Active is:
Why investors should get active in a late-cycle economy

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In a late-cycle economy like this one, asset-class returns tend to be modest, suggesting a difficult environment for passive portfolios that merely track an index. Moreover, as central-bank stimulus is withdrawn, passive investors could be further hurt by rising volatility and falling correlations. It all adds up to an environment that could provide attractive opportunities for active investors.

As challenging as investors may find today's economic climate, it could be set to get even trickier. We are approaching major turning points in economic and corporate earnings growth, central-bank liquidity and fiscal stimulus – as well as heightened political headwinds. While we do not think the global business cycle is finished yet, it is maturing: the US and Chinese economies are cooling and medium-term recession concerns have risen sharply.

Mounting evidence suggests global growth is past its peak – though still hovering at around potential – and we are now heading into the last phase of what has been a long period of expansion. We do not think the global business cycle is finished yet, but as it matures, the world economy faces slower near-term growth. Following the favourable "Goldilocks" setting of the past couple of years – where conditions were consistently "just right" – financial markets are now facing a more challenging backdrop. This environment demands a considered investment approach, because portfolios

Key takeaways

- As the global business cycle matures, the world economy faces slower near-term growth. Historically, major asset classes have tended to deliver lacklustre returns in this kind of late-cycle environment
- For active investors, there are still attractive opportunities, as this economic cycle still has some way left to run
- The hunt for income remains urgent for investors, and the biggest risk may be to take no risk at all
- As central banks withdraw stimulus, we think market conditions are changing in ways that should favour those with a selective investment approach

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that may have served investors well during the steady ascent of risk assets over recent years could be exposed now. But while there are risks for everyone, the end of a cycle also brings opportunities, particularly for active investors.

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No reward for just taking beta risks

If there's one lesson from previous late-cycle environments, it's that navigating financial markets will require more thought and selectivity from here on.

Looking at historical patterns of investment performance over a full economic expansion, the typical pattern would be that stock returns surge perhaps a year or two out from recession (see chart below). We could have already seen that "final hurrah" this time round. As the end of a cycle nears, investors have rarely been rewarded for just taking beta risk – that is, for passively holding a portfolio with broad market exposure.

The biggest risk could be to take no risk

Faced with uncertainty, it may be tempting to take risk off the table altogether. But doing so could harm purchasing power over time and, with interest rates expected to remain low for a while longer, the hunt for yield remains pressing. Economies may be cyclical, but time is linear – people still need to plan for the future. The biggest risk could be to take no risk.

That said, from a tactical investment standpoint, as the business cycle draws to an end, investors may want to adopt a slow-motion derisking strategy, selectively reducing market risk and increasing alpha exposure instead.

With an active approach, it is possible to remain invested and continue benefiting from the long-term power of compounding. Global growth is patchy and recession fears have intensified, but we believe attractive opportunities still exist. To build a resilient portfolio, investors should aim to look past the headlines to focus on strong balance sheets and other qualities that underpin the sustainability of investments.

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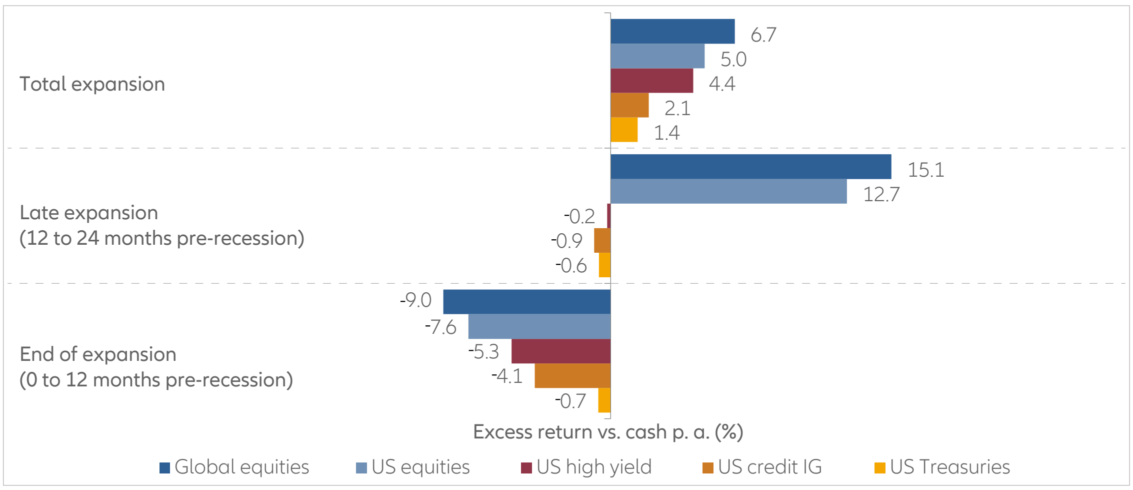
Use volatility and dispersion to your advantage

In a late-cycle period, active investing is not just a defence against an anticipated deterioration in the global economy; it also provides the chance to be proactive during periods of higher volatility and lower correlations.

