Beyond the business cycle

Focusing purely on "where we are in the cycle" risks overlooking the signs of structural changes already afoot.

Throughout 2018, a sense of unease has repeatedly seized financial-market participants. For a wide range of asset classes, returns year-to-date have tended to be somewhere between disappointing and dismal. It began with cryptocurrencies at the start of the year followed by sharp increases in equity-market volatility in February. October proved truly dreadful for most risky asset classes. There was also extreme nervousness, heading into December. In between, emerging markets suffered from a combination of self-inflicted policy errors, rising trade tensions, rising U.S. interest rates and a stronger U.S. dollar, pushing emerging-market equities as a whole into bear-market territory.

Investors were not the only ones to lose their calm. Again and again, voters and citizens did so as well. Meanwhile, upheaval in governments, parliaments and at ballot boxes contrasted sharply with more sanguine readings from conventional economic indicators. The market mood kept oscillating between taking comfort from seemingly solid economic fundamentals and apprehension around the latest political surprises, often on trade and often transmitted via Twitter. As we head into 2019, it's worth pausing and trying to get a better grasp on this contrast. From a market perspective, leading indicators are tried and tested tools in assessing the likelihood of the next downturn within a given forecasting horizon. In financial-market parlance, the question is typically put in terms of "where we are in the cycle." By that, investors tend to mean two distinct, though related things. The first is how close we are to major economies, such as the U.S., succumbing to a recession. Recessions, of course, tend to, secondly, coincide with bear markets for risky assets, such as equities and riskier corporate bonds.

Typically, risky assets tend to continue to do quite well until the very late stages of a cycle. As we have argued recently in our Multi-Asset Perspective "Capital-market cycles," (see Capital-market cycles) history and recent economic data suggest that the current cycle still has further to run. Periods of weakness, in other words, might once again look like buying opportunities with the benefit of hindsight. There are plenty of downside risks to this view, however, and since 2016 they have tended to be related to politics. Starting roughly with the Brexit referendum and the election of Donald Trump, odd things began to happen quite frequently, often catching investors by surprise. That trend continued in 2018. On Brexit, it remains as hard as it has ever been to predict the ultimate outcome. In heavily indebted Italy, two broadly euroskeptic parties won the parliamentary elections in March, formed a new government and kept pushing against the budgetary constraints previously agreed with their Eurozone partners. Populists also won elections in Brazil and Mexico.

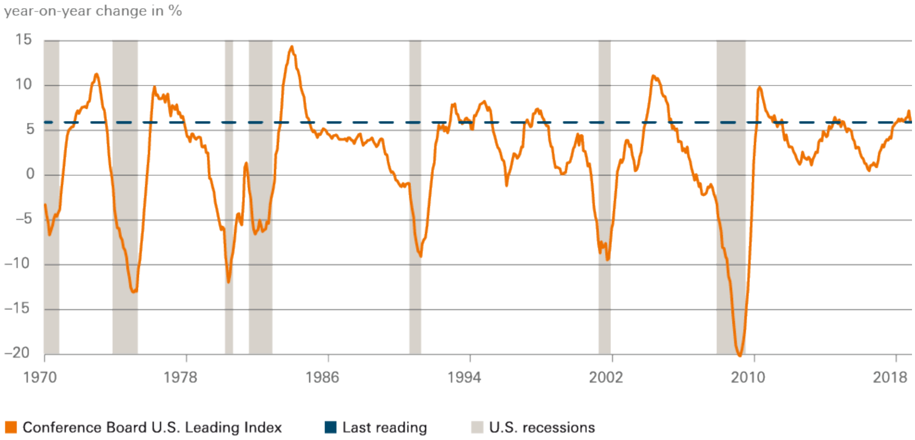
While less eye-catching, the traditional mainstream parties continued to see their electoral fortunes decline in a wide range of countries, including generally steadfast Germany and Sweden. In France, erstwhile political newcomer President Emanuel Macron faced sustained and at times violent street protests. In the U.S. midterms, Donald Trump's Republicans suffered a larger–than-usual defeat in the House of Representatives. High turn-out levels in the United States and several other countries suggest voters are more engaged than usual.

Set against financial and political turbulence, the world economy has been remarkably steady so far. The U.S. did a little better than forecast, most other developed countries and China somewhat worse. For the world as a whole, the economic outlook remains quite benign. It would be a mistake, however, to conclude, as an old German piece of investment wisdom has it, that politics rarely dominates markets for long. Elections, after all, are a way of aggregating information, just like markets are. The message that voters and citizens have been sending since 2016, in country after country, is that they are fed up with business as usual.

