SOLVING FOR 2020

NEUBERGER | BERMAN

JOSEPH AMATO
PRESIDENT AND CHIEF INVESTMENT OFFICER—EQUITIES

KEY POINTS

- The current cycle may live longer than expected
- There are few signs of over-exuberance in credit markets
- Inflation may be on the rise, but it is likely to be gradual
- Monetary stimulus needs to be replaced by fiscal stimulus
- Private markets present opportunity, but discernment is increasingly important

CONFERENCE SUMMARY

THE YEAR AHEAD: OUTLOOK AND CHALLENGES

"We would argue that there have in fact been three mini-recessions, in 2011, 2015 and 2018, which have flushed out some of the excesses from this record-breaking expansion."

Joe set out to answer five key questions:

Where are we in the economic cycle?

The current economic expansion is the longest in modern U.S. history, Joe observed. But expansions have been getting longer over recent decades, partly because the U.S. economy is less manufacturing-led and cyclical than in the past, and Joe also showed that the current expansion is actually the smallest, in terms of cumulative GDP growth, since the 1940s. Moreover, he pointed to three "mini-recessions"—the 2011 euro crisis, the 2015 commodities sell-off and the 2018 global trade and growth scare—that have flushed out some of the excessed from the current cycle. It is fast, uninterrupted growth that tends to build the excesses that bring cycles to an end, and indeed many economic indicators suggest that we are still in the late-cycle phase rather than the end-cycle phase of the current expansion. That is critical for investors, because there is potentially a lot to miss out on late in the cycle. Joe showed that equity returns up until 7 – 12 months before a recession begins have often been very high, but that overstaying your welcome can be perilous—returns up until 1 – 6 months before a recession have tended to be negative.

Are credit markets overheated?

Joe noted that, while debt levels stopped growing in high yield as long ago as 2014, issuance of BBB rated investment-grade has continued to balloon. On the other hand, the constituents of the BBB universe have changed a lot over the past seven years, with much more issued by non-cyclical sectors such as healthcare, pharmaceuticals, technology and food and beverage, and much less issued by cyclical sectors such as mining and oilfield services. These non-cyclicals businesses can generally afford to run with higher levels of debt. Taking a broader view, Joe noted that the total debt-to-EBITDA ratio of S&P 500 companies has been close to its peak since 2016—but with rates so low for so long, it has been prudent for companies to borrow while they can to buy back stock, make investments or refinance with longer debt maturities. Rising leverage levels are not necessarily a sign of over-exuberance. At the same time, the net debt-to-EBITDA ratio remains well below its previous peak, because many companies have built substantial cash reserves even as they have been borrowing at these low rates. While there are signs of excess in some parts of mid-market private equity, Joe concluded that there is no clear evidence of late-cycle exuberance in credit markets generally.

Is inflation set to spike?

There is certainly concern that central banks, including the U.S. Federal Reserve, are becoming complacent over inflation: in an attempt to end a long period of undershooting their inflation targets, they appear increasingly willing to allow the economy to "run hot" in order to bring things back in line. Joe argued that, while we do not dismiss the possibility of rising inflation, there are some strong, secular trends pressing down on consumer prices. While wages are rising, we see little evidence that companies have the pricing power to pass that on to their end consumers. New analysis from the Fed indicates that deflation from the technological advances of recent decades has been greater than reported in official data. And online retail has transformed the price transparency of virtually every consumer market, leading to much faster convergence to the lowest level.

Will fiscal policy come to the rescue?

Central banks have been very creative, but it now appears that the effectiveness of their policies is wearing off, that they have very little firepower with which to fight the next downturn, and that there is a clear need for governments to play their part with more fiscal stimulus. With fiscal deficits in the major developed economies almost back to their pre-financial crisis balance, there appears to be the economic capacity to act, Joe argued. But in today's politically divided world, is there the will to act? The question is especially relevant in the U.S. as it heads into election year. We think that if a moderate Democratic party candidate emerges to fight that election, markets will be satisfied with either result in November. If a more liberal candidate advances, however, that may raise expectations for fiscal stimulus, but it will also raise concerns about policies that could directly threaten the energy, technology, financial and healthcare sectors—a big share of the S&P 500. Current economic performance would, in past elections, have strongly favored the incumbent: Joe thought that markets may already be too confident in pricing for that outcome, which could set the stage for some volatility in early summer.

Are private markets the solution in a lower return environment?

Contrary to the impression that investor assets have poured into private equity, Joe showed that fund distributions have almost exactly matched fund contributions over the past 20 years, and that the private markets remain tiny compared with the value of worldwide listed companies. Nonetheless, the valuation gap that has historically existed between public and private companies has largely closed, and that has important implications for future private markets investing. Simply buying private to take public is no longer an easy route to returns, and investors may need to work harder to find and get access to the private equity managers who can genuinely add value to the companies they acquire.

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Neuberger Berman
Lansdowne House
57 Berkeley Square
London W1J 6ER
United Kingdom
www.nb.com

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