CIBC Wood Gundy | Papau Armstrong Schmidt Financial Group

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The Business Cycle is Alive and Well

We have all heard of the business cycle. Economic growth typically follows a cyclical pattern. An economy may grow and expand for many years. At some point, the expansion phase reaches its peak, which is followed by a recession, defined as two consecutive quarters of falling gross domestic product (GDP). Finally there is a trough in the cycle before the expansion begins again. Just as it can be difficult during a recession to imagine that good times will return, many people struggle to envision a recession ever happening again after many years of expansion.

The business cycle in the U.S. is of primary global importance. The last recession in the U.S. began in December 2007 and lasted 18 months. June of 2009 represented the trough of the cycle.[1] Subsequently, the U.S. economy embarked on a long, weak expansion, with some acceleration in growth in recent quarters, fueled in part by tax cuts. The current U.S. economic expansion will become the longest ever expansion if it continues into June of 2019.

In our fourth quarter of 2017 Newsletter, we estimated that the probability of a Canadian and U.S. recession occurring in the next few years was rising; however, we did not see any signs that one was imminent. Updating these comments, we still do not believe that a Canadian and U.S. recession is imminent. On the other hand, we do believe that we are nearing the peak in this economic cycle. We therefore believe that the probability of a Canadian and U.S. recession in the next two years has risen significantly.

The concept of the business cycle is useful today, despite the mainly positive economic news coming from both countries. Economies rise and fall in cycles, as do interest rates, and the stock and bond markets. These cycles are not simultaneous, but there are strong relationships binding them together, which we will discuss below.

Nearing the Peak

Near the peak of the economic cycle, we would expect to see minimal spare capacity in the economy, tight labour markets, central bank interest rate hikes and increasing inflation. At some point, the yields on short-term government bonds may exceed the yields on long-term government bonds, which is referred to as an "inverted yield curve". While the yield curve is not currently inverted, we are seeing many of these other indicators today.

There have been frequent media headlines regarding low unemployment rates and demands for higher wages. Canada and the U.S. are both at or near full employment. Interest rates are likely to keep rising in both countries over the next 6-12 months. The biggest reason to doubt that the Bank of Canada would raise rates was the trade dispute with the U.S., which has now ended. With the new US-Mexico-Canada

Agreement in place, the economic environment justifies higher short-term rates. Canadian inflation is currently running above 2%.[2] The Bank of Canada's overnight lending rate is now 1.75%, as it increased rates on October 24th.

More importantly for the global economy, interest rates are also likely to keep rising in the U.S. over the next 6-12 months. The U.S. economic environment clearly no longer justifies emergency-level low rates. U.S. inflation is running above 2%.[3] Central banks are responsible for maintaining price stability, so rising inflation will typically lead to rising interest rates. The U.S. Federal Reserve's Federal Funds rate rose in September to a range of 2.0% and 2.25%, and could rise again before the end of 2018. The September increase was the eighth increase within the last two years.[4]

If short-term interest rates move too far or too fast, they could have a dampening effect on the economy. There is a lot of debt in the economic system at every level – households, corporations and governments. In Canada, the problem with elevated household debt is acute, as we have discussed in past Newsletters. It may take less of a rise in rates to trigger a recession than it did in the past when participants in the economy borrowed less money.

Where the Stock Market Fits In

In recent years, we have noticed more inexperienced investors discussing the stock market as if it functions like a guaranteed investment certificate (GIC) offering an 8% compounded annual return. This is a dangerous misconception. Historically, when central banks have undertaken a sustained cycle of interest rate increases, economic growth tends to slow, and, after a lag period, there is often a recession and a bear market in stocks, defined as a drop of 20% or more.

Of course, the timing of these events is uncertain. The stock market's performance will often foreshadow what happens in the economic data. This means that once it is clear to investors that a recession has begun, it is often too late to avoid the drawdowns in investment accounts that accompany bear markets. As investors, we must therefore make decisions about increasing or decreasing our weighting in equities without certainty about where we are headed economically.

