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20 years on from 1999 – a comparison of economic cycles

Market Comment, August 2019

The US economic cycle has reached a ripe old age in the last few weeks. To be precise, it has become the oldest, i.e. the longest, in the history of economics. This has seen it surpass the cycle of the 1990s. Below we highlight some of the parallels and differences compared to the latter cycle. The 1990s cycle is remembered for ending with an increase in the valuations of global equities thanks to interest rate cuts. However, these were ultimately not enough to prevent an economic downturn, hence the subsequent correction.

Over the last few weeks, the US economic cycle has reached 121 months of age, making it the oldest or most prolonged in the history of economics. Two observations are called for here. Firstly, the economic cycle of the 1990s, which lasted 10 years and ended with the bursting of the technology bubble in 2000/2001, has now been surpassed in its longevity. It is therefore only logical to ask questions about the parallels and differences between these two economic cycles.

The recession of 1990 was followed by a 10-year economic cycle in the US that also resulted in a similarly prolonged bull market for equities. This period of pronounced gains for equities – which was replicated globally – was driven by US technology stocks, not dissimilarly to the current economic cycle. The cycle of the 1990s was finally broken by two crises in the emerging markets: the Mexican crisis of 1994, and the Asia/Russia crisis of 1997/1998. In the current cycle too, one can in a sense discern two emerging market crises. In 2015/2016 we saw a crisis in connection with China and commodities, while last year marked the start of the trade war between the US and China. A common feature to all these problems involving the emerging markets was that they weakened global economic growth and ultimately also US economic growth, which had already revealed signs of weakness.

Another parallel is that in each of these crises the US central bank (Fed) held off from raising interest rates, or indeed even resorted to temporary rate cuts. This in turn had two repercussions. On the one hand, the economic cycle was to all intents and purposes artificially extended by cheaper money. On the other hand, market valuations – of bonds, and even more so equities – were pushed beyond reasonable levels as a result. In particular, this affected technology stocks, which were particularly popular with investors as an "automatic" growth sector.

The parallels with the 1990s are clearly evident in this latter development, as equity markets and above all US technology stocks are currently once again trading at high (and rising) valuations. The parallels with the 1990s are also striking when it comes to using interest rate cuts to artificially prolong the current economic cycle. Not least in response to pressure from the Trump administration, the Fed is now extending the US economic cycle. At some point the decision must be taken as to whether lowering interest rates by 1/2 or 3/4 of a percent is really going to solve the existing economic problems.

> "Structurally and cyclically lower growth probably means "low for long" – low interest rates for a prolonged period."
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> Gérard Piasko, Chief Investment Officer

Here the differences compared to the 1990s are immediately apparent. This time, it is not excessively high interest rates that are responsible for a weakening in the global (and more recently also the US) economy. Other causes can be discerned here. For one thing, there is general uncertainty among companies as to the outcome of the trade conflict, and the degree to which key components from suppliers will be more expensive – or indeed not available – as a result of higher tariffs. As a secondary factor, there are also certain signs of saturation in various consumer goods markets, such as smart phones, consumer electronics and cars (in the latter case the climate change is causing many consumers to delay car purchases). And thirdly, structural upheaval in numerous sectors of the economy is leading to both declining margins (with the financial industry being a good example) and an increasing reluctance to invest. It is clear that these defining features of the current situation have nothing to do with high interest rates, and a great deal to do with geopolitical and trade policy rivalries. The new question that arises here is whether the equity markets will put on their optimistic hat and first of all boost valuations (in the hope of higher corporate earnings), only to then undergo the so-called "double moment of truth" at a later stage – namely when a combination of high valuations and unfulfilled hopes in respect of corporate earnings lead the market to accept the new reality. The latest escalation in the trade dispute, involving the threat of a punitive 10% tariff on further Chinese exports to the US with a value of USD 300 billion, has accentuated the problem. This could depress global economic growth by some 0.50-0.75%, which would have the effect of further reducing worldwide corporate earnings. In summary, we therefore continue to prefer defensive stocks to those of companies dependent on the economic cycle or exports. We advocate a circumspect investment strategy with diversification through bonds as well as commodities such as gold.

On a final note, we would also highlight another key difference compared to the 1990s. Back then, the level of growth (of both the global and the US economy) was significantly higher than it is in the current economic cycle. Indeed, in relative terms it was 30-50% higher – around 3-4% rather than some 2-3% and in Europe around 2-2.5% instead of 1-1.5%.

This has two repercussions. Firstly, it is actually logical in a situation of low economic growth for the economic cycle to be more extended/prolonged. But this emphatically does not mean that the economic cycle is any less fragile, particularly given that geopolitical problems are more pronounced in the current cycle than they were in the golden 1990s. We would therefore argue that markets are probably still pricing in (i.e. expecting) too low a level of volatility. Secondly, structurally lower economic growth also means less upward pressure on inflation, which means that fixed-income investors should position themselves in keeping with the motto of "low for long" – in other words, low yields/interest rates for a prolonged period of time.

Gérard Piasko

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