Hamilton-Bates

End of the Cycle? What to Look For

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How much further can global growth fly? A number of market headwinds, including trade tensions, geopolitical issues, rising interest rates, and a general fear the long-running US economic expansion may be fading have cast a shadow over the markets this month. Nonetheless, US economic growth (measured by GDP) managed to hit a four-year high in the second quarter, with US equity markets remaining in what many regard as the longest bull run in post-WWII history. During that run, which began in March 2009, the S&P 500 has skyrocketed 300 percent.

Since the 2007–2008 global financial crisis, rising corporate earnings and profit margins have supported the global recovery, along with hyper-supportive Central Bank activities i.e. Quantitative Easing. However, some of those trends are weakening if not reversing, and the Central Banks are in the process of trying to unwind what they have done. In the United States in particular, monetary policy is becoming less accommodative, even as fiscal policy tries to pick up the slack.

An 'Oldie' but not a 'Goodie'

The economic recession ended in June 2009, which means the 109 months old recovery is the second-longest since the end of the Second World War. The average recovery since 1980 (a period of longer-than-average expansions) is 83 months. So this expansion has been extraordinarily long — far longer than average — indicating that a recession should be expected sooner rather than later. But even though the current cycle is long, economic and market cycles don't die of 'old age', they die because something kills them, and that culprit is usually the Fed. Eventually as cycles mature the Fed hikes rates to stave off inflation and cool asset prices. Just as they are doing right now. Historically, the Fed ends up going too far and the expansion not only cools but reverses.

The current economic recovery is unusual not only because of its longevity but also because of its sluggishness as it is the weakest recovery on record. Average annual growth during this expansion is 2.30%, compared with average annual growth for all expansions since 1980 of 3.21%. That 3.21% figure is what economists mean by "trend" growth. The weakness of the current cycle could indicate the next decline could be as harsh as the 2007-2008 Great Recession, which itself was preceded by the weakest recovery on record to that point. In our view a weak recovery = large declines once the cycle ends.

Historically, stocks often see rough sledding in September of years that feature midterm elections— and other years as well. For midterm years, analysts often chalk it up to uncertainty since midterm elections typically see the president's party lose seats. That same look at historical performance shows that stocks tend to do just fine as Election Day nears and in the aftermath of the vote, regardless of the outcome, as the uncertainty wanes.

But we all know that historical performance is not indicative of future results. So how will we know the cycle is coming to and end? Don't count on the 'experts'. In 2007-2008 virtually no one saw the downturn coming, especially the Fed. Only **years after the fact** did the Economists

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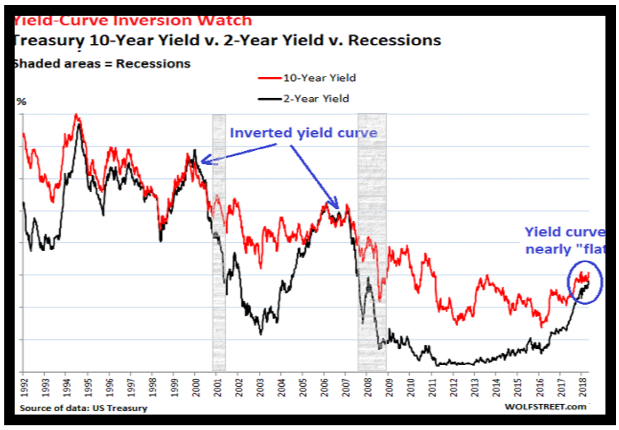
determine that a Recession started in late 2007. With so much financial news, and so many variables in play, we will focus on the handful of indicators and items we believe will serve as clues on the economy and thus the stock market.

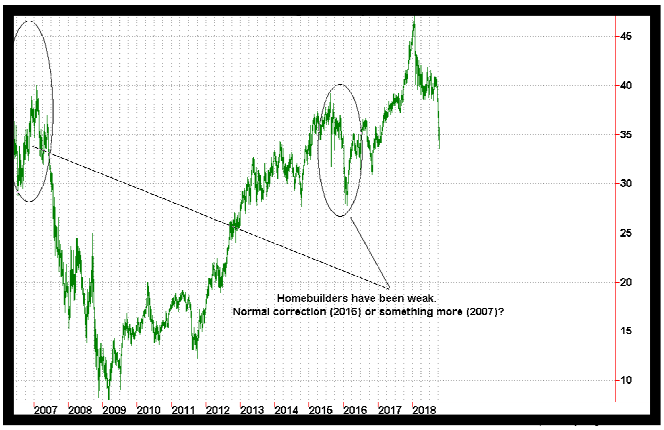
1). Interest Rates/Yield Curve Inversion
Interest rates are like the pulse of the economy, rising during activity, falling during lulls. In and of itself the level and direction doesn't tell you much other than what is happening at the moment. What can give you clues is the interplay or relationship between short-term and long-term interest rates. A normal relationship occurs when



long-term rates are higher than short-term rates– this is considered healthy. When short-term rates move up above long-term rates, its called inversion, and it happens infrequently, but when it does it's a warning sign.

