Late-expansion investing

White paper

Investment opportunities in the late-expansion stage of the business cycle

Key highlights

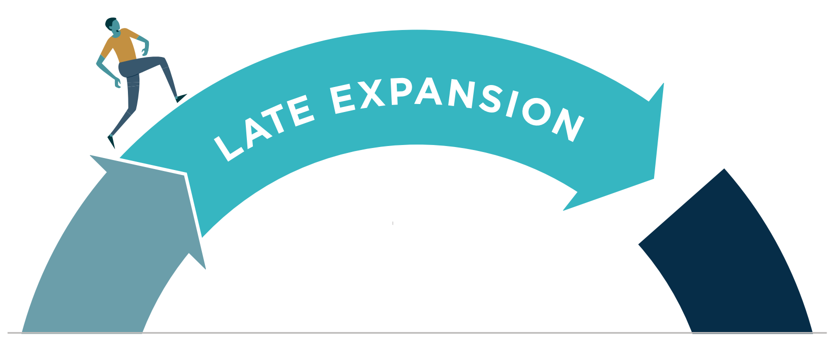
- Economic expansions do not follow a timetable; they typically come to an end because of a combination of economic and policy factors
- Historically, the late-expansion stage has persisted for a few years even as the Federal Reserve has raised interest rates
- Momentum in today's late-expansion environment could postpone the recession phase, and equities could benefit, as red flags that precede a market top are not yet present

Summary

The current economic expansion, which began in July 2009, has continued for more than eight years and is one of the longest on record. It is now showing signs of maturity, and investors have begun to wonder how much longer it can endure and whether a market downturn is imminent.

An understanding of the business cycle can help answer these questions. It can indicate where the economy is in the cycle and can provide reasonable expectations for market performance.

Although the United States is now in late-expansion, **there's still room to run** before we expect to see a recession.

