Market Synopsis – August 2017

In our July Market Synopsis, we took an in-depth look at the fundamentals which will inevitably cause inflation to rise over the coming years. This month, we discuss the recovery since the Great Recession of 2008 and build on last month's conclusions to gauge the timing and nature of the next recession.

Conditions for the short term continue to appear reasonably rosy, with earnings continuing its solid uptrend. The profit recovery has been broad-based across countries and sectors while consensus estimates for global growth are trending higher.

Running in its eighth year, the current US economic recovery is now the third longest on record. If it continues to July 2019, it will take the top spot from the 1990s' expansion to become the longest recovery in US history.

It is not too surprising that the current recovery has endured for so long. Characteristically, financial crises are followed by long, drawn out recoveries. This time round has not been any different: The Great Recession was one of the deepest in modern history.

With the US unemployment rate improving to pre-recession levels, the logical question is whether the current expansion is nearing its end. While the recovery is getting long in the tooth, there is nothing of significant value to be concerned about over the near term.

The long-term Fed Funds Rate, together with periods of recession, is presented in Figure 1. It is evident that all US recessions have been preceded by interest rate increases. It therefore follows that the current cycle of increasing interest rates may be a catalyst of a forthcoming recession.

In broad terms, recessions since World War II can be grouped into two categories: The first group comprises recessions that resulted from the bursting of asset bubbles, where interest rate hikes were the instigator, rather than the cause of ensuing recessions. The second group contains recessions where the Fed found itself behind the curve in normalising monetary policy and was forced to respond to rising inflation by means of aggressive interest rate increases.

The last three recessions were all the result of burst asset bubbles: The 1990-1991 resulted from the commercial real estate bust and the subsequent Savings and Loan crisis. This was followed by the dotcom bubble which caused the recession of 2001. Lastly, the Great Recession was largely the result of the US subprime mortgage crisis which resulted from the US housing bubble.

