Strategist's Corner
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Market Cycles: Lather, Rinse, Repeat

Author

Robert M. Almeida, Jr.
Portfolio Manager and
Global Investment Strategist

In brief:

- Market cycles are unique but often share familiar outlines.
- Supply and demand imbalances are hallmarks of the beginning and end of cycles.
- Today's imbalances are less obvious than those of prior cycles, but they are increasingly evident.

When the temperature drops below freezing and there's enough moisture in the air, tiny ice crystals collide with one another to form snowflakes. As it falls to earth, each flake follows its own trajectory, passing through different weather conditions, causing its form to be unique.

Like snowflakes, no two financial market cycles are identical. However, as with the formation of snowflakes, market cycles follow familiar patterns. Cycles all begin and end with investment supply and demand imbalances.

Investment supply and demand

Early in the cycle, markets are in the process of recovering from a correction — or worse — and uncertainty is high. Investors are demoralized and short on capital, resulting in low demand for, and an abundant supply of, investments. The result, along with the potential for outsized returns, is abnormally high risk premia, typified, for example by episodes when high-yield bond yields rise 800 basis points or more above those of US Treasuries.

As the few take advantage, supply is absorbed. Thinly traded financial markets begin to yield strong returns, coupled with declining levels of volatility. This inviting return and risk profile creates confidence and lures more capital into markets. Demand rises, causing the supply of mispriced assets to shrink further, accelerating financial returns and reducing asset price volatility.

Supply and demand reach an equilibrium and risk premia return to their historical norms at midcycle, such periods when high-yield bond spreads average around 500 basis points more than Treasuries. Financial markets are functioning properly, distributing capital appropriately based on the perceived fundamental risk and return potential.

Exhibit 1: Cycles tend to repeat

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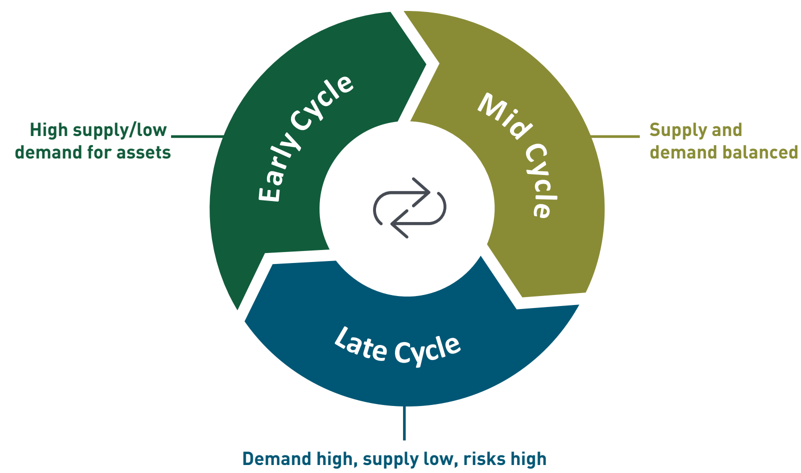

However, markets are complex human systems. Their actions can't be predicted with certainty, and they are self-referential, as when buying begets more buying or selling begets more selling. Despite the dwindling prospects of the outsized returns typical in early cycle, investor demand accelerates. With confidence high, leverage is often employed to boost returns in order to make up for the shortage of return potential compared with early and midcycle levels. Risk and reward analysis and due diligence fade as investors seek to match the returns realized earlier in the cycle. This is generally when mistakes happen and capital is misallocated.

The irony of market stability midcycle, when supply and demand are relatively balanced, is that it ultimately sows the seeds of future instability. Demand outstrips supply and market imbalances are created.

Where are we today?

As we close the book on 2019, and the tremendous return and risk profiles not just of this year but also of the past 11 years, I'm struck by how market participants love to talk and write about the longevity of this cycle. But does the *length* of the cycle matter? Is that a true risk factor? I don't think so. Markets correct because of imbalances, not because of old age. What matters is the stage of the cycle and the return versus risk tradeoff. Is this early, mid or late cycle? If late in the cycle, where was capital misallocated, and where are investors most at risk?

We believe the market is exhibiting symptoms of late-cycle dynamics. In the 1990s and 2000s, there were observable excesses in technology and real estate. This cycle's capital excesses are less obvious. But as I wrote in October's *Strategist Corner*, Here's What Keeps Me Up at Night, it's becoming increasingly apparent that corporate chieftains have over engineered financial metrics and capital return policies in order to appease short-term investors.

Equity and fixed income market returns grew in a linear and almost indiscriminate fashion this cycle. Market or asset class beta likely accounts for nearly all of portfolio return, with alpha probably a minimal contributor.[1] That is typical mid-to-late-cycle behavior, when investor demand overwhelms available supply and capital is allocated indiscriminately.

Choose wisely

Looking ahead, against what we believe is a late-cycle backdrop, we think prudent security selection and mistake avoidance will prove vital. That's why we emphasize the importance of owning companies and debt issues with durable cash flows supported by unique intellectual property and high barriers to entry.

While predictions of snowfall can be imprecise, it doesn't take a meteorologist to explain why it's snowing. We know the conditions required for snowfall. And while markets can be even more unpredictable than the weather, it doesn't take a strategist to notice what stage of the market cycle we're in when risks are elevated and return prospects are lacking.

With that, I wish you and your families a prosperous new year.

[1] Beta is a measure of the volatility of a portfolio relative to the overall market. A beta less than 1.0 indicates lower risk than the market; a beta greater than 1.0 indicates higher risk than the market. It's most reliable as a risk measure when the return fluctuations of the portfolio are highly correlated with the return fluctuations of the index chosen to represent the market. Alpha is a measure of the portfolio's risk-adjusted performance. When compared to the portfolio's beta, a positive alpha indicates betterthan-expected portfolio performance and a negative alpha worse-than-expected portfolio performance.

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