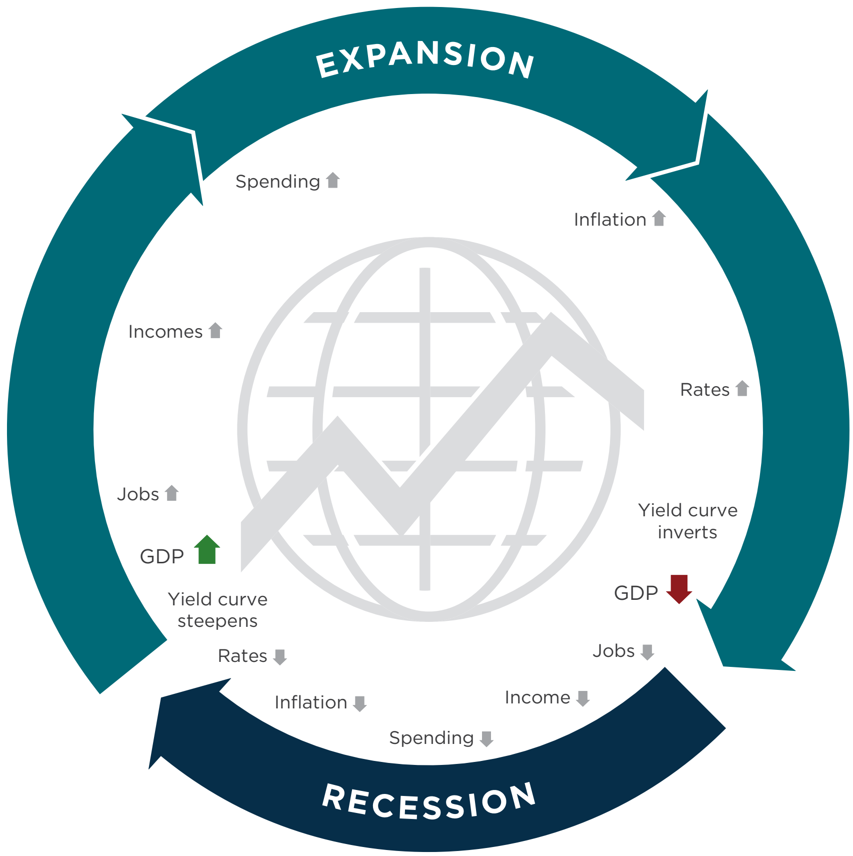


This paper focuses on one part of the cycle: the late-expansion stage. It illustrates how even when expansions reach this stage, the economy has historically continued to grow for quite some time. This paper will also note some factors that differ from past late-expansion stages and how they could add momentum, helping to extend this stage further. We then describe some red flags to watch for as the cycle begins to turn, and suggest some potential investment opportunities.

The business cycle

In the short term, the stock market is moved by all kinds of forces — political events, economic news, policy changes, interest rate moves and geopolitical developments, among others. Over the intermediate-to-long term, however, the economy is a primary driver of earnings. As the economy expands, corporate profits grow, and as profits grow, the stock market tends to rise as well.

The business cycle, which describes how the economy is likely to perform at different stages, can therefore be helpful in gauging the strength of corporate earnings and the likely movement of equity markets.



*The actual timing of economic indicators may change based on the cycle.

Expansion: Three stages

The business cycle typically lasts between five and 10 years and consists of an expansion phase and a recession phase. In the first stage of expansion — recovery — the economy emerges from the previous recession. Growth picks up, job creation improves and aggregate incomes and consumer spending increase. In the second stage — mid-expansion — rising employment and wages eventually result in inflationary pressures, causing long-term interest rates to climb.

In the third stage — late expansion — the central banks begins to raise short-term interest rates to prevent the economy from overheating and keep inflation from accelerating. As inflationary pressures cause interest rates to begin to climb, the growth of the economy becomes constrained. Often the currency will also begin to appreciate, which can hinder exports and slow the economy further.

As the central bank continues to raise short-term rates, they may rise more rapidly than long-term rates, causing the yield curve to flatten. Eventually, the yield curve, which is normally upward sloping, inverts or becomes downward sloping, as short-term rates become higher than long-term rates.

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Recession: One stage

The late-expansion stage is followed by a phase in which the economy contracts and a recession takes hold. Jobs are lost, and incomes and spending decline while inflation subsides. To end the recession, the central bank seeks to stimulate the economy by lowering short-term interest rates. Eventually the cycle starts over again, starting with the recovery stage. (It's important to note that the expansion phase typically lasts much longer than the recession phase.)

Where we are in the cycle

Assessing where an economy is in the cycle requires examining certain economic signposts. Seven of these in particular are critical: GDP growth, employment, income, consumer spending, inflation, short-term interest rates and the yield curve. These signposts are subject to interpretation, however, and when it comes to foreseeing the direction of the economy, no one's crystal ball is perfect. Investors should therefore remain well-diversified and maintain a long-term perspective.

Currently, these signs suggest that the economy is in the late expansion stage. Employment conditions — one of the earliest signs of a transition in the cycle — have tightened, wages have begun to climb and consumer spending has rebounded from recession levels. And while inflation is low by historical standards, inflation expectations have been on the rise. In addition, although long-term interest rates have risen, the Fed has raised short-term interest rates faster, causing the yield curve to flatten somewhat.

The yield curve merits special attention. Historically, it has been the best indicator of the economy's future performance. It has inverted, making short-term rates higher than long-term rates, prior to every recession in recent history and has steepened prior to every expansion. This is how a market top and a recession normally begin.

So far, the curve has not inverted and some distance remains before this will occur. Of the seven signs below, five suggest the economy is in the late expansion stage.

Only the economy's recent growth spurt is inconsistent with this late-phase position.

