

Market Trends & Analysis

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Multi-Asset Solutions Team

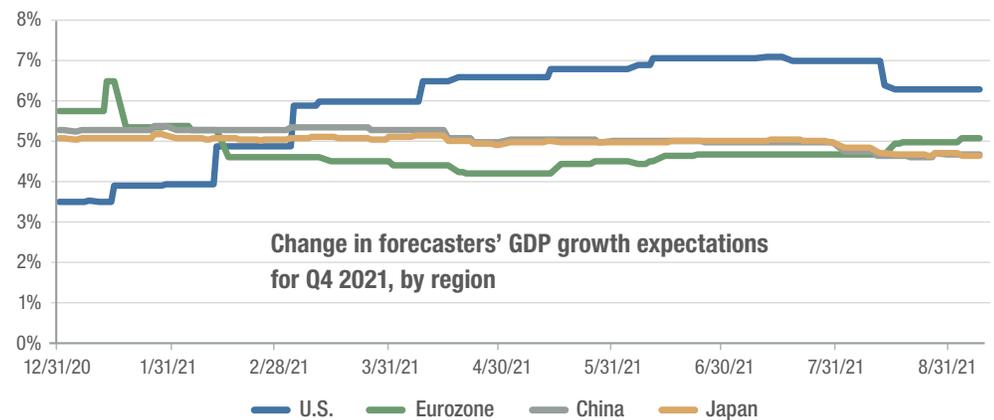
We are New York Life Investments' specialists in multi-asset investing, assisting our partners in their pursuit of investment success.

Four scenarios for the markets

Our conversations with investors point to growing anxiety over the economic and market path ahead. The COVID-19 Delta variant is slowing the recovery, companies are facing disruptions and supply chain bottlenecks, the Fed is preparing to taper its asset purchase program, and tax increases loom. With asset prices boasting record levels, how will the markets hold up?

Our view is that strong economic and corporate fundamentals mean the recovery can be sustained, and risk assets will continue to move higher. However, we are shifting into the mid-cycle phase of economic recovery. As a result, we expect moderating equity gains, more frequent pullbacks than in the last year, and ongoing leadership rotation across asset classes and sectors.

Economic growth expectations are decelerating in many regions, but not turning negative



Sources: New York Life Investments Multi-Asset Solutions team, Bloomberg Survey of Professional Forecasters, 9/8/21.

That said, it's important to be humble in our assertions. In this report, we describe our base case perspective on the economic and market outlook. For those investors concerned about less optimistic market outcomes, we provide alternative scenarios and investment implications. Our strongest conviction is that, even amid market risks, investors should stay focused on their long-term investment goals. While there are pockets of investor complacency and excessive valuations, we believe the worst action an investor can take is to excessively reduce risk. Cash and duration may do little to bolster a portfolio in this phase of the cycle.



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Scenarios for the next 12 months

In our view, the three key drivers of the economy and markets' path forward are: the COVID-19 pandemic's course, the monetary policy response, and fiscal policy's contribution. These factors are only semi-independent of one another. The resulting economic trajectory impacts consumer comfort, earnings expectations, and financial markets outcomes.

	 Base case	 Hawkish surprise	 Growth disappoints	 Stagflation
Scenario	Economic and earnings growth are strong and help markets to muddle through a series of (largely expected) risks.	Higher spending results in overheating the economy. Markets react to monetary tightening and higher tax rates.	Recovery stalls. "Lower for longer" growth returns quicker than we thought.	Supply chain and labor imbalances result in higher costs, choking off economic growth.
Likelihood*	60%	20%	15%	5%

Key drivers

 COVID-19 pandemic	The Delta (or other) variant(s) slows, but does not derail, the recovery. Consumers shift spending slowly from goods to services.	COVID-19 impact wanes more quickly than we expect. Consumers confidently spend on COVID-19-impacted services such as travel and restaurants.	COVID-19 is now an endemic, not a pandemic. Consumer spending on goods wanes, but a pickup in services spending is not forthcoming. Inflation returns to near 2.0% levels.	COVID-19-related disruptions create shortfalls in materials and labor, driving up costs. Real spending weakens as prices rise.
 Monetary policy	Fed tapers asset purchase program this year, but rate hikes are at least a year away.	Fed is forced to pump the brakes, accelerate its tapering program, and raise rates more quickly.	Fed is unable to tighten policy.	Fed is left in a very tough spot, as labor force participation stalls and consumer price and wage inflation accelerate.
 Fiscal policy	Physical infrastructure legislation passes (\$1.2 trillion); Some human infrastructure passes, but with a lower price tag than the \$3.5 trillion currently proposed. Tax increases are moderate, but not yet priced in.	Both physical and human infrastructure spending passes with large numbers. Associated tax increases spook the market.	Physical infrastructure legislation passes, but human infrastructure gets held up. Tax increases are moderate.	Gridlock prevents fiscal spending on infrastructure and social programs, contributing to a growth slowdown.

