



Ken Kozlowski Podcast – December 2022

Multi-Asset Income Investing with Loomis Sayles & Company



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Transcript

Ken

Hello and welcome to this podcast. I'm Ken Kozlowski, Chief Investment Officer of Equitable Investment Management, the investment adviser for the 1290 Funds. It's been a volatile market this year and many investors are anxious, and we want to help. We are pleased to offer you the insights of a range of professional money managers who are looking at markets and companies—day in and day out—trying to find opportunities for their clients. So joining me today is Elaine Kan. Elaine is a portfolio manager and rate & currency strategist for the fixed income group at Loomis, Sayles & Company. She is also a member of their Multi-Asset Strategy team and she's been in the industry for 25 years and with Loomis since 2011. Elaine is responsible for implementing interest rates and currency derivatives strategies for the alpha strategies group, as well as providing support to other products across the fixed income group. Elaine earned a BS in engineering, a BS in finance and a master's degree in electrical engineering from the Massachusetts Institute of Technology and is a Chartered Financial Analyst. Elaine Welcome to today's podcast. It's great to have you here.

Elaine

Thank you, Ken, it's a pleasure to be here.

Ken

The multi-asset strategy team describes a "regime-based investment process." What does that mean? What kind of regime are we in now?

Elaine

As many of us are aware, the market is cyclical. We define a credit cycle having four distinct regimes: downturn, credit repair, recovery, and expansion/late cycle. At any given moment in time, different countries and industries are in different regimes of their credit cycle. Each regime of the cycle has its own unique risk and return characteristics, and we believe optimizing the portfolio in different regimes of the cycle is crucial to adding value.

Currently, the U.S. is in the expansion/late cycle regime. China is in a downturn; and Europe is at the verge of a downturn. Let me explain each of these 4 regimes in more detail.

Let's start with a discussion on downturn: In a downturn, economic growth slows, putting pressure on earnings. Highly leveraged companies are most vulnerable as funding conditions worsen and liquidity dries up. Many companies will start having trouble paying their debt. Default rates rise and credit spreads widen. Most recently, we saw that China's second largest property developer defaulted on their obligations in 2021, and the entire real estate sector went into a crisis. We have experienced many of these financial crises in the past: They emanate from shocks, and are amplified by vulnerabilities in the financial system. During a downturn, investors divest assets to increase liquidity, which creates in a downward spiral in asset prices. This is the time when cash is king and safe haven assets outperform.

Typically, we transition to credit repair when the government or central bank steps in to support the function of the financial market. We experienced this in previous crises, and more recently during the pandemic when the Fed stepped in to serve as a liquidity backstop. In the credit repair regime, risk appetite comes back when investors perceive that the central bank will do whatever it takes to support the market. Remember-- the Fed unleashed an -- alphabet soup of liquidity facilities during the pandemic to support the flow of credit, committing not only to buy Treasuries and Mortgage-backed securities, but also commercial papers, municipal debts, corporate debts and other asset-backed securities. Some of these facilities were not fully utilized but the program itself served as a backstop to halt the downward spiral and restore investors' faith and risk appetite.

Since we just went through a downturn, valuations are extremely cheap, and companies are deleveraging. This is the time when lower quality companies, that were pushed to the brink, outperform higher quality companies as credit spreads compress.

As growth picks up, we move into recovery. In recovery, all risk assets tend to do well. We saw a stunning example of recovery in the U.S. equity market in 2021. The Fed's accommodative monetary policy not only restored market functions, it also massively stimulated economic activities and growth.

As the economy starts to overheat, we move into expansion/late cycle. This is where we are now. We are feeling that pain as the Fed removes liquidity to fight inflation by bringing down growth and demand. At the current regime of the credit cycle, we would position defensively for the next downturn. Our focus is on quality over growth. Companies with strong balance sheets and leaders in their industry should outperform highly leveraged companies.

The most important thing to remember is that different asset classes behave very differently in each regime of the credit cycle. The key to generating alpha is to optimize the asset mix to achieve best risk-adjust return and income at different regimes. Our portfolio during a downturn will be a lot more conservative than our portfolio in recovery.

Ken

Can you tell us about your risk control framework and how risk controls work in the various stages of growth/for various stages of growth?

