Investing Strategies for a Maturing Business Cycle

Understanding the potential portfolio implications of a U.S. transition to the late cycle

Dirk Hofschire, CFA | Senior Vice President, Asset Allocation Research
Lisa Emsbo-Mattingly | Director of Asset Allocation Research
Jacob Weinstein, CFA | Research Analyst, Asset Allocation Research
Cait Dourney, CFA | Research Analyst, Asset Allocation Research

Key Takeaways

- The risk of U.S. recession remains low, but late-cycle pressures have been on the rise.
- Tax cuts have boosted the U.S. corporate sector and partially offset these late-cycle pressures, but their effects are likely to fade as monetary policy grows tighter.
- The business cycle can be a critical determinant of asset market returns and the relative performance of various asset classes; asset return patterns during the late cycle tend to be less consistent than during other stages of the cycle.
- The business cycle can be used as one tool for portfolio positioning, to inform small, intermediate-term portfolio tilts within the context of a long-term asset allocation strategy.
- At this point in the cycle, portfolio diversification is essential, smaller cyclical tilts are warranted, and investors may benefit from inflation-resistant assets.

Our 2018 outlook posited that the U.S. and global economic expansions would continue but that the maturing business cycle backdrop could result in higher market volatility. As we move toward the end of the year, signs of later-stage cyclical trends are becoming more evident.

Every business cycle is different, but our historical analysis suggests that the rhythm of cyclical fluctuations in the economy has tended to follow similar patterns. Such distinct changes in the rate of growth in economic activity have influenced the relative performance of various asset classes over the medium term. To identify shifts in the business cycle, we focus particular attention on changes in three key mini cycles—the corporate profit cycle, the credit cycle, and the inventory cycle—as well as changes in the employment backdrop and monetary policy. While the economy expands in both the mid- and late-cycle phases, the transition to the late cycle typically moves the economy past the peak rate of economic growth. It's important to note that the evolution from mid to late cycle tends to be less well defined than during other phase shifts, which may lead to an extended transition period.

