

EQUITY

End-of-Cycle Management

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Stephen H. Dover, CFA
Head of Equities

As the US economic cycle continues to age, many are starting to question when—and how—it will end. Our Head of Equities Stephen Dover says it's certainly wise for investors to prepare, but doesn't see reason to think a recession is on the immediate horizon.

Although we don't believe the length of the economic expansion by itself should be a concern for investors, one of the big questions we have heard recently is: "When are we going to have the next recession?"

We are not trying to predict or time a downturn, but there's no doubt to us that we are near the end of a very long economic cycle. The economic cycle fluctuates between periods of expansion and contraction and each is marked by certain characteristics. The peak of a cycle marks a time of maximum output, typically accompanied by imbalances which need to be corrected. Following that peak thus comes a contraction, then a trough, or recession.

[**WHAT IS A RECESSION?**](#)

Historically, when the United States economy was manufacturing-based, recessions happened when inventories got too big. Over the last 20 years, as the United States has moved more into a service-based economy, there isn't that same inventory dynamic. So, I don't think we can conclude a recession is imminent just because the current expansion is longer than it has been in the past.

It's true that the expansionary phase of the current US economic cycle has been running much longer than what is typical, now more than 10 years from the last trough in 2009. However, Australia has the record for the longest expansion—now more than 20 years.

As far as we can see at this point, it doesn't look like a recession is going to happen within the next year or two, so we think the US expansion can continue. That said, we think investors should certainly be prepared for the cycle to change.

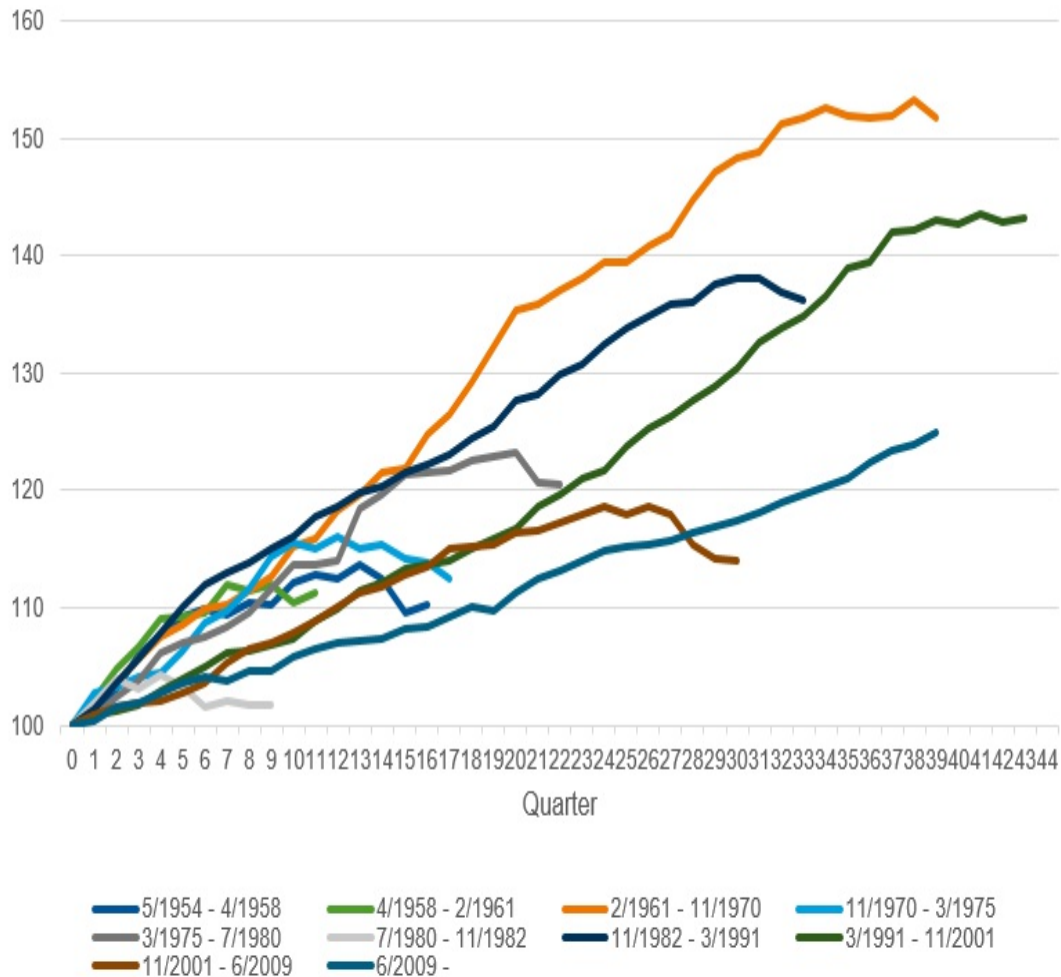
A recession is a decline in economic activity for two consecutive quarters. This can occur for a number of reasons, including an increase in the cost of capital or a decrease in access to capital. A significant rise in inflation is a major culprit, leading to an increase in the cost of money and rising interest rates as central banks use monetary policy tools to combat it. Other factors, including plummeting trade, a drop in consumer confidence, speculative bubbles or exogenous events such as natural disasters can trigger a recession.

