China and Fed Direction Likely to Drive the Tone of This Late Cycle

A review of key factors that may influence global financial markets

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Key Takeaways

• With asset-market expectations appearing split between whether global growth will improve or falter in 2019, the direction of China’s economy and the Fed’s policy may prove pivotal.

• Our base-case scenario is that economic growth in China is stabilizing but not sustainably reaccelerating in a way that will meaningfully boost the global economy.

• If this proves correct, U.S. core inflation should remain range-bound, allowing the Fed to be patient holding interest rates at current levels.

• This scenario suggests a mature cycle with constrained upside for asset prices, implying a smaller tilt toward riskier assets than earlier in the cycle.

• Alternative scenarios include a disinflationary boom that could lead to much larger asset-price gains, or deteriorating growth—especially amid a trade war—that might cause equity markets to falter.

The global business cycle has entered a mature phase. However, improvement in China’s economy, continued solid growth in the U.S., low inflation, and a pivot toward more accommodative monetary policy have combined to boost asset prices so far in 2019. The rebound in stocks suggests some optimism about growth prospects, while the six-month drop in bond yields appears to reflect caution. Short-term market movements are nearly impossible to predict, but our analytical focus will be on the trajectory of the Chinese economy, how the Federal Reserve (Fed) reacts to the U.S. and global business cycle developments, and the trajectory of U.S.-China trade tensions.

Base-case scenario: Muddling through the late cycle

Our base-case scenario is that the global economy is past its peak and most major countries are in mature stages of the business cycle. While the absolute level of global growth remains muted, leading indicators of activity have recently reflected some signs of stabilization (Exhibit 1).
China: Better but may not be enough to lift all boats

China’s outlook has improved in 2019. Due in large part to a greater shift toward fiscal and monetary stimulus, industrial production growth has begun to recover and it appears the economy may be emerging from its growth recession. Nevertheless, it does not appear that the magnitude of China’s policy stimulus response is anywhere near the prior episodes this decade that led to a meaningful and sustained reacceleration in both the Chinese and global economies. The expansion of fiscal policy has been effective in front-loading infrastructure spending and providing tax cuts to consumers and businesses.

So far, however, monetary and credit easing has been much narrower than during prior cyclical recoveries this decade, which were powered by significant broad-based accelerations in credit growth. Policymakers have signaled a desire not to indiscriminately add more debt to an already over-leveraged economy. While this is a responsible posture over the medium term, in the near term credit growth is far below our estimate of prior policy easing. As a result, China is likely to experience more of a stabilization than a meaningful, sustained reacceleration (Exhibit 2, page 3). In addition, the escalation of the U.S.-China trade confrontation...

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EXHIBIT 1: Global growth remains positive but most major economies have progressed toward more advanced stages of the business cycle.

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 April 30, 2019.
is putting China’s tentative stabilization at risk, and is likely to result in an even greater policy easing stance to counteract the headwinds from higher tariffs.

**Europe: Stabilizing at a weak level**
The 2018 downturn in China weighed heavily on industrial sectors in Europe and other export-oriented economies, and we expect the stabilization in China’s activity to act as less of a drag over the coming months. However, it’s important to note that a recovery in China may not automatically drive a European reacceleration to the same degree as during prior episodes over the past decade. First, China’s stimulus has been less focused on stimulating autos and other heavy industries that have a high multiplier effect on manufactured goods imported from Europe and other areas. Second, the European domestic economy is on less of an upswing than it was three years ago when China’s stimulus boosted global trade and manufacturing. While labor markets have generally continued to improve in many core European economies, consumer sentiment and consumption gains remain muted. In fact, German households have increased their savings rate over the past year, even as unemployment has dropped to cyclical lows (Exhibit 3).

**U.S.: Late-cycle dynamics clear, pace of phase progression uncertain**
The U.S. is in the late phase of economic expansion, and our models continue to indicate that the near-term risk of recession remains low. Historically, late-cycle phases have ranged from nine months to more than two years. The lack of excesses built up during this nearly 10-year expansion—for instance, in inflation or consumer debt—has so far tended to prolong the cycle.

**EXHIBIT 2: China’s credit growth remains subdued, and well below prior periods of stimulus.**

China Credit Growth

**EXHIBIT 3: Despite extremely healthy labor markets, German consumers have increased savings.**

Germany Savings and Unemployment

Gray bars represent China growth recessions as defined by AART. China credit growth estimate based on current economic conditions. Source: China National Bureau of Statistics, Haver Analytics, Fidelity Investments (AART), as of March 31, 2019.
The U.S. is currently displaying more key late-cycle trends than it has over the past three years (Exhibit 4). However, these trends remain relatively slow moving, and some have recently stalled, including wage growth and Fed tightening. The direction and rate of change of these trends should help determine how long the current cycle extends.

