Macro Monthly

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UBS Asset Management
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- The US business cycle is aging, although we see little risk of a recession over the next twelve months. We remain overweight global equities but recognize that risk-adjusted returns will be lower as the cycle matures.
- US tax reform could end up extending the current economic expansion, depending on its effects on productivity and labor force participation.
- As the US economy transitions into late cycle, we recommend reducing exposure to credit and increasing exposure to commodities.

Investing in a mature cycle

Where are we in the business cycle? This is always one of the most important questions for asset allocation, but it is becoming even more relevant as this historically long expansion trudges forward. In May, the US economic expansion became the second longest in post-war history,[1] which inevitably brings into question how much longer it can possibly last. Of course, the answer to this question can only truly be known ex-post—we can only be sure where we stood in the cycle at any given time once the expansion ultimately ends in the form of a recession. What we can do now is look at historical cycles and compare current economic and financial market data to what has preceded recessions in the past. In this Macro Monthly we discuss what the past tells us about where we currently are in the cycle, what could shorten or extend this cycle, and how we are positioning our portfolios based on these assessments.

Why the focus on the US business cycle, as opposed to the global expansion? This is a valid and important question. The expansion has been longer in the US given mini-contractions in Europe and Japan earlier in the post-crisis period. Many of the emerging market economies also suffered a dip in activity in 2014 and 2015 amid a sharp decline in Chinese manufacturing and in commodity prices. Moreover, recent global economic performance has been synchronized; it is reasonable to imagine some decoupling of the rest of the world from a mild recession in the US. That said, the US remains the world's largest economy and importantly, the world's largest importer. A sharp cutback in spending by US consumers and production by US businesses will impact countries and regions with large trade surpluses, including Europe, Japan and China. Just as important are financial linkages. Dollar assets make up half of the investable world; a sharp decline in US asset prices will inevitably lead to de-risking in other areas of the world, even if there is some rebalancing outside the US. And the US dollar remains the world's global funding currency. Tighter financial conditions in the US spread to those countries that fund in dollars; recent weakness in emerging markets is a useful reminder of these ties. In short, while there may be some decoupling amid a US downturn, it is unlikely that non-US economies and risk assets would perform strongly.

Mid or late cycle?

An oft-cited refrain, repeated in recent years by former Fed Chair Janet Yellen, is that 'expansions don't die of old age.' While we agree, we do note that the longer economic cycles last, the more time there is for the underlying conditions to build that lead to an overheating and Fed tightening that triggers an end to the expansion, either via inflation or financial market imbalances. In some ways today looks very late cycle.

[1] The National Bureau of Economic Research (NBER)

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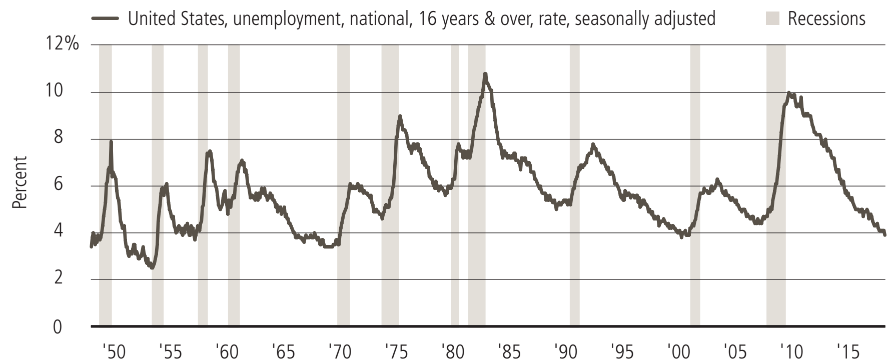
The unemployment rate is exceptionally low, and history shows that typically labor markets do not remain this tight for long before a recession hits (see Exhibit 1); too hot a labor market implies reduced capacity, higher inflation and encourages tighter monetary policy. Indeed, labor market tightness along with gradually rising wages and inflation are prompting the Fed to remove accommodation, both via unwinding its balance sheet and rate hikes. And the yield curve continues to flatten (see Exhibit 2), which is the market's way of telling the Fed that expected near-term rates are closing in on perceptions of the long-term average rate.

