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Schroders

Late cycle investing: Are investors in for a Dickens of a time?

September 2018

It was the best of times; it was the worst of times....

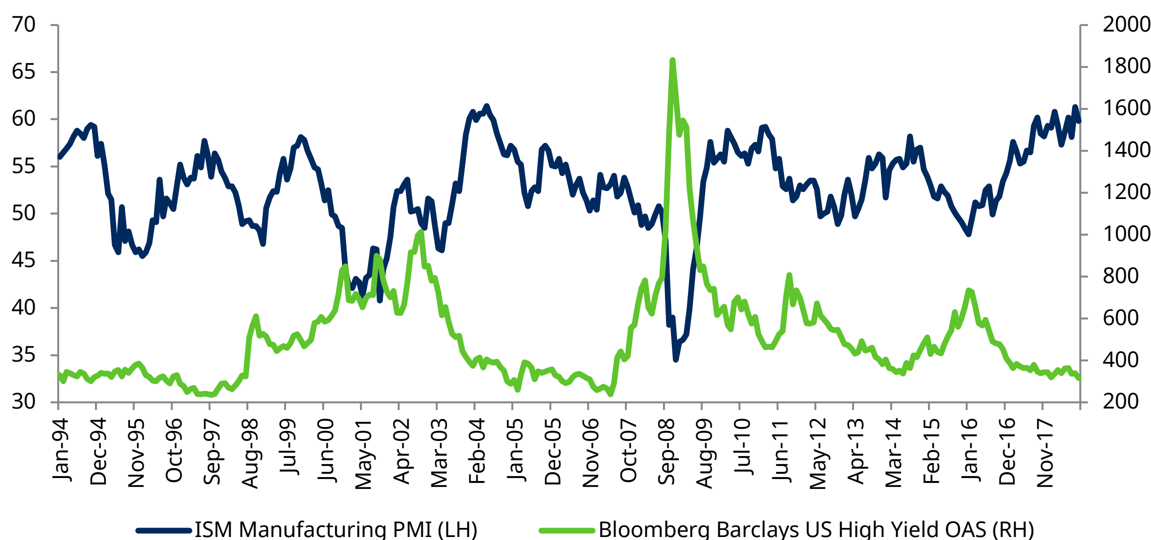
Charles Dickens' famous opening sentence from his 19th century novel *A Tale of Two Cities* is an ideal allegory for the environment we operate in today. The economy is booming, we have the lowest unemployment since the moon landing and Federal Reserve (Fed) Chair Jerome Powell recently cited a "remarkably positive outlook." Simply put, for the US economy, it is the best of times. However, the corollary is that the opportunity, value and tailwinds in a variety of fixed income assets are as challenged today as they have been for a number of years. For those looking to find outsized gains from risk assets, it really is the worst of times.

A strong economy doesn't necessarily transform into strong financial markets

Surely +4% prints on GDP, full employment, and rising bond yields suggest you should allocate more, not less, to risk assets? We would advise more caution as markets are finally transitioning from an environment of negative to positive real interest rates for the first time in over a decade, and the consequences are likely to be profound. The impact is already being felt as an environment of suppressed volatility, low term premium, yield chasing, and relentless stock buybacks is becoming increasingly challenged.

The peak for risk assets often occurs when economic data is strongest, as shown in Figure 1, for ISM Manufacturing PMI versus high yield credit spreads below. In addition, historical analysis confirms that prospective 5-year returns for equities (S&P 500) tend to be negative when the unemployment rate drops below 5%.

