NEUBERGER | BERMAN

Late Cycle Investing: What's Next?

Disruptive Forces in Investing

August 22, 2019

Anu Rajakumar: According to the National Bureau of Economic Research, we are now experiencing the longest U.S. economic expansion in American history. According to today's guest, Erik Knutzen, Neuberger Berman's Chief Investment Officer of Multi-Asset Class Strategies, we still have some way to go before the end of the cycle. Welcome to Disruptive Forces, a podcast from Neuberger Berman where we discuss insights and innovations in the investment management industry. I'm your host Anu Rajakumar and today's episode is all about late cycle investing. Erik, thank you for joining me today.

Erik Knutzen: It's great to be here, Anu.

Anu: So Erik, you and I work together on the Multi-Asset Class team where we focus on strategic and tactical asset allocation across the investment spectrum. And we've been speaking to a number of our clients, large and small around the world, who want Neuberger Berman's insights about how much longer this record-breaking U.S. economic expansion can last. What are you sharing with them regarding where we are in the cycle?

Erik: Our view is that we are in the late stage of the economic cycle, however, it is unlikely, in our view, that this cycle will end in the next six to 18 months, and in fact may continue on for some time.

Anu: Now this cycle has been unique. It's long and shallow. But with that said, there have been some bumps along the road but none of those have led to a recession. Why is that, and what do you think could be the catalyst to the end of the cycle?

Erik: This has been an extraordinary cycle. And the length of this cycle I think can be attributed to first and foremost that, the start of the cycle and the Great Financial Crisis of '07, '08 and into '09 was the most severe economic crisis that we have experienced since the Great Depression, so we started at a very low level. The second reason is that the monetary and policy tools that have been used have led to a very shallow and gradual response. And so we have seen on average 2 percent real economic growth in the United States over this 10-year period of time. That is a quite shallow recovery. So that has not led to as many major excesses as we have seen in prior economic cycles. Now, as you said Anu, we have had a number of bumps along the road and I think those have served to extend the cycle, whether it was the European debt crisis in 2010 and '11. The Taper Tantrum in 2013, the Chinese Devaluation and oil price declines in '15 and early '16, even the volatility we saw late last year and continues into this year in May, in late July and early August of this year. Each of these episodes have served to take some excesses out of the system and we believe, likely extend the cycle. In terms of what could cause an end to this cycle, we look back at history and there have been four major reasons why economic cycles have ended historically. Those include an inventory correction, an inflation shock, an energy price shock or significant financial imbalances. And given where we are in the global economy demographics, we do not think that we are at imminent risk of an inventory correction with just in time inventory management and global supply chains or an energy shock with the shale revolution and energy revolution that has made the U.S. and developed market economies less sensitive to changes in energy prices. And also the inflation shock does not seem as imminent where we have not been able to generate inflation from Central Bank or fiscal policy actions over the last number of years. So we're really very focused on financial imbalances. And in fact, significant financial imbalances have led to the ends of the last two cycles. And so those that's the key set of drivers that we're looking at.

Anu: I'm just curious if you could share what are some of the indicators that the team is looking at, and what are you seeing in those indicators?

Erik: We look at an array of indicators from financial market indicators to more real economic indicators, leading economic indicators, levels of unemployment, of inflation, financial indicators, stock market levels, price to earnings ratios, debt levels, etcetera, etcetera. And given a battery of those indicators, very few are flashing red in terms of real excesses or imbalances. Two that are potentially is the shape of the U.S. Treasury yield curve which has been inverted in portions of it since late March and more recently became more significantly inverted from three months to two years out to ten years. Historically this has been an indicator of impending recession—at this point however, we do not believe that this is necessarily a significant indicator of recession in the United States over the next 12 to 18 months. At this time there are other factors that we believe are driving the inversion of the treasury yield curve as apposed to expectations of future economic growth. These other drivers include low growth and negative interest rates overseas, that have led to a negative term premium in the treasury yield curve. It is our view that other drivers of the U.S. economy remain robust, including a healthy consumer, lower rates and increasing monetary stimulus as the Fed looks to reduce rates. In fact, we do expect the Fed to continue to cut short term rates and over time we believe that this will address the inversion of the yield curve. The other concerning indicator right now is around corporate debt levels which are elevated and at secular highs. However, corporate credit fundamentals remain strong. And so we do not believe that corporate debt levels will be an imminent catalyst for the end of cycle.

