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Investment strategy insights

A 9-year bull market: What could go wrong? | 11 September 2017

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- Many investors are apprehensive about their equity exposure, given that we're in the 9th year of a bull market and valuations are no longer cheap.
- We don't believe that the bull market or the economic cycle will end any time soon. The US economy is firmly in the expansion stage, and non-US economies are even earlier in the cycle. This matters because bear markets rarely occur without the economy sliding into recession.
- While this expansion is quite different from prior ones, making it more difficult to assess, it's probably a lot closer to the end than the beginning. A material policy shift (e.g., tighter monetary policy) or a significant external shock are the most likely reasons why the cycle will end.
- Investors should ensure that their portfolio is globally diversified, regularly rebalanced, and is consistent with a goals-based financial plan. It's also important to note that it's costly to reduce equity allocations too early, valuations are a poor short-term guide, and bonds are still a good recession hedge.

Investors are asking with increasing frequency if the bull market is near an end. The interest is understandable. US equities are now in the ninth year of a bull market that began in March 2009. The major indices have routinely hit all-time highs in 2017 and the S&P 500 is up 266% since the start of the bull market. This has been a great outcome for investors who've been fully invested all this time, but many are now apprehensive about their equity exposure given the length of this market rally and current valuations. That begs three questions: How long can this bull market last? What will bring it to an end? And what should investors do about it?

The same questions can be asked about the economic, or business, cycle. The US economy is also in the ninth year of an expansion that began in 2009, making it one of the longest in the post-WWII era. To better understand whether or not this bull market is entering the terminal phase, we need to gauge and focus on the evolution of the economic cycle. That's because bear markets rarely occur without the economy sliding into recession. Absent that, any equity sell-off is likely to just be a mid-cycle bull market correction, along the lines of the five 10%-plus corrections the S&P 500 has experienced periodically since 2009.

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Cause and effect

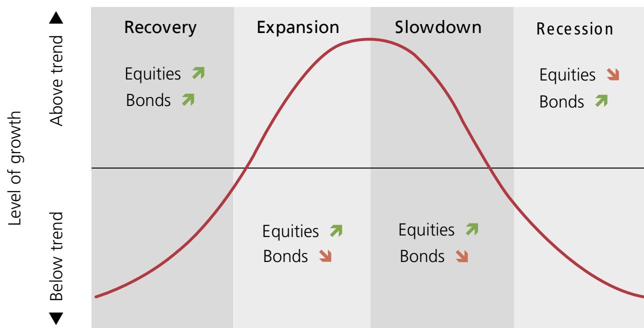
We don’t believe that either the bull market or the expansion stage of the economic cycle will end any time soon, which is one reason why we’re overweight global equities in our six-month tactical investment horizon. It's also our view that the expansion will continue through 2018, but recognize that expansion stage of this cycle is probably a lot closer to the end than the beginning. How close depends on what could bring it to an end. History suggests that business cycles end because of either a material shift in policy (e.g., tighter monetary policy) or a significant exogenous shock (e.g., a supply-driven spike in commodity prices). So our assessment of the probable causes that would lead to an end to the expansion – as well as the bull market – begins with these factors.

Successfully navigating the later stages of a bull market requires discipline, engagement, and active monitoring of the economic cycle. For starters, investors should always ensure that their portfolio is globally diversified, regularly rebalanced, and is consistent with a goals-based financial plan. Doing so has clear benefits regardless of the cycle, but they’re even greater in uncertain times when investors have a tendency to make impulsive or emotional decisions. As for monitoring the cycle, we review a number of economic and market data points that have been good end-of-cycle indicators—a deteriorating LEI (leading economic indicator), rising interest rates, accelerating inflation and an inversion of the treasury yield curve being at the top of the list. These indicators inform the tactical asset allocation adjustments investors should consider making to their portfolios. But rather than provide specific recommendations for scenarios that haven’t, and may not, materialize, we outline a general asset allocation strategy, which we will revisit as the cycle evolves.

Cycles 101

Keep in mind that economies habitually oscillate through cycles over time, which can be decomposed into the four distinct stages shown in Fig. 1: recovery, expansion, slowdown, and recession. Although a simplification of actual business cycles, it reflects the essential characteristics that growth is almost always above trend or average growth rates during expansions, and then starts to decelerate during the slowdown stage. During a recession economic growth actually contracts, which then lays the groundwork for the next strong snap-back during the recovery stage.