Expansions Don't Tend to Die of Old Age Alone

Cumulative US Growth

NBER Trough to Trough (Indexed to 100 at each trough date)

Complete Quarters Subsequent to Each Trough Date
May 1954–March 2019



For illustrative purposes only.

The cumulative real gross domestic product (GDP) growth is based on quarters subsequent to referenced trough date. Trough dates are monthly, GDP data is quarterly.

Sources: Franklin Templeton Capital Market Insights Group, US Bureau of Economic Analysis, National Bureau of Economic Research (NBER), Macrobond. See www.franklintempletondatasources.com for important data provider terms and information.

Positioning an Equity Portfolio for the Late Cycle

Equity markets tend to be leading indicators of the onset of a recession. Fearing a downturn in the cycle, market participants start to revise their expectations, and this is reflected in lower stock prices. Our analysis shows that the average lead time between the start of an equity drawdown and the start of a recession is eight months.

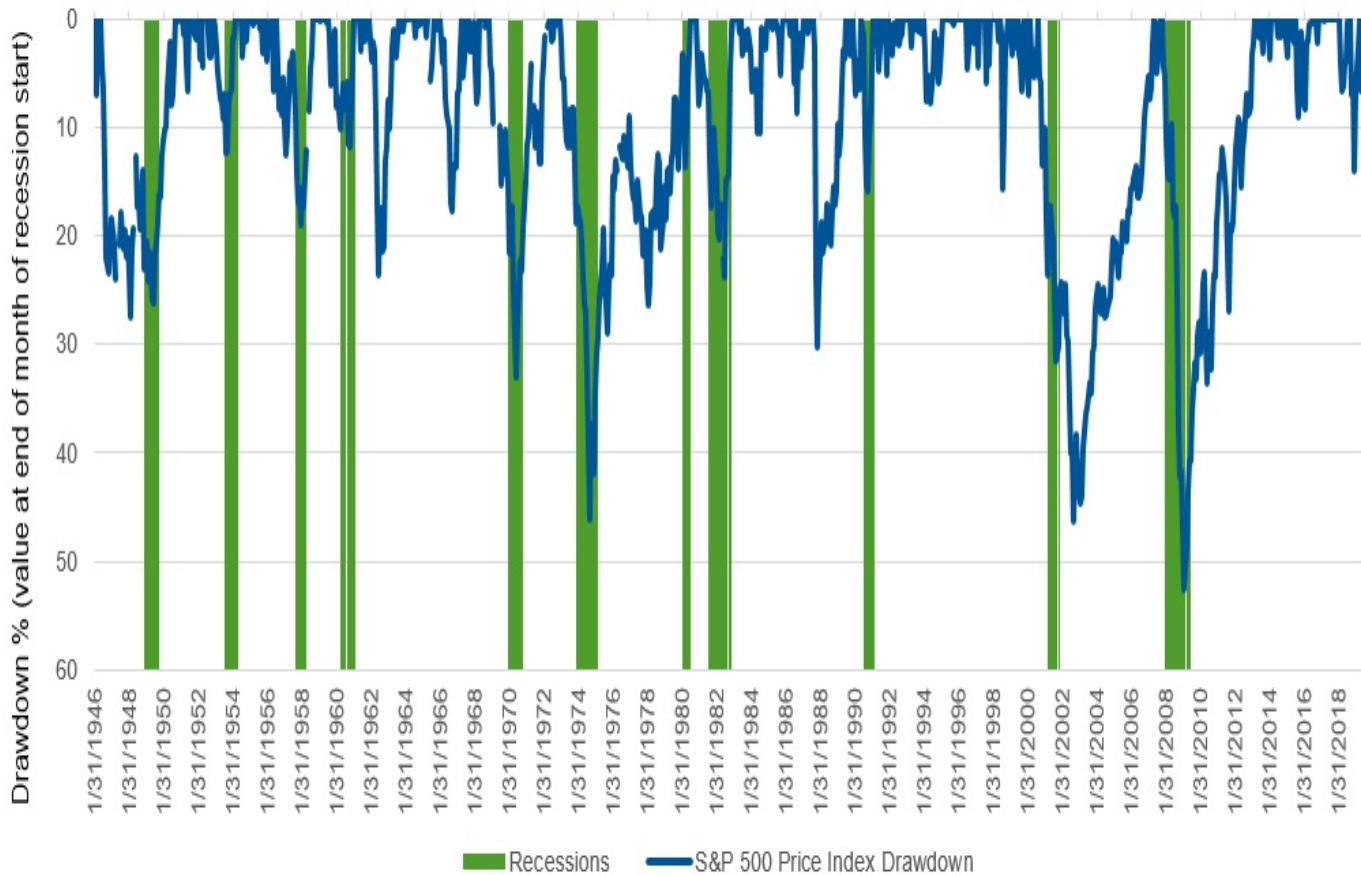
However, there can be false signals. Obviously not every equity market decline leads to a recession; notably, the recession of 1980 was not preceded by a significant equity market pullback.