Anu: We released a paper earlier this year called, “Survive and Thrive”, which provides four principles for investing in the late cycle. We’ll add a link to the paper in the show notes so listeners can take a read at their convenience. But, Erik, in the paper you explain why the late stage of the cycle is the most complex and challenging time for investors. Could you briefly share some thoughts on that?

Erik: No stage of the economic cycle is easy. All stages require thoughtful insight, analysis and courage for investors to invest well. However other stages of the cycle are more straightforward in terms of the implications for investment portfolios. We’ll start with the end of cycle. An environment where bubbles are bursting and investors simply want to be allocated to risk off assets, to reduce risk in portfolios. It’s very straightforward, just take risk down. Early stage in the investment cycle, again, not easy to identify but the implications are straightforward. You want to begin to start easing into riskier assets which will be recovering as policymakers respond to the late cycle environment and turn on spigots of monetary policy and fiscal policy. Mid cycle is very obvious. It’s a positive economic growth, inflation is not there yet. Interest rates are still well-behaved, if not declining and it’s really just exposure to risk on assets, equity, credit, growth oriented assets. Now we come to the late cycle environment and we find this to be much more complex. Economic growth is still in evidence. Although there may be concerns about the pace and direction of that growth as we see now. It is likely in the late cycle that we’re starting to see pricing pressures whether from labor prices or wages and commodity prices. It is likely that interest rates are starting to rise. And these dynamics are beginning to put pressure on corporate profit margins, on fundamentals. Corporations may still be expanding their balance sheets, taking on more debt to build capacity and response to economic growth. But that is leading to a deterioration in credit conditions. At the same time that volatility is starting to increase, it’s starting to manifest and is likely that stock bond correlations are increasing. The implications of this fact pattern, of this array of factors is less straightforward for investors.

Anu: So in our discussions with clients, we’re focused on asset allocation from both a strategic and tactical perspective. So what goes through these four key principles for late cycle investing?

Erik: So, in our paper, as you said, we identify the four principles that we recommend clients consider as they address the challenges of investing in the late cycle. The first is, distinguish signals from noise. Along with market volatility, the late cycle environment is very noisy and we are in a particularly noisy environment right now.

Anu: Tweets, trade rhetoric.

Erik: Yeah, daily—and one of our comments is it’s important to distinguish between the news cycle and the business cycle. Get past that daily barrage of information and focus on what can really drive the economy. And that gets to those indicators that we described earlier. And based on that array of indicators, there is no more evidence of financial imbalance in the system now than there was a year ago. What this tells us based on this array of views is that we still have some time to go. That the risk of recession in the next 12 months is still modest.

Anu: Now the second principle is reassess strategic asset allocation. Could you talk a little bit more about that?

Erik: Many investors, at this point in the cycle may have allowed their asset allocation to get out of balance. And we think that it’s very important to reassess the overall balance in your strategic asset allocation to make sure you’re not solely bias towards equity or credit or growth-oriented assets, but to ensure that there is true and proper diversification built into a strategic asset allocation. One important aspect of this right now is that it is likely that as the business cycle continues, the correlation between stocks and government bonds increases. Investors have had something of a free ride for the last 10 years as stock-bond correlations have been negative. Historically, over the long term, they’ve actually been slightly positive and late in a business cycle as inflation and economic growth increases, those correlations tend to creep higher. So, investors may not receive as much diversification benefit from owning government bonds to help offset the risk of their equities as they may have seen historically. So we think it’s important to, first of all, make sure that you’re comfortable with the equity risk in your portfolio, that that hasn’t gotten, kind of out of bounds as it were. And second of all, look to other sources of diversification. Yes, you can own some government bonds, of course and other investment grade fixed income, but consider inflation sensitive assets, TIPS, linkers, to inflation linked bonds, commodities. As well as uncorrelated strategies.

