

Global Asset Allocation: US economic expansions do not die of old age

They are always murdered by the Fed

For the savviest investors, however, such "murder" has never been a source of grief!

On the contrary, over the last 40 years, each recession provoked by the Fed has been a great buying opportunity. In fact, for the equity market the Fed was always like a "purger", rather than a murderer, cleansing it from all sorts of intoxicating illusions about the future. Of course, cathartic medication is by nature excessive. The market, rather than reverting to economic reality, undershoots. Hence the buying opportunity.

Our readers will forgive us for the gastric description of US (and global) equity market cycles since 1980. In reality the 40 years of *Great Moderation* have been very beautiful, rather than ugly. Over this period fiscal policy and labor market regulation have largely given way to the Fed as the sole steward of the economy. The latter's monetary policy has been extraordinarily successful. Interest rates have come down with inflation. Expansions' life expectancy has risen, whilst recessions have become shorter and shallower, allowing the Fed to stay close to its full employment target.

Today it is the Great Moderation that is being murdered

Unfortunately something has changed. Since the beginning of this century full employment alone has become increasingly ineffective in preventing the continuous erosion of US wages. The successful economic model is now broken. Monetary policy is no longer being relied on as the key driver of economic policy. Trade policy is being experimented as the new panacea. But it will not be enough. Increasingly, US voters are demanding redistribution. The "Tea Party" slogans are gone and whoever wins the US elections in November 2020, it is time to reckon with higher taxes, and potentially more labor market regulation. This is a very serious concern for investors since it is the continuous and persistent increase of the capital income shares at the expense of the labor income share that explains much of the stock market performance since 1980¹. Recessions might still remain short-lived, but higher taxes and increased regulation will lead to less growth and more inflation. The 20s will see more equity drawdowns and sideward movements than we have grown accustomed to during the beautiful four decades of the *Great Moderation*. On the argument of long-term equity returns we also refer our readers to our recently published [Equity Thematician](#).

For 2019, however, we advise to enjoy the (tea) party as long as it lasts. We see no recession, rather a pick-up in global growth in the second half of the year. As a result the current volatility in global equity markets will give way to a more sustained upward movement later in spring. Troubles will re-emerge sometime in 2020 when the Fed will raise rates, instead of cutting them as the market is currently expecting. Higher rates and a stronger US dollar are likely to cause a recession in 2021. Based on the belief that the Fed has no monetary policy ammunition left, many observers argue that the next recession will be big and long. We disagree. It will be a short and shallow recession. As such it will again be a buying opportunity. The real question is another one. Will it be the last *big* buying opportunity of the *Great Moderation*? Or will it be the first *small* buying opportunity of the new era of lower equity returns?

Luciano Jannelli, Ph.D., CFA
Head Investment Strategy
Tel: +971 (0)2 696 2340
luciano.jannelli@adcb.com

Kishore Muktinutalapati
Equity Strategist
Tel: +971 (0)2 696 2358
kishore.muktinutalapati@adcb.com

Prerana Seth
Fixed Income Strategist
Tel: +971 (0)2 696 2878
prerana.seth@adcb.com

Mohammed Al Hemeiri
Analyst
Tel: +971 (0)2 696 2236
mohammed.alhemeiri@adcb.com

Noor Alameri
Analyst
Tel: +971 (0)2 696 2340
noor.alameri@adcb.com

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¹ Greenwald, Lettau and Ludvigson, *Origins of Stock Market Fluctuations*, NBER, 2016.

