INVESTMENT INSIGHTS

Multi-Asset Solutions Weekly Strategy Report

Global markets and multi-asset portfolios

October 3, 2016

IN BRIEF

- In this report, we take a break from asking, "Is the end near?" to address how the end might look. The late stages of U.S. business cycles are more typically gradual decelerations than bursts of exuberance and when this expansion's late-cycle stage finally arrives, it is shaping up to be a long one.
- We hold the steadfast view that it is still, at present, mid-cycle, suggesting a modestly pro-risk tilt with overweights to credit and equities vs. government bonds and cash. The prospect of a long late cycle highlights the potential opportunity cost of being overly cautious.
- The flat mid-cycle dynamic in the U.S. makes the global economy incrementally more reliant on emerging markets (EM) as a driver of growth. As EM fundamentals recover, we see a role for EM equities and debt as a barbell to our more defensive exposure to U.S. equities.

WHAT'S IN STORE FOR THE LATE STAGE OF THE CYCLE?

From the perspective of a multi-asset investor, the motivation for contemplating the last traces of an economic expansion—"late cycle"—is clear: Some point in late cycle will be a high-water mark for the performance of risky assets such as equities, relative to safer assets such as bonds and cash. Moreover, considering the potential size of recession drawdowns, the implication is the cyclicality of risk assets should take precedence over other tactical considerations as the economy tilts toward recession.

Where are we now? Our scoring of the current expansion puts us in the middle of a very long and flat cycle, a view that has not materially changed for several years. To be sure, over that period our view has been that mid-cycle has begun to mature. However, as time passes, we find ourselves increasingly discordant with the voices proclaiming the expansion to be in its late phase, ending—or even over and done. As such, it is important to clarify what we expect of late cycle and what, if any, associated contingency planning we should be doing.

What does late cycle look like?

Images of the late-cycle period typically take one of two forms. The first depicts exuberance, accelerating into an eventual implosion. The second depicts weakening,

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decelerating and eventually capitulating into the deeper slump of recession. Which set of imagery is correct for this business cycle?

A caveat before answering this question is that even with the benefit of hindsight, it can be difficult to distinguish the direction of economic trends at the end of the business cycle. For example, a look back at the two-year periods preceding U.S. recessions in 2001 and 2007 shows several false alarms, where growth dipped down to zero but then quickly recovered. And in contrast to both the acceleration and deceleration narratives, GDP growth revealed no discernable upward or downward trend during either of those periods (**Exhibit 1**). Core inflation has shown a similar pattern—generally flat—in the final stages of recent cycles, before dipping during recession.

There also does not appear to be a unique combination of telltale signs that signal late cycle. Rather, a rotating set of factors flashed "late" in the run up to previous recessions. Factors that were becoming stretched prior to the dot-com recession and global financial crisis (GFC), such as tightness in the labor and housing markets or measures of business debt, were less pronounced prior to recessions in the 1960s and '70s. We also note that indicators that have reliably signaled the late cycle over time—the slope of the yield curve and labor force participation of prime-age workers—might not be sending as sharp a signal this time around, due to the effects of central bank balance sheet policy and U.S. demographic changes, respectively.

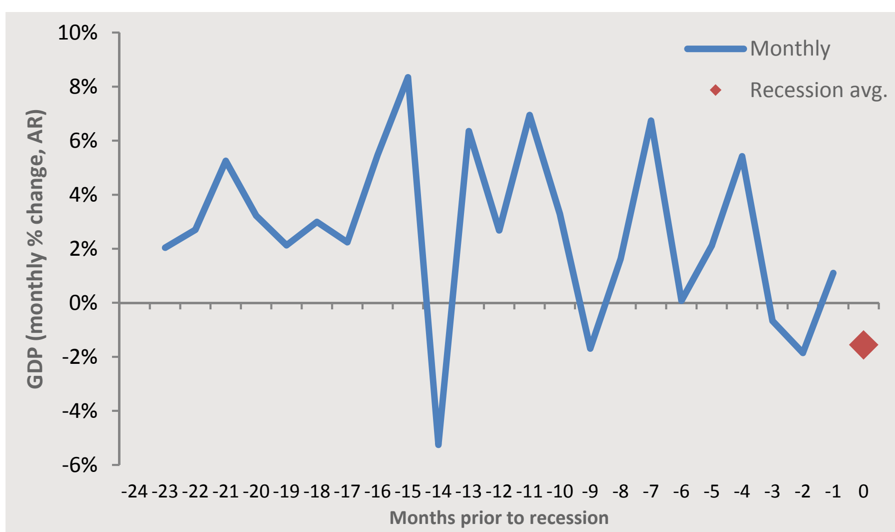
Notwithstanding these caveats, we find evidence supporting the notion that the economy is likely to weaken gradually as this cycle winds down. Employment growth, a linchpin of our current U.S. outlook, has historically slowed at the tail end of expansions before plunging negative during recessions. As an important driver of household income and spending behavior, decelerating job growth coincided in previous cycles with a step down in real income and personal consumption and as firms took those cues, production. These trends manifested themselves in weakening corporate profit growth and sentiment, which sowed the seeds of the subsequent downturn. Thus, on average, late-cycle dynamics are ones of weakening and eventual capitulation and not exuberance.

