

Preparing Portfolios for Late Cycle Dynamics

After the late-2018 swoon in risk-asset prices, the early months of 2019 saw a sharp, steady rise in global equity prices, substantial declines in credit spreads, and lower global government bond yields. While concerns about slowing more aggressive Fed policies have clearly abated, growth and policy worries remain.

With global equities at or near all-time highs, spreads tight, and government bond yields low, valuations across asset classes are posing challenges. For investors seeking not only to participate in the rest of this cycle, but also to prepare for the next downturn, it is critical to build robust portfolios, designed to improve downside protection and diversification.

Against this backdrop, this piece will discuss our outlook for the sustainability of the current economic expansion, as well as the market positioning preferences and strategic priorities in the OCIO practice at State Street Global Advisors.

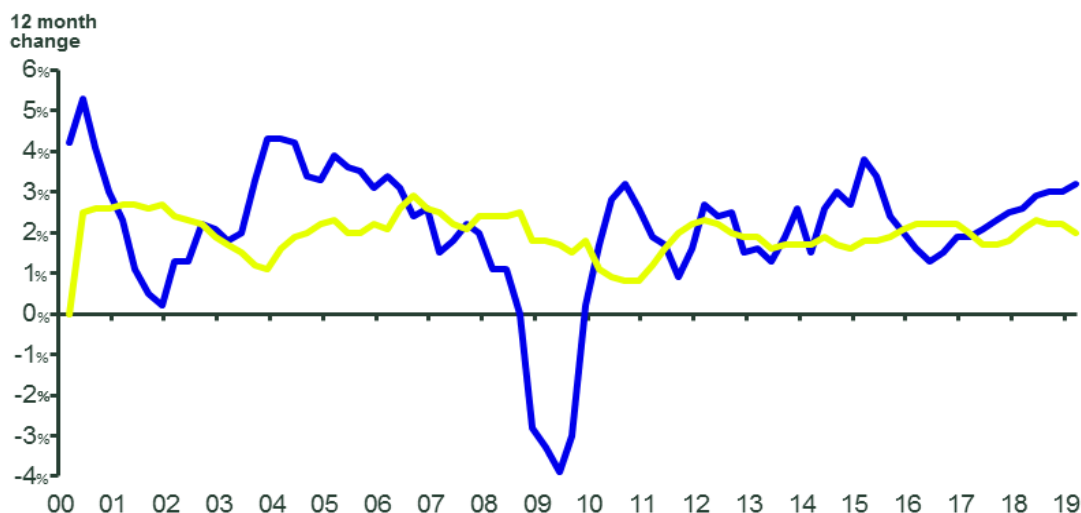
Continued economic expansion

The longevity of the cycle and the prospect for continued expansion are among the most important near-term issues for investors to consider. The current expansion and equity rally has recently celebrated its tenth anniversary following the global financial crisis – but the passage of time is only one very simple measuring stick. Although this has been one of the longest recoveries on record, it has also been one of the slowest, its early years hindered by deleveraging and balance sheet repair.



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Outsourced CIO Team

Figure 1. Moderate Growth and Stable Inflation



Source: State Street Global Advisors, Bloomberg. March 31, 2000 to March 31, 2019

Figure 1.

Legend

Real GDP
Core CPI

Looking ahead, we continue to see a backdrop that should be conducive to ongoing, if modest, expansion. In fact, we do not foresee a recessionary backdrop in the next 12 to 18 months.

Modest, sustained growth

In general, although there are some regional variations, there are three main sources of support for global growth. First, firm labor market conditions and rising wage growth should underpin consumption. Second, strong earnings growth (in most markets), healthy balance sheets, and access to capital are likely to continue to bolster business investment. Third, the absence of major imbalances reduces the risk of retrenchment. The pockets of leverage or the valuation concern that exist do not appear to be systemically destabilizing. Inflation also remains low and stable in most regions. Accordingly, central-bank policy has remained accommodative and rhetoric has been favorable.

This combination of factors provides a backdrop for sustained, yet modest, economic activity. However, a period of robust, above-trend or accelerating growth also seems improbable. The biggest sources of stimulus – driven by declines in unemployment rates, increases in earnings growth, US tax cuts and wealth effects from rising asset prices – are likely behind us. Ongoing expansion could lead to modest increases in inflation, particularly given the low level of unemployment, although recent data do not suggest that a spike in core inflation is impending.

As a result, our expectation for central bank activity is fairly muted. The Fed, ECB, and Bank of England have each made clear that they have little tolerance for weak growth or low levels of inflation. Each of these has also signaled an intent to keep rates unchanged for a prolonged period, in an attempt to allow for ongoing expansion, higher inflation and continued balance sheet repair. The Fed, in particular, materially shifted its stance compared to late last year. Ultimately, the inability or unwillingness for central banks to raise rates may reduce their ability to fight the next downturn, but that is an issue we will address in future analysis.

Some risks to continued expansion remain, but these appear largely exogenous so long as central banks remain on the sidelines. Policy and politics pose the greatest risk of disruption: trade tensions may persist, the lack of clarity around Brexit lingers, and election cycles are likely to dominate headlines this year and next. None of these issues are likely to derail growth, but each certainly holds the potential to disturb the otherwise stable market backdrop that has characterized 2019 to date.

