

Late cycle showdown: Five keys to weather the storm

A MULTI-ASSET PERSPECTIVE

Executive summary

- **Rising economic and market risks** have made investors less willing to reflect structural economic changes in their portfolios. This may be a mistake.
- **The factors elongating this economic cycle**—such as strong household and corporate balance sheets—could contribute to investment opportunity even as recession arrives.
- **Structural economic changes** may have impacted the long-term outlook for interest rates.
- **Our highest conviction investment ideas** capture not only the cyclical and structural factors impacting the markets, but also provides portfolio construction techniques that may allow investors to take a more resilient approach to this market.

Introduction

We tell investors not to try to time the market. And for the past several years, it has been equally difficult to time the economic cycle. At the tail end of the Fed's most rapid and severe hiking cycle in history, market participants are fiercely debating the timing and severity of a potential recession. We have held to our view that after such a severe bout of inflation and interest rate tightening, a soft landing is nearly impossible. A recession will be necessary not just to bring price growth durably back to earth, but also to re-set the standard cycle cadence, which was disrupted during the pandemic.

Several factors will settle the debate around recession timing and severity. The primary determinant will be the behavior of inflation: will services inflation finally respond to monetary tightening? Or will the threat of a double peak in inflation force the Fed to stay hawkish?

The other swing votes are tradeoffs around the inflation question. Top of mind is financial stability. The banking fragility of the past several months seems contained, but if weak spots broaden, policymakers may capitulate sooner than the economic data would suggest is wise. Finally, there's the labor market. Households have handled the inflation surge with surprising ease, bolstered by their pandemic savings and a bunker-like jobs market. But when the jobs backstop cracks, policymakers will again need to balance competing priorities: returning inflation to a level that makes the economy work better for everyone, and the labor market pain that may be required to achieve it.

The array of competing factors makes recession scenarios perhaps less helpful for investors as we head into the second half of the year. Instead, we are focused on four features of this economic cycle that may drive portfolio construction:

- 1. The nature of the economic cycle is the same, but the factors influencing it are unique this time around**
- 2. A mild recession is still our base case, but this does not imply a more bullish market outcome**
- 3. Calls for the Fed to cut rates do not align with the fundamentals**
- 4. The long-term outlook for interest rates has structurally changed**

Deciphering the outlook for the economy is complex, but interpreting how to allocate in a time of slowing growth and market volatility can be, counterintuitively, more straightforward. While many investors have fled to cash, we caution against the paralysis that can come with sitting on the sidelines. We see ample opportunity for investors to rebalance in ways that reflect the reawakened dynamism of the bond market, as well as new themes with decades-long runways for growth.

Investors can't escape the late cycle limbo

Historically, when the Fed raises interest rates, components of the economy slow in a sequential manner, resembling a domino effect. Once that process begins, the pace at which recession arrives is driven by the specific conditions of that cycle: the forces pushing down or holding up the economic “dominoes.”

This cycle's economic deceleration has been notably sluggish, partly due to the lingering effects of pandemic-related imbalances impacting various sectors of the economy. Nevertheless, our base case expects a recession later this year as the dominoes continue to fall.

The economic dominoes suggest we are in the last leg of this cycle

The “domino effect” of a standard economic slowdown is intact, but atypical forces are affecting the speed of this cycle

Forces pushing on the dominoes

(accelerating the pace of recession)

Tighter monetary policy

(higher rates)

Draining liquidity

(flow not stock argument)

Tighter credit conditions

(banking fragility)

Political risk

(dysfunctional Congress)



Forces holding up the dominoes

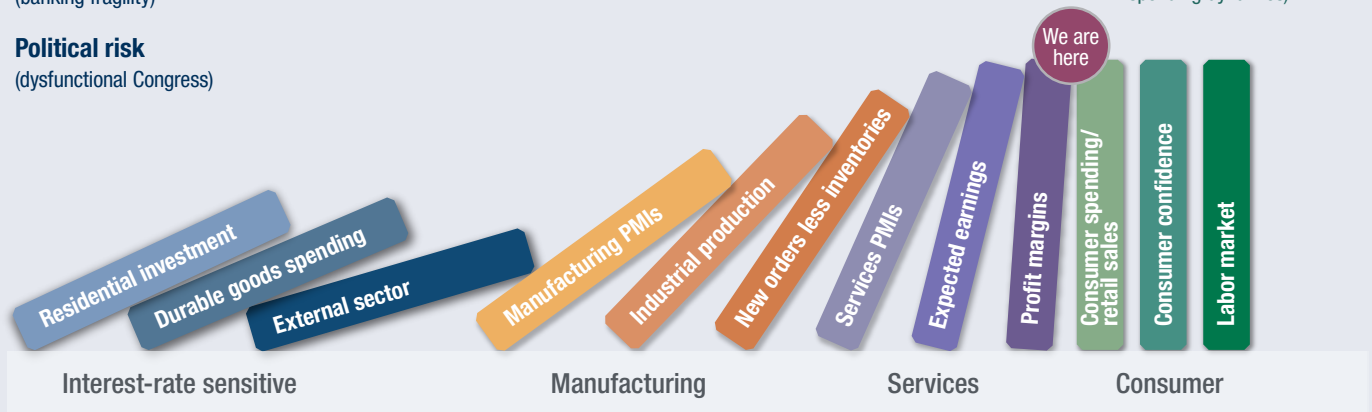
(slowing the pace of recession)

Business support

(pandemic programs earnings resilience)

Consumer support

(excess savings, labor market strength, post pandemic spending dynamics)



Source: New York Life Investments Multi-Asset Solutions, June 2023. For illustrative purposes only.

Factors accelerating the path to recession

A rapid tightening of monetary policy: The Fed is now at the tail end of its most aggressive monetary policy tightening cycle ever. But a faster pace of hikes doesn't necessarily mean these impacts are felt more quickly in the real economy. Historically, interest rate hikes have taken roughly 12 to 18 months to impact the economy, and 18 to 24 months to impact the labor market; it takes time for higher borrowing costs to affect bank, company, and household behavior. That experience is holding today. This late cycle dynamic, the "long and variable lag of monetary policy" to the real economy, can feel like a genuine limbo in portfolio strategy. But we caution investors not to equate that lag with a free pass; the impact of tightening policy is likely to be a matter of timing rather than substance.

Draining liquidity: A "lower for longer" interest rate environment, coupled with more regular use of central bank balance sheets as a policy tool, contributed to ample economic and financial market liquidity in recent years. Now, central banks are reducing their balance sheets, draining liquidity from the global system. This process, called quantitative tightening, is a relatively new economic development

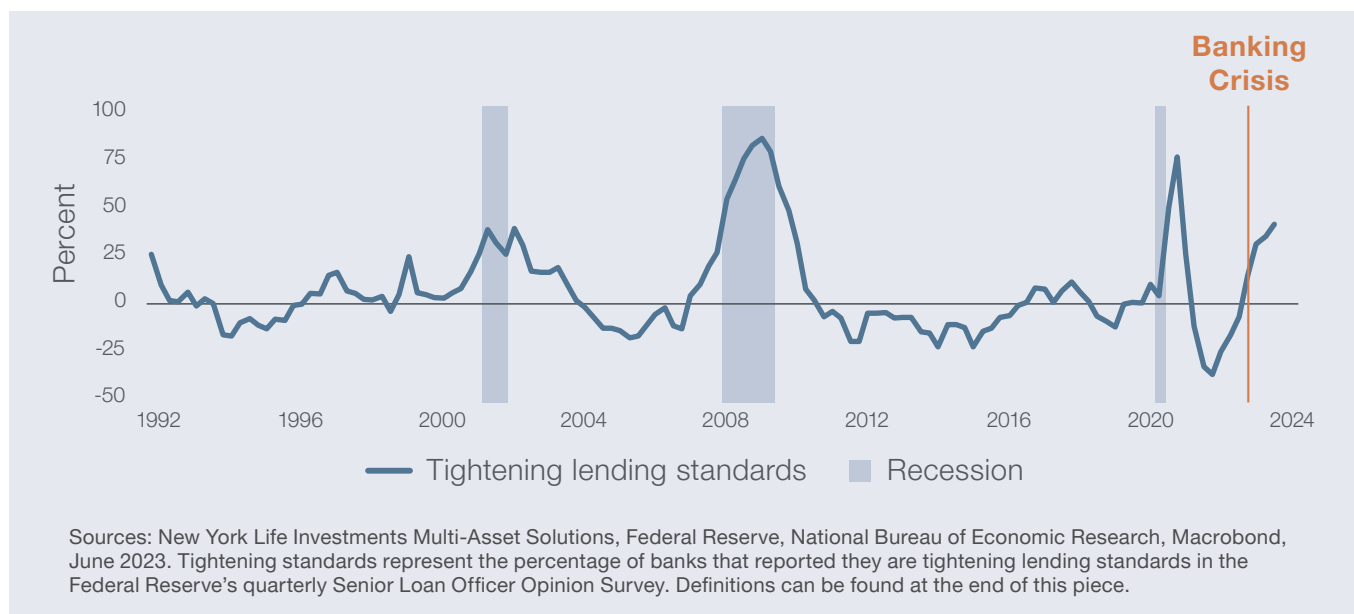
and therefore, not well understood by investors. What we do know is that ample liquidity tends to improve sentiment toward risk assets, particularly longer duration or more interest rate-sensitive securities. Investors, therefore, tend to expect that tightening liquidity could contribute to an economic or market contraction. Notably, the timeline of quantitative tightening need not end when the Fed stops hiking; the liquidity drain could continue working to slow activity and inflation even during a Fed pause.

