How business cycles end, and implications for investors

In our Labor Day *Eye on the Market*, I concluded that rising Fed policy rates, the end of Central Bank intervention (see page 2), US import tariffs[1], slowing growth outside the US (particularly in Europe[2]), rising US budget deficits and elevated levels of market concentration in a handful of tech stocks would cause equity P/E multiples to contract. What I might have underestimated was by how much they would contract, and how these forces would offset continued US earnings growth and stock buybacks[3] .

Part of the investment discipline at the end of business cycles is to understand what such periods look like. One critical question is this: how much lead time do investors have before asset prices peak? When the last two business cycles ended, corporate earnings, economic growth[4] and equity markets all collapsed at roughly the same time. As a result, if earnings growth looked good, the cycle still had legs. But in the 5 business cycles before the last two, equities peaked around a year *before* economic growth slowed, and *before* earnings started to materially weaken. If so, what we are now witnessing could be the final stages of what has been one of the best performing US equity markets since the Great Depression in the 1930s[5].

How cycles end: US equity markets often peak even as profits and the economy keep growing

Equity market peak	Next 12m equity return	Months until economic data peak	Next 12m earnings growth	
Jan-66	-7%	10	4%	Business cycles when equities peaked a year or more before profits and the economy
Nov-68	-13%	9	2%	
Dec-72	-19%	11	27%	
Nov-80	-13%	9	4%	
Aug-87	-18%	19	41%	
Aug-00	-25%	1	-16%	Business cycles when equities peaked with earnings and the economy
Oct-07	-25%	4	-23%	

Source: Bloomberg, J.P. Morgan Asset Management, Shiller. 2018.

[1] ***Tariffs***. The next round of tariffs on China will have a bigger impact on US consumers than the prior two, given the shift in targeted products from capital goods and intermediate goods to consumer goods as well.

[2] ***Europe***. European leading indicators are weakening, and the Q3 European earnings season got off to a weak start with only 23% of companies beating expectations. Looking at earnings beats and negative earnings revisions, Q3 may be the worst earnings season in Europe since Q4 2008. As illustrated in the September 2018 *Eye on the Market*, overweighting US equities relative to both Europe and Japan has been the most rewarding asset allocation strategy that I have seen in my 30 years at JP Morgan, including another large US outperformance gap again in 2018.

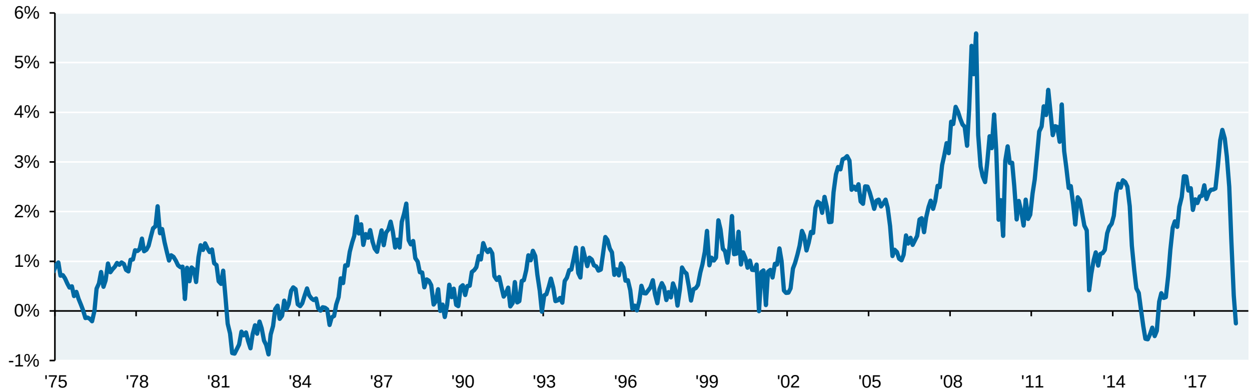
[3] ***US earnings and buybacks***. We currently project 8%-10% S&P profits growth for 2019, although there is some downside risk to this number as tariff impacts become clearer. Most projections we have seen indicate $800 to $900 bn in US stock buybacks in 2019, following ~$700 bn this year.

[4] ***Economic growth***. For purposes of tracking when the US economy "turns", we use an indicator which combines the unemployment rate and manufacturing capacity utilization.

[5] ***History of bull markets.*** Since the recovery began in March 2009, the price-only return on the S&P has been ~14% annualized, a nine-year return that has only been matched a few times since 1940: in 1956, 1958, 1987, 1989, 1991 and during a longer stretch at the end of the 1990's.

An added risk for markets: the *Lord of the Flies* aspect of central bank withdrawal. In 2019/2020, for the first time in almost 20 years, financial markets will probably be left on their own, without the benefit of intervention from either developed economy or emerging economy central banks[6].

Lord of the Flies: a 20 year period of central bank intervention comes to an end
Developed economy and emerging economy central bank net purchases of G4 financial assets, % of world GDP, rolling 12m



Note: The G4 is normally comprised of the US, the Eurozone, the UK and Japan; we also include Switzerland. In the chart, we include G4 central bank purchases by looking at changes in their own balance sheets, and include purchases of G4 assets by emerging economy central banks and by non-G4 developed country central banks by looking at changes in their foreign exchange reserves ex-gold. Sources include individual central bank disclosures, the IMF's International Financial Statistics database, a 2014 analysis from Niall Ferguson and Moritz Schularick and J.P. Morgan Asset Management. 2018.

In July of this year, I gave an interview to Barron's which cited the risks mentioned on the prior page as reasons to start playing more defense in portfolios[7]. To be clear, the 9.5% S&P 500 correction since August 2018 has taken some of the steam out of extended US equity valuations, which have fallen from 17x to 15.5x 2019 earnings estimates[8]. I also expect US equity markets to rebound a bit after this steep a decline, as they did after the 10% selloff last February. Nevertheless, a reflexive "buy the dip" mentality, which worked so well during the 16 corrections of 6% or more since 2009, appears less compelling right now.

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Note: the podcast for today's piece will be posted later today

[6] **We will discuss this chart in greater detail in the 2019 Outlook**. The bottom line: both developed and emerging economy central banks have been intervening and buying G4 assets aggressively since the year 2000; the former for quantitative easing purposes since 2008, and the latter to prevent unwanted currency appreciation to build a stockpile of FX reserves for rainy day periods. Both of these trends are now coming to an end.

[7] See "*It's Time for Investors to Play Defense*", Barron's, July 17, 2018.

[8] Using quarterly IBES projected operating earnings since 1985, the current 15.5x US P/E multiple still ranks at the 65th percentile vs history, and that's assuming 10% earnings growth in 2019 following 20%+ earnings growth in 2018. During the recent correction, the hardest hit sectors in the US include those sensitive to rising interest rates (homebuilders, companies with high dividends), the strong dollar and declining globalization (companies with high foreign sales) and crowded trades (the FANG stocks). Over the medium term, pressures on earnings are likely to mount due to rising US labor, interest and credit costs, fading globalization, an eventual decline in financial engineering through share repurchases.

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