UBS

Bull Market Monitor

A closer look at the cycle

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Brian Rose, Senior Economist Americas, brian.rose@ubs.com

- Equity bull markets rarely end in the absence of a recession occurring. We track key attributes of the business cycle to gauge how the expansion is evolving and risks of a recession.
- We think that the US business cycle has transitioned to the late stage. The good news is that the economy can be late cycle for a long time.
- While now late cycle, we view the current growth, inflation, and monetary policy environment as still supportive of risk assets.
- In this report, we take a deeper dive into some of the indicators that we are following.

Cycle status

According to the National Bureau of Economic Research, the current recovery began in July 2009 and has now set a new record for the longest in US history. Entering the 11th year of the recovery, we consider the economy to be in late cycle, which begs the question of how much longer can it last? With growth slowing and trade disputes weighing on business confidence, some estimates of recession probability are the highest they've been in this cycle.

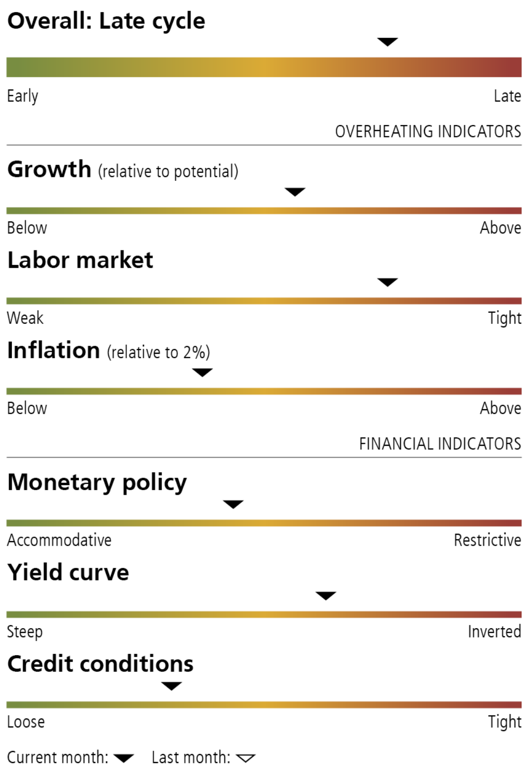
The good news is that cycles don't die of old age. In our view, the US economy appears to be trending towards an extended soft-landing. The combination of large tax cuts and more government spending helped to boost growth in 2018. With that stimulus fading, monetary policy at a roughly neutral setting, and the economy already at full employment, it is natural for growth to slow. Importantly, there's little sign that the economy is overheating, nor are there significantly worrying imbalances, other than in public finances, which is more of a long-run concern. But this soft landing is at risk from multiple cross-currents. The outlook could deteriorate quickly if tariffs increase or there is another government shutdown.

The medium term outlook for the cycle got a boost with the dovish pivot by central banks, led by the Fed, in the past few months. Central banks are worried about inflation getting permanently stuck below their targets, giving them an incentive to cut rates even though economic conditions are reasonably strong. If loose policy eventually leads to overheating then this could create problems down the road, but in the near term looser policy will help to support the recovery.

Below we assess the US cycle and the risks to it using our BMM framework and indicators.

Key cycle indicators for US

The cycle indicators gauge whether the economy is overheating and if financial conditions are restricting growth. These determine our assessment of where we are in the cycle.



Each indicator is evaluated relative to a neutral level that is sustainable over time in order to determine whether the economy is at risk of overheating or if financial conditions will start to restrict growth.

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Growth: slowing toward a more sustainable pace

The combination of large tax cuts and more government spending helped to boost growth in 2018. With that stimulus fading, monetary policy at a roughly neutral setting, and the economy already at full employment, it is natural to expect economic growth to be at best in line with the medium-term potential growth rate. In the three decades prior to the global financial crisis, growth averaged 3.2%. In the post-crisis recovery the average has been 2.3% (Fig. 1) even as the unemployment rate fell from 10% to below 4%. This suggests that the potential growth rate is below 2.3%, and our current estimate is around 2%.

Recent data has been mixed but overall suggest growth is slowing toward that 2% mark. Growth is being driven mainly by consumer spending, which rebounded strongly in 2Q19 after a slow start to the year. The rising wage income generated by the strong labor market (more on that below) provides support. Household balance sheets are reasonably healthy in aggregate, and low interest rates help to keep the debt burden manageable.

Business investment has been soft amid the uncertainty created by trade disputes. Residential investment has been declining over the past few quarters but is showing signs of stabilization, and the recent drop in mortgage rates should help.

On the production side, the manufacturing sector has been struggling amid a global slowdown, with the ISM PMI, a timely measure of current conditions, falling closer to a neutral reading of 50 (see Fig. 2). Since manufacturing represents the more cyclical part of the economy, a downturn could be a worrying sign that trouble will spread to the service sector. However, a recent rebound in auto production has helped to lift overall output, and with support from robust consumer demand, the risk of a sharp decline appears limited.

