

CHARTBOOK

Market Comment

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Market Comment

Despite a recent pullback in most global stock markets, recent readings of economic data suggest that the global economy is entering the mid-cycle phase of the business cycle, which (if correct) remains a positive environment for equity investors. Recent data on sentiment among retail investors shows that these investors have soured on stocks lately. This is a contrarian signal (meaning it tends to be bullish), which tends to be associated with strong equity returns over the following 12 months.

“Taper talk” has started, as central banks around the globe have begun discussing their shift from accommodative monetary policy towards a more neutral policy, where quantitative easing will come to an end, and is often a precursor to tightening, where interest rates will rise. However, the first interest rate hike in the US is still likely over a year away. Despite the general sentiment that rising interest rates are bearish for stocks, the 12 months preceding the initial rate hike in a new interest rate regime is often a period of strength for stocks.

Business Cycle Scorecard



U.S. business cycle scorecard

	Start of cycle	Early cycle	Mid cycle	Late cycle	End of cycle	Recession
Cycle age						
Monetary policy						
Leverage						
Credit						
Bonds						
Inventories						
Economic trend						
Sentiment						
Consumer						
Employment						
Business investment						
Volatility						
Housing						
Corporate profitability						
Equities						
Economic slack						
Prices						
Allocation to each stage of cycle	2%	53%	29%	13%	3%	0%

Note: As at 2021-08-06. Darkness of shading indicates the weight given to each input for each phase of the business cycle. Source: RBC GAM

In the U.S., it appears that the early-cycle phase is ending, and we are entering the mid-cycle phase. This is typically the longest phase of the business cycle and is characterized by a positive but more moderate rate of growth than that experienced during the early-cycle phase. Economic activity gathers momentum, credit growth becomes strong, and profitability is healthy with an accommodative—though increasingly neutral—monetary policy backdrop. This is typically the second-best phase for equity investors.

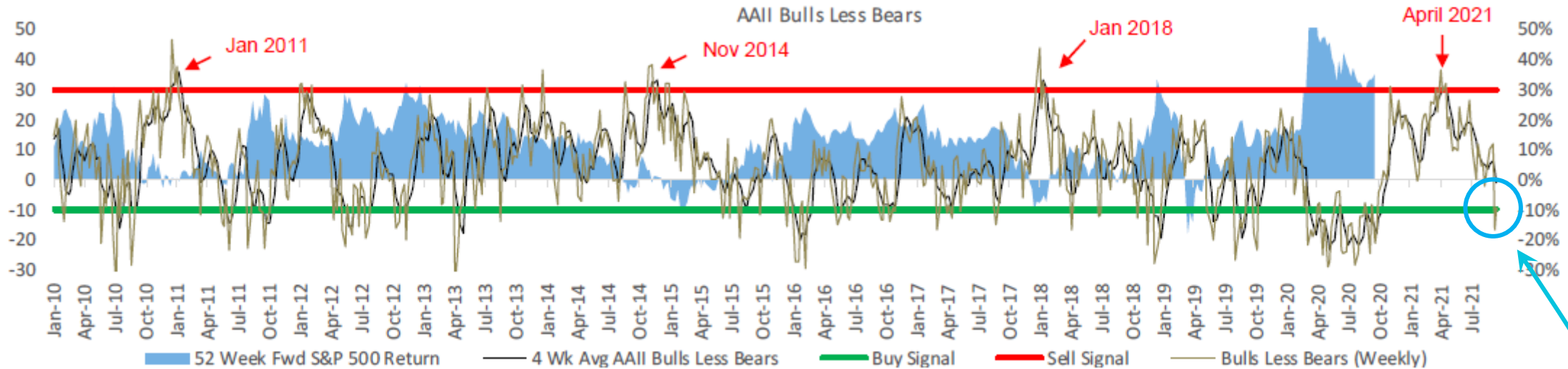
Mid-Cycle Returns By Sector

	Early Cycle	Mid Cycle	Late Cycle	Recession
Overall Equity Market Avg.	24%	15%	9%	-14%
Economically Sensitive				
Consumer Discretionary	36%	14%	4%	-16%
Materials	29%	11%	18%	-15%
Industrials	29%	16%	9%	-20%
Technology	29%	20%	5%	-20%
Financials	28%	15%	10%	-16%
Consumer Staples	22%	13%	14%	-1%
Health Care	20%	16%	16%	-7%
Energy	17%	17%	23%	-14%
Economically Insensitive				
Utilities	13%	11%	14%	-3%
Maximum Delta	23%	9%	19%	19%

The early to mid-stage of the business cycle has historically been associated with strong equity returns.

Negative Sentiment...is Good



As measured by the American Association of Individual Investors (AII) survey, retail investor sentiment has taken a sharp and sudden bearish turn, with net bulls falling to levels that – when sustained – are usually followed by strong S&P 500 returns looking forward 3 months and 12 months (in other words, a contrarian buy signal for stocks).