Figure 1: High Yield OAS tends to widen after peaks in PMI

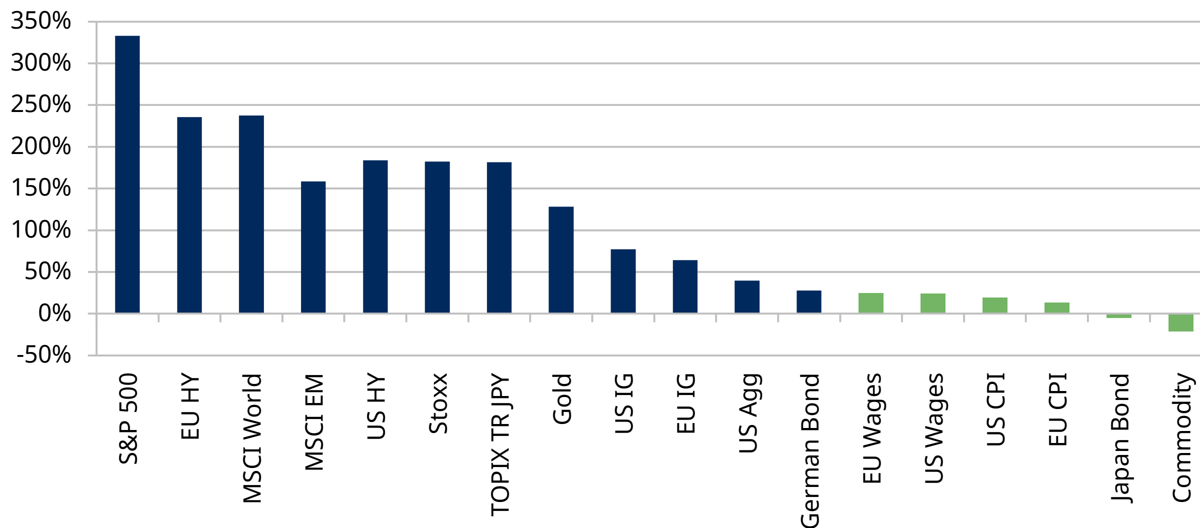


Source: Bloomberg, Schroders, as of September 30, 2018.

Although corporate earnings have been strong, it is important to keep in mind that earnings and data prints often give you a good idea of where the economy has been and are less illuminating in where it is going. Don't forget that in 2007 Lehman Brothers made profits of $4.2 billion on revenues of $19 billion!

In order to identify what is likely to drive financial assets in the coming quarters, we need to understand what has driven the remarkable rise in most financial assets in recent years. In the 10 years since the financial crisis, we have seen truly remarkable outperformance of financial assets versus the real economy (see Figure 2).

Figure 2: Total returns of various indices over the past 9 years (January 2009 – September 2018)



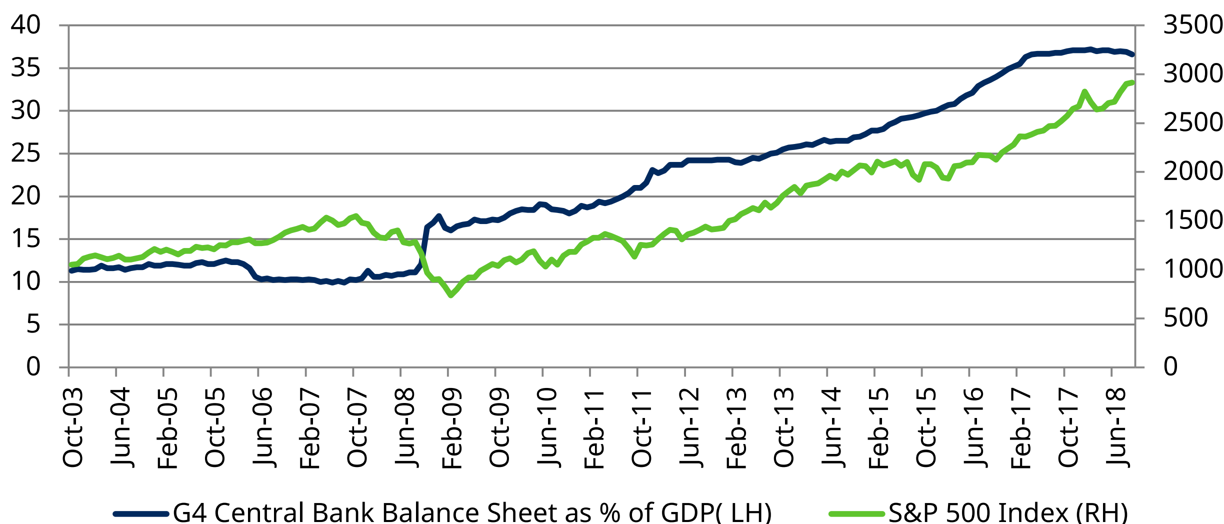
Source: Bloomberg, as of September 30, 2018. Past performance is no guarantee of future results. Investors cannot invest directing in any index.