Late-expansion checklist

	Late-expansion tendency	Current conditions (as of March 2018)
1 Employment	The labor market tightens.	✓ Job creation has improved, and the unemployment rate stands well below the historical average.
2 Income	Wages and salaries rise.	✓ Income growth has remained flat since the recession ended in 2009, but more recently it has improved.
3 Consumer spending	Spending increases.	✓ Though not as strong as prior to the global financial crisis, consumer spending has rebounded from recession levels.
4 Inflation	Inflation accelerates.	✓ Inflation has edged up, though it remains slightly below historical averages. Commodity prices, which are one signal of inflation, are still relatively low but have begun to climb.
5 Short-term interest	The Fed raises rates.	✓ The Fed has raised the federal funds rate a quarter-point six times since December 2015. Gradual hikes are expected in 2018.
6 Yield curve	Long-term interest rates fall; the curve eventually inverts.	✗ Although the curve has flattened considerably in the past year, it still has some distance to go before it inverts.
7 Economic growth	GDP slows.	✗ Growth has been steady though unspectacular since the recession ended in 2009 but has picked up in recent quarters.

Source: Nationwide, March 2018

Factors supporting an extended expansion phase

Although expansions don't die of old age, the current one has endured for more than eight years and is one of the longest on record. Over time, however, these periods of growth have become increasingly long. Since 1950, they have averaged between 60 and 70 months, or approximately $5\frac{1}{2}$ years.

At the same time, recessions have become shorter, averaging about 10 months. So a longer-than-normal expansion does not necessarily indicate that a recession is imminent.

But with the U.S. economy in the late expansion stage, how long can growth be expected to last? Three factors — interest rates, tax reform and the global economy — suggest that this late stage could continue for a while.

3 factors

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Interest rates

Historically, the final stage of an expansion has tended to persist for a few years. It has normally come to an end only after the Fed has raised interest rates repeatedly and the cumulative rate hike has become quite significant. In the current cycle, the Fed has been hiking rates since December 2015. But even today, more than two years later, interest rates remain quite low by historical standards. And the cumulative increase remains below the level that has often been reached before the onset of a recession, particularly over the past 50 years.

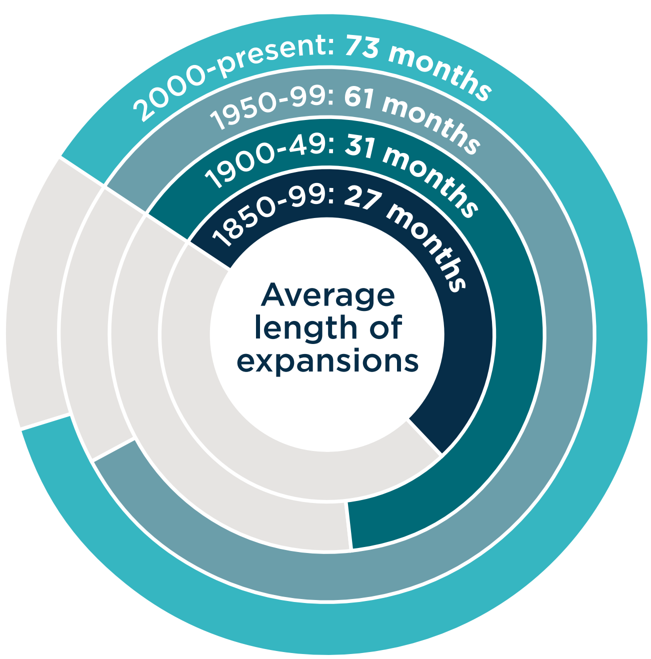
When the Fed begins to raise rates, the tightening period can persist over a period of years. In fact, on average, the last seven Fed tightening cycles have extended for almost four years before the recession phase began.

In some cases, an expansion may continue despite significant tightening. In 1983 and 1994, the late-expansion stage extended significantly longer as tightening monetary policy produced a "soft landing" in which the economy slowed but avoided slipping into recession.

In addition, the slow pace of rate hikes has limited the flattening of the yield curve. Flattening eventually happens as the Fed raises short-term rates faster than long-term rates are rising. This typically occurs before the curve inverts, which signals that a recession is imminent.

