

Preparing portfolios for late cycle: Part 4

Strategies for improving potential outcomes



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LATE-CYCLE INVESTING TO IMPROVE POTENTIAL OUTCOMES

While we may be closer to the end of the business cycle than the beginning, the risk of a recession or bear market during the next 12 – 18 months remains low. In fact, the continued corporate earnings expansion, economic growth momentum and subdued inflation outlook supports our risk-on stance for U.S. equities across client portfolios.

However, investors with a more cautious near-term outlook, or those who would prefer to slowly reduce risk rather than attempt to time the top of the market, can take steps to improve portfolio outcomes at the end of the cycle.

KEY POINTS

- We maintain a risk-on stance in U.S. equities, as the near-term risk of a recession remains low.
- Investors with a cautious outlook can take steps to improve outcomes at the end of the market cycle.
- Long-term U.S. Treasury bonds have been among the best diversifiers of equity risk, outperforming stocks and corporate bonds in past bear markets.
- Income investors concerned about a possible market correction should maintain some exposure to longer-duration bonds, and start increasing credit quality by reducing high yield bond exposure.

ADVICE FOR GROWTH INVESTORS

Growth investors have benefited tremendously from the 10-year bull market. However, assuming investors still need growth to fund expenses far in the future, now is not the time to move to cash. Nuveen’s Solutions team recommends the following steps to help reduce the volatility of a growth-oriented portfolio at the end of the business cycle:

Tilt toward large-cap growth over value

Near the end of the business cycle, investors tend to pay a premium for growth stocks, as finding attractive opportunities becomes more challenging (Exhibit 1). While growth has outperformed value consistently since 2017, we don’t expect this trend to reverse in the near future.

Exhibit 1: Growth has outperformed value before most recessions



Source: Bloomberg

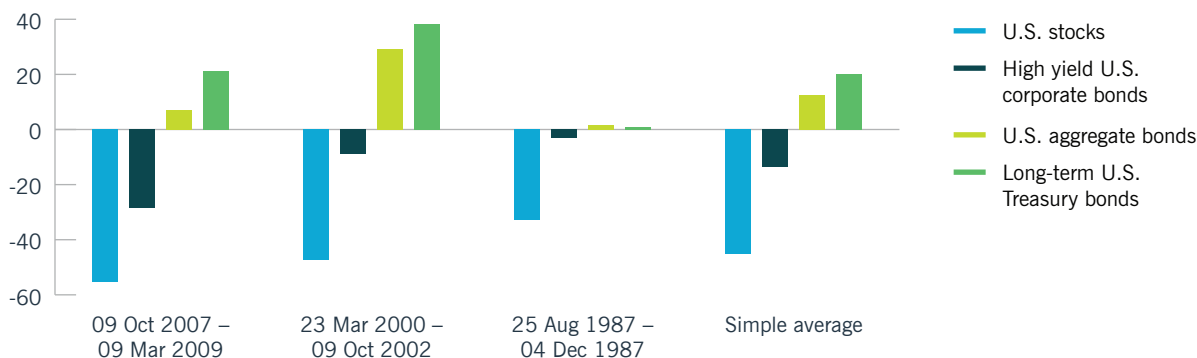
Look for opportunities to hedge downside risk

Long-term government bonds have historically been among the best diversifiers for equities, maintaining negative correlation with the S&P 500 Index, particularly during times of market stress. Unlike hedging with S&P 500 put options, extending duration with government bonds is a lower-cost approach that also provides income from bond coupons. Rather than abandoning equities in a recession, hedge some of the risk with exposure to long-dated U.S. Treasury bonds. During the global financial crisis between 2007 and 2009, for example,

S&P 500 stocks and high yield bonds lost 55% and 29%, respectively, while long-term U.S. Treasury bonds gained 21%, outperforming the U.S. Aggregate Bond Index’s 7% gain (Exhibit 2, next page). The pattern has been relatively consistent for the past three recessions since 1987. Even during milder corrections when the S&P 500 fell by more than 10%, which has occurred 14 times since the 1987 recession, long-term U.S. Treasury bonds have outperformed the U.S. aggregate by 5% on average. Although many investors focus on shortening duration in a rising-rate environment, the Solutions team recommends lengthening duration in fixed income if you believe a correction is likely.

