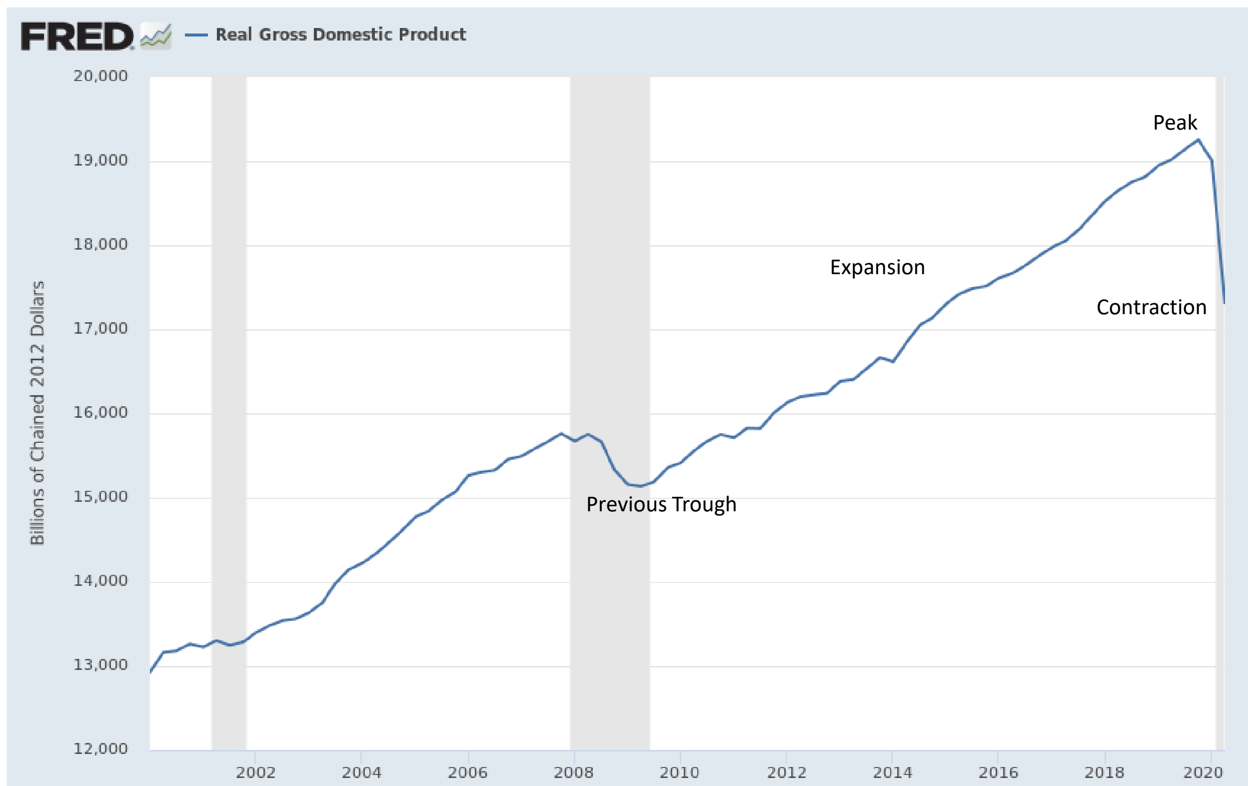
Repositioning Portfolios for the Next Expansion

October 2020

By Brian Luster

For 11 years following June of 2009, the US economy has been in the midst of a business cycle expansion. This period came to an end in February 2020[1] as a result of the COVID-19 pandemic, the shutdown of non-essential businesses, and an unemployment rate that peaked at 14.7%. Recessions (contractions) begin at the peak of a business cycle and end at its trough. While initial signs indicate that we may be in the early stages of an economic recovery, it is still too early to definitively understand if we are past the business cycle trough. What is clear is that once we do reach that trough, thoughtful investors will be best served by repositioning their investment portfolios for the next multi-year economic expansion.