Wage growth remains a key lynchpin of the outlook as tighter labor markets have historically led to faster wage growth during late cycle. Almost all measures of wage growth have indeed moved upward over the past two to three years, including average hourly earnings, the Atlanta Fed wage growth tracker, and the employment cost index.

However, the improvement in wage growth has stalled in recent months, despite the falling unemployment rate and continued solid job gains (Exhibit 5). If wage growth is peaking, it would exert little upward pressure on overall inflation and further strengthen the Fed’s inclination to remain on pause in its hiking cycle. Taken on its own, a patient Fed would provide less impetus for further yield curve flattening or tighter credit conditions, and might therefore help prolong the expansion.

On the other hand, total employee compensation is higher than earlier in the cycle, which may constrain corporate profit margins through higher costs for businesses. As the positive effects of the 2018 tax cuts fade and worker compensation costs remain elevated, there is limited upside for profit margins and corporate earnings growth.

As a result, even if the possibility of a prolonged late cycle has risen across some indicators, the potential
upside for asset markets may not have improved materially. The late cycle remains a time for great uncertainty and a generally less favorable risk-reward trade-off, implying a smaller overweight to risk assets than earlier in the expansion.

Best-case scenario: Prolonged Goldilocks environment

The best of all possible worlds would be if U.S. productivity growth accelerated on a sustained basis, providing faster growth without stoking inflation. Under these conditions, the Fed could avoid hiking rates and even consider easing into a positive disinflationary cycle, which would presumably provide another round of ideal “Goldilocks” conditions for asset markets.

In our view, it will be difficult to thread the needle to sustain this perfectly balanced backdrop. One reason is that although labor productivity growth accelerated last quarter, it’s not clear whether this result was boosted by inventory building that may not continue. Moreover, most historical bouts of rising productivity tend to be preceded by a fast pace of business investment years prior to the improvement, and capital spending growth has been relatively muted for the majority of this cycle. Over the past year, there has been an uptick in capital spending, but it tends to take several years for business investments to realize their full productivity potential, challenging any immediate sustained boost to productivity in the near term (Exhibit 6).

It’s important to note that our best-case scenario does not include a substantial reacceleration of global growth, with China surprising to the upside and global commodity prices reflating. If that happens, a robust global backdrop and higher inflationary pressures in conjunction with unemployment at cyclical lows could cause the Fed to adopt a more hawkish tone and potentially consider hiking interest rates.

Worst-case scenario: Rising recession risks

The worst-case scenario is that the global economy is already faltering. In this scenario, China’s stimulus would prove insufficient, global economic growth would remain lackluster, and the U.S. economy would decelerate. Current market expectations that the Fed’s next move will be a rate cut would be proven correct, but this would be a response to rising recession risks. Riskier assets, such as stocks, would be expected to perform worse than more defensive ones, such as government bonds.

The big wild card: Trade policy

One potential catalyst that could shock the global cycle into a more challenging outcome would be the
escalation of U.S.-China trade tensions. As of early May, the two sides had yet to secure a trade agreement, and the U.S. raised tariffs to 25% on $200 billion of Chinese goods on May 10. A return to tit-for-tat tariff increases would create stagflationary headwinds on a global basis, and they would likely weigh heavily on business and financial-market sentiment. The worse-case scenario of rising global recession risk would become more pronounced.

Even if a near-term agreement becomes reality, it will not eliminate the long-term undercurrent of anti-globalization risk generated by growing U.S.-China strategic competition and geopolitical rivalry. An announced truce would be a short-term positive, but it shouldn’t be interpreted as a complete or permanent resolution of U.S.-China tensions.

**Asset allocation outlook**

It is possible that the strong start for the financial markets in 2019 can continue. Earnings growth may not have tremendous upside, but it remains positive and could end up beating expectations. Asset valuations across most categories are somewhat above historical averages, but they could go higher if investors believe monetary authorities will hold interest rates at lower levels indefinitely. However, late-cycle historical patterns point to both a larger distribution of outcomes and a less favorable risk-return profile for assets than during earlier phases of the cycle. This more asymmetric risk profile—alongside heightened trade policy risk—warrants relatively small cyclical asset allocation tilts.

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Endnotes

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