MARKET INSIGHTS

MACKENZIE Investments | CONFIDENCE IN A CHANGING WORLD

North American Equities Team | September 2018

Are We There Yet? An Analysis of Current Economic Cycle Duration

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As bottom-up investors, our process focuses predominantly on company fundamentals and stock valuations. We also incorporate analysis on the economies and markets in which these companies operate. This analysis can help inform portfolio construction.

We also consider the economic cycle. Although we are likely in the later stages of one of the longest economic cycles on record, the Canadian economy is expected to continue benefiting from strong demand for goods and services from the United States. This should allow for continued strength in corporate profits, supporting equity market returns. While the Canadian economic cycle may differ from the US economic cycle, we do believe the next Canadian recession will be closely tied to the next US recession. The North American Equities Team therefore monitors several key indicators in the US that have historically proven to give some lead time before the expansion part of the cycle matures and we enter a recessionary period.

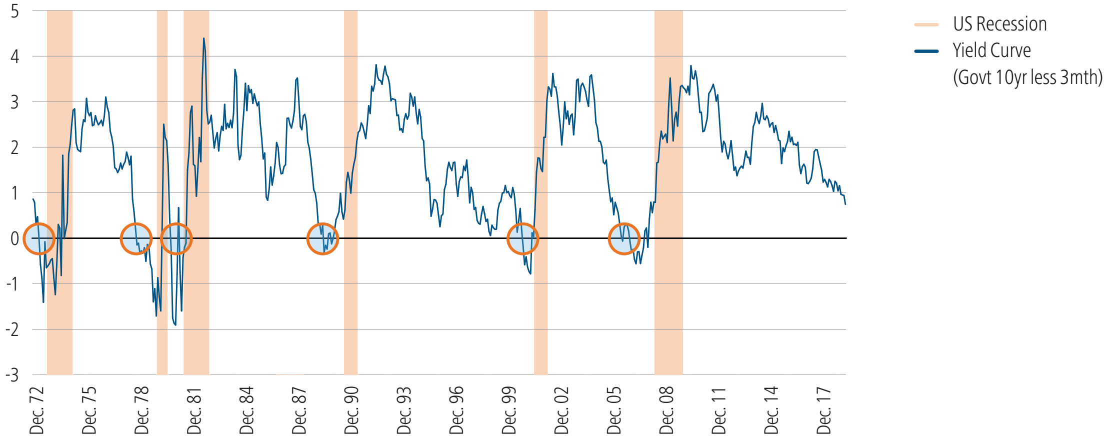
While each individual indicator may not necessarily be indicative of economic growth or decline, when they are evaluated in aggregate these indicators can provide a stronger signal and lead time to adjust portfolio construction. As of now, none of these indicators are signaling a near-term end to economic growth.

1. The Yield Curve

The US treasury yield curve is determined by plotting a line through the yields of US treasuries with different maturities. For our analysis, we use the 3-month and 10-year yields to determine the shape of the curve. When 10-year rates are higher than 3-month rates, the curve is upward sloping; when the 10-year rate sits below the 3-month rate, the curve is downward sloping (or inverted). When we examine historical yield curves, and more specifically those preceding a US recession, we find that in each of the last five recessions dating back to the early 1970s, the yield curve inverted before a recession occurred.

Historically, a recessionary period began approximately 13 months after the curve inverted. We have recently experienced a flattening of the yield curve but it has not yet inverted (see chart below). The orange circles mark points where the curve inverted.

US Yield Curve (Shape)



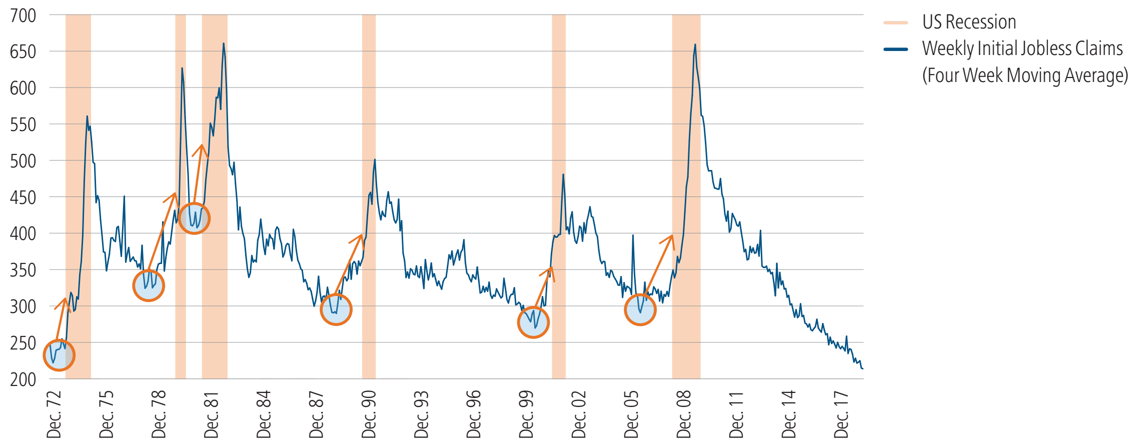
Source: Bloomberg, Mackenzie Investments as at August 23, 2018.