Much of this growth is justified given the starting point in valuations and the recovery from the steepest financial crisis since the great depression. However, we believe that there were other equally important drivers, all of which are now moving into reverse: growth in central bank balance sheets, low inflation, low overall yields and zero returns on cash.

Central banks have our back?

All three drivers are connected, but perhaps the most important has been the extraordinary accommodation of central banks and unprecedented expansion of their balance sheets. A regression of credit spreads or equities (S&P 500) versus growth in G4 balance sheets shows an alarmingly high degree of correlation (Figure 3). The Fed has already started to reduce the size of its balance sheet and the European Central Bank is expected to end its purchase program at year-end. We do not believe it is a coincidence that we have seen a significant increase in volatility this year coinciding with slowing growth in central bank balance sheets.

Figure 3: Central Bank balance sheets and Equity markets are at all time highs



Source: Bloomberg, Schroders, as of September 30, 2018. Past performance is no guarantee of future results.

In addition, the Fed under Chairman Powell appears to have a slightly different approach from his predecessors. Jerome Powell's plain-speaking pragmatic style is a refreshing change from the academic and model-driven dogmatism of recent chairs. One crucial difference is Powell's recognition that the last two downturns have been driven by asset bubbles (dotcom in 2001 and subprime in 2007) rather than inflation.

"In the run-up to the past two recessions, destabilizing excesses appeared mainly in financial markets rather than in inflation. Thus, risk management suggests looking beyond inflation for signs of excesses." – Jerome Powell, Jackson Hole August 2018

This is a crucial distinction and indicates that he may be willing to go further and faster than markets appreciate in hiking rates regardless of the impact on financial assets. In fact, these comments suggest he would like to take some of the froth out of markets. Financial assets have benefited over the last few decades from what became known as the "Greenspan put"—a belief that the Fed will be there as a backstop for markets in time of financial stress. It is our belief that Chairman Powell may not be as accommodating.

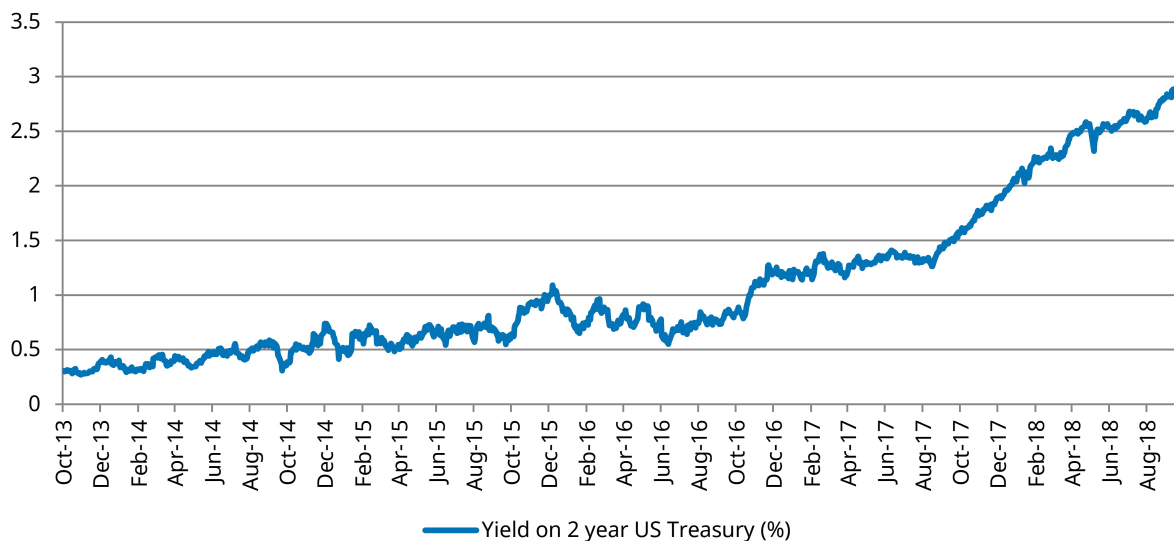
We are already seeing the impact of increasing real rates on global markets.

There is no alternative (TINA)?

