The iron law of the business cycle

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Financial markets have been buoyed for almost a year by the emergency measures and stimulus plans put in place to deal with the pandemic-induced recession, but now they'll have to prepare for the impact of their gradual phaseout, explains Kevin Thozet, a member of Carmignac's Investment Committee.

What's your take on the current state of financial markets?

Kevin Thozet : For almost a year now, financial markets have been buoyed by a recovery on steroids, driven by the exceptional measures adopted by governments to revive their own economies and by central-bank action. But rekindling growth is no longer the authorities' primary concern since their emergency programmes have put the economy back on a more promising trajectory. So that means the law of the business cycle will take back the reins it previously lost to those crisis-fighting measures.

How so?

K.T. : The central banks, whose decisions help regulate economic activity, are leaving centre-stage. They have begun focusing more on price and financial stability than on GDP growth per se. Meanwhile, a number of government spending programmes – whether implemented or announced – will get toned down as the economy shows it is powering ahead under its own steam. But all that raises any number of questions, particularly in light of the massive support measures that have characterised this most unusual period.

For example?

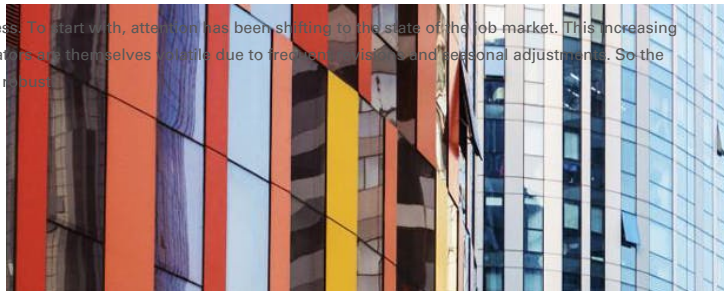
K.T. : What will happen once fiscal and monetary stimulus is removed? How will financial markets react once conditions recover a semblance of normality? Will they go into free-fall? Will they succumb to the law of gravity, or revert to what appears to be their long-term trend?

Could you be more specific about what that will imply?

K.T. : As we've pointed out several times over the past few months, the United States has once again emerged as an archetype for both the crisis and post-crisis periods. And the country is approaching an inflection point. The Federal Reserve (Fed), the US central bank, keeps a close watch on price levels, and has adjusted its messaging. In the coming months, the Fed could well slow the pace at which it regularly buys financial assets in the market to sustain the US economy – possibly as early as this autumn - if the economic indicators are still pointing in the right direction. This change of gears will likely be extremely gradual, and the prospect of a return to more conventional monetary policy comes somewhat as a relief, as demonstrated by both the financial-market response and the continued good performance of what are known as risk assets.

Can we infer that there are no clouds on the horizon in the US?

K.T. : No, we certainly can't. In fact, a number of problems could well surface in the process. To start with, attention has been shifting to the state of the job market. This increasing dependence on employment indicators can be a source of volatility, because those indicators can themselves be volatile due to freak events, distortions and seasonal adjustments. So the Fed may be forced to hike interest rates if the employment figures prove to be extremely robust.



Why is that an issue?

K.T. : It may sound like a contradiction, because the prospect of a healthy job market would normally be considered good news. But the trouble is that we're not living under normal conditions. With the huge amount of debt in the world economy today, the financial system can't handle higher interest rates – and thus more higher financing costs. The system has become terribly sensitive to rate hikes.

What other problems do you reckon could surface?

K.T. : What will happen when the Fed and other central banks, which are contemplating similar moves, start scaling back the support policies that financial markets are now addicted to? Such a major shift will eventually result in a slower-growing global economy – no doubt about it. So far, the new language adopted by central banks has been rather well-received. But it's advisable to start bracing for less favourable financing conditions and how they will affect financial markets. Even if this is a slow, step-by-step change process.

You've emphasised the role of central banks. Could you say a bit more about government action?

K.T. : While the emergency measures pursued by governments for these past 18 months probably won't be scrapped before the end of the year, we do expect they will be phased out. Those measures have helped save countless jobs and sustain confidence in the creditworthiness of households and companies. They have also kept a lot of businesses from going under. So if some of them are discontinued, the number of bankruptcies and defaults is likely to rebound.

In other words, quite a few companies could come face to face with the iron law of economics.

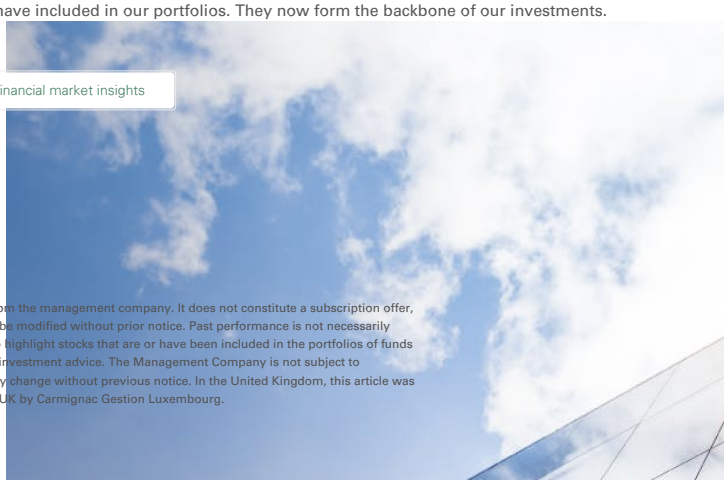
K.T. : Exactly. In addition, the Biden administration's spending ambitions will most likely get dialled down, particularly as the Democratic Party's razor-thin majority in Congress will make negotiations highly challenging. So there is a genuine risk that the global economy will be getting less support from US fiscal stimulus this year than previously expected, or even that the amounts involved will decline as of next year.

Should we prepare for the world economy to go abruptly into reverse?

K.T. : No. For the coming quarters, the US and European economies are on course to post double-digit growth on an annualised basis – driven by rebounds in consumer spending, world trade and tourism. But a subsequent slowdown can be expected. The Chinese economy, which recovered earlier than others, is already operating at a more moderate pace, and without government intervention, output will likely fall short of China's potential growth rate by the end of this year. The consequences will also spill over to the European economy, which is highly sensitive to Chinese GDP growth.

What's your approach to managing this situation?

K.T. : Predicting when economic growth will peak is never an easy job. But judging by past experience, scaled-back central-bank support policies are typically an early sign that the economic cycle is heading downward. Shifts of that kind obviously impact stock-market performance. So the current market environment is favourable to companies whose earnings growth is less dependent on the economic cycle. Those are the names that we have included in our portfolios. They now form the backbone of our investments.



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