Since 1955, by the San Francisco Fed's count, a negative inverted yield curve—where short rates are higher than long rates—has forecasted all nine U.S. recessions. There was just one false positive, in the mid-1960s. A near perfect record! The catch, and there's always a catch, is that there is usually a lag between the inversion point and the end of the cycle and market decline. It has varied between 3-months to 2+ years. This lag coupled with the one false positive make following this indicator difficult as it does not reveal the timing of the negativity an inverted yield curve portends, lulling investors that there is no problem or tricking them into thinking there is a problem before there is one.

Nonetheless, and as stated above, interest rates are the pulse of the economy, and an inverted curve is akin to an irregular heart-beat. But unlike innocuous Arrythmia in the human body, an inverted yield curve is a sign that something is definitely wrong in the underlying economy. We watch the 2yr/10 yr Treasury relationship. The current 2-year yield is 2.83%, the 10-year yield is 3.13%. No inversion yet. If the curve inverts pay attention.



2). Key Sectors Weakening (Homes, Autos, Banks)
The US economy is driven by big-ticket purchases of houses and auto's, and consumer driven activity. If the economy is hitting on all cylinders, these sectors will reflect that by doing very well. When they hit the skids it could be a sign that the economy is headed for trouble. Automotive stocks are getting beat-up (not shown), as are the home-builders, which have been among the weakest stocks this year.

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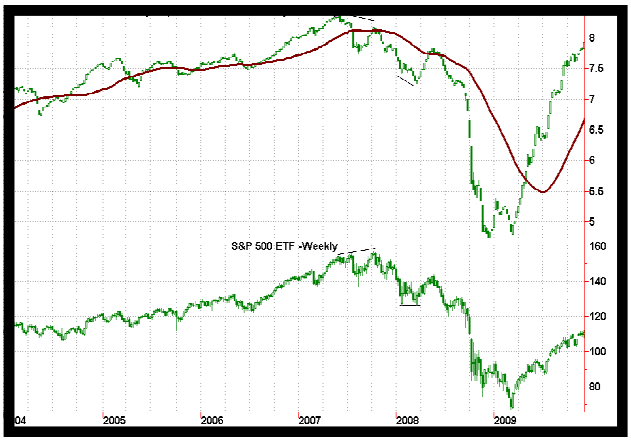
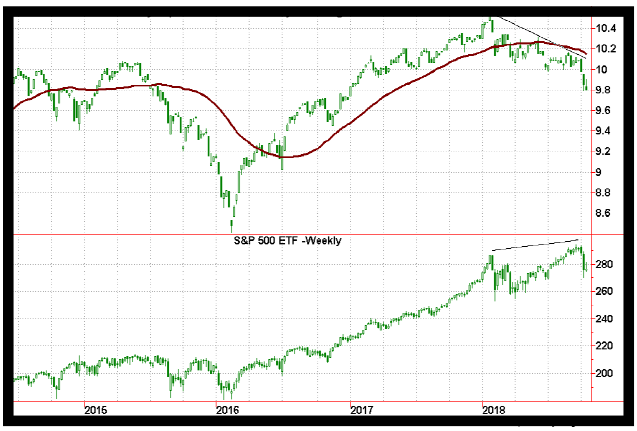
This weakness is not unexpected, as rate hikes certainly have an effect on affordability. In 2008, by the time the stock market peaked the homebuilder ETF was off by 50%! The current decline is severe (29%), but is still more similar to the mid-cycle pullback in 2016 (30%). However, if it gets any worse, we risk triggering 2007 type warnings.

3). High Yield Bond Market

High-Yield bonds, or 'Junk Bonds' as they are otherwise known, represent bonds from the weakest group of corporations. The biggest risk to these category of bonds is default risk—risk that the company cannot pay its debt. The single biggest reason that would occur is overall economic decline. Therefore, High-Yield bonds have a high correlation with the economy as well as the stock market. This sector of bonds is the 'canary in the coalmine'. Declines begin at the margin—so if economic weakness is unfolding it will occur in this sector of the bond market early on.



At the peak of the last cycle, in 2007-2008, high-yield bonds peaked ahead of the stock market and began a sharp decline ahead of stocks (see chart above). By the time the stock market weakened in late 2007 high-yield bonds had already dropped 10%. High yield bonds declined with stocks through 2008, before bottoming AHEAD of stocks in early 2009.



We are seeing some similarities in the high-yield market now, with high-yield bonds not confirming the most recent stock market peak, and that is a concern (see chart above). The current decline is not nearly as severe as it was at the peak of the last cycle, and as long as it does not get worse, could still be considered part of another mid-cycle correction rather than the end of the economic expansion and the bull market.

Conclusion

Two of our 'big-three indicators' have triggered some level of concern that the end of the market/ economic cycle could be near. However, the weakness in both the Homebuilders and High-Yield bonds is still within the margin of prior mid-cycle (normal) corrections. Its only if this weakness persists that red flags will fly. In our view the yield-curve is the most important, as it has never failed to fire ahead of a recession, and so far it has not. Were the yield curve to invert, we would consider it a major warning sign.