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Preparing portfolios for late cycle: Part 2

Headwinds for equities

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The U.S. equity bull market is over nine years old, but continues to grind on thanks to stronger sales and the reduced corporate tax rate. While the rally is undoubtedly long in the tooth, we don't expect it to die of old age. Rather, as we look to the final years of the current economic cycle, lower profits growth and waning risk appetite may bring lower returns and affect the way we manage portfolios.

KEY POINTS

- Equity bull markets do not die of old age; they are killed by recessions.
- We expect U.S. stocks to continue to rally on positive earnings over at least the next 12-24 months.
- As with previous cycles, a deceleration in profits growth in 2019 and waning risk appetite may be headwinds to earning high returns on broad indexes.
- We are more focused on security and sector selection with market returns likely to be somewhat lower in the coming years.

WHAT WE'RE WATCHING FOR IN THE EQUITY MARKET

In the second quarter of 2018, S&P 500 Index profits grew by over 25% from the prior year. It should not be surprising that, in this environment, U.S. stock indexes are close to their all-time highs. But as earnings growth decelerates thanks to the fading effects of last year's corporate tax cut, risk appetite may begin to recede and valuations along with it.

This will mark a change from much of the last decade, during which equity investors have experienced dual tailwinds from expanding earnings multiples (e.g., price-to-earnings ratios) and accelerating earnings growth, the 2014-16 energy swoon notwithstanding. But those tailwinds are likely to turn into headwinds over the next few years, which we expect will result in more modest — though not necessarily negative — returns for U.S. stockholders.

Much like the early parts of the last cycle, U.S. companies have outperformed their global counterparts. Non-U.S. stocks are relatively inexpensive, but are backed by slower earnings growth than their U.S. peers. As U.S. earnings growth slows, however, international stocks may finally have a chance to catch up.

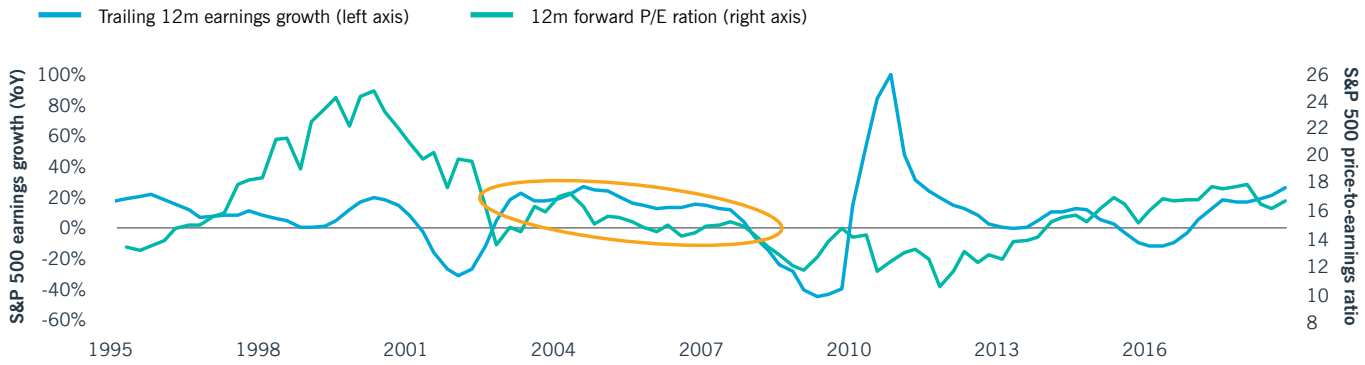
APPROACHING LATE CYCLE AS AN EQUITY PORTFOLIO MANAGER

The S&P 500 Index has returned more than 10% on average over the past ten years, an impressive feat given the starting point in the teeth of the global financial crisis. We do not believe U.S. stocks are poised to deliver returns of that caliber over the next five to ten years, given 1) the likelihood of a recession at some point during that period; and 2) their relatively high current valuations. With market-based returns likely to be lower, we are seeking to derive a larger percentage of our overall returns from active risk.

Higher-dividend defensive stocks have remained unusually expensive this late into the cycle, given the persistent demand for yield. We prefer to avoid them in favor of companies with strong secular earnings growth, particularly in the health care sector, which has been out of favor in recent years and has become attractively valued as a result. We also believe that with the potential for higher growth and inflation leading up to the end of the expansion in the coming years, it will be important to find attractively valued names in the energy or financials sectors without adding too much cyclical risk to portfolios.

Within global or multi-asset portfolios, we also continue to find value in non-U.S. markets, particularly in EM, which are trading at a deep discount to the U.S. and hold greater potential for accelerating earnings growth over the next few years.

Expect both U.S. earnings growth and equity valuations to fall in the coming quarters



Data source: Bloomberg, L.P., Q1 1995 — Q3 2018.

PORTFOLIO POSITIONING

- With equity market returns expected to be lower in coming years, active management may offer opportunities for better returns than broad market indexes.
- Higher-dividend defensive stocks have remained unusually expensive. Avoid them in favor of stocks with strong secular earnings growth, such as the health care sector, which has become attractively valued.
- With the potential for higher growth and inflation, look for attractively valued energy and financials stocks, without adding too much cyclical risk to portfolios.
- Investors may find better value in emerging markets, which look inexpensive and offer the potential for higher earnings growth, compared to developed markets.

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