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What Trades Work in a Recession?

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Worrying about the beta: ripples vs. the tide

Conventional thinking assumes equity investors should only worry about company fundamentals or price charts. But macro events tend to drive the systemic risk (the beta) rather than the idiosyncratic risk (the alpha) for each asset. Here are a few reasons why paying attention to macro could help:

- Macro events (fiscal stimulus, monetary policy) often impact the level of interest rates, which drives valuation models for companies
- Geopolitical events can lead to risk aversion that temporarily drives investors into safe assets, offering potentially attractive entry points to risky assets
- Company management actions can improve margins and profitability but macro events (transition from recession to expansion) can drive volume and topline

What is a recession?

The official definition of a recession has been the topic of much debate lately. Often thought of as “two or more consecutive quarters of negative GDP growth” (incidentally, a criterion met in Q1 and Q2 of this year) the actual definition is more complicated.

The NBER defines it as a significant decline in economic activity that is spread across the economy and that lasts more than a few months. Each of the three criteria—depth, diffusion, and duration—needs to be met individually to some degree, extreme conditions revealed by one criterion may partially offset weaker indications from another.

That’s why Q2 of 2020 is considered a recession although it lasted only a quarter.

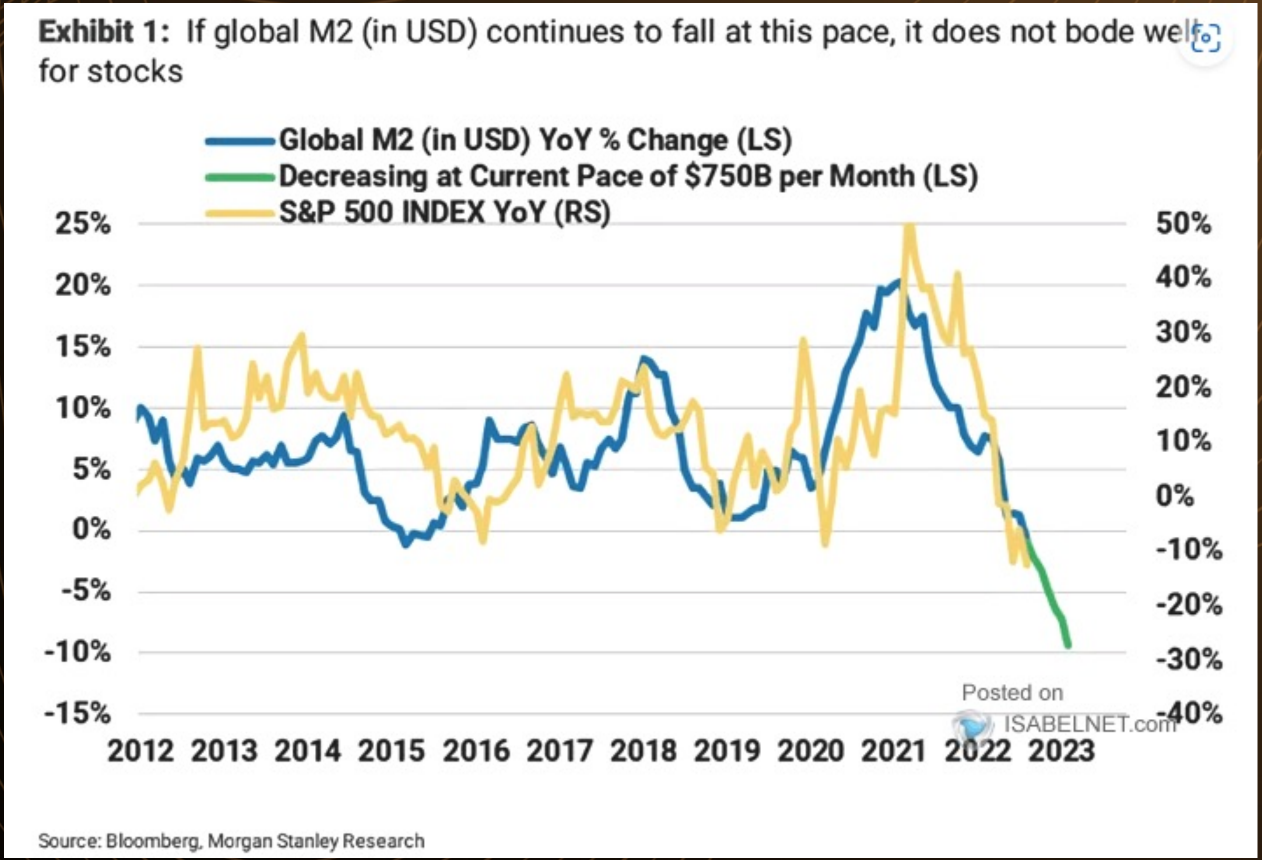
Forecasting a recession

Stocks markets are awful at forecasting recessions (economists are worse). Nobel Prize-winning economist Paul Samuelson once quipped that the stock market had predicted nine of the last five recessions.

