Economic Check-In: Tensions Push Economy Toward Late Cycle

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Growth has been strong, but risks could lead to an economic "boomerang."

Key Takeaways

- The economy has been growing rapidly, but trade tensions and higher rates could be headwinds.
- Keep a close eye on inventory levels.
- Investors should consult their financial advisors to make sure they are diversified across the equity market.
- Consider inflation-protected investments.

When Viewpoints spoke in May with Lisa Emsbo-Mattingly, Fidelity's director of asset allocation research, she expected tax cuts to stimulate the U.S. economy in the short term but to contribute to a "boomerang effect" that could hold back growth later in the year. We checked in with her in early August for her take on where the economy stands now. She says trade tensions and a tightening Fed increase the likelihood of an economic boomerang—and suggests investors check their portfolio's diversification and inflation protection.

Are you still thinking of 2018 as a boomerang year?

Emsbo-Mattingly: If anything, the likelihood of a boomerang has increased. At the beginning of this year, fiscal stimulus gave us a release from late-cycle pressures like credit tightening and compression in profit margins. But now those kinds of pressures seem to be reemerging at the same time that trade tensions are accentuating the late-cycle dynamics.

For example, vendor delivery times in the United States have skyrocketed this year, recently hitting their highest level in about 15 years. There are 2 main reasons for that. One is a trucker shortage. The second is that everyone is trying to get their supplies before tariffs are put on.

What could tariffs mean for the economy?

Emsbo-Mattingly: Tariffs reinforce the boomerang idea. In the short term, the tariffs actually created a very positive economic stimulus: A lot of people rushed to get their orders in over the last few months. The flip side to that development is that the orders have just been frontloaded, so all else being equal we'd expect orders in the third and fourth quarter to be lower than they would have been otherwise.

What's your take on wages at this point?

Emsbo-Mattingly: The labor market is very, very strong. All the surveys—of CEOs, hiring managers, temp firms—say it's hard to find workers. Wage growth hasn't been as strong as we would have expected, but it has accelerated slightly over the last few years, and we think it will continue to rise through the rest of this year.

The willingness of the Fed to continue to tighten has everything to do with the labor market. The Fed's view is that a hot labor market and wage gains will show up in an acceleration in inflation. The unemployment rate is down at 3.9%, and we think the labor force participation rate is back to where it would have been had the financial crisis never occurred. This likely means higher interest rates, which could lead to a headwind for the economy.

Wouldn't an increase in productivity growth help restrain inflation?

Emsbo-Mattingly: Yes, that's true. But productivity growth has been much slower over the past decade than it was in previous decades. Part of the reason is that we haven't had strong capital investment over the last decade—companies haven't been investing much in productivity-enhancing technology and equipment.

Some people argue that tax cuts and the deregulatory push from the administration are going to increase productivity. And in fact there was evidence that companies were becoming more willing to invest. Ironically, though, just as companies were stepping up to the plate, the trade war broke out and caused a lot of uncertainty, which in turn has made it hard for companies to make capital spending plans.

The auto sector, for example, has seen a big step away from more regulation. That's been positive for those firms and supportive of capital investment. But auto companies have very long global supply chains that may be disrupted by changes to trade policy. Uncertainty about trade policy makes it hard for those firms to decide whether, where, or how much to invest in their businesses.

What do inventories, credit, and corporate profits tell you about where the economy is in its cycle?

Emsbo-Mattingly: Those 3 cycles are the components of the economic cycle. The profit cycle was very positive at the beginning of the year, thanks largely to the tax cuts, but we think it's going to be more challenging as we go through the rest of this year. In the credit cycle, the tax cut relieved the pressure early in the year, but higher interest rates are likely to contribute to some deterioration later this year.

The inventory cycle is another indicator to watch—growth in inventory, for example, in auto supply chains and computer hardware supply chains. Some of that inventory build may be related to the trade environment. I'm always keen on canaries in the coal mine.

Inventories aren't late in their cycle yet. But it could be that 2 months from now, everybody's ordered everything they need in the near term, inventories are high, and at that point, we would be on the wrong side of the cycle.

What does all of this mean for investors?

Emsbo-Mattingly: One important point is that only a handful of stocks have led the market's advance in recent months. It's a dangerous situation when the breadth of the market is low. If any of these companies disappoint, the market as a whole could suffer. And the firms have to meet extremely high expectations: Not only do they have to grow, they have to accelerate their growth. The key for investors is to make sure that you're still diversified across the equity market, and you haven't unwittingly or otherwise become overly concentrated.

Investors also should consider making sure they have some inflation protection. They might want to have some investments in Treasury inflation-protected securities and/or the types of equities that tend to benefit from inflation.