While there is no natural limit to the end of a cycle, they are often derailed by higher interest rates; with the 10-year US Treasury at five-year highs we may be closer to the end than the beginning. We are already starting to see some pressure in interest rate sensitive portions of the market, such as the housing market, with existing home sales and building permits under pressure and homebuilder stocks off 25% from their January highs.

Real yields are breaking out to post-crisis highs in the US which implies monetary tightening is taking hold and diminishes the appeal of riskier assets. As we wrote about earlier this year in the first quarter paper titled *Is cash king? No – but short maturity bonds just may be!*, the ability to earn a "risk-free return" of 3% on a short duration Treasury fundamentally changes the calculus for buying riskier assets (Figure 4). The TINA investment regime where zero returns on cash forced you to extend down the risk spectrum is now behind us.

Figure 4: Income on short duration is higher than it has been since the Great Financial Crisis



Source: Bloomberg, Schroders, as of September 30, 2018.Yields fluctuate over time.

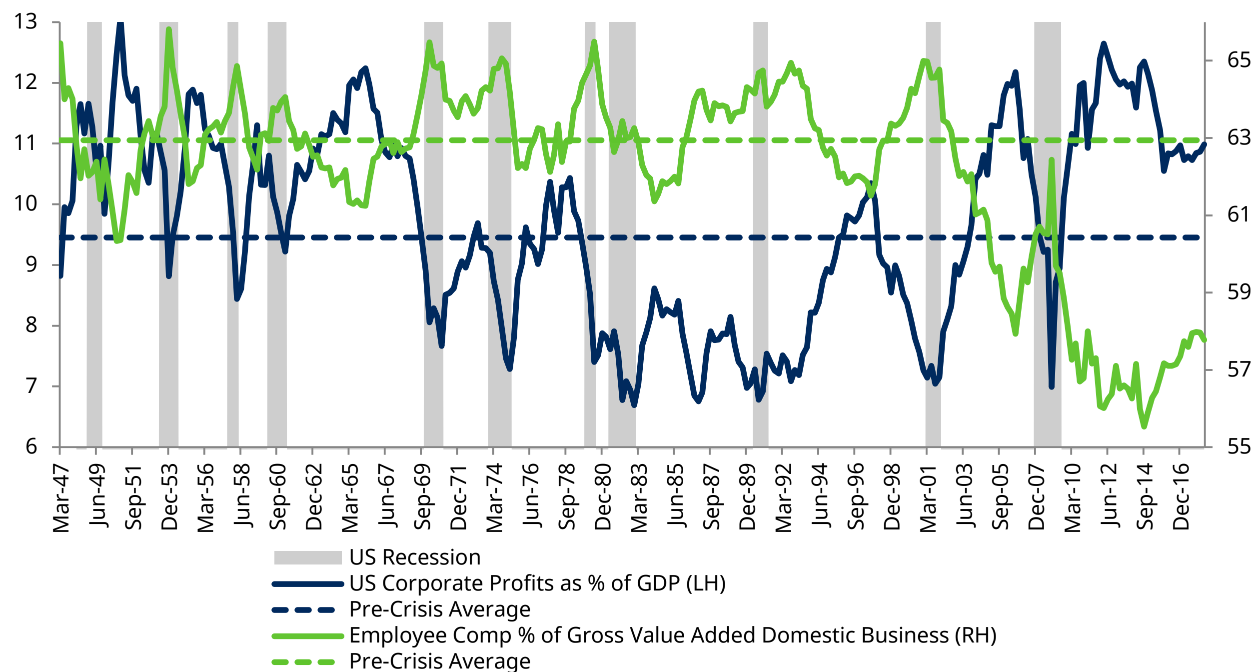
Peak profitability – from capital to labor

Stronger growth is also drawing down capacity and creating inflationary pressures. The Atlanta Fed median wage growth tracker is approaching its highest level since the financial crisis and our analysts see capacity constraints across a broad array of industries. The trucking industry, for example, is one where shortage is particularly acute with an estimated 50,000 shortfall in drivers and skilled drivers commanding salaries in excess of $100,000. This isn't just a US phenomenon, it's a global phenomenon.