Elevated valuations

Moderate growth, stable inflation, and tentative central bank action are broadly favorable to financial markets. This has been borne out in recent years, which have seen rising equity prices, tighter credit spreads, and stable government bond yields. An important consequence of this trend is that valuations across markets are somewhat elevated. Although we do not see current valuation levels as an imminent threat, a couple of meaningful implications flow from this phenomenon. First, macro and market fundamentals need to ‘validate’ current market levels going forward. Without material room for error, earnings need to remain firm, inflation subdued, and growth supported. Second, the ability for valuation to drive returns going forward is probably limited. In other words, prospective returns are likely to be more muted in future than has been the case in recent years.

Figure 2. Low Rates and Tight Credit Spreads



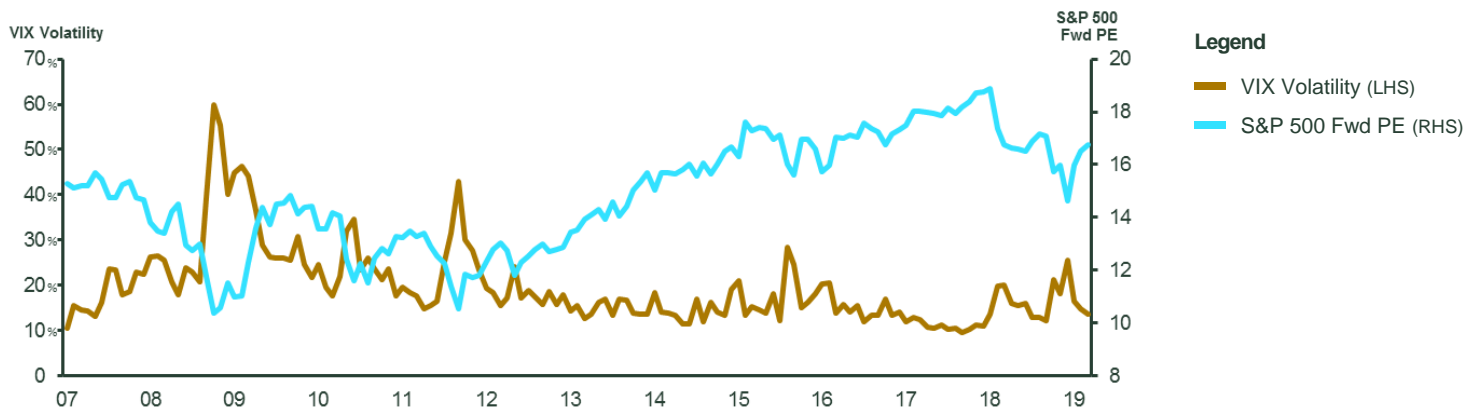
Source: State Street Global Advisors, Bloomberg. January 1, 2007 to March 31, 2019

Figure 2.

Legend

- 10-year Treasury
- Long Corporate Spread

Figure 3. Higher Price to Earnings Ratios and Lower Volatility



Source: State Street Global Advisors, Bloomberg. January 1, 2007 to March 31, 2019

Figure 3.

Legend

- VIX Volatility (LHS)
- S&P 500 Fwd PE (RHS)

Portfolio considerations

The prospect of more muted returns has influenced our approach to managing portfolios in three key ways:

- *Strategic asset allocation is our anchor for building all client portfolios. This starting point sets the targets for risk and return, allowing for participation in market returns over the course of the business cycle.*
- *From a tactical perspective, we still see some value in maintaining overweight allocations to risk assets against cash and government bonds.*
- *We believe the risk-reward tradeoff for taking on incremental portfolio risk is less favorable now, compared to recent years. Elevated valuations and low levels of market volatility, together with the growth outlook, are not likely to compensate investors for piling into risk today.*

We believe that portfolio construction should increasingly focus on positioning for the next major pivot in the business and market cycle, even if that time may be some ways off. To that end, we advocate for building in downside protection strategies and improving diversification within portfolios.

Close attention to downside protection carries clear benefits in addition to supporting long-term returns. The ability to weather downward movement in asset markets effectively is critical to maintaining or improving a plan's funded status, limiting the need for additional plan sponsor contributions.

The high degree of correlation across markets in recent years has made achieving portfolio diversification more challenging. Using a broad range of investment strategies – index, active, and factor-based – within and across asset classes is one important part of the effort to achieve portfolio diversification. Another important part of that effort is to blend strategies with different management approaches and with excess returns that exhibit low correlation. To be clear, this does not simply mean adding more line items to a portfolio. Rather, it's imperative that a portfolio's overall return, risk, and exposures are well known and understood so that forward-looking prospects can be optimized.

It appears that the current market expansion has room to run. But this does not mean that markets are immune to volatility and dislocation, as the sharp, painful, declines in Q4 2018 and later in the first half of 2019 highlighted. These periods of increased volatility and stress underscore the need to prepare portfolios for an environment that is not as stable and benign as the last decade has been. Building portfolios that are more robust in challenging periods allow for plans to maintain risk exposure today and reap the benefits while conditions are still supportive, but also to hold up well when the cycle finally turns.

Glossary

Price to Earnings Ratio – ratio of a company's share price to the company's earnings per share

VIX Volatility – The CBOE Volatility Index (ticker symbol VIX), is a measure of the stock market's expectation of volatility as implied by S&P 500 index options.

Spread – A credit spread is the difference in yield between a U.S. Treasury bond and another debt security of the same maturity but different credit quality.

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Assets under management as of March 31, 2019

Marketing communication State Street Global Advisors Worldwide Entities

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