RBC Global Asset Management

Investing for the late-cycle

Investors today have a lot to consider, grappling with both a fear of recession and a fear of missing out on a rally. In this piece, we examine our current place in the business cycle and look at ways to build a portfolio that can maximize return potential without taking on too much risk.

Identifying where we are in the expansion

The natural first step in positioning a portfolio for the current economic climate is figuring out exactly where we are in the business cycle. Historically, returns have been positive for major markets through all stages of the cycle except recession.[1] But with a well-positioned portfolio, investors can add alpha beyond the norm and create a smoother investing experience.

If you look at a wide range of economic signals, many suggest we are now "late cycle." However, we are not yet "end of cycle" and there is still potential growth to be had in equity markets.

U.S. business cycle scoreboard

Economic indicators	Start of cycle	Early cycle	Mid cycle	Late cycle	End of cycle	Recession
Volatility						
Corporate profitability						
Prices						
Credit						
Business investment						
Employment						
Inventories						
Housing						
Equities						
Sentiment						
Leverage						
Economic trend						
Consumer						
Economic slack						
Monetary policy						
Cycle age						
Bonds						
Scores for each stage of business cycle	**0**	**0**	**7**	**14**	**7.5**	**0.5**

Legend: Orange shading indicates the most likely stage of business cycle (1.0 weight); light shading indicates alternative interpretation (0.5 weight).
Source: RBC GAM, as of May 2019.

The late cycle is often associated with moderating growth, rising inflation, tightening credit, and earnings pressure. Growth begins to slow as central banks shift to a more restrictive policy, and inflation rises as wages and commodity prices increase. At the same time, rising cost inflation puts pressure on profit margins – which in turn causes earnings to lose their luster.

Despite these challenges, only a pessimistic view suggests taking risk off. Uncertainty about the direction of markets should prompt focus on a portfolio that is prepared for a variety of scenarios. This kind of portfolio includes high-quality fixed income and globally diversified equities, augmented with non-correlated assets like alternatives and low volatility strategies. Here are three considerations for maximizing alpha in the late-cycle:

1. Turn fixed income into an effective diversifier
2. Tailor equities to capitalize in the late stages
3. Get the right balance in your portfolio

Turn fixed income into an effective diversifier

The role of fixed income in a portfolio is to provide stability and act as a ballast during a downturn. This is more important than ever late in the business cycle. Now is the time to give your fixed income allocation extra attention. Some of the key things to consider include:

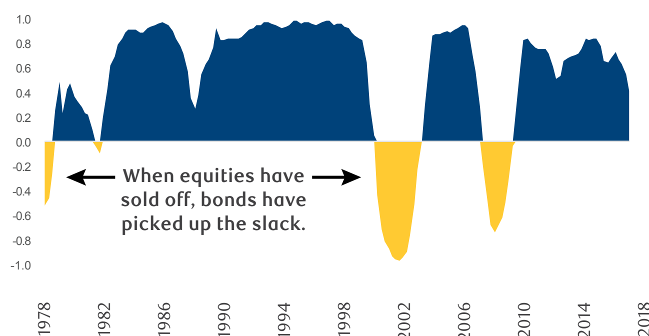
1. **Duration.** Duration is a measure of how sensitive a bond or other fixed income investment is to a change in interest rates. Through a bull market of falling rates, being long duration is a tailwind, giving a lift to returns. But when the expansion slows, the temptation is to rotate into shorter duration bonds and cash. However, investors should be cautious, as this kind of shift can reduce the ability of fixed income to do what it does best: offset downside in equity markets. This was evident in the December 2018 sell-off of equities, when the broad Canadian bond index gained 1.4%, outperforming short-term bonds with a gain of 0.9%.

2. **Yield.** Yield is the income returned on an investment, such as the interest you receive on a bond or other fixed income product. Rising rates have made yields in North America more attractive nowadays. However, there continues to be interesting opportunity in international and emerging market debt. Looking outside North America not only provides stronger yields, but also much needed diversification. As well, a globally diversified fixed-income portfolio minimizes the impact of changes in monetary policy in any individual country on investment performance. Diversification is thus an important feature of any effective fixed-income allocation.

Keep in mind that in the event of a recession, we are likely to start seeing downgrading of debt below investment grade. When investing in managed fixed-income products, investors should ensure the manager has the flexibility to upgrade if this happens. Although that isn't as much of a concern in the late cycle, investing in a core of issuers with strong balance sheets is hardly a bad idea at any stage to reduce volatility.

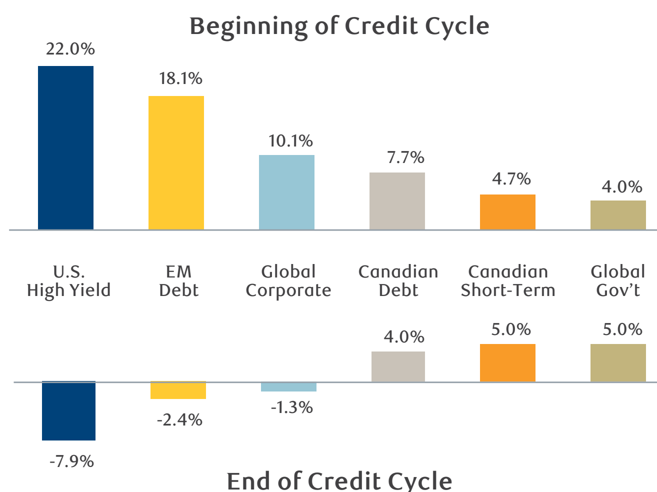
Decisions around duration, yield and global diversification are far from simple. However, there are sophisticated actively managed global bond portfolios that allow for instant diversification across global credit and currency markets. Seeking an experienced fixed income manager that can make tactical decisions for you leaves you more time to focus on other high value activities.

