THE LONG VIEW: CURRENT EXPANSION HEADED FOR THE RECORD BOOKS

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Those waiting for the next crash may be disappointed if the market pattern that has persisted for the past 80 years continues.

Key Takeaways

- The ClearBridge Recession Risk Dashboard continues to point to a healthy backdrop for the U.S. economy.
- Buybacks and other shareholder-friendly actions should give U.S. equity markets a boost into year end.
- Longer term, a weaker dollar could extend the secular bull market in the U.S. and lead to a rebound in international equities.

Current Expansion Headed for the Record Books

It's hard to believe that September officially marked the 10-year anniversary of the collapse of Lehman Brothers. If there was a defining moment of the Great Financial Crisis, Lehman's bankruptcy and the ensuing selloff would top the list. As other 10-year milestones from the crisis are reached over the next several months, investors will be reminded of these painful memories. It's natural to be wary of a market that has moved relentlessly higher after experiencing two 50% declines in less than a decade. However, those waiting for the next crash may be disappointed if the market pattern that has persisted for the past 80 years continues.

Going back to the 1930s, U.S. stock market returns tend to cluster, with long patterns of consolidation followed by multi-decade expansions (Exhibit 1). Such periods of consolidation, known as secular bear markets, have traditionally provided weak returns for equity investors. These tough market environments included the Great Depression, the 1970s inflation outbreak and the lost decade of the 2000s. Importantly, these challenging periods create the fertile ground that gives rise to secular bull markets, where the lion's share of stock market returns have been generated historically. These extended periods of strong market gains create excesses that build up and eventually burst, setting the stage for the next secular bear market. The evidence suggests the U.S. exited a secular bear market with the end of the 2008 recession. If the historical pattern continues, the current secular bull market could continue for years to come.

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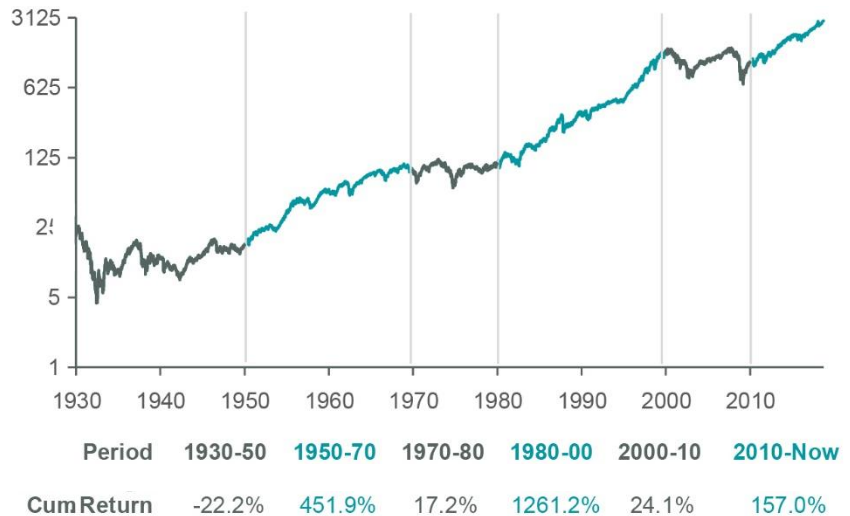
Exhibit 1: Secular Bull Market Has Room to Run
S&P 500



As of Sept. 30, 2018. Source: Standard & Poor's and Bloomberg.

The primary drivers behind secular bear or bull markets are always different. For example, the extended gains in the 1980s and 1990s were due to Reaganomics and Federal Reserve (Fed) Chairman Paul Volcker's successful purging of inflation. The Great Depression, poor monetary policy and World War II, meanwhile, were responsible for the declines of the 1930s and 1940s. The early part of the current secular bull market was propelled by low interest rates and ultra-easy central bank policy. While rates have been rising and policy has become tighter, conditions remain conducive for additional equity market gains, particularly with central bankers reluctant to re-normalize policy too quickly. This is not to say that there won't be bumps in the road, however. The biggest proverbial potholes typically occur during recessions.

Given the length of this economic cycle, many are questioning how long the good times can last. After all, this expansion is only nine months away from becoming the longest in modern U.S. history. However, unlike most items you buy at the grocery store, economic expansions do not have expiration dates. There is no predefined timeframe until a recession ensues. In fact, numerous international expansions have lasted well beyond 10 years (Exhibit 2). Four expansions in particular stand out as potential parallels to the U.S. today: Australia from 1992 to the present, the UK and Canada from 1992 to 2008 and Japan from 1975-1992. These expansions had similar characteristics that allowed them to defy the gravitational pull of a recession. Each demonstrated strong financial regulations, a stabilization of the labor force without stoking wage inflation (better known as a flat Phillips curve) and few financial excesses. The U.S. currently shares each of these dynamics, which bodes well for the longevity of the current expansion.