This is important because subdued inflation and wages have had two consequences. First, it has enabled the Fed to pursue extremely accommodative monetary policy. Secondly it has allowed profits to take up a disproportionate amount of GDP relative to labor. Figure 5

demonstrates labor share as a proportion of GDP is close to 60 year lows. The chart also shows a reversion to the mean tendency, suggesting the pendulum is swinging back towards labor or from Wall Street to Main Street.

Figure 5: Corporate profits and employee share of profits are far from historic normals



Source: Bloomberg, Schroders, as of September 30, 2018.

Rising wages, increasing input costs and even politics will create more pressures on margins moving forward, which may challenge the very benign earnings outlook. Amazon recently announced a minimum wage increase to $15. With the S&P 500 ending the quarter near all-time highs and rosy expectations for the first half of 2019, the hurdle for disappointment is relatively low. This is also ignoring the potential headwinds of slowing global growth, escalating trade tensions and a stronger dollar.

When will the economic cycle end?

To be frank we don't know, nobody does with any certainty, particularly the Fed and refreshingly they have admitted as much recently. The International Monetary Fund (IMF) says it most succinctly "the record of failure to predict recession is virtually unblemished." This is the reason we try to limit the amount of forecasting embedded in our investment process and focus more on what we can calibrate, namely price.

Although our expectation is that US growth will remain strong for the immediate future, the recent enthusiasm from Powell "there's no reason to think this cycle can't continue for quite some time, effectively indefinitely" should be treated with at least some element of caution. Maybe he's right, but circumstances in markets change fast and markets often inflect when optimism is highest. For perspective, below are some comments prior to the last three down turns.

1990-1991 Recession
"In the very near term I see little evidence to suggest the economy is dipping into recession." – Alan Greenspan, July 1990

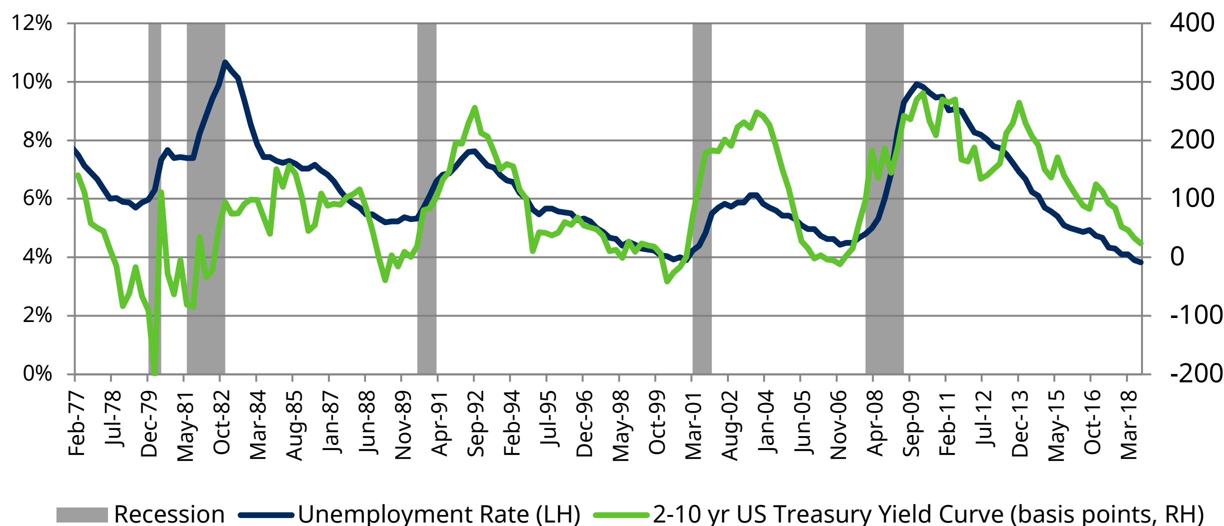
2001 Recession
"Survey conducted in March 2001, 95% of American economists said there would not be a recession"

2007-2009 Recession
"Overall, our forecast could admittedly be read as still painting a pretty benign picture." – Ben Bernanke, December 2007

Historically the market has been a far more reliable indicator of downturns than any economist, and according to research by the St. Louis Fed, the two most reliable indicators historically have been yield curves and the unemployment rate. The research revealed these two factors have anticipated every downturn since 1969. An inverting yield curve and trough in the unemployment rate has on average led a recession by 9 and 10 months, respectively.

