CONSUELO MACK | WEALTHTRACK

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On this week's Consuelo Mack WEALTHTRACK: an exclusive interview with the award winning portfolio manager of the MainStay Unconstrained Bond Fund. Dan Roberts says this is anything but a Reagan bull market and it is much higher risk.

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CONSUELO MACK: On this week's WEALTHTRACK exclusive, award winning bond fund manager and former Washington economist Dan Roberts explains why this is no Reagan bull market and why he is going risk off in his portfolios, next on Consuelo Mack WealthTrack.

CONSUELO MACK: hello and welcome to this edition of WealthTrack, I'm Consuelo Mack. Animal spirits are up… business, consumer and investor confidence have been improving for months. Ever since the election the markets have been building on the strength of last year when just about every asset class, stocks, bonds and commodities rose. There are fundamental reasons for optimism, some recently cited by Federal Reserve chair Janet Yellen. The economy has continued to make progress…The labor market has improved with large declines in unemployment rates for all major demographic groups. Consumer spending has continued to rise at a healthy pace…Business sentiment has noticeably improved in the past few months…

And inflation is picking up. As measured by the Fed's favored personal consumption expenditures index, or PCE, total consumer prices rose 1.6% in 2016, still below the FOMC's 2% target but up 1 percentage point from its pace in 2015.

When you add it all up the Fed expects the "evolution of the economy to warrant further gradual increases in the federal fund rates to achieve and maintain its dual mandate of maximum employment and price stability.

But many on Wall Street believe there is another element at play, which explains the strong market rally since the election. They believe the Trump administration's agenda of tax reform, fiscal stimulus and regulatory rollbacks is very positive for the economy and business. They liken it to the Reagan era when similar policies did result in accelerating economic growth and a prolonged bull market.

This week's guest believes they are overly optimistic, and that bold assumption is dangerous for investors. He is Dan Roberts, chief investment officer and head of the global fixed income division at MacKay Shields, a global fixed income manager with approximately $95 billion in assets under management. He is co-portfolio manager of two award winning mutual funds. The MainStay Income Builder Fund is rated five-star by Morningstar and is ranked in the top decile of its world allocation category over the past 3, 5 and 10 year periods. The MainStay Unconstrained Bond Fund has a four-star rating and is rated in the top 11th and 18th percentile respectively over the five and ten year periods. It is also a 3-time Lipper Award winner.

Mainstay is a WealthTrack sponsor, but Roberts is here because of his long term investment record. Roberts also has a background in Washington, serving in the Reagan White House with the president's council of economic advisors, and as chief of staff of the U.S. congress' joint economic committee, which is yet another reason to have him on WealthTrack now. I asked him why he feels so strongly that this is not a Reagan bull market.

DAN ROBERTS: Consuelo, the reason that we think that this is not as simulative as the market suggests, is that we think the market needs to take into account what the states of the economies were when Reagan took over.

CONSUELO MACK: In ’81.

DAN ROBERTS: In ’81 and when Trump took over. In 1981 when Reagan took over, you recall that interest rates, the federal funds rate were almost 20 percent.

CONSUELO MACK: Versus under one now.

DAN ROBERTS: Versus under one now. The unemployment rate was seven and a half percent, versus almost three percentage points lower today. It’s anywhere between four and a half and five percent. And inflation was running at about 13 percent when Reagan took over. Under Trump, when he’s taken over, it’s about two percent. So the environments are really, really very different, and so when you think about the policies that are being imposed, yes, they are very similar policies.

CONSUELO MACK: I know, but that’s what people are looking at. They’re looking at tax cuts. They’re looking at fiscal stimulus. They’re looking at regulatory rollbacks, and they’re saying, “Reagan,” and those are similar. Right?

DAN ROBERTS: Very similar, very similar.

CONSUELO MACK: But we’re in a very different place you just described as far as the macro economic situation is, like polar opposites.

DAN ROBERTS: Exactly. Absolutely. That macro situation makes a huge difference in terms of the impacts of those policies. What the market believes is all three of these things are going to have very significant positive impacts. So let’s take a look at all three. Are they going to have big, significant, positive impacts? The market’s up a lot, and you think to yourself, the market’s up a lot, yet people generally I think would agree that there’s a lot more uncertainty that we face today. So when the market is facing all of this uncertainty – and to be fair it’s both positive and negative uncertainty, but the market’s facing all of this uncertainty – the market doesn’t like uncertainty.