The spread between the 10-year Treasury note and the federal funds target rate, though below average, is still positive and has some distance to go before the curve inverts. Moreover, the Fed's stated intention to increase rates only gradually and to make future hikes dependent on the strength of the economy seems likely to delay inversion and extend the late-expansion stage.

Expansions have become longer



Sources: National Bureau of Economic Research, Federal Reserve Board of Governors

Corporate tax reduction

The U.S. tax reform bill enacted last year could also extend the expansion's final stage, and it has already lifted the expectations for 2018. Nationwide economists now expect growth to reach 2.9% this year, up about 0.5% due to tax reform.

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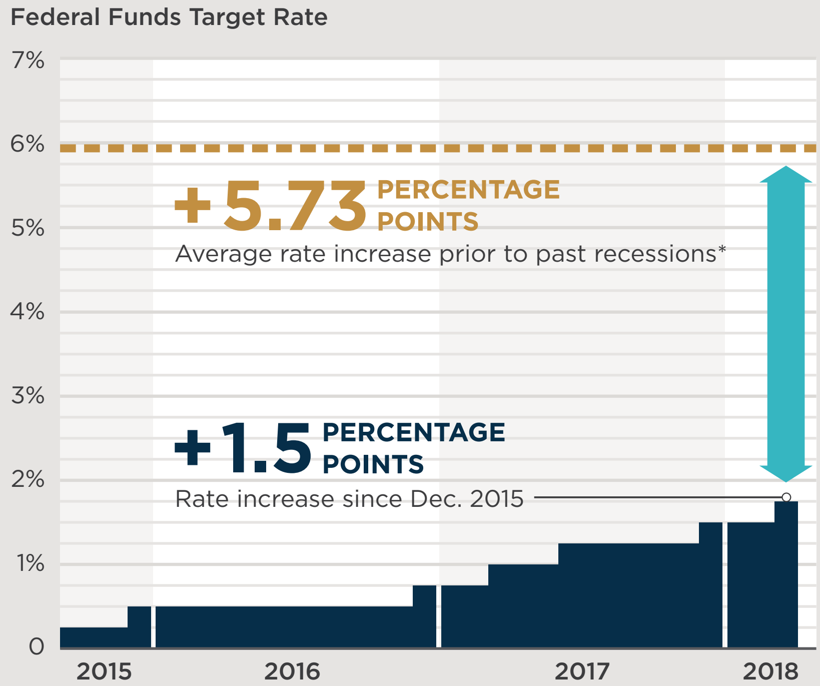
The improved expectations are largely due to changes in the corporate tax code. In addition to reducing the tax rate, the new rules allow for the immediate write-off of capital expenditures, further lightening corporate tax burdens and potentially spurring a rise in business investment.

The tax cut has also helped keep various indicators of sentiment at relatively high levels. Indexes such as the Institute for Supply Management's (ISM) surveys of manufacturing and services companies and the National Federation of Independent Business's survey of small business confidence remain at high levels. Usually, these measures plummet before recessions.