Yield Curve is probably the single most reliable indicator. The Yield Curve is a central element of asset pricing in the economy. It reflects market expectations of future Central Bank policy, which is primarily driven by macro variables like economic growth and inflation

"Don't fight the Fed"

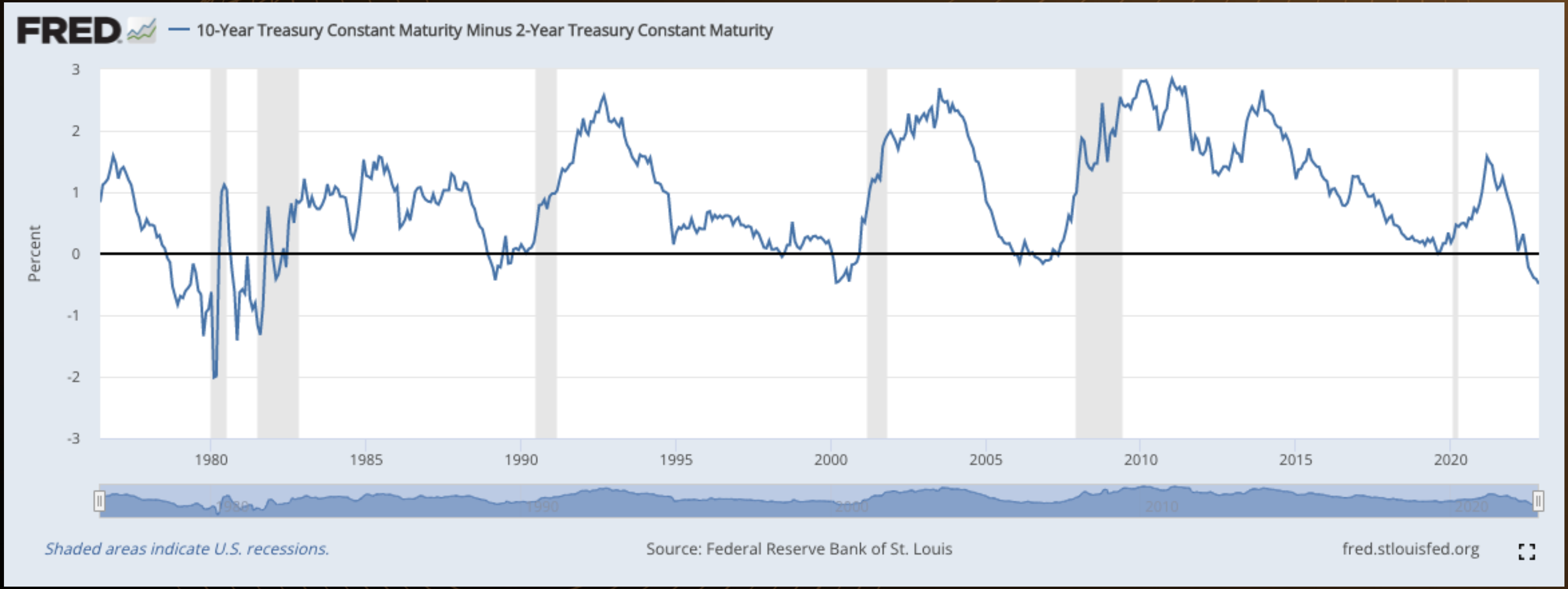
We have never seen such dramatic (and fast) changes in global liquidity conditions.