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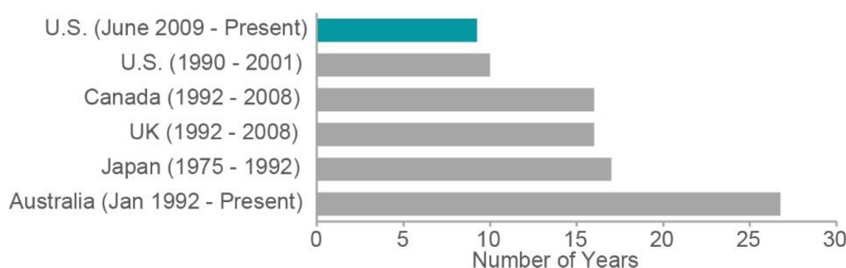
Exhibit 2: Historically Long Economic Expansions



As of Sept. 30, 2018. Source: FactSet.

Dashboard Signals All Clear for Now

The ClearBridge Recession Risk Dashboard also points to an elongated period of economic expansion, with little chance of a recession on the immediate horizon. During the third quarter, two indicator changes occurred: corporate profit margins improved to green (from yellow) and money supply worsened to yellow (from green). Importantly, these adjustments have not altered our near-term outlook of continued growth for the U.S. economy.

Although ClearBridge takes a longer-term outlook than many, we believe it is important to watch for near-term inflection points, which typically can impact markets. Despite the recent barrage of negative news related to trade/tariffs, Fed tightening, and slower growth in China, we believe equity markets will continue to grind higher as we approach year end. Repatriation and robust earnings growth have allowed corporate cash to grow substantially during the year. This cash is being used for a variety of shareholder- friendly activities such as share buybacks, increased dividends, mergers and acquisitions (M&A) activity and capital expenditures.

Exhibit 3: ClearBridge Recession Risk Dashboard

		Third Quarter 2018	Second Quarter 2018
Financial	Yield Curve	Expansion	Expansion
	Credit Spreads	Expansion	Expansion
	Money Supply	Caution	Expansion
Inflation	Wage Growth	Expansion	Expansion
	Commodities	Expansion	Expansion
Consumer	Housing Permits	Expansion	Expansion
	Jobless Claims	Expansion	Expansion
	Retail Sales	Expansion	Expansion
	Job Sentiment	Expansion	Expansion
Business Activity	ISM New Orders	Expansion	Expansion
	Profit Margins	Expansion	Caution
	Truck Shipments	Expansion	Expansion
	Overall Signal	Expansion	Expansion

Expansion Caution Recession

Data as of September 30, 2018. Source: Bureau of Labor Statistics, Federal Reserve, Census Bureau, Institute for Supply Management, Bureau of Economic Analysis, American Chemistry Council, American Trucking Association, Conference Board, and Bloomberg.

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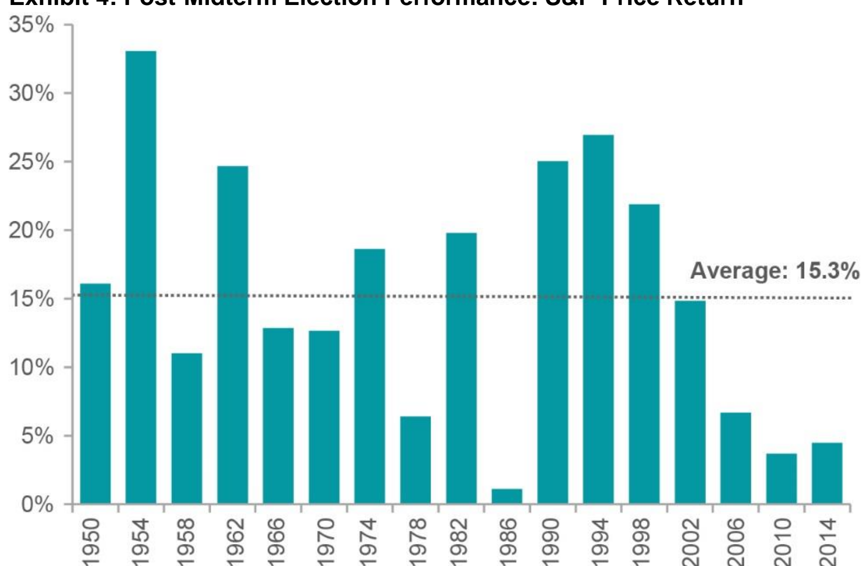
Corporate buyback activity, in particular, should give equity markets an additional boost over the next several months. As companies exit their mandated earnings blackout period later this month, buyback activity should accelerate considerably given the US$324 billion gap between authorizations and executions. Typically, this gap narrows into year end, representing a hefty source of demand for equities. This should provide positive price momentum for equity markets.

Another driver of equity momentum relates to the election cycle. Since World War II, the fourth quarter has typically proven to be a great entry point for investors during midterm election years. In fact, the 12-month period following a midterm election has never experienced a negative return and has enjoyed an average one- year return of 15.3% (Exhibit 4). This dynamic occurs because investor preoccupation over short-term concerns tends to overwhelm what is often a robust fundamental backdrop. However, as Congressional races become clearer, markets should refocus on what is important. Additionally, the U.S. economy has not entered a recession in the third year of a president's term, which will be 2019. We believe this streak should continue, as many of the risks that have preoccupied investors' attention this year subside.

