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# Four late cycle signs put Boston fund giant on alert

by **Jonathan Shapiro**

In his four-decade career as a fund manager, James Swanson says he has learnt that the most important thing is to "know where you are in the business cycle".

Right now, the strategist at $US450 billion ($620 billion) Boston-based mutual fund MFS Investment Management says the evidence is mounting that we're entering the latter stages of the cycle, thereby making stocks vulnerable to a sharp correction when it does end.

"The signs are showing up with great regularity and you need to think about conservation of capital when they appear," he told *The Australian Financial Review* in an interview this week.

Mr Swanson, who joined MFS in 1985, admits you can't time cycles, but looking for signs can "give you a sense of how far you are from the waterfall".

He pointed to four signals that have put him on higher alert.

One is that a third of all companies in the Russell 2000 index "don't actually make money".

"A lot of that is because of disruption and tech companies, but it is a bit disturbing. This is late cycle behaviour, and if you cut corporate taxes it doesn't help companies that aren't making money."

## Margin lending

Another indicator is a run up in margin lending by US share market investors to levels not seen since 1928.

"People seem to have forgotten that stocks can go down but one day they will get a polite phone call to remind you they can."

The third sign is the increased proportion of investment industry professionals who have "not lived through the business cycle", which is perhaps a sign of how long this cycle has run for, and how potentially ill-equipped investors are to respond when it does turn.

Finally, there are signs that economic data is weakening. Global trade is weakening and manufacturing indices in large economies such as France and Germany are turning down.

Services sector data in the US is also softening – something that he says "should not be happening in a robust economy".

Housing sales have also been weak for eight consecutive weeks, which he attributes to deterioration in affordability.

"The tightening by the Fed is already having its effect," he says.

For now though, the US economy is "booming".

"I don't think I have seen anything like this in my life. The unemployment rate is falling into the 3 [per cent range] maybe the 2s. In places like Wichita, Kansas, it is 1.8 per cent"

Mr Swanson concedes "people are not high-fiveing themselves in investment land because of the driving down of fees and the rise of passive investing".

"But for the average American, manufacturing jobs are up, consumer spending is pretty robust and companies are starting to get involved in capex projects."

The US stock market though, he fears, may be running out of steam, especially as tax cuts and offshore cash repatriation triggered share buybacks that are largely complete.

And he says the stock market is trading as though it distrusts the notion that the fiscal stimulus will fade.

A view that the end of the cycle is drawing near and risks are rising has led Mr Swanson, who runs a fund that allocates across five major asset classes, to switch to a more conservative positioning. Equities typically fall between 30 and 50 per cent when the US economy enters a recession.

With the US stock market at elevated levels, history suggests investors should expect annual returns of about 3 per cent to 4 per cent over the next decade.

And as long term interest rates have increased in recent months – the 10-year US Treasury rate is trading around 3.1 per cent – a switch into safer assets appears more compelling.

## High-grade bonds

Meanwhile, the two-year US bond yield of 2.8 per cent now exceeds the 1.9 per cent dividend yield of the S&P500 Index for the first time in a decade.

For those reasons Swanson has moved to an overweight position in high grade corporate and government bonds.

"If you can get 3 to 4 per cent in corporate bonds and 2.8 per cent in short term US Treasuries, which limits interest rate risk, I don't see anything wrong with that," he says.

"You are offsetting inflation and buying assets that have less rocky price patterns."

Mr Swanson is overweight emerging market bonds and US real estate investment trusts on valuation grounds.

He is bullish on the US dollar given the US economic growth outlook and positive interest rate differentials, although with the caveat that currencies are notoriously hard to forecast.

He points to an article published in the *Financial Analysts Journal* to caution investors that are confident in their ability to trade currencies.

"They did their biggest study ever a couple of years ago on foreign exchange and hired four universities to study it. Their final conclusion was summed up with one sentence at the end – 'we have found the ultimate random walk'."