Equities as a Signal of Economic Recessions



Equities have tended to turn lower before a drop in economic activity

S&P 500 Price Index Drawdowns
January 1946–June 2019



Average lead time between start of equity drawdown and recession: 8 months. Note: recession of 1980 was not accompanied by significant pullback (using monthly data). Drawdown defined as cumulative return since all-time high for the period analysed, multiplied by negative one.

Sources: Franklin Templeton Capital Market Insights Group, Standard & Poor's Dow Jones, National Bureau of Economic Research, Macrobond. Indices are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator or guarantee of future results. See www.franklintempletondatasources.com for additional data provider information.

Sectors That Can Shine

In many ways, our approach to end-of-cycle management is similar to our regular investment approach. We remain focused on building portfolios that we believe should be poised to benefit from multi-year secular growth themes or innovation.

We take a long-term view and leverage our bottom-up research to identify businesses that have dominant brands or franchises with high-quality management teams, healthy financial returns and a track record of resilience.

In the current environment, our portfolio managers in general are avoiding high-debt companies, while targeting companies where we see strong cash-flow generation.

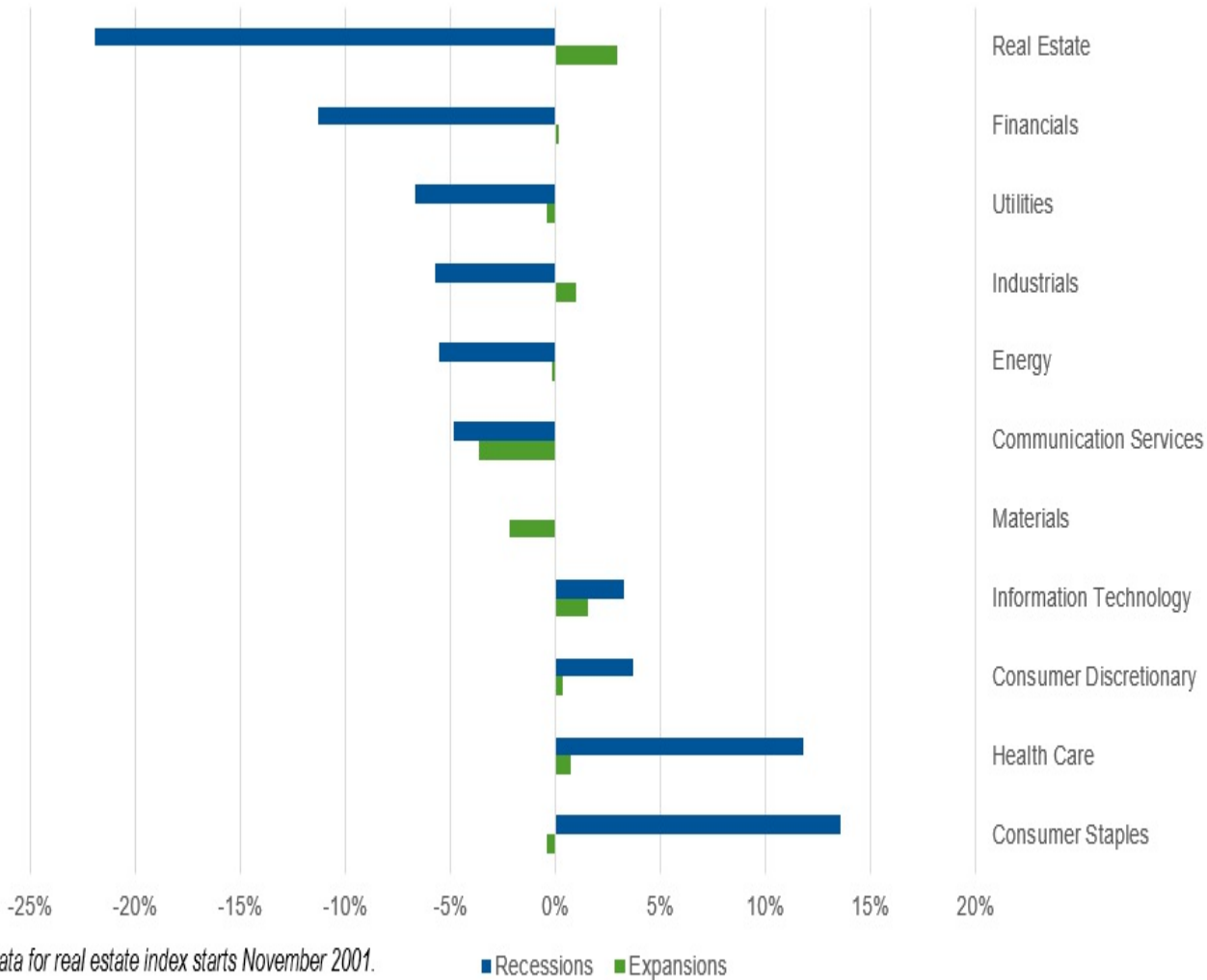
Meanwhile, it's important to recognise that traditionally, different sectors have responded differently during recessions. Consumer staples, health care, energy, materials and utilities sectors have a history of outperforming the market in periods of decline, as these goods are relatively inelastic. For example, during a recession, consumers will cut back their spending in areas such as entertainment or air travel, but not likely on things like toothpaste or electricity.

Equity Sector Performance



Expansions vs. Recessions

Annualised Excess Total Return for S&P 500 Sector Indices, Relative to S&P 500
October 1989–June 2019



For illustrative purposes only and not representative of any Franklin Templeton fund performance or portfolio composition. **Past performance is not an indicator or guarantee of future results.**

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Global Diversification