The global economy

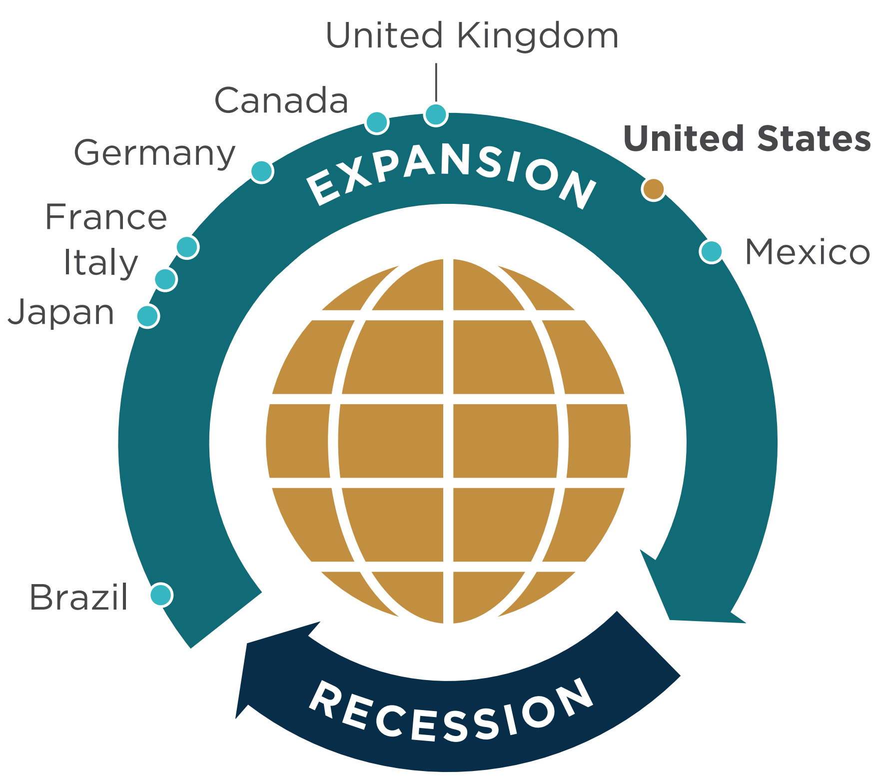
Robust economic activity elsewhere in the global economy could also add somewhat to momentum. While in the past the pace of global growth depended heavily on the United States, economies are more interdependent today, and other major players now share that leadership role.

Historically, recessions have occurred only after a long period of significant rate hikes



*Since 1971

Sources: National Bureau of Economic Research, Federal Reserve Board of Governors