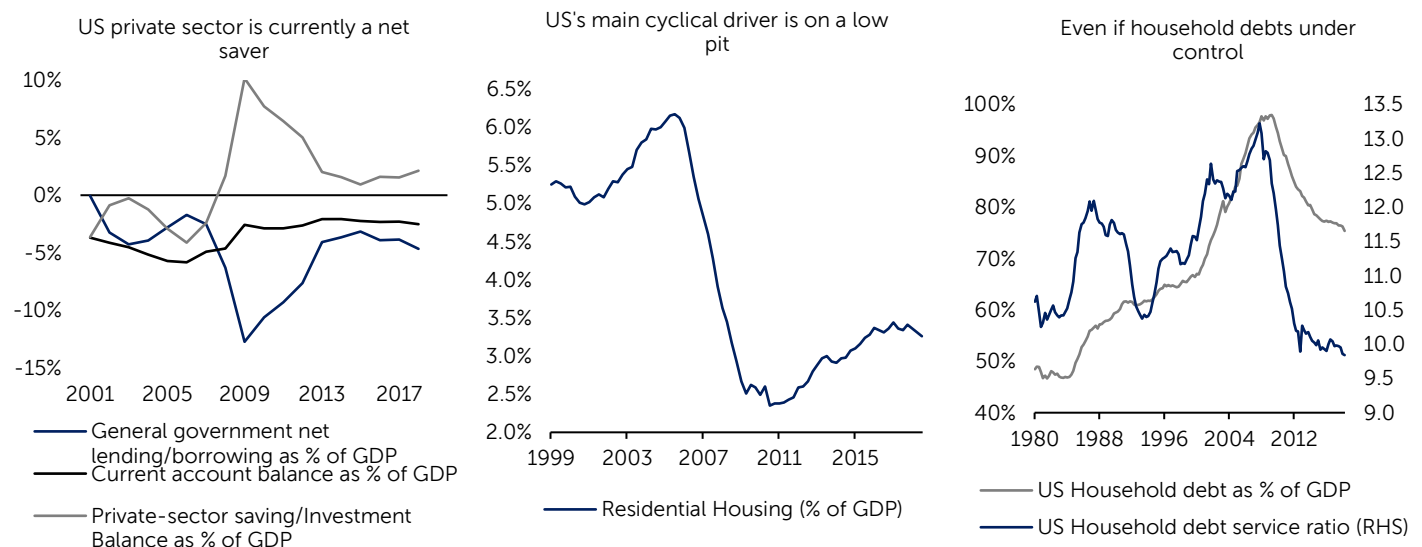
Taking stock of Q1 2019 – preparing for 2020 and 2021

- On [June 4 2018](#) we reduced our global equity allocation to neutral in anticipation of a global growth slowdown, maintaining overweight positions only in US and Indian equities;
- In our [January Quarterly Investment View](#) we told our clients that a continuing sell-off was unlikely, and stuck to our stance;
- Since then we have taken on [tactical equity calls on Brazil and South Africa](#), whilst maintaining a [broadly defensive global equity stance](#);
- We remain underweight bonds, and in particular emerging market bonds, with the exception of [GCC and Brazil bonds](#). We also stick to long-term US Treasuries as a risk hedge;
- We remain overweight cash and neutral alternatives, and in the latter category we maintain an overweight position in market-neutral strategies;
- Global risk markets are likely to remain volatile over the next months as investors continue to fret about the sustainability of global growth
- In the second half of this year we should see a pick-up of growth in Asia and Europe, which will put downward pressure on the US dollar, and lift global equity markets in a more sustained and less volatile manner. We are, however, not yet ready to move overweight global equities, in the same way as we are [not yet ready to move overweight European and Emerging equity markets](#);
- Beyond 2019 investors will want to take risk off the table. There is a concrete risk that in 2020 growing US inflation might force the Fed's hand. After the 2020 presidential election there is a good chance that US fiscal and regulatory policy will become less market friendly, whomever wins that election. In that sense 2021 might well become the year in which the US business cycle – which never dies out of old age – met a new, more subtle, murderer: the country's elected politicians.

Elderly business cycle not yet on significant life support

Today markets expect the Fed prospectively to cut rates, as they continue to fret about the risk that the US economy is entering a recession. We still expect the Fed to raise rates sometime in 2020. At the end of this note, we will discuss the risk of further rate hikes in 2020. For now, we explain why a US recession is not imminent.

