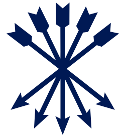

# Market Perspective

## Recessions and portfolios

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Rothschild & Co
Wealth Management

# Foreword

"Good morning, and in case I don't see ya, good afternoon, good evening and good night!"
*The Truman Show* (1998)

It looked like stability was breaking out – at least, until the latest trade tweets. The global economy has indeed slowed, not collapsed, and we have been pleasantly surprised (so far) by corporate profitability.

China and the US remain at the top of the premier league growth table, with the eurozone close to the bottom (even a rudderless UK may be outpacing it). But nowhere is there much inflation. We may think central banks – especially the Fed – are being too generous, but they've not done much damage yet.

Meanwhile, stock markets have been flying. Can they have much more short-term headroom? We've just been reminded that a US-China trade deal is not done yet, and the Fed may come to share our views on interest rates. But valuations remain unremarkable, and much 'clever money' is out of the market (again). Over the long term, we think stocks remain the asset most likely to beat inflation.

For a decade now this unloved US expansion has outlasted and outpaced the miserable prognoses that have accompanied it. This summer it may become the longest ever, and its core growth rate looks little different to last time's (flattered then, of course, by mortgage excesses).

A downturn is coming at some stage. This month we look back at history and ask how scared of recession investors should be. The answer is that it all depends – which is good news if you think we're doomed to another event like the Global Financial Crisis (GFC).

We also suggest that despite economists' hubristic wish to abolish it, the cycle is a fact of economic life – and this may not be such a bad thing. A world in which we're routinely spared excesses and hangovers would be a bit like Truman's – superficially attractive, but somehow poorer.

**Kevin Gardiner**
Global Investment Strategist
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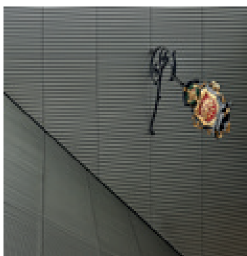

Cover:
A very public symbol of the heritage and values of the family business is the Rothschild shield positioned on the exterior wall of our New Court office in St Swithin's Lane, London. The five arrows combined with the family motto is the only advertisement for the business within.

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# Recessions and portfolios

It all depends

### Unloved cycle enters new territory

This may shortly become the longest-ever US expansion. If it lasts until mid-year, it will nudge the cycle of 1991-2001 off the top spot in the National Bureau of Economic Research's (NBER) league table dating back to 1860.

Some investors are nervous – its great age seems to suggest the end is overdue. Should they prepare for its eventual demise – and if so, how?

We have given it the benefit of the doubt so far. But many pundits wrote it off from the start – it has been the least loved of any recent cycles. Lots of 'clever money' has been selling or ignoring it all the way up.

It's considered smart to say the US can't grow much any more ("too much debt", "secular stagnation" and all that). In fact, growth in real household and business spending has averaged 3.1% – little different to the 3.4% in the previous upswing. This ought not to have been a surprise.

It's also fashionable to say the US doesn't matter so much any more. But while China may have contributed more to global GDP gains recently, the growth that matters most to capital markets is (still) in the US. And because US imports are bigger and grow faster than its exports, it has made a bigger international contribution.

Nor have the gains been quite as uneven as suggested. The unemployment rate is the lowest since the 1960s, and widely quoted median household income data can be misleading. It's a little inconsistent to believe, as well-meaning commentators do, both that quantitative easing wealth effects have driven the upswing and that growth has been unusually unequal – wealthy consumers don't account for much of total spending. And contrary to what pundits seem to suggest, there has been no golden age of equality.

Meanwhile, our main reason for giving the US cycle the benefit of the doubt remains intact: the absence of excess. Consumers have not been borrowing – or banks lending – recklessly. Inflation remains subdued.

Nonetheless, underappreciated and well-behaved though it is, the US upswing will end at some stage, and the economy will shift into reverse gear for a while. The likely human costs are clear: a rebound in unemployment and a fall in incomes. But what might it mean for investments?

The frustrating but honest answer is: it all depends. We often cut corners, and use the term 'recession' indiscriminately to signify A Bad Thing. But downturns vary tremendously – and their impact on portfolios varies even more.