Stricter credit conditions: The collapse of three regional banks earlier this year ignited concerns about the outlook for midsize banks and a further tightening of lending conditions, beyond what had already been achieved by the tightening cycle. The business cycle relies on the credit cycle, so when lending conditions tighten and credit creation slows, so does economic growth.

Political risk: As the latest debt ceiling debacle reminded us, even risk-free instruments can come under scrutiny when (geo)political risk rears its head. This can prompt investors to demand a higher interest rate for this risk, sending yields upward and potentially weighing on both the cyclical and structural growth outlook.

Tighter lending standards have historically hastened the path to recession

Lending standards were rising before the banking crisis; a spike in lending standards has historically preceded hard landing recessions



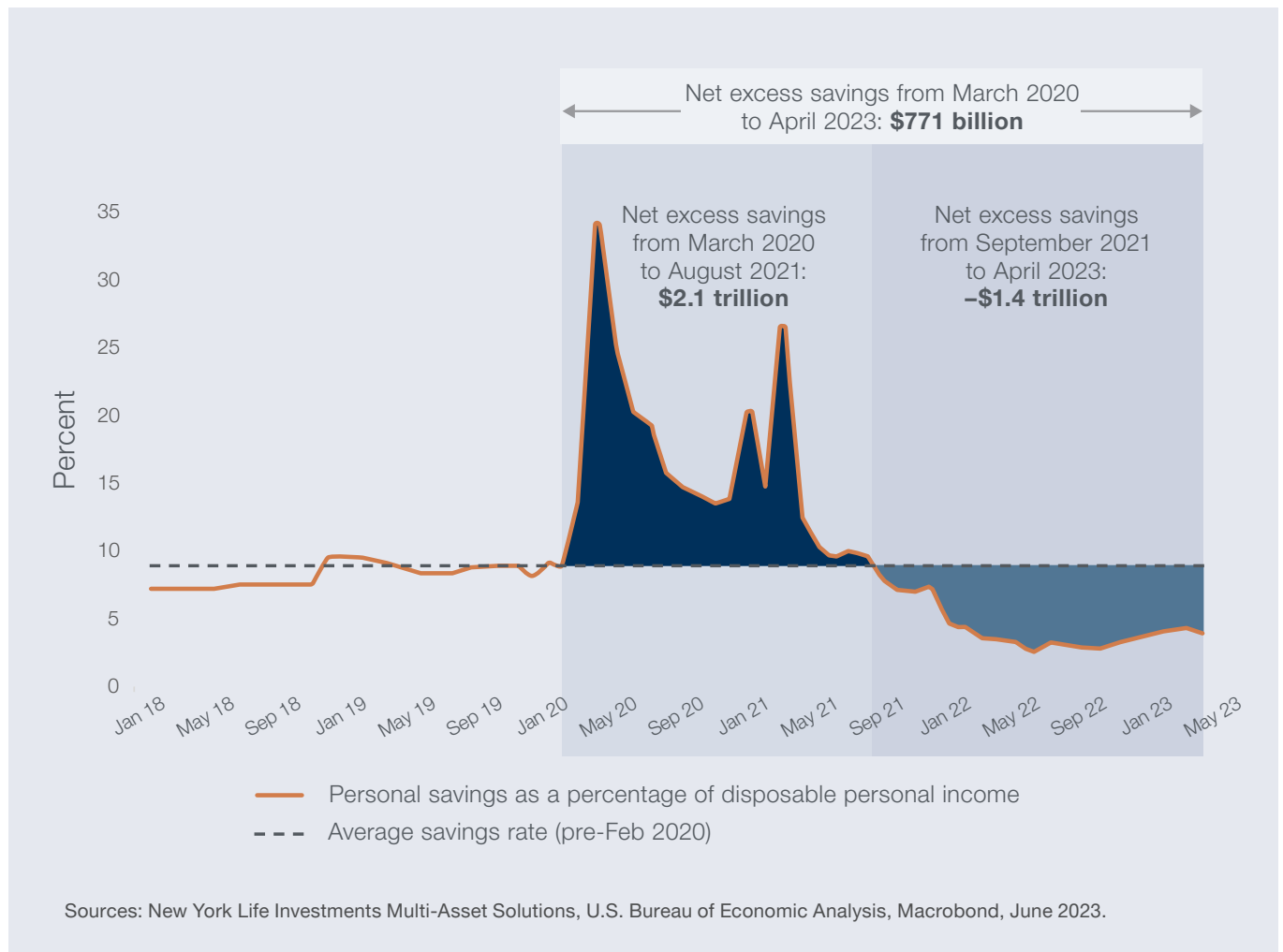
Factors delaying the recession timeline

Excess savings: With fewer places to spend during the pandemic, consumers accumulated to the tune of \$2 trillion in excess savings—those savings above the normal level. When COVID-19 restrictions were lifted, consumers began to spend

down these savings, but nearly \$800 billion remains. This surplus has helped consumers maintain their spending levels even amid inflation, supporting companies' revenue growth.

The strength of the consumer is holding up the dominoes

Consumers are still sitting on almost \$800 billion in excess savings

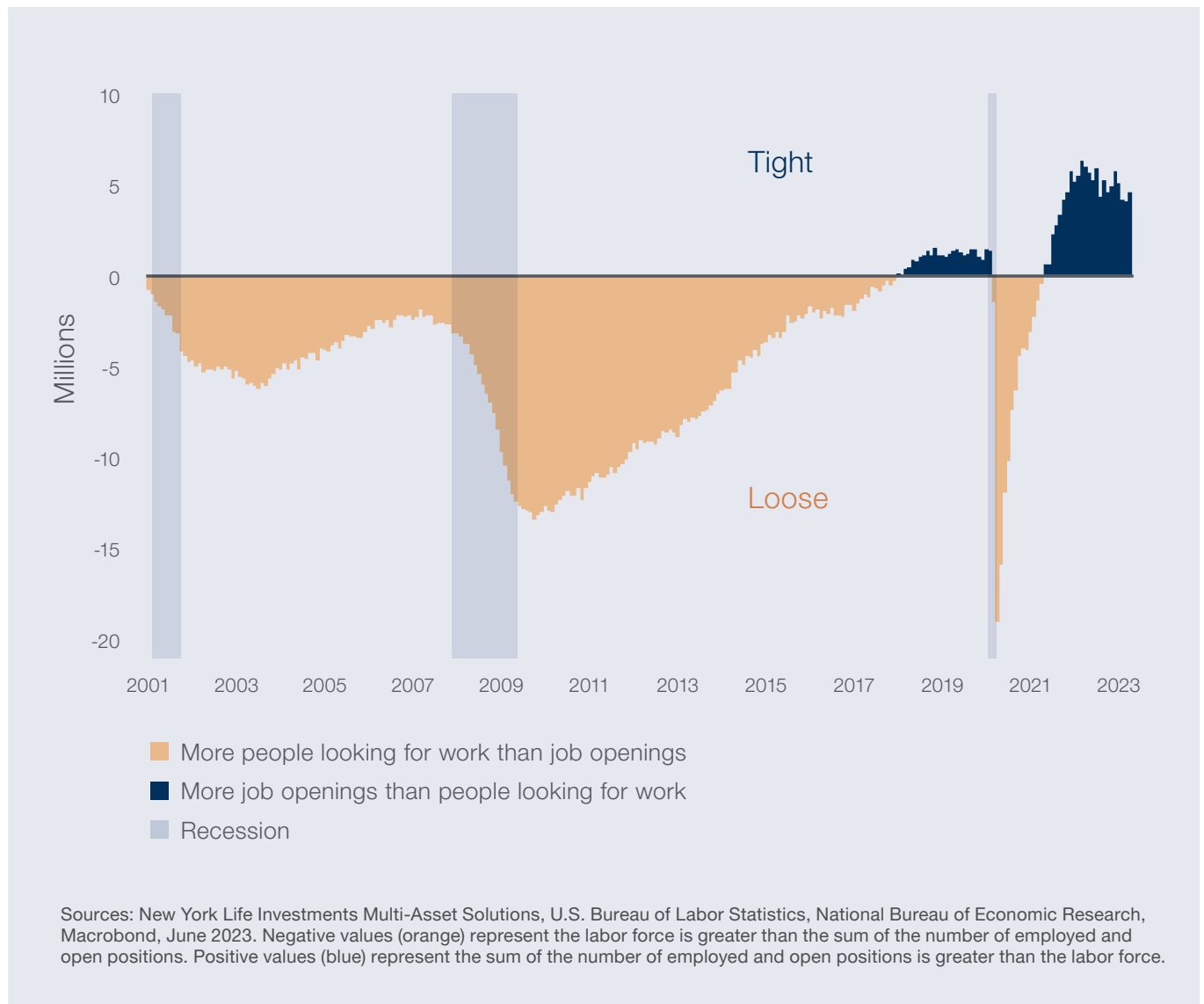


Labor market strength: The pandemic caused a major disruption, or more specifically, a reshuffling of America's labor force. This shift has led to a scarcity of workers in several sectors, especially healthcare and manufacturing. Given that so many jobs remain hard to fill, we have observed companies across sectors engaging in labor hoarding or maintaining headcount when under

