Global business cycles: converging at last?

The business cycles of the major economies are out of sync. While the US and the UK are several years into a sustained expansion, the Eurozone economy has only recently begun to show signs of repair, and the emerging markets are tipping into downturns of varying severity. This asynchronicity has had profound repercussions for the global economic backdrop and the performance of asset markets over recent years – but the picture may be starting to change in 2016.

We use a range of macroeconomic variables to date and characterise business cycles beyond simply looking at the lagging and frequently unreliable gross domestic product (GDP) figures. On this basis, the United States, which led the world into the downturn in 2007, has been on a steady expansionary path since mid-2009. The UK business cycle has followed a similar course, albeit with a quarter or two lag. The Eurozone, meanwhile, entered a renewed downturn in late 2011 as the debt crisis reached its nadir, and is only now moving through the repair and recovery phases of the business cycle. By contrast, a number of the major emerging markets – most notably China – have recently entered a renewed downturn on the back of the commodity price rout and the slowdown in world trade growth. Finally, Japan continues to show little sign of an economic cycle at all.

The asynchronicity of the global business cycle has shaped many key macroeconomic and asset market themes over the past year or so. By ensuring that spare capacity at a global level remains abundant, it has kept inflation in the developed economies remarkably contained - even as their labour markets have tightened significantly. It has also been behind the US dollar’s strong rise, as the outperformance of the world’s largest economy has attracted capital into dollar assets, increasing demand for dollars and boosting the currency. Together, subdued inflationary pressures and a strong currency have made the US Federal Reserve’s exit path from ultra-loose monetary policy extraordinarily difficult, extending the period of near-zero policy rates. Finally, out-of-sync global business cycles have allowed expansions in the US and the UK to continue for a remarkably long time, with few signs of the typical late-cycle overheating that ultimately tips the economy back into a downturn when central banks are forced to raise interest rates.

Throughout much of this year, investors appear to have been positioned for a scenario in which global business cycles would begin to converge again in 2016 as the rising tide of the US (and to a lesser extent the UK) economy lifted many boats. This would be helped along by robust consumer demand in the world’s largest economy, as well as the hope of a more embedded recovery in the Eurozone and even an underlying optimism that the situation in emerging markets would become more encouraging. Such a scenario would favour risk assets like equities, oil, industrial metals and even selected emerging market currencies.

But the possibility of a rather less benign convergence of global business cycles – whereby the slowing emerging market economies weigh on the fragile Eurozone and even the US and UK recoveries – has recently reared its head. The sheer size of the emerging markets in the global economy – some 40% of global output at market exchange rates, compared with just over 20% a decade ago – means that when they sneeze, the rest of the world risks catching a cold. Previously, that level of market influence had been reserved for the US alone. Following the latest slowdown in the emerging markets, a raft of economic data in the US, UK and the Eurozone – activity surveys, export growth, job creation and retail spending growth – have all shown signs of weakness. Should these developments presage a decisive downturn in the developed markets’ business cycles, central banks have little room to add stimulus because policy rates are already near zero. This scenario would favour traditional safe-haven assets such as government bonds, gold, the US dollar and the yen. But the prospect of further unconventional monetary policy stimulus may also provide a temporary fillip to equity markets.

Whether or not 2016 will mark the year that turmoil in the emerging markets brings the long expansions in the US and UK to an end, and throw off the nascent improvement in the Eurozone’s business cycle, we can be sure that no recovery can continue forever. Investors would do well to think ahead to how they wish to be positioned heading into the inevitable downturn.
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The value of investments and the income from them can go down as well as up and you may get back less than the amount invested.

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