Source: US Bureau of Economic Analysis, Collective Family Office

[1] National Bureau of Economic Research. "Determination of the February 2020 Peak in US Economic Activity." https://www.nber.org/news/business-cycle-dating-committee-announcement-june-8-2020

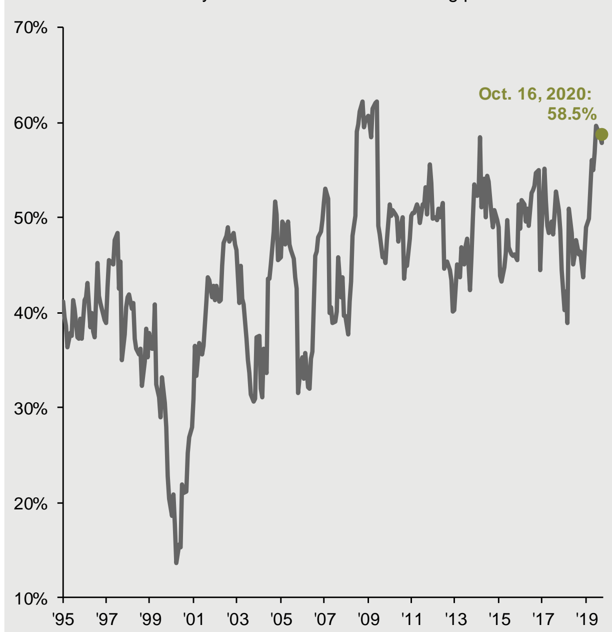
SETTING OURSELVES UP FOR THE NEXT EXPANSION

There are four key themes that we have embraced for the first half of the next economic expansion. These include:

- A shift from Growth to Value
- A shift from Large Cap to Small Cap
- A shift from US to International equities (both developed and emerging markets)
- A shift away from historical core fixed income to "non-traditional" fixed income investments

FROM GROWTH TO VALUE

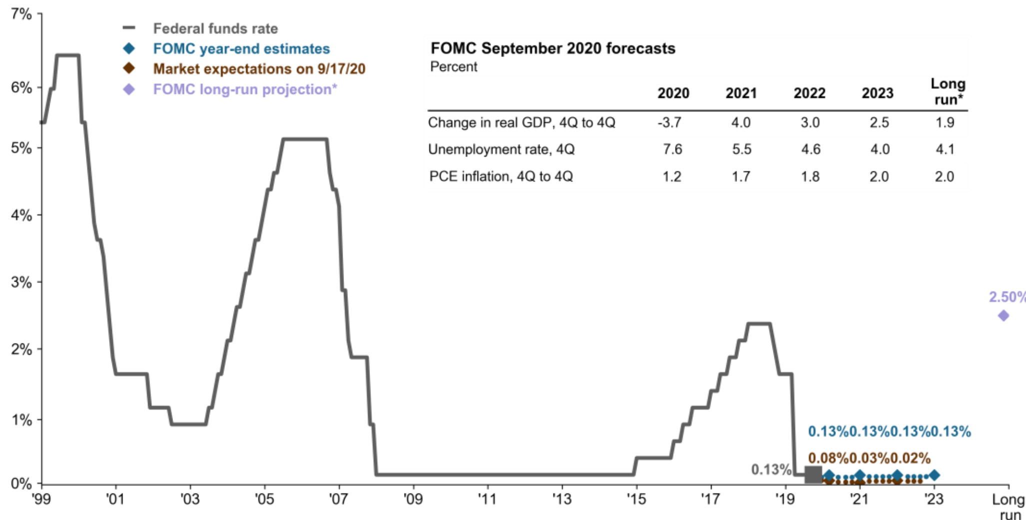
On a relative basis, value stocks are cheaper than growth stocks by 1.3 standard deviations. This simply means that value stocks are over 70% cheaper than growth stocks, compared to their historical average relationship. But they could certainly stay that way. Growth typically outperforms value when the economy is muddling along, as we are today, and may continue to do so for the next 6-12 months due to COVID. Value tends to outperform growth when economic activity accelerates, and inflation expectations rise. When a vaccine or therapeutic arrives, when the threat of additional COVID lockdowns are behind us, and when consumers begin to resume more normalized behaviors, we expect economic activity to accelerate in a more meaningful way, and we expect investors will do well by reducing their exposure to growth and increasing their exposure to value. We are quickly approaching that period.