CONSUELO MACK: What’s more uncertain about today than in 1981?

DAN ROBERTS: Well, I think people are just very uncertain about what this current administration’s policies are finally going to work out to be. What’s going to go through? What’s going to be passed? What’s finally going to become the law of the land? So for example the tax cut, we can get a sense of I think the degree of stimulus that was available under the Reagan administration and the degree of stimulus that is available under the Trump administration. So when Reagan took over, the top marginal tax rate you may remember was 70 percent, seven zero. Living in New York State in New York City, you add another ten to 15 percent on that, and what do you have? Well, for every dollar you make, you're giving 80 to 90 percent of it to the government, state, local or federal.

CONSUELO MACK: I would call that confiscatory. (Laughter)

DAN ROBERTS: Today it's 39.6.

CONSUELO MACK: For the top income.

DAN ROBERTS: For the top income. So what Reagan said is, "I'm going to lower that. I'm going to lower it from 70 percent," and he ultimately lowered it to 28 percent or 42 percentage points. Now when you start at 39.6, you can't lower it (Laughs) the 42 percentage points, but what Trump has said is he said, 'We'll, we're going to lower it to 33 percent." So he's going to lower it six, seven percentage points. Reagan's tax cut was six or seven times what this is. Will this be simulative? Are tax cuts simulative? Of course they are. Yes, they are. Empirical evidence suggests they are. They are simulative, but it's the degree that we're talking about. So those are tax cuts.

CONSUELO MACK: How simulative would it be if he reduces by six percentage points?

DAN ROBERTS: The multiplier that people use, in other words, if you cut taxes by one dollar, what kind of GDP lift do you get? Well, it's as much as three dollars. It's one of the most stimulative kinds of policies that the government can run. Now on the other hand when you look at infrastructure spending or you look at fiscal policy, it's a different kettle of fish here. Now remember, today we are close to if not at full employment. Now people will say we have another couple percent or another 0.2 percent maybe to go down, but I think everyone would agree that we're at least close to full employment. That means that almost everyone that wants a job can get a job. Now when you think about Trump's policies of, well, what I'm going to do is I'm going to come in and I'm going to do a great deal of fiscal spending. I'm going to build roads. I'm going to build bridges. I'm going to do all of this infrastructure spending.

CONSUELO MACK: And I'm going to create "good" jobs. That's what's he's saying, too. I'm going to create higher-paying jobs.

DAN ROBERTS: Right and maybe his jobs are somewhat higher-paying, but does Trump have to do? He has to go to the private sector where people are already employed and convince them to come to the public sector. Now one way he can do that, and the way he probably will do it, is to raise wages. That's inflationary. So number one is we're going to get inflation out of this. Number two is, how really stimulative is it when you move somebody who already has a job in the private sector, take them out of the private sector and put them into the public sector? Is that a really huge boost to GDP? We don't think it is. So you look at tax cuts and, yes, there will be some stimulus from the tax cuts but nothing like we saw under Reagan. Then you look. Remember we're starting at full employment, and when you start at full employment, it's very hard to raise GDP by employing more people because there aren't a lot more people to employ.

CONSUELO MACK: Regulatory rollback.

DAN ROBERTS: Regulatory reform, will that and has that over time increased productivity and, therefore, increased GDP? Yes, it has. But there are thousands of these regulations that have to be rolled back. How long is that going to take? It's going to take some time in order for that to happen. So we're not going to see the stimulative impact of that regulatory reform for some time.

CONSUELO MACK: Let me ask you about the fundamental underpinnings of the market rally. I know the market has rallied tremendously since the November 8th election, but it also had rallied from the last year's February low a great deal. So there are people out there who are saying look. This would have happened anyhow, I mean the economy is getting stronger. Aren't the fundamentals pretty good anyhow?

DAN ROBERTS: Yes, yes.

CONSUELO MACK: I mean how much of the rally do you attribute to the Trump assumptions?

DAN ROBERTS: Well, I mean let's start with the fundamental underpinnings. Central banks around the world have been stimulative for some time.

CONSUELO MACK: Years.

DAN ROBERTS: For years, and that's made a big difference. So the underpinnings were already there. You're absolutely right. So when we look at that additional rally, what we're saying to ourselves is if the market really does believe that the policies that Trump is putting in place are going to be very similar, which they are, and the impact is going to be very similar to what happened during the Reagan administration, we're just saying we don't think the market has that part of it right.

