



InvesTips

How to invest in a recession and thrive afterwards

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WS Global CIO Office

Are we in a recession yet?

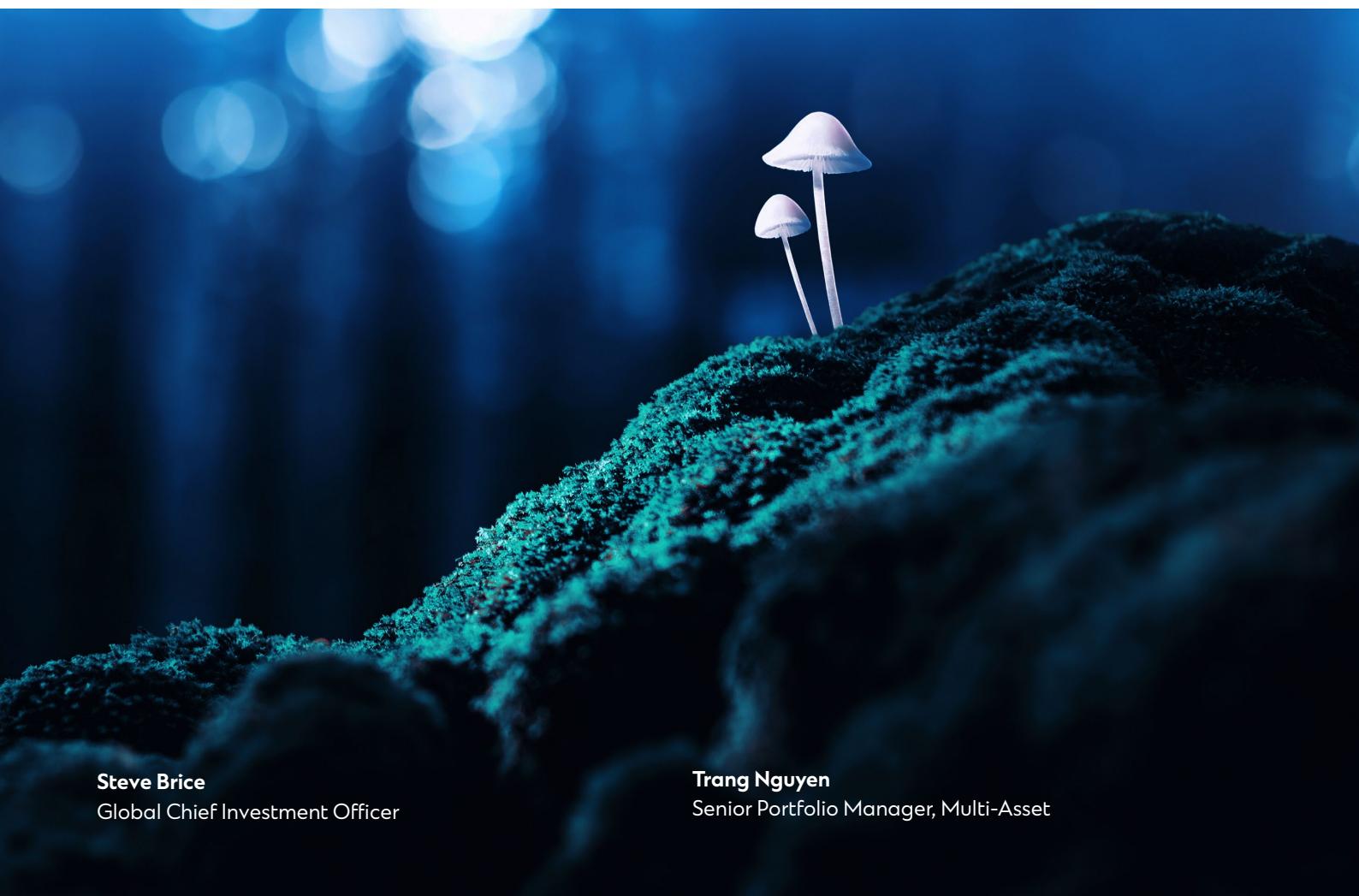
To say that it has been an eventful investing journey since the onset of Covid-19 is an understatement. First a pandemic, then a bear market, and then the highest inflation in four decades. Now the question on top of every investor's mind is: "Is the next recession around the corner?"

A recession is commonly defined as at least two consecutive quarters of declining GDP. More formally, the National Bureau of Economic Research (NBER) defines a recession in the U.S. as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real gross domestic product (GDP), real income, employment, industrial production and wholesale-retail sales."

In 2022, the US economy contracted 1.6% in the first quarter and 0.6% in the second quarter. However, this is

unlikely to be seen as the start of a recession. According to the NBER, more evidence of a significant deterioration in the economy is required for the official declaration of a recession.

While the jury is still out on that question, we are clearly in economically challenging times. For those that wonder what you can do now to best position your investments to cope with the challenging times ahead, here's what you need to know about investing in a recession and set yourself up to thrive afterwards.



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Cash is the king

Cash means different things for different people. In the investment world, cash generally refers to liquid investments that you can cash out quickly. In these instances, cash can mean money market accounts, certificates of deposit, Treasury bills and other short-term interest-bearing investments.

For investors, there are two advantages of holding cash during a recession. First, unlike all other investments, the risk of losing (nominal) value is extremely low for cash. As cash rates tend to go up during central bank hiking cycles, historically, cash has tended to yield positive returns during recessions. For this reason, cash offers great diversification benefits in an investment portfolio in times of crisis. Second, keeping liquid assets on hand during market downturns allows investors to take advantage of discounted investments during the recovery phase.

