Morgan Stanley

INVESTMENT MANAGEMENT

When Will the Cycle End?

FIXED INCOME | FIXED INCOME TEAM | MACRO INSIGHT | 2018

At the root of determining when a cycle may end is trying to determine when a recession may begin. As a result, we rely on signal strength of recession indicators to determine where we are in the current economic cycle. To be very honest, it is difficult to identify discrete periods that mark turning points in a cycle. This is especially true today because there is such heavy disagreement on where we are in this cycle. As we see it, there are three key indicators of the current cycle that are at odds with each other:

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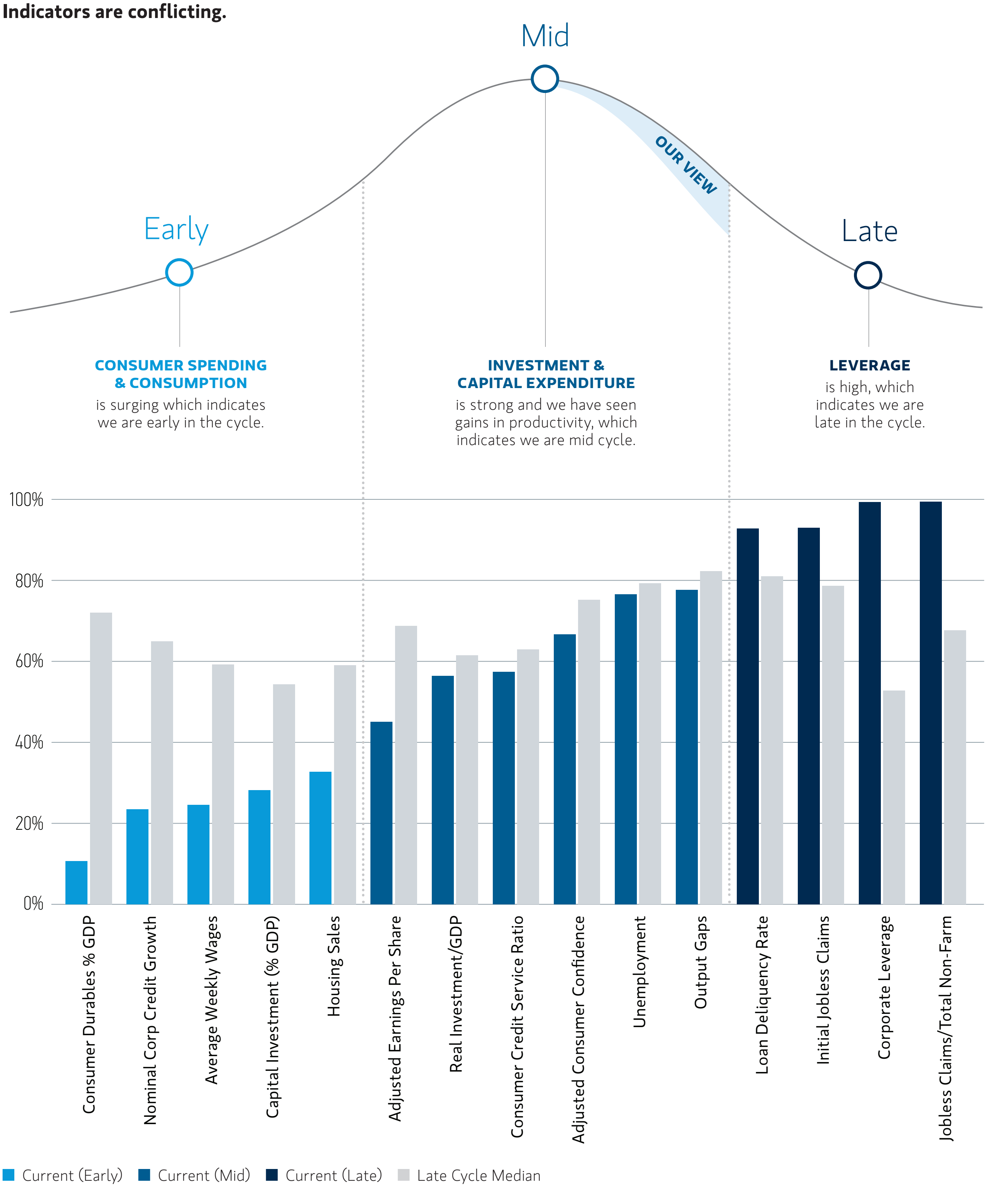
Where are we in the current economic cycle? Indicators are conflicting.



Note: This normalized data set represents US economic cycles going back to 1960
Source: Haver Analytics, Bloomberg, BIS, NAIRU, Morgan Stanley Investment Management. Data as of July 31, 2018

Our view on the economic cycle indicators

We believe we are halfway to two-thirds of the way through the current economic cycle. Why? Because we believe the current signals indicating we are earlier in the economic cycle are stronger than those signaling we're late in the cycle.

High levels of corporate leverage are often cited as a late cycle signal. However, we must take into account that many corporations have taken advantage of the low interest rate environment. Over the past several years corporations have refinanced their debt at lower rates and extended its maturity. This weakens leverage as a late cycle signal.

On the other hand, business investment and consumer related indicators are currently signaling we are earlier in the economic cycle. Thus pulling our view of the cycle inward leading us to believe we are somewhere past the midpoint, but not late cycle.

But policy matters too

Fiscal policy, namely corporate taxes and regulatory reform, have bolstered the markets, allowing the current high growth environment to continue for longer than previously expected. This likely means the economic cycle has been extended.

But the U.S. Federal Reserve (Fed)'s policy may be at a tipping point. Following the global financial crisis the Fed conducted a period of quantitative easing in which it purchased government securities, building up its balance sheet, in an effort to increase cash/liquidity available in the market. During this time the Fed also lowered the fed funds rate to further reduce interest rates and increase market liquidity.

As the economy improved, the Fed began unwinding these policies by first increasing the fed funds rate. However, these rate increases have created foreign currency and U.S. dollar distortions, as well as global asset price dislocations.

We believe it is time for the Fed to shift their focus from increasing interest rates to reducing the assets on its balance sheet. This would allow time for the rest of the world to catch up to our interest rate levels. A reduction in balance sheet could "normalize" the yield curve and restore the excess yield earned on long term bonds over short term bonds, otherwise known as term premia.

Conclusion

If we had to make an estimate, we would argue that the economic cycle comes to an end in 2021, which lines up with many recession model forecasts. Broadly, we believe we are in a benign interest rate environment, and high yielding strategies will remain coveted.

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