Source: FactSet, FTSE Russell, NBER, J.P. Morgan Asset Management. Growth is represented by the Russell 1000 Growth Index and Value is represented by the Russell 1000 Value Index. Beta is calculated relative to the Russell 1000 Index. U.S. Data are as of October 16, 2020.

Clearly, inflation expectations are not rising. The Fed has almost guaranteed this with their commitment to keep rates at 0% through 2023 and beyond. Economic activity is not yet accelerating to the pace we desire, as unemployment and weekly jobless claims remain elevated. We would expect economic activity to have begun to pick up in the third quarter of 2020 for the first time since the recession began yet remain negative for the full year 2020. This dynamic should improve in 2021, with GDP growth of +3-5%, but investors do not need to get in front of the data. Growth outperformed value for a decade. When value has its turn, it too should outperform over a multi-year cycle. It may prove better to rebalance after the data confirms we are in the new cycle and the risk of a double dip recession is behind us. In the interim, we believe it is better to be more defensive (owning Large Cap Growth) until after a Fall COVID season and election outcome are behind us.

Federal funds rate expectations



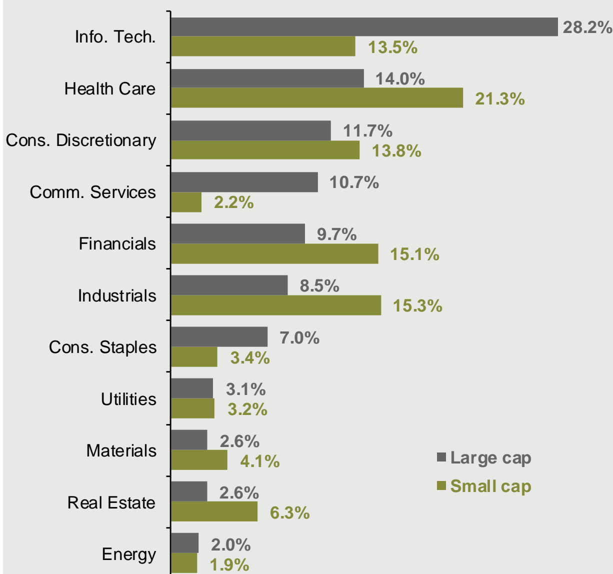
FOMC September 2020 forecasts
Percent

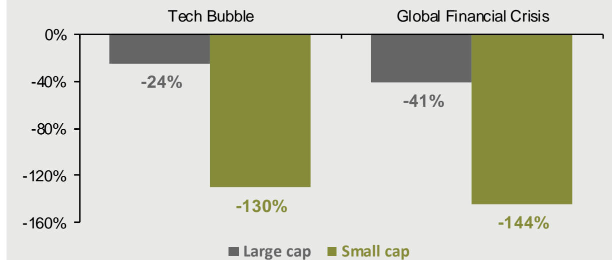
	2020	2021	2022	2023	Long run*
Change in real GDP, 4Q to 4Q	-3.7	4.0	3.0	2.5	1.9
Unemployment rate, 4Q	7.6	5.5	4.6	4.0	4.1
PCE inflation, 4Q to 4Q	1.2	1.7	1.8	2.0	2.0

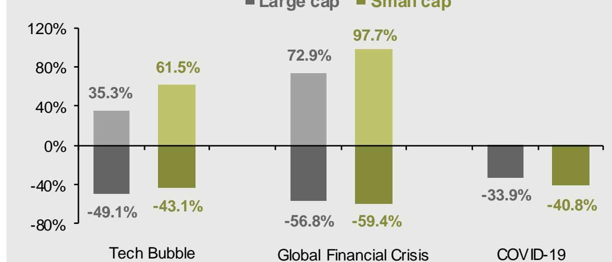
*Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management. Market expectations are the federal funds rates priced into the fed futures market as of the following date of the September 2020 FOMC meeting and are through August 2023. *Long-run projections are the rates of growth, unemployment and inflation to which a policymaker expects the economy to converge over the next five to six years in absence of further shocks and under appropriate monetary policy. U.S. Data are as of October 16, 2020.*