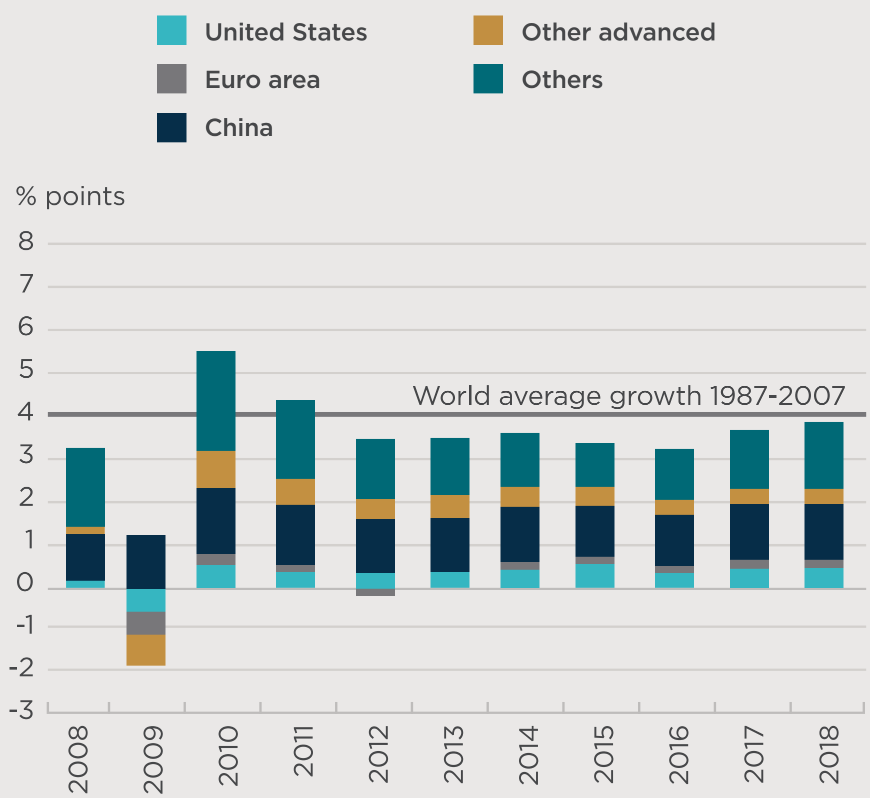
Source: Nationwide, March 2018

Continuing global growth is likely because relative to the United States many major economies are in an earlier position in their business cycle. Countries such as Germany, France and Italy only recently emerged from a recession in 2012-13, so their expansion is relatively young. Japan, the world's third-largest economy, did not exit from recession until the fourth quarter of 2014, so its expansion is also in a much earlier stage. Though the U.S. economy does not rely heavily on exports, strong global demand could provide a tick up in U.S. GDP. But more significantly, since large U.S. corporations, as represented by the S&P 500, now generate more than 40% of their sales overseas, their earnings growth may be sustained longer. Worldwide, the expansion is more synchronized than it has been in a decade, with all 45 countries of the Organization for Economic Co-operation and Development (OECD) experiencing growth. The OECD notes further that more economies were accelerating in 2017 than were slowing or contracting, and that this is anticipated to continue in 2018. The ongoing growth in the global economy could create a virtuous cycle in which overseas demand lifts economic activity in the U.S., extending the cycle further.

Global growth has strengthened and broadened

Global GDP growth

Contributions by regions



Source: OECD Economic Outlook Database

Today's late-expansion environment

The market environment surrounding today's late-expansion stage differs some what from previous late expansion periods. As noted earlier, the domestic economy has recently accelerated. In contrast, during the last stage of the previous two expansions — the mid-1990s and the mid-2000s — domestic growth flattened or declined. Of course, it's still possible that, like other late expansion stages, this one will see some slowing. In fact, Nationwide economists expect some deceleration after 2018, although growth should still be positive. But the recent surge in GDP has so far set this late-expansion stage apart from the previous two.

The current late-expansion environment also differs in that it has been affected by the extraordinarily loose policy implemented by central banks in response to the global financial crisis. This has played a part in the market's rise and its low volatility.

Although late-expansion phases are known for low market volatility, the daily ups and downs of the current market have been at or near record lows, especially over the past two years. Late in 2017, the CBOE VIX Index, which measures implied volatility, dropped to less than 10.0, well below the 20-year average of 20.4. This period of calm is unlikely to persist much longer, however. The coming year may prove to be more volatile, but investors should note that during the previous two bull markets stocks continued to post gains despite a rise in volatility.

A repeat of the mid-1990s?

Although today's late-expansion stage differs somewhat from the previous two, in some ways it has begun to resemble that of the mid-1990s. Three similarities are worth noting: global economic growth, valuations of domestic equities, and the performance of international stocks.

Global economic growth

As it was then, the environment today is characterized by rapid growth in the global economy and a domestic tax cut that is anticipated to provide an additional lift to the U.S. economy.

Valuations of domestic equities

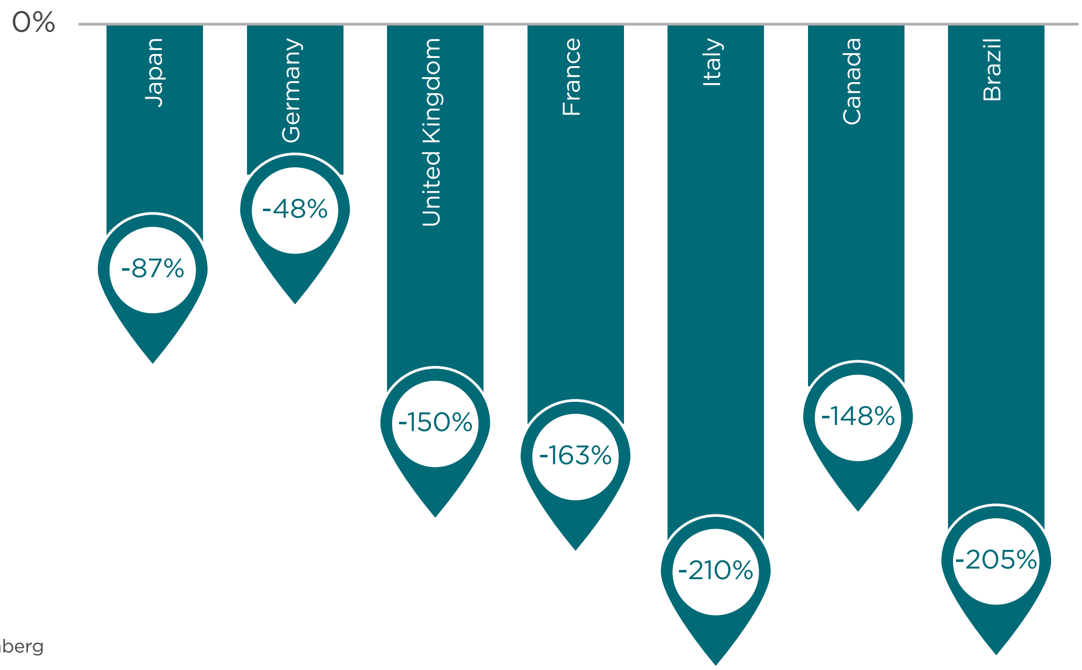
As in the mid-1990s, stock valuations have risen above the long-run average. Late in 2017, the cyclically adjusted price-earnings ratio (CAPE) stood at 32.4, double the average and about where it was at the end of 1997. Nevertheless, with the U.S. and global economies in robust health, the market continued to rise for more than two years, with the CAPE hitting 44.2 right before the peak.