Investment considerations

As this scenario occurs	<ul style="list-style-type: none"> ■ International developed equity ■ Small caps ■ Value ■ Short-duration high-yield bonds ■ Bank loans 	<ul style="list-style-type: none"> ■ Extremely short-duration fixed income ■ Bank loans ■ Value equity 	<ul style="list-style-type: none"> ■ Multi-asset income ■ Long-duration fixed income ■ U.S. and growth equity ■ Alternative asset classes 	<ul style="list-style-type: none"> ■ Emerging markets equities ■ Growth equities ■ Commodities ■ Precious metals, gold ■ Government bonds
No matter which scenario occurs	<p>Secular themes: Infrastructure and ESG investing</p> <p>Build portfolio flexibility: Multi-sector bond strategies</p> <p>Maintain portfolio resiliency: Multi-asset income and asset allocation products</p>			

Source: New York Life Multi-Asset Solutions, September 2021. *These likelihood estimations reflect the views of the Multi-Asset Solutions team and are for illustrative purposes only.



60% Likelihood

Our base case: Strong economy sees market through

Our base case perspective is that strong economic and corporate fundamentals will continue to support risk assets, albeit likely at lower rates than the exceptional returns of the last year. Three main drivers underpin our perspective.



First, we expect that variants of the COVID-19 virus will slow, but not derail, the recovery.

Consumers are learning to live with the virus, and each subsequent wave has had a marginally smaller economic impact—albeit equally tragic. The pandemic-era shift in spending away from discretionary services and towards goods is reversing. We expect that to continue as households' accumulated savings allows them to navigate the decline in federal spending programs.

Supply chain and labor market disruptions will likely heal, albeit in fits and starts. As a result, we expect consumer price and wage inflation rates to be higher than pre-pandemic levels, *but only moderately so*. In the meantime, those same disruptions are likely to encourage capital investment and boost productivity—a plus for longer-term growth.



Second, we expect the Federal Reserve to act in a manner that is very close to what the markets expect.

This means an announcement to taper asset purchases later this year, with tapering beginning at the end of this year or early next. Meanwhile, market liquidity is expected to remain plentiful and, in fact, still *growing* until the Fed's tapering program ends and bond purchases cease—likely not until the second half of next year. Economic liquidity, marked by low-interest costs for companies, will likely not be impacted.



Finally, fiscal policy will continue to support economic growth and some secular investment trends.

We believe that direct emergency stimulus payments to consumers are behind us, but that high savings rates and well-funded consumer balance sheets will keep investor concerns at bay. We expect both physical and human infrastructure plans to become law, though likely at a lower price tag than currently proposed. This means tax increases would be more moderate than investor worst-case scenarios—although we anticipate they are not priced in and may create opportunities for investors.

Investment thesis: Stick with cyclical value, but no more “junk” trade.¹ This base case presents an altogether constructive backdrop for investing. The best days of cyclical value may be behind us, but it's too early to turn to defensive themes entirely. We believe it's better to stick with the reflation trade, but with a focus on identifying companies likely to experience upward earnings revisions. We favor a global allocation, with an overweight to international developed equity. Value and small-cap equities, with a focus on quality companies, should continue to thrive.

As the economy strengthens and Fed policy adapts, rates are likely to rise. Investors may be complacent to this risk. Rather than moving into cash, we are using short-duration securities in our portfolios and prefer credit over duration risk. Keep in mind that higher rates do not mean *high* rates. Investors may still need diversified sources of income in a balanced portfolio. Focusing on multi-sector and multi-asset income can help build portfolio resiliency while still leveraging these base-case themes.