LARGE CAP TO SMALL CAP

Small Cap stocks tend to underperform Large Cap stocks during economic recessions yet return more during economic recoveries. This has certainly held true in all of the past three recessions (tech bubble, global financial crisis, COVID-19). One reason for this is that Small Cap stocks are more cyclical (exposed to more cyclical sectors such as healthcare, financials, and industrials) than Large Cap stocks (which are exposed more to non-cyclicals such as info tech and consumer staples). Another reason is that their earnings tend to fall significantly further than those of their Large Cap peers.







Source: FactSet, FTSE Russell, NBER, J.P. Morgan Asset Management. The S&P 500 is used for large cap and the Russell 2000 is used for small cap. Market drawdowns during the Tech Bubble, Great Financial Crisis and COVID-19 were calculated for the periods 3/24/00 – 10/9/02, 10/9/07 – 3/9/09 and 2/19/20 –3/23/20, respectively. U.S. Data are as of October 16, 2020.

As economic activity accelerates, and we enter a period of prolonged economic expansion, we expect to underweight Large Cap and overweight Small Cap equities in our investors' portfolios. As you can see from the chart below, valuations of Small Cap Value compared to Large Cap Growth are particularly attractive relative to historic norms. Again, while fundamentals certainly support our theme today, we will monitor short-term uncertainties around a return to normalized consumer behaviors before unilaterally implementing these portfolio changes.

QTD

	Value	Blend	Growth
Large	4.2%	3.7%	3.9%
Mid	5.7%	6.1%	7.0%
Small	8.8%	8.4%	8.0%

YTD

	Value	Blend	Growth
Large	-7.9%	9.4%	29.2%
Mid	-7.9%	3.7%	21.9%
Small	-14.6%	-1.0%	12.2%

Current P/E vs. 20-year avg. P/E

	Value	Blend	Growth
Large	17.6 / 13.7	22.0 / 15.4	31.3 / 18.6
Mid	18.6 / 14.3	23.1 / 16.2	39.9 / 20.3
Small	21.4 / 16.7	37.4 / 21.1	113.8 / 35.7

Since market peak (February 2020)

	Value	Blend	Growth
Large	-9.0%	4.2%	18.2%
Mid	-9.5%	-0.2%	13.9%
Small	-12.8%	-2.5%	6.8%

Since market low (March 2020)

	Value	Blend	Growth
Large	47.2%	57.3%	72.5%
Mid	60.1%	67.2%	77.2%
Small	53.4%	64.2%	73.5%