As shown in Figure 6, the unemployment rate is approaching the lowest level in 30 years and the US Treasury 2-10 year yield curve spread is approaching zero (Eurodollar curves have already inverted briefly). This doesn't necessarily suggest a rush for the exits, but it does indicate that we should at least be entertaining the possibility of a transition in economic circumstances, particularly when we are approaching the longest economic expansion since recordkeeping began in 1854 (we are 112 months into the current recovery, eight months shy of the previous record from 1991 to 2001).

Figure 6: Unemployment troughs and inverted yield curves typically indicate a recession is on the horizon



Source: Bloomberg, Schroders, as of September 30, 2018.

What is more important for the outlook for riskier assets is the rate of change in growth. The recent run for risk assets started in mid-2016 when the absolute level of growth was low, but accelerating. We have now seen nine consecutive quarters of year-over-year growth accelerating, which is a record. We expect that to moderate as year-over-year comparisons become more demanding and will present more challenges for riskier assets.

What else keeps us awake at night?

When markets approach inflection points, the trigger that pushes them over the edge are often factors which are exogenous to the broader economy such as a subtle shift in sentiment or dynamic. If we are all looking at the broader economy to offer comfort on the level of financial assets, we may be looking in the wrong place. As we alluded to earlier, even the best forecasters are likely to get it wrong, but understanding where the structural vulnerabilities may lie helps us navigate these risks and build more resilient portfolios. Although we do not claim to know the trigger for the next downturn, three areas we think bear watching include financial asset excesses, liquidity and changing bond/equity correlations.

Financial market excess

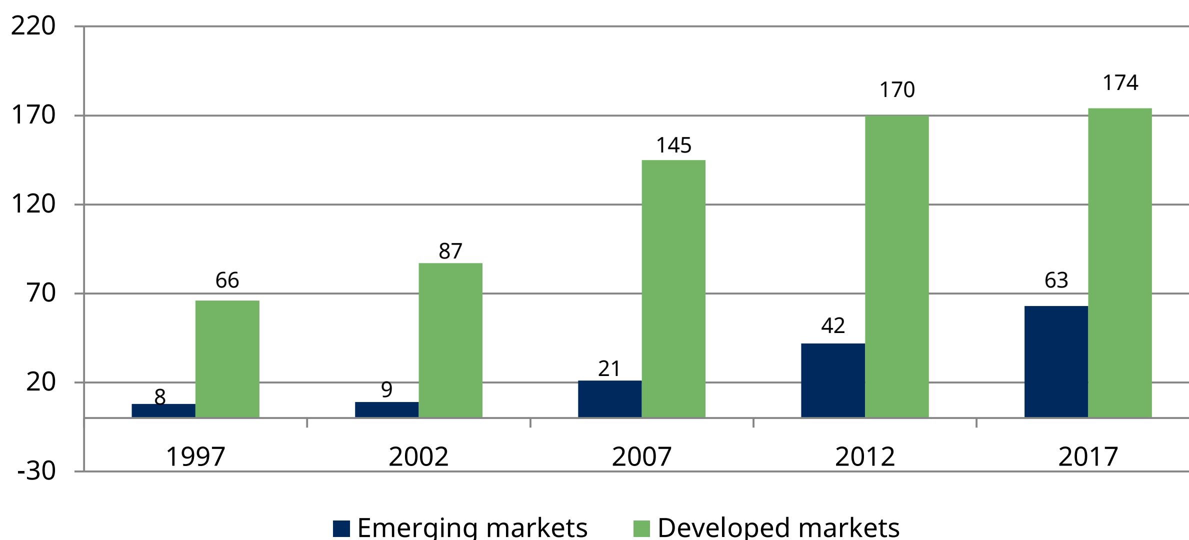
Although asset prices have seen a modest correction through October, asset prices across most risky US markets are at or around multi-year highs. While valuation excesses can persist for prolonged periods, the tailwinds which have created this environment, particularly central bank accommodation and lack of viable alternatives, are moving decisively into reverse. Global Central Bank stimulus has reduced the supply of financial assets by over a trillion dollars annually since the financial crisis. This has coerced investors into riskier assets as the alternative paid you nothing. And it hasn't been limited to financial assets—the price of wine, housing and fine art (to name a few) have all benefitted from this low rate, low volatility environment.