Elaine

Certainly. Risk management may not be the most exciting topic. However, it is crucial to our process. While asset allocations will change in different regimes of the cycle, the risk management process does not change. Risk control and management is embedded in every step of our investment process. We have our own internal risk management systems that were developed in-house, which we utilize on a daily basis. These tools allow us to monitor risk exposures, run scenario analysis, and review upside and downside expectations.

We have already discussed different regimes in a cycle, and how complex they are. Our macro department combs through all the macroeconomic data and debates regularly on regime identification. We also have machine-learning tools utilizing real time market data to help us identify the transition from one regime to the next.

Our investment framework allows us to take a balanced approach so that our portfolio is not dominated by specific risk factors. We optimize the asset mix to achieve a higher Sharpe ratio through diversification, and we then optimize the portfolio to minimize drawdown.

Ken

Can you talk about some of the themes that are most impactful for today's investor?

Elaine

Of course. Central banks' monetary policy, inflation and global growth are some of the themes that are on everyone's mind. As global central banks raise interest rates to fight inflation, the likelihood of a downturn increases. The Fed has hiked 375bps so far this year and likely another 50bps in December. Our firm's view is that inflation will persist through Q2 of 2023, which is going to keep the Fed on a hawkish tilt through the first quarter. Our base case is that we will enter a downturn in '23. However, the market has already priced in terminal rate at around 5% in early '23 and the Fed is nearing the end of this hiking cycle. In fact, other developed market central banks such as Bank of Canada and Reserve Bank of Australia surprised the market last month by reducing the pace of rate hikes.

In addition, the U.S. dollar is the strongest it has been in 20 years because the Fed has been hiking interest rates faster than the ECB, the Bank of England and the other developed market central banks. The strong dollar is wreaking havoc in the global economies, which can spill back to the U.S. and alter how high the Fed can raise rates.

Ken

Inflation, interest rates – very impactful themes. So how does this translate to your views of the equity market and the fixed-income market?

Elaine

On the fixed income side, we favor a barbell approach, investing in cross-over short duration bonds and high-quality long bonds that are trading at attractive discounts.

On the equity side, we favor U.S. equity over global equity, as the U.S. economy is more resilient. Global growth looks anemic given the uncertainty of the geopolitical risks in China and Europe. We would start rotating back to global equity when we see the trend of the strong dollar reversing. We continue to favor high quality, dividend-paying companies that have healthy balance sheets to support their dividends. We like defensive companies, such as those in the health care sector—everyone needs healthcare.

Given the elevated volatility, this is the best time to employ call-writing strategies. We are able to collect higher premiums for writing calls that allow us to increase income, reduce volatility of the overall portfolio, and provide a limited amount of downside protection.

Ken

Final question – can you tell us about your outlook for the next 6-12 months – what do you see?

Elaine

We expect volatility to remain elevated. We have macro risks in inflation, global growth, the strong dollar, the energy crisis and geopolitical risks. Nevertheless, we are seeing real time inflation indicators rolling over very quickly, which hopefully will soon translate to the CPI data and give the Fed some comfort to slow and pause tightening. However, if the Fed overtightens, it will lead to a further slowdown in the global economy and increase the risk of severe downturn. This could lengthen and deepen anticipated recessions. Bank loans and high yield credit will become susceptible to increased defaults. The unemployment rate may approach 6%, for which the market is not priced.

Geopolitics will play a key role over the next 6 months. China zero-COVID policy and the current unrest due to this policy, the war in Ukraine, and U.S.-China relationship will remain sources of near-term risk, clouding economic outlooks. While we expect the U.S. economy to go into a recession sometime next year, we do not expect the recession to be deep, as household and corporate balance sheets have been relatively healthy. The unemployment rate is the key indicator to watch, as a deep recession is unlikely with a relatively benign unemployment rate. We expect default rates to rise slightly but remain historically low in the 2-3% range. We also expect the S&P to be in a trading range around current levels in the next few months.

We see our current environment as the most opportune time to invest in income-focus strategies. Despite the many challenges investors are facing, there are still many attractive opportunities out there from both yield and valuation perspectives.

Ken

Elaine thanks for spending the time with us and sharing some really great insights. We really appreciate it. Thank you.

Elaine

Thank you so much, it was a pleasure being here.

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