With corporate debt as a percentage of GDP hovering

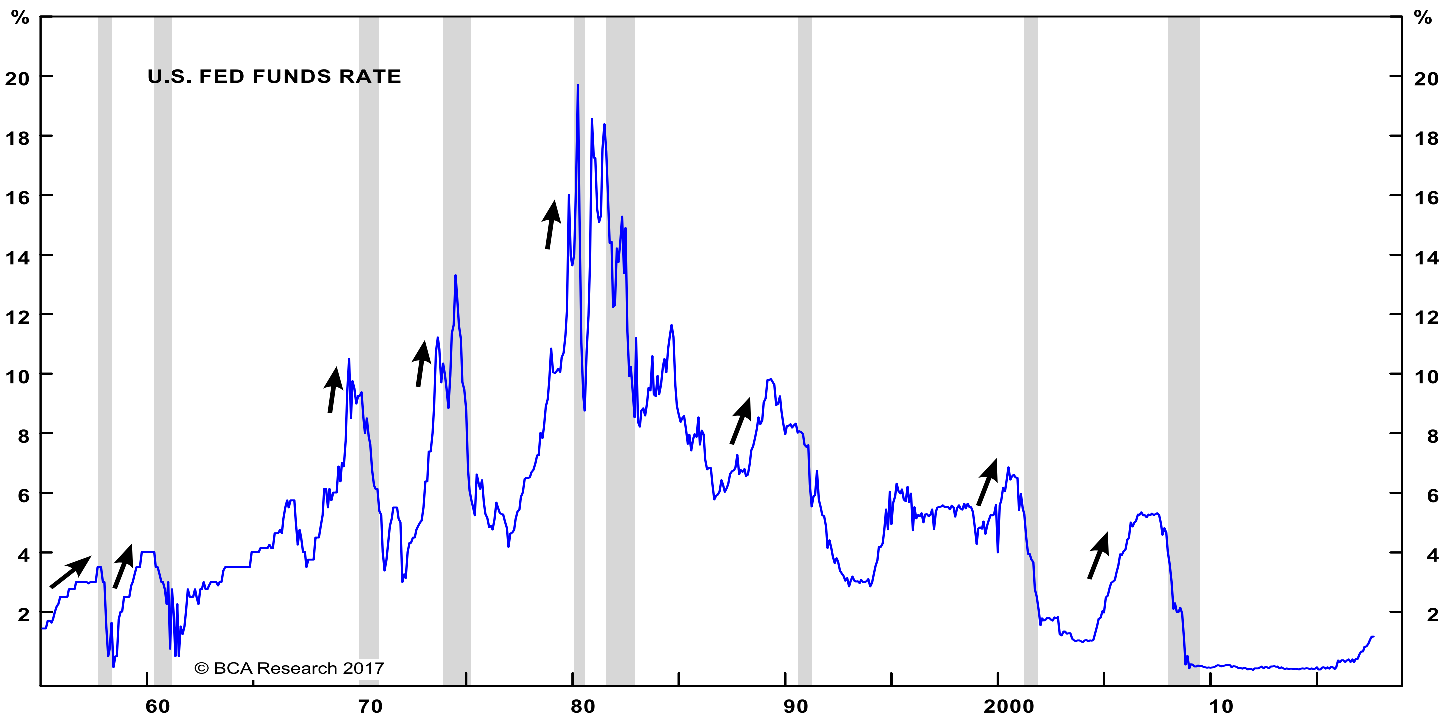

Figure 1: Recessions are always preceded by increases in interest rates. NBER periods of recessions are denoted by shaded areas.

close to record levels and valuations appearing stretched across the board, as seen in Figure 2, today's financial landscape appears far from pristine. Although these imbalances are bad enough to exacerbate a recession, they do not appear severe enough to cause one. This suggests that the next economic downturn could look more like the "classic" recessions of the 1960s to early 1980s, as opposed to the last three recessions.

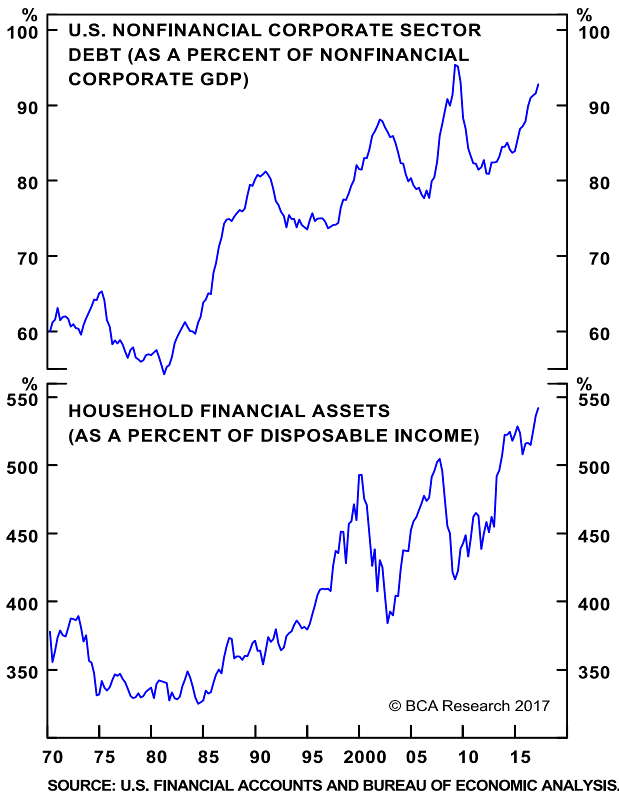

Figure 2: Debt and asset values are at or near record highs

If it is assumed that the next recession will follow the steps of a "classic" recession, it follows that inflation will be a key determinant in the timing of it, as the Fed will be hesitant to act decisively until inflation starts to accelerate. At this point, the Fed may find itself behind the curve and may need to increase interest rates more aggressively to curb rising inflation. Fortunately, inflation should remain subdued for another 12 months.