The IMF highlighted these risks in their recent financial stability report citing US equity valuations as "stretched" and volatility too low relative to forecast. They also cited concerns regarding the tight spreads of high yield and leveraged loans. No one can say with certainty where the risk taking has been the most irresponsible, but we would look to asset classes which have seen outsized growth since the credit crisis. One good example of that is the investment grade corporate market which has more than doubled in size since 2008 while the overall credit quality has fallen by one ratings notch. Another market we are watching is the leveraged loan market which has doubled in size since 2010 while the underwriting standards have deteriorated.

Debt has never been solved
Solving one crisis creates the ingredients for the next one, and the fundamental causes of the last downturns have never been addressed—debt. The vulnerabilities and potential instabilities the high levels of debt cause can be masked as long as liquidity is ample, money is cheap and asset prices are rising. It is no coincidence that the debt-heavy winners in the QE era, such as credit and emerging markets, have been increasingly challenged this year as rates have risen and central bank largesse has diminished. We expect this volatility to continue.

Ten years since the financial crisis, global debt levels have increased from $166 trillion to $237 trillion (Figure 7). The largest increases over the period were in Chinese debt, up an eye watering 460%, government debt up 73% and corporate debt up 62%. Interestingly financials which remain our preferred credit sector have seen the lowest debt growth.

Figure 7: Global Debt levels in USD trillions/Debt as a percentage of GDP



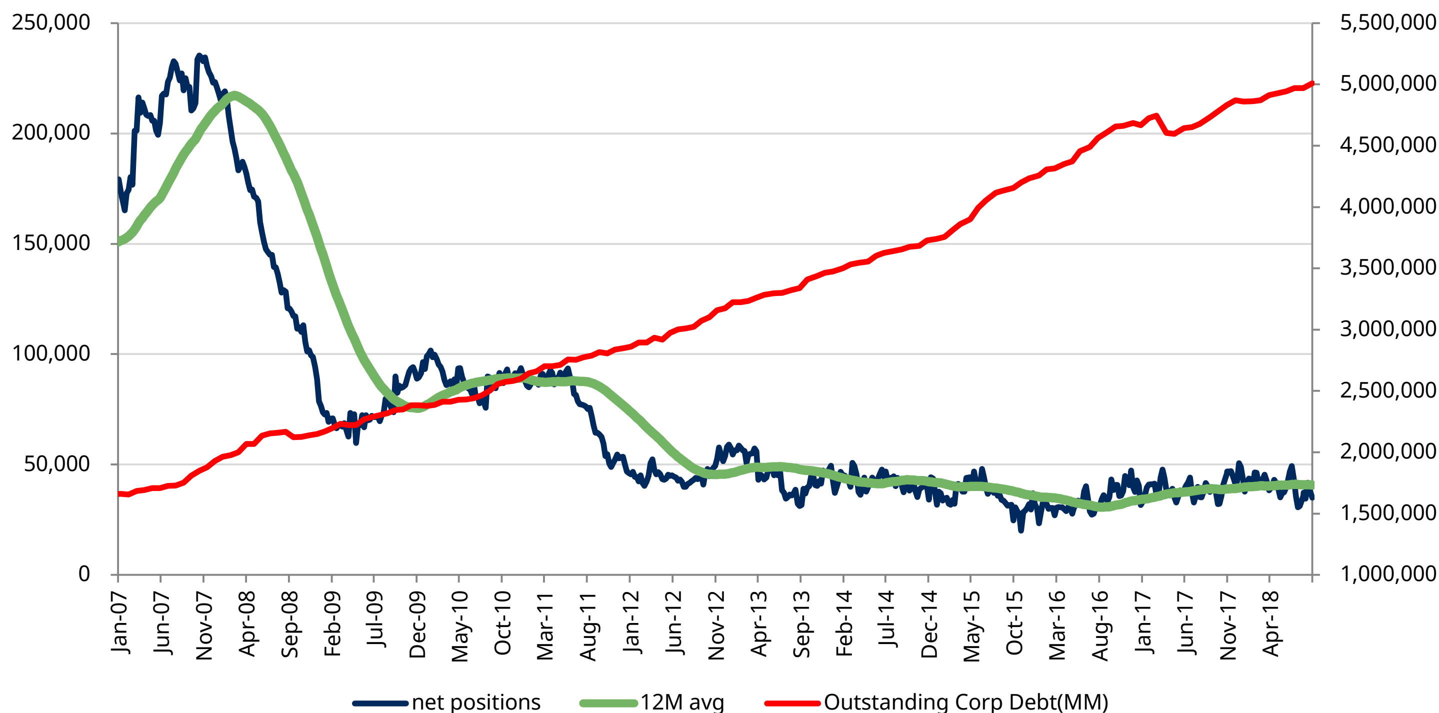
Source: IIF, BIS, IMF as of December 2017.