### Spoiler alert: forecasters beware

The end of an NBER expansion is not the only definition of recession. The NBER dates the US cycle to the nearest month, using several indicators, whereas a recession is generally defined – anywhere – as two consecutive quarterly falls in GDP. But both denote shrinking economies.

We may not spot the next US contraction beforehand. We will do our best, but the exact timings of most recessions are unpredicted. Most of the recessions that *are* predicted don't happen, but turn out to be the mistakes of more routinely unhappy forecasters.

Why are contractions so difficult to spot? They are quite rare: most of the time, economies grow. Unexpected events – such as 9/11, or the seizure of the global money supply in 2008 – can knock economies off course. But usually, downturns arrive unexpectedly because the economy is driven by people, people are driven by emotion, and emotions fluctuate.

Confidence can swing sharply and infectiously. Knowing when our collective mood will shift away from seeing discretionary purchases (the new car or an upgraded production line) as life and business-enhancing assets, and see them instead as liquidity-draining burdens, is an art, not a science. And it is an art without any great artists.

### Can't central banks abolish recessions?

In economists' ideal world, the instant a downturn seemed imminent, interest rates would be cut, and/or public spending raised and/or taxes reduced, neatly cancelling it. Similarly, if it looked as if growth were too strong for comfort, the authorities could raise rates and/or tighten fiscal policy.

This 'control engineering' view was first popularised in the 1950s. But in practice, instead of smoothing the cycle away, the lags in the system – it took time to identify the problem, to decide what to do,

and then to act – often resulted in the cycle being amplified, not smoothed. By the time the economy was given a boost, for example, it had begun to revive of its own accord. This was the 'stop-go' era.

More timely data, and the success of counter-cyclical policies in 2008/9, have encouraged economists and central bankers to think such cyclical fine tuning is once again worth trying. We are sceptical. 'Control' problems remain, and a completely stable world might not be the boon economists imagine.

It can still take some time to decide that an economy may be on the turn: a single month's data is rarely enough. In 2008, Lehman Brothers' collapse followed a prolonged period of market volatility during which bankruptcy did not seem inevitable (in contrast to the perfect view accorded to hindsight in *The Big Short*).

Central banks hope that new machine-learning techniques and big cross-sectional datasets will help spot major downturns quicker. We doubt any patterns identified will be meaningful, and there are too few events to allow us to talk of a 'typical' crisis.

Control remains difficult too because the links between interest rates, for example, and the economy are looser than economists imagine. Talk of 'transmission mechanisms' is misleading. There are just too many moving parts, and they have minds of their own.