The ISM non-manufacturing index also fell in June down to a level consistent with our view of growth slowing toward the potential rate. As noted above, in our view this slowdown was in some sense inevitable given the late stage of the cycle and fading fiscal stimulus. For the moment, we keep our growth indicator at slightly above neutral.

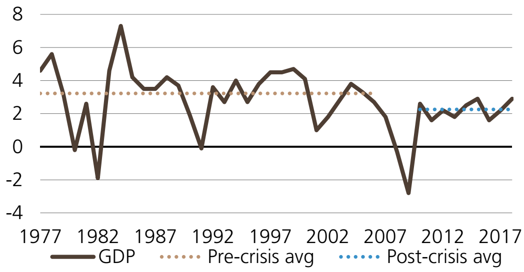
Labor market

Job growth rebounded in June after a weak May and it still appears that the underlying trend is well above 100,000/month, the level that demographics would suggest is the sustainable pace over the medium term. As noted earlier, the current economic recovery is the longest in US history, and the labor market has also set a new record for the most consecutive months of job growth.

Labor market conditions reflect the advanced stage of the recovery. The unemployment rate is near a 50-year low, and there are more job openings than people available to fill them (Fig. 3). Companies across the country are reporting they are still interested in hiring but are having difficulty in finding new workers.

Fig. 1: Slower growth post-crisis

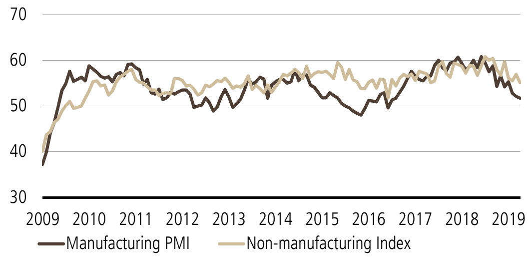
Annual GDP growth, in %



Source: Bloomberg, UBS, as of 10 July 2019

Fig. 2: Growth is slowing

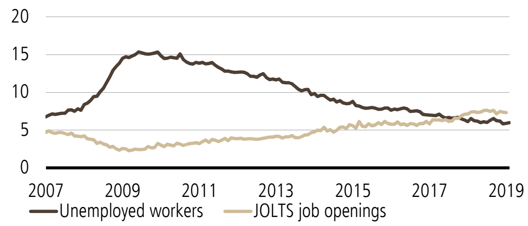
Institute for Supply Management (ISM) Purchasing Managers Index and Non-manufacturing Index



Source: Bloomberg, UBS, as of 10 July 2019

Fig. 3: More job openings than people to fill them

Unemployed workers and JOLTS job openings, in millions



Source: Bloomberg, UBS, as of 10 July 2019

While the labor market appears very tight, wage growth remains relatively modest and the quit rate has been stable. If the labor market was truly overheating, we would expect more people to be quitting jobs for higher pay elsewhere, leading to more rapid wage growth. We therefore leave our indicator for labor toward the "tight" end of the spectrum but not at the extreme reading suggested by the unemployment rate and job openings.

Inflation

The Federal Reserve's preferred inflation measure, the core Personal Consumption Expenditures (PCE) price index, showed solid monthly gains in April and May, and we expect June data to also be reasonably strong. The core PCE price index is likely to rise at around a 2% pace for 2Q19 as a whole. However, in year-over-year terms the inflation rate will remain below the Fed's 2% target.

As noted above, wage growth has remained modest, so that the tight labor market has not been enough to generate strong inflation. However, looking at the details of the data, service prices are rising faster than 2% (see Fig. 4). Durable goods prices, which are driven lower by technological change and are less affected by wages, have been falling by enough to drag overall inflation below 2%.

While the Fed is keen to hit its inflation target, from the point of view of the business cycle, low inflation should be seen as good news. High inflation would require the Fed to hike rates in an attempt to weaken demand, possibly pushing the economy into recession. The main reason to worry about low inflation and low interest rates is that it gives the Fed less room to cut rates in case there is another downturn, but until that happens low inflation is not a problem for the economy.

We set our inflation indicator slightly left of center based on core PCE inflation (1.6% y/y in May) relative to the Fed's 2% target.

Monetary policy

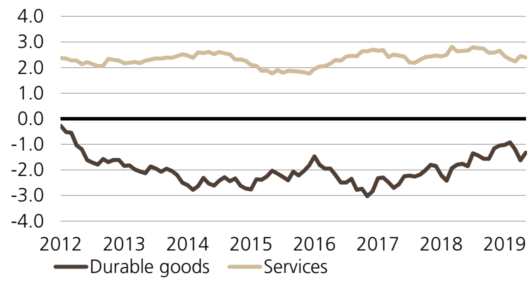
The Fed left monetary policy unchanged at the FOMC meeting on 19 June. However, changes made to the dot plot (Fig. 5) and the FOMC statement, as well as comments from FOMC participants, all suggest that a rate cut is likely at the next meeting on 31 July. Normally, with labor market and financial conditions so strong, the Fed would if anything be considering hiking rates. However, we see three main reasons for the Fed to cut rates.

First, as noted above, inflation continues to run below the Fed's 2% annual target. A rate cut under current circumstances would send a strong signal to the market that, after years of missing to the downside, the Fed is serious about getting inflation up to the target.

