From the desk of Amit Lodha

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What to watch at the end of the cycle

The world seems full of questions at the moment: Where are we in the cycle? How will the shift away from quantitative easing impact markets and the global economy? Are valuations more attractive now? What will be the fallout from the trade war? Here are some of my answers.

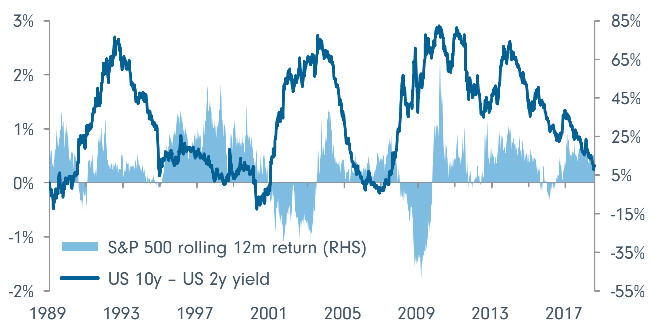
Notes from the end of the cycle

A question I am being asked a lot at the moment is: Where are we in this most atypical of economic cycles? I tend to think we are in the late cycle of the economic recovery, as suggested by data points such as the Fidelity Leading Indicator.

Valuations only tell half the story. While current valuations are high on an absolute basis, they appear more reasonable on a relative basis thanks to strong earnings growth driven by tax cuts. In any case, I do not believe valuations can be used to time the market. High valuations do not mean the market will decline tomorrow, but they do imply that the margin of safety is lower, the trade-off between risk and reward is poorer, and the probability of loss is higher should any other risks become eventualities.

Another indicator of where we are in the cycle is the flattening yield curve, which has received a lot of attention recently. An inverted curve is not a guaranteed precursor of a recession – it is necessary but not solely sufficient. If it was so easy, you could allocate according to one indicator! In the past, markets have done well even during periods when the yield curve inverted; albeit the mix of sectors that performed well shifted.

Chart 1: Don't fear inversion



Note: Weekly data. Source: Datastream, July 2018.

Price return, 12 months to:	S&P 500
31/07/2018	14.0%
31/07/2017	13.7%
31/07/2016	3.3%
31/07/2015	9.0%
31/07/2014	14.5%

Past performance is not a reliable indicator of future results.

What has me worried?

As is common at this stage of the cycle, there are a number of opposing factors driving the market. Covering the amber warning lights first, my primary concern is that there is a new sheriff in town at the Federal Reserve – and our conversations with people who have worked with him suggest that chairman Jerome Powell wants to get to the 'neutral rate' when times are good and that he is much more relaxed with market volatility than his two most recent predecessors. In other words, there is a put, but as yet the strike price is unclear.

Secondly, the Fed is already on the path to quantitative tightening and is set to be joined in late 2019 by the European Central Bank. Chinese liquidity has also come down in recent months. This leaves only Japan as the outlier riding the tiger of liquidity easing, although the Bank of Japan has recently tweaked its policy transmission mechanism.

Not all signals are bearish

While there is plenty of cause for caution in the current environment, I do not feel the outlook is completely bearish. The primary reason for optimism is that Donald Trump has been extremely positive for US business sentiment. Tax rates in the US are the lowest they have been since the 1930s, the average age of infrastructure is the highest it has been since before the war and, from the standpoint of domestic businesses, trade disputes make the prospect of investing back in the US more palatable. All this suggests there could not be better fiscal conditions for corporates to invest and for a capex cycle to commence. If that happens, we will be back in mid-cycle rather than late-cycle.

Another positive consideration is that although tech counters like the FAANGs (Facebook, Amazon, Apple, Netflix and Google's parent, Alphabet), and growth stocks have driven the market in recent months, we are yet to see the traditional signs of euphoria that should make rational investors nervous. Lastly, if the Fed were to suggest a pause in its rate-hiking cycle (or even more unlikely, a cut), we would be back to the races.

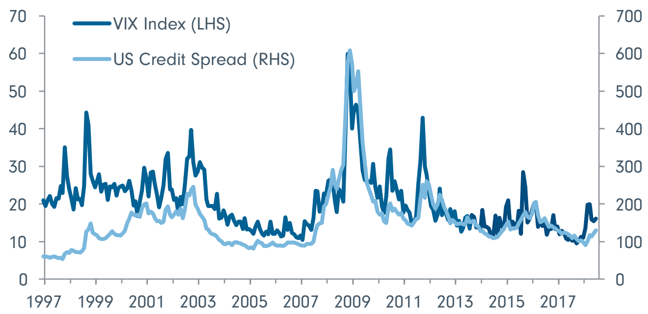
Potential flashpoints

Several potential flashpoints bear watching. First of all, it is becoming increasingly clear that the trade war is a real issue. Longer term, the geopolitics of trade are only going to get worse. Tariffs are already having a first-derivative impact – just look at commodity prices or talk to US soybean farmers – but currently the market is taking a more sanguine view about second-derivative impacts, such as lower economic growth and stagflation. A re-evaluation of these harder-to-forecast risks would have far-reaching implications.

Secondly, I have been spending more time with my colleagues in fixed income recently, and they point out that corporate debt has risen quite substantially. When the 32nd largest borrower globally is not a country but a corporate (slow hand clap for AT&T, which now has a larger outstanding debt pile than Argentina), it is time to pay attention. The gross amount of BBB rated credit is the highest it has been and any small slowdown could have a significant impact on credit markets and spreads.

I am also monitoring liquidity characteristics in credit markets. Conditions have changed dramatically over the last few years and any market moves will be accentuated by poor liquidity – and made worse by algorithmic trading and AI engines. I take a deterioration in liquidity as a signal to be more defensive. Lastly, I am keeping an eye on China for any signs of an unexpected slowdown or accident in the financial system.

Chart 2: Fixed income markets need to be monitored, even by equity markets



Note: Correlation coefficient between the VIX Index and US credit spread is 0.7.
Source: Fidelity International, Bloomberg, July 2018.

Price return, 12 months to:	VIX Index
31/07/2018	25.0%
31/07/2017	-13.6%
31/07/2016	-2.1%
31/07/2015	-28.5%
31/07/2014	26.0%

Past performance is not a reliable indicator of future results.

There's always a bull market somewhere

How should investors position themselves in this environment? For starters, stock-specific stories should be where we put our money to work – one thing you can be assured of late in the cycle is that stock dispersion will increase and that there will be a lot of opportunity to increase or decrease relative performance. Having said this, beware the new breed of 'certain growth' stocks. Algorithms which suggest that FAANG stocks will hold up in a downturn forget some basic maths – with market caps close to $1 trillion, I expect these companies will be much more geared towards the real economy than the last crisis, when they had lower penetration and a long runway for growth.

Here are some of the markets I think have the most potential to perform well over the next few years:

- The US – strong policy divergence should mean domestically focused US stocks continue to outperform.
- India – not impacted by trade wars and has strong long-term demographic tailwinds.
- Emerging markets – value is clearly starting to emerge.
- Japan – strong corporate governance cycle (return of capital to shareholders) with some of the best corporate balance sheets in the world.
- Energy/oil – underinvestment over the last few years should mean strong markets over the next few.
- The UK – upside would emerge under a 'no Brexit' scenario.
- Value stocks – if the Fed were to pause its rate-tightening cycle, these would be the biggest winners, led by financials.

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