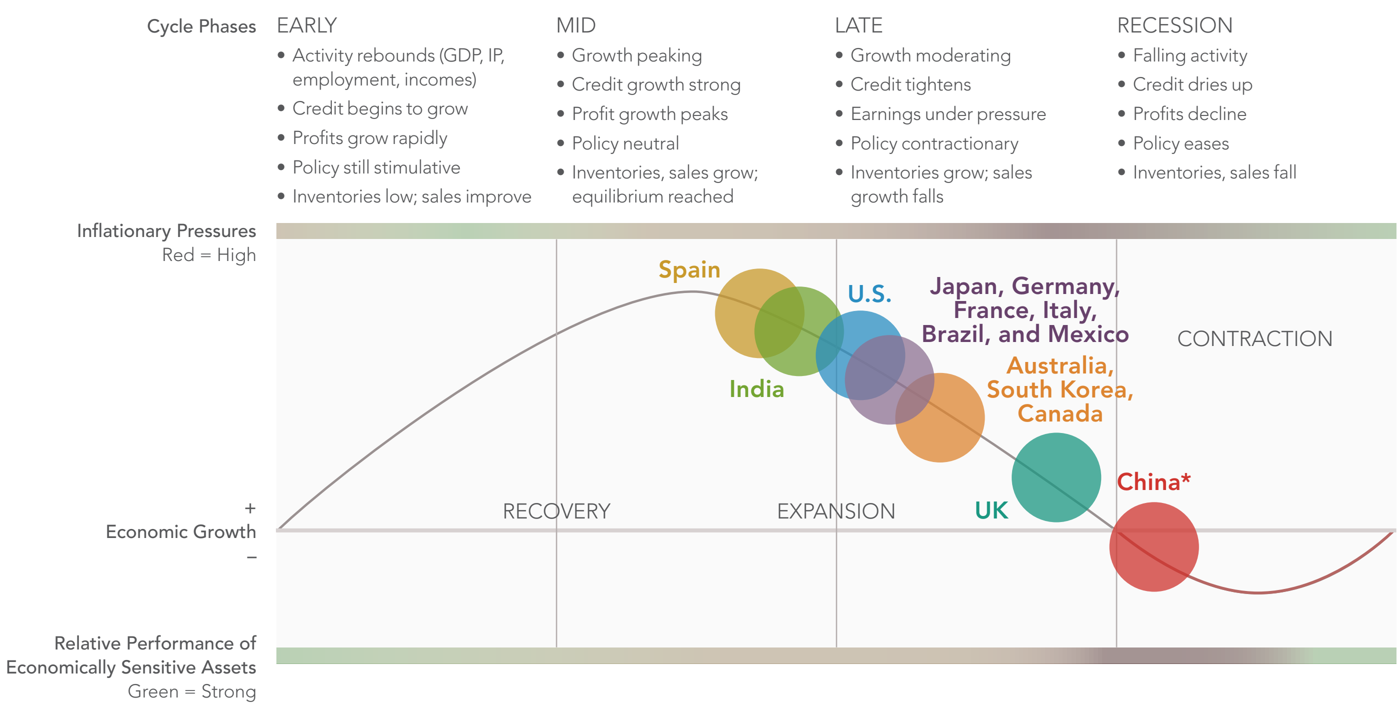
Fidelity INVESTMENTS

The following is a review of major factors that characterize a shift from the mid to the late stage of the business cycle:

- **Labor markets—**Unemployment typically declines the most during the mid-cycle phase, leading to late-cycle tightness in the employment markets that tends to spur accelerating wage inflation.
- **Monetary policy—**The Federal Reserve (Fed) typically begins hiking rates and neutralizes monetary policy during the mid-cycle phase, often resulting in a flattening of the yield curve (when the differential between short- and long-term yields narrows). Additional monetary tightening generally leads to outright restrictive policy during the late cycle.
- **Corporate profits—**During the typical mid-cycle phase, corporate revenues and profit margins expand. In contrast, rising input inflation during the late-cycle phase generally causes profit margins to shrink and earnings growth to decelerate.
- **Credit—**Credit growth is generally strong during the mid-cycle phase, as demand rises while credit availability improves. During the late-cycle phase, credit access usually tightens when lenders become more restrictive.
- **Inventories—**Typically, inventories (relative to sales) remain lean during the mid-cycle phase and then rise as production outpaces sales growth during the late cycle.

EXHIBIT 1: The U.S. and global business cycles are maturing.

Business Cycle Framework



The diagram above is a hypothetical illustration of the business cycle. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one. * A growth recession is a significant decline in activity relative to a country's long-term economic potential. We use the "growth cycle" definition for most developing economies such as China because they tend to exhibit strong trend performance driven by rapid factor accumulation and increases in productivity, and the deviation from the trend tends to matter most for asset returns. We use the classic definition of recession, involving an outright contraction in economic activity, for developed economies. Source: Fidelity Investments (AART), as of Sep. 30, 2018.

Transition to late-cycle phase: Tighter capacity and higher inflationary pressures

Historically, the transition from mid cycle to late cycle has involved a pickup in inflationary pressures. The late-cycle phase can often be characterized as an overheating stage for the economy when capacity becomes constrained, which leads to rising inflationary pressures. While rates of inflation are not always high, rising inflationary pressures and a tight labor market tend to crimp profit margins and lead to tight monetary policy.

Late cycle is not synonymous with recession

It's important to note that while the late-cycle phase typically coincides with peak economic activity, it is distinct from the recession phase that usually follows it. Recessions are characterized by outright and broad-based declines in economic activity, contractions that typically unwind the excesses built up during the expansionary upturn. On average, late cycles last a year and a half. However, the character of late cycles tends to be less homogenous than other phases, and historically has ranged in length from less than a year to more than two years before the beginning of recession.

What are the current business cycle dynamics in the U.S.?

The U.S. has remained on a gradual progression through its business cycle, experiencing mid- and late-cycle dynamics and low risk of recession (Exhibit 1). Economic growth remains healthy, but the onset of late cycle appears imminent, as late-cycle pressures have recently been on the rise. Most notably:

- Improving job conditions have pushed labor markets even tighter and are now putting upward pressure on wages.
- The Fed has responded by hiking short-term interest rates, and the yield curve has flattened.