Unfortunately, inflation is a highly lagging indicator and, as discussed in last month's Market Synopsis, usually does not peak until well after a recession has started and does not bottom until well after it has ended. Hence, once inflation does start to rise decisively, the Fed may find itself unable to act with the required efficiency and swiftness.

Another key indicator which the Fed monitors to measure the health of the economy, is the rate of unemployment. Current expectations are for unemployment to remain stable at the current level of 4.3% and declining marginally to 4.2% by the end of 2018. In addition, the Fed expects annual real GDP to grow by 2.2% in 2017 and 2.1% in 2018, in line with average GDP growth since the start of the recovery.

The aforementioned assumes that labour force growth will accelerate and/or productivity growth increases. However, neither of these may be achievable, which could cause the actual unemployment rate to drop significantly lower. As shown in Figure 3, labour force participation has been declining steadily over the course of the last two decades, being mostly flat over the last four years. This has occurred against the backdrop of an aging population which has forced more people into retirement.

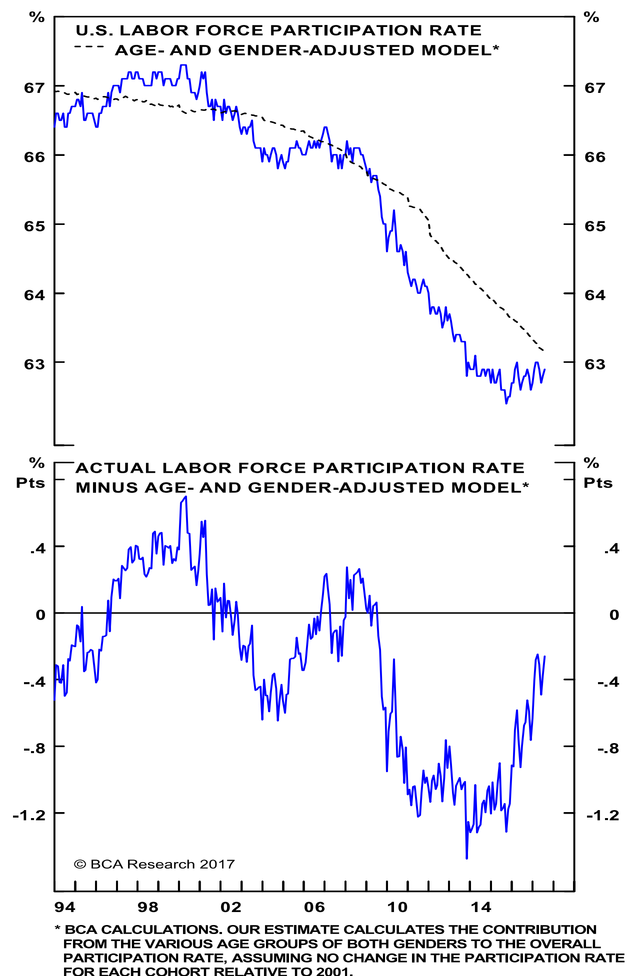

Figure 3: Labour force participation have been declining

In particular, the decline in labour force participation is most pronounced amongst less educated workers, as shown in Figure 4. The growing shortage of workers has already started to translate into rising wage pressures at the lower end of the skill distribution. It can therefore be concluded that labour force growth will be slowing at a time when the economy is running out of workers who are willing to seek employment.