Source: MS and Bloomberg

The Yield Curve is signaling a recession ahead

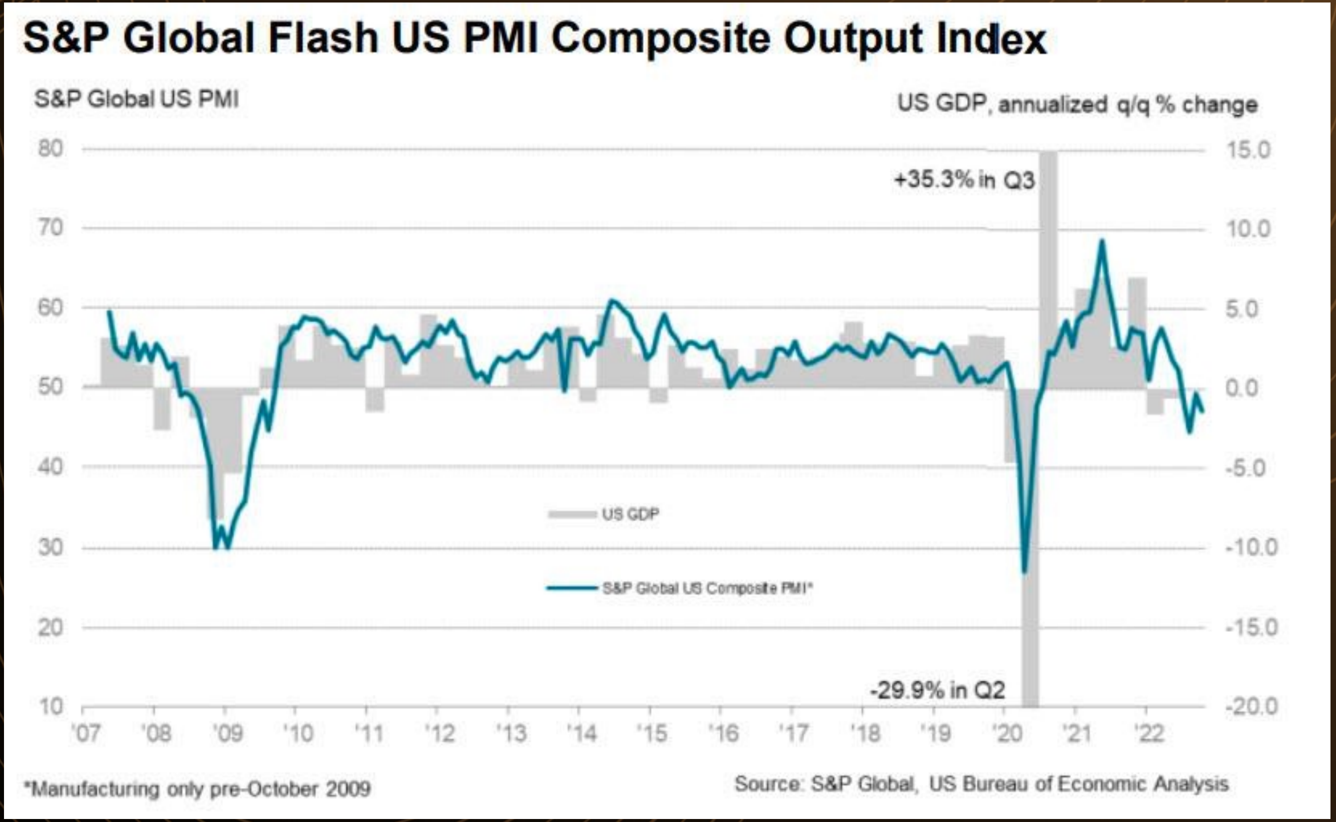
The Yield Curve has been inverted – and flashing a red recessionary signal – for some time now.



Source: Federal Reserve bank of St. Louis

High frequency survey data also flashing red

Monthly and weekly surveys of a broad range of industries is pointing to a downturn that's picking up steam.



Source: S&P Global, US BEA

The macro vs. micro

Evaluating company fundamentals (the micro) gives investors a good sense of a company's profit margin and potential within a particular macro context. But macro context can drive wholesale shifts in the demand curve (think Zoom, Netflix) and therefore volume.

- Fundamental analysis worries about the slope of the demand curve (how much can company earn if it prices the product here, or here). Macro analysis worries about upward and downward shifts of the demand curve.

- Cyclical changes can lead to substantially different environments for a particular sector (Netflix in the pandemic, Housing during monetary easing etc.)