normal economic slowdown conditions this headcount might be reduced. Will companies preserve headcount through a recession, or simply delay layoffs? Regardless, the persistence of labor market strength is a key factor keeping the U.S. consumer afloat. Rising unemployment claims would be a key signpost that the end of the cycle is arriving.

A tight labor market bolsters the final dominoes

When jobs are hard to fill, employers are reluctant to reduce headcount

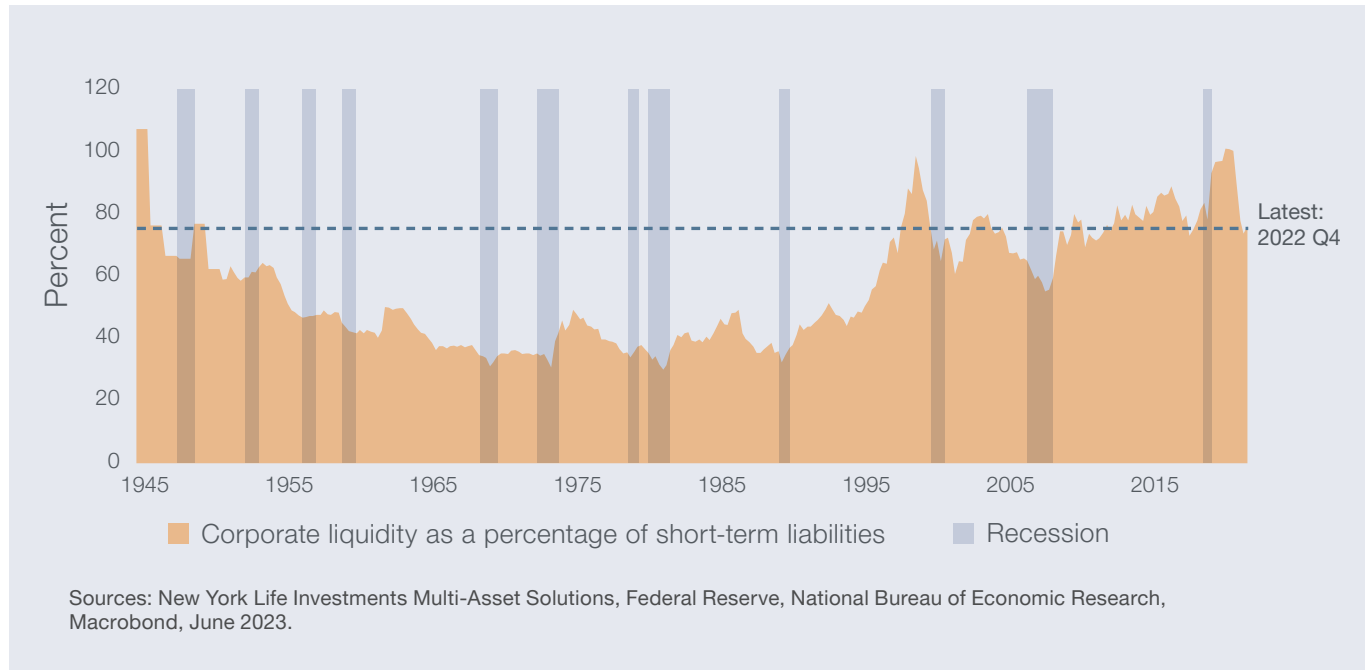


Pandemic-era business support: Fiscal stimulus (pandemic programs) and monetary stimulus (low interest rates) allowed companies to both build up cash and deleverage, even while facing inflationary pressures. As a result, many businesses have

protected their bottom lines, with cracks only just beginning to appear in corporate earnings reports. Negative sales growth (top line) and earnings growth (bottom line) would be another red flag that the economic cycle is waning.

Corporate balance sheets look healthy relative to past cycles

A buildup of cash has supported earnings resilience



Implications for investors

To us, a hard landing appears inevitable. Tight monetary and credit conditions mean that the economy will continue to weaken. But that’s not all bad news, especially for investors. By any measure, the economic cycle has been moving slowly. And, as we know from experience, a Fed pause window can create market upside even alongside concerns for the broader environment.

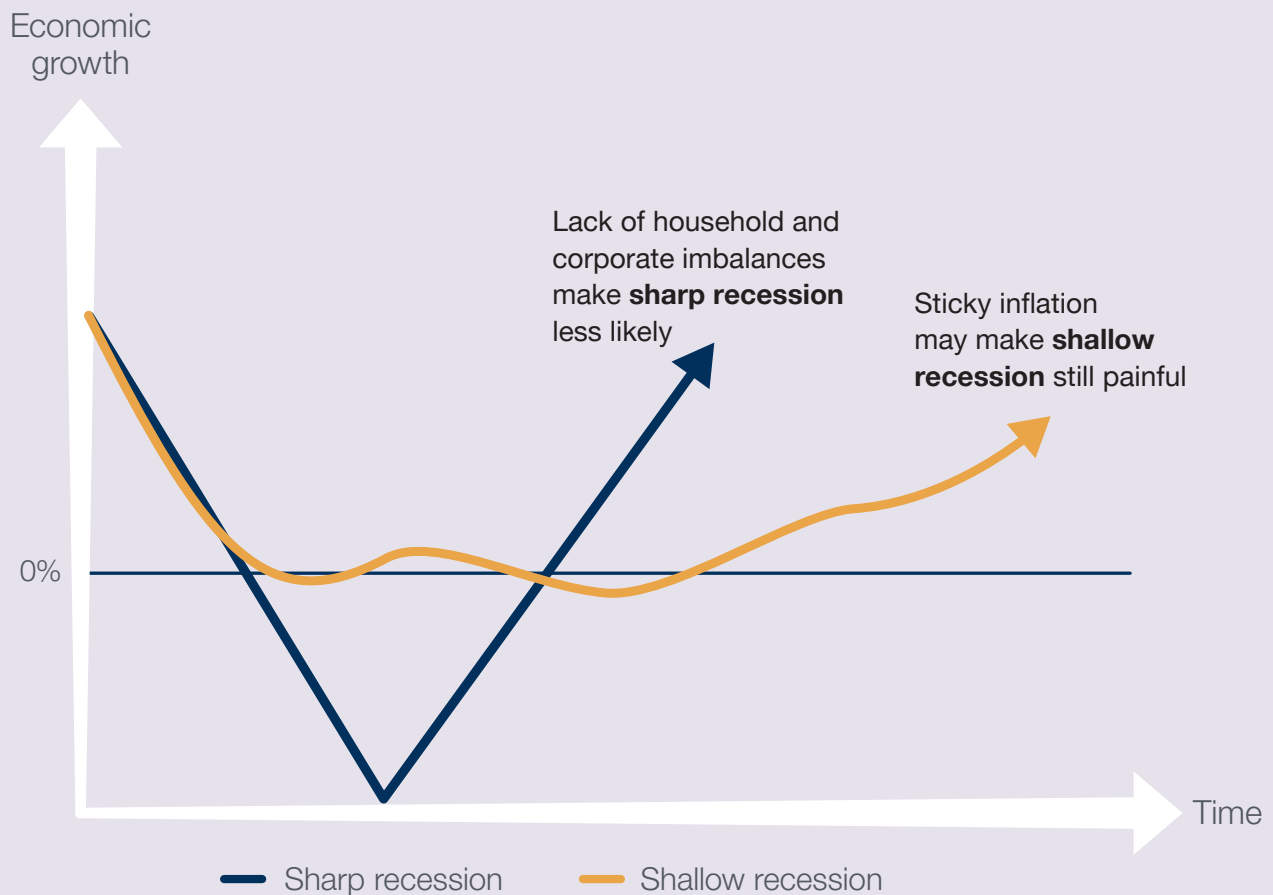
We have mentioned a few key signposts that would signal the cycle is coming to an end, such as rising unemployment claims or declining sales and earnings growth. As we will describe in the next section, we expect these conditions to prompt a market reaction. In the meantime, for many investors, the most prudent approach is not to try and time the market—or the economy—amid so many powerful crosscurrents.