Even if we believe that a bear market is imminent, for most clients, we will not decrease our equities weighting to zero. We try to think in probabilities, not absolutes. It is better to be somewhat right than absolutely wrong, and it is easy to be wrong about economic growth and interest rates. We tend to take incremental action in client portfolios as the economic news comes in.

Clients should understand that different types of stocks perform differently near the end of the economic cycle. Right now, it is concerning how poorly the shares of large global automakers are doing. Lumber producers are also faring poorly. Auto sales are often considered a leading indicator at turning points in the economic cycle. Housing starts are also a standard leading indicator. Lumber prices and lumber producers may be reacting negatively in conjunction with housing starts. Seeing the share prices of companies in these industries decline strongly may suggest that slower economic growth is coming. These types of companies are called cyclical, as their earnings are strongly linked to the business cycle.

Well-established large companies in less cyclical businesses like health care and consumer staples tend to outperform small cyclical companies around this point in the economic cycle. That tendency suits us fine, as we have a bias towards high-quality large companies that pay dividends and have survived many economic environments.

Where the Bond Market Fits In

Longer-term bonds can perform poorly at the beginning of an interest rate hike cycle because investors demand higher yields. We have tried to stick mainly to short and medium term high-quality bonds in our Balanced Portfolio, but even many of those have experienced some price weakness in recent months. Once a recession appears to be imminent and central banks begin cutting rates, high-quality medium to longer-term bonds with minimal risk of default tend to perform well, as investors want to lock in high yields for many months while the economy struggles.

One area of the bond market where we have already reduced our exposure is high-yield U.S. bonds. These bonds tend to pay high interest, and they tend to be issued by lower-quality companies that exhibit some risk of default. The combination of higher interest rates and economic weakness, if it occurs, can weigh heavily on these bonds, and they can decline substantially, causing losses. We have been fairly proactive in eliminating exposure to bonds of this kind in our Balanced Portfolio.

Conclusion

The business cycle is alive and well, despite the fact that we have not seen a recession in nearly a decade. We still do not believe that a Canadian and U.S. recession is imminent. On the other hand, we do believe that we are nearing the peak in this economic cycle. We therefore believe that the probability of a Canadian and U.S. recession in the next two years has risen significantly. Bear markets in stocks typically accompany recessions. This means that understanding where we are in the business cycle is of high practical importance for client returns. We do not know when we are about to enter a bear market today, but it is safe to say that the odds of a bear market beginning in the near term are rising.

Our discretionary portfolios are already positioned somewhat cautiously, given our views on the economic cycle. Discretionary management gives us the ability to rapidly reposition portfolios to potentially take advantage of bargain investments and reduce some of the pain of bear markets. We will do our best to manage the risks that we believe the markets are facing as well as look for new opportunities to profit.

Thank you for reading our third quarter Newsletter. As always, we look forward to communicating with you and answering any questions you may have about your personal circumstances, our discretionary model portfolios or other topics of interest. Thank you for your business.

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APPENDIX "A"

DISCRETIONARY MODEL PORFOLIOS

We encourage clients to contact us for more information regarding our three fully discretionary model portfolios, namely the Total Return Portfolio, the High Yield Portfolio and the Balanced Portfolio. Our research efforts are now primarily devoted to finding investment ideas that will suit the criteria established for these portfolios and contribute to their returns.

1) Our Total Return Portfolio is focused on providing clients with an average annual return of around 8-10%, consisting mainly of capital gains and dividends.

2) Our High Yield Portfolio is focused on providing income-seeking clients with an average yield of 4%, plus around 2-3% of annual capital growth.

3) Our Balanced Portfolio is a more conservative portfolio that typically consists of approximately 50% fixed income investments and 50% equity investments.

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[1] https://www.investopedia.com/terms/b/businesscycle.asp#ixzz5UJTVBG3I
[2] https://business.financialpost.com/news/economy/wrapup-1-canada-inflation-still-well-above-target-rate-hike-seen-likely
[3] https://www.bloomberg.com/news/articles/2018-10-11/u-s-core-inflation-trails-estimates-as-used-car-prices-tumble
[4] https://www.cnbc.com/2018/09/26/heres-how-the-fed-rate-hike-will-impact-you.html

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