Asset Allocation Views: Late Cycle vs. End Cycle Investing

February 8, 2019

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As the economic expansion aged and volatility increased throughout 2018, consensus shifted from viewing the U.S. expansion as likely to continue for the foreseeable future to believing that we are in the late stages. We believe we are late cycle, not end cycle – a base case outlook driven by our rigorous approach to macroeconomic forecasting. Our key view is that one should continue to be invested, but judiciously prefer securities that are higher in quality and liquidity across asset classes.

Here are key takeaways from our 2019 *Asset Allocation Outlook* on how we are positioning asset allocation portfolios in light of our outlook for the global economy and markets. In the outlook, we also stress the importance of maintaining "dry powder" in portfolios in order to target idiosyncratic investment opportunities, and we highlight three areas where we are seeing such opportunities today: master limited partnerships, U.K. banks, and China property developers.

Overall risk

Given broadly slowing growth, lower levels of monetary policy support and generally higher levels of volatility, we are maintaining overall risk close to our benchmark, but building liquidity to take advantage of tactical buying opportunities.

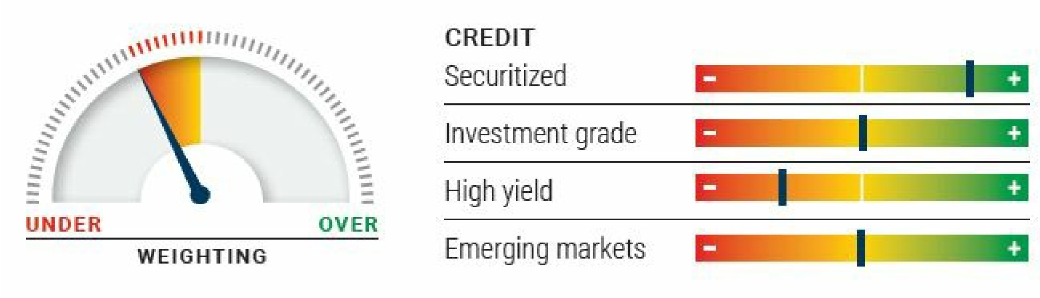
Equities

We expect volatility and slowing profit growth to continue to impact investor appetite for equities in 2019. Therefore, we have a modest underweight to equities with an emphasis on liquidity and high quality, defensive sectors. We favor large caps over small caps, U.S. equities over European equities and are modestly overweight Japanese equities given positive earnings, low leverage and still supportive Bank of Japan.

Rates

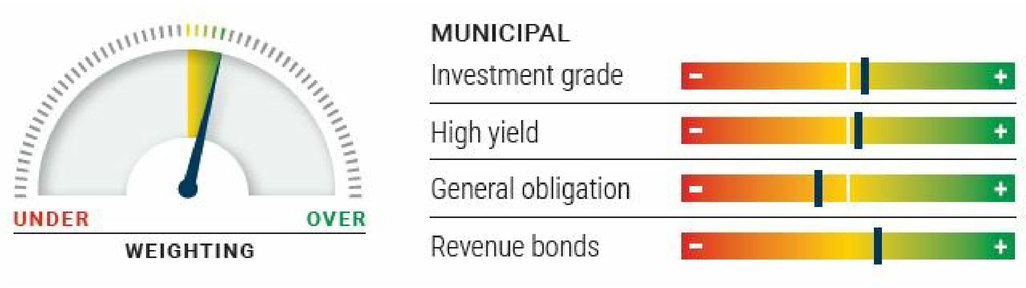
We prefer high quality duration as we move toward the later part of the cycle as we still believe that fixed income offers an attractive diversifier for risk in portfolios. However, we are selective in our exposures. We find U.S. rates the most attractive in developed markets. Beyond the U.S., we find U.K. gilts and Japanese government bonds rich, and we believe valuations of eurozone peripheral bonds are suspect without continued ECB support.

Credit



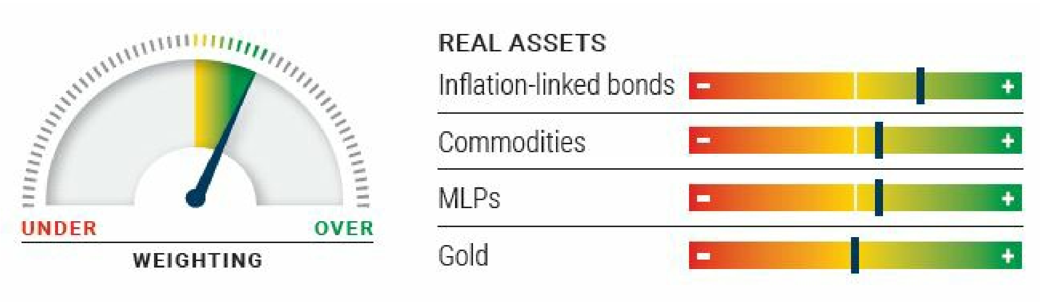
Given our late-cycle view, we expect corporate credit will underperform over the coming year. Within corporate credit, we prefer shorter-dated bonds from high quality issuers, especially in defensive and noncyclical sectors, which is in keeping with our quality and liquidity theme. The high yield underweight reflects in particular the glut of low quality leveraged loan issuance. We continue to favor non-agency mortgage-backed securities (MBS) as they remain a relatively stable high quality alternative to corporate credit. We are also keeping dry powder in order to pursue targeted opportunities which we think offer attractive risk/reward characteristics.

