetings left this year; the next one is on September 18. The federal funds futures market is a little more aggressive in its outlook compared to us. It expects two to three cuts this year (see Figure 5).

FIGURE 5

Federal Funds Futures Market Pricing Two to Three Cuts
Yield of December 2019 Federal Funds Contract (%)



Source: Chicago Board of Trade as of 8/2019.

LABOR

The pace of employment gains remains strong despite concerns over the weaker global economy and trade policy uncertainty. That said, it has slowed compared to last year. But 2018's very strong pace was a bit of an aberration.

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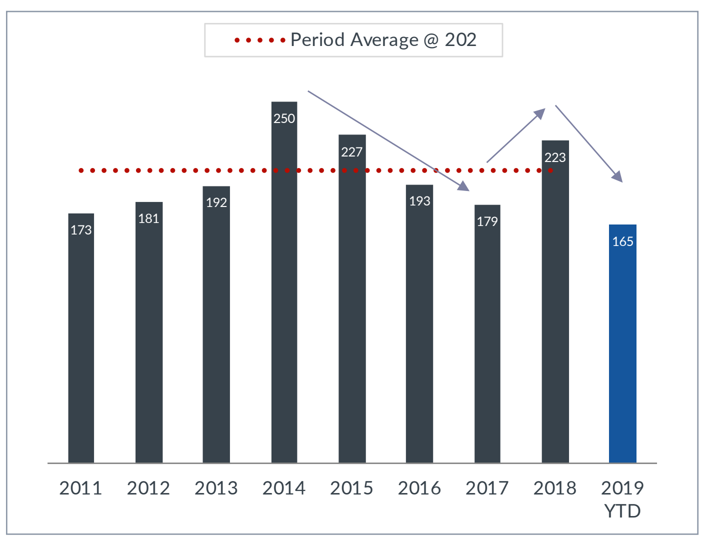
After peaking in 2014, the average monthly gains in payrolls fell for three consecutive years. In 2018, however, the labor market got a boost from the President Trump/GOP stimulus plan. With the large corporate tax cut, many businesses increased hiring to expand their businesses. As that stimulus wears off, payroll gains are reverting to the slowing trend in growth that is normally found in our aging expansion (see Figure 6). Although current year-to-date gains are lower than the average annual gains of the previous nine years (the full calendar year of positive monthly gains in payrolls), they are still well above the amounts needed to absorb new entrants into the workforce. It is important to note that the Bureau of Labor Statistics will be revising its labor data, which will show that job growth in 2018 was not as robust as the current official data states. Those revisions will be available in Q1 2020.

FIGURE 6

Average Monthly Change in Nonfarm Payrolls ('000)



Source: Bureau of Labor Statistics as of 7/2019.

Another indicator of sustained strength in the labor market is the unemployment rate, which is holding steady at 3.7%. It has been at 4.0% or lower for about a year and a half.

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INFLATION

Price pressures are beginning to mount as the big three inflation components (housing, transportation, and food and beverage) are starting to have an impact on prices. The monthly change in the core Consumer Price Index (CPI) has increased by 0.3 in the past two months compared to half that rate for the previous 12 months (see Figure 7). To show how long a period of time we have been experiencing low inflationary pressures, the recent gains mark the first time there have been two consecutive monthly gains of 0.3 or higher since the mid-1990s. The yearly change in core CPI is at 2.2%, slightly above the Fed's target rate of 2.0%.

