

Preparing portfolios for late cycle: Part 1

Late cycle signals and implications



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Nine years into what may turn out to be the longest economic expansion in U.S. history, we are starting to see signs that a recession may finally be on its way. Interest rates are on the rise, and the U.S. Treasury yield curve is flatter. We see no reason to dramatically shift one's investment approach at this stage, but we are beginning to make changes to our strategies to prepare for the end of the cycle.

KEY POINTS

- The U.S. economic expansion likely has only a few years left to go.
- We see several leading indicators pointing to an approaching — though not imminent — end of the cycle.
- At this stage, it makes sense for investors to approach financial markets cautiously, while sticking to a pro-growth, risk-on stance.
- We also believe there is opportunity for investors to increase their risk-adjusted returns through the remainder of the cycle by including income-providing alternatives in their portfolios.

HOW CAN WE TELL THAT WE'RE IN LATE CYCLE?

The current U.S. expansion that began in mid-2009 will become the longest ever should it last through mid-2019. The unemployment rate is low and corporate profits are high, while inflation has remained contained. So what does the path from here to the next recession look like? For starters, we expect interest rates and inflation to rise and leading indicators like consumer confidence and business orders to fall. Economic growth will likely decelerate through the balance of 2018 and 2019, as the fiscal stimulus wears off and higher rates take their toll. Tighter financial conditions typically translate to slow growth and lower investment returns.

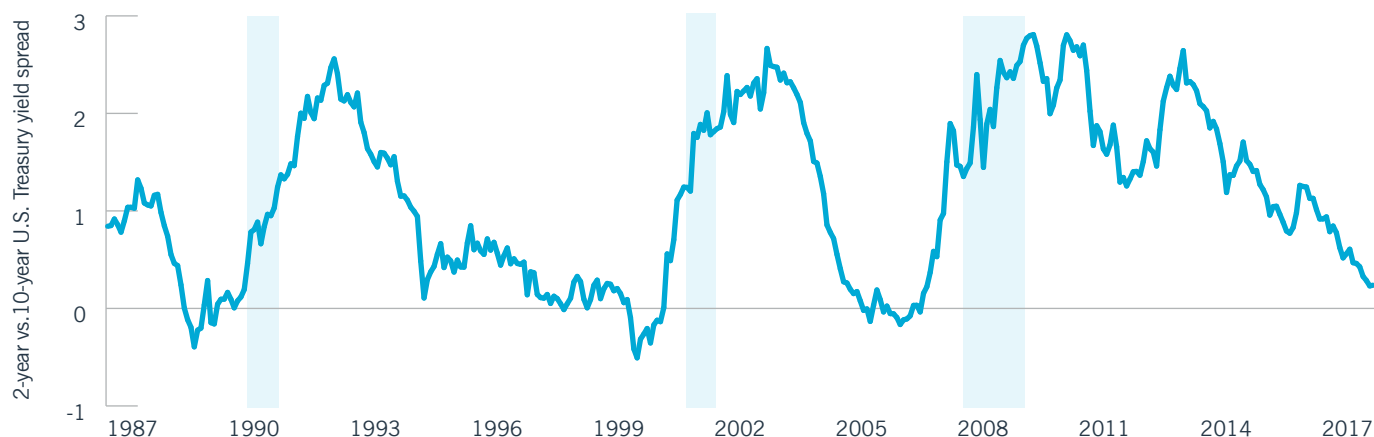
Of all the indicators used to predict recessions, the shape of the Treasury yield curve may be the most popular. The curve normally slopes upward: Longer-term bonds like the 10-year U.S. Treasury typically yield more than shorter-term bonds like the 2-year Treasury. The positive slope is a sign that markets expect growth and inflation to strengthen. As economic cycles advance, short-term rates begin to climb as the Federal Reserve (Fed) tightens monetary policy to prevent the economy from overheating. As those short-term rates catch up to longer-term

rates, the curve becomes flatter. If short-term rates exceed long-term rates, the curve is inverted, a sign that markets expect economic conditions to deteriorate in the coming years.

So far in 2018, 2-year Treasury yields have risen by 94 basis points to decade highs, while the 10-year Treasury yield has risen by just 66 basis points, bringing the spread between the two to its narrowest level since 2007. Are bond markets saying it is time to turn out the lights on the expansion? We don't think so, for three reasons. First, strong growth and rising inflation should nudge longer-term rates modestly higher, preventing the curve from inverting in the very near term. Second, the introduction of a fiscal boost to growth at this stage is unusual, and its results are difficult to predict, but we believe it has lowered the odds of a recession in 2018 and 2019. Third, very low interest rates outside the U.S. have increased demand for U.S. assets, including government bonds, which has helped artificially flatten the yield curve.

Whether it happens in 2018, 2019 or beyond, the yield curve and other leading indicators will eventually flash red with recession risk. At that point, history suggests a downturn could occur within a year or two. So what can investors do now to prepare?

Yield curve inversions have preceded U.S. recessions by 1 or 2 years



Data source: Bloomberg, L.P., 1 Jan 1987 to 30 Sep 2018. Shaded areas denote NBER U.S. recessions.

WHAT ARE THE BROAD IMPLICATIONS FOR INVESTORS IN LATE CYCLE?

Equity markets remain well supported by growing profits, despite the rise in short-term rates. Even after each of the past three yield curve inversions, the S&P 500 Index rallied for nine months or more. Bull markets have tended to end just a few quarters before recessions begin. Our equity portfolios are still positioned for a risk-on environment in the medium term.

Fixed income markets will remain sensitive to changes in Treasury yields, but our taxable fixed income strategies are running with somewhat reduced exposure to rising rates. Our portfolio managers still find attractive opportunities in U.S. credit sectors, including high yield, but they are increasingly diversifying into other higher-income areas, such as select emerging markets debt and bank loans, to avoid taking on too much U.S. credit risk.

Real estate, private markets and real assets also hold the potential to deliver income later

in the cycle with total returns that are less-influenced by the day-to-day whims of public markets. These asset classes typically exhibit low correlations to the prices of both stocks and bonds and can provide significant income for investors who are able to access them.

Wrapping this together for multi-asset investors, the Nuveen Solutions team continues to recommend greater tactical exposure to global equities versus global bonds, as well as larger positions in less rate-sensitive portions of the fixed income market like high yield municipal bonds. Solutions also recently initiated overweight positions in preferred securities and middle market loans.

In the coming weeks, we will enlist the help of members of our Nuveen Global Investment Committee to drill deeper into several key markets, and share thoughts about late cycle implications for each and what changes we are making in portfolios.

PORTFOLIO POSITIONING

Equity: Maintain risk-on positioning with greater tactical exposure to global equities versus global bonds.

Fixed income: Diversify holdings in higher income areas of the market other than high yield, such as select emerging markets debt; increase exposure to less rate-sensitive portions of the market, such as high yield muni bonds, preferred securities and middle market loans.

Real estate, private markets and real assets: These alternatives offer potential for diversification and delivering income later in the cycle.

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