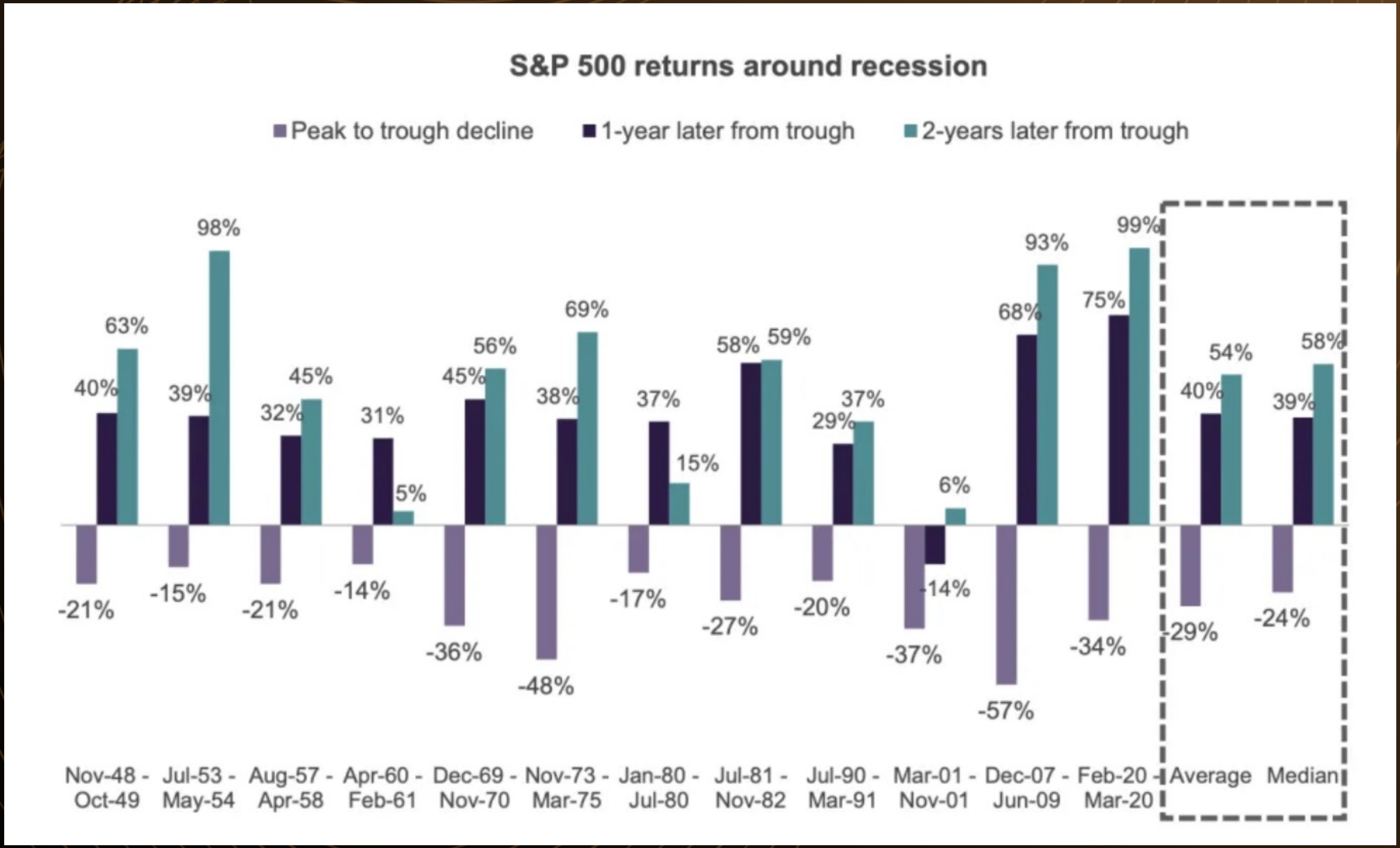
Why is a macro lens relevant now?

We are in an highly unusual environment:

- High (and stubborn) inflation
- Central Bank hell-bent to fight it
- Taking back trillions in liquidity injected during COVID

All of the factors above dramatically heighten the risk of a recession.

How assets historically performed in a recession



Source: Yahoo Finance

Two important observations about the stock market in recessions

- First, in many cases, the index declined significantly well before the official start of the recession.

- Second, the S&P 500 frequently began to rebound well before the end of the recession.

What assets might do well, and which might not, in a recession?