Correlation between stocks and bonds over time



As of December 31, 2018. Source: Bloomberg.

The importance of fixed income diversification throughout the cycle



All foreign currency exposure hedged in CAD. Please see disclosure for indices used to represent each asset class. Beginning of credit cycle refers to Dec 1, 2005 to Nov 30, 2008. End of credit cycle refers to Dec 1, 2008 to Nov 30, 2011. Returns are annualized.

Tailor equities to capitalize in the late stages

The role of equities in a portfolio is to be the main driver of returns. That doesn't change in the late cycle. Equity returns have been strong historically at such times. In fact, the S&P 500 has averaged a 10.4% return in the late cycle.[1] This suggests it may be too early yet to reduce your exposure to equities. Proceed with caution, considering:

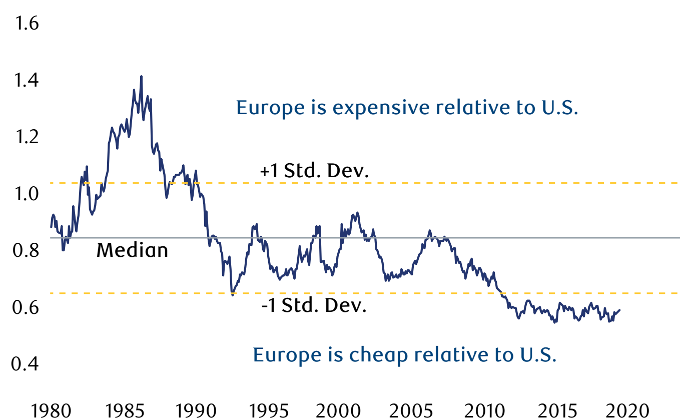
1. **Quality.** Look for companies with a strong balance sheet and profitability. These have historically performed well during the latter half of the cycle.[2] With rising borrowing costs, preferences should shift to companies that have a manageable amount of leverage and are growing earnings faster than their cost of debt. It's equally important to remain mindful of the price the market is putting on those earnings.

   Investors may consider employing a dividend strategy in the later stages of the business cycle. Dividend payers generally tend to be higher quality companies and exhibit reduced volatility. From 1986 – 2018, dividend payers have exhibited 2.5% less volatility than the S&P/TSX Composite Index. Conversely, dividend cutters and non-payers have exhibited 7.0% and 9.5% more volatility respectively.[3]

2. **Going Global.** An often overlooked way to add alpha is to look to overseas markets. It's possible to diversify globally into economies that are earlier in the cycle than Canada and the U.S. In fact, many countries haven't yet had a full recovery and are trading at much cheaper valuations. Owning quality companies with strong management teams at these favourable valuations is key to improving returns when domestic markets are challenged.

European Stocks are trading at more attractive valuations than U.S. Stocks

MSCI Europe/MSCI U.S. cycle-adjusted P/E



As of April 2019. Source: J.P. Morgan.

Get the right balance in your portfolio

The last consideration is how best to allocate between asset classes to build a portfolio that can achieve the optimal return without taking on too much risk. In the past, this was a simpler exercise. A balanced portfolio simply allocated between domestic bonds and domestic equities. Today, there are endless combinations of assets available. Making asset allocation decisions is daunting for many investors – and even more so in the late cycle.

The best place to start is focusing on your core. A balance between core equities and fixed income (both domestic and global) should make up the bulk of your portfolio, offering a mix of stability and exposure to rallying equity markets.

From there, Modern Portfolio Theory would suggest adding some auxiliary, lower-correlated assets. This would include investments such as specialty fixed income (e.g. convertible bonds, emerging market debt), alternatives and preferred shares, along with low volatility strategies. This approach can offer diversification and increase risk-adjusted returns. It can position you to keep upside potential, as the late cycle continues to offer positive returns. At the same time, it reduces your exposure to risk in equities.

A summary of key considerations

Fixed Income	Duration	Exercise caution shortening duration, as it can reduce the hedging ability of fixed income
	Yield	Look outside North America for strong yields, while also minimizing the impact of changes in monetary policy in any individual country
Equity	Quality	Build a core around quality companies, while remaining mindful of valuations
	Going Global	Look internationally to economies earlier in the cycle than Canada and the U.S. to add alpha when domestic markets are challenged
Portfolio construction	Diversification	Add non-correlated assets like alternatives and low volatility strategies to add alpha without adding an equivalent amount of risk

As volatility increases and the business cycle grows old, it's natural to want to reposition your portfolio after every powerful headline or each gyration of the stock market. However, the ability of the market to deliver returns to investors over time remains in place. A well-positioned portfolio can achieve that long-term potential while managing late cycle risk.

[1]Wolfe Research, RBC GAM
[2]https://www.blackrock.com/us/individual/investment-ideas/what-is-factor-investing/factor-commentary/factor-perspectives/quality-in-uncertain-times
[3]RBC Capital Markets. Companies are analyzed on a trailing 12-month period to determine whether they fall into the dividend grower, payer or cutter category.

"U.S. High Yield" is represented by the ICE BofAML U.S. High Yield BB-B Index. "EM Debt" is represented by the JPM EMBI Global Diversified Index. "Global Corporate" is represented by the Bloomberg Barclays Global Aggregate Corporate Bond Index. "Canadian Debt" is represented by the FTSE Canada Universe Bond Index. "Canadian Short-Term" is represented by the FTSE Canada Short-Term Bond Index. "Global Government" is represented by the FTSE WGBI Index.

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