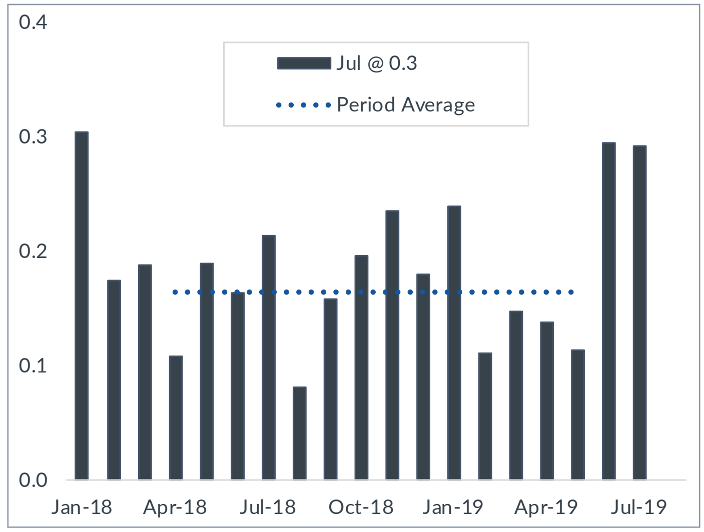
This summer's tariff increase on $250 billion in imports from China from 10% to 25% will probably drive prices higher. But higher prices from tariffs is not what the Fed is looking for in its goal to strengthen inflation. It knows that tariff-induced price increases will last for just one year, as the price will eventually fall off the yearly calculation of inflation. Also, these tariffs and trade conflicts are helping to drive down economic growth outside the U.S., which is weighing on commodity prices and strengthening the U.S. dollar. Both of these factors will exert offsetting downward prices pressures in the near term.

CONSUMPTION

Consumer spending is alive and well, with the monthly retail sales report posting six consecutive monthly gains.

FIGURE 7

Consumer Price Index (%)
Monthly Change (%)

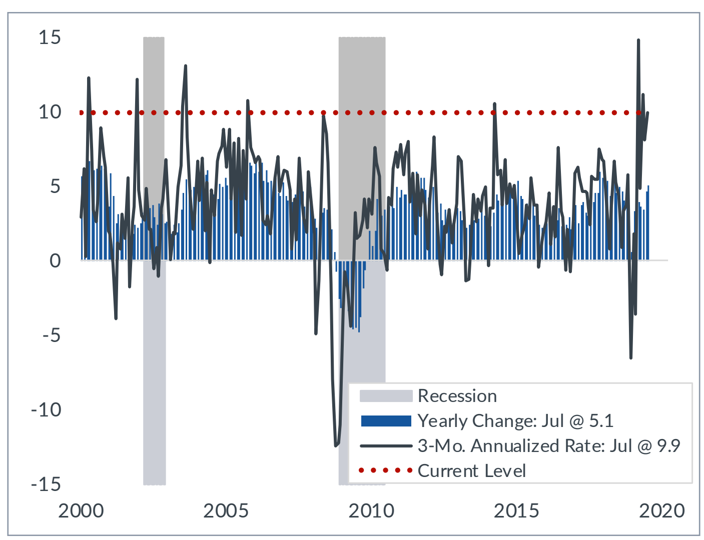


Source: Bureau of Labor Statistics as of 7/2019.

> The yearly change in core CPI is at 2.2%, slightly above the Fed's target rate of 2.0%.

FIGURE 8

Consumer Spending Continues at a Strong Pace
Retail Sales Control Group (% change)



Source: Bureau of Labor Statistics as of 7/2019.

This is a dramatic shift from the previous 12 months, in which there was never more than two consecutive monthly gains. This recent consistency of gains, along with strong employment and income fundamentals, gives economists confidence that households are not apt to significantly pull back on spending as market volatility makes headline news. All of this is happening at a time when the savings rate is above 8.0%, so households are not straining to spend. Furthermore, consumers are getting a boost from financing costs that are falling due to the Fed cutting short-term interest rates, and weakness in the global economy is helping to push down longer-term interest rates (the 10-year Treasury note is at 1.61%, down 1.63 percentage points from its recent high in November).

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Within the retail sales report is a sub-category called the control group, which excludes volatile components such as food services, auto dealers, building materials and gas stations. It feeds into the consumption calculation for GDP. This has been very strong in the past few months (see Figure 8), leading economists to believe consumption will be an important part of Q3's performance.

Index Definitions

The Standard & Poor's 500 Index (S&P 500) is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.

The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them.

Indices are unmanaged, and one cannot invest directly in an index. Index returns do not reflect a deduction for fees or expenses.