CONSUELO MACK: Dan, therefore, how dangerous are these Trump policies? We didn't even mention trade protectionism. Some of the things that MacKay Shields, some of your colleagues, have written about are how disruptive Trump policies could be geopolitically, economically. So talk to us about that aspect of this, of the negative disruption potential.

DAN ROBERTS: Well, the negative disruption potential could be significant, but we don't know yet. We don't know yet. Congress has to approve this. Trump's own party, the Republican Party, is a free trade party. So they're not going to line up behind this. So let's take a look at trade. The negative impacts of this could be something like what we experienced. This would be an extreme, but it could happen. Back in 1930 there was the Smoot-Hawley Tariff Act, and

President Hoover at that time put 20,000 tariffs on imported goods.

CONSUELO MACK: To protect the American market. It would be kind of America first redux.

DAN ROBERTS: What happened to world trade? You can imagine if we're doing it. Do you think everybody else is just going to sit by and say, "Oh, go ahead and do that"? No. What happened is world trade spiraled down. That's a real worry, and that is we should let countries and people, they should compete at their comparative advantage and using their comparative advantage. Putting on tariffs is not a good way to do it. The problem we have is if you stop countries using their comparative advantage, then everybody suffers. We've seen that before. We've seen with Smoot-Hawley what happens. We don't want to go down that path.

CONSUELO MACK: No. Definitely do not want to go down that path. What do you do as an investor? You told me that you've taken risk off in your portfolios in a meaningful way. Why are you reacting so strongly to this environment?

DAN ROBERTS: Well, as we see this overreaction, what we've said to ourselves is that in some parts of the market the valuation just doesn't...

CONSUELO MACK: Make sense.

DAN ROBERTS: …justify the risk that we're taking on.

CONSUELO MACK: I see. So high-yield being one part of the market.

DAN ROBERTS: Well, some parts of the high-yield market.

CONSUELO MACK: What other areas of the market?

DAN ROBERTS: Well, I mean high-yield is probably the center, but basically is: when you look at any of the higher risk sort of asset classes what you'll find is that there's been a compression in spread.

CONSUELO MACK: So what are the other higher risk areas? In the MainStay Income Builder, I know you and Epic, MacKay Shields does the fixed income portion. But you're doing kind of the asset allocation. Right? Between the two?

DAN ROBERTS: We are, and in Income Builder we are doing the same kinds of things. We're taking risk off in the same kinds of ways as we are in our other portfolios, and that is in those parts of the market that we find are the riskier parts of the market where valuations have really come up, but it's not justified, we don't think it's... in other words, we're not really being compensated for the risk that we're taking off. What we're doing is we are putting the money in other areas like investment grade, like bank loans. So we're shifting our allocations as we see we're not being compensated for the risk.

CONSUELO MACK: How much attention are you as a money manager paying to what's going on in Washington versus what you typically would have done let's say a year ago?

DAN ROBERTS: Well, clearly uncertainty in Washington has, and I think everyone would agree, is higher than it has been. Our style is that we don't really look at the headlines. We don't look at the tweets. We are a longer-term investor, so what we try to do is we try to look at strategy. And what that means is that we try to look at those policies that we think will make a big impact over time and those policies that have a higher probability of being enacted. So yes there are things that are going on in Washington and, yes, there are things that we should be paying attention to, but we're looking at them very much from a strategic point of view. So an example of that would be in 2006 and 2007 we started taking risk out of the portfolios. We believed that what was going on with the Federal Reserve – the Federal Reserve had raised rates from 2004 to 2006 something like 17 times – and what we believed was that the Fed would pop a number of bubbles that had arisen. Those are the kinds of things that are important to us, and in fact they did, and those had very significant long-term impacts. So those are the kinds of things that we try to look at given our style.

CONSUELO MACK: So fast forward to today, what are the policies that are having an impact on your strategy today? Are there any?

DAN ROBERTS: Yes. So it's the things that Trump has brought up. For example, the tax cuts, infrastructure spending, regulatory reform but also of course, what is the Federal Reserve doing, and how will the Federal Reserve react given everything else that's going on. Those are the things that we think have a big impact. They are likely to be enacted and, given our style, those are the things that we're focused on.

CONSUELO MACK: What about the Federal Reserve and how policy is going to be affected?

