
How Value Stocks and Inflation Assets Outperform in the Second Half of the 18.6 Year Cycle



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In this last installment of the 3-part series on the 18.6-year United States real estate and stock market cycles, we will dive into which assets outperform in each half of the cycle. In the first half of the cycle, growth assets generally outperform, and inflationary and cyclical/value assets typically outperform in the second half of the cycle. We will take a look at why this happens and what we can expect as the second half of the cycle unfolds.

As a quick review, in part 1 of this series entitled *Cycles Within the US Stock and Real Estate Markets*, we walked through several cycles. We started with cycles which typically last approximately 25-26 years for secular bull markets and another 6-10 years for secular bear markets, making a total secular cycle time of 31-36 years. We then looked at the 18.6-year stock market and real estate cycle and finally ended with the 11-year stock market cycle. We spent a large portion of the paper looking at the work that Phillip J. Anderson did on the 18.6-year cycle as it is the most dominant cycle in our economy.

In part 2 of this series, entitled *Private Debt's Role in Stock Market and Real Estate Cycles*, we looked at Richard Vague's work which recorded the role that private debt bubbles had in causing the major economic panics around the globe over the last 200-300 years. Mr. Vague identified the critical formula consisting of 150% nominal Private Debt to GDP combined with at least an 18% growth rate in the ratio of Private Debt to GDP of the previous 5 years as the trigger for causing major panics. We then tied this private debt information into the timing of the 18.6-year cycle to form a complete picture of not only when we should be looking for major cycle panics, but the fundamental signposts that may point to the severity of the upcoming panics.

Growth in the First Half and Cyclical/Value in the Second Half of the Cycle

Tech and growth stocks have led the markets higher since the 2009 bottom, but value and cyclical/inflationary assets will most likely lead the markets higher in the second half of the cycle. We are already seeing this in 2021. The reasons for this phenomenon are many, but it can be boiled down to a few key points. In the first half of the cycle the economy and stock market are still recovering from a massive deflationary shock as the real estate sector crash has typically caused some sort of debt implosion. This puts the banks in a precarious position, which in turn causes the government to tighten up regulations around banks using the logic that it must have been profligate lending and behavior by the banks that caused the implosion to begin with. This has the effect of massively reducing lending into the economy for the first half of the next cycle, so only stocks and companies that can show high growth levels can raise capital easily.

The second reason that growth typically outperforms in the first half of the new cycle is that the debt implosion also causes the Federal Reserve to reduce interest rates to rock bottom levels which allows discounted cash flow statements to look even better for those companies projecting large growth rates into the future. This makes investors feel better about deploying capital.

Lastly, many of the sectors and companies that were caught up in the bubble from the previous cycle have now collapsed under huge debt levels and will face many years of digging themselves out of the mess before they can be considered in favor again. Take the banking, homebuilding and commodities related sectors for instance, these sectors typically all enjoy massive success in the second half of the cycle as the government is pouring huge amounts of cash into infrastructure projects and homebuyers have been buying houses at ever increasing prices into the ultimate cycle peak and crash. Once the cycle rolls over, commodity and mortgage debt demand fall precipitously because everyone who did not see the turn coming is now caught in the down cycle. This wreaks financial havoc on those most levered and not prepared.

Mid-cycle Recession Facilitates the Handoff

In the middle of the 18.6-year cycle, there is almost always a mid-cycle recession such as the dotcom bust or the Covid panic of 2020. This sharp downturn causes the government to panic and pour billions if not trillions of dollars into infrastructure projects and stimulus projects. This recession is also the typical hand off period from growth stocks to the aforementioned cyclical assets and value stocks. This is because the government and the Fed are now content with letting inflation run hot as they pour massive stimulus into the economy in order to avoid a double dip recession. They also incentivize banks to begin loosening lending policies to get the economy going again. This ultimately ends up with mortgages handed out to anyone who wants one for almost any house or home equity line of credit they can think of. This increased lending, increases demand for homes along with the massive infrastructure projects enacted by governments, putting upward pressure on commodity demand and therefore home and commodity prices. This continues on for 5-7 years as everyone begins to make money and feel good again, ultimately leading to overspeculation and a cycle top.

