Is Monetary Policy Overwhelming the Business Cycle?

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KEY TAKEAWAYS

• Today’s ultra-low-rate environment may feel different, but monetary policy is just one component of the business cycle trends that affect intermediate-term asset performance.

• Current patterns of how the business cycle and monetary policy influence one another are similar to past cycles, particularly accelerating wage gains that make the Federal Reserve more likely to tighten.

• The main difference is that the weaker and more deflationary global environment has made the Fed more cautious.

• We expect continued improvement in U.S. labor markets and a stabilizing global backdrop, to induce the Fed to continue hiking at a gradual pace.

• This backdrop should be supportive of global equities, but will also likely increase U.S. late-cycle dynamics that may benefit more inflation-resistant assets.

Fidelity’s Asset Allocation Research Team employs a multi-time-horizon asset allocation approach that analyzes trends among three temporal segments: tactical (short term), business cycle (medium term), and secular (long term). This monthly report focuses primarily on the intermediate-term fluctuations in the business cycle, and the influence those changes could have on the outlook for various asset classes.
Today’s global economic backdrop may appear different from past cycles. With all eyes on the Federal Reserve’s (Fed’s) next move and the persistence of extraordinary easing policies by the European Central Bank and Bank of Japan, it may seem like all that matters for the global market outlook is the direction of monetary policies. However, central bank actions take place within the context of the business cycle, and understanding how one influences the other remains a central consideration for intermediate-term asset allocation decisions. This paper will discuss the impact of monetary policy on the business cycle, with particular focus on the United States.

**Monetary policy in a business cycle context**

Within our business cycle framework, monetary conditions play a critical role. For example, when the Fed lowers interest rates to boost the economy, or raises them to tamp down a potentially overheating business cycle, it influences the shifts of the economy through four main cycle phases. In general, the Fed eases policy during recessions to help stimulate lending and typically maintains low rates during the early cycle to help support the recovery. As an expansion broadens during the mid-cycle phase, the Fed typically begins to neutralize policy by hiking rates, and then continues to tighten monetary conditions through the late cycle in order to combat inflationary pressures. The influence of monetary policy on bank lending and credit markets is one of several factors that affect where the economy stands in the business cycle.

**Is this cycle different?**

In the aftermath of the 2008 global financial crisis, the Fed successfully provided extraordinary monetary accommodations to help avert an economic depression. Though the recovery process was prolonged, monetary policy helped the healing in a variety of ways. Higher asset prices improved investor sentiment, lower rates fostered healthier consumer balance sheets, a weaker U.S. dollar made exports more competitive, and the recapitalization of banks helped ease lending standards. As we have discussed in recent Business Cycle Updates, the U.S. has maintained a slow but sustainable expansion that has enabled the Fed to shift to a tightening stance. To understand how monetary policy and current

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**Exhibit 1** U.S. Treasury Five-Year Real Yields

Five-year real rates (inflation adjusted) have increased around 150 basis points since the Fed signaled tapering

Real Yield (%)

Source: Federal Reserve Board, Haver Analytics, Fidelity Investments (AART), as of May 24, 2016.

**Exhibit 2** Average Weekly Earnings During First Hike of Fed Cycle (1983–2016)

The pace of real wage growth is above the historical average of when the Fed has begun hiking rates

cyclical conditions are influencing one another, it’s worthwhile to investigate how this current cycle compares with past cycles.

**Level and speed are different, but patterns are similar**

This cycle feels different because the level of interest rates and inflation is so low, the Fed’s balance sheet is so large, and the Fed has lacked the ability to raise rates at a faster pace. The zero policy rate was unprecedented in U.S. modern history. Even when the Fed finally got to its first hike (December 2015), it was five-and-a-half years after the recession (versus 26 months historically) and inflation was at only 0.5% (relative to 2.5% on average).\(^1\)

However, when examining this history more closely, it appears monetary policy has followed the business cycle in a very similar pattern compared to prior cycles. While it has taken longer for the economy and labor markets to heal during this expansion, the direction of policy and cyclical conditions have generally moved in the same way.

