Economic Cycles and Sector Tilts

The U.S. economy emerged from recession in 2009 and then delivered one of the longest U.S. economic expansions in history. In every country economic levels typically move through a multi-year cycle. Here, we review the common stages of the economic cycle. We also highlight how different sectors perform during the various stages of the cycle and explore how we use sector "tilts" to try to enhance returns during different points in the cycle.

First, economic cycles do not necessarily follow a prescribed path. Unexpected macroeconomic events, geopolitical conflicts, natural disasters or other unexpected shocks can sometimes disrupt an economic expansion or contraction. And legislative changes, such as the 2017 Tax Cuts and Jobs Act, can also lengthen an expansion by giving earnings a near-term boost. As a result, determining current location in the economic cycle can be challenging. Economic cycles typically unfold in the following stages: [1]

1. **Early:** The economy emerges from recession with low interest rates, and growth accelerates from low or negative levels. Investor mood is poor, and most amateur investors are reluctant to invest in "bad times." Yet this is the best time to invest as stocks and other investments are available at terrific value. The media is filled with stories of doom, and these stories act to shift wealth from amateur to sophisticated investors.

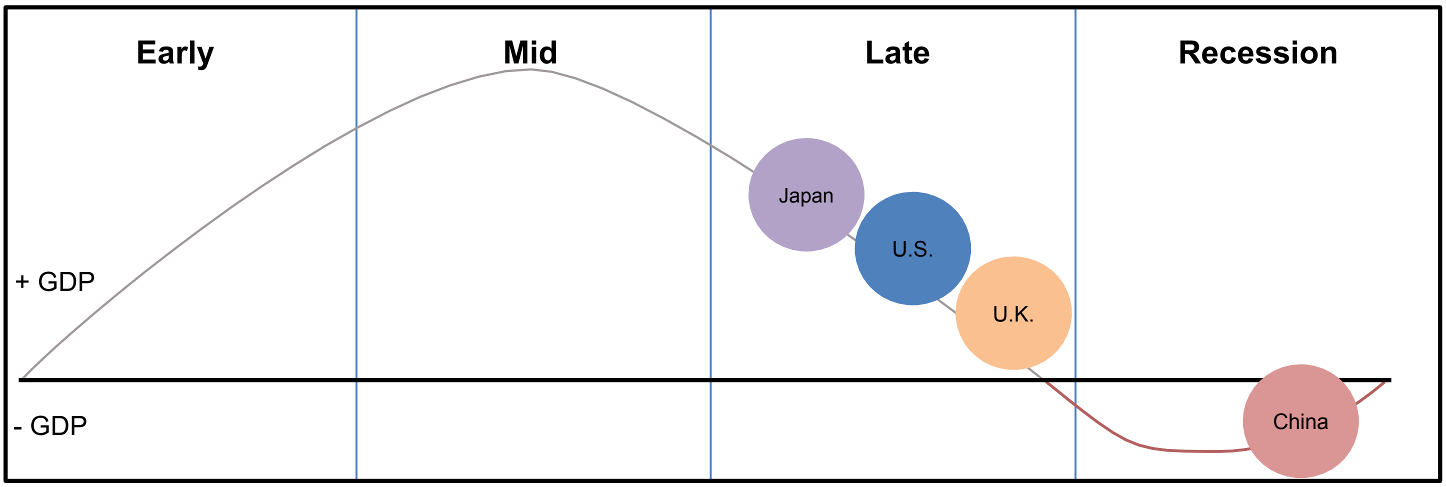
2. **Mid:** This is the longest phase. Investors gradually regain belief in the economy, overcoming memories of the recession. Consumers find confidence to make large purchases, such as homes, furniture and cars. Hiring increases. The expansion becomes entrenched, and growth remains strong.

3. **Late:** With employment strong, the Federal Reserve begins to gradually raise short-term rates to temper wage growth and prevent an unwanted rise in inflation. The economy posts a few more strong quarters, as decreasing interest rates attract buyers of homes and cars, and painful recession memories fade.

   During this stage, the Federal Reserve typically walks a delicate balance. They need to slow economic growth and inflation with higher interest rates but raising rates too much or too quickly can trigger recession. Economists refer to this effort as "navigating a soft landing."

4. **Recession:** Finally, rising rates or some unexpected shock slows growth and tips the economy into contraction, where at least two consecutive quarters register negative GDP growth (a common definition of recession). This economic slowdown leads the Fed to lower interest rates and help move the economy toward recovery.

