CAN THE NEXT RECESSION BE AVOIDED?

A recession may not be imminent, but its chances are increasing

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KEY POINTS

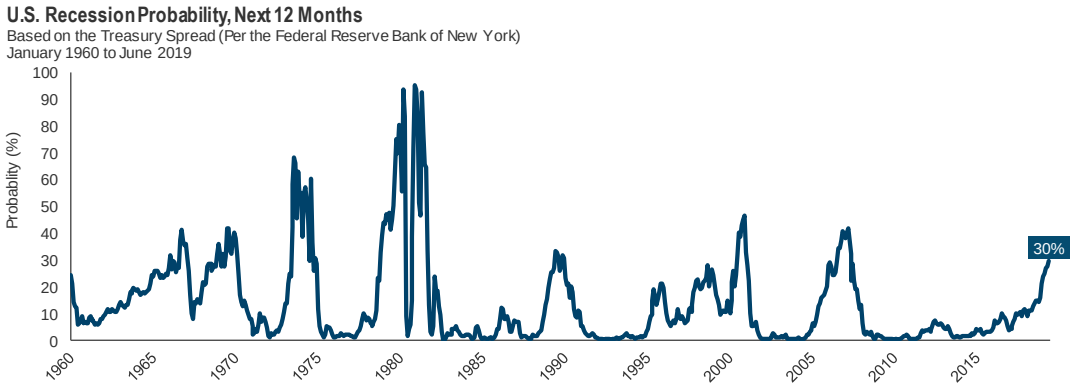
- Financial markets have performed well amid the 'new normal' of low interest rates, benign inflation, and low and steady economic growth
- The current economic cycle is the longest on record, causing some investors to worry about an imminent recession, although this seems a low probability in the next 12 months
- With the direction of markets uncertain, we are modestly underweight equities, selectively holding risk assets that provide higher yield

AN EXTENDED MARKET CYCLE

In recent years we have seen financial markets operate in an environment that we call the 'new normal'. This is an environment where it's normal for interest rates to remain low, bond yields are on a downward trend, and equity markets see strong performance against a backdrop of slow, steady economic growth combined with low inflation. Under these Goldilocks conditions of growth (not too hot to raise fears of rising inflation and hawkish central banks, and not too cold for concerns of an economic slowdown), we have seen markets reaching new highs again and again, following nearly each correction. This was particularly the case following the sell-off in the final three months of 2018, followed by a strong recovery in the first half of 2019.

At the same time, we are a long way into the current market cycle – so, does this mean a recession is upon us?

Not exactly. While some market observers have interpreted an inverted US Treasury yield curve as a bellwether of an imminent recession, our view remains that this is an unlikely event in the short term. We see several reasons for why this is the case.



Sources: Haver Analytics/[JP Morgan/IHS Market, Business Roundtable, Federal Reserve Bank of New York]

For starters, while the current economic cycle is the longest on record, age alone is not enough of a reason for it to come to an end. We have seen cycles become longer recently, with the average length of the past four cycles lasting around eight years. This could therefore be a sign of a structural change in cycle length, so length alone isn't enough to end the cycle.

Similarly, most economic models are still telling us we're in mid-cycle territory, with only a small chance of recession in the next 12 months. Indeed, the current cycle seems modest compared to long cycles in the past. With US economic growth standing at around 25% during the current cycle, it's overshadowed by previous periods of expansion. The boom of the 1990s, for example, saw the economy grow by 43%. During this cycle the S&P 500 Index rose by around 300%. While this is impressive, during the 1990s the US stock market returned over 390%*.

One reason why the current cycle has lasted for so long is down to monetary policy. Low interest rates and years of bond-buying, known as quantitative easing, have injected liquidity into the economy and stimulated financial markets. This cycle has also started when the economy has fallen to depths following the 2008 global financial crisis and the 2011 European sovereign debt crisis, so it isn't surprising it took the economy a long time to recover.

While history tells us that we can't avoid a recession entirely, central banks are now doing their level best to fend one off or, at the very least, mitigate its effects. Whereas at the end of 2018 the US Federal Reserve (Fed) was still talking about rate hikes, it has now shifted to possible rate cuts in an effort to stem slowing growth and stimulate the economy.

Yet, as expected future rate cuts and muted inflation push sovereign bond yields lower once again, this creates a challenge for investors. Government bonds are typically seen as a safe haven during periods of economic uncertainty, but there are questions as to whether they will effectively diversify equity risk as rates are so low or even negative.

OUR POSITIONING

The current environment is challenging for investors. The current cycle, while not the strongest on record, is certainly the longest. While our economic models are not warning us of an imminent recession, major central banks are clearly signalling their desire to fend off – or at least mitigate – the next recession. At the same time, markets are sending us mixed signals; government fixed income is bearish, while equities have been bullish.

In the current climate, we believe there is still room for equities to grow but the downside risks are piling, so we are moderately underweight equities, preferring investments in growth equity as opposed to value, and we also like emerging markets. In fixed income, we are underweight government bonds due to their low yields and instead see reason to take some risk in this area. With that in mind, we see attractive opportunities in emerging market debt and high yield markets because investors seeking yield may support these assets. In these uncertain times, we think, it is important to remain diversified across risky and conservative assets, and take an active approach, ready to change portfolio positioning in case economic conditions deteriorate.

***Past performance is not a reliable indicator of future performance.**

Sources: T. Rowe Price analysis using data from FactSet Research Systems Inc. See Additional Disclosures in Appendix.

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