This is the kind of environment we're seeing now, thanks to ongoing geopolitical uncertainty and central banks that are returning their monetary policy to normal. As central banks remove liquidity from the economy, we've already seen volatility (ie, price fluctuations) move up, and we expect it to stay that way for some time to come.

Asset returns through economic expansions in the United States[2]

Negative excess returns in the final year of business cycles, on average



The chart shows asset-class returns over cash during US expansions since 1975 (high-yield return data is from 1982), with overall excess returns shown in the top row. Global and US equities have on average recorded low double-digit returns toward the latter phase of a cycle (1-2 years pre-recession; middle row). As the end of a cycle draws near (1 year pre-recession; bottom row), excess returns vs. cash on all asset classes shown here have been negative, on average.

Another effect of the policy shift is that single stocks should exhibit lower correlations – in other words, they should show less of a tendency to move in tandem (see chart below). Generally speaking, the excess global liquidity created by central banks' quantitative easing programmes has been a rising tide that has lifted risky asset classes. As this broad blanket stimulus is gradually removed, single stocks will likely move less in tandem and we expect greater dispersion between the best and worst performers – or more clear winners and losers – as fundamentals and specific factors become stronger influences on asset prices.

In times like this, we expect the prices of risk assets to deviate more around fair value, creating potential opportunities for active investors to pick up mispriced securities – tomorrow's winners whose growth potential is not yet adequately reflected in prices. Active managers usually have the flexibility required to move between what they believe are attractive asset classes, regions, sectors and companies.

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On the topic of dispersion, it's important to remember that global indicators aggregate a broad range of metrics, not all of which point in the same direction. For example, while many equity markets, including the US, are still richly priced, emerging markets stocks appear attractively valued, while European prices look moderate. Given the range of valuations, selectivity is key, and an active approach may offer the best opportunity to build a portfolio with long-term return potential.

Keep an active eye on which risks you're taking

As this economic cycle winds down, we see several threats with the potential to impact markets globally. Investors should watch them carefully and position their portfolios appropriately.

- Trade conflicts are unlikely to cause a global recession by themselves, but they can sour sentiment and disrupt supply chains. This can exacerbate economic weaknesses.

- As select countries lurch toward protectionism, those nations that are heavily export-oriented and dependent on international supply could find themselves vulnerable.

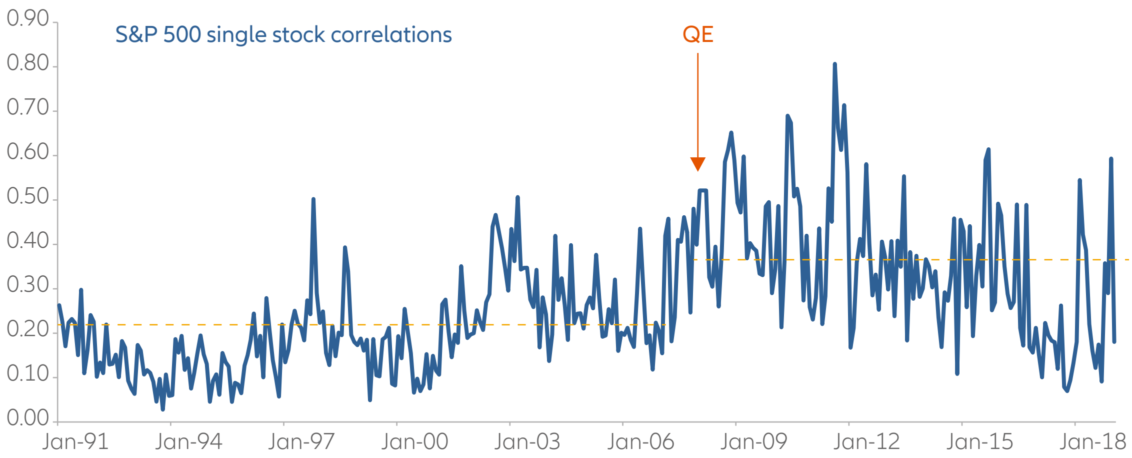
- Heightened geopolitical uncertainty has the potential to further roil markets. But while US President Donald Trump and Brexit attract the most attention, they are not the only political question marks.

- Leverage may be the biggest problem facing the global economy. Much of the world solved the last debt crisis essentially by borrowing more. China is one of the most indebted nations, but many other countries have taken on more debt too and US dollar-denominated debt outside the US now stands at record levels.

Stay alert, be active

A late-cycle environment like this one is undoubtedly more challenging, and investors should position for lower market returns, more volatility and tail risks. But in our view, this is not a time to step back. The current cycle may be entering its twilight, but there are still potential rewards for active investors.

Single stocks will likely move less in tandem



Source: Datastream, FactSet, AllianzGI Global Economics & Strategy. This chart shows correlations between individual shares in the S&P 500 Index (ie, the extent to which stocks tend to move in tandem). Quantitative easing (QE) caused average correlations to rise (the dotted-yellow line on the right);. Data as at 31 January 2019.

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