Historically, the Fed has tended to enact its initial rate hike and the majority of its tightening during mid cycles. This cycle, the Fed began its directional tightening campaign three years ago during the mid-cycle expansion, when it publicly discussed ending its quantitative easing program. Since, the market “taper tantrum” in mid-2013, five-year real yields have climbed around 150 basis points, implying the Fed-induced tightening of monetary conditions began long before the first rate hike in December 2015 (Exhibit 1). From this perspective, the Fed may have already tightened more than the 25-basis-point rate hike of December 2015 would suggest.

While overall inflation has remained low, domestic wage-induced inflationary pressures have resembled prior cycles. Today’s pace of nominal wage growth is somewhat below the average seen when the Fed first hiked rates during the past five tightening cycles. However, on an inflation-adjusted basis, real wage growth is higher today than it has been historically around the Fed’s first rate hikes (Exhibit 2). This is important because the Fed tends to look through cyclical fluctuations in volatile, non-core items—such as energy prices—and focus more on underlying labor-market trends. Since it took longer during this expansion for unemployment to fall and wage pressures to build, the Fed understandably held off on more aggressive tightening for a longer period.

Since the Fed concluded its quantitative easing program, it has maintained a constant balance sheet by reinvesting tens of billions of bond coupons and mortgage pay downs per month. Ending these reinvestments is another tightening tool that the Fed may choose to employ during this cycle, despite still maintaining a large balance sheet.

**A key difference: A weaker global backdrop**

Traditionally, the Fed has been more focused on its dual mandate of price stability and full employment, with global developments not a principal issue. However, the explicit reference to “global economic and financial developments” within the Federal Open Market Committee’s statements from September 2015 to March 2016 highlighted the elevated

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**Exhibit 3 Global Growth and Inflation When Fed Tightens**

Global growth is weaker and inflation is lower than at the start of previous tightening cycles

<table>
<thead>
<tr>
<th>Year-Over-Year Headline CPI</th>
<th>High inflation, strong global growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.0%</td>
<td>◆ 1983</td>
</tr>
<tr>
<td>3.0%</td>
<td>◆ 2004</td>
</tr>
<tr>
<td>2.0%</td>
<td>◆ 1994</td>
</tr>
<tr>
<td>1.0%</td>
<td>◆ 2015 ◆ 1986</td>
</tr>
<tr>
<td><strong>Low inflation, weak global growth</strong></td>
<td>40% 50% 60% 70% 80% 90% 100%</td>
</tr>
</tbody>
</table>


importance of external conditions for U.S. monetary policy. In the current period, the global environment is much weaker and more deflationary than during previous periods of Fed tightening, making the Fed more cautious:

- Inflation is extremely low, primarily due to the plunge in oil prices (Exhibit 3).
- Fewer countries are exhibiting rising leading economic indicators (LEIs) compared to historical Fed tightening cycles (Exhibit 3).
- Much of the rest of the world is still easing monetary policy (e.g., Europe, Japan, China).
- The Fed’s move to tightening created a negative feedback loop by strengthening the dollar and tightening global dollar liquidity, which has slowed U.S. external sectors (exports, manufacturing, oil production).

Perhaps the area of biggest concern outside the U.S. is China’s economic outlook. As the second-largest economy and biggest trader in the world, China has a disproportionate influence on global trends in trade, manufacturing, and commodity prices. Tighter U.S. monetary policy has a major impact on China’s outlook because of China’s need to ease its own monetary conditions in a slowing growth environment (see “China’s Stability Key to Global Improvement, Business Cycle Update,” February 2016). The Fed’s move to tighten has pushed up the value of the dollar, putting downward pressure on the Chinese currency, and causing capital to flow out of China (Exhibit 4). When expectations of Fed tightening have risen during the past year, China’s financial stress level has increased as well. This stress has triggered periods of global market volatility, making China’s outlook far more important to Fed policy decisions than usual.