Exhibit 2: Long-term government bonds have outperformed in bear markets

Total return % during the last three bear markets



Total returns reflect the following indexes: U.S. stocks (S&P 500 Index), high yield U.S. corporate bonds (Bloomberg Barclays U.S. Corporate High Yield Total Return Index), U.S. aggregate bonds (Bloomberg Barclays U.S. Aggregate Bond Index), long-term U.S. Treasury bonds (Bloomberg Barclays Long Treasury Total Return Index).
Source: Bloomberg, Yardeni Research

Keep a dollar bias

As the world’s reserve currency, the U.S. dollar tends to attract capital during times of heightened volatility. A stronger dollar lowers the return that U.S. investors earn from non-dollar denominated investments. To reduce currency risk, we recommend tilting toward U.S. dollar assets, such as U.S. equities, which we believe will continue to outperform non-U.S. developed equities in the near term.

ADVICE FOR INCOME INVESTORS

Income in the form of bond coupons and dividends from stocks and real estate investment trusts (REITs) helps to dampen portfolio volatility. Income investors have been kept on guard this year by Fed rate hikes, a flattening yield curve and record-tight credit spreads, which reduce compensation for taking credit risk. Accordingly, we offer this advice for income investors looking to protect their capital:

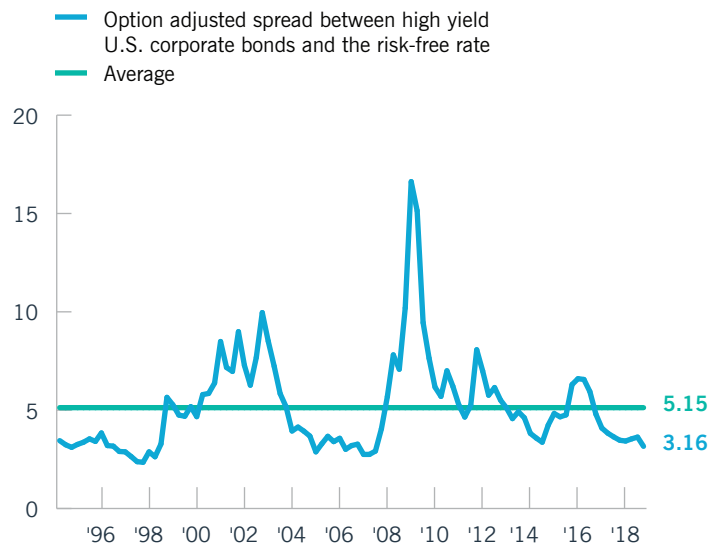
Don’t completely abandon interest rate risk in favor of credit risk

Investors moving to short-duration bonds in response to the Fed raising rates must remember that the Fed controls the short end of the yield curve — not the long end. Long-term interest rates are more influenced by macroeconomic views, such as GDP growth, inflation and investor preferences for the safety of long-term government bonds. Although the spread between the 10-year and two-year U.S. Treasury yield reached a postcrisis low in August, the curve could flatten even further. A combination of investors, notably foreign buyers and institutions with long-dated liabilities, continues to bid up the prices of long-dated U.S. Treasuries.

Start to shift to higher-quality credit

We don’t see a catalyst for significant high yield spread widening in the near future (Exhibit 3, next page). However, given that further price appreciation is unlikely, investors should look for opportunities to increase credit quality as we approach the end of the cycle. Historically, high yield bonds have tended to underperform core fixed income during periods leading up to equity market corrections.

Exhibit 3: High yield bond spreads are near historic lows



The option adjusted spread is shown for the Bloomberg Barclays U.S. Corporate High Yield Total Return Index.

Data range: (31 Mar 1994 – 28 Sep 2018)

Source: Bloomberg

Increase real interest rate duration through TIPS and real assets

The end of the market cycle is often characterized by the economy overheating, causing unexpected inflation. Asset classes such as Treasury Inflation Protected Securities (TIPS) and income-producing real assets can help to protect a portfolio from a rise in nominal rates due to inflation, while improving diversification.

PORTFOLIO POSITIONING

- For stocks, tilt toward large-cap growth over large-cap value.
- Look for opportunities to hedge downside risk, such as investing in long-term government bonds.
- Tilt toward U.S. dollar assets, such as U.S. stocks, to reduce currency risk.
- Start shifting to higher-quality credit within fixed income. For those in need of higher yields, consider extending duration, rather than adding to high yield allocations.
- Consider exposure to TIPS and real estate to hedge against an unexpected rise in inflation.

Solutions team recommendations are intended to help investors consider portfolio adjustments that could potentially add return and reduce risk through the end of the business cycle. However, investors must also consider a portfolio’s investment objectives and constraints, as well as their tolerance and capacity for risk. If investors are overly concerned about a market correction, their allocation to risky assets, such as stocks, may be too high. Investors who may need access to cash over the next 12 – 24 months should strongly consider paring back their allocation to stocks and corporate bonds.

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