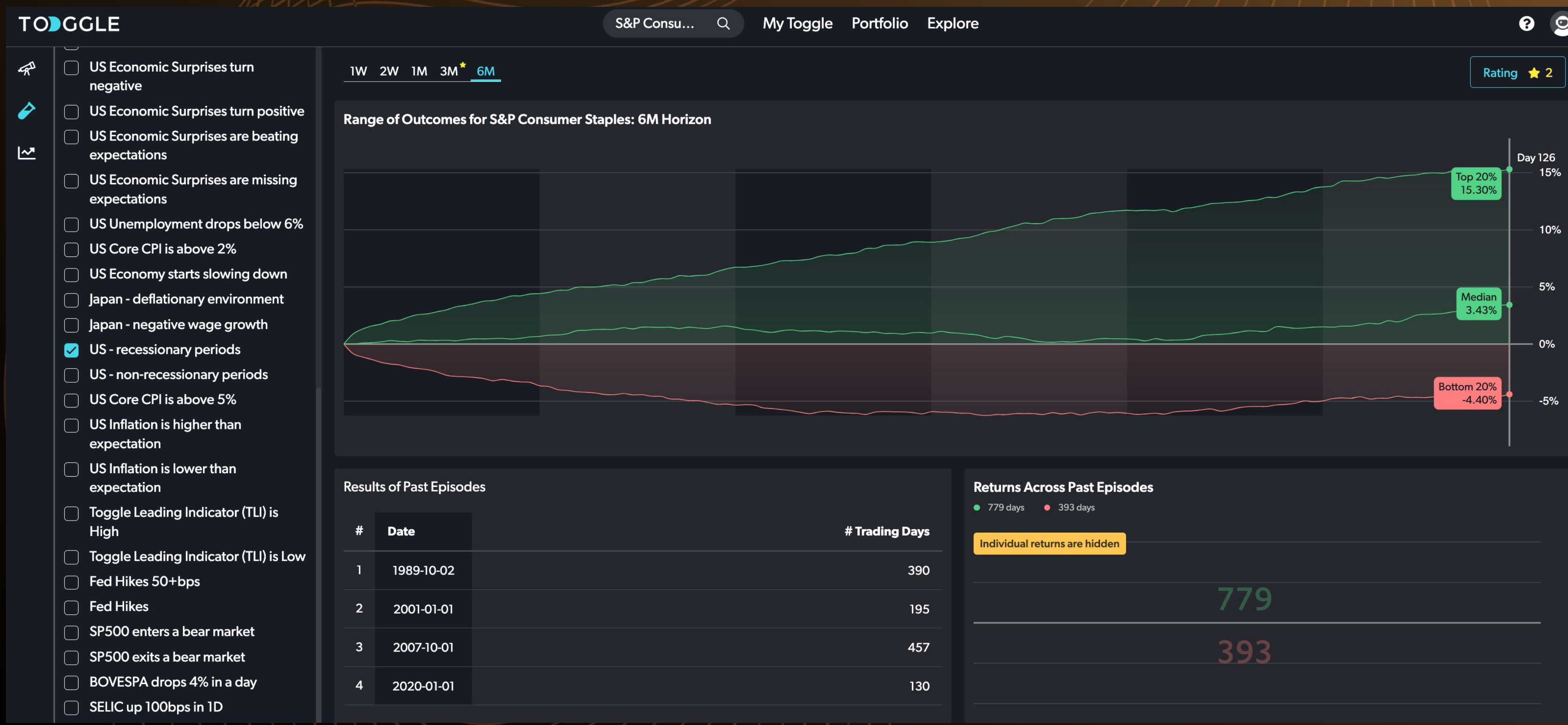
Does well	Doesn’t do well
Bonds	Consumer Discretionary
Dividend-yielding stocks	Tech
Consumer Staples	Financials
Healthcare	Industrials
Selling puts on stocks you want to own	

How have equity sectors performed thus far

S&P 500 Sector Performance	2022 Q1–Q3
Energy	+30.71%
Utilities	-8.58%
Consumer Staples	-13.52%
Health Care	-14.15%
Industrials	-21.72%
Financials	-22.41%
Basic Materials	-24.90%
Consumer Cyclical	-30.32%
Real Estate	-30.43%
Technology	-31.93%
Communication Services	-39.43%