The Dollar's Role

In the next few sections, we will walk through the history of this back-and-forth outperformance positioning of growth in the first half and cyclicals/value assets in the second half by looking at several different charts that tell the story very well. The first chart we will look at is the long-term chart of the US Dollar. We will look at its long-term movements up and down as it very clearly follows the two halves of the 18.6-year cycle.

The chart we are going to look at below is one that I built showing the US Dollar along with oil, the CRB commodity index, gold and the emerging market ETF (EEM). The dollar has been in an 11-year rising channel which began in the very beginning of 2009 as stocks were sniffing out their lows. This chart shows the history of these assets going back to the early 1980's, which gives us two full cycles to analyze. I realize this is not a large sample set of data, but studies of the history of markets and this 18.6-year cycle does go back 200+ years.

Figure 1:



Source: Chart Courtesy of StockCharts.com

Largely what we see in the first half of the cycle is that growth and tech companies lead the markets higher as disinflationary conditions unfold stemming from the bursting of the previous 18.6-year cycle bubble. During this part of the cycle, the Dollar strengthens as the bad debt from the previous cycle downturn is written off at a greater rate than the government can provide stimulus, thus creating the disinflationary environment. Then we go through the midcycle recession, which clears the path for consumers to begin borrowing again as governments attempt to stave off another crisis with even greater stimulus. These factors together typically send inflation higher and the dollar lower. That is precisely where we are sitting today.

If we look at the chart above (figure 1), we can see that the last two upswings have lasted approximately 105 months (nearly 9 years). Then we see swings lower

for 7-8 years. The dollar cycle topped in early 2017 and double topped in 2020, which suggests that we should see a move lower into approximately 2028 – exactly when the 18.6-year cycle is expected to be in the most intense phase of the next panic.

The ramifications of this potential move lower in the dollar are many. This move has historically caused commodities to move higher, including oil, silver, gold and lumber. Lumber and gold have already hit new all-time highs in recent months as this reflation has begun. We would also expect to see sectors such as homebuilders, industrials and materials move higher along with banks and emerging markets – especially Latin America countries such as Brazil. In the last multi-year run lower in the dollar, the Brazilian stock market tracking ETF (EWZ) went up 20-fold.

Now on to the chart itself – I already mentioned the time cycles that the dollar has been moving in over the last 40+ years – but there are several other technical indicators going on here as well. If the dollar has indeed topped, then it has completed 4 waves (2 down and 2 up) out of a 5-wave formation. The next wave should be down in this case. The dollar also formed and broke down from a diamond shaped topping pattern that formed from 2015 to 2020 and has also broken the uptrend line that has been in place since 2011.

Oil and the CRB index have likely completed their 5 wave formations in their respective 12-year bear markets. We had been looking for an oil price low in the neighborhood of \$10, and we saw prices move lower than even that extreme back in March of 2020. As mentioned earlier, gold has moved to new all-time highs recently, which is likely telling us that inflation is heating up and probably starting a new commodity bull market. Lastly, emerging markets have largely gone nowhere for the last decade as the dollar has moved higher. This will most likely change in a big way if we see another sustained run lower in the dollar like we saw in the second half of the last two 18.6-year cycles. If this scenario does play out as described above, I think we can expect to see a much different regime in markets with growth taking a back seat to the sectors and assets mentioned above.