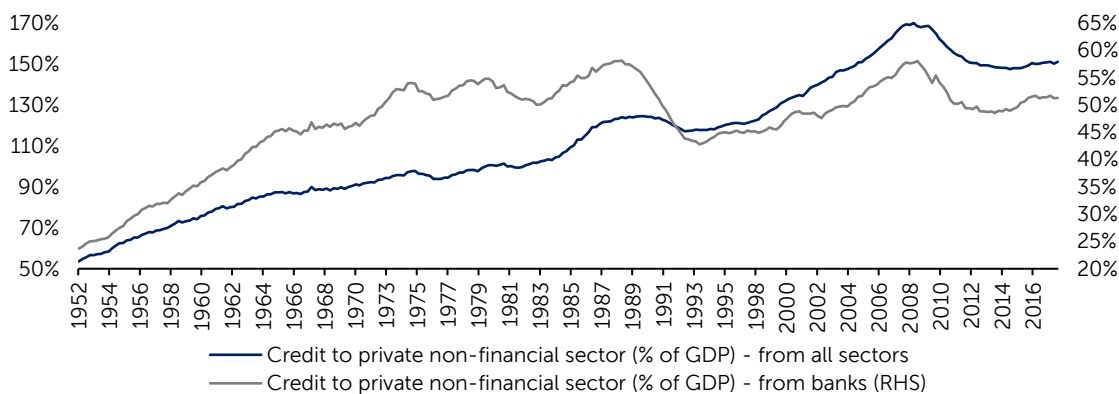
When thinking about the Fed's potential to murder an overheated economy, inflation comes first to people's mind. Instead it is debt levels that should be the true reason of concern. During the last two recessions, in fact, the overheating was mainly reflected in overleveraged households. High household debt levels can be seen as a form of life support for an aging business cycle. By borrowing households manage to keep up consumer spending, and thus keep the cycle alive and kicking. Thus raising rates is like taking life support away since it makes the servicing of the debt too costly, thereby inducing a reduction in spending. If, however, households have lower debts, as they do today, they are less likely to suffer from higher capital costs, or from corrections in the value of financial and real assets.



As can be seen from above charts, in terms of household debt spending, the US economy is not overheating when compared to prior cycles. The US private sector is a net saver, and US residential real estate investments - the key driver of US business cycles over the last forty years - are "abnormally" subdued if one considers the "advanced age" of the current business cycle. US household balance sheets, and associated debt service costs, are much more solid than they used to be in the run-up to the prior recessions. In addition, wages are rising and government spending is up. This makes an imminent recession much less likely, especially if the Fed will not raise rate at least until 2020.

Many clients and colleagues have pointed out to us that it is not US consumer debt, but US corporate debt one should be concerned about. We disagree. For starters, it has always been the consumer to drive the US business cycle, never the corporate sector. In addition, whilst there are some weak spots in the non-financial corporate debt space (and for sure there are also some weak spots in the consumer debt space), in the aggregate US non-financial corporate debt has not risen significantly as a share of the overall economy, as can be seen from below chart. Moreover, compared with many other developed economies US non-financial corporate debt is still relatively small as a share of the overall economy. Finally, US banking exposure to non-financial corporate debt is also relatively small.

Corporate US debt is still contained



Source: BIS

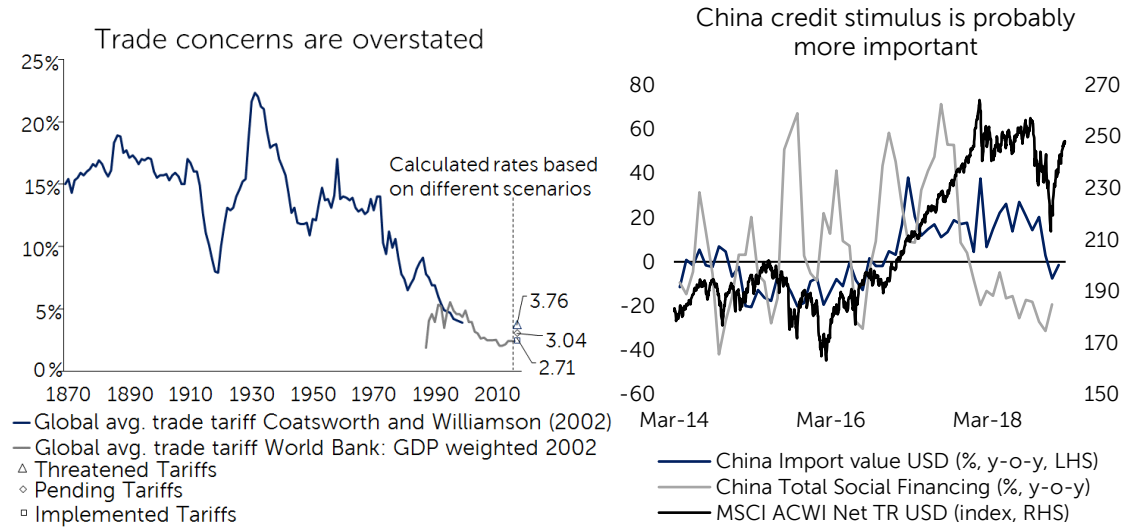
China stimulus more important than trade talks ...