Mild recessions can still be painful

If a hard economic landing appears inevitable, an extreme recession may not be. We have written in recent economic outlooks that healthy household and corporate balance sheets make a mild recession more likely than not. However, and despite our base case for a mild recession, we discourage investors from equating “mild” or “garden variety” with easy;

a mild recession can still be painful. Sticky inflation may contribute to higher nominal corporate earnings and worker paychecks, but it also makes it less likely that the Fed will cut rates or fiscal spending will step in. The economy could therefore remain sluggish for longer—an elongated “U-shaped” recovery.

A shallow recession may still be painful



Source: New York Life Investments Multi-Asset Solutions, June 2023. For illustrative and educational purposes only.

As demonstrated by the table below, the median post-World War II experience (therefore removing extreme examples such as the Global Financial Crisis) paints a picture in which even a moderate recession is likely to result in higher unemployment, lower earnings, and a market correction.

Historical experience of U.S. recessions

Recession onset	Real EPS drawdown	Rise in unemployment rate	Real GDP drawdown
July 1953	-23%	3.4%	-2.5%
August 1957	-21%	4.9%	-3.6%
May 1960	-13%	3.2%	-1.3%
December 1969	-20%	2.5%	-1.1%
November 1973	-21%	4.0%	-3.1%
January 1980	-17%	2.2%	-2.2%
July 1981	-23%	5.2%	-2.6%
July 1990	-23%	1.8%	-1.4%
March 2001	-19%	1.7%	-0.4%
December 2007	-37%	5.1%	-4.0%
February 2020	-19%	11.2%	-10.1%
Median	-21%	3.4%	-2.5%
Mildest	-13%	1.7%	-0.4%
Recession not yet priced by the markets? If the price-to-earnings ratio remained stable, then a 21% drop in earnings per share would result in a S&P 500 correction of 15%-20%.		Optimistic labor? The mildest U.S. recession since World War II resulted in a 1.7% increase in the unemployment rate. Investor estimates today call for an increase of only 1.3%.	

Sources: New York Life Investments Multi-Asset Solutions, U.S. Bureau of Economic Analysis, National Bureau of Economic Research, June 2023. For illustrative and educational purposes only. Definitions are provided at the end of this document.

Wait—a market correction is still to come? After the drawdown investors experienced in U.S. equity markets last year, isn't this already priced in? We don't believe so. Equity market volatility in 2022 was driven primarily by interest rates, resulting in valuation or multiple compression—which is the sheer gravitational force on equity valuations that occurs when interest rates impact the future value of corporate earnings.

This means that further market volatility could arrive as recession does. For example: even if valuations in

the S&P 500, measured by the price-to-earnings (P/E) ratio, remained stable, then the median 21% drop in earnings per share cited above would result in an S&P 500 correction of 15%-20%. However, the median peak-to-trough correction in S&P 500 over the last five recessions (not counting the pandemic) was 27%. The difference reflects the fact that valuations may still have further to fall, because investors require a higher risk premium for holding risk assets when the economy is in a downturn.

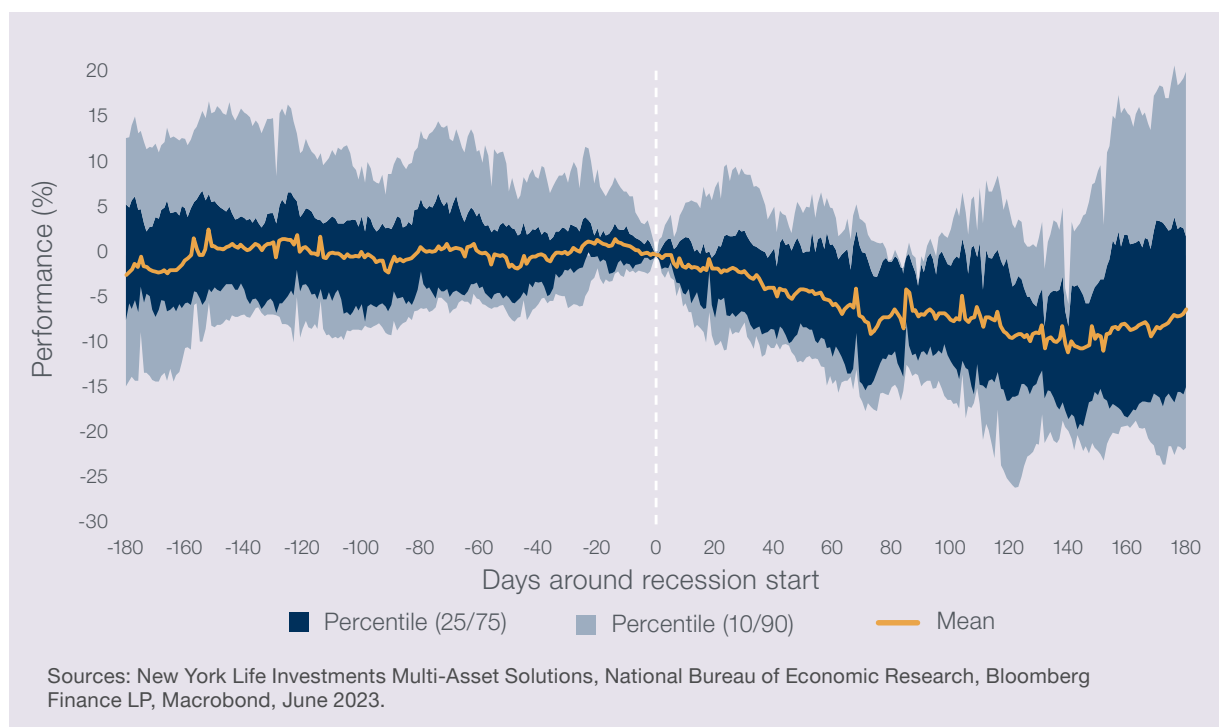


Implications for investors

It is important to note that this market impact may not be felt all at once. Investor estimates of earnings per share tend to decline over several quarters. The critical point for investors, though, is around the timing of the market impact. Historically, equity markets have led the economy *out* of recession. However, the popular investor story that equity markets lead the economy *into* recession is not necessarily true. Typically, we do not see equity market outcomes reach their lowest point until unemployment claims rise and earnings are revised downward—when recession is already upon us.

Historically, equity markets have not anticipated recessions

S&P 500 when recession starts, based on the last 16 recessions (not including 2020)



We will discuss interest rates in the next section, but it merits mentioning here: if inflation is stickier, then central bank policy is likely to be slower to ease back down to neutral levels—the point at which policy neither constricts nor supports economic growth. In this circumstance, even a mild recession may be more drawn-out than investors appreciate.

Even a mild recession is a “hard landing.” The factors maintaining economic activity—the business and consumer supports to the economic dominoes—are also making the withdrawal of policy support more assertive. The longer this cycle lasts, the longer recession may last too.

The bar for sustained Fed cuts is high

We believe a hard landing may be inevitable to bring inflation lower. And yet that view—especially when it comes to slowing economic growth—raises investor questions around when the Fed will cut rates. Certainly, investors are eager for cuts, and that eagerness may explain some of the recent buoyancy in equity markets.

Still, we hold that hopes for rate cuts are premature. In our view, the checklist of items—rooted in the Fed’s two mandates of price stability and full employment—that would signal price

stability is far from being met. It is worth noting that the historical experience of U.S. recessions, reviewed in the previous section, suggests that meeting the conditions for a Fed pivot may *require* recession.

More to the point: rate cuts may not be the market boon that investors are hoping for. If inflationary pressures are not clearly behind us, then a double peak in inflation becomes more likely. In response, a second hiking cycle may be required—a challenge for market outcomes.

Conditions for a Fed pivot

Conditions for a Fed pivot	Signposts	Condition achieved?	Would a shallow recession achieve this condition?	Would a more severe recession achieve this condition?
Price stability Bring inflation closer to target	Well-anchored inflation expectations	Yes	Yes	Yes
	Core inflation near target (2.0%)	No	No	Yes
Full employment Keep the labor market from overheating	Wage gains consistent with price stability	No	Maybe	Yes
	Unemployment rate above 4.0%	No	Yes	Yes

Opinions of the New York Life Investments Multi-Asset Solutions team, June 2023.

