NAVIGATING THE ODDS OF A RECESSION

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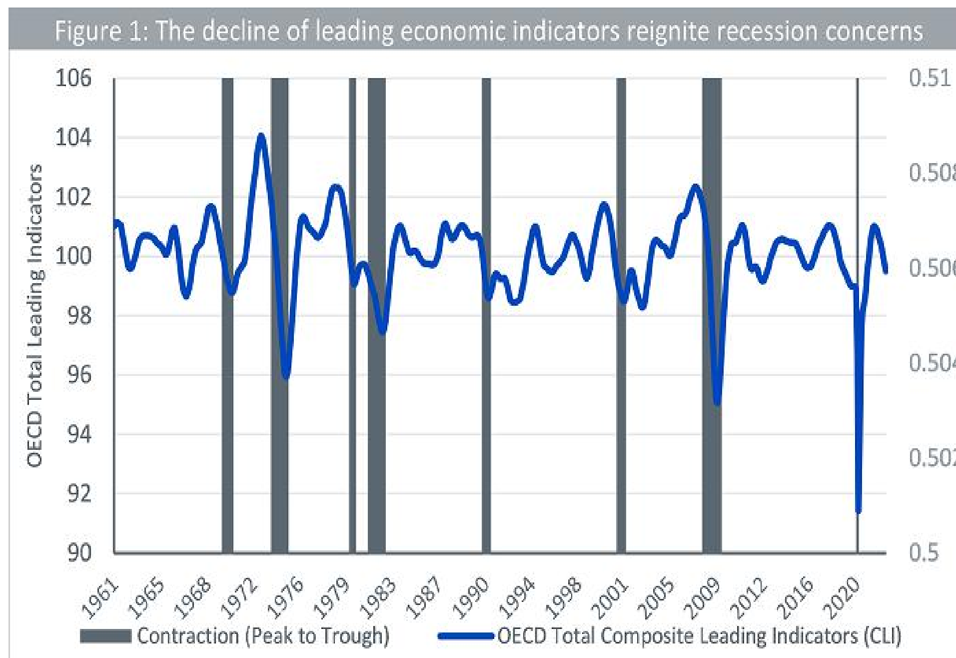
The re-opening trade in 2021 has evolved into the ‘recession trade’ in 2022, owing to a tardy start to the hiking cycle by central banks in developed markets. This has left them way behind the curve due to their misreading of inflation being transitory. To save face, they are moving expeditiously ahead in tightening monetary policy at a time when breakeven inflation expectations are receding. Sure, core inflation is showing signs of cresting but is unlikely to decelerate, paving the way for further hikes. This aggressive tightening plan is slowing the global economy, raising the probability of a global recession. As central banks in the US, Europe, the UK, and China have been on different paths in their efforts to quell inflation, the probability, timing, and intensity of a recession will differ across each of these regions. Leading economic data (LEI) shows economic momentum is fading quickly. Historically, four consecutive monthly declines in the LEI have foretold a recession.



Source: Bloomberg, National Bureau of Economic Research, WisdomTree as of 30 June 2022.

Historical performance is not an indication of future performance, and any investments may go down in value.

Recession risks appear highest in Europe versus US and China

The Russia/Ukraine war exacerbated the energy crisis, fuelling higher global inflation.

The uncertainty of the war and falling real income growth is evidently taking a toll on consumers across the globe. Owing to its proximity to the war alongside its high dependence on Russia for energy supplies, recession risks are higher in Europe. With no abatement of the war in sight, we expect higher energy prices to erode purchasing power of the European consumer and further rationing of energy intensive production sites.

The likelihood of recession in Europe has risen to 50% in the next six months. We expect to see two consecutive quarters of negative growth starting in the second half of 2022. The European Central Bank (ECB) is likely to step up the pace of tightening rates, bringing the refi rate to 1% before year-end. The looming recession in the Eurozone alongside doubts about debt sustainability should restrain the ECB from going beyond the initial normalisation, keeping rates on hold in 2023.

In the US, the current economic dynamics appear consistent with a recession. While June payrolls came in at +372,000, exceeding expectations, US inflation rose 9.1% in a broad based advance in June. The inflation data will keep Fed officials on an aggressive policy course to rein in demand, despite unemployment remaining low at 3.6%. Historically, when average quarterly inflation rises above 5%, the probability of a recession over the next two years is above 60%, and when the unemployment rate drops below 4%, the probability of a recession over the next two years approaches 70 percent. Since 1955, there has never been a quarter with average inflation above 4% and unemployment below 5% that was not followed by a recession within the next two years. In Q1 2022, the US economy shrank by an annualised rate of 1.6%, signalling we might well be on our way to the technical definition of a recession.