There are increasingly signs that China and the US will find an agreement on trade. There is a problem though. Whatever happens, by the November 2020 elections the US trade deficit versus China will be bigger, not smaller. This will make President Trump more vulnerable during the election campaign, especially if he will have signed a deal with China. That's why we suspect that he will try to gain some more time, before finalizing a "complete" deal with China, such that he can argue that its effects will need more time to mature.

We stress that the pick-up in China credit stimulus is more important for the global economy than a positive solution of the US-China trade talks, as is rather obvious from below charts. Nonetheless over the next few months bad news on the trade front is likely to continue to be a major source of volatility, since markets will remain unconvinced of a sustained pick-up in global growth in China and Europe.

Over the last years we have been relatively bearish on the prospects of China once more injecting significant stimulus into its economy and, as such, we were surprised by the significant boost in credit last January. We have consistently argued that China's credit-driven growth model, whilst arguably successful for many a decade, has become increasingly unsustainable since the 2008 Global Financial Crisis. We have interpreted the country's recent political "revolution", culminating in Xi Jinping's recent elevation to a political status second only to Mao's, as the prelude of the dismantling of that very model. We still believe that we will not see a credit expansion similar to what we witnessed between 2015 and 2016. But it is reasonable to expect some additional credit growth as nominal GDP growth continues to decelerate. The problem is that even such modest credit growth, whilst good for global growth and in particular emerging markets, still risks further increasing the country's debt to GDP ratio since most of

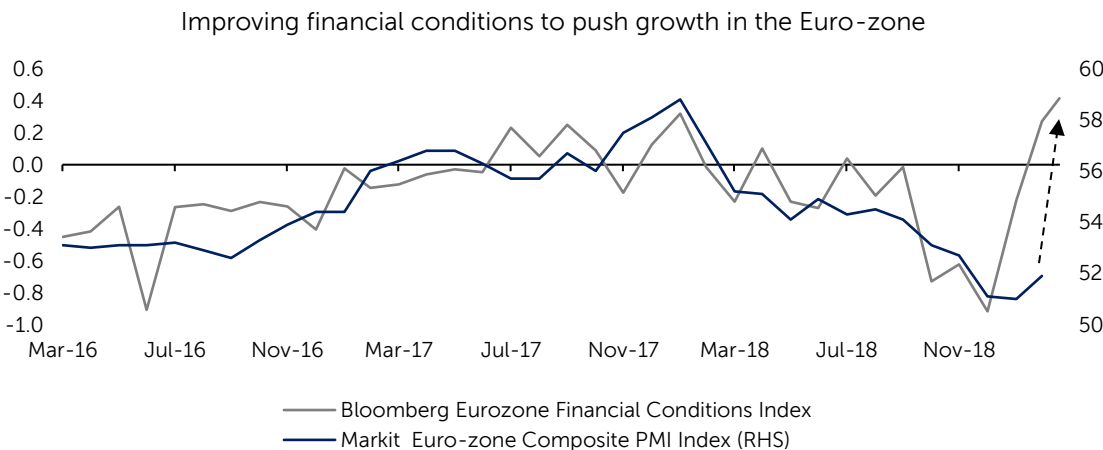
the credit typically goes to the inefficient state-owned enterprises. We remain cautious on Chinese growth prospects, and thus also on emerging markets equities over the next couple of years.



Source: Oxford Economics/World Bank/National Bureau of Economic Research, MSCI, China NBS, Bloomberg

... and Europe might help out too ..

In addition to stimulus by the Chinese authorities, a stronger euro will also provide a temporary boost for emerging markets. For the euro to strengthen we need growth in Europe to pick up again. This is becoming increasingly likely as financial conditions in the euro area are improving, fiscal policy will gradually become easier, automobile production in Germany is likely to rebound, and the "yellow vest" movement is bound to fail.