Price stability

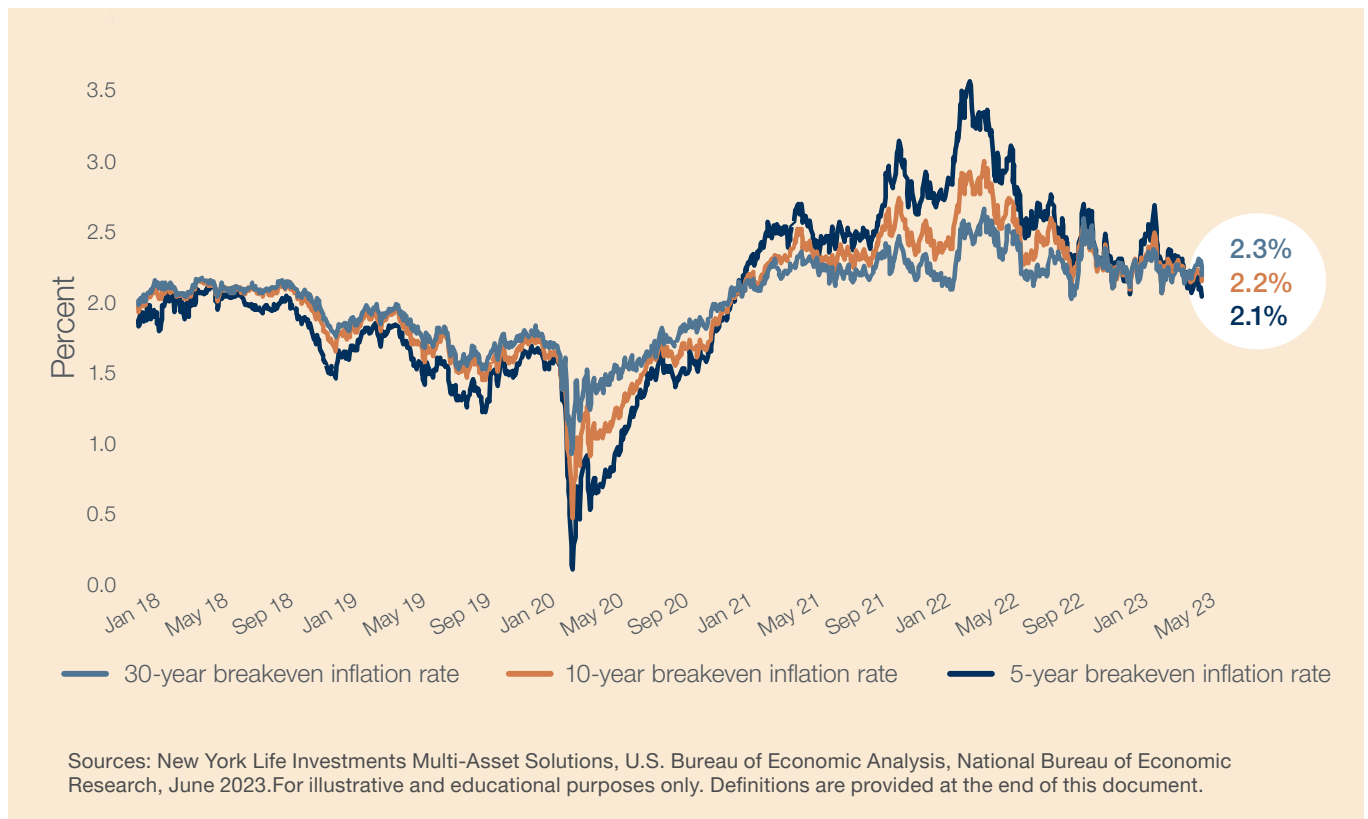
As U.S. inflation has risen, the Fed has held that without price stability, the economy does not work well for anyone. We tend to agree. In the near term, a higher cost of living burdens household spending decisions; even higher wages have not kept up with the pace of price growth for over two years now. In the medium term, an *expectation* that prices will continue to move higher can be a self-fulfilling prophecy. If you expect the price of a television to rise in the near future, you may try to buy one

sooner to avoid the inflationary impact. Stronger demand today begets higher inflation.

This concept is called inflation expectations. And for the Fed, well-anchored inflation expectations are crucial to avoiding an ongoing price spiral and to reduce sticky inflation. This is the one condition towards a Fed rate cut that is holding relatively well today. Inflation expectations—based on breakeven inflation rates—have stabilized.

Signpost #1: Well-anchored long- and short-term inflation expectations

✓ *Achieved: inflation expectations have stabilized*

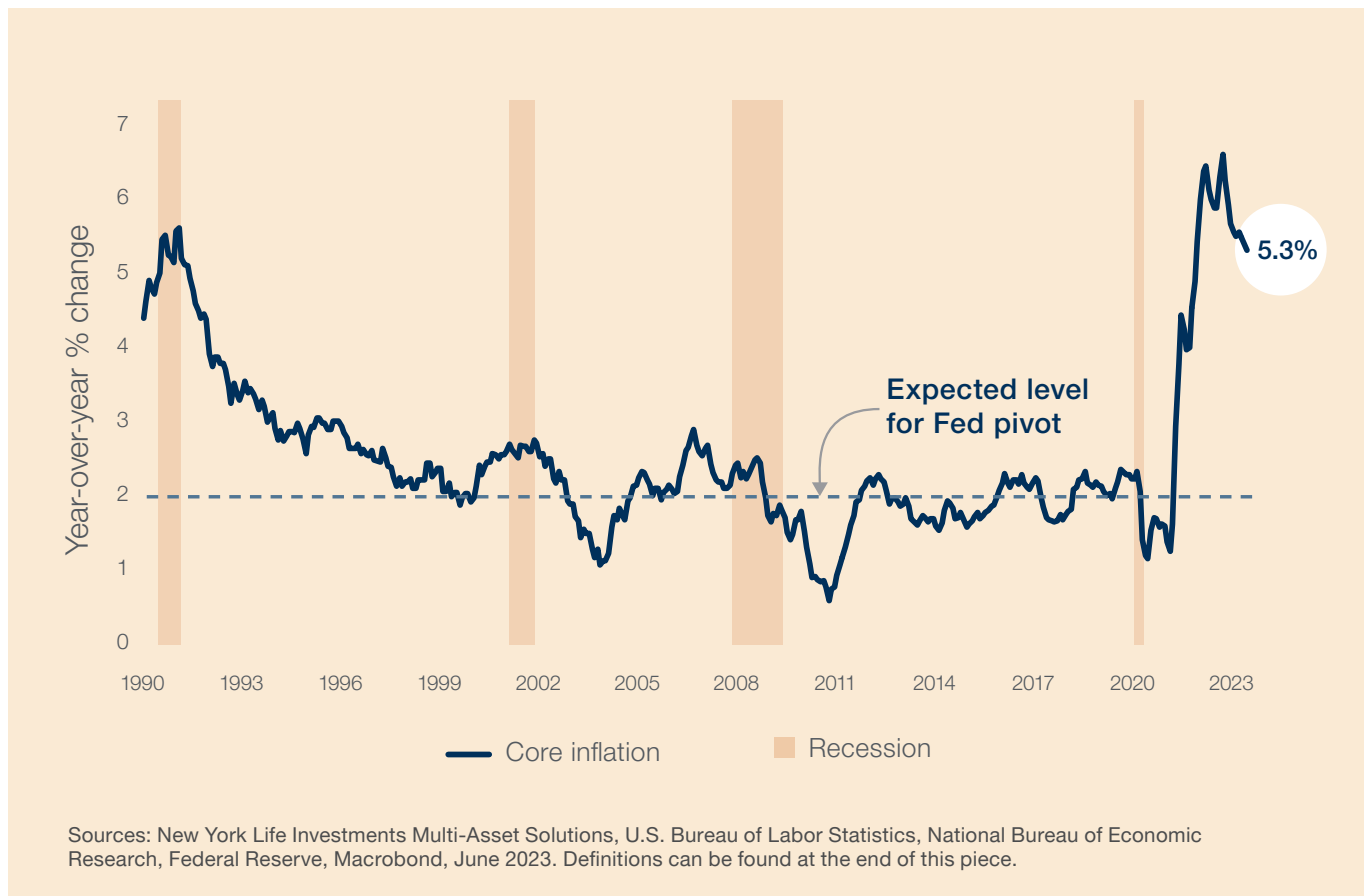


Unfortunately, that is where the good news on our Fed checklist ends. While inflation expectations have stabilized, the inflation reality *today* is still too high. We believe the disinflationary process in the U.S. is intact, but core inflation tends to be “sticky” and will take time to ease. Some academic research suggests core inflation is so sticky that unemployment needs to reach up to 7.5% for one to two years to return inflation to its 2.0% target. This is much different than Fed projections, which estimate that a 4.6% unemployment rate is required to ease inflation to target.

