NEW YORK LIFE INVESTMENTS STRATEGIST OPTIMISTIC ON ECONOMY AND FINANCIAL MARKETS

FALL FORUM 2021: SHAPING THE NEW NORMAL

By: Randy Myers

It's easy to find reasons to be pessimistic about the economy and the financial markets right now. Global commerce is grinding slowly in some sectors, hamstrung by labor shortages and snarled supply chains in the wake of the COVID-19 pandemic. Energy prices have shot up. In the U.S., inflation broadly is on the rise, as are government spending and the federal debt. Those concerns notwithstanding, economist Lauren Goodwin, director of portfolio strategy for New York Life Investments Multi-Asset Solutions team, says her organization has a constructive view of the global economy and the financial markets.

Speaking at the Stable Value Investment Association's 2021 Fall Forum in mid-October, Goodwin noted that while economic growth expectations are decelerating in some regions of the world, they aren't turning negative. In fact, the economic recovery that began in the summer of 2020 after a brief but sharp pandemic-induced downturn has led in 2021 to the strongest expectations for earnings-per-share gains over the next 12 months in at least three decades. And the U.S. stock market so far in 2021 has had its fifth-biggest gain, as measured by the S&P 500 stock index, in the last 20 years.

While the novel coronavirus is still shaping the global economy, Goodwin said, it is not expected to derail it as consumers learn to live with the pandemic and each succeeding wave delivers less economic impact. Already, consumer spending is shifting back toward pre-pandemic levels, with more money being spent on things like travel, dining and entertainment. Spending is buoyed, she said, not only by government stimulus checks but also by savings accumulated in 2020 when leisure activities took a back seat to sheltering at home to avoid COVID-19.

The pandemic is one of three main drivers of New York Life Investments' outlook on the economy and markets, Goodwin said. The others are U.S. monetary and fiscal policy. On monetary policy, Goodwin expects the Federal Reserve to act in a manner remarkably close to what investors are expecting—to begin tapering its purchases of Treasury and mortgage-backed securities toward the end of the year and wind that program down over the course of eight or nine months. That process shouldn't be particularly market-moving, she said, since the Fed has been talking about it for some time. Economic liquidity should remain strong throughout the taper, Goodwin added, accompanied by interest rates that remain low by historic standards.

On the fiscal policy front, Goodwin acknowledged that the U.S. government has been engaged in some of its strongest spending in "quite some time," pushing federal debt to its highest levels as a percentage of gross domestic product since World War II, with President Biden and Democrats pushing for still more spending on infrastructure. While high levels of spending and debt can be worrisome, they don't have to be a negative for the financial markets, Goodwin said. She pointed out that the federal government shouldn't be compared to a household when assessing how it spends money but rather as a business, and that it makes sense for businesses to spend money if it's being invested in projects that generate a positive return. She noted that whatever worries might exist, "investors all over the world are (still) clamoring for a piece of U.S. debt and U.S. money (even) at historically low interest rates."

In considering how all these factors play into the investment outlook, Goodwin observed that New York Life Investments still has a "fairly constructive" perspective on investing, although it is evolving its strategy.

Through much of 2021, Goodwin said, she and her team have been supportive of the "reflation" theme—the notion that cyclical sectors of the market will perform well in the wake of last year's economic downturn. While the best days for that theme may be past, she anticipates it's too early to turn entirely to defensive themes. "We're sticking to the reflation trade, but with a focus on identifying companies that are likely to experience upward earning revisions," she explained. The challenge, Goodwin added, is to identify those companies that are best able to leverage the ongoing reopening of the economy. In addition to tilting toward companies that fit into this theme, New York Life Investments' Multi-Asset Solutions team also is increasing its allocation to assets outside the U.S., including Europe and Japan, where it believes rising vaccination rates will support the reopening theme. In assessing individual securities, Goodwin and her colleagues are looking for high-quality companies making productive use of debt and boasting resilient operating margins.

Goodwin acknowledged that financial markets aren't entirely predictable—she suggested that her firm puts about a 60% probability on its constructive base case for the economy and markets to hold true. Accordingly, she said she and her colleagues have modeled three other scenarios, too: a hawkish surprise in which higher spending overheats the economy and leads to monetary tightening and higher tax rates (they give it a 20% chance), a stalled recovery in which growth disappoints (15% chance) and stagflation, in which supply chain and labor imbalances lead to higher costs, choking off economic growth (5%).

While Goodwin said she expects inflation to remain higher moving forward than it's been for some time, it may not be a negative for the economy if coupled with the stable or even improving economic growth she's anticipating. Inflation in non-COVID sectors of the economy has remained fairly stable, she noted, and COVID-related inflationary pressures should prove transitory.

"The best guess we can give is that inflationary pressures are likely to firm somewhat, so we might see an inflation regime of 2% to 2.5% rather than the 1.5% we saw before the pandemic," Goodwin said. That would be helpful for some investors, in her view, particularly those in or near retirement expecting to generate income from bonds, since bond yields often rise in tandem with inflation.

"We expect the 10-year Treasury yield to end near 1.8% this year," Goodwin said, "and perhaps slightly above 2% next year."

That said, 2% is still low by historical standards, and the dearth of attractive yields in the bond market is another ongoing source of support for the stock market. At the same time, she said, bond yields are not so high as to derail bond market performance on their own.

Asked to comment on investment-grade fixed income, Goodwin said her firm is recommending that clients stay invested in that sector of the market., with her own organization overweight corporate credit due to "strong fundamentals, improving credit quality and a strong technical backdrop for the asset class."

"We're quite constructive on asset-backed securities as an asset class, which look cheap relative to corporate credit," Goodwin added. "We're still underweight agency mortgage-backed securities, though, due to valuations and because we believe continued rate volatility could be negative for that asset class. We're being selective in commercial mortgage-backed securities, where there are opportunities, but it is important to be properly compensated for post-pandemic risk as conditions in the commercial markets stabilize."

Questioned about the growing demand for asset decumulation strategies for retirees, Goodwin called the conversion of lifelong assets into an income stream one of the biggest challenges for investors today. She said coupling investment risks with sequence-of-return risk to generate predictable retirement income is essential. "In thinking about additional sources of income, stable value products could make sense, as could multi-asset income," she concluded. "We're also seeing more and more advisors pairing rather traditional stock and bond investment portfolios with an income annuity that can potentially stabilize, or provide a little bit of visibility into, an income stream in the decumulation phase of retirement."