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How to Invest in the Upside Down Cycle

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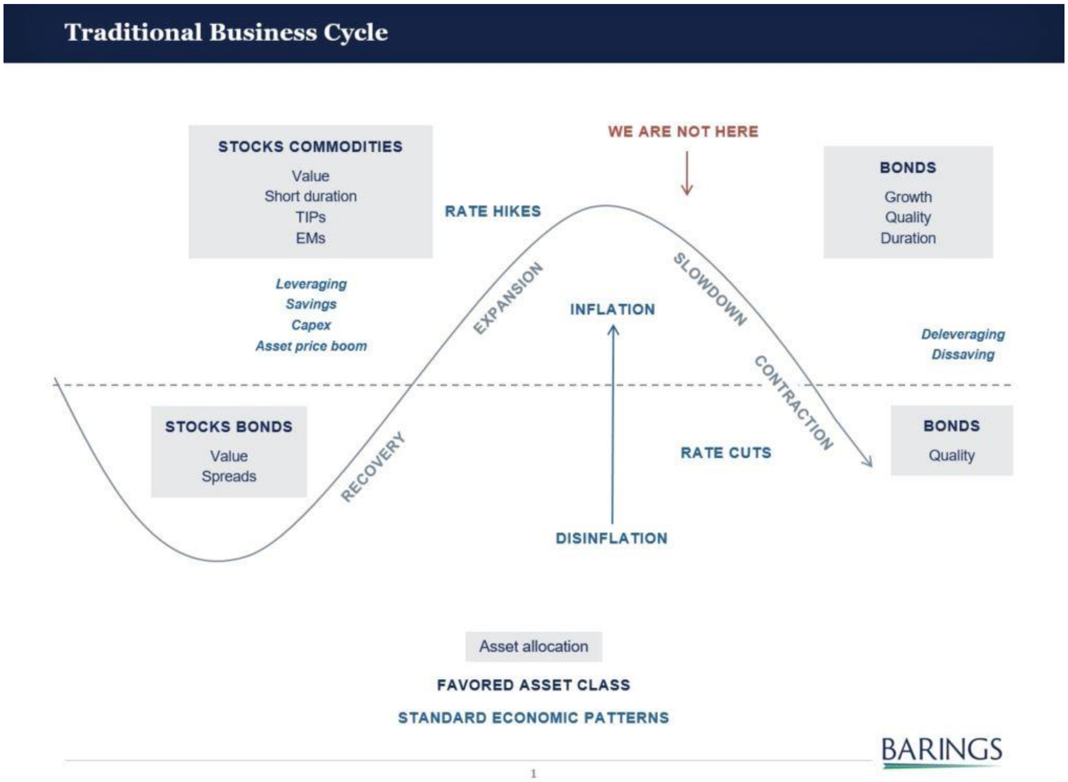
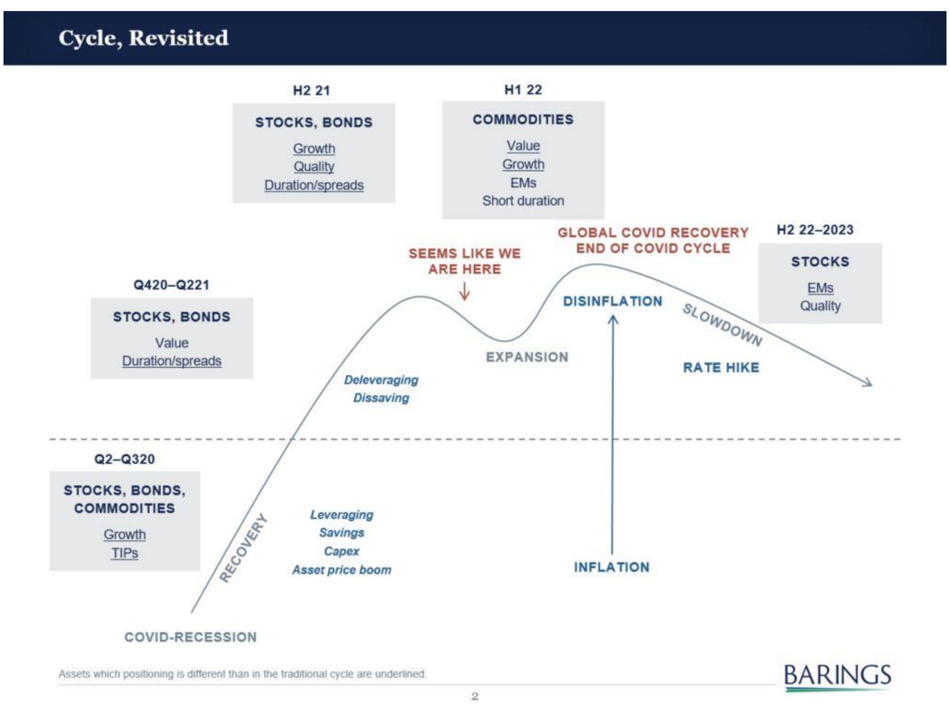
The post-COVID expansion is decelerating in advanced economies, which raises the question: have we entered the slowdown phase that usually precedes a recession in the standard business cycle? After double-digit growth in retail sales and industrial production in the first half of 2021, PMI surveys of business expectations have softened, though they remain in expansionary territory. Inflation, however, remains high—the result of a clash between 18 months of pent-up demand and COVID-induced global supply chain disruptions. In this context, central banks are careful about exiting accommodative policies too fast.