DAN ROBERTS: Well, the Federal Reserve said and we believe that the Federal Reserve will continue to monitor the economy and that if they see that the impacts from the Trump policies are starting to stimulate the economy and in particular start inflation, the Federal Reserve will react, and we believe that they will react reasonably strongly to that. Now why is that? Why will they react reasonably strongly?

CONSUELO MACK: Contrary to the way they've been very dovish!

DAN ROBERTS: The reason is the Federal Reserve has created this enormous pool of reserves. It's been very stimulative for a long time, so it's been adding monetary base for quite some time. If all of that stimulus starts to be translated into inflation, we're going to have a problem.

CONSUELO MACK: What kind of a problem?

DAN ROBERTS: Significant inflation, and the Federal Reserve knows that, and they know that they need to react and they're going to have to react pretty fast (Overlap/Inaudible).

CONSUELO MACK: By raising interest rates.

DAN ROBERTS: Yes, exactly right. The risk markets aren't going to like that very much.

CONSUELO MACK: Going forward, what are you going to be watching that's going to determine your strategy?

DAN ROBERTS: The Federal Reserve.

CONSUELO MACK: The Federal Reserve.

DAN ROBERTS: What's going to be a big determiner of what the Federal Reserve does is going to be inflation. We'll have to watch to see how Trump's policies turn into inflation. The Federal Reserve is one of the first triggers that we generally see. The Federal Reserve is trying to slow the economy, and as they try to slow the economy, eventually they will get it slowed, and so that's one of the very first things that we look at.

CONSUELO MACK: Another question. Many bond investors have been told for several years now that the bond markets are very high risk; that they're overpriced. Interest rates are going to start to go up which they've started to do. You run an unconstrained bond fund. You can go anywhere, invest in anything. How high-risk do you think the bond market is, and therefore how defensive are you getting in your portfolio?

DAN ROBERTS: With the unconstrained bond fund, we have a relatively short duration, because we do believe that there is risk of rates rising. If the economy starts to pick up and inflation starts to pick up, the Fed will start to raise rates, and as they start to raise rates it will affect all of the rates. The curve will probably continue to flatten, but it will impact all rates, and as a bond manager that's something that people need to be concerned about, and that is they could lose money as rates continue to rise.

CONSUELO MACK: Short duration means basically that the securities that you have are going to be the least interest rate sensitive so, therefore, they're usually shorter maturities. Right?

DAN ROBERTS: They are. That's right.

CONSUELO MACK: Another question is about the MainStay Income Builder Fund. Investors have been searching for income for a long time, harder and harder to get. Where are you finding income in the Income Builder Fund?

DAN ROBERTS: So the Income Builder Fund we've been investing in the same kinds of things that we've been investing in the unconstrained portfolios. That is, we have been investing in credit instruments and mostly in credit instruments.

CONSUELO MACK: That means credit instruments are...

DAN ROBERTS: Investment grade bonds, in high-yield bonds, and those bonds pay a spread over U.S. Treasuries. So they allow us to make more than what we otherwise would make had we put this in very, very short duration LIBOR instruments or Treasury instruments.

CONSUELO MACK: Final question, Dan. One investment for a long-term diversified portfolio. What would you have all of us buy or own in a long-term diversified portfolio?

DAN ROBERTS: So what I would suggest to your viewers is that they consider a balanced fund at this point, and a balanced fund is a fund that invests in both stocks and bonds, and then what we believe is that they should hire someone, an active manager that will make that switch between stocks and bonds depending on what they think the economic environment looks like. So I think they want to look for an active manager, and they want to look for an active manager that will take them out of risk if they believe that the market environment is starting to change. At this stage of the cycle, we think that that is a particularly important point.

CONSUELO MACK: Dan Roberts, thank you so much for joining us on WealthTrack.

DAN ROBERTS: Thank you very much, Consuelo. I very much enjoyed it.

CONSUELO MACK At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term. This week's action point is: de-risk your bond portfolio. High yield bonds and emerging market debt have been excellent performers investments, up 17% and 10% respectively last year. With the economy improving, the Federal Reserve prepared to raise rates again and political uncertainty building it is a propitious time to take some gains and trim those positions.

To hear more of Dan Roberts interview click on the Extra feature on our website Wealthtrack.com. Also thank you for contacting us on Facebook and Twitter. It might take us some time but we will respond to each and every one of you. Have a great weekend and make the week ahead a profitable and a productive one.