Fig. 1: Four stages to the economic cycle



Source: UBS, for illustrative purposes only

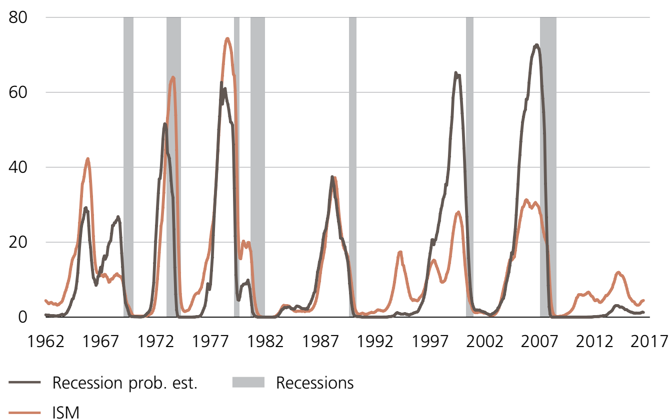
The differences in cycle stages matter a great deal for investing because asset class performance varies considerably across each of the stages. Fig. 1 illustrates how equities and government bonds are likely to perform in each stage, with an up (down) arrow indicating higher (lower) returns compared to the average. Equities generally provide high returns in the recovery and expansion stages, and lower but still positive returns in slowdowns. Only during recessions are returns significantly negative. Bonds do best in recession and recovery stages, when interest rates are falling and have yet to start rising. Returns tend to be lower in the expansion and slowdown phases, because central banks are raising rates—first to get back to neutral policy and then to cool the economy. Consequently, it's imperative to know which stage of the cycle the economy is currently operating in and when it will transition to another stage in order to make appropriate asset allocation decisions.

Where are we in this cycle?

The latest data suggests that the US economy is still well in in the expansion stage. GDP growth was 3% in the second quarter and the ISM manufacturing index has been around 56 all year, which is consistent with moderate GDP growth of at least 2%. Based on the past century of data, the probability of a recession in any given year is roughly 15%. But most estimates for the probability of a recession over the next 12 months—including the UBS hard data and ISM recession indicators shown in Fig. 2—are actually well below 15% at present.

Fig. 2: Forecast models have very low probability of a recession in the next year

Probability of recession over the next 12 months

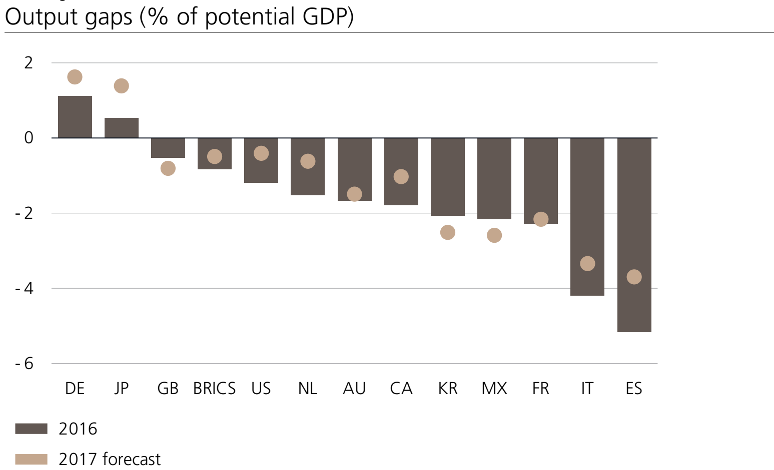


Source: UBS, Haver Analytics

The story is similar outside the US, with most major countries also in the expansion stage. For the first time since 2007, all 35 countries that the Organization for Economic Cooperation and Development (OECD) tracks are set to grow this year. Moreover, nearly three quarters of them are growing faster this year than last. Consequently, the global economy is growing slightly above the long-term trend rate. But while they all may be expanding, there are differences as to where each is in the cycle. This is evident in the significant dispersion in the gaps between a country's actual and potential GDP (Fig. 3). The result is that the cycle in non-US economies appears to be closer to the middle rather than late in the expansion stage, at least relative to the US.

Fig. 3: Large cross-country variation in output gaps, and thus stage of the cycle

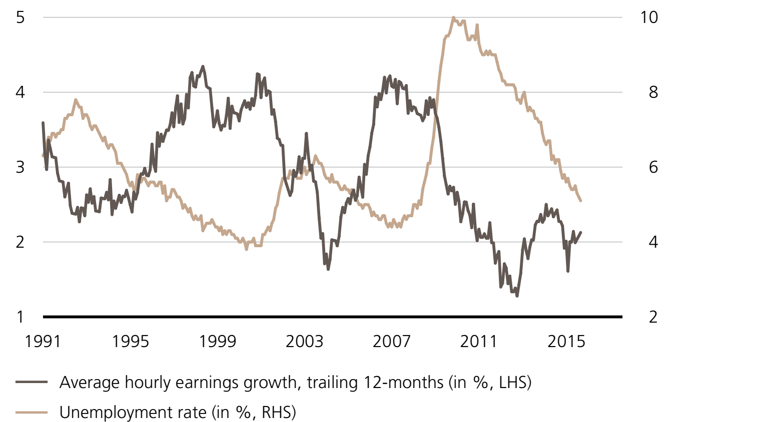
Output gaps (% of potential GDP)