Source: Seeking Alpha

Consumer staples can do well through recessions



Source: Toggle

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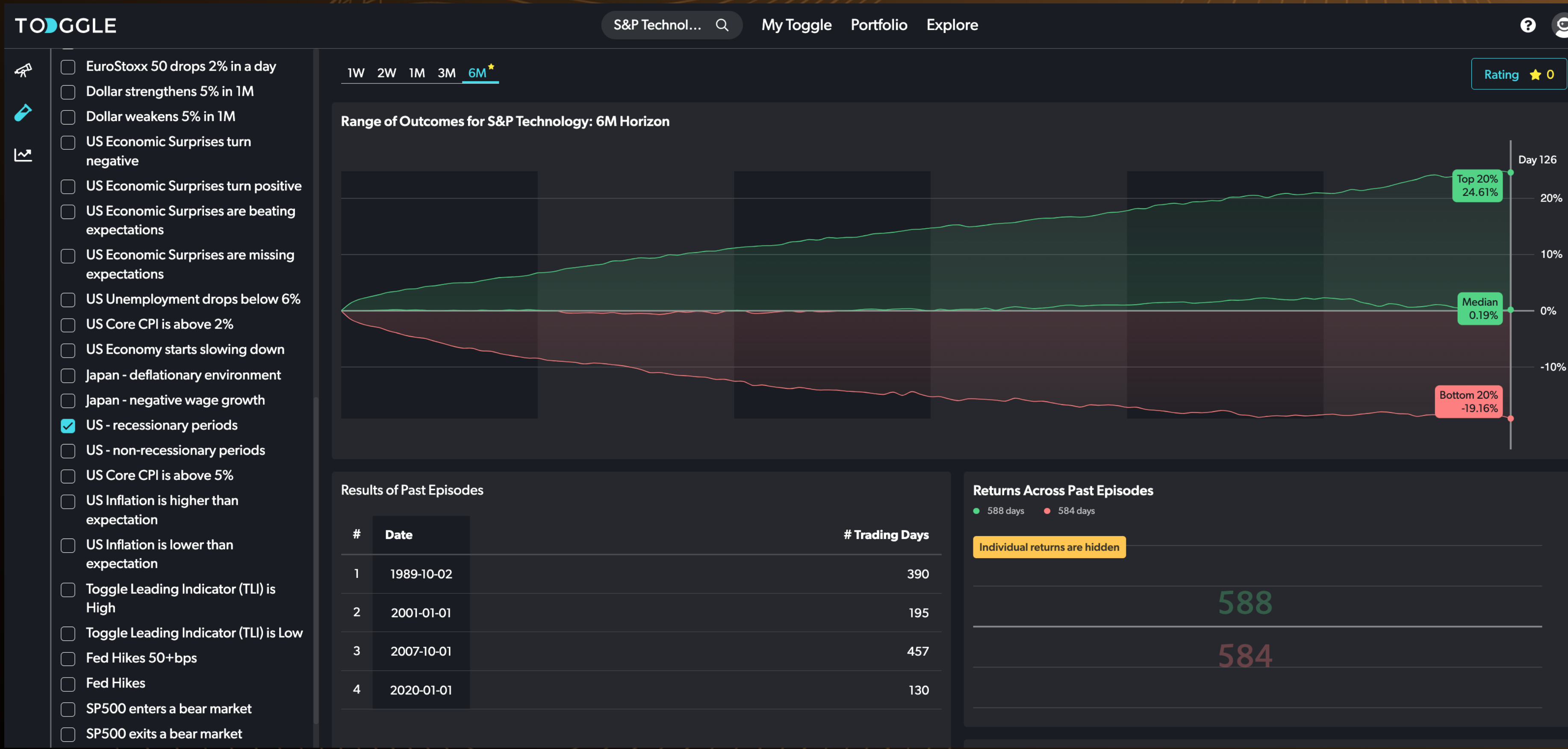
Tech sector has not done well in past recessions



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Stocks that have performed well in past recessions

WW Grainger (Consumer staples)
Returns 6M: 12.3%

Progressive (Insurance)
Returns 6M: 11.8%

Church & Dwight (Consumer staples)
Returns 6M: 11.3%

JM Smuckers (Consumer staples)
Returns 6M: 10.8%

General Mills (Consumer staples)
Returns 6M: 10.1%

Sysco (Consumer staples)
Returns 6M: 9.8%

Kellog (Consumer staples)
Returns 6M: 7.9%

Humana (Healthcare)
Returns 6M: 7.1%

Nucor (Industrial
Returns 6M: 6.7%

Source: Toggle

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