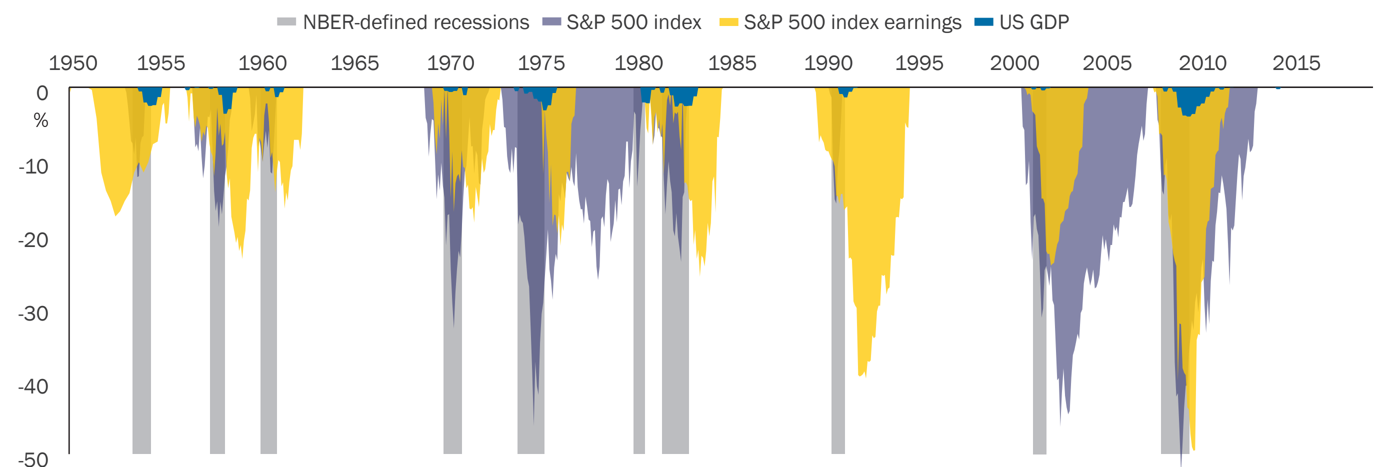
## A Truman Show economy

Perfect control might in any case prove counterproductive. A world without economic accidents would be a bit like *The Truman Show*. Truman, "on air, unaware" as the subject of a reality TV programme, is protected from all sorts of mishaps – including the use of his own free will.

It might seem a nice problem to have. Truman's world is well-ordered and superficially cheerful. But we'd lose something important – just as Truman, cocooned against misfortune, is missing out on real life.

### Figure 1: NBER recessions and US stocks

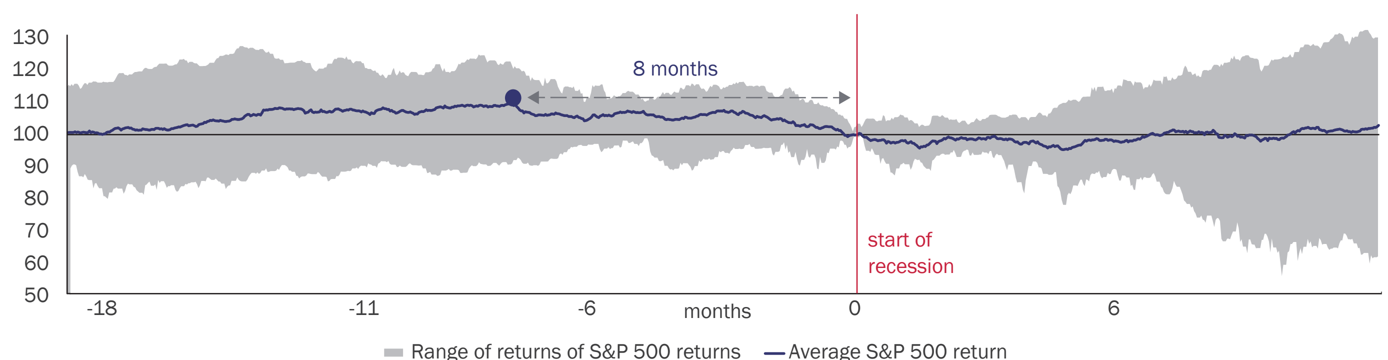
**Peak-to-trough drawdowns in US GDP, stock prices and earnings around NBER recessions**




*Source: Datastream, NBER, Shiller, Rothschild & Co*
*Past performance should not be taken as a guide to future performance.*

### Figure 2: Market timing and NBER recessions

**Market performance before and after NBER recessions: average experience**




*Source: Datastream, NBER, Shiller, Rothschild & Co*
*Past performance should not be taken as a guide to future performance.*

A world seemingly without cyclical risk might be poorer in the longer term. It would lack urgency and spontaneity. Risky assets might be repriced – perhaps mistakenly. Eliminating dangers posed by a changing business climate – the exuberant overinvestment that follows (for example) technological breakthroughs, or the discovery of new resources, or free cashflow – might also eliminate many opportunities.

We need adequate insurance for those displaced by the cycle. And there are of course limits to the risks we might embrace in the spirit of creative destruction – the authorities should strive to avoid major crises and systemic collapse. But if the real world is unavoidably and profoundly uncertain, carefully designed artificial ones may have less appeal. We don't share the growing belief that, having saved the world in 2008, central banks should try to abolish the cycle completely. It smacks of hubris.

This doesn't mean we're looking forward to the next recession. But a downturn sooner or later is likely anyway (those control problems), and can be seen as part and parcel of the workings of the market economy – the least bad economic system we've yet discovered.

### Theory and past practice

Recessions affect stocks mostly via their impact on business: falling revenue, squeezed margins, enhanced credit risk, asset writedowns. We'd expect their portfolio impacts to vary. Are companies and/or the banking system especially fragile, and prone to contagious systemic risk? Is it a complete surprise, or partly priced in?