Source: IMF, BIS, OECD, central banks websites

This positive news about the cycle is tempered by the fact that this expansion appears to be quite different from prior ones, therefore also making it more difficult to assess. Parts of the US economy do appear to be in the later stage of the cycle, such as the unemployment rate. As Fig. 4 shows, at 4.4% the unemployment rate is already below the cycle low reached prior to the financial crisis. But that's contrasted by wage growth that is far below where it typically is at this stage of the expansion. Consequently, the labor market may not be as tight as the unemployment rate alone might suggest. If so, the expansion could well have a lot longer to run. But this uncertainty about the labor market, as well as other segments of the economy, makes it harder to draw definitive conclusions about just how long this cycle will last.

Fig. 4: The unemployment rate looks late cycle; wage growth early-to-mid-cycle



Source: Bloomberg, UBS

What could cause the cycle to end?

It's important to keep in mind that expansions don't simply die of old age. The natural state for the economy is to grow, fueled by an expanding labor force and productivity growth. At 98 months, the current US expansion is long by post-WWII standards (the average being 67 months). But simply because it is elongated doesn't mean the end is imminent. Instead, something has to happen for the expansion to end. As we've already noted, recessions are typically triggered by a marked change in policy that causes a slowdown or an external shock that reverberates into a recession.

But before recessions begin, economies usually "overheat" due to excessive investment and imbalances in large swaths of the economy – such as the TMT sector in the late 1990s and the housing market in the 2000s. Oftentimes, this investment binge is fueled by substantial debt accumulation, making the inevitable reckoning even more painful. Given that investment spending in the current expansion has been far weaker than in past cycles, the typical excesses haven't really occurred, nor have imbalances built. That's partly why this expansion has lasted as long as it has. With fewer excesses, the economy should also be more resilient to these triggers, and when a recession finally does occur it could be relatively short and shallow.

That being said, there still appears to be no shortage of potential triggers that could end the current expansion. Higher rates due to tighter central bank policy are the most likely trigger, as has so often been the case historically. But an exogenous shock could also be the catalyst this time, even though they're not all equal in their likelihood, relevance, and potential timing.

Higher interest rates due to accelerating inflation: Exceptionally low rates have supported growth and asset prices in this expansion, and both are vulnerable to rates moving much higher. If the rate rise is due to continued solid global growth, the economy and equities should prove resilient. But a scenario of inflation accelerating past 2% and the Fed responding in kind with rate hikes that are much faster than expected could slow the economy enough that it falls into recession. This would likely occur only gradually because rate hikes tend to impact the economy with a 9-to-12 month lag. With inflation still trending well below expectations, this is very unlikely to be a threat for at least a year. But this risk will tend to increase over time, especially as the labor market tightens further, which therefore warrants monitoring.

Higher interest rates due to central bank policy error: The Fed is expected to start reducing its balance sheet this fall, which is likely to be followed shortly thereafter by the ECB tapering its bond purchases throughout 2018. Together, this could lead to a surge in rates globally. In effect, central banks could make a mistake by allowing rates to rise too much, too fast. As in the inflation scenario, these higher rates would tend to slow the economy. But they could also trigger a decline in risk asset prices, by negatively impacting confidence, investment, and economic activity. Given central banks' apparent aversion

to making such a mistake, this appears to be a low risk. It's also one that will either materialize in the next year or dissipate as these central bank policy changes get underway.

Domestic politics: Political dysfunction in Washington could worsen, but neither that nor failure of the Trump administration's entire economic agenda would be sufficient by itself to trigger a recession. This scenario could eventually sap consumer and business confidence however, and thus impair growth. What's more, the Trump administration could also implement protectionist trade policies if the rest of its economic agenda is stalled, thus triggering an escalating trade war that plunges the global economy into recession.