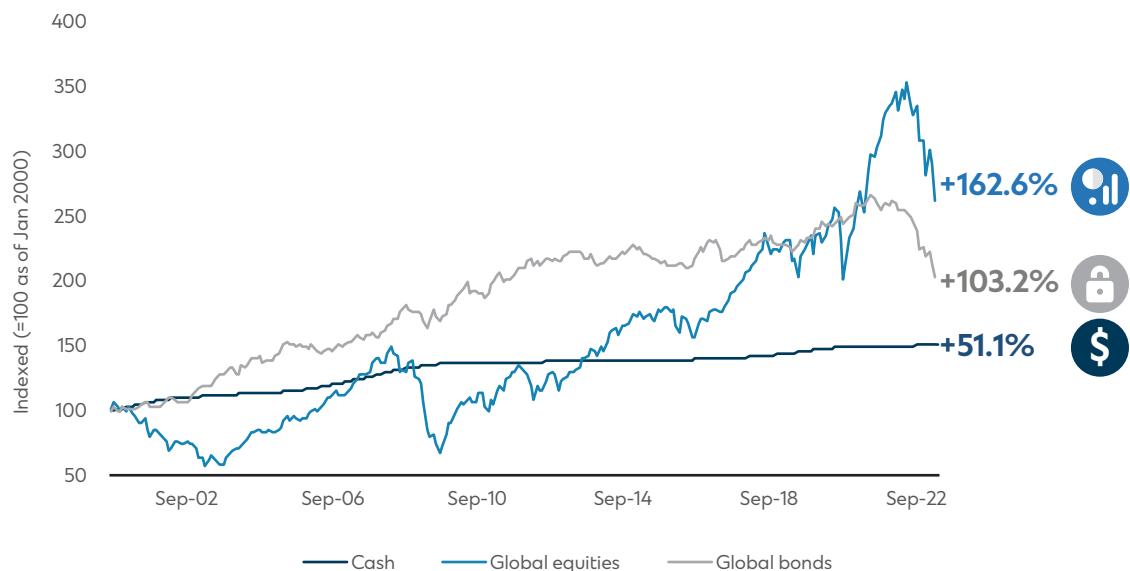
However, holding an excessive amount of cash can lead to unintended consequences:

- 1 when recessions are accompanied with persistently high inflation, holding cash can mean losing purchasing power.
- 2 timing the markets to deploy cash is easier said than done. Instead, we believe it makes more sense for investors to incrementally use cash for investment opportunities that have been significantly discounted.

In the chart below, we note that while recessions can be a scary time for equity investing, staying invested through market drawdowns has proven to yield much higher returns over the long term.

While cash is often perceived to be king during a recession, staying invested in equity and bond markets has proven to be more beneficial for long term investors

Cumulative returns of cash vs. global bond and global equity (2000 – 2022)



Source: Bloomberg, Standard Chartered.



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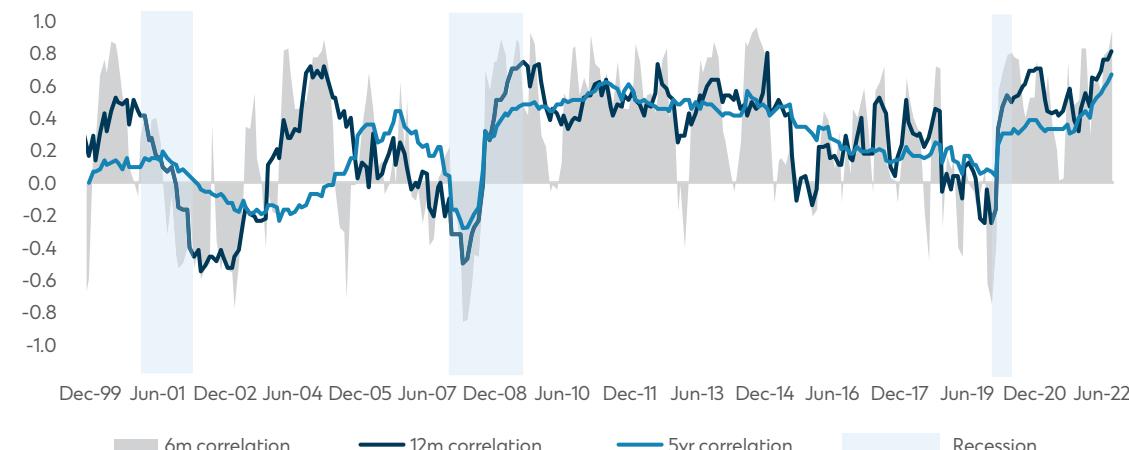
Diversification is not dead

The recent weaknesses seen in almost all financial assets, including so-called safe-haven investments such as global government bonds and gold, has undoubtedly posed the question of whether diversification benefits are a thing of the past. A close examination based on history reveals the following:

- 1 Such an outcome (i.e. diversification fails) is not unprecedented, but extremely rare. Including this year, there have only been 4 years in the past 150 years that we have seen both US equities and bonds lose value.
- 2 Correlation is a commonly used metric for diversification across assets. Historically, a spike in short term correlation (6 months) between global equity and global bonds tends to be short-lived, with a strong overshoot characteristic.
- 3 The long-term case for diversification remains valid. The longer term correlation (eg. 5 years) has proven to be more stable and should be a more appropriate proxy for diversification. While it has gone up recently, it remains low and not too dissimilar to past recessions.

The long-term case for diversification remains valid

Different windows (6m, 12m, 5-year) of rolling correlation between global bonds and global equities (1997 to 2022)



Source: Bloomberg, Standard Chartered.

Own defensive and dividend stocks