Municipal bonds



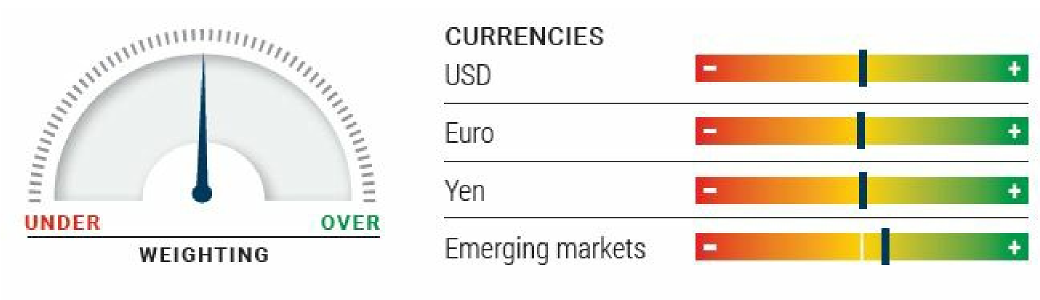
In U.S. portfolios, we favor overweighting municipal allocations as U.S. tax reform has created a favorable technical dynamic for the market. Tax law changes have contributed to a drop in issuance while demand has remained steady, particularly in high-tax states where state and local tax deductions were curtailed. Additionally, in this macro environment, municipal bonds may offer investors a late-cycle refuge with attractive, tax-efficient income absent default. However, credit selection will become more critical as economies cool. We continue to emphasize credits backed by dedicated revenue streams less subject to politics and pensions.

Real assets



Historically, real assets tend to perform well in late-cycle environments; however, that relationship has become less stable in recent periods. That said, we still view real assets as an effective tail risk hedge against rising inflation as well as a portfolio diversifier, and we therefore maintain a modest allocation to what we feel are attractively valued opportunities, including TIPS and MLPs, which should benefit from U.S. production growth.

Currencies



We have a nuanced view on currencies, and expect more significant alpha opportunities to emerge outside of the majors. We are currently close to neutral in U.S. dollars (USD) versus the other majors, and will pursue idiosyncratic opportunities in emerging markets as they unfold. We expect downward pressures on the Chinese yuan (CNY) to persist, and therefore also maintain Asian currency shorts versus the USD.

For detailed insights into our views across asset classes together with investment ideas, please read our 2019 Asset Allocation Outlook, *"Late Cycle vs. End Cycle Investing."*

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DISCLOSURES

Past performance is not a guarantee or a reliable indicator of future results.

All investments contain risk and may lose value. Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and the current low interest rate environment increases this risk. Current reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. Sovereign securities are generally backed by the issuing government. Obligations of U.S. government agencies and authorities are supported by varying degrees, but are generally not backed by the full faith of the U.S. government. Portfolios that invest in such securities are not guaranteed and will fluctuate in value. Inflation-linked bonds (ILBs) issued by a government are fixed income securities whose principal value is periodically adjusted according to the rate of inflation; ILBs decline in value when real interest rates rise. Treasury Inflation-Protected Securities (TIPS) are ILBs issued by the U.S. government. Income from municipal bonds is exempt from federal tax, but may be subject to state and local taxes and at times the alternative minimum tax; a strategy concentrating in a single or limited number of states is subject to greater risk of adverse economic conditions and regulatory changes. Equities may decline in value due to both real and perceived general market, economic and industry conditions. Investing in foreign-denominated and/or -domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Currency rates may fluctuate significantly over short periods of time and may reduce the returns of a portfolio. Commodities contain heightened risk, including market, political, regulatory and natural conditions, and may not be suitable for all investors.

Investing in MLPs involves risks that differ from equities, including limited control and limited rights to vote on matters affecting the partnership. MLPs are a partnership organised in the US and are subject to certain tax risks. Conflicts of interest may arise amongst common unit holders, subordinated unit holders and the general partner or managing member. MLPs may be affected by macro-economic and other factors affecting the stock market in general, expectations of interest rates, investor sentiment towards MLPs or the energy sector, changes in a particular issuer's financial condition, or unfavorable or unanticipated poor performance of a particular issuer. MLP cash distributions are not guaranteed and depend on each partnership's ability to generate adequate cash flow. Mortgage- and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and while generally supported by a government, government-agency or private guarantor, there is no assurance that the guarantor will meet its obligations. The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio. Diversification does not ensure against loss.

There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market. Investors should consult their investment professional prior to making an investment decision.