2. Initial Jobless Claims and the Unemployment Rate

Jobless claims in the United States are another signal of future economic strength that we evaluate. Typically, what we observe before a recessionary period is a bottoming in the number of jobless claims followed by a prolonged period of increasing jobless claims before we enter a recessionary period. This occurs because the slack in the labour market has been eliminated and rising wage inflation means companies must turn an eye to managing labour costs.

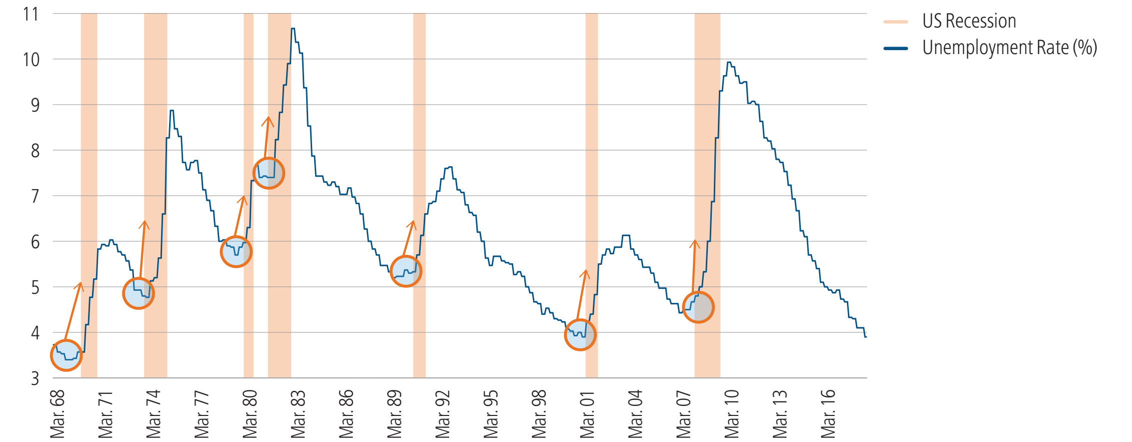
Historically, a recession has come, on average, 13 months after the number of jobless claims bottoms and inflects upwards. Similarly, the US unemployment rate hits a low and inflects upwards in advance of a recession. As we see in the charts below, neither of these metrics have hit a bottom yet. In the first chart, the orange circles show a bottom in claims. In the second chart, the orange circles signal a low in the unemployment rate.

US Initial Jobless Claims (1000s/week)



Source: US Department of Labour, Bloomberg, Mackenzie Investments as at August 17, 2018.

US Unemployment Rate (%)

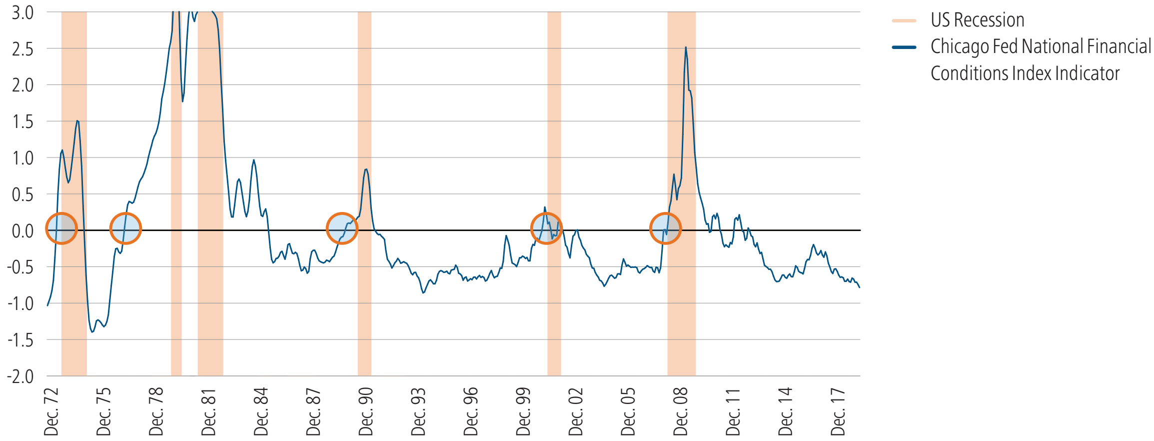


Source: US Bureau of Labor Statistics, Bloomberg, Mackenzie Investments as at July 31, 2018.

3. Credit Conditions

Another indicator we monitor is the Chicago Fed's National Financial Conditions Index, which measures U.S. financial conditions weekly based on 105 measures of financial activity. Historically, values above zero signal tighter-than-average financial conditions while values below zero signal looser-than-average conditions. The US economy is currently signaling looser-than-average conditions, a good sign there is room left in the economic cycle (see the chart below). Orange circles indicate tightening periods where conditions move from looser-than-average to tighter-than-average, crossing through the zero (average) line.

