Hello Darkness, My Old Friend

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Central Issue of the Paper

"This time it'll be different" has been the proverbial go-to phrase for recent media outlets in trying to explain why we should all be concerned about the looming crisis given our 10-year anniversary. Earlier in 2018 we published a whitepaper titled "Endgame" by Michael Ning and Michael DePalma, which highlights why history may not repeat itself, but it sure may rhyme. No market cycle has lasted forever, and the current cycle is likely to be no different. The market turmoil experienced in early February may be a warning of what's to come. Although each market cycle peak and trough has come with its own unique set of circumstances and flashpoints, history suggests their attributes and trajectories follow similar patterns. Consequently, the investment implications at different points in market cycles have tended to follow similar patterns, and performance across and within asset classes is consistent within each phase of those cycles.

Approach Employed by Paper

Despite the rosy economic backdrop, there are signals pointing to something more ominous ahead. History shows that economic cycles exhibit fairly consistent symptoms leading up to a recession, starting with a hot labor market, strong PMI and a monetary policy stance that progresses from loose to tight in response. During past cycles when their own proprietary signal and PMI (and other macroeconomic indicators) have converged, it has spelled trouble for financial markets. It's easy to dismiss a single indicator in isolation. However, their proprietary signal coupled with an array of other evidence suggests investors could face difficult markets in the near future. In this whitepaper, the authors believe investors should prepare for higher volatility, resetting risk premiums and the potential for significant drawdowns.

The current bull market run is in its tenth year. After a prolonged period of excesses, they are beginning to see many characteristics that have previously indicated a late-cycle market, where euphoric investor behavior coincides with peaking economic growth, tightening of monetary policy and a pickup in inflation. They believe the time is ideal for investors to consider the **Endgame**.

While U.S. economic growth is expected to remain solid for the foreseeable future, the bond market seems to believe the potential for increased growth is limited, and a growth decline is likely on the horizon as evidenced by the continued flattening of the U.S. **yield curve**. The slope of the yield curve offers a simple way to gauge market expectations for interest rates and, by extension, offers a way to gauge economic prospects.

On the **credit** side, U.S. corporate debt-to-GDP is near previous peaks. It appears, sooner or later, that the expansion of credit will come to an end. Credit is the life blood of the economy and credit expansion drives business cycles. During an expansion of credit, asset prices are bid up by those with access to leveraged capital. This asset price inflation can then cause a speculative price "bubble" to develop. The upswing in new money creation also increases the money supply for real goods and services, thereby stimulating economic activity and fostering growth in national income and employment. When buyers' funds are exhausted, asset price declines can occur in markets that benefited from the expansion of credit. The ripple effects are many, from insolvency, bankruptcy, and foreclosure all the way to threatening the profitability and solvency of the banking system itself in extreme cases. Ultimately, this results in a contraction of credit as lenders attempt to protect themselves from losses.

As the business cycle matures, tight labor markets typically lead to demands for higher wages. In addition, resource utilization may approach full capacity and demand for materials such as copper, steel and energy tend to outpace supply. As a result, a common characteristic of late-stage business cycles is rising **inflation**.

They also expect **asynchronous business cycles** to mean that countries will require different monetary policies. In contrast to the Fed's monetary policy tightening path, other major central banks have largely stayed on hold, and some have even embarked on further easing which has exacerbated monetary policy divergence.

As the economic cycle advances, they will likely start to observe an increase in corporate leverage accompanied by rising corporate defaults, as well as declining recovery rates. They think this is especially true of the current growth cycle, which is one of the longest on record, having begun in March 2009. After years of debt accumulation in the system, U.S. corporate leverage has exceeded the peak level of previous cycles. Moreover, their research suggests companies are finding it increasingly challenging to continue trimming costs or improve profit margins. Economic growth is perceived to be on track, business leaders' confidence is high, and the economy is showing all the signs of gaining momentum in the near term. Under these conditions, companies will likely start to favor external growth and engage in mergers and acquisitions, further expanding already stretched balance sheets.

The authors don't equate risk as volatility. Volatility is the degree of variation of an asset's return from its mean return. They define risk as the likelihood of permanent loss of capital. It is normal and healthy for markets to experience corrections, whereby the S&P Index loses ~10% of its value or more. These corrections help to shake out some of the more speculative players and bring share prices back to their fundamental values. Recent data shows U.S. investors are overwhelmingly holding U.S. stocks at a time when they look expensive. The cyclically adjusted P/E (CAPE), a valuation measure created by economist Robert Shiller, now stands at 32.56 (a more recent reading from September 21, 2018 is at 33.54), a level only exceeded during the 2000 tech bubble and higher than the 1929 mania. Their research shows that high valuations have no predictive ability as to the timing of market drawdowns. However, it can indicate the severity of the potential loss if the market cycle turns.

Findings of the Paper

The authors conclude that they expect the U.S. economy to continue to exhibit classic late cycle characteristics in 2018, with deteriorating liquidity, rising inflation and increasing dispersion in credit markets. Global markets will likely benefit more from the asynchronous global business cycle. It's easy to dismiss a single indicator in isolation. However, their proprietary signal coupled with an array of other evidence suggests investors could face difficult markets in the near future.

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