And, importantly, how will the authorities respond? Stock prices can be affected by interest rates, and if the latter fall far enough – whatever our misgivings about the possibility/desirability of perfect control – stocks might even respond positively to the downturn.

History confirms there is no such thing as a typical recession or market response. Figure 1 shows NBER downturns, and the associated performance of GDP, corporate earnings and the stock market. The falls in GDP look small, but remember GDP is a measure of economy-wide value-added growth, and much less volatile than corporate earnings – a drop of 'just' 3% in GDP is actually a big cyclical deal.

Clearly, it would have paid to have avoided most downturns. But in some cases, by the time the event occurs and portfolio decisions have been taken and implemented, the picture is less clear.

On 'average', stock markets have peaked eight months before an NBER recession starts, and are broadly unchanged eight months after it. Even though its exact timing may still come as a surprise to economists, when it does start it thus turns out to have been effectively partly priced in (Figure 2).

The 1990 recession followed a prolonged period of economic excess, but the market peaked before it started, and rallied before it ended. You could have ended up selling after the fall and missing the rebound. There have been other instances too where the total drawdown was brief, or just not alarming.

One of the biggest market falls was associated with only a modest economic dip, in 2000. In current data it no longer qualifies as a conventional GDP recession. It was the bursting of the 'new economy' bubble – a reminder that the stock market is quite capable of starting a fight in an empty room, as it were. The most recent market drawdown – the GFC in 2008/9 – was certainly associated with a big economic hit. But again, the trauma really originated in the markets, not the economy.

If we do get wind of a looming recession, and think it could be big enough – or not priced in enough – to try to avoid, what would we advise?

A carefully designed portfolio will hold some diversifying assets alongside procyclical ones. Figure 3 focuses on periods in which GDP was

### Figure 3: Winners and losers during declines in GDP

**Stocks vs bonds, and cyclical vs defensive sectors, when GDP has been falling (figures are after inflation)**

| Recession | 1953 | 1958 | 1960 | 1969–70 | 1973–75 | 1980 | 1981–82 | 1990 | 2001 | 2007–09 | Average* |
|---|---|---|---|---|---|---|---|---|---|---|---|
| US GDP | -2.5% | -3.6% | -1.3% | -0.7% | -3.1% | -1.9% | -2.2% | -1.3% | -0.3% | -4.0% | **-2.1%** |
| US Treasuries | 9.6% | 10.0% | 5.8% | 11.5% | -7.4% | -8.5% | 4.2% | 6.5% | 3.6% | 11.2% | **4.6%** |
| US stocks | 16.7% | -2.2% | 5.3% | -5.1% | -14.9% | 13.1% | -15.5% | 3.9% | -9.8% | -34.5% | **-4.3%** |
| Cyclical stocks* | – | – | – | – | -25.6% | 6.7% | -22.8% | 1.3% | -12.3% | -41.0% | **-15.6%** |
| Defensive stocks* | – | – | – | – | -19.7% | -1.3% | -7.1% | 1.2% | -3.6% | -30.1% | **-10.1%** |

*Source: Datastream, NBER, Rothschild & Co*
** Cyclical and defensive stock returns only available from 1973 onwards. Average based on 1973 to 2009. Past performance should not be taken as a guide to future performance.*

falling, and shows, as we'd expect, that bonds and defensive sectors usually do best. But it is not easy: while bonds did better than stocks in the inflationary 1970s recessions, they still delivered negative returns (after inflation). When GDP fell in 1980, stocks actually beat bonds, and delivered positive real returns. And a sector's cyclical sensitivity can vary with its valuation, balance sheet leverage, interest rates – and its shifting footprint.

Are 'defensive' consumer staples, for example, necessarily safer when the value of their brands – and distribution networks – is being questioned?

**Conclusion: keep an open mind**

We do not yet think the next US recession is imminent. The 'usual suspects' that have triggered downturns in the past – inflation, reckless borrowing/lending, market bubbles – are missing. This is no guarantee, but we continue to give the cycle the benefit of the doubt.

There will be one: recessions are unavoidable. But their impacts vary hugely, and a world without them could be a poorer one.

