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The 'R' Word

By Joseph Caplan and Jonathan Caplan

As we entered 2022, the economy and financial markets were already facing a number of uncertainties and challenges. Nevertheless, a path to a post-COVID economic recovery appeared likely. But following the Russian invasion of Ukraine, a number of unforeseen economic challenges have significantly increased the possibility of a recession. First, price increases in basic commodities have begun to accelerate as fears of shortages of grains and energy have proliferated globally. Moreover, the effects of geopolitical uncertainty in Europe are increasingly likely to have ramifications for global economic growth. Finally, the Federal Reserve has made clear that more restrictive monetary policy is in the offing.

Aside from the macroeconomic headwinds, a bond market phenomenon known as a yield curve inversion has taken place. Simply put, some shorter-term interest rates are rising above longer-term interest rates. Why does that matter? Each recession since 1955 was presaged by a yield curve inversion.

Looking back at the past two recessions of 2008/2009 and 2020, there were few economic forecasters who accurately predicted the timing and depth of those slowdowns. Yet there were signs of stress in the financial markets highlighted by a yield curve inversion.

Historically, the time between the inversion of the yield curve and the ensuing recession has varied between a few months and a couple of years. For example, the yield curve inverted in August 2006, approximately 16 months prior to the economic recession in the wake of the Financial Crisis.

As we face growing economic uncertainty and a possible recession, how should investors think about the potential risks and rewards in this new paradigm?

No Two Recessions Are Exactly Alike

The current confluence of economic circumstances is dissimilar to anything we have seen historically. The COVID-19 pandemic created a unique set of economic challenges. This precipitated unusual government responses including massive fiscal spending and a very accommodating Federal Reserve. As a result, we are now experiencing inflationary pressures that we haven't encountered since the early 1980s. But interest rates then were much closer to the rate of inflation. With short-term interest rates currently below 1%, the gap between interest rates and inflation has rarely been so wide. Thus, the Federal Reserve may be compelled to aggressively raise interest rates to break the back of inflation.

There are arguably no proper historic analogues that can provide investors comfort in this dynamic climate. No investor or economist knows exactly how this period will evolve due to the idiosyncratic factors that shape today's economy. Therefore, rather than making grand predictions about the future, investors should consider the risks that shape today's macroeconomic environment and how those risks may impact portfolio performance.

Focusing on Portfolio Risk

Following the Great Financial Crisis of 2008/2009, the U.S. economy progressed on a steady path of stable economic growth, a healthy labor market, low interest rates and benign inflation. As a result, portfolio performance was not predicated on effective risk management. The false sense of security that ensued is likely to be challenged in the future.

The emergence of the COVID-19 pandemic in early 2020 was the first major event since the financial crisis to highlight the vulnerabilities of all asset classes. Today, as the recovery from the pandemic has taken hold, one may have expected portfolio risk to revert back to pre-pandemic levels. Rather, it seems as if the paradigm has markedly shifted in sharp contrast with the prior decade. Rising interest rates, systemic inflation and heightened geopolitical turmoil are now exposing additional vulnerabilities of the major asset classes: equities, fixed income, real estate and cash.

Looking forward, a portfolio's prospects will likely be predicated on the management of risk rather than simple asset allocation. Risk factors that professional portfolio managers evaluate include volatility, concentration and valuation. Ultimately, the main focus of portfolio managers is the ability to withstand the most significant headwinds. Famed investor and academic Peter Bernstein once said: "Survival is the only road to riches." The most important question is: Can the portfolio survive in all economic and market environments?

Long-Term Opportunism

What frequently gets ignored during volatile markets are the favorable opportunities that emerge from market dislocation. When exogenous events roil the financial markets, many investors panic. Emotional response to market instability often leads to poor decision-making and can easily result in sustaining permanent losses of capital. For example, in March 2020, those who liquidated their portfolios when the market was swooning undoubtedly regretted their decision following the sharp recovery. Conversely, those who had a disciplined investment approach found numerous opportunities to purchase great assets at attractive prices as they became more prevalent. When a great company's stock price falls due to market instability rather than worsening fundamentals, the valuation discount makes for an improved risk/reward profile. As Warren Buffett famously stated: "Bad news is an investor's best friend. It lets you buy a slice of America's future at a marked-down price."

A Recession Now or Later

There is no certainty that a U.S. recession is inevitable this year or next. First, corporations and consumers are generally in strong financial health. Second, the labor market is tight, with millions of jobs remaining unfilled. In fact, the latest unemployment rate at 3.6% is close to record-low levels. Lastly, one can argue that the yield curve inversion could be giving a false signal this time due to the Federal Reserve's actions that have engendered market anomalies.

All that said, recessions do occur with some regularity as a consequence of the natural progression of the business cycle. Therefore, investors should always be prepared by having a defensive mindset. Maintaining a disciplined, long-term approach to investing is a sure way to successfully navigate market cycles.

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