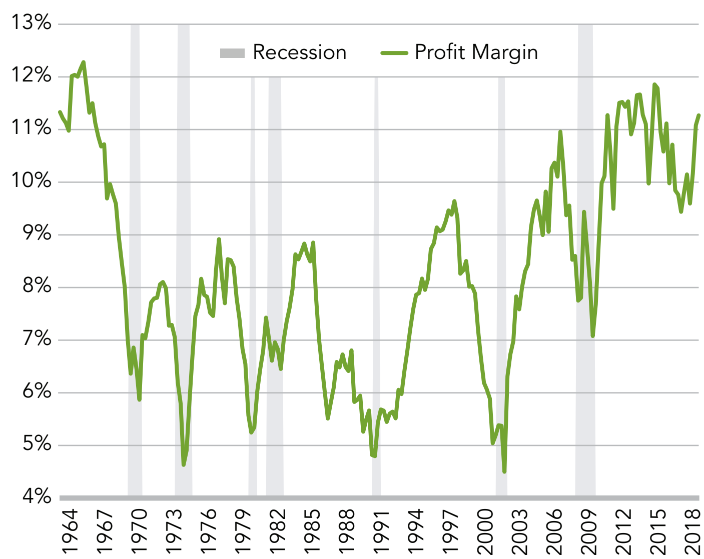
So far, the beneficial effects of changes in tax policy that were implemented in early 2018 have partially offset these late-cycle pressures. Most importantly:

- Corporate tax cuts significantly boosted after-tax profits for U.S. companies, reversing the trend of falling profit margins that had been in place since 2015 (Exhibit 2).
- Earnings growth—also boosted by a healthy global economy and tax cuts—is expected to rise 22% in 2018.[1]
- Cash from the tax windfall and overseas repatriation has improved creditworthiness and reduced borrowing needs, forestalling any significant tightening of credit conditions.

EXHIBIT 2: Profit margins have experienced an upward reversal fueled by tax cuts, but late-cycle pressures lie ahead.

U.S. Corporate Profit Margins

	Revenue Growth	Earnings Growth	Change in Profit Margin
Late Cycle Average (ppts)	8.0	1.1	–1.2



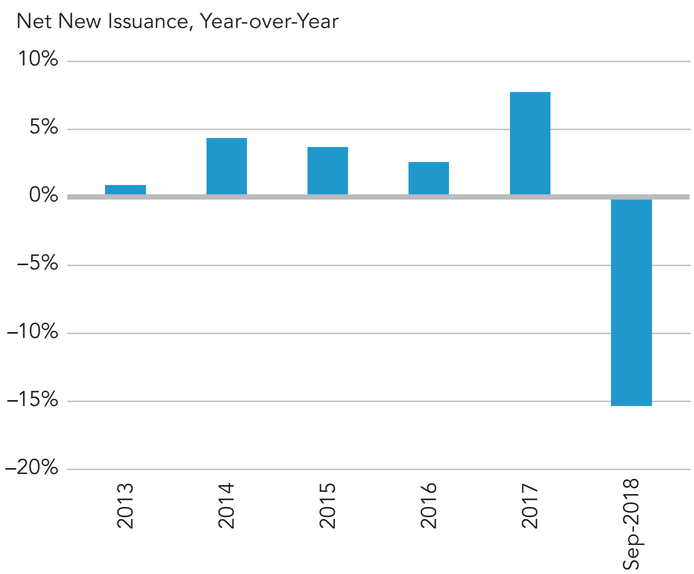
Gray bars represent recessions as defined by the National Bureau of Economic Research (NBER). Source: NBER, Bureau of Economic Analysis, Haver Analytics, Fidelity Investments (AART), as of June 30, 2018.

While ample corporate liquidity has boosted the technical backdrop for U.S. stocks and corporate bonds, the liquidity provided by central banks is dwindling as central banks shift toward monetary tightening.