The opportunity cost of caution

Notwithstanding the subtleties of identifying whether the economic expansion is actually nearing an end, what would late cycle imply for the positioning of a multi-asset

EXHIBIT 1: GDP IN LATE CYCLE (MONTHLY % CHANGE, ANNUAL RATE [AR])

Real GDP growth in the two years leading up to the dot-com bust and the GFC did not have an easily discernable up or down trend and was punctuated by several false alarms. More granular data from a wider set of business cycles suggests that the run-up to recessions is typically marked by a gradual deceleration.



Source: Macroeconomic Advisers, J.P. Morgan Asset Management Multi-Asset Solutions; data as of September 2016. For illustrative purposes only.

portfolio? It boils down to a trade-off between the expected benefits and costs of being cautious. The benefits of a defensive stance—of favoring bonds and cash over stocks, U.S. equities vs. the rest of world's, seeking high quality duration and the dollar—need to be weighed against the potentially foregone benefits of being in riskier asset classes that have higher expected returns.

It is difficult to get the timing right on when to turn cautious while in late cycle. One reason is that the length of late cycle has varied markedly across U.S. post-war experiences. According to our scoring of cycle characteristics, "late" lasted for less than a year in the 1970s and '80s and lengthened to at least two years beginning in the 1990s. In each of the last three expansions, there were extended periods of risk asset outperformance in late cycle before the eventual recession drawdowns (Exhibit 2). Another reason, of course, is the variation in how big the drawdown turns out to be; the large correction during the GFC, for example, swamped late-cycle gains.

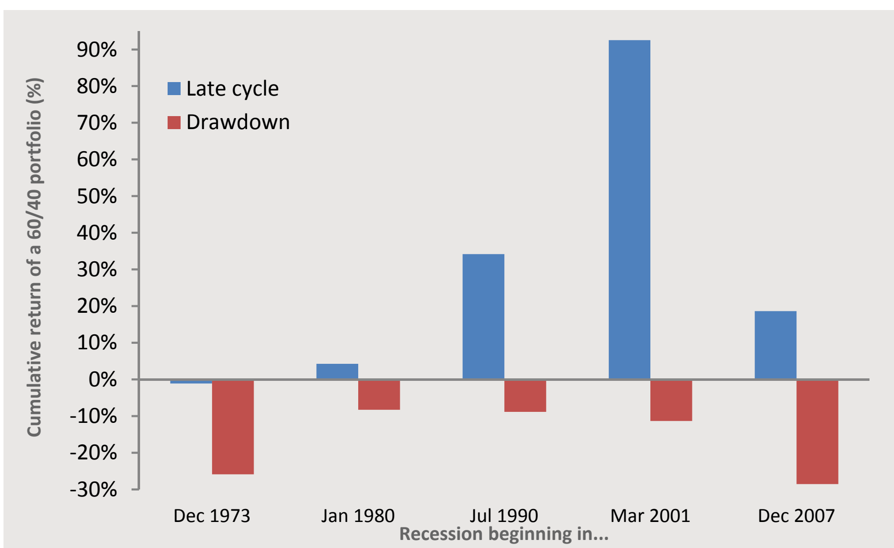
ASSET CLASS IMPLICATIONS

From where we sit at present, this business cycle is shaping up to be on the longer side of historical experience, and thus we maintain a modestly pro-risk tilt, with overweights to credit and equities vs. government bonds and cash. Moreover, seeing somewhat limited evidence of the excesses that would lead to a large recession drawdown, there may well be a significant opportunity cost to turning too cautious too soon, even when late cycle arrives.

In the meantime, we continue to pore over the data in an effort to discern late-cycle deceleration dynamics from what has been a low-growth expansion generally. The flat mid-cycle dynamic in the U.S. makes the global economy incrementally more reliant on emerging markets as a driver of growth. And as emerging market fundamentals recover, we see a role for EM equities and debt as a barbell to a more defensive exposure to U.S. equities.

EXHIBIT 2: LONG CYCLES AND THE COST OF CAUTION

The cumulative returns of a 60/40 portfolio during late cycle can potentially be larger than the subsequent drawdown heading into recession. It depends on the length of the late cycle –which has been getting longer over time –and the eventual size of the drawdown. The prospect of a long late cycle thus implies a high opportunity cost of moving into cash.



Source: Bloomberg; data through September 2016. For illustrative purposes only. Past performance is no guarantee of future results.

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