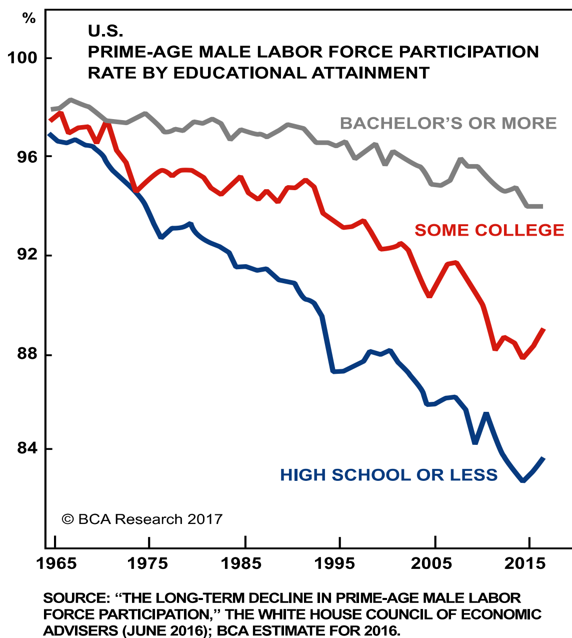

Figure 4: Labour force participation by education

Moreover, it remains doubtful that productivity growth can make a significant rebound. As discussed last month, productivity growth in the developed world has been slowing since the early 2000s. This can partly be explained by the fact that today's new innovations are probably not as transformative as previous new technologies, including indoor plumbing, electricity, the internal combustion engine and the internet.

Since the start of the recovery, the unemployment rate has declined by over five percentage points, backed by GDP growth which has remained stable at around 2%. Therefore, if labour force growth fails to accelerate and productivity growth remains weak, it follows that GDP growth of 2% is bound to drive the unemployment rate down from current levels. Conversely, the unemployment rate can decline even more, should GDP growth accelerate to over 2%.

Given the significant amount of easing in financial conditions which the US has enjoyed over the last few months, GDP growth in excess of 2% may not be too far-fetched. This may result in the unemployment rate decreasing to below its low of 3.8% in 2000. At this point, a further reduction in unemployment may become unlikely, leaving the most likely outcome to be an

