Late cycle investing: Keeping the party going

This is the second part of a multi-part special series on investing at what can be a challenging time for investors.

At a glance:

- Policymakers have leveraged various mechanisms historically including monetary easing and fiscal stimulus to prevent a recession.
- However, major central banks have now little or even no room to bring interest rates lower to stimulate the economy.
- A critical element in extending the cycle relies on fiscal support so businesses and employment levels are not compromised. Employment rates in major developed economies will indicate if the cycle can be sustained.

Getting the recession timing is important. With the yield curve inversion in August 2019 signalling a countdown to the next recession, policymakers have tools at their disposal to extend the current global expansion.

The growth drag from US-China trade tensions is an incentive for government policymakers to deploy monetary and fiscal stimulus to stimulate demand. The Federal Open Market Committee is expected to further slash interest rates to offset the effects of slowing growth from escalating trade tensions.

One of the key silver linings of recent global weakness is that inflation remains low around the world, implying central banks have much more flexibility than is usual at this stage of a cycle. We are of the view that the US Federal Reserve (Fed) will enact a minimum of two interest rate cuts up till the end of 2019.

However, this may or may not be sufficient to prevent a recession or could have the effect of extending the recession onset further down the road. Though the well-trodden paths of fiscal spending and massive quantitative easing helped to ease the effects from the 2008 global financial crisis, the economy is now facing a different set of demands.

Limits of monetary policy

The effectiveness of monetary stimulus has been diminished as major central banks have little or even no room to bring interest rates lower. In fact, the US is left as the only major economy with interest rates above zero. Monetary policy can only do so much in an era where more than one third of developed market debt is yielding negative returns. It is possible, and the case is growing, that governments would increasingly turn to fiscal stimulus to pick up the slack initially before enacting unconventional options.

Meanwhile, for corporates, rate cuts could possibly signal economic uncertainties and in turn, lead to a more cautious outlook on expenditure.

Historical comparisons

Historically, the Fed has enacted interest rates cuts to extend a cycle and not all have achieved the intended purpose. The successful instances occurred in July 1995 and September 1998 when the markets rallied after the first rate cut. Conversely, markets slumped after rate cuts in January 2001 and September 2007.

Our view is that a critical element in extending the cycle in 1995 and 1998 was support for businesses so that employment levels were not compromised. In 2001 and 2007 once employment levels started to drop, consumer confidence tumbled which led to weaker spending and in turn dismal hiring activity.
It is all about jobs, jobs, jobs.

Hence we will be closely watching employment rates in major developed economies over the coming quarters. Throughout the G3 countries (Japan, US, European Union), employment has not yet shown significant signs of weakness. If rate cuts can solidify business confidence and margins, allowing employment to remain solid, then that provides strong evidence that the cycle can be sustained. Conversely, if we see weak employment trends and rising unemployment claims in the US, that would be a sign that the downward momentum is building toward a recession.

Conclusion

The US economy has seen business confidence, trade and manufacturing numbers taking a hit, while consumer spending, jobs and housing data are not raising alarm bells. Between these two camps, it is possible for healthy consumer spending to improve business or have the former drag on consumer sentiment.

It is our view that the tension between weak global business confidence and healthy global consumer confidence is going to determine whether the cycle can be extended or not. If inflation were high and central banks did not have room to cut rates, then we think the risks of a recession would be overwhelming. But in the current environment with low inflation and rate cuts, we note the increased risks of a recession but remain cautiously optimistic the cycle can be extended.

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