- Tax cuts and access to overseas cash has reduced the need for corporations to raise capital, resulting in a shrinking supply of corporate bonds and equities (Exhibit 3).
- Higher after-tax earnings induced a record amount of stock buybacks (up nearly 30% over the past 12 months).[2]
- Those positive technicals have supported corporate asset prices in 2018.
- Meanwhile, major central bank balance sheets grew by roughly $2 trillion in 2017,[3] but they will likely contract by the beginning of next year as the Fed further reduces its balance sheet and the European Central Bank ends quantitative easing (Exhibit 4).
- We ultimately expect the positive tax-cut effect to fade and central bank tightening pressures to build. Consistent with our 2018 outlook, the overall liquidity backdrop is likely to shift from a tailwind to a headwind and contribute to heightened market volatility.

EXHIBIT 3: Effects from corporate tax reform have supported U.S. market technicals, but will likely fade over the coming year.

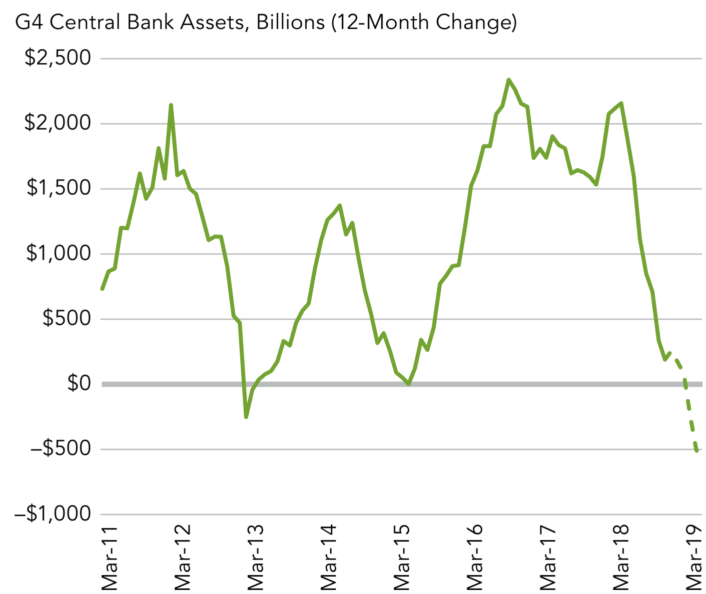
U.S. Corporate Bond Issuance



Source: Security and Financial Markets Association (SIFMA), Fidelity Investments (AART), as of Sep. 30, 2018.

EXHIBIT 4: Central bank liquidity is likely to turn negative in Q1 2019, and may contribute to elevated market volatility.

Fed, ECB, BOJ, BOE Balance Sheets



Dotted line estimates future central bank assets: Fed to roll off balance sheet assets by lesser of stated caps or total bonds maturing each month; ECB to purchase EUR15B per month in Q4; BOJ to purchase at annualized rate of average purchases over last 12 months; BOE to keep balance sheet constant. Source: Federal Reserve (Fed), European Central Bank (ECB), Bank of Japan (BOJ), Bank of England (BOE), Haver Analytics, Fidelity Investments (AART), as of Sep. 30, 2018.

Adding to the late-cycle dynamics, global activity has peaked and most major economies have drifted into more mature business-cycle phases.

- As we had projected earlier in the year, China's economic slowdown has become more pronounced and its policymakers have turned toward more forceful easing measures (see Fidelity *Leadership Series* article "China Growth Outlook: Weaker Than It Appears?").
- The global expansion continues, but China has descended into a growth recession and risks remain tilted toward the down side.

U.S. tariffs, and the retaliatory tariffs of other countries, have so far been relatively limited in scope and size, but rising trade barriers tend to strengthen the same late-cycle pressures that have already been gathering steam (see Fidelity *Leadership Series* article "Trade Risks Exacerbate Late Cycle Pressures").

- At a time of tighter capacity, trade disruptions tend to create additional strain through uncertainty, bottlenecks, and supply chain interruptions.
- These challenges often exacerbate inflationary pressures and may also cause deterioration in the quality and certainty of growth.
- Already, micro-level trade effects can be seen across industries that have faced tariffs, including higher prices, longer supplier delivery times, and higher inventories.