On the other hand, there are reasons to think that this cycle still has plenty of room to run. While wages and inflation are rising, they are hardly breaking out to the upside. The Fed is tightening but at an extremely slow pace—the Federal Funds rate is still negative on a real basis (1.50%–1.75% policy rate minus an assumed 2% inflation), while overall financial conditions, measured via broad indexes or bank willingness to lend, remain easy. US profit margins, which typically decline late cycle, have been rising.

Moving the goalposts?

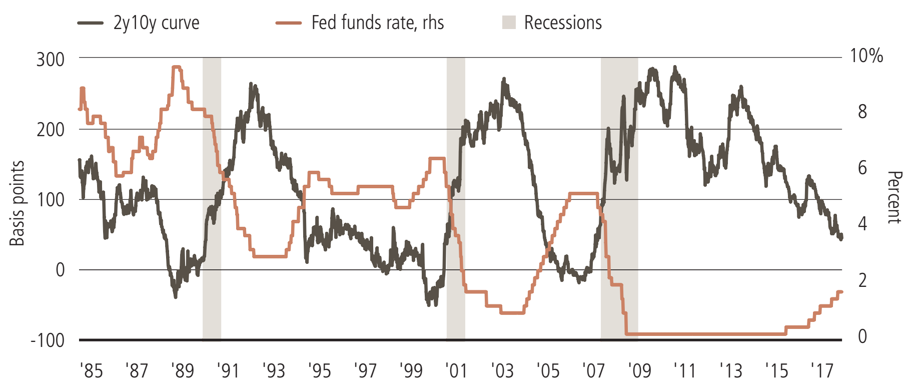
Further complicating considerations of this cycle's remaining runway is the significant fiscal stimulus to the US economy provided by the Tax Cuts and Jobs Act passed late in 2017 and the spending bill passed earlier this year. The stimulus is only now beginning to impact the economy and comes at a time when labor markets are already very tight. Thus, there are reasonable arguments on whether this will shorten or extend the current economic cycle. On the former, pressing on the fiscal gas pedal at full employment adds to risks of overheating and the Fed has already signaled a somewhat faster rate hike trajectory in response to the fiscal stimulus. Indeed, this would seem to set the stage for a challenging macro backdrop in 2020 when the Fed will have likely moved into restrictive territory just as the fiscal impulse to growth may be shrinking.

Exhibit 1: The unemployment rate rarely stays this low for long before a recession



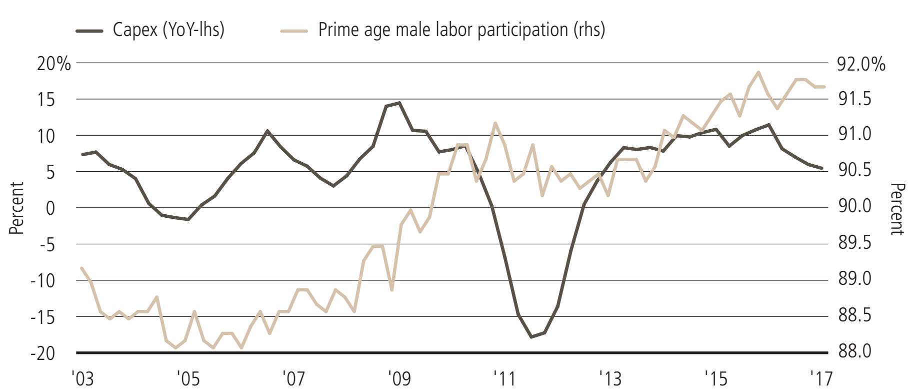
Source: UBS Asset Management, Macrobond.

Exhibit 2: An inverted yield curve has preceded recent recessions in the US



Source: UBS Asset Management, Macrobond.

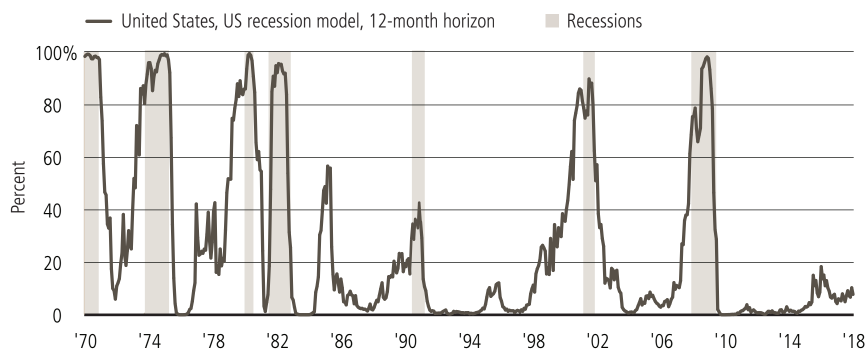
Exhibit 3: Capital expenditure and measures of labor force participation have picked up since 2016



Source: UBS Asset Management, Bloomberg.

