Asset Management

THE 'END OF CYCLE GAME' UPDATE

By Francis P. Rybinski, CFA, Chief Macro Strategist &
D. Harris Kere, CFA, Investment Strategist

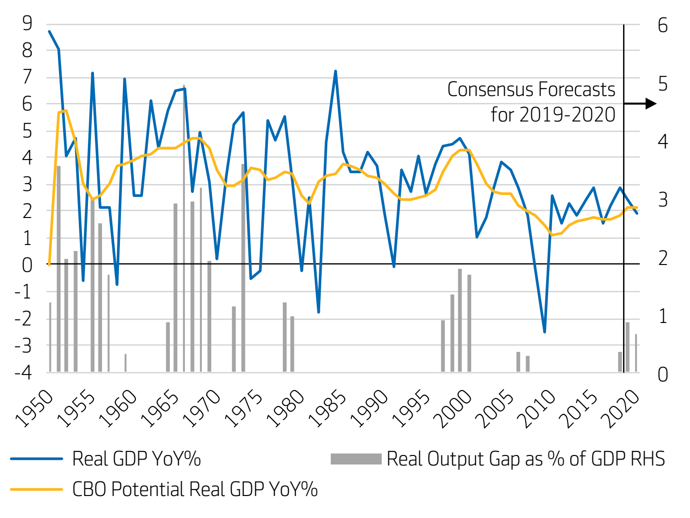
The following provides an update on the note we issued in March 2019, "Still Playing the 'End of the Cycle' Theme."

Will history rhyme?

While each economic cycle has its own idiosyncrasies, there are often threads of commonality in overarching elements. Two cases in point for the post-World War II era:

1. **When the output gap has peaked, the above-trend level of growth has not reverted just to trend, it has generally gone below it (Exhibit 1).** We highlight this because after years of above-trend growth, the output gap is now positive and consensus forecasts are calling for growth to slow to roughly trend over the next couple of years.

Exhibit 1: Historically, growth has slowed below trend once the output game peaks

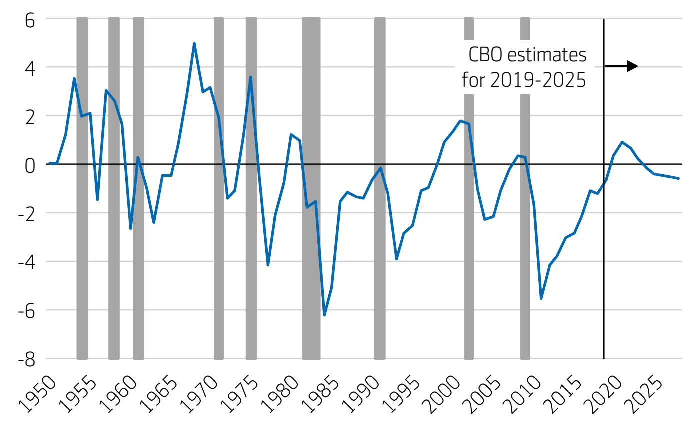


Consensus forecasts call for growth to slow roughly to trend over the next couple of years. Historically, this has been a rare occurrence once there is a positive output gap and peak growth reverts. (Historical precedence suggests growth goes a fair amount below trend.)

Sources: Aegon AM US, BEA, CBO, Bloomberg

2. **As a positive output gap corrected, it has not stopped at equilibrium; rather, it has always gone below equilibrium and eventually leads to a recession (Exhibit 2).**

Exhibit 2: Real US output gap as a percent of real potential GDP (with forward estimates)



CBO projections show the positive output gap corrects, but suggest there will not be a recession in the next decade. That would be first time in post-WWII history!

Sources: CBO, Haver Analytics. Data as of December 31, 2018.

What does this highlight? First, that the consensus growth scenario for the next few years is quite unlikely given historical precedence, and that it suggests downside risk. Second, that the typical late-cycle unwind process historically has led to a recession.

We are updating macro forecasts to reflect a more dovish Federal Reserve. Back in December the Fed did an about face and took a much more dovish tone. While we think monetary policy is currently in a tight zone, the fewer rate hikes now implied by the Fed dot plots decrease the risk of a severely restrictive policy stance, as illustrated in the recent drop in the St. Louis Fed Bank Stress Index. As such, we have modestly increased our growth forecast for 2021 from 1.0% to 1.3%. It is important to note that we still see growth heading to below trend. The new forecasts are just dampening the negative velocity and exhibiting a more balanced risk profile.

Rates update. In light of the modest tweak higher to our 2021 forecast, we are slightly raising our 10-year forecast by 10 basis points to 2.15% (Exhibit 3). However, we are leaving our call for FOMC rate cuts unchanged. This is primarily due to the directional component of growth remaining consistent with our previous forecast, the magnitude of change to our GDP forecast itself being relatively modest, and the lack of change to our forecasted level of inflation.

Catalysts for slowdown. While there is more uncertainty the further forecasts go out, especially as the timeframe in question incorporates the 2020 US presidential election cycle, we continue to think that, in addition to tight monetary policy, the other leading suspects of the slowdown will stem from the manifestation of our 'Small(er) World After All' theme. That is to say, the secular trends driving global growth lower have broad economic and political implications, with demographics, global fracturization, and a rise in protectionism and populist movements, key among them.

Exhibit 3: Aegon AM US economic forecasts

	2016	2017	2018	2019	2020	2021
GDP (Real %, YoY)	1.60	2.30	2.90	2.25	1.80	1.30
Unemployment (%)	4.90	4.40	3.90	3.60	3.90	4.40
Core PCE	1.70	1.60	1.90	2.00	1.90	1.70
Fed Funds (%)	0.75	1.50	2.50	2.50	1.75	1.25
TSY10 (%)	2.45	2.41	2.72	2.60	2.35	2.15

Sources: Aegon AM US as of May 1, 2019. Includes historical data sources from Bureau of Economic Analysis, Congressional Budget Office, Haver Analytics.