The other area of concern is the deficit and ballooning issuance in the US Treasury market. At the moment, pro-cyclical fiscal policy feels good and is benefitting the broader economy, but ultimately the consequences of higher debt will weigh on the markets. The federal deficit is up 17% over the last year and CBO projections suggest it could approach $1 trillion in 2019. We are in an unusual situation of falling unemployment AND a rising deficit. The last time the deficit was at these levels, unemployment was 7.5%. The longer-term repercussions are uncertain, but the complacency around it currently makes us uncomfortable. One thing that is certain is markets will need to absorb significantly more Treasury supply and this could crowd out assets in other sectors.

The Great Liquidity crisis – Less active, less intermediation, more gap risk
A final element of concern is one of market structure. One of the features of the post-crisis period has been increasing debt burdens, increasing regulation and the increasing trend towards passive strategies.

As we mentioned earlier we have seen exponential growth across a variety of riskier fixed income sectors particularly US dollar Emerging markets, leveraged loans and Investment grade credit. In the chart below we can see that since the financial crisis, investment grade credit (the red line) has almost tripled in size with BBB-rated bonds experiencing outsized growth. Against this, as a result of the Volcker rule, dealer inventories (green line) have collapsed to a quarter of their pre-crisis levels. This concerns us because it means that in a world of increasing model driven and passive flows, the ability of market makers to intermediate risk has been severely diminished. In times of market stress, overshoots and dislocations relative to fundamentals could be much more material than what we have experienced historically.

Figure 8: Debt markets have tripled while inventories are down 80% since 2007



Source: Bloomberg, Schroders, as of September 30, 2018.

Summary

Even though the US economy remains robust and imminent recession risks appear muted, we believe the outlook for riskier financial assets is likely to become increasingly challenged in the coming quarters. The tailwinds of the QE era are going decisively into reverse, valuations offer little margin for error and structural vulnerabilities are abundant. Unlike the previous 10 years, we now believe we have entered an environment where you sell the rallies, rather than buy the dips. As such, portfolio composition today and level of risk may look markedly different from recent quarters, and for good reason.

Outlook/Conclusion

Given the value lens through which we approach markets and the structural headwinds we believe are building, the appropriate fixed income portfolio today is very different from 18-24 months ago, particularly with regard to corporates. However, increasing volatility and shifting regimes often provide opportunity in alternative sectors. Currently, there are three areas we would highlight: municipal bonds, short maturity bonds and securitized debt.

The lowering of corporate tax rates and subsequent selling by banks and insurance companies has driven valuations in municipals to the most attractive in several years. We have not pulled the trigger yet but we believe we are approaching a point where significant allocation to the sector may be appropriate in non-tax paying accounts. In our view, high quality, shorter maturity bonds look attractive outright as well as against other riskier asset classes. Given flat yield curves and short maturity bond yields at 10-year highs, we can construct a fairly defensive investment grade portfolio with yields in excess of 4%. Finally, the securitized sector currently looks increasingly alluring, with cash rates rising, strong fundamentals and less reliance on foreign sponsorship.

In terms of asset allocation between corporates and Treasuries, our allocation to the former is as low as it has been in a number of years and the latter the highest. This is entirely deliberate. Allocation to lower rated and riskier segments of the credit market, such as subordinated debt and high yield, have been eliminated almost entirely. We still see some value in specific corporate industries such as financials and energy, but we no longer believe generic beta allocations are appropriate.

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