By most analysis, the United States is at a later stage of its cycle than other countries, so we are alive to opportunities globally in terms of diversifying our portfolios.

European markets tend to do well late in the cycle, due to their high exposure to inflation- and rate-sensitive sectors like commodities and financials, which tend to outperform in a rising price and interest-rate environment.

European companies have been vastly under-earning their US peers while trading at historic valuation discounts, offering scope for both profit improvement and multiple expansion as policy conditions normalize.

Value Stocks Have Often Become More Attractive in a Recession

Volatility in the global markets is currently near-normal levels, and we look at that as an opportunity. Value investors are looking for mispriced stocks, and when there's not a lot of volatility, you don't get a whole lot of mispricing. But as investors pull their money out of the market, they tend to pull it out somewhat indiscriminately. That indiscriminate selling often creates mispricing of stocks based on their fundamentals. Value investors look for opportunities to step in and take advantage of that mispricing as volatility increases.

That said, we believe both growth and value investment styles can be well-positioned for the cautiously optimistic scenarios we see. The outlook for corporate earnings growth looks positive to us, as does the outlook for global economic growth in 2019.

Focus Should Return to Stock-Picking

In my opinion, over the last few years, many equity investors have been thinking a bit too much about the wrong things.

Traditionally, equity investors would look at earnings when seeking out viable companies to invest in. However, the last 10 years of accommodative central bank monetary policy have made a lot of investors more macro-oriented, rather than micro-oriented. We think these investors should go back to looking at the differences in individual stocks and not be so focused on the actions of central banks—particularly the US Federal Reserve.

While we don't see a near-term recession, that doesn't mean we think stocks will always continue to rise. To have a healthy bull market, you have to have volatility and the occasional pullback or correction. Ultimately, we focus on companies that have good quality earning streams.

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