Other scenarios



20% Likelihood

Hawkish surprise

In this scenario, COVID-19 concerns recede faster than we expect. This could occur due to new information, such as improvements in vaccination, highly effective treatment options, or changes in the virus itself. Mobility improves as students go back to school and workers return to offices. Consumer spending shifts robustly from a pandemic-era goods focus toward discretionary services. Labor and materials suppliers struggle to keep up with demand, prompting a re-acceleration of inflationary trends. Government spending surprises to the upside, contributing to an overheating economy.

In response to stronger consumer price and wage inflation pressures, the Fed is forced to tighten policy—whether tapering asset purchases more quickly, raising rates, or both. Adding insult to injury, stronger government spending requires higher-than-expected tax increases for businesses and households, prompting higher costs for both.

Investment thesis: After a disruption, reflation trade on steroids. The immediate impact of a hawkish surprise would likely be market negative. Rates-sensitive assets, including long-duration (growth) equities, would experience outsized impacts. After the initial shock, though, this scenario could present a buying opportunity. Short-duration assets, including short-duration and high-yield fixed-income, bank loans, and value equity, would likely thrive.



15% Likelihood

Growth disappoints

In this scenario, the COVID-19 *pandemic* becomes an *endemic*. Variant after malign variant slows consumer spending and uncertainty creates a stall in business investment. The labor market slumps as uncertainty makes businesses less confident in hiring.

As a result, the Fed is unable to tighten policy, and interest rates stay low. Government spending—whether on longer-term infrastructure plans or shorter-term COVID-19 support—faces political challenges and ceases its growth impulse. The days of “sizable and swift” government support are over.

This scenario doesn’t necessarily point to recession. But for the market to react, you don’t need recession—you only need growth to disappoint.

Investment thesis: “Lower for longer” again. The pre-pandemic days of “lower for longer” growth, inflation, and interest rate fluctuations are back. This isn’t necessarily a bad outcome for investors, but it would point to a change in leadership relative to today. In this environment, investors could expect pre-pandemic themes such as long-duration fixed income, U.S. equities, growth equities, and alternative asset classes to outperform. A persistently low interest-rate environment points to the benefits of generating income across asset classes and through multi-asset income products.



5% Likelihood

Stagflation

Possibly the most ominous scenario for investors is stagflation, which is characterized by slow economic growth, low employment, and rising inflation—all at the same time. We perceive 1970s-style stagflation to be nearly impossible amid the current global low-rate environment. However, a form of stagflation-lite could emerge under the right (or wrong) conditions.

Today, those conditions are likely to be driven by sustained COVID-19 disruptions. The inaccessibility of targeted materials and the hesitancy of workers to re-join the workforce could prompt costs of goods and services to rise rapidly. We already know that higher prices are eroding consumer confidence. Under stagflation, that confidence would likely plummet, reducing spending and hindering economic growth. Higher input costs also compress margins for businesses, and could result in negative earnings surprises.

This combination of factors would put the Fed in a tough place: overheating prices with an underwhelming labor market recovery. In this case, the resulting policy uncertainty could prompt further market volatility.

Investment thesis: Resiliency is key. This scenario likely prompts a “risk-off” moment for investors who would seek safety in government bonds over high-yield credit or equities. A weakening dollar may also support commodities, precious metals, and emerging markets equities.

Persistent investment themes

As we considered these potential scenarios, a few themes stood out regardless of expectations.

 Durability	 Flexibility	 Portfolio resiliency
<p>Some investments' potential cash flows do not depend on macroeconomic themes.</p>	<p>Uncertainty around the drivers of global investment makes it more important for investors to leverage opportunities across geography, sector, and security selection as they arise.</p>	<p>Investors with a lower risk tolerance or a shorter time to retirement may consider multi-asset sources of income to diversify portfolios or to include growth alongside income.</p>
<ul style="list-style-type: none"> ■ Infrastructure ■ ESG 	<ul style="list-style-type: none"> ■ Multi-sector bond strategies 	<ul style="list-style-type: none"> ■ Multi-asset income ■ Asset allocation products

Amid market uncertainties, investors should remember there are always *risks* to investing. Those risks are intertwined, making it very difficult to time the ups and downs of market movements. Instead, investors should focus on their long-term investment goals and position their portfolios accordingly. For most investors, this is unlikely to mean running for the hills as risks mount. Instead, investors should work with a financial professional to identify those allocation adjustments—if any—that best support their individual risk tolerance and investment time horizon.



For more information

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1. "Junk" trade is a term meant to represent an investment in lower-quality securities.

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