Has the Investment Cycle Changed Forever?

By Ad van Tiggelen
Senior Investment Specialist
ING Investment Management Europe

In the past few years, the investment cycle appears to have shortened meaningfully. The periodical switches by investors in and out of risky assets can be measured in months rather than years. These "risk-on" and "risk-off" periods are surprisingly intense, with historically high correlations between asset classes. Will this pattern persist in the coming years? And what does this mean for investors?

We think that the investment cycle has changed indeed, maybe not forever but at least for the next few years. The reason for this can be found in the changed nature of the medicines which are used to fight economic downturns in the developed world. With short-term interest rates already near zero, the monetary medicine has become ineffective. Traditional monetary stimulus (interest-rate cuts by central banks) will only become possible again after the "medicine box" has been filled with a number of rate hikes and when interest rates are clearly above 2% again. This is not likely to happen in the foreseeable future, given the current slow growth of the Western economy and the resulting accommodative stance of central banks.

The other medicine, fiscal stimulus, is also in scarce supply, as sovereign-debt levels are currently too high to afford tax cuts. Only in the U.S. some tax benefits have been extended into 2012, but that stimulus will surely have to end after the presidential elections. Conversely, in Europe we already see widespread fiscal austerity.

In the absence of these two traditional, time-proven medicines, central banks in the developed world have resorted to a new method to counter economic distress: Quantitative Easing (QE). The printing of money has proven to be a good way to oil the economic machinery in times that it starts to stutter.

QE is a drug, not a medicine

However, the effects of QE are much shorter lived than those of the two traditional medicines. After all, a drawn-out string of interest-rate cuts has a much more gradual effect on economic activity than a money injection straight into the "blood vessel". In that sense, one could regard QE as a drug rather than a medicine. And the marginal effect of that drug is likely to decrease with every new injection. Until now, the use of QE appears to have resulted in the occurrence of "risk-on" and "risk-off" periods of approximately half a year. These short cycles have replaced the old pattern of long cycles with multi-year boom periods which ended in a relatively short recession.

The use of QE is symptomatic for a developed world which has to deal with historically high overall debt levels (ranging from 300 to 400% of GDP if one takes all types of debt together) and which is burdened by an aging population. These are long-term issues which are likely to keep economic growth in the developed world lower for longer. In this sense, the banking crisis and the euro crisis have only brought forward a "drug addiction" which would have been unavoidable anyway. And as long as QE does not lead to a significant increase of spending in the real economy, the inflationary effects are likely to be minimal. With inflation being no issue, the drug can be administered without immediate repercussions. We therefore think that we will see more rounds of QE.

Given this expectation, it is important for investors to recognize the likely

triggers for major central banks to inject this drug in the future. We think that a rise of the weighted average of 10-year Spanish and Italian bond yields to around 7% could trigger such an action by the ECB. In the U.S. the triggers are less easily defined, given the diverging opinions within the Fed. However, it is likely that a significant slowdown of the U.S. economy will cause the Fed to start a third round of QE. For example, when payrolls fall to 100,000 and/or the ISM Manufacturing Index falls to 50, the signs for QE will likely turn green.

What are the implications for investors?

Given the lack of alternatives, it is likely that new rounds of QE and the associated "risk-on" and "risk-off" periods will dictate investor behaviour for some time to come. This has a few important implications. Firstly, it means that investors have to be very alert and nimble, even more so than in the past. Alternatively, they can adopt a very long investment horizon of a decade or more, which gives them a good likelihood to fully capture the premium yields which risky assets still offer. Secondly, investors have to realise that correlations of risky assets in "risk-off" periods may remain very high. In other words, when markets become nervous there are very few places to hide. Only government bonds of the strongest countries, securities of the most defensive multinationals and certain commodities have proven to be real safe havens.

What kind of risky assets do we prefer?

Let us first look at equities. For 2012 as a whole, we expect corporate earnings to be roughly flat for U.S. companies and to decline moderately for European companies. The core reason for this slowdown is declining revenue growth; a direct consequence of lower global growth combined with diminishing profit margins. However, compared to previous recessions we only expect a moderate profit decline this time. Companies do not struggle with a big inventory overhang or excess capacity. On top of that, they have not added a lot of "fat" during the latest recovery. Costs are kept well under control, which makes companies' earnings more resilient to a downturn in revenues. In general, companies are in good shape. Balance sheets are strong and profit margins have been largely restored to pre-Lehman levels and this despite the below-par economic recovery we witnessed over the past two years.

Current equity valuations already reflect many uncertainties. From a historic point of view, the trailing price/earnings ratio for global equities is more than 1 standard deviation below its 40-year average. In Europe, the valuations relative to the government-bond markets are close to the levels reached in the aftermath of the Lehman crisis. Of course, this has as much to do with low bond yields as with cheap equity valuations. In a low-growth or recessionary environment, bond yields and equities move in the same direction.

We will, of course, observe big divergences between companies. Those heavily dependent on European sales and a high commodity input will undoubtedly suffer most; especially as emerging-market growth is likely to keep commodity prices high. Internationally, emerging-market-exposed companies will fare better. We generally prefer the big multinational companies in sectors such as technology, energy and consumer goods (with a limited cyclicality) for the long term. In an environment where there is limited room for profits to rise, we focus on high, stable and well covered dividends as an attractive source of income.

For bond investors, as for equity investors, the potential for significant price gains has become limited. Therefore, the annual income generated by a bond investment has gained in importance. In this sense, emerging-market debt (in hard currency) is still one of our preferred asset classes. In general and despite recent doubts, prospects are better for emerging markets than for developed markets. We think that emerging markets will perform in line with their superior fundamentals (low indebtedness, high growth, vast countercyclical ammunition, attractive valuations etc.). A necessary condition for this is a soft landing in China. Lately some doubts were popping up and fears of a hard landing crept into investors' minds. We nevertheless think that China is still on track for a soft landing and that it will ease policy if necessary. A failure on this front would be very detrimental for cyclical assets and would limit the much-needed growth.

We also like high-yield bonds, an asset class which is dominated by midsized U.S. corporates. Investors are still relatively well rewarded for the risk taken in this asset class. As stated before, corporate balance sheets are in good shape and the risk of a deep U.S. recession and high corporate default levels is limited, given the fact that the Fed will initiate new rounds of QE as long as necessary.

Having said this, we are still living in an environment where investors have to deal with short and intense cycles. *Effective* risk diversification can only be realised when also holding some low-yielding government bonds. Even so, the rewards for taking risk are still substantial. After all, risky assets offer attractive yields *and* some protection against inflation for those who fear it. We do not, yet.

ad.van.tiggelen@ingim.com
www.ingim.ch

Effective risk diversification can only be realised when also holding some low-yielding government bonds. Even so, the rewards for taking risk are still substantial. After all, risky assets offer attractive yields *and* some protection against inflation for those who fear it. We do not, yet.