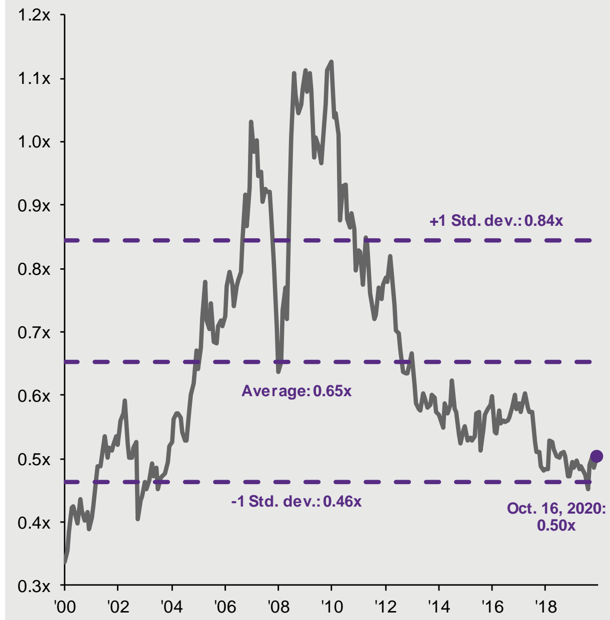
Current P/E as % of 20-year avg. P/E

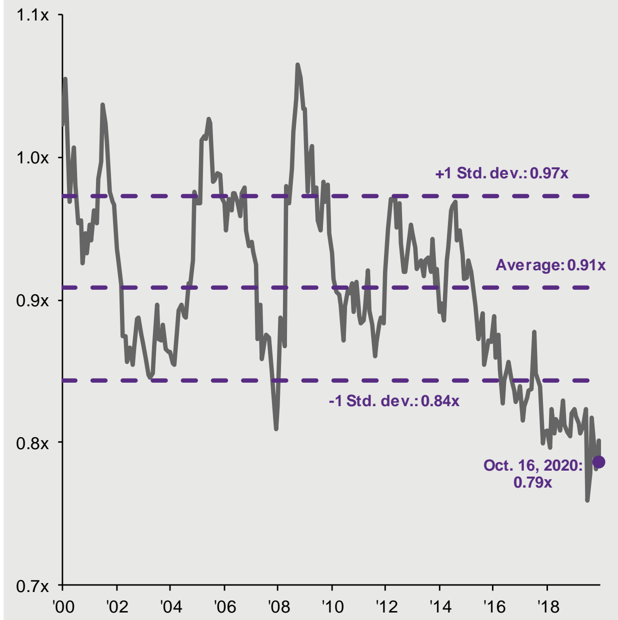
	Value	Blend	Growth
Large	128.9%	142.6%	168.2%
Mid	129.9%	142.4%	197.0%
Small	128.7%	176.9%	318.9%

Source: FactSet, Russell Investment Group, Standard & Poor's, J.P. Morgan Asset Management. All calculations are cumulative total return, including dividends reinvested for the stated period. Since Market Peak represents period between February 19, 2020, and October 16, 2020. Since Market Low represents period between March 23, 2020, and October 16, 2020. Returns are cumulative returns, not annualized. For all time periods, total return is based on Russell style indices with the exception of the large blend category, which is based on the S&P 500 Index. Past performance is not indicative of future returns. The price to earnings is a bottom-up calculation based on the most recent index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. U.S. Data are as of October 16, 2020.

US TO INTERNATIONAL (DEVELOPED AND EMERGING)

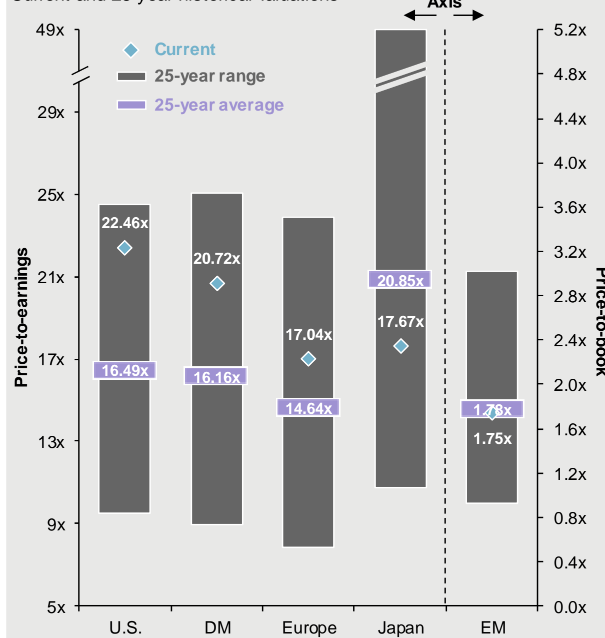
Both Emerging Market and International Developed Market equity valuations are 1 standard deviation cheap relative to their US counterparts. In fact, compared to US stocks, those from the Emerging Markets are the cheapest they have been in nearly two decades, while those from International Developed markets are the cheapest they have ever been.