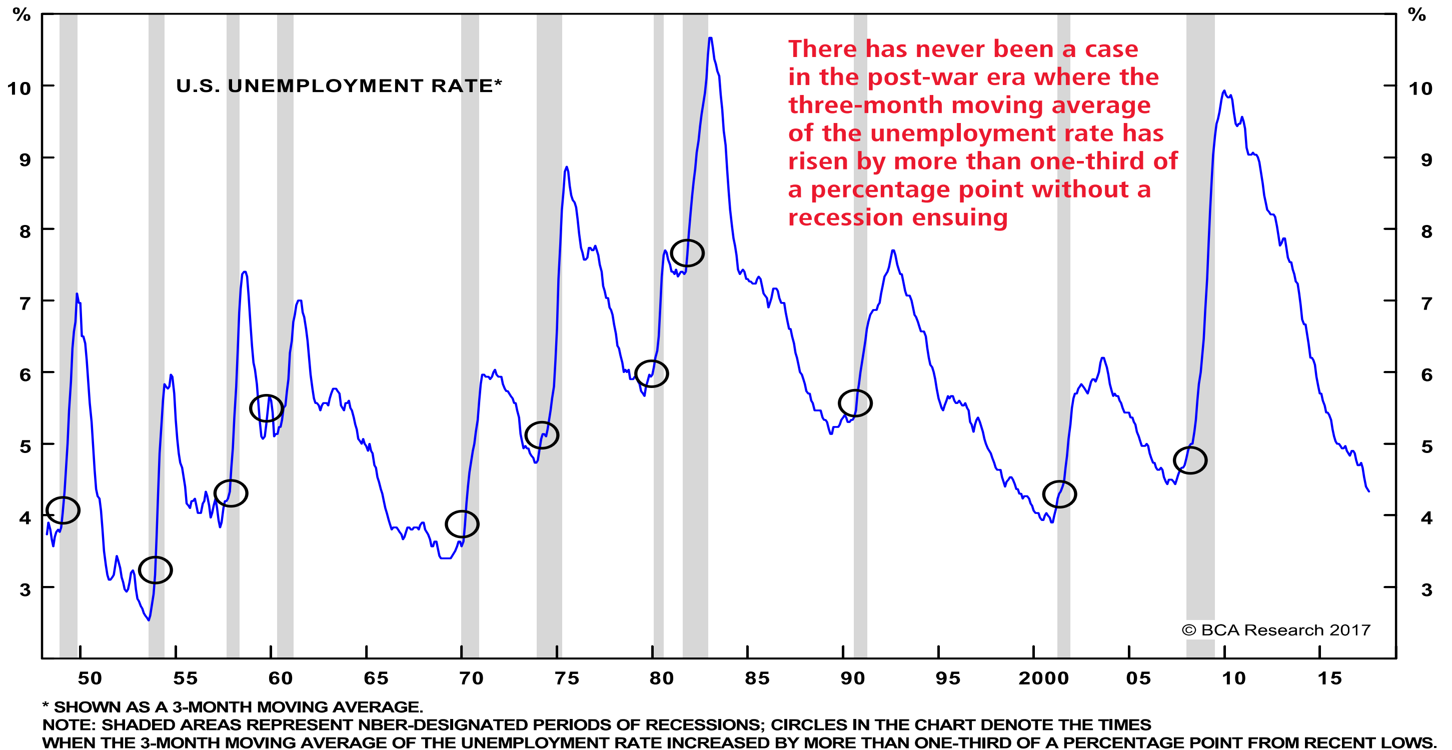

Figure 5: Even a small increase in unemployment can trigger a recession

increase in unemployment. As shown in Figure 5, this poses a twofold problem: Once unemployment starts to rise, it continues to rise. In addition, the US has never been able to avert a recession when the three-month average unemployment rate has increased by more than a third of a percentage point.

In conclusion, it appears that a recession may be on the medium term horizon: Declining unemployment, backed by stable GDP growth will fuel wage growth over the coming quarters. Over the longer run, this could cause an increase in inflationary pressures, which will force the Fed to increase interest rates more aggressively. However, there is little evidence of this scenario occurring within the next 18 months.

In the interim, stronger US growth should support upward revisions in rate expectations, which in turn would put upward pressure on Treasury yields and ultimately boost the USD. A stronger USD is necessary for tilting US consumption towards foreign-made goods, thereby allowing domestic spending to rise in the face of tighter supply constraints.

An increase for foreign-made goods would be good for foreign producers in developed economies. However, an appreciation of the USD could spell trouble for firms in emerging markets, which have incurred large amounts of USD denominated debt. We hence continue to favour European and Japanese shares over their US counterparts in currency hedged terms.

For more information on this Market Synopsis or to discuss solutions provided by Integrity Asset Management, please contact us at:

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Indicator	Spot	MTD	YTD	Y-o-Y
Gold	1 308.64	3.1%	13.6%	0.0%
Brent Crude	50.86	-3.2%	-10.5%	8.1%
USDZAR	13.01	-0.1%	-5.3%	-11.6%
EURZAR	15.49	1.2%	7.2%	-5.7%
GBPZAR	16.82	-1.6%	-0.7%	-13.0%
JSE All Share TRI	7 884.33	2.6%	12.9%	9.5%
JSE Resources TRI	2 201.57	5.1%	12.5%	16.7%
JSE Industrials TRI	14 367.15	1.9%	19.2%	8.2%
JSE Financials TRI	8 320.70	2.6%	6.6%	11.7%
JSE Listed Property TRI	2 239.64	0.4%	6.5%	9.0%
S&P 500	2 457.59	-0.6%	9.8%	13.2%
Euro STOXX 50	6 825.59	-1.8%	5.7%	15.5%
FTSE 100	6 193.84	0.8%	6.4%	12.9%
Nikkei 225	30 093.53	-2.2%	3.1%	17.7%
Hang Seng	75 144.34	4.5%	31.5%	26.8%

Source: Bloomberg, as at 30 August 2017

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