International stocks

In the mid-1990s, international equity markets lagged domestic stocks for several years before catching up in the early 2000s. The MSCI EAFE Index trailed the S&P 500 every year from 1995 through 1998 before bouncing back and beating the S&P 500 for five consecutive years in 2002 through 2006. The same pattern may hold in this cycle. As the chart below indicates, many major stock markets have lagged the S&P 500—with many trailing by 100 percentage points or more—since the bull market began in 2009.

International stocks have lagged the S&P 500 since 2009

Changes in global benchmark indexes relative to the S&P 500 in the current bull market



Source: Bloomberg

The current market: signs to watch

With the cycle in the late-expansion stage, investors should be vigilant. According to Strategas Research, the previous two bear markets were preceded by various warning signs. These can be monitored for hints as to whether the current market is reaching a top.

For example, markets that are peaking are often characterized by investor exuberance. This will typically be evident in the form of large flows into equity mutual funds. In addition, these markets are often accompanied by deteriorating fundamentals, including declining earnings.

Market leadership may also shift to defensive sectors and may center on just a handful of companies. Initial public offerings and acquisitions may proliferate as well.

As the chart below indicates, these warning signs are largely absent from the current market.

Signs to monitor

	Late 1990s	Mid-2000s	**Today's late-expansion environment** (as of March 2018)
A runaway market: "Irrational exuberance" and a surge of flows into the market	✓	✓	✗ Annual flows into domestic equity funds have been flat since 2014 while flows into bond funds have continued to soar. But investor sentiment bears watching.
Deteriorating fundamentals: Aging bull markets are often characterized by slowing earnings growth	✓	✓	✗ Earnings have been improving. In 2017, they were expected to grow by 8% despite some tax-related charges resulting from 2017 reform. In 2018, they are projected to grow by 18%.
Technical factors: Rotation to defensive leadership, market strength driven by fewer companies (poor breadth), widening spreads	✓	✓	✗ Technical factors, including breadth and sentiment, are not consistent with a market peak. Credit spreads continued to narrow in 2018.
Corporate management's changing behavior	✓	✓	✗ Merger and acquisition activity has picked up, but IPOs have been limited.