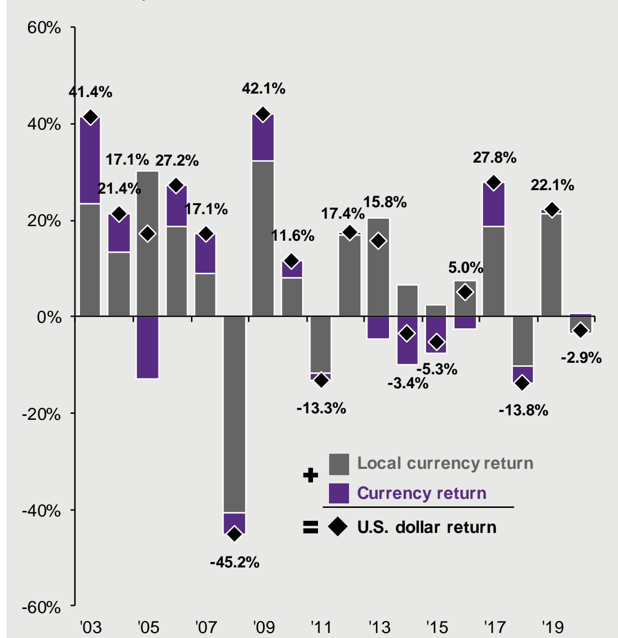




Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. U.S. Data are as of October 16, 2020.

Interestingly, all three economies are at the very beginning of a new economic cycle, with even recovery start times, and plenty of fiscal and monetary stimulus (both in the US and international markets). We believe we are in the beginning of a long cycle of dollar depreciation, which given current valuations, should be more favorable for international equities. In addition, international equities have room for multiple expansion, while US equities do not. For all of these reasons, we believe it is prudent for investors to increase their weighting toward International Developed equities and Emerging Market equities and reduce their allocation toward US equities as economic activity begins to reaccelerate.





Source: FactSet, MSCI, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

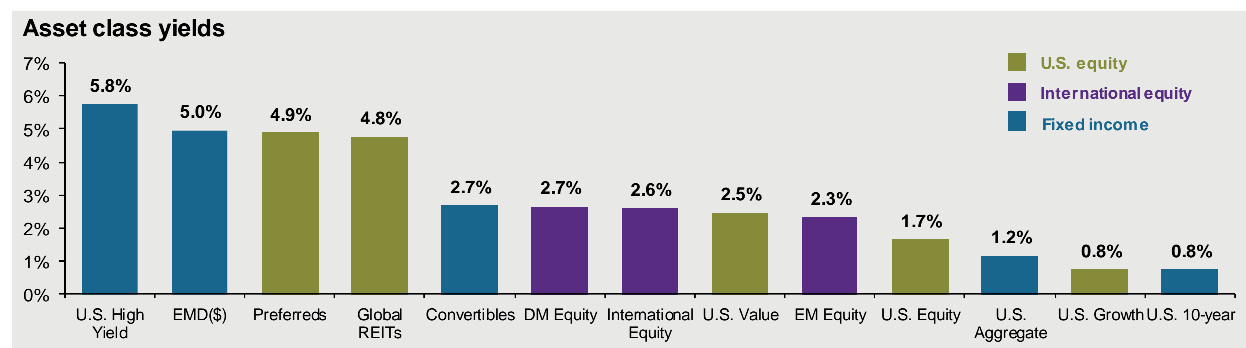
(Left) Valuations refer to NTMA P/E for Europe, U.S., Japan and developed markets and P/B for emerging markets. Valuation and earnings charts use MSCI indices for all regions/countries, except for the U.S., which is the S&P 500. All indices use IBES aggregate earnings estimates. MSCI Europe includes the eurozone as well as countries not in the currency bloc, such as Norway, Sweden, Switzerland and the UK (which collectively make up 44% of the overall index). Past performance is not a reliable indicator of current and future results.
(Right) Currencies in the U.S. Dollar Index are: British pound, Canadian dollar, euro, Japanese yen, Swedish krona and Swiss franc. Data for the U.S. Dollar Index are back-tested and filled in from March 9, 1973 and January 17, 1986 using the Federal Reserve's nominal trade-weighted broad currency index. Past performance is not a reliable indicator of current and future results. U.S. Data are as of October 16, 2020.