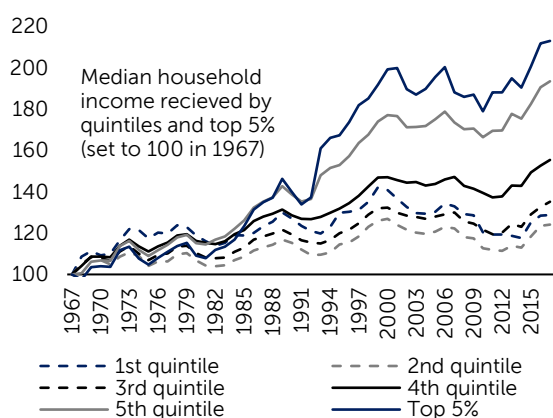


Source: Markit, Bloomberg

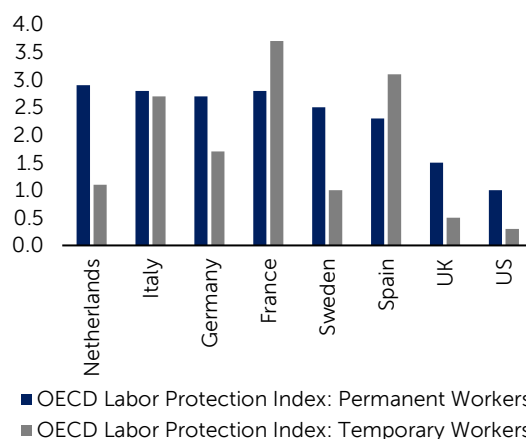
The Fed no longer the "only game in town"

If we exclude temporary backstop measures such as the Bush Jr. tax cuts and the Bush Jr. and Obama fiscal support measures in the aftermath of the 2008 Global Financial Crisis, it is fair to say that monetary policy has been overwhelmingly the main driver of US economic policy and, as such, of the fortunes of the financial markets². For almost forty years the Fed has been extremely successful in maintaining price stability and full employment, i.e. ensuring that recessions were always short lived. Over the last twenty years, however, the maintenance of full employment has no longer gone hand in hand with rising wages. Protection of workers has gone down in line with labor market liberalization, whilst higher paid salaries and asset prices have continued to go up.

Lower income segments no longer profit from the *Great Moderation*



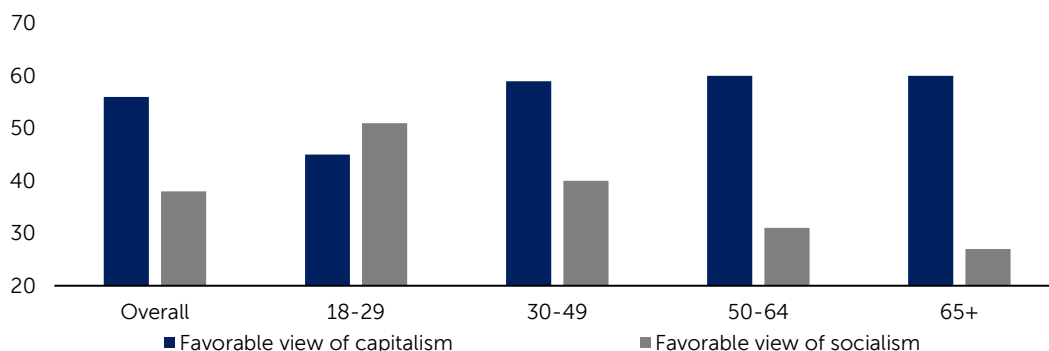
US success story comes at a price



Source: BEA, World Bank, OECD

Rising public discontent about the Fed and, more in general, about the political system is now causing a change of mind in Washington D.C. US politicians, interestingly both democrats and increasingly republicans, are abandoning their low tax stance and openly discussing more progressive income taxes, as well as taxation of share buy backs. According to Gallup around 70% of the US population thinks that the upper income population pays too little taxes versus around 20% who believe that they pay their fair share, and 10% who believe they pay too much. On our side we would like to stress that this discussion is going on in the midst of an economic expansion. We think that the current swing in public opinion versus more taxation would strengthen if, say in 2021, a recession would hit the country whereby the government is forced to bail out companies who had used debts to finance share buybacks. Below chart shows that in particular the younger generations will be more open to politicians who favour re-distribution away from the wealthy to the less wealthy.