Chicago Fed Financial Conditions Credit Subindex

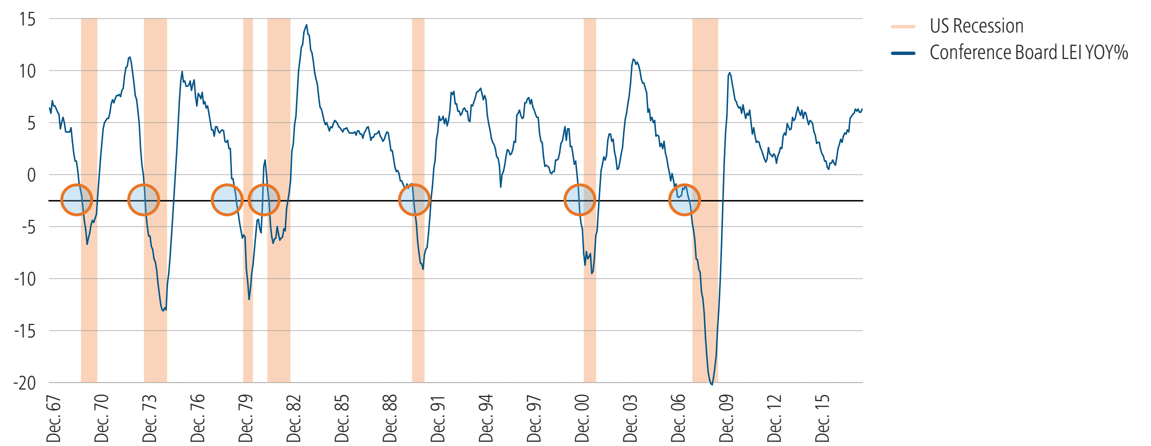


Source: US Federal Reserve Bank of Chicago, Bloomberg, Mackenzie Investments as at August 17, 2018.

4. The Conference Board Leading Economic Index (LEI)

An aggregate of ten indicators such as consumer expectations, new building permits and manufacturers' new orders, the U.S. Conference Board LEI is designed to signal peaks and troughs in the business cycle. Historically, recessions have occurred an average of five months after this indicator declines below -1.3. The indicator, as seen in the chart below has been at values of 6.0 or higher since February 2018; a level that has signaled growth ahead in previous cycles. The orange circles mark where the indicator has fallen through the -1.3 level.

Conference Board LEI YOY%

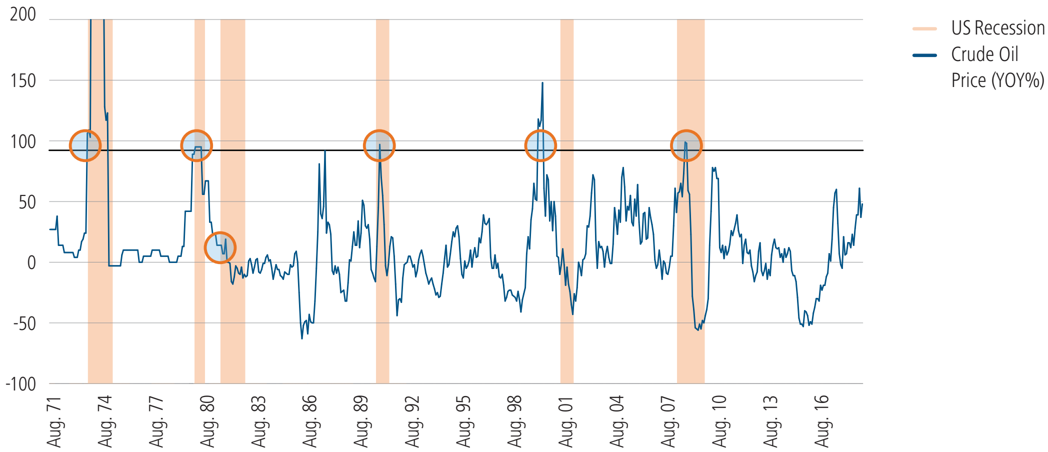


Source: The Conference Board, Bloomberg, Mackenzie Investments, as at July 31, 2018.

5. A Spike in the Price of Oil

As economic cycles mature and move towards an ultimate peak, current economic output (or GDP) rises above its long-term potential (potential is often referred to as the capacity of the economy). Demand for resources such as oil continues to rise during this period. In fact, when we examine the months preceding the last six recessions, oil prices spiked by more than 95% year-over-year in five instances. The increasing input costs of rising energy prices can put a damper on corporate margins and equity market returns. Although current oil prices are significantly higher than recent lows in 2014, the climb in prices has been mostly gradual when compared to the spikes observed before prior recessions (see chart below).

Crude Oil Price YOY%



Source: Bloomberg, Mackenzie Investments as at July 31, 2018.

While it is difficult to predict the timing of a recession or the probability of exogenous events that could put an end to economic growth, the above indicators, when taken in aggregate, suggest that we aren't there just yet. We believe there is still more road to travel.

For information on investment solutions from the Mackenzie North American Equities Team, please contact your financial advisor.

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