	Average quarterly inflation above:	Average quarterly Unemployment rate below:	Probability of recession over next 4-quarters	Probability of recession over next 8-quarters	Number of Quarters	When did the US economy most recently cross threshold ?
Inflation only	5%		45%	62%	29	Q3 2021
Unemployment Rate only		4%	42%	69%	26	Q1 2022
Inflation and Unemployment rate	4%	6%	59%	89%	27	Q2 2021
	4%	5%	73%	100%	11	Q4 2021
	4%	4%	57%	100%	7	Q1 2022
	5%	6%	83%	100%	12	Q3 2021
	5%	5%	100%	100%	5	Q4 2021
	5%	4%	100%	100%	3	Q1 2022

Note: The calculation for the probabilityof recesion over the next 4-quarters and 8-quarters excludes quarters when the US economywas alreadyin a recession. Recession is defined using NBER based recession indicators for the United States from the period following the peak through trough. Te measure of inflation used is Consumer Price Indexfor all urban consumers.

Source: Bureau of Labor Statistics via FRED, Analysis by Harvard Kennedy School – Akash Domash and Lawrence Summers.

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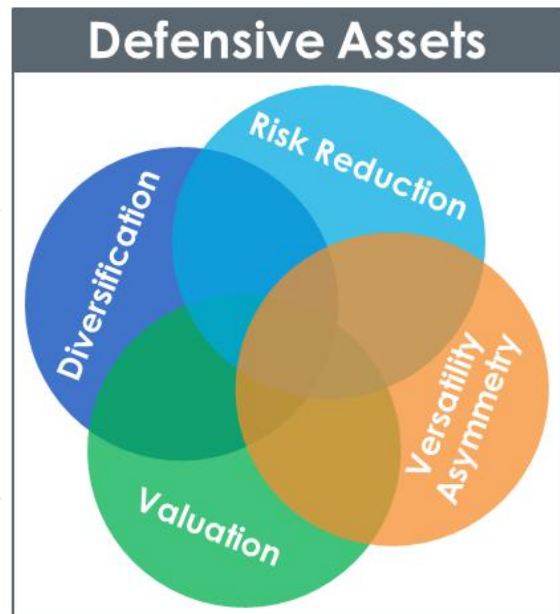
With recession risks rising across economies but with timing and intensity remaining uncertain, investors need to be careful within their equity allocation. In uncertain markets, when contradictory scenarios are possible, portfolio construction is paramount. The objective should be to build versatile portfolios that can adapt to quickly changing market conditions and can remain resilient in the face of unexpected events. In other words, portfolios whilst having a defensive tilt can also participate in market rallies.

All-weather or asymmetric asset?

Most (all?) equity drawdowns are violent and are triggered by unpredictable events.

Investors do not have a crystal ball to tell them when to switch into defensive assets just before the drawdown. Therefore, they need to consider staying invested in defensive assets for long periods of time in preparation for possible shocks. The opportunity cost of doing so could be significant and varies a lot from one asset to another. This is why, we introduce a detailed framework to define “useful” defensive assets. Useful defensive assets should tick 4 boxes:

- Risk Reduction i.e. reduction of drawdowns, volatility...
- Asymmetry of returns i.e. versatility, capacity of the asset to capture more of the performance of an asset when it goes up than when I goes down and to reduce opportunity cost (i.e. the performance that an investor did not benefit from because he was invested in an other asset)
- Diversification i.e. uncorrelated behaviour to the rest of the portfolio and in particular to equities
- Valuation i.e. a cheaper asset usually exhibits less room for negative performance and less crowding as well



In order to improve the versatility of a portfolio, it is important to consider all 4 aspects for potential investments.

The right choice for an equity portfolio

Traditionally defensive equities like minimum volatility (Min Vol) or utilities, typically exhibit strong defensiveness in the form of low volatility and lower drawdown. However, they also exhibit limited upside potential in trending upward markets. This means that properly timing the point of entry and exit for this strategy is key to their success. But this is of course very difficult. Factors such as Quality, High Dividend on the contrary provide a more balanced risk return profile allowing for more versatility. They remain somewhat defensive, but they also can capture market upside very efficiently.

We believe that the right quality strategy is the cornerstone of an equity portfolio. High quality companies exhibit an ‘all-weather’ behaviour that could deliver a balance between building wealth over the long term, whilst protecting the portfolio during economic downturns. A quality focused investment can deliver resilient portfolios helping investors looking to build wealth over the long term and weather the inevitable storms along the way. This makes quality an ideal candidate for a strategic, long term, core investment in equities.

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