Which brings us back to the question so dominant in financial markets of "where we are in the cycle." At least as far as politics is concerned, the old political cycle that started after the global financial crisis is already over. So is the politics of what you might call "There is no alternative," in honor of Germany's crisis chancellor Angela Merkel. In the UK, the opposition Labour Party may be only one or two Brexit-related accidents away from getting a crack at implementing radical, redistributionist ideas, considered unthinkable not so long ago. And from Donald Trump in Washington and Emmanuel Macron in Paris to Rome's new populist government, outsiders are already eagerly implementing alternatives to their countries' erstwhile political status quo. Some of these policies are more market-friendly and more thought-through than others. But leaving aside the policy content, the sheer speed at which old ways of doing politics disintegrated has been stunning. The scope for policy errors has dramatically increased, and not just in monetary policy with the still unfamiliar tool "quantitative easing (QE)" making room for the never before tried tool of "quantitative tightening." For investors, the key implication is that matters are a lot more uncertain than standard economic-health assessments might suggest. The real surprise would be if you didn't start to see more of the fallout in both financial markets and the economic data throughout 2019. Investors might be well-advised to pay just as much attention to signs of structural changes already afoot as to "where we are in the cycle."

U.S. leading indicators suggest a rather benign outlook

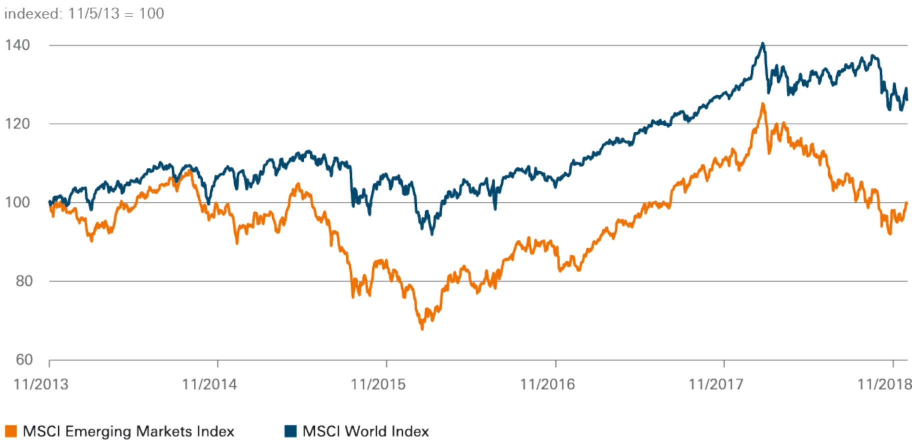
The Conference Board's U.S. Leading Index is a composition of several indicators and suggests that the U.S. economy remains quite solid.



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 11/30/18

Another difficult year for emerging-market equities

Since 2013, emerging-market equities have been comparatively weak. Things got worse in 2018, partly because rising U.S. interest rates pushed up the dollar.



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 12/5/18

Glossary

Bear market

Technically, a **bear market** refers to a situation where the index's value falls at least 20% from a recent high.

Brexit

Brexit is a combination of the words "Britain" and "Exit" and describes the exit of the United Kingdom of the European Union.

Cryptourrency

Cryptocurrencies are a new generation of digital currencies and payment systems that rely on cryptotechnology and distributed data management. They are privately organised and not bound to oversight by central banks or other official institutions. The pioneer and still most traded cryptocurrency is the bitcoin.

Emerging markets (EM)

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

Eurozone

The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

House of Representatives

The United States **House of Representatives** is a legislative chamber consisting of 435 Representatives, as well as non-voting delegates from Washington, D.C. and U.S. territories. Representatives are elected for two-year terms and each state's representation is based on population as measured in the previous Census.

Labour Party

The **Labour Party** is a center-left political party and one of the three biggest parties in the United Kingdom.

Monetary policy

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

Quantitative easing (QE)

Quantitative easing (QE) is an unconventional monetary-policy tool, in which a central bank conducts broad-based asset purchases.

Quantitative Tightening (QT)

Quantitative Tightening (QT), as opposed to Quantitative Easening, describes the process of a Central Bank reducing its monetary stimulus by shrinking its balance sheet.

Recession

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

Republicans

The **Republican Party (Republicans)**, also referred to as Grand Old Party (GOP), is one of the two major political parties in the United States. It is generally to the right of its main rival, the Democratic Party.

Volatility

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

Risk warning

Investments are subject to investment risk, including market fluctuations, regulatory change, possible delays in repayment and loss of income and principal invested. The value of investments can fall as well as rise and you might not get back the amount originally invested at any point in time.

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