Signpost #2: Core inflation near target (2.0%)



Not achieved: Core inflation can be slow to normalize without a severe recession



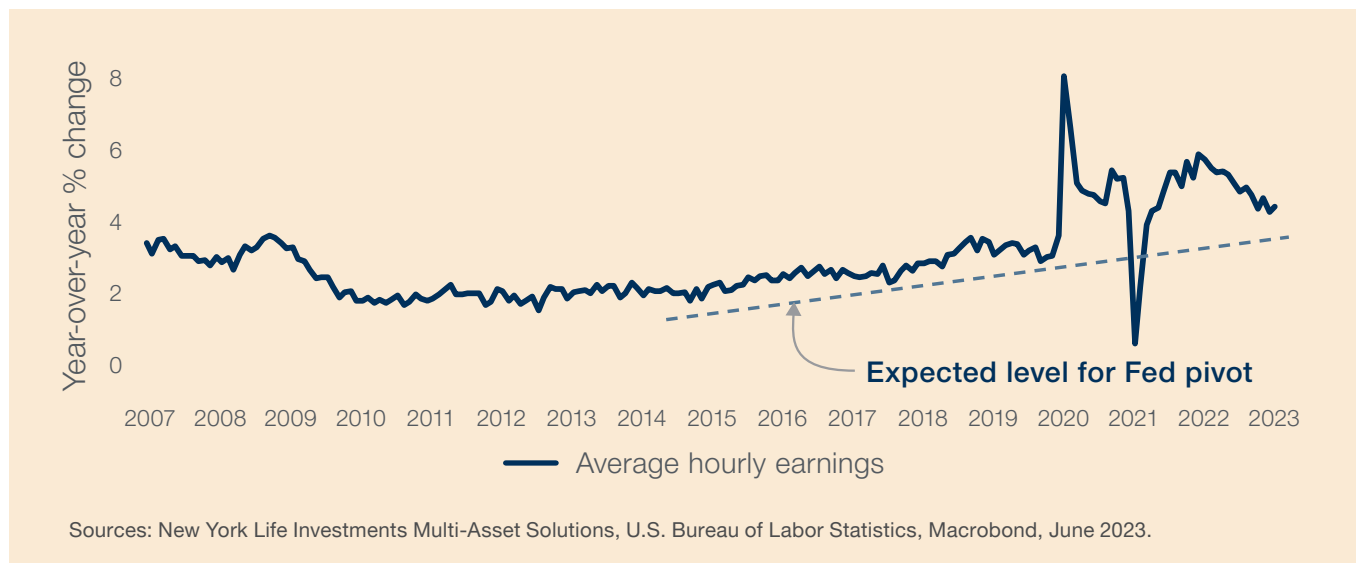
Full employment

A tight labor market means more people are working and spending. This is keeping upward pressure on core inflation, and notably on the shelter and transportation costs that make up the “stickier” inflation the Fed is concerned about.

The return of inflation in the economy naturally led to higher wages—as prices rise due to inflation, workers demand higher wages to maintain their real income. If left unchecked, this cycle can result in a self-reinforcing loop of increasing wages and prices. The Fed is aware of creating a wage-price spiral and is attempting to return wage growth to its pre-inflation trend line with tighter monetary policy. We believe it’s possible for wage growth to align with price stability in a shallow recession, but it’s not guaranteed.

Signpost #3: Wage gains consistent with price stability

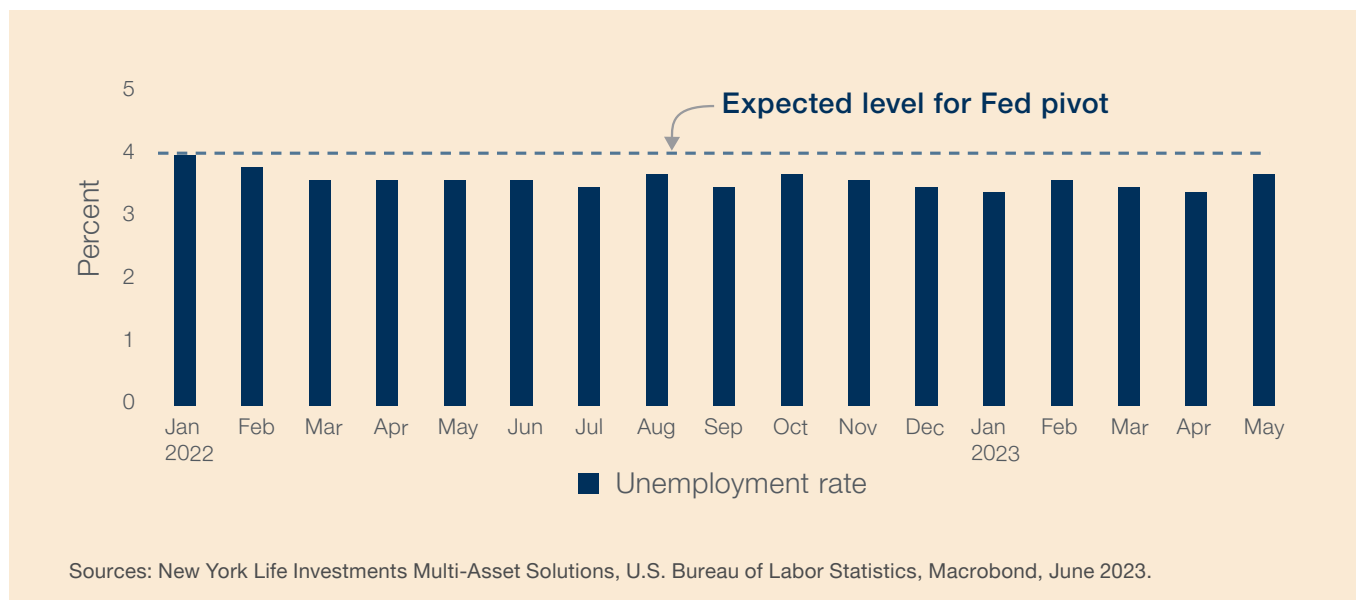
X Not achieved: high wages are still supporting inflationary pressures



Even if and as wages fall, it can take time. Historically, it takes 18 to 24 months for interest rate adjustments to impact the labor market. The Fed started this hiking cycle in March 2022, which suggests we may still have a few months before the Fed’s policy is felt in the labor market. 4.0% is a minimum condition and not necessarily the extent of labor market impact we expect to see as the economy slows. Because of the pace and extent of interest rate hikes, especially after such a long period of low interest rates, we believe the impact of economic slowdown on the labor market could send the unemployment rate above the 4.0% pivot condition level. Since World War II, even the mildest recessions have seen an unemployment rate increase of 1.7% or more.

Signpost #4: Unemployment rate above 4.0%

X Not achieved: Labor market slack is nowhere to be seen





Implications for investors

Each of these factors, rooted in the economic cycle, are important for the Fed's interest rate decision-making. But there are also structural factors putting upward pressure on inflation, which we describe in the next section.

The key takeaway for investors is that interest rate cuts in the next few months, contrary to market sentiment, could be bad news for investor outcomes. If the Fed cuts rates in response to a financial stability risk, for example, especially when the labor market and inflation data have not sufficiently cooled, then it would only increase the likelihood of a double peak in inflation. The resulting scenario—slowing growth with still-high inflation—would likely be challenging for businesses, households, and investors.