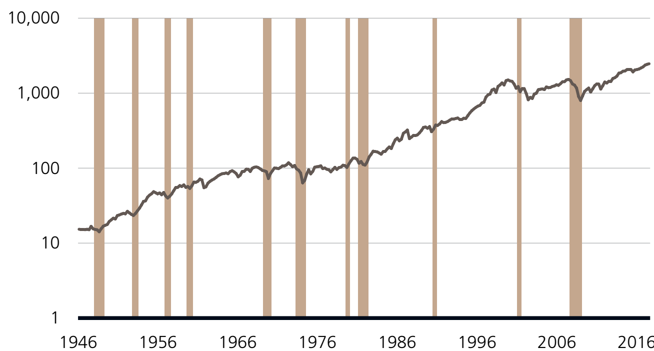
Geopolitics: While tensions exist around the world, escalating military conflict with North Korea is the immediate threat. In recent history, wars involving the US have not caused recessions. However, the use of nuclear weapons by North Korea would be an unprecedented event that would likely have catastrophic economic consequences. Still, the much more likely scenario is that the US uses economic measures, such as trade barriers on China, to isolate the North Korea regime. Doing so risks a retaliatory response that would adversely affect the global economy. This is a low risk that could persist until regime-change occurs, and therefore one which we're monitoring closely.

China hard landing: China's reliance on credit-financed investment spending has resulted in massive growth in total debt and leverage throughout the economy. This has raised the risk of a financial crisis, capital flight, and a large devaluation of the Renminbi. Though such an outcome is still unlikely, the risk could rise if President Xi pushes more aggressively for structural economic reforms after the National Party Congress in October, thus impairing cyclical growth.

Why does the end of the cycle matter for bull markets?

While each cycle is unique, it's rare to experience a bear market without a recession. As Fig. 5 shows, virtually every bear market in the US since WWII was accompanied by a recession within a year. Though the causes of recessions vary across cycles, certain conditions are usually, but not always, present when a bull market ends. They are: rising inflation, the Fed raising rates, and the yield curve flattening to the point of inverting. The first two are evident of an overheating economy, while the latter indicates bond markets anticipate a recession and expect low returns on new debt financing.

Fig. 5: Bear markets almost always accompany recessions



Source: Bloomberg, NBER, UBS, as of 6 September, 2017

Fig. 6 summarizes the status of these indicators at the end of each bull market, and where they are now. The three indicators currently flash, at best, a yellow warning sign. In prior periods, the Fed raised the funds rate by about 80 basis points (bps) on average in the last year of the bull market. The Fed has raised rates 100bps since December 2015, including 25bps for three straight quarters, and is about to start reducing its balance sheet. But it's hard to argue that the Fed is moving to a "tight" policy rather than just getting back to a neutral stance, especially when measures of financial conditions have loosened enough to offset those rate hikes. The slope of the yield curve —the difference between the yield on the 10-year Treasury bond and the Fed Funds rate—has flattened 40bps this year, but at 88bps it's far from inverted. Inflation has been much higher at the end of prior bull markets than the current 1.7% and is usually above the long-term average, while inflation has also been falling this year. Still, a yellow warning sign is not a "green light", and thus warrants caution and a closer monitoring of these signals.

Fig. 6: Current conditions are not consistent with the end of bull markets

Bull market start	Bull market end	Fed Funds change over last 12m	10y Tsy yield minus Fed Funds at end	CPI over last 12m
Jun-49	Jul-56	1.07	0.41	2.2%
Dec-57	Dec-61	0.35	1.78	0.7%
Jun-62	Apr-66	0.58	0.12	2.9%
Sep-66	Nov-68	1.69	-0.04	4.7%
Jun-70	Dec-72	1.19	1.08	3.4%
Sep-74	Dec-76	-0.55	2.16	4.9%
Feb-78	Nov-80	2.67	-3.13	12.6%
Jul-82	Aug-87	0.56	2.23	4.3%
Nov-87	Mar-00	1.04	0.17	3.8%
Sep-02	Oct-07	-0.49	-0.28	3.5%
Feb-09	?	1.02	0.88	1.7%

Source: Factset, UBS, as of 6 September, 2017

Significant market corrections could occur without a recession, as they did earlier during this expansion. However, these "growth scares" raised the specter of a recession and were a factor in those temporary corrections, which lasted only a few months or weeks before fully retracing their losses. Without an end to the economic cycle, any sell-offs should remain only as corrections and not become a sustained bear market.

Alternative paths for the cycle

The US economy will eventually experience another recession. But before that happens, other scenarios could play out that have different investment implications. Two plausible, but unlikely, scenarios include:

Stuck in secular stagnation: GDP growth of just over 2% is underwhelming, but it's actually above the estimated US potential growth rate of about 1.5% (the sum of labor force and productivity growth). Economies can't grow above potential indefinitely without overheating. Before that occurs, US growth could fall to 1.5% or lower if, for instance, consumer and business confidence wanes on a lack of progress on Trump's economic agenda, or because a shrinking supply of workers slows monthly job growth to below 100,000. In either case, growth would decline, though not to recession levels. Once the economy is growing at potential, the expansion could last multiple years, albeit at very low growth rates.