**Monetary Outlook: U.S. and Global Indicators**

As with prior cycles, monetary policy will be a key ingredient influencing the U.S. business cycle, along with trends in labor markets, corporate profits, credit, and manufacturing. We expect the underlying trends in these areas will be sufficient to induce the Fed to hike its policy rate again during the next few months (see U.S. Macro Update). With external conditions mattering more than ever before, one key area to monitor is whether the Fed can tighten without causing extreme escalation in China’s financial stress. Our expectation is that while the markets may turn volatile, the trends toward global economic stabilization will ultimately allow the Fed to continue its gradual pace of tightening (see Global Macro Update).

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*Shaded areas represent periods when fed funds futures indicated a greater than 50% chance of two rate hikes by June 2016. Source: Federal Reserve Board, Bloomberg Finance L.P., Fidelity Investments (AART), as of Apr. 30, 2016.*
Business Cycle: Macro Update
While the trends in economic releases have softened some since our last Business Cycle Update, they still point toward cyclical expansion for the U.S. and global economies. The U.S. continues to experience a mix of mid- and late-cycle indicators, and the odds of recession remain low.

United States: Late-cycle indicators elevated, but recession odds remain low

Household sector in solid shape
During the past several years, employment conditions have improved substantially, soaking up a significant amount of excess slack in the labor markets and generating incipient upward pressures on wages. Given how much slack has already dissipated, the slower pace of hiring and relatively elevated average hourly earnings reported last month are consistent with labor market trends that have tended to shift the economy toward the late-cycle phase (see “Job and Wage Gains Sowing Seeds of Late Cycle, Business Cycle Update,” May 2016). Consumer confidence has remained elevated, bolstered by rising expectations for real income growth during the next year. Tighter labor markets and rising income expectations suggest the U.S. consumer is providing a solid foundation for continued U.S. expansion.

Mixed bag in business sector
U.S. business sector activity has moderated recently, though the underlying trend remained solid. From September 2015 through March 2016, the percentage of regional Purchasing Managers Indexes that were in expansionary territory steadily rose from roughly 30% to 90%, before slipping to 70% in April. Late-cycle trends are evident with banks tightening lending standards for businesses, and rising wage inflation beginning to pressure corporate profit margins. However, profit and credit conditions remain relatively favorable for most domestic-oriented sectors, and more stable oil prices and a U.S. dollar may provide relief to globally exposed industries. The recent slowdown in business activity may likely prove temporary, particularly if the global economy, oil prices, and the dollar stop providing headwinds.

Global: Weak growth, but signs of stabilization emerging
The global economy is struggling, but there are some signs of stabilization. Roughly half the world’s largest economies have posted positive growth in leading economic indicators (LEIs) on a six-month basis, the broadest pace of expansion since the start of 2015. Global manufacturing bullwhips (the new orders less inventories component of purchasing manager indexes) have softened over the past month but are still indicating a pickup in global manufacturing activity. Tightening energy supply and demand and higher oil prices are mitigating global deflationary pressures and easing the burden on oil-producing countries. Global growth remains tepid and uneven, but signs of stabilization continue to build.

Exhibit A U.K. Business Confidence and Retail Sales
Business confidence eroding but consumption holding up ahead of the Brexit vote


Source: Lloyds Bank, Office for National Statistics, Haver Analytics, Fidelity Investments (AART), as of Apr 30, 2016.

3 Source: University of Michigan, Haver Analytics, Fidelity Investments (AART), as of May 13, 2016.

4 Fidelity Investment proprietary analysis of regional Purchasing Manager Index performance. Source: Haver Analytics, Fidelity Investments (AART), as of May 13, 2016.
China continues to stabilize
A downshift in growth at the end of an overextended credit boom has caused China to remain in a growth recession for the past year, but recent signs suggest a possible bottoming in near-term activity. The recent increase in loan demand suggests monetary stimulus is increasingly transmitting through the banking system and into credit creation, which should support near-term economic activity (albeit at the expense of medium-term dynamism). Rising fiscal support from China’s policymakers should help stabilize conditions in the near term, although greater structural reforms will be needed for a sustainable reacceleration.

European consumption trends slowing, but near-term recession risks low
Business cycle indicators are mixed in Europe. While demand for the region’s industrial sector should benefit from the continued stabilization of China, consumer sentiment and spending patterns have waned of late.6 Despite the mixed signals, supportive monetary policy and the lagged impact of China’s stimulus on demand suggest a low probability of recession in the short term.