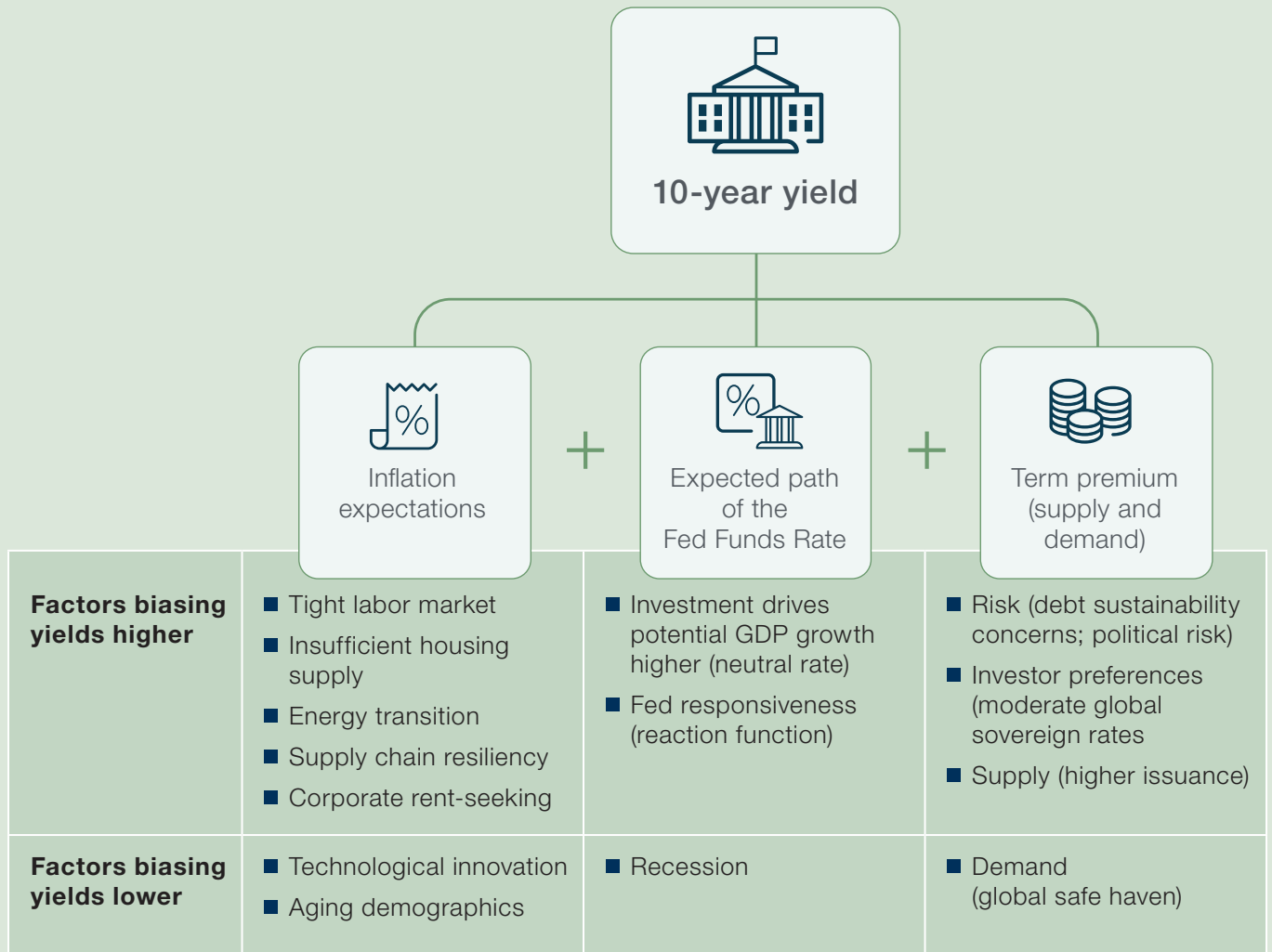


Long-term interest rate inputs are shifting

In the last year, investors have been focused on moves in short-term interest rates, and with good reason; the Fed's latest hiking cycle has been sizable and swift, impacting nearly every asset class. However, despite wild moves in the short

end of the curve, long-term Treasury yields have remained relatively rangebound. We believe this dynamic warrants examining, because so many factors impacting interest rates have shifted in recent years.

Factors impacting long-term Treasury yields



Sources: New York Life Investments Multi-Asset Solutions, 2023. For illustrative and educational purposes only.

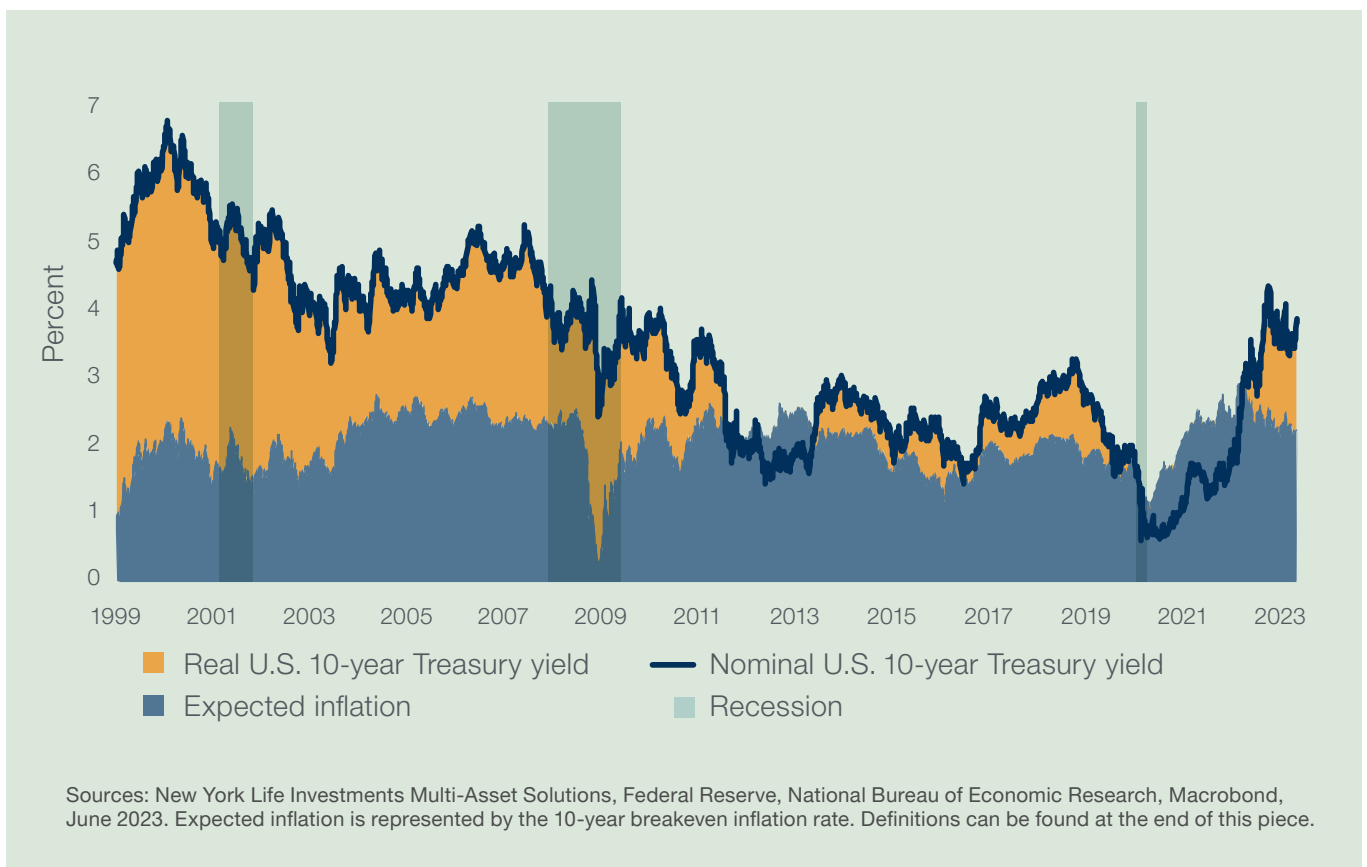
Each of the factors impacting long-term Treasury yields are uncertain in size and timing, difficult to measure, and therefore challenging to weigh against one another. To illustrate:

Inflation. Price growth tends to ebb and flow with the economic cycle. Factors such as a tight labor market and high corporate profits drive prices higher, until a slowing economy eases those pressures. This cycle, however, has seen prices bolstered by structural changes as much as cyclical ones. The global pandemic has drawn attention to supply chains, making access just as important as efficiency. Russia’s invasion of Ukraine may have accelerated a global energy transition. This combined focus on global resiliency points to redundancy, meaning higher costs. As these transitions are likely to require ample time and investment, inflation may be biased higher in the medium and longer term.

Combating these factors are the disinflationary impacts of technological innovation—economic efficiency drives productivity higher and prices lower—and an aging demographic. Economic theory suggests that people spend less and save more as they age. In the last economic cycle, these factors prevailed over any cyclical drivers of inflation, contributing to a low-inflation, low-rates environment. Today, the impact is less certain. Demographic disruptions have contributed to a dearth of labor supply, pushing wages and prices higher in the near term. Until the labor market is brought into balance or innovation displaces labor, this factor has contributed to stronger price pressure.

Even after a dramatic rise in the past year, the 10-year Treasury sits comfortably in its historic range

Composition of nominal U.S. 10-year yield



Path of the Fed Funds Rate. Here, we aren't talking about the Fed Funds Rate today or tomorrow, but rather the path of the Fed Funds Rate over a long term. This is driven by two factors: the neutral interest rate—the “goldilocks” policy rate that neither stimulates nor constrains the economy, and the Fed's reaction function—how quickly it tends to respond to inflation as it deviates from target.

The neutral rate would move higher if potential GDP growth, the maximum sustainable economic capacity, moves higher. We can see this happening: sizable investment in the energy transition technological innovation appears inevitable. Global competition in these areas may spurt that trend further. The question, then, is how productive these investments will be. Reshoring supply chains may have important security benefits, but it's not necessarily productive—at least in terms of potential GDP growth, how it is measured today.

The Fed's reaction function was in the process of changing just as this inflationary cycle took off. Flexible Average Inflation Targeting, or FAIT, was introduced in August 2020 as a recognition that being highly responsive to small changes in inflation around the 2.0% target had been counterproductive in recent economic cycles. Instead, the Fed would become less reactive to inflation changes around the 2.0% level. On aggregate, this may have biased the path of the Fed Funds Rate lower over time. The high and sticky inflation experience of the post-pandemic era, however, may have neutralized this impact.