After the GFC, many pundits assert that the next economic/market setback must be equally seismic. It could be – but there is no reason it has to be. It may turn out – eventually – to have more in common with 1990 than with 2008.

Meanwhile, remember that net of recessions and drawdowns, in inflation-adjusted terms the US economy is nine times bigger than in 1950, and the stock market's total return index is 146 times as high. As long-term investors, we shouldn't let these signals be obscured by the cyclical noise, however distracting it is at the time.

Now, back to watching the numbers...

## Current investment conclusions

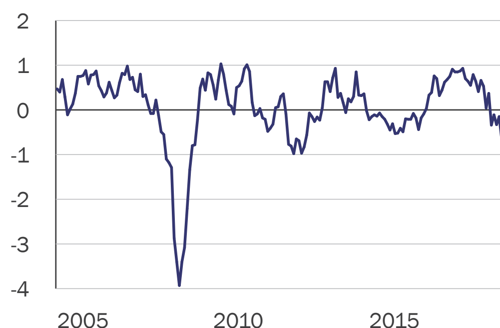
Stocks' late 2018 sell-off looked overdone, but the rebound recently took the US index to a new high, and we wonder how much more short-term headroom there can be. Recession does not seem imminent, and valuations are not outlandish: we still think stocks can deliver long-term inflation-beating returns, in contrast to bonds. But conviction is lower now than it has been since the market rally began more than 10 years ago.

- We still see most bonds and cash as portfolio insurance, not as likely sources of real investment return.
- Most government bond markets remain expensive, and offer little compensation for inflation and duration risk. Few high-quality yields exceed current inflation rates.
- After their rally, we no longer prefer high-quality corporate bonds to government bonds in the US. In Europe, spreads are less tight (over much lower government yields).
- We favour relatively low-duration bonds. We still see some attraction in US inflation-indexed bonds. Speculative grade credit did not reach sufficiently attractive levels in the sell-off, and has now rallied – and supply has returned. We still see little appeal in local currency emerging market bonds for multi-asset portfolios.
- We still prefer stocks to bonds in most places, even the UK (where the big indices are really global), but after their rebound, we see tactical risk from paused earnings and/or a rethink at the Fed. We have few regional convictions, but emerging Asia's cyclical appeal has brightened, trade nerves notwithstanding, and its structural attraction is intact. Meanwhile, US profitability seems set to stay high. We still mostly favour a mix of cyclical and secular growth, but the balance tilted recently towards the latter.
- Trading currencies does not systematically add value, and there are few major misalignments to exploit. US growth and interest carry have more than offset the Fed's softer tone, but the dollar may have now risen far enough. The euro faces an even more doveish central bank, but its growth disappointments are fading. Sterling is still hostage to Brexit and local politics, but it is competitive, and capable (eventually) of rallying even after a no-deal exit (looking less likely again than it did).

# Economy and markets: background

## Growth: major economies

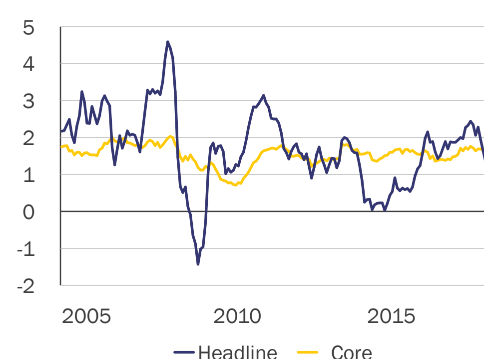
**Business optimism: standard deviations from trend**




*Source: Bloomberg, Rothschild & Co*
*Composite of the forward-looking components of manufacturing surveys from China, Germany, Japan, UK and US loosely weighted by GDP*