On the other hand, should the lower tax rate and incentives for investment lead to an increase in capital investment, that could boost productivity and non-inflationary growth. Moreover, to the extent that labor force participation rises (see Exhibit 3), due to favorable economic policies or other considerations, the US's growth 'potential' would also be raised, reducing concerns about the US exhausting resources. Prime age male labor force participation and capital investment have been on an upward trend since 2016. To the extent that the tax plan or greater economic optimism continue these trends, it is possible that this economic cycle could have even more runway.

Exhibit 4: Our near-term recession model implies low probability of a downturn over 12 months

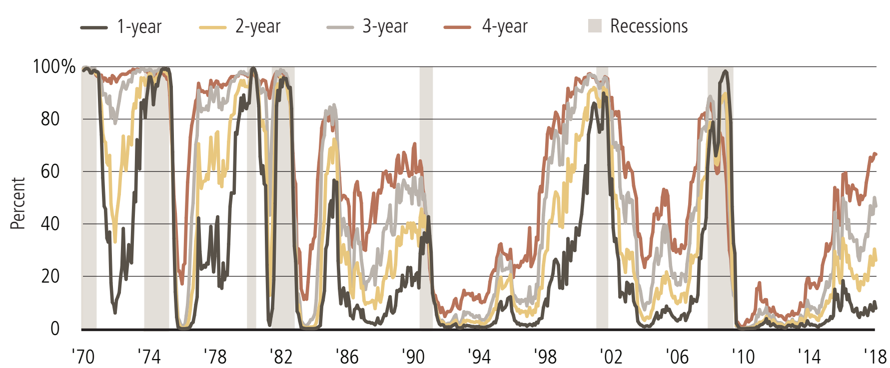


Source: UBS Asset Management, Macrobond.

Tracking the probability of a recession

With all of these cross-currents, it is very difficult to estimate how far this cycle will go. In addition to the framework discussed above, we have built a quantitative recession probability model. The model compares current economic conditions to those in place prior to past recessions. We have broken our recession model into two parts. The first is a short-term indicator, designed to detect a slowdown in leading growth indicators such as consumer and business sentiment, jobless claims and building permits. The idea here is to capture a deterioration in economic data as quickly as possible to gauge if the probability of an imminent recession is rising. The second part of our recession model looks at longer-term economic conditions that tend to precede recessions over time, such as the unemployment rate, wage growth, and profit margins. We compare current levels of those indicators to past periods in order to forecast the probability of a recession over time horizons further out.

Exhibit 5: The recession model implies higher probabilities of a downturn in coming years



Source: UBS Asset Management, Macrobond.

What do our recession models currently show? They suggest that given the current state of timely economic data, the probability of a recession over the next twelve months is low, at about 10% (see Exhibit 4). Of course, as is evident in past recessions, the probabilities can change quickly once these key data begin to deteriorate. As such, we will keep a close eye on this near-term recession model to gauge how probabilities are changing. And we keep a healthy humility that recessions are incredibly difficult to predict ex-ante, and therefore use this tool as an indicator rather than as a systematic trading strategy.

Our medium-term models suggest the probability of a recession rises to about one in three over the next two years and to 50% over three years (see Exhibit 5).