Yet, this cycle stands apart in the history of business cycles because there is still plenty of slack to keep inflation at bay and several sources of growth that have yet to play out. At this stage in a traditional cycle, the economy would be leveraging and saving, and inflation would be rising. In contrast, the current period is one of deleveraging and dissaving, which will likely drive the continued expansion. Inflation is likely to turn lower the further the expansion goes, as supply-side bottlenecks are resolved and low base effects fade away.

Above all, final demand is nowhere near peaking. Although the pace of activity is slowing, growth is still set to remain high in absolute terms. While job markets are usually tight as the peak approaches and household savings dwindle, many European workers are still on furlough and millions of Americans have opted out a red-hot job market, for now. Meanwhile, large savings accumulated during lockdowns are providing the comfort of time before people have to return to an old job they probably did not like very much. When savings run out or workers can match their skills with those required in different jobs, the rise in employment will provide a new impetus to growth, particularly as labor productivity improved during the pandemic.

The charts below provide a stylized illustration of where advanced economies may currently lie. Instead of the final slowdown before a recession, it may well be a temporary dip <u>before</u> the true peak of the expansion. The global recovery will fire new engines to propel growth again and, in the absence of excesses in the economy, central banks can afford to remain supportive until then.





Source: Barings. As of September 16, 2021

Emerging markets (EM) are still hampered by border restrictions and low vaccination rates, but they will provide an additional boost to global demand over the next 12 months. Their recovery will also help restore global supply chains that are currently a drag on PMIs. From Brazil to South Africa to China, truck drivers, warehouse staff, stevedores and other workers essential to the functioning of global supply chains are still missing in parts of the world where vaccinations lag. Advanced economies cannot fully recover alone—and the cycle will not peak until EMs are back in play.

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The health of private balance sheets will also make this expansionary cycle longer. Governments provided blanket income support to unemployed workers and firms during lockdowns. Small- and medium-sized firms saved and used the cheap liquidity conditions to leverage. After paying bills, these extra funds were hoarded out of precaution, in case of a delayed economic reopening. Thus, unlike in previous cycles, the private sector entered the recovery with very strong balance sheets. Nonperforming loans are at historical lows and bank capital asset ratios are unusually high, which should translate into an ample supply of credit for the next leg of expansion. Driven by animal spirits, firms already increased capex as soon as vaccines illuminated the end of the COVID tunnel. Apart from rising asset prices, none of the usual financial stability risks in the system are forcing central banks to slow things rapidly. It can hardly be the peak of the business cycle if consumers' savings are high, firms remain cash-rich, banks stand ready to expand business, and policymakers show few signs of being on the verge of a nervous breakdown.

As long as the global economy is not fully prepared to live with the virus through widespread vaccinations and testing protocols, there will likely be a few slowdowns and reaccelerations in this expansion cycle before it truly peaks. Reservoirs of strength will remain idle due to malfunctioning global supply chains, labor market slack, and lingering restrictions to service activities. They may empty at some point if the final recovery takes too long to emerge, leaving permanent scars and capping potential growth at lower levels.

Policymakers' "whatever it takes" motto is designed to mitigate risks of an early recession. They will support a reacceleration of activity if an incomplete recovery makes the economy too frail to survive a downturn. Given strong private balance sheets, central banks can afford to keep liquidity cheap and fight nascent asset market bubbles, for example with well-targeted macro-prudential measures such as capital gains taxation and housing finance regulation. This new type of cycle will see growth accelerate with inflation falling as more capacity comes online. Thus, if central banks still want to hike interest rates when growth has passed its peak, say, to create space to ease again in the next recession, the rate path will be lower than in the traditional cycle. To nurture the recovery, fiscal policymakers will also avoid too contractionary a consolidation.

Implications for Asset Allocation

In this context, investors would be wise to adapt their investment style to this different cyclical pattern and keep some room for upside surprises in the expansion cycle.

- **Value stocks** will likely perform later when supply disruptions finally subside and the expansion can bloom.
- **Growth stocks** can be an upcycle investment as society learns to live with the virus, including through hybrid ways of consuming and working, both online and brick-and-mortar.
- **Bond** investors' duration call needs not fall victim to fears of higher policy rates typical of expansionary phases. Governments will tiptoe into normalizing financing conditions. Credit spreads can continue to perform in this elongated expansion.
- **Inflation-indexed bonds** will lose their allure because inflation will peter out when bottlenecks are resolved.
- With a fuller global recovery, the demand for **commodities** will continue to rise. It will also be magnified by a secular demand for the commodities necessary to the green transition.

Once developed economies near peak cycle and move into a real slowdown, other investments than usual will become interesting.

- Some **EM** will stand ready to perform. Recent supply-side bottlenecks and virus scares deteriorated current account balances, weakened currencies, and unleashed inflation. Central banks tightened financing conditions, slowing their recovery, but vaccinations will reopen borders, relaunch activity, and reduce price pressure. It may even allow some central banks to ease.
- **Quality** will continue to benefit because capex supported productivity growth, keeping wage-price inflation spiral at bay.

The tail risk to every scenario is that vaccinations lose efficacy and/or the vaccination rate does not rise sufficiently in parts of the world. If so, supply-side bottlenecks would likely persist and inflation expectations would rise. Not every company will have the margins necessary to afford increasing wages while paying higher input costs. Bottlenecks would then reduce production, employment, and activity. Policymakers would need to find space in their balance sheets to support the economy again. Let's hope we get a chance to climb the final peak in the synchronous expansion.

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