Second, while the Fed expects the economy to grow at around a 2% pace going forward, it is worried about downside risks. The various trade disputes and tariff hikes have created uncertainty that makes it more difficult for businesses to commit to new investment opportunities. Another policy risk is the government budget for fiscal year 2020, which begins on 1 October. Negotiations have not gone well and if a deal isn't reached, the government will either shut down, or spending will drop sharply.

Fig. 4: Falling durable goods prices dragging down inflation rate

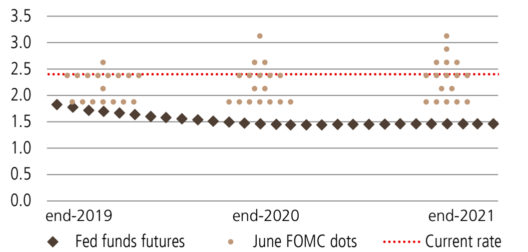
Sub-components of PCE inflation rate, year-over-year change in %



Source: Bloomberg, UBS, as of 10 July 2019. Note: PCE = Personal Consumption Expenditures

Fig. 5: Rate cut appears likely

Fed funds futures yields, dots from June FOMC meeting, in %



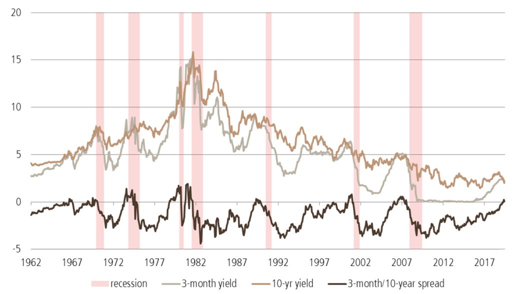
Source: Federal Reserve, Bloomberg, UBS, as of 10 July 2019

Third, the yield curve is inverted (more on this below), with 10-year Treasury yields below the 3-month rate. Minutes of the 19 June FOMC meeting indicate that this was a source of concern for at least some participants. With the federal funds rate currently at 2.4% and 10-year Treasury yields at 2.1%, cutting rates by 50 basis points should be enough to get the yield curve out of inversion. We expect the Fed to cut by this amount, either all at the next FOMC meeting on 31 July, or spread out over two meetings. In our view, cutting rates by more than this would require further deterioration in the economic data.

There is considerable uncertainty over what level of the Fed Funds rate would represent "neutral", equivalent to allowing a car to roll along without pressing on the gas or brakes. In the past, most estimates were around 2% above the inflation rate, but it appears that neutral is now much lower, perhaps 0.5% above inflation. For the moment we see the current Fed Funds rate of 2.4% as close to neutral, and if the Fed cuts by 50 basis points then this would make policy moderately accommodative.

Fig. 6: Inverted yield curve has signaled recession

Treasury yields in %



Source: Bloomberg, UBS, as of 16 July 2019

Yield curve

Historically, an inverted yield curve has been one of the most reliable indicators that a recession is on the way (see Fig. 6). Because of this, most models of recession probability include the shape of the yield curve, often as the single most important component. Yields on 10-year Treasuries fell below 3-month yields earlier this year, raising fears of recession.

Examining previous periods where the yield curve was inverted, the proximate cause was usually the Fed raising interest rates. Typically, the Fed was hiking rates in an attempt to slow the economy down because inflation was too high or the Fed was worried about overheating. In our view, there's nothing magical about this process--the Fed steps on the brakes and then the economy slows.

While it is true that the Fed has raised rates by quite a bit in the current cycle, including 100 basis points of hikes last year, rates are still very low from a historic perspective. It seems unlikely that a Fed Funds rate 2.4% is so high that it makes a recession inevitable. Importantly, in this cycle the Fed has never been trying to lift rates above neutral, and it seems perfectly willing to reverse course and cut rates to reduce downside risks.

Further, there are good reasons to think that the yield curve will be flatter on average than in the past. In an environment where the main problem for central banks is that inflation is stuck below their target, holders of long maturity bonds will require less compensation for the risk that interest rates will have to be raised sharply in the future. The extremely low yields offered by non-US developed market bonds also helps to put a cap on US yields. So it may turn out that one aspect of the "new normal" US economy is that when economic conditions are good, the yield curve is flat rather than upward sloping.

All of that said, we would not entirely dismiss the idea that an inverted yield curve represents a risk to the economy. If nothing else, an inverted curve suggests that markets perceive that there are downside risks that will cause the Fed to cut rates in the future.

That could cause consumers and especially businesses to adopt a cautious stance toward spending that hurts growth.

Credit conditions

Relative to other countries, US corporations are more reliant on market-based funding rather than bank lending. The spread between corporate bond yields and Treasury yields is important both for funding conditions that companies face and as an indicator of market expectations for future economic developments. The willingness of banks to lend is also still an important factor for the economy, especially for consumers and small businesses.

Overall, credit is readily available throughout the economy. We view credit conditions as looser than normal, although not at the extreme levels reached at the height of the housing bubble.

Appendix

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