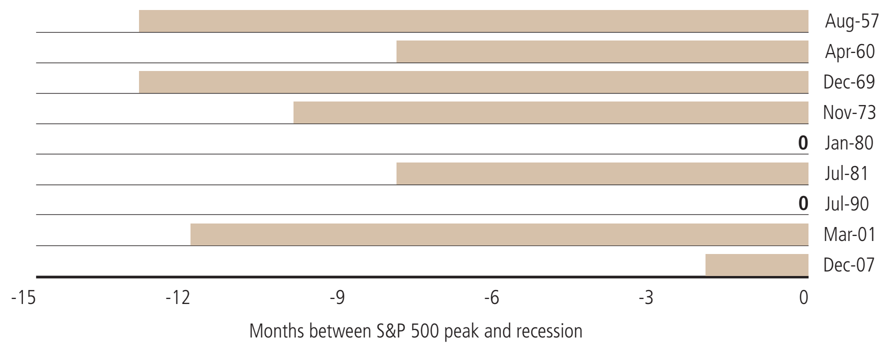
The rise in these probabilities over time reflects that when key variables like the unemployment rate look extreme, a recession is typically not too far out. Of course, forecasting over such long time periods based on the information we have today carries tremendous uncertainty. How economic data plays out, the future state of monetary and fiscal policy and geopolitical developments that will impact the economy in coming years are all unknowns that can materially affect forecasts, so these numbers should be viewed with healthy caution.

The cycle and markets

As economic cycles get closer to the end, risks rise and volatility picks up. That certainly has been the case this year, in which risk-adjusted returns for global equities have been much lower than in 2017, and we expect this to continue to be the case. That said, it is difficult to be too cautious on equities with our near-term recession indicator still showing a low probability that the expansion ends over the next twelve months. The S&P 500 has peaked a maximum of 13 months and an average of seven months ahead of each of the last nine recessions (see Exhibit 6). For January to have marked the peak in equities for this cycle, that would imply a recession by 1Q 2019. Given our recession indicator shows a low likelihood of recession over that time frame, it seems that fresh highs for this cycle are still likely, at least based on historical precedent.

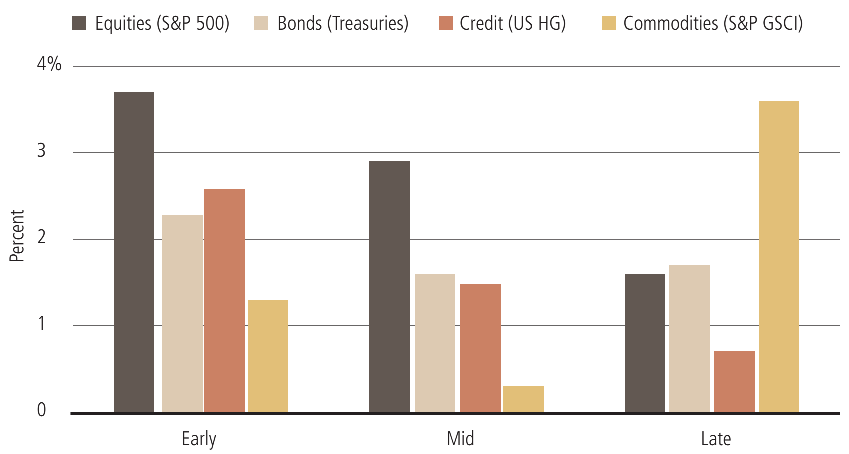
Still, performance of various asset classes tends to change depending on where we are in the cycle. Exhibit 7 shows annualized asset performance in early, mid- and late-cycle periods. While 'late cycle' can be defined in different ways, here it refers to the last four quarters before a recession. As we move from mid to late cycle, the performance of equities is lower but remains positive. Credit tends to underperform other asset classes late cycle, and ahead of the last two recessions credit peaked a few quarters before equities did. As discussed in last month's Macro Monthly on oil, historically, the standout performer late cycle is commodities as demand outstrips supply.

Exhibit 6: The S&P 500 has peaked on average seven months before a recession



Source: UBS Asset Management, NBER, Bloomberg.

Exhibit 7: Average quarterly returns by phase in US business cycle



Source: UBS Asset Management, J.P. Morgan. Late cycle refers to the last 4 quarters before recession starts. Early cycle refers to the first 4 quarters after recession ends. Mid-cycle refers to the period in between.

The bottom line: Asset allocation

While we cannot be sure exactly where we are in the cycle until the recession hits, our impression is that we are in a period of transition from mid to late cycle. As we go through this transition it makes sense to reduce credit exposure, and we are underweight high yield given our unattractive risk-reward view of it at this stage. We have also added exposure to oil both as a diversifier against inflation and geopolitical risks, in addition to its history of performing well in the late cycle. With a recession still looking over a year away, we remain comfortable with an overweight stance on global equities. That said, we are keeping a close eye on our recession probability models and the effects of policy that may shorten or extend the cycle to guide our positioning.

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Americas

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