WHEN BUSINESS CYCLES GO AWOL

The politicisation of risk may be damaging investor confidence, argues David Bowers

Central bankers should be getting worried. Three years after some of them embarked on quantitative easing (QE), there is no sign that the business cycle has been restored and is back in the driving seat. That's not to say that there haven't been variations in economic activity during that period. But what is striking now is the lack of confidence investors and companies have in assessing where we are in the business cycle, and what might happen next. This lack of transparency about the business cycle has its origin in a disrupted monetary cycle. The uncertainty surrounding the monetary transmission mechanism ('just how exactly does QE work?') and the absence of a credit cycle continue to present serious challenges to businesses and investors alike.

It is leading to some significant changes in behaviour. In the investment community, the loss of confidence in the business cycle as a reference point is leading to a polarisation in investment process. Some investors are responding by focusing on short-term sentiment cycles, scalping a few basis points of performance where they can. Others are responding by becoming more long term, more thematic, focusing on the next two to five years.

In contrast, investment approaches that rely on reading and projecting where we are in the business cycle are very much out of favour. In the corporate space, there are also signs of a shift in focus. Gone are the days of riding the business cycle. Instead, companies are focused on providing predictable earnings streams that can sustain steady dividend growth, which is much favoured by investors in this low interest-rate environment. Companies have changed tack: instead of running themselves 'for growth', they are now running themselves 'for cash'.

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FACTS AND FIGURES

£375bn
THE AMOUNT OF QUANTITATIVE EASING THAT THE BANK OF ENGLAND HAS COMMITTED TO SINCE 2009
SOURCE: BBC

$600bn
THE VALUE OF TREASURY SECURITIES BOUGHT BY THE US FEDERAL RESERVE BY JUNE 2011 DURING ITS SECOND ROUND OF QUANTITATIVE EASING (QE2)
SOURCE: BBC

JPY 70tr
THE SIZE OF JAPAN'S ASSET PURCHASE PROGRAMME BY JUNE 2013
SOURCE: NEW YORK TIMES

$221bn
THE INCREASE IN US TAX PAYMENTS IN THE 2013 FISCAL YEAR, FOLLOWING THE EXPIRATION OF THE BUSH TAX CUTS
SOURCE: ABSOLUTE STRATEGY US POLITICAL BRIEFING 2012

The lack of confidence in the business cycle stems from a widespread perception that we have had a credit bubble that has created a debt overhang, which will take many years to resolve. Faced with the need for multi-year deleveraging, how can a credit cycle get re-established in the developed world? The situation is aggravated by the rise in political risk that tends to accompany any debt workout. In the run-up to the credit crunch, the markets called the shots and politics was a sideshow. The balance has now swung the other way, as debt overhangs are often accompanied by battles between creditors and debtors over who is going to bear the burden for excessive borrowing and inappropriate lending. The stand-off between northern European creditors and southern European debtors is a classic example of how the politics turns more toxic the longer it takes to reach a resolution. One consequence is 'the politicisation of capital markets', where political event risk becomes ever more pervasive in finance. This also 'muddies' the business cycle 'waters'.

As we head into the autumn, there is plenty for the bears to fret over... from euro break-up to hard landings in China to the 'fiscal cliff' and the possibility of a renewed recession in the US. They are also overlooking a lot of positives – such as the potential for lower inflation to trigger an aggressive easing of monetary policy in the developing world, more unorthodox monetary easing in the developed world, and the lagged effect of a major decline in energy prices. If US politicians can come to their senses over fiscal policy before the year end, people may suddenly see the economic glass as 'half full' rather than 'half empty'.

At the height of the credit boom in 2007, investors were seduced into thinking that the business cycle was dead – and mispriced credit/risk too cheaply as a result. The irony is that, five years later, investors could be making the same mistake in believing that the business cycle is dead – only this time, 'risk' has been mispriced in the opposite way. The biggest surprise out there could be that the business cycle makes a comeback.

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