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Briefing from the ARVEST Investment Committee

Where are we currently in the business cycle? Exactly twelve months ago, we covered in this commentary the then just recently made, retroactive decision by the relevant NBER[1] panel that the U.S. economy had been in recession since February 2020. Since then, however, the NBER has been reluctant to put an official end to the recession. We have some sympathy for this. After all, the relevant economic data were distorted by the pandemic in a very different way than in previous recessions. For example, this time government financial transfers to U.S. households exceeded any lost wages suffered, and have done so continuously in every month since April 2020. At the same time, consumption of many services was made impossible, which also changed demand patterns for goods. Some turned to financial markets and invested the government money they received, with 80% of participants from the Generation Z[2] saying in a recent survey[3] that they had also turned to borrowing to do so, mainly via personal loans, credit cards, and friends and family.

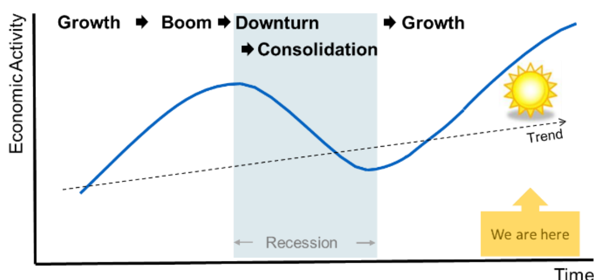
What was a transitory effect at work here, and what remains an underlying trend? A final judgment on a scientific basis was not yet feasible for the NBER. In the ARVEST Investment Committee we dare to make timely decisions, because financial markets do not wait for a balanced historical analysis. We expect the NBER to set the end of the recession at about August 2020. In fact, we think that the U.S. has by now already passed the initial recovery. This is especially true with regard to the sentiment indicators that are important to us.

In recent months, investors have increasingly been talking about inflation. The broad consumer price index rose to 5.0 percent in the USA in May. This is the highest annual rate since 2008, but central banks and most analysts view this as a transitory event. Indeed, there is much to be said for a strong base effect. Recall that a year ago in May, oil prices fell into negative territory as a massive oversupply of oil and a shortage of storage facilities loomed. However, a repeat of this oil price increase can be practically ruled out in the

[1] National Bureau Of Economic Research, nber.org
[2] Born between about 1995 and 2010
[3] Magnify money by lendingtree

next twelve months. On the other hand, Stephen Roach's worthwhile recollections[4], for example, show that it was dangerous even for veteran U.S. central bank chiefs like Arthur Burns to commit themselves to so-called transitory influences.

The inflation discussion is an important one. If the expectation of runaway inflation in the U.S. dollar were to prevail, it would probably be the party killer par excellence in the asset markets. We do see risks that rising government spending, rising corporate taxes or increasing deglobalization in the wake of the power struggle between China and the US could drive inflation expectations in coming years. On the other hand, central banks enjoy a very high reputation and can shape the discussion on what is a transitory and what is a structural factor to justify their monetary policy. Ultimately, everything in a human life is temporary and the U.S. dollar today is flexibly steerable and not tied to physical limits such as gold holdings. The continued bullish behavior in stock markets, as well as the decline in long-term bond yields in the second quarter, indicate that investors continue to see more short-term opportunities for their capital than they fear long-term inflation risks.



Future Prospects

The ARVEST Investment Committee sees the global economy as a whole in a growth phase. In the second half of the year, we expect strong global economic growth and high corporate earnings growth. Even though, given the rapid economic recovery, we believe that the current economic cycle to probably be shorter than the preceding ones, we do not yet see ourselves in a final, overheated boom phase.

Despite the high stock market prices, which imply below-average long-term returns, there is no convincing alternative to equities and real assets on the financial markets. We counter the high valuation risks with a targeted selection of individual stocks and a portfolio structure that can deviate significantly from the sector and country composition of the broad equity indices. We prefer stocks that we expect to perform relatively better if the aforementioned inflation risks should increase.

New all-time highs for stock indices are exceptional so soon after the end of a recession. Usually, investors have a lower risk appetite for a longer period of time after the losses they have suffered. We expect that the current optimism could well be tested in the coming quarters. We therefore continue to set the maximum equity exposure in our cyclical investment strategies somewhat lower than we did at the same time in previous economic cycles. Of course, we also discourage the sort of borrowing that Generation Z seems to favour.

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On behalf of the Investment Committee
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[4] https://www.project-syndicate.org/commentary/fed-sanguine-inflation-view-recalls-arthur-burns-by-stephen-s-roach-2021-05

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