Exhibit 4: Post-Midterm Election Performance: S&P Price Return



Source: FactSet.

Emerging Markets Less Immune to Vagaries of U.S. Dollar

Emerging markets are one such area where we see diminished risks moving forward. Since 1950, there have been 13 Fed tightening cycles, 10 of which ended in a U.S. recession. The others frequently saw emerging markets come under pressure, such as the Asian Financial Crisis in 1997. Fed tightening can have impacts far beyond our borders, and U.S. dollar (dollar / USD) strength associated with higher U.S. rates typically puts pressure on emerging markets. As Warren Buffett says, you only learn who's exposed when the tide goes out – in this case, when funding costs rise.

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There are key differences today as compared with emerging market (EM) flare-ups of the 1990s. First, far fewer EM central banks currently peg their currency to the USD, which affords them much more flexibility as the dollar strengthens. Further, most EM central banks have substantial foreign exchange reserves, which they can use to defend their local currencies. Finally, current account deficits for many emerging markets are much lower today, making these countries less reliant on foreign capital. Two countries that defy this trend and have larger current account deficits – South Africa and Turkey – have come under pressure recently. Perhaps most importantly, we believe the USD has peaked, which should help stabilize emerging markets.

The USD should weaken due to several dynamics. First, the dollar tends to lag the combined size of the fiscal and trade deficits by two years, with larger deficits causing dollar weakness (Exhibit 5). Fiscal deficits are projected to increase substantially due to tax reform and higher budgetary spending, which should pressure the dollar. Second, the potential for a dovish surprise from the Fed could also keep the greenback in check. As the Fed approaches its neutral interest rate – a hypothetical rate where monetary policy is neither restrictive nor accommodative – the hurdle for continued rate hikes rises. This creates the potential for the Fed to back off from its projected pace of four hikes per year over the next few years.

A potentially dovish turn for U.S. central bank policy could keep the greenback in check.

Exhibit 5: Twin Deficits Drive Dollar

Data as of September 30, 2018. GDP=Gross Domestic Products. Source: Bureau of Economic Analysis, Federal Reserve, FactSet.

Third, the dollar tends to weaken when the rest of the world is gaining relative economic momentum and strengthen when the U.S. grows faster. Coming into 2018, consensus expectations were for Europe and emerging markets to outgrow the U.S. As such, there were extreme levels of speculative short dollar positioning. The script did not play out that way due to the passage of U.S. tax reform and a slowdown in China and Europe. These events widened the growth gap between the U.S. and the rest of the world, creating a short squeeze on speculative short dollar positions, which further strengthened the dollar as shorts were closed. Today, there is speculative long positioning in the USD, reducing upside for the greenback. Additionally, we believe the economic growth differential between the U.S. and the rest of the world should narrow as Chinese leadership moves from a deleveraging focus toward a more accommodative stance. Should this transpire, the dollar would likely weaken.

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China Revives Stimulus Plans

China is breaking out their playbook from 2015-2016 as they can ill afford to fight both a deleveraging war and a trade war at the same time. They have decisively changed course on the home front, preferring to stimulate their economy through multiple channels. In fact, China will put more fiscal stimulus, as a percent of GDP, into their economy in the second half of this year than the U.S. did through 2018 tax cuts and increased budget spending. Furthermore, China has pulled several monetary levers to reverse the course of monetary policy, including rate cuts, currency depreciation, US$100 billion of capital injections via their medium-term lending facility (MLF), and encouragement of banks to increase loan growth (Exhibit 6). Chinese stimulus can be a very powerful force on global GDP and equity performance, with the last round of stimulus in 2015-2016, helping set the stage for the upswing of growth in early 2016 and ensuing strong stock market returns.

Exhibit 6: Chinese Monetary Policy Changing Course
Chinese Monetary Conditions lead GDP*

*Note: China Monetary Conditions Index Advanced 6 Months (Adv 6 Mo).
Chinese Monetary Conditions data as of August 31, 2018. Year-to-year (YoY) China GDP data as of June 30, 2018. Both are most recent available as of September 30, 2018. Source: National Bureau of Statistics China and Bloomberg.

Finally, Beijing appears to have set a floor on the yuan/dollar exchange rate and has taken substantial action to arrest yuan depreciation. This should provide a ceiling for how high the dollar can rise since the yuan is the largest component of the trade- weighted dollar index at 22%.

Putting this all together, share buybacks, historical post-midterm election performance trends, a peaking USD and Chinese easing should all provide the necessary ingredients for further positive price action in U.S. stocks and a reversal of fortune for international equities. As the wall of worry recedes, risk assets should do well as the record books document another year of the ongoing secular bull market.

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* As of 31 August 2018.

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