CORE FIXED INCOME TO NON-TRADITIONAL FIXED INCOME

There is an old axiom embraced by wealth managers that is often referenced in client conversations – "you own bonds so that you can handle owning stocks". Its meaning is quite simple. Stocks outperform bonds over the long-term but do so with more risk (volatility). Investors that cannot psychologically embrace these inevitable periods of high volatility can smooth out their returns over time by allocating some of their portfolio into bonds. The more bonds they own, the less volatility and lower the return they can expect from their total investment portfolio.

With that in mind, US Treasuries and Municipal Bonds have been at the core of many investor's fixed income portfolios throughout the last expansion. Yet with 10-year US Treasury bonds yielding <1%, and short-term rates near 0%, traditional safe haven bonds are no longer effective at hedging portfolios given their current prices. One can even argue that today's record low interest rates make longer duration bonds amongst the riskiest investments available to investors. Corporate bond spreads are not much better. Their spreads are very tight, and their credit quality is focused on the lower end of the investment grade spectrum.

Rather than bottom fish the corporate investment grade universe, we believe investors will be best served by looking elsewhere and repositioning a portion of their fixed income portfolios into non-traditional fixed income solutions. This can include the incorporation of preferred stocks, high yield bonds, emerging markets sovereign debt, and even global REITs and utilities.



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. Preferreds: BAML Hybrid Preferred Securities; U.S. High Yield: Bloomberg US Corporate High Yield; Global REITs: FTSE NAREIT Global REITs; U.S. Aggregate: Bloomberg Barclays US Aggregate; EMD($): J.P. Morgan EMBIG Diversified; Convertibles: Bloomberg Barclays U.S. Convertibles Composite; International Equity: MSCI AC World ex-U.S.; EM Equity: MSCI Emerging Markets; DM Equity: MSCI EAFE; U.S. Equity: S&P 500; U.S. Growth: Russell 1000 Growth; U.S. Value: Russell 1000 Value; U.S. 10-year: Tullett Prebon. U.S. Data are as of October 16, 2020.

While unlikely, given all of the fiscal stimulus to date and the expectation of another $1-3 Trillion after the election, it is certainly reasonable that inflation may arise earlier than the Fed would like to admit – perhaps as early as the second half of 2021. When combining that possibility, with the more likely scenario of a declining US Dollar, it may be pragmatic to incorporate Gold or TIPS into one's fixed income allocation as a hedge against either outcome.

CONCLUSION

Whether investors choose to implement our four key themes today or delay rebalancing for another six months is of little concern to us. Business cycle recoveries and expansions occur over many years, and

our themes should hold true regardless of timing. For those that wish to take a more defensive posture, maintaining an overweight toward US Large Cap Growth is likely a safer bet in the short-term than International Small Cap Value, as we would expect these asset classes to outperform in the case of a double dip recession driven by a surge in COVID cases leading to another economic shutdown. The same can be said about reallocating to higher yielding “non-traditional” fixed income asset classes, which too should fare worse in another economic contraction, however short-lived. With the upcoming elections, an expected Fall surge in flu/COVID cases, a saturation of hospital capacity, and the potential for a delay in the availability of a vaccine or therapeutic, there is certainly reason for investors to consider taking a more defensive position. However, markets do not like uncertainty, and when we look out 6-12 months, we believe many of these risks will be behind us. So, for investors willing to bear a bit more volatility in the short-term, implementing these themes sooner may prove to be a more thoughtful approach.

ABOUT THE AUTHOR

BRIAN LUSTER is a Principal and Chief Investment Officer of Collective Family Office located in York, Pennsylvania. With over 20 years of Wealth Management experience, Mr. Luster has previously served as Founder and CEO of a boutique Multi Family Office in New York City, as the Managing Member and Portfolio Manager of a long/short US event-driven value-oriented hedge fund in New York, and as a Senior Wealth Manager for BNY Mellon Wealth Management in Central Pennsylvania.

An avid thought leader, he has authored over 60 articles covering investing, tax, trust & estate planning, family governance, and next generation education, featured in such publications as Forbes, Barron's, The Wall Street Journal, Private Asset Management Magazine, Family Office Elite, and The Huffington Post.

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