Positioning Our Investments for Future Recovery: CIO Perspective

Featured Speaker: Jon Cheigh

Key Points:

- **The economy is transitioning to a normalization phase:** With markets leaning to ”live” with the pandemic, we expect a rotation in leadership that favors deeper value, cyclical and reflation plays.
- **Five important developments expected to affect how we position our portfolios:** The “new normal” may be characterized by a) an appetite for higher deficits and greater fiscal activism, b) a fight against income inequality, c) climate change mitigation, d) digital transformation, and e) the rise of economic nationalism.
- **Implications for portfolios in the post-pandemic world:** We expect the new economic regime will likely result in higher taxes and higher inflation, yet interest rates are likely to remain low for years, driving the need for alternative sources of income and diversification.

The economy is transitioning to a normalization phase

We are in the second of what we believe will be three phases to the economy

Phase One: Recession

- Period of greatest uncertainty; markets are volatile due to the potentially wide range of outcomes. Typically lasts up to six months and tends to result in declining or range-bound markets, with leadership from defensive or high quality; this occurred between February and mid-July.
- Seeking clarity, Cohen & Steers early on formed a cross-investment task force to develop a high-conviction view on the impact of the virus. We concluded that virus cases would peak around mid-April and that economies reopening would occur in a two-steps-forward, one-step-back fashion.
- While we initially favored defensive issues, we had high conviction that good values were to be found in the markets and that fundamentals would ultimately recover.

Phase Two: Pre-vaccine recovery

- Equity markets bottomed in late March and rallied as the outlook became clearer, but rather than rotating away from defensive issues as would typically be expected, leadership has remained unusually concentrated in technology, consumer staples and health care.
- While markets grew concerned about a second virus wave, we instead interpreted that financial markets were beginning to understand that the economy was learning to “live” with the pandemic. This global process is not yet complete, and more stops and starts are likely, in our opinion.
- In mid-July, Cohen & Steers began to rotate out of Phase One winners into deeper value, cyclicality and reflation plays, including REIT sectors like retail, health care, leisure & gaming; freight rails and toll roads in infrastructure; and more credit sensitivity in fixed income.

Five important developments expected to affect how we position our portfolios

Phase Three: The post-vaccine "new normal"

- The post-vaccine phase should see the economy recover, and the deep-value rally is expected to give way to other winners in the new regime.
- Five important shifts likely occurring in the long term will affect how we position our portfolios, the advice we give on asset allocation, and what might be strategies that make sense over the next eight to 10 years:
    - Unconventional government policy: The lines between monetary and fiscal policy are being blurred. In the last six months (in contrast with the previous decade), we have become tolerant of higher deficits. We believe an appetite for higher deficits and greater fiscal activism will have important implications for growth and inflation.
    - The fight against income and wealth inequality: Social safety nets may increase, driving up spending and bringing down savings rates. Higher taxes may have important implications for inflation.
    - Decarbonization and ESG: Climate-change mitigation efforts are likely to increase materially, both at the government and corporate levels.
    - Digital transformation: An accelerating shift toward a digital economy will have positive investment implications across several industries, including data center, cell tower and industrial REITs.
    - The decline in economic globalism and the rise in nationalism: The increasing focus on income inequality suggests that countries are going to focus on their own domestic agendas. We expect greater onshoring, supply chain shortening and a focus on operational resilience, with important implications for growth and inflation.

Implications for portfolios in the post-pandemic world

- We see six major investment themes emerging in the new regime:
    - Alternative income: We expect that, almost irrespective of the inflation outcome, low nominal interest rates are here to stay. And so demand for alternative income should remain very high throughout this regime, not just for fixed income, but also for equities that pay high distribution rates.
    - Inflation, duration and real assets: The equity market has been dominated by large-cap growth stocks, which have benefited from declining discount rates. As a result, stocks (like bonds) now have greater sensitivity to inflation and higher interest rates than ever. An allocation to diversified real assets may help to mitigate this risk.
    - Real estate and infrastructure: We expect these asset classes to perform well over the next 5-10 years due to their history of equity-like returns, higher-than-average dividends and their above-average inflation sensitivity. And after underperforming the broad equity market this year, they are currently trading at compelling valuation discounts versus equities.
    - Tax management: We expect taxes to rise, whether to pay for deficits or to address inequality. We are focused on delivering tax-advantaged income to clients.
    - Thematic strategies: We believe digital infrastructure, decarbonization and ESG (environmental, social and governance policies) will be enduring investment

themes in Phase Three. We are employing strategies that we think fit those themes, not because they're popular, but because we think they are going to be great investment opportunities.

– Customization and completion strategies: Opportunities exist to combine listed real estate or infrastructure with private portfolios, providing solutions around certain sectors or geographies. For example, completion portfolios may be constructed to provide exposure to listed real asset sectors that are not represented in an investor's private allocation.

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