Source: Strategas Research and Nationwide, as of March 2018

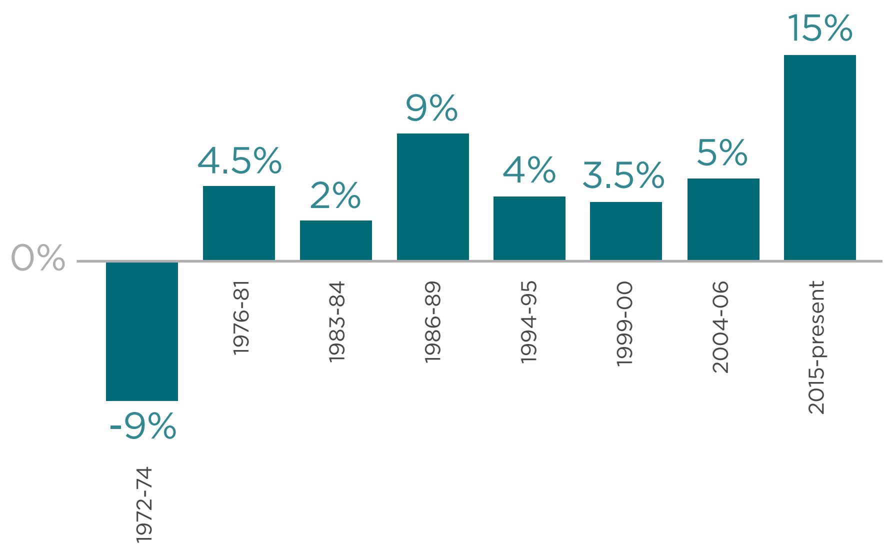
Investment opportunities in today's late-expansion market

Given that the economy is in the final stage of expansion and that the market does not yet exhibit signs of peaking, investors should consider investment options that historically have performed well in this kind of environment. In the expansion phase, equities typically perform well as they benefit from an improving economy.

Even in the final stage of an expansion, equities have often continued to climb while the Fed has raised interest rates. Over the six years between December 1993 and December 1999, for example, the S&P 500 rose by more than 200% (excluding dividends) despite an increase in the fed funds target rate from 3.0% to 5.5%.

Stocks often climb even as the Fed is raising rates

Annualized changes in the S&P 500 during Federal Reserve tightening cycles



Source: Nationwide, January 2018

Quality growth

Within this asset class, investors may want to consider quality growth stocks in case the expansion begins to slow. These companies are typically industry leaders whose earnings are not as dependent on the performance of the economy. In addition, they often have many tools for boosting their earnings in all economic environments. These include price increases/ margin expansion, reinvestment of cash flow, share repurchases and deleveraging.

International stocks

Overseas equities may also be appropriate for some investors. As noted earlier, the global economy is experiencing a rare period of synchronized growth, and many major economies are in an earlier stage of the business cycle than the U.S. So economic expansion in those markets may persist longer.

In addition, as in the mid-1990s, international stocks have lagged domestic stocks for an extended period. If the pattern of that period holds, then international stocks could be expected to catch up soon. In fact, the catch-up process may have already begun. As of Dec. 31, 2017, the S&P ranked 54th in the world on a year-to-date basis among global benchmarks.

Fixed income

Investors should, of course, remain diversified by owning bonds. Although the improving economy has caused yields of 10-year Treasuries to rise a bit, their attractiveness relative to yields on government bonds in the rest of the world may keep them from rising further. The recent rise also means they have further to go before they invert, suggesting some appreciation is likely before the late-expansion stage comes to an end. In the credit market, spreads are likely to remain narrow, given generally healthy balance sheets and an economic environment that is boosting corporate profits. In this environment, lower-duration, credit-sensitive strategies may be an attractive option.

Key takeaways

Investors should remember that expansions do not come with an expiration date. They end for very specific reasons and can be anticipated if key economic data are monitored. As we have seen, historically the late-expansion stage may persist for years even as the Fed is raising interest rates. In addition, reduced corporate taxes and the synchronized global expansion could provide momentum over the near term. The stock market may also have more upside, as the red flags that accompany a market top have not yet begun to wave.

1

Monitor economic reports for signs of a transition in the business cycle and to set reasonable expectations for investment performance.

2

Increase allocations to quality growth and international stocks if appropriate, given the investor's risk profile.

3

Remain diversified by remaining in the bond market, with a particular emphasis on lower-duration, credit-sensitive strategies.

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