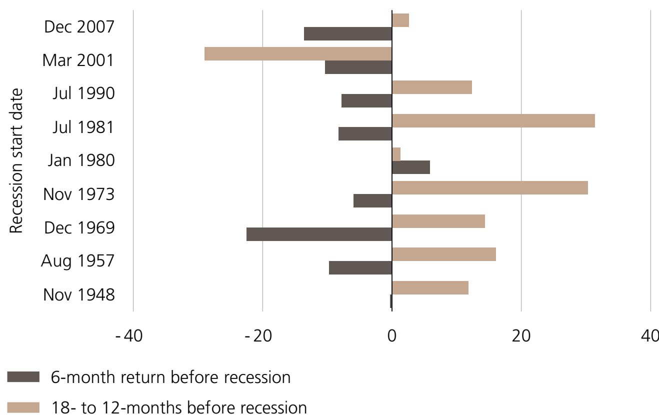
Growth accelerates: Instead of the expansion ending, US growth could accelerate to about 3% annually. Tax reform and regulatory relief could exceed current diminished expectations, thereby directly stimulating the economy and boosting capital investment and productivity. Wage growth could also accelerate as the labor market tightens, thereby leading to increased consumption growth. If these forces become self-reinforcing, growth could reach levels not seen in over a decade. While this would ensure the expansion lasts at least a couple more years, it would also raise the risk of overheating and the Fed needing to act more aggressively down the road by tightening policy.

Mature cycle investment considerations

Though mature in years, the cycle still appears firmly entrenched in the expansion stage. This fact, together with favorable earnings dynamics and central banks that want the cycle to continue, supports risk assets. Nonetheless, investors must be prepared for the cycle to end and for lower future returns given that few assets are cheap. Irrespective of how the cycle evolves or which potential recession triggers flare up, there are a few things investors must keep in mind given where we are in this cycle.

- **It's costly to reduce equity allocations too early.** While it's tempting to reduce equity exposure now, doing so comes with an opportunity cost: potentially continued attractive stock market gains. A recent example of this occurred when the MSCI All Country World Index fell 12% at the start of 2016 on rising recession risks. Investors who sold then would have missed out on the 40% return since the low reached on 11 February 2016. On average, US stocks have provided positive returns up to six months prior to the start of recessions (Fig. 7). With a very low probability that the cycle ends within six months, selling stocks now likely means leaving material returns on the table.

Fig. 7: US equity returns are usually positive until 6 months before a recession



Source: UBS, Bloomberg, as of 6 September 2017

- **Valuations are a poor tactical allocation guide.** High equity valuations are near the top of investors' list of worries. However, while US P/E multiples are above long-term averages, they're not expensive given the macro environment and the trailing P/E multiple for global equities is close to its 20-year average. Regardless of how expensive equities are, the important point is that current valuations are actually a poor predictor of stock returns over the next one to three years. In other words, current valuations are not a good reason right now to reduce equity allocations. They do, however, have higher correlation with long-term returns, which

is part of the reason why we expect large-cap US stocks to generate a lower than normal 7.1% return over the market cycle.

- **Bonds are still a good recession hedge.** The 10-year Treasury yield falling below 2.1% has renewed talk of a bond bubble. Bonds do face the likelihood of rising rates—UBS forecasts a 2.5% yield on the 10-year by year-end—which would result in meager returns going forward. But in a recession, rates are almost certain to fall. Granted, with such low starting yields the cushion they provide may not be what it has been in the past. But they should still provide effective portfolio diversification during a recession.

Beyond these specific considerations, to successfully navigate the eventual end of the cycle, investors must be disciplined, engaged, and actively monitor the economic cycle. After eight years of a bull market, portfolios can easily be overexposed to equities relative to their long-term strategic allocation, because of performance-induced drift and investors being seduced by high equity returns. Rebalancing back to the target allocation will reduce the adverse impact of a bear market. Similarly, investors must be engaged in order to respond to opportunities that arise during corrections. This could include option hedging strategies that protect against portfolio drawdowns. As these are complex strategies, speak to your advisor to determine whether they are appropriate for your portfolio. Lastly, it's vital to actively monitor the cycle because the optimal tactical asset allocation changes will be contingent on how and why it's evolving. This will be a central focus of our ongoing research.

Appendix

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