Anu: And what are some specific examples of uncorrelated strategies that you find particularly attractive right now?

Erik: These can be strategies that are seeking to take advantage of other compensated risk factors in markets. Those can be style premia type strategies. They can be more hedged or alpha oriented strategies, strategies that seek to take advantage of other risk exposures which may not be tied to global markets such as, insurance linked strategies and exposures. They can be strategies that are associated with trend following or momentum which tends to do well when, volatility is increasing and traditional markets are selling off.

Anu: And the third principle is identify through cycle themes which I understand to be, you know, kind of the mega trends that we've been speaking about on this podcast so far. Could you explain a little bit more about that?

Erik: Here are the ideas to, look to have components of a portfolio that are not dependent on the short-term vagaries of the business cycle. One key component of this can be private market strategies. Strategies where capital is locked up for the long-term and is being invested in companies or credit or real estate or other real assets that either are not dependent on more cyclical aspects of the economy, or which can specifically weather downturns. Other examples would be liquid market exposures which have return drivers that are secular and long-term in nature and are not tied to the business cycle. Examples of those could be thematic strategies tied into, the kind of trends that are changing society over the long-term. Trends around autonomous vehicles and 5G technology. Trends around Fintech, disruptive financial technology. And another category is tying into economies that have their own long-term cycles. So, a number of emerging market economies are either earlier in the cycle or they have very different growth dynamics than the kinds of cycles that we see in the developed markets. And here there is an opportunity to invest in companies that are benefiting from the rising consumer in these markets or very positive long-term demographics where investors can benefit from long-term growth drivers that will be somewhat distinct and separate from the more traditional developed market business cycle.

Anu: Makes sense. And the fourth principle, Erik, is be prepared to provide market liquidity which of course means more than just holding cash.

Erik: We think there will be increased episodes of this because many of the traditional liquidity providers are no longer in the system, banks, and brokerages and what not are no longer providing as much capital. So if as an investor you can step in and be a liquidity provider at those times, you are in position to benefit through the late cycle and into the end of cycle. A key aspect of this also is to have a governance framework over an investment program that allows that program to be nimble and opportunistic and take advantage of those environments.

Anu: That's true. Often times it seems that attractive investment opportunities arise when market volatility heightens. I'm just curious, Erik, what keeps you up at night at the moment?

Erik: Well, I think a question that all investors should ask is how could this time be different and it is reasonable to assume that this cycle will end in the manner of prior cycles which is through an aggregation of excesses that leads to bubbles and then bubbles burst and markets sell off, businesses have to change and we start all over again. If this time is different though, it may be that we simply fall back into recession or experience a very prolonged experience of very low growth without inflation. And we're seeing now as QE has not worked terribly well in Europe, in Japan, and Europe is revisiting the notion of QE. Certainly if we experience a recession sooner rather than later without major excesses and before policymakers have rebuilt their toolbox of applications to help address a downturn, then we are at risk of a more shallow recession because we won't have the excesses to lead to the sharp break but perhaps a longer period of negative or slow or low growth.

Anu: Thanks Erik, that's a really helpful roadmap for this stage of the business cycle. I'll quickly summarize your 4 key principles again 1) focus on signals not noise, 2) reassess strategic asset allocation, 3) identify through cycle themes and 4) be a liquidity provider. And on that note Erik I want to thank you for joining me on today's show.

Erik: My pleasure.

Anu: And for our listeners, if you'd like to learn more, I encourage you to read our publication, "Survive and Thrive." You'll find a link to it in the podcast show notes or you can find it on our website, www.nb.com where you can also learn more about our firm and offerings. And if you haven't already subscribed to our podcast, please do so via Apple Podcast or Google Podcast. Thanks for listening.