U.K. expansion continues as Brexit decision looms
The U.K. is in the latter stages of the mid-cycle heading into the Brexit vote.7 Both business and consumer confidence have weakened ahead of the vote. While business activity has waned, with the manufacturing PMI falling into contractionary territory in April, consumer demand is holding up—retail sales grew at a 4% annualized rate in April (Exhibit A).8 Positive consumer spending patterns continue to support the U.K. mid-cycle expansion despite the uncertainty surrounding the political outlook.

Outlook/asset allocation implications
Due to the extraordinary nature of the monetary response during this cycle, policy has taken center stage for investor sentiment. As always, however, monetary policy is both influenced and influences the business cycle, and must therefore be considered alongside fundamental economic trends. Recent global data have proven not poor enough to justify the steep market sell-off during the early part of 2016, nor quite sufficient to sustain the sharp rally in February and early March. With investors reacting poorly to negative policy-rate moves in Japan and the eurozone in recent months, the sense of a limit to the effectiveness of additional policy easing has undergirded a feeling of financial-market and economic malaise (see Leadership Series article “Potential Pitfalls of Negative Policy Rates: Ultra-low and negative rates may result in unintended outcomes for large central banks,” June 2016)

Nevertheless, our view coming into 2016 has not changed—we expect tightening U.S. labor markets and gradual stabilization of the global economy to provide a backdrop for moderate additional Fed tightening. These trends should provide support for U.S. and global equity markets, though they are also likely to push the U.S. toward the late-cycle phase. From an asset allocation perspective, volatility may remain elevated and smaller cyclical asset allocation tilts may be warranted than earlier in the cycle. A move toward late-cycle dynamics may favor assets with inflation-resistant properties, with selective opportunities in a number of the most beaten-down categories, such as emerging-market equities, energy stocks, and TIPS.

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7 Brexit vote refers to the U.K.’s referendum vote to leave the European Union.
BUSINESS CYCLE UPDATE: IS MONETARY POLICY OVERWHELMING THE BUSINESS CYCLE?

Business Cycle Framework
The world’s five largest economies are in various stages of the business cycle.

Inflationary Pressures
- Red = High

Economic Growth
- Green = Strong

Cycle Phases
- EARLY
  • Activity rebounds (GDP, IP, employment, incomes)
  • Credit begins to grow
  • Profits grow rapidly
  • Policy still stimulative
  • Inventories low; sales improve

- MID
  • Growth peaking
  • Credit growth strong
  • Profit growth peaks
  • Policy neutral
  • Inventories, sales grow; equilibrium reached

- LATE
  • Growth moderating
  • Credit tightens
  • Earnings under pressure
  • Policy contractionary
  • Inventories grow; sales growth falls

- RECESSION
  • Falling activity
  • Credit dries up
  • Profits decline
  • Policy eases
  • Inventories, sales fall

Relative Performance of Economically Sensitive Assets
- U.S.
- China*
- Japan
- U.K.
- Germany

Note: The diagram above is a hypothetical illustration of the business cycle. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one. A growth recession is a significant decline in activity relative to a country’s long-term economic potential. We have adopted the “growth cycle” definition for most developing economies, such as China, because they tend to exhibit strong trend performance driven by rapid factor accumulation and increases in productivity, and the deviation from the trend tends to matter the most for asset returns. We use the classic definition of recession, involving an outright contraction in economic activity, for developed economies. Please see endnotes for a complete discussion. Source: Fidelity Investments (AART).

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The Asset Allocation Research Team (AART) conducts economic, fundamental, and quantitative research to develop asset allocation recommendations for Fidelity’s portfolio managers and investment teams. AART is responsible for analyzing and synthesizing investment perspectives across Fidelity’s asset management unit to generate insights on macroeconomic and financial market trends and their implications for asset allocation.

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**Investing involves risk, including risk of loss.**

**Past performance is no guarantee of future results.**

**Diversification and asset allocation do not ensure a profit or guarantee against loss.**

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