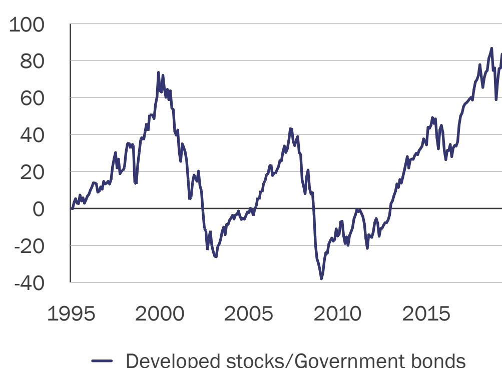
## G7 inflation

**%, year-on-year**



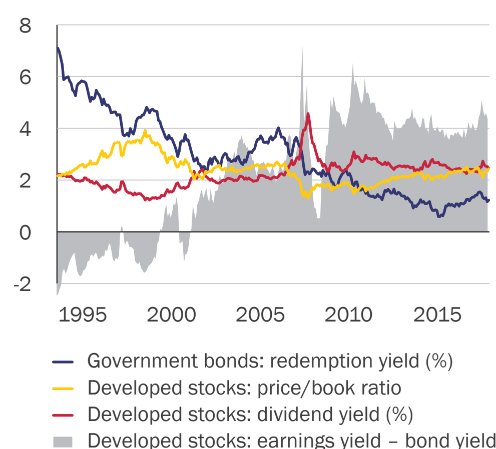

*Source: OECD, Bloomberg, Rothschild & Co*

## Stocks/bonds – relative return index (%)




*Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co*

## Stocks/bonds – relative valuations




*Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co*

## Selected bonds

**Current yields, recent local currency returns**

| | Yield (%) | 1yr (%) | 3yr (%) |
|---|---|---|---|
| 10-yr US Treasury | 2.5 | 6.6 | 2.5 |
| 10-yr UK Gilt | 1.2 | 4.1 | 8.8 |
| 10-yr German bund | 0.0 | 5.3 | 5.1 |
| 10-yr Swiss Govt. bond | -0.3 | 3.2 | 1.5 |
| 10-yr Japanese Govt. bond | -0.0 | 1.3 | 0.6 |
| Global credit: investment grade (USD) | 1.8 | 5.4 | 8.6 |
| Global credit: high yield (USD) | 6.2 | 5.4 | 22.8 |
| Emerging (USD) | 5.3 | 5.9 | 15.4 |

*Source: Bloomberg, Rothschild & Co*

## Selected stock markets

**Dividend yields, recent local currency returns (MSCI indices)**

| | Yield (%) | 1yr (%) | 3yr (%) |
|---|---|---|---|
| World: all countries | 2.5 | 7.5 | 41.3 |
| Developed | 2.5 | 8.6 | 41.4 |
| Emerging | 2.7 | -0.6 | 41.3 |
| US | 1.9 | 12.7 | 49.1 |
| Eurozone | 3.3 | 0.7 | 27.7 |
| UK | 4.6 | 3.0 | 33.4 |
| Switzerland | 3.0 | 12.7 | 33.2 |
| Japan | 2.4 | -5.5 | 27.3 |

*Source: Bloomberg, Rothschild & Co*

## Selected exchange rates

**Trade-weighted indices, nominal (1980 = 100)**

| | Level | 1yr (%) | 3yr (%) |
|---|---|---|---|
| US Dollar (USD) | 109 | 5.6 | 5.5 |
| Euro (EUR) | 124 | -1.3 | 4.7 |
| Yen (JPY) | 91 | 3.4 | -1.0 |
| Pound Sterling (GBP) | 79 | 1.0 | -7.2 |
| Swiss Franc (CHF) | 154 | 3.5 | -2.1 |
| Chinese Yuan (CNY) | 134 | -1.3 | -0.6 |

*Source: Bloomberg, Rothschild & Co*

## Commodities and volatility

| | Level | 1yr (%) | 3yr (%) |
|---|---|---|---|
| CRB spot index (1994 = 100) | 184 | -8.8 | -0.2 |
| Brent crude oil ($/b) | 72.8 | -3.2 | 51.3 |
| Gold ($/oz.) | 1,284 | -2.4 | -0.7 |
| Industrial metals (1991 = 100) | 248 | -9.6 | 24.2 |
| Implied stock volatility: VIX (%) | 13.1 | -17.6 | -16.4 |
| Implied bond volatility: MOVE (bps) | 49.5 | -1.8 | -23.8 |

*Source: Thomson Reuters, Bloomberg, Rothschild & Co*

*Data correct as of 30th April 2019.*

*Past performance should not be taken as a guide to future performance.*

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