Economic Cycle [1]



- Strongest stock returns
- Fed stimulative
- Profits grow
- Hiring rebounds
- Bank lending increases

- Longest phase
- Fed neutral
- Profits peak
- Bank lending strong

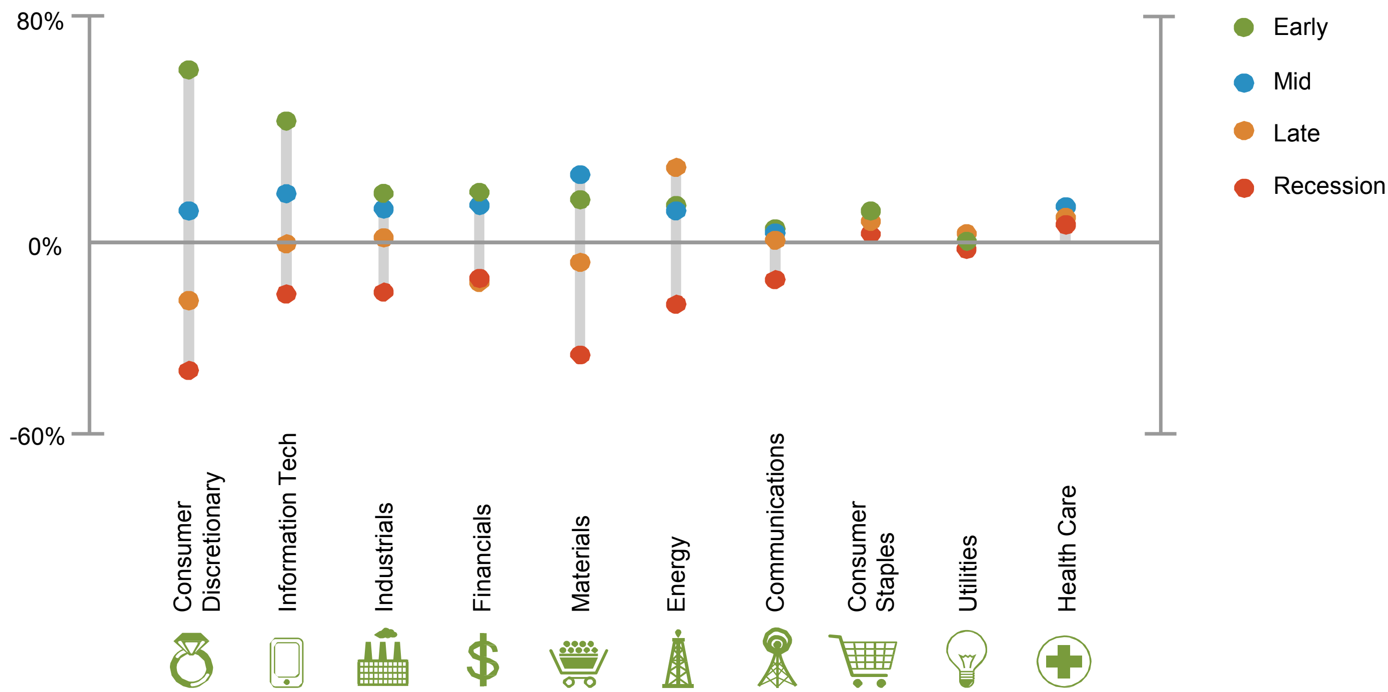
- Corporations struggle to meet earnings projections
- Likely inverted yield curve
- Potential asset bubbles
- Increasing inflation

- Stocks fall; bonds gain
- Retail sales fall
- 6 – 9 months negative GDP
- Fed stimulative
- Unemployment rises

While cycles are challenging to interpret, current leading economic indicators signal that the U.S. is likely in the late stage. [3] The late stage may last several months to a couple years, and position within the cycle may shift slightly back and forth over time. Also, the bear markets in stocks which correspond to recessions generally initiate 6 – 9 months *before* the recession begins. Because of this, investors should not try to perfectly time the transition from late stage to recession.

However, understanding where we are in the cycle and favoring sectors or industries that perform best within that stage may help improve returns and lower risk. Research shows that relative sector performance is responsible for 19% of a stock's total return.[2] Thus, Sharper Granite will tilt portfolios based on the current stage of the economic cycle. Tilting is a technique used by money managers to emphasize certain sectors within a portfolio based on expectations that those sectors will outperform the general market on a risk-adjusted basis.

Earnings Per Share Growth during Economic Cycles 1964 - 2018 [2]



The chart above indicates that in the late stage, the strongest profits are generated by energy, health care, and consumer staples companies. Also, the latter two are among the most stable industries, which may help to cushion a potential market decline. While our allocation tilting process is dynamic, we are currently tilting portfolios toward these sectors to capture earnings and reduce risk.

If you are concerned about the effects of the changing economic cycle and how your portfolio may weather the shifts, contact your advisor for more information. We have sophisticated tools that allow you to see how market changes and economic cycle shifts may effect your portfolio.

Notes and Acknowledgements:

1. "The Business Cycle Approach to How Sectors Have Performed During Different Phases of Market and Economic Cycles," Fidelity, September 2014;"Measuring Business Cycles," Fidelity, May 31, 2019
2. "The Evolution of Portfolio Construction," Fidelity, based on rolling 12-month analysis of variance (ANOVA), which uses statistical models to attribute the variance of a variable to certain factors (sector, style, and market cap), data as of October 31, 2017
3. Leading Economic Indicators and Summary, Sharper Granite Summer 2019 Letter on the Economy, July 2019