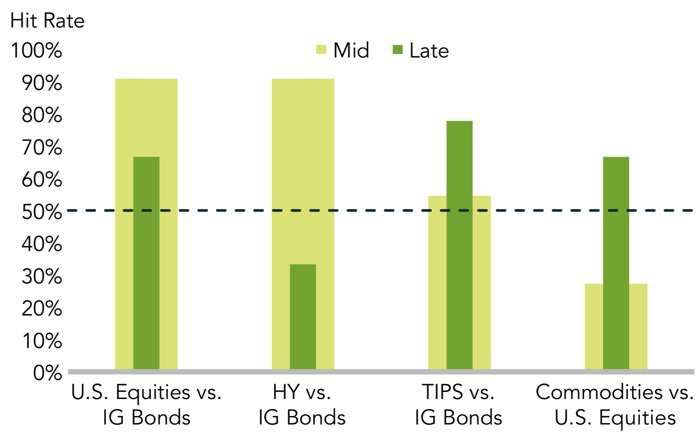
Tariffs are a tax whose cost is ultimately born by some entity. In the aggregate, trade friction pushes in the same direction as general late-cycle conditions by amplifying inflationary and profit-margin pressures.

Late-cycle investing implications

From an asset allocation perspective, the shift from the mid- to late-cycle phase generally has implications over the intermediate term. The historical business-cycle road map suggests that relative performance among asset classes is much less consistent during the late cycle compared with the mid cycle. This implies less confidence that riskier assets such as equities will outperform more defensive assets like investment-grade bonds, due to their lower historical frequency of outperforming during the late cycle. (The "hit rates" in Exhibit 5 demonstrate how often certain asset classes perform better than others during the mid- and late-cycle phases). The late

EXHIBIT 5: Late-cycle playbook: less consistent patterns for riskier assets; inflation protection helpful.

Relative Asset Performance by Cycle Phase (1950–2015)



Past performance is no guarantee of future results. HY: high yield. IG: investment grade. Hit Rate: frequency of an asset class outperforming another. Results are the difference between total returns of the respective periods represented by indexes from the following sources: Fidelity Investments, Morningstar, and Bloomberg Barclays. Fidelity Investments source: proprietary analysis of historical asset class performance, which is not indicative of future performance, as of Sep. 30, 2018.

cycle has also typically experienced more variability of stock and bond returns and lower overall portfolio returns than the mid cycle.

Moving toward the late-cycle playbook

The shifts in business cycle phases influence relative asset performance patterns and can be used to help create portfolio tilts over the intermediate term. It is important to remember that cyclical allocation tilts are only one investment tool. Any adjustments should be considered within the context of long-term portfolio positioning, driven by the risk-return objectives of the overall investment strategy.

The following are some of the historical late-cycle asset-class return patterns that may inform intermediate-term portfolio tilts amid a maturing business cycle:

- Smaller cyclical tilts are warranted—stick closer to strategic portfolio weights (long-term asset allocation mix).
- Consider inflation-resistant assets such as commodities to diversify a portfolio against inflation risk.
- For fixed income, consider Treasury inflation-protected securities (TIPS) and shorter-duration bonds; tighter credit conditions tend to favor higher-credit-quality bonds.
- Facing both downside risks to growth and upside risks to inflation, portfolio diversification is essential at this juncture in the cycle.

Authors

Dirk Hofschire, CFA | Senior Vice President, Asset Allocation Research

Lisa Emsbo-Mattingly | Director of Asset Allocation Research

Jacob Weinstein, CFA | Research Analyst, Asset Allocation Research

Cait Dourney, CFA | Research Analyst, Asset Allocation Research

The Asset Allocation Research Team (AART) conducts economic, fundamental, and quantitative research to develop asset allocation recommendations for Fidelity's portfolio managers and investment teams. AART is responsible for analyzing and synthesizing investment perspectives across Fidelity's asset management unit to generate insights on macroeconomic and financial market trends and their implications for asset allocation.

Fidelity Thought Leadership Vice President Christie Myers provided editorial direction for this article.

Endnotes

[1] Source: Standard & Poor's, Fidelity Investments (AART), as of June 30, 2018.

[2] Source: Standard & Poor's, Fidelity Investments (AART), as of June 30, 2018.

[3] Source: Federal Reserve, Bank of England, European Central Bank, Bank of Japan, Haver Analytics, Fidelity Investments (AART), as of June 30, 2018.

864952.1.0