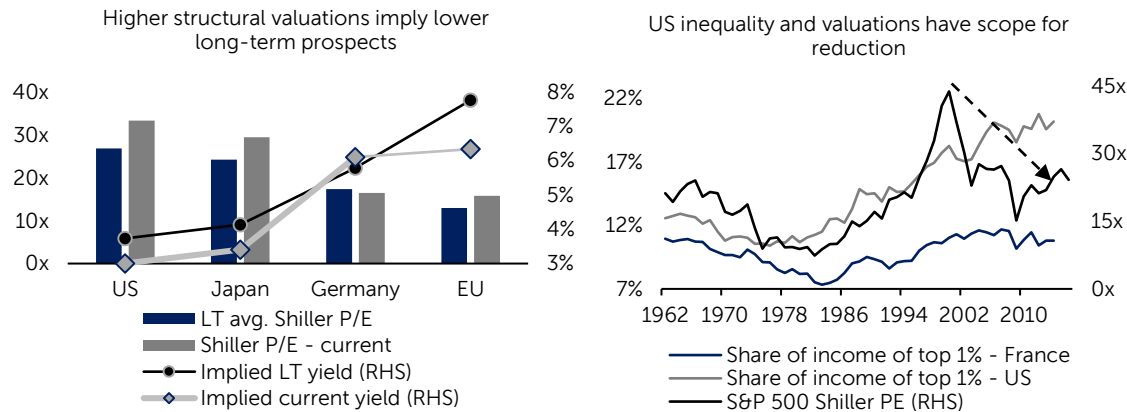
New American generations no longer embracing "Washington Consensus"



Source: Gallup (2018), NBER, R. Chetty et al (2018)

² See, amongst others, Mohamed El-Erian, *The only Game in Town: Central Banks, Instability and Avoiding the Next Collapse*, Random House, 2016

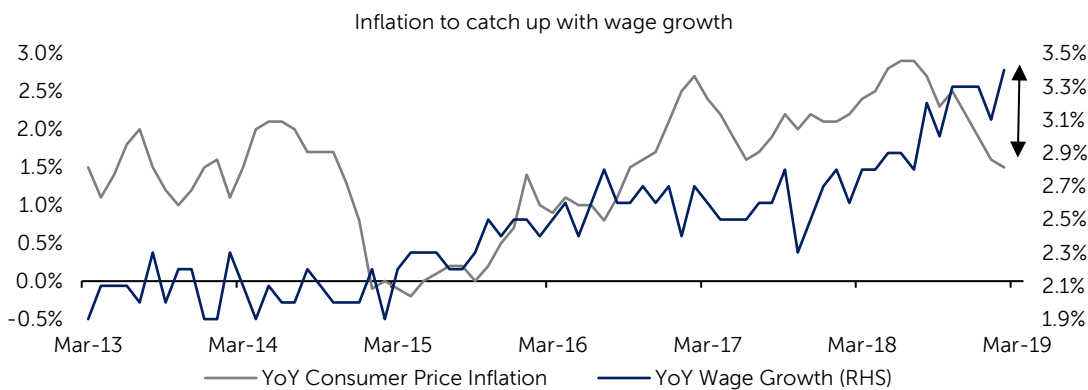
High cyclically adjusted price-earnings ratios explain a lot about depressed low-income wages and increasing inequality, in particular if those cyclically adjusted earnings are significantly higher than current price-earnings ratios, like they are today in the US. In fact, in the case of the Shiller price-earnings ratio, which is adjusted over a 10 year period, it simply means that the average earnings of the last 10 years are significantly lower than today's earnings. However, since economic growth has been subdued, revenues have also grown rather modestly. In fact, earnings have grown significantly because companies have been able to cut labor costs, which is the largest cost component for US companies. But this is like a dog that is biting its own tail. Or, to put it in investors' terms, today's prices are already discounting long-term earnings that at some point will no longer be sustainable. The cyclically adjusted US price-earnings ratio today carries a long-term yield of less than 4%.