Term premium. Supply and demand for U.S. Treasuries are the remaining factor impacting yields over time. Given the likelihood of higher investment noted above, financing needs, and the supply of U.S. Treasuries along with them, are likely to increase. On aggregate, this would drive yields higher to attract buyers. Demand factors, however, are less certain. Today, the U.S. remains an important global safe haven, driving strong demand for U.S. Treasuries when global risks are high, even when that risk originates within the U.S. itself—an important, and nearly structural, downward force on U.S. sovereign yields. At the margin, though, those factors may be shifting. For many years, the U.S. was one of the only developed countries to provide positive-yielding government bonds; negative-yielding debt from across Europe and Japan once neared \$20 trillion. Today, that is no longer the case; negative-yielding debt has declined to less than \$2 trillion and is exclusively issued by Japan. What's more, the cost of servicing government investment—due both to the volume of debt outstanding and higher interest rates—has moved higher. Any commensurate increase in concerns about debt sustainability could reduce demand on the margin, pushing yields higher.



Implications for investors

In the near term: the Fed is unlikely to cut rates. See the previous section for our criteria for Fed rate cuts. The cyclical and structural factors biasing inflation higher mean that the Fed is unlikely to cut rates, even as economic growth slows. In the medium and longer term, we are sympathetic to the argument that the strategic nature of ongoing tech and energy investment may bias inflation higher with a need for non-restrictive rates. In our view, though, this is unlikely to play out in the next year. Furthermore, we remind investors that neutral rates are likely to be closer to 3.0% than the “lower for longer” environment that investors became accustomed to in the last cycle.

In the longer term: monitor the productivity of government investment. Where interest rates settle is important for investors, but why may be even more important. Long-term Treasury yields can move higher for two reasons. Treasury issuance to fund productive investments may bias long-term rates higher by increasing potential economic growth (the natural rate); this may impact the range at which U.S. Treasuries trade, but in a modest and sustainable way. If, by contrast, yields are moving because of a misstep in supply and demand (the term premium), investors can expect more volatility.

Remain cautious on aggressive duration bets. While duration may well benefit in the short term as interest rates fall, the medium-term duration argument is murkier. If structural investment needs continually push the front end of the curve, why move farther out? We encourage investors to maintain a neutral position in their overall duration exposure. We prefer shorter duration in corporate credit, paired with longer duration in municipal bonds where curve structure is more attractive.

Investors may not be prepared; making the case for change

Looking back on the last several years, we see several structural shifts that will potentially impact both how and where we all invest for the next several decades. But the current cycle—namely the slow march toward recession and the sideways market volatility accompanying it—has interrupted investors' willingness to reflect structural changes in their portfolios.

It is natural that near-term cyclical needs are front of mind, but we have been concerned by a common occurrence across the marketplace: cash paralysis. Investors are eager to sit this cycle out, allocating heavily to the shelter and yield of the money market. And while this makes sense for investors close to or in retirement, we feel strongly that another leg down in the markets—reflecting earnings pressure as the economy slows more markedly—will present opportunities for investors to rebalance. This rebalancing can not only add risk back to portfolios as the cycle bottoms, but can also reflect the changing structural forces across asset classes.

Our highest conviction investment ideas capture not only the cyclical and structural factors impacting the markets, but also the portfolio construction techniques that may allow investors to take a more resilient approach to this market.

Durable adaptations to the economic cycle

In our view, a deeply inverted yield curve gives investors little incentive to take excessive risk in duration in U.S. Treasuries. However, not all duration is created equal. Municipal bond curves, for example, provide some incremental benefit for duration exposure taken, and can balance shorter-duration allocations in the money market or high yield corporate bonds.

We like **taxable municipal bonds** as a duration-balancing, long-infrastructure play. Higher credit quality and diversified credit exposure provide additional benefits to this portfolio construction technique, in our view.

The assertive U.S. rate hiking cycle has further impact on a global allocation. During the pandemic

and recovery in 2020 and 2021, driving economic forces were primarily global in nature. Most major regions faced synchronized economic contraction in 2020—met with meaningful fiscal and monetary policy stimulus—and a less synchronized, though directionally harmonious, recovery period in 2021. As the post-pandemic recovery matures, we see organic economic cycles and monetary policy adjustments taking hold, resulting in disparate asset allocation takeaways by region.

The U.S. appears to be later in its economic cycle, and many investors are underweight international. Considering **adding international equity exposure**, either directly or through global structural themes.

Companies with longer-dated expected earnings, namely growth stocks, are more sensitive to changes in interest rates, and therefore struggled with the Fed's rate hikes. Looking ahead, equity style performance may be more mixed as rates stabilize and growth is sluggish. Our structural view that investors may need exposure to "value, growth, a little bit of both" is likely to hold as

late cycle narratives—and economic data—ebb and flow.

Given high growth equity valuations and a sensitivity to interest rate volatility, we are taking a U.S. equity base of **overweight value equity, overlaid with quality, profitable tech.**

Integrating structural shifts

The very source of last year's market volatility—higher interest rates—has also reopened a lever of value creation that had been dormant for many years. The income generation aspect of portfolio construction is back.

After 15 years of low rates, investors may be structurally over-allocated to stocks relative to bonds. **Investors may consider a modestly higher structural allocation to bonds.**

Just as late-cycle narratives can push and pull on returns to U.S. equity styles, so too can those narratives sway between winning economic sectors. Rather than relying on traditional cyclical or defensive sectors, we look for durable, quality earnings and the tendency to use profits to reinvest in the business or in shareholder value. And given the sheer volume of changes in the economic landscape, we are looking to longer-term themes to dictate where durable and quality earnings may emerge.

Identify durable themes and the companies that will facilitate them. We particularly like global **infrastructure**, with a focus on digital infrastructure, green and brown energy, utilities, and communications. In the equity sleeve of a portfolio, infrastructure as a global theme may also help investors to close a frequent gap in international exposure.

In the past, high yield bonds have been an important tactical indicator of the economic and credit cycle. As economic risks rise, high yield spreads widen. Conversely, compressing spreads have historically given investors an important signal that it may be safe to add risk. We believe this may not be the case in the upcoming cycle. Strong corporate balance sheets have been an important supporter of the economy (keeping the "economic dominoes" upright) and may not see the volatility of past cycles.

While we expect credit spreads to widen as the cycle turns, we expect public credit to fare better than in past cycles. Rather than play tactically in **high yield corporate bonds**, it may be appropriate to consider a higher structural allocation to this asset class. From a portfolio construction perspective, investors concerned about volatility could move some equity risk into high yield corporate bonds as an opportunity to benefit from higher coupons as the cycle unfolds.

Definitions

Breakeven inflation rates are derived from the difference in yields between nominal bonds and inflation-linked bonds of the same maturity. It serves as a market-based indicator of inflation expectations over a specific time horizon.

Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Core Consumer Price Index (Core CPI) is the Consumer Price Index excluding the more volatile prices of food and energy.

Earnings per share is the monetary value of earnings per outstanding share of common stock for a company.

The National Bureau of Economic Research (NBER) traditionally defines recession as a significant decline in economic activity that is spread across the economy and that lasts more than a few months.

The nominal 10-year Treasury yield represents the interest received from a U.S. 10-year government bond without adjusting for inflation. It is the yield expressed in current dollars.

The real 10-year Treasury yield represents the yield adjusted for changes in the purchasing power of money.

Real gross domestic product (GDP) is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy.

The S&P 500 Index is an unmanaged index that is widely regarded as the standard for measuring large-cap U.S. stock market performance.

The Senior Loan Officer Opinion Survey on Bank Lending Practices is a quarterly survey conducted by the Federal Reserve on the standards and terms of the banks' lending and the state of business and household demand for loans.

The Multi-Asset Solutions team is New York Life Investments' specialist in multi-asset investing.

The team leverages the depth and breadth of New York Life Investments' platform to seek to deliver strong investment opportunities across multi-asset strategies, market intelligence and insights, and customized solutions to its strategic partners.



Jae Yoon

Chief Investment
Officer



Jonathan Swaney

Senior Portfolio
Manager



Poul Kristensen

Chief Economist,
Portfolio Manager



Amit Soni

Portfolio Manager



Lauren Goodwin

Director of
Portfolio Strategy



Julia Hermann

Multi-Asset
Portfolio Strategist



Michael LoGalbo

Multi-Asset
Portfolio Strategist

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New York Life Investment Management Asia Limited

金融商品取引業者 登録番号 関東財務局長（金商）第2964号

一般社団法人日本投資顧問業協会会員

一般社団法人第二種金融商品取引業協会会員

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