

The phase of the cycle points to further risk asset outperformance

The current mixture of improving economic activity but enough spare capacity to mean that monetary policy will remain loose for a considerable period, is one in which investors should continue to favour equities and corporate bonds over government bonds. Investors should also bias the equity portion of their portfolios towards emerging markets rather than developed markets.

Regular readers of our research will be aware that we define the economic cycle with reference to the position of the economy relative to its long run trend. This enables us to specify four distinct phases of the cycle according to whether activity is above potential and whether growth is above or below its trend. The four phases are: slowdown, recession, recovery and expansion. Each phase of the cycle is characterised by the different behaviour of interest rates, inflation, activity and most importantly, for investors, relative asset class performance.

Which phase of the cycle are we currently in?

Using unemployment and capacity utilisation as reasonably real time proxies for GDP growth and the output gap, shows that economic growth in August was below its trend rate and activity was below potential. Strong deflationary forces remained at work in the economy and there was no need to increase interest rates anytime soon.

In other words, the economy was still in the recession phase of the cycle, a phase that it entered in February 2008. Given that the economy has been in recession for eighteen months, however, it seems likely that we are comfortably into the second half of the recession phase.

Implications for asset class performance

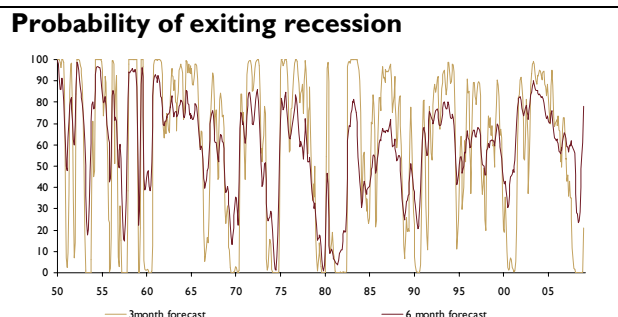
The table below, which looks at the historical probability of relative asset class outperformance, highlights that in the second half of the recession phase, equities and corporate bonds tend to outperform government bonds and emerging markets equities typically outperform developed markets. Oil also tends to beat cash.

Probability of asset class outperformance

	Recovery	Expansion	Slowdown	Early Recession	Late Recession
Corp vs Gov	57	50	49	40	61
HY vs Gov	55	54	37	33	63
HY vs Corp	57	56	37	41	59
Equity vs Bonds	61	68	39	44	56
Corp vs Equity	41	33	55	53	44
EM vs DEV	65	53	53	57	68
Oil vs Cash	59	58	68	41	68
Gold vs Cash	48	35	47	54	44
UK Prop vs Cash	82	91	58	28	56

Source: Coutts, Datastream

As the following chart shows, probability modelling indicates that the prospects of moving out of recession over the next three months are low but improving and that there is a nearly 80% chance that this will happen over the next 6 months. History suggests that such a transition is likely to cause corporate bonds, which have performed in line with equities since the start of June, to lag behind equities. This phase of the economic cycle should also be favourable for UK commercial property relative to cash.



Source: Coutts, Datastream

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