Sources: Robert Shiller, Thomas Piketty

Where do we go from here?

We believe that there is a good chance for global growth to pick-up in the second half of 2019 and are waiting to take advantage of that by increasing our global equity allocation. We will be closely monitoring credit growth in China and in the EU, since positive numbers here could trigger that decision. A weaker USD will at that point go together with stronger performance in emerging equities. In 2020 we expect inflation in the US to pick-up as prices finally catch up with stronger wages.



Source: Bloomberg

The Fed will thus raise rates, which will determine again an increase in the US dollar. This, together with the continuing structural slowdown in China, warrants our long-term bearish structural view on emerging markets. At any rate, rising US rates and a rising US dollar increase the chances for a US recession in 2021. But what is more important, a 2021 US recession – however shallow – is likely to force politicians' hands. They will very likely reverse a forty year old trend of lower taxes and labor market deregulation. This will constitute a structural headwind for risk assets for years to come. The fortunes of the equity markets will no longer be temporarily "murdered" by the Fed safeguarding price stability. There will be a much more subtle "murderer" in town. That "murderer" will be the elected

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politician. He will increase taxes and focus on workers protection, shifting income back to labor away from capital. The 2020s will therefore see much more drawdowns and sideward movements than we got used to over the last four decades.

Our global asset allocation in five minutes

Asset allocation summary				
	Underweight (UW)	Neutral (N)	Overweight (OW)	Comments
Asset allocation				
Equities				Cautiously optimistic. OW US, UW EM and EU
Fixed income				Treasuries as a risk-hedge
Alternatives				Market-neutral strategies and gold
Cash/liquidity				
Equities - by region				
US				Prefer consumption and services themes
Canada				
Europe ex UK				Focus on defensive quality
UK				Stick with the benchmark
Japan				Prefer a cyclical tilt
Asia Pacific ex Japan				Structurally OW India
EM LatAm				Tactically OW Brazil
EM EMEA				Tactically OW South Africa
GCC				Prefer KSA; regional banks
Equities – by sector				
Comm. Services				Prefer US exposure over rest of the world
Consumer Discr.				Prefer Consumer Services to Auto & Components
Consumer Staples				Prefer Household & personal products
Energy				Companies with positive cash flow to outperform
Financials				Prefer Banks with diversified business models
Health Care				Prefer Pharma, biotech & life sciences
Industrials				Prefer Commercial & Professional Services
IT				UW Tech H/W and Semiconductor sub-sectors
Materials				UW Materials hedged with OW Brazil and SA
Real Estate				Prefer US exposure over Europe
Utilities				Stick with the benchmark
Equities – by factors				
Large cap				Strong balance sheet, earnings visibility
Mid cap				Likely to be market-performers
Small cap				US small cap strained by leverage
Growth				Prefer non-cyclical growth
Value				Growth at a reasonable price (GARP)
Dividend yield				Prefer quality dividends
Quality				Quality in the environment of low risk-tolerance
Momentum				Watch momentum for leadership change
Legend				
	<i>New</i>	<i>Old</i>	<i>No change</i>	

Source: ADCB Investment strategy

Asset allocation summary (continued)

	Underweight (UW)	Neutral (N)	Overweight (OW)	Comments
Fixed income				
Duration				Barbell approach with LT and ST instruments
DM corporate bonds				Spreads remain unattractive
US credit				Valuations remain expensive
Euro credit				Valuations are more expensive than US credit
US treasuries				OW duration
EM hard curr. bonds				Hard-currency bonds preferred over local
GCC				Remain resilient amidst the global sell-off
India				The central bank to adopt a dovish bias
Commodities				
Energy				Looking for a balanced market
Industrial metals				China moving to consumption-led growth
Precious metals				Risk-off hedge
Currencies*				
EUR				USD to lose some strength in 2019
GBP				Pound sterling to follow the euro rather than USD
JPY				BoJ yield curve targeting
Legend				
	<i>New</i>	<i>Old</i>	<i>No change</i>	

*For currencies, OW = appreciation bias, UW = depreciation bias, N = stable

Source: ADCB Investment strategy

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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