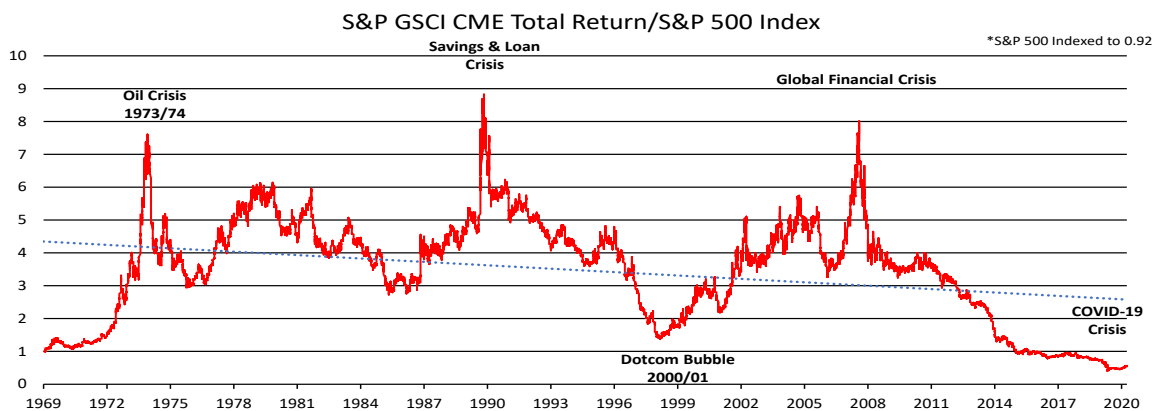
Alternating 18.6-Year Growth/Value Stocks Structure

As we have mentioned several times above, growth leads in the first half of the 18.6-year cycle and hands off to value stocks and inflation sensitive assets in the second half of the cycle. In Figure 2 below, we see a ratio chart of the S&P GSCI Total Return Commodity Index vs. The S&P 500 since 1971 when the US went off the gold standard. As we can see in the chart (figure 2), the ratio of commodities to stocks spike hard into a peak that is about 18 years between tops. The first peak is a little skewed from a timing perspective likely due to the Oil Crisis and the US Dollar’s removal from the gold standard which caused massive dislocations throughout the 1970’s.

The 1990 Gulf Crisis peak also happened to be the exact timing of the Savings and Loan Real Estate Crisis. The Global Financial Crisis in 2008 was, of course, the real estate caused global meltdown that we all experienced. There was a 1972 peak in both real estate activity and prices, but it was trumped by the sharp inflation of the 1970’s.

We can see that this ratio bottoms near the mid-cycle slowdown and peaks with a massive spike at the end of cycle downturns. Interestingly, commodities tend to produce rounded bottoms and spike highs whereas stocks tend to produce rounded highs and spike bottoms.

Figure 2:



Source:
Internal and
Bloomberg

Assets That Have Historically Benefitted

In the following charts we will look at the ratio of other inflation linked assets to the Nasdaq (growth stocks) to see how they have performed over the last 20 years, and where they are today. The first one we will look at is the ratio of the US homebuilders index to the Nasdaq. The homebuilder index outperformed the Nasdaq by over 2400% from the mid-cycle bottom to the housing peak in the last cycle. And true to form, the homebuilders to Nasdaq ratio fell by 90% in the first half of this cycle. The ratio is starting to turn higher and has outperformed the Nasdaq by 48% since the March 2020 low. This outperformance from 2000 to 2005 and the outperformance since the March 2020 low are exactly in line with the bubble behavior that happens in the second half of the 18.6-year cycle. Similarly, the extreme underperformance is exactly what we expect in the first half of the cycle as the economy recovers from the previous cycle collapse.

Figure 3:



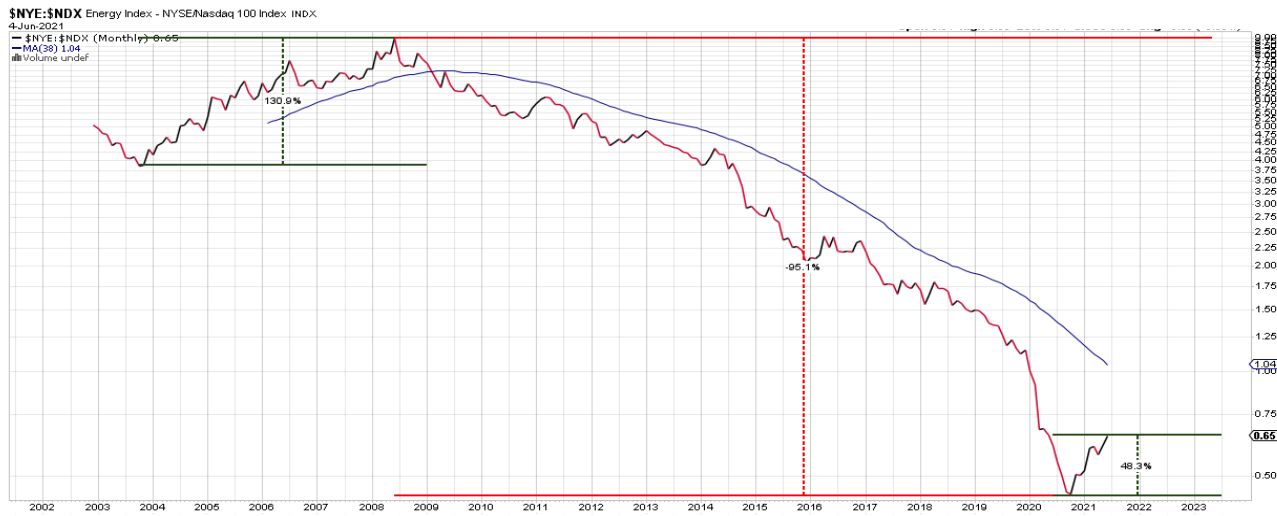
In similar fashion to the homebuilder stocks, banks tend to outperform in the second half of the cycle. Much like the increased demand and improved economic picture that benefits the homebuilders in the second half, banks tend to see much higher profits as they increase lending to finance all of the houses being bought. Not only do the banks begin to see much higher demand for loans, but they have also spent a decade or more repairing their balance sheets after the previous financial crisis. They have also typically spent several years lobbying Congress to roll back some of the more draconian regulations that are always put in place in response to the crash in the previous cycle. These factors combine to provide a fertile ground in which banks can begin to see profits grow in a way that they have not experienced in the first half of the cycle. As we can see in figure 4 below, banks outperformed the Nasdaq by over 430% in the second half of the last cycle. So far this time around, the index has outperformed the Nasdaq by over 50%.

Figure 4:



Another group we should look at is energy stocks. With commodities and inflationary assets typically outperforming growth stocks in the second half of the cycle, we would expect to see energy stocks outperform as well. The sector definitely underperformed in the first half of the cycle as we would expect. The energy to Nasdaq ratio was down 95% in the first half of the cycle as oil fell into the extreme lows of its secular bear market. Since hitting the aforementioned lows in March 2020, the energy sector has outperformed the Nasdaq by approximately 48% as of the time of this writing. From 2003 to 2008 (which was the second half of the previous cycle), energy stocks outperformed the Nasdaq by 131%.

Figure 5:



Source: Chart Courtesy of StockCharts.com

The last example we will look at is the materials sector to Nasdaq stock ratio. Being the US stock sector (outside of energy) most directly tied to commodities, we would expect this ratio to rise in the second half and fall during the first half of the 18.6-year cycle. This is exactly what we have seen over the last 20 years. The ratio was up approximately 475% in the second half of the last cycle and is down approximately 75% in the first half of this cycle. So far, the materials sector to Nasdaq ratio is up 23% in the second half of the current cycle.

Figure 6:



Source: Chart Courtesy of StockCharts.com

Although we only have approximately 20 years of data for these ratio charts, the first ratio chart (figure 2) going back to 1971 is a very good blueprint for what we should expect going forward. In my mind, these charts solidify the fact that the US Dollar historically falls in the second half of the 18.6-year cycle as borrowing, stimulus and construction pick up in earnest causing inflationary forces to inflate these assets. Conversely, the charts also show that the Dollar rises in the first half of the cycle due to deflationary forces from the bursting debt bubbles brought on by over speculation and over lending to real estate projects and wildly

overleveraged consumer credit levels. By knowing the structure of the 18.6-year rotation from technology/growth leaders in the first half of the cycle to inflationary/value leaders in the second half of the cycle, investors may have a better idea of when to transition from growth leaders to cyclical/value leaders and why the respective assets are leading at different points during the cycle.

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