US Dollar



After crashing in 2020, the US Dollar Index appears to have established a strong upward trend since bottoming in May 2021. This is a positive for unhedged US Dollar denominated assets. It is a negative for foreign borrowers who owe funds in US Dollars but generate revenue in their domestic currencies.

Crude Oil



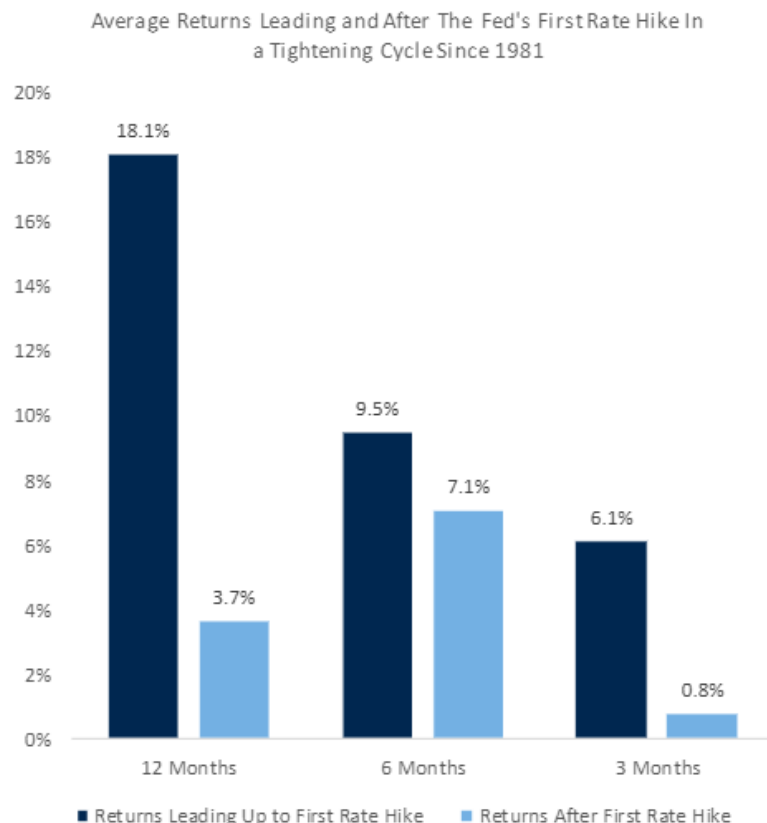
The price of Crude Oil is also in a strong uptrend. Oil crashed last year as demand dried up during COVID restrictions, the price of the near-month futures contract was even negative at one point. It has since rallied back to a 3-year high in price.

Taper Talk Has Started



- At the November Federal Open Markets Committee meeting, the Federal Reserve in the U.S. is widely expected to announce it will start reducing the \$120 billion or so of bonds it buys each month. The actual taper would be expected to start in December.
- A “taper tantrum”, similar to what happened in 2013 where there was a panic spike in US Treasury yields in response to a similar Federal Reserve policy shift, is not expected as the mechanics of reducing stimulus are much better understood this time around.
- The Fed has also commented that tapering is not an automatic signal that rate hikes are about to start. However, completing the taper does set the stage for the first rate hike discussion.

Stocks Returns Preceding Rate Hike Cycles



Source: RBC US Equity Strategy, Bloomberg, Haver

Returns Leading Up to First Rate Hike			
Tightening Cycle Start Date	12M Trailing	6M Trailing	3M Trailing
03/31/1983	36.6%	27.0%	8.8%
01/31/1987	29.4%	16.1%	12.3%
02/28/1994	5.4%	0.8%	1.2%
06/30/1999	21.1%	11.7%	6.7%
06/30/2004	17.1%	2.6%	1.3%
12/31/2015	-0.7%	-0.9%	6.5%
Average	18.1%	9.5%	6.1%
Median	19.1%	7.1%	6.6%

Returns After First Rate Hike			
Tightening Cycle Start Date	12M Fwd	6M Fwd	3M Fwd
03/31/1983	4.1%	8.6%	9.9%
01/31/1987	-6.2%	16.3%	5.2%
02/28/1994	4.3%	1.8%	-2.3%
06/30/1999	6.0%	7.0%	-6.6%
06/30/2004	4.4%	6.2%	-2.3%
12/31/2015	9.5%	2.7%	0.8%
Average	3.7%	7.1%	0.8%
Median	4.4%	6.6%	-0.8%

Fed Fund futures can be used to calculate the probability of when an interest rate hike is expected. These calculations currently point to late 2022/early 2023 for the first rate hike in the US.

Historically, the 12 months leading up to the first rate hike have been a strong period for stocks (the S&P500 in this case).

References

<https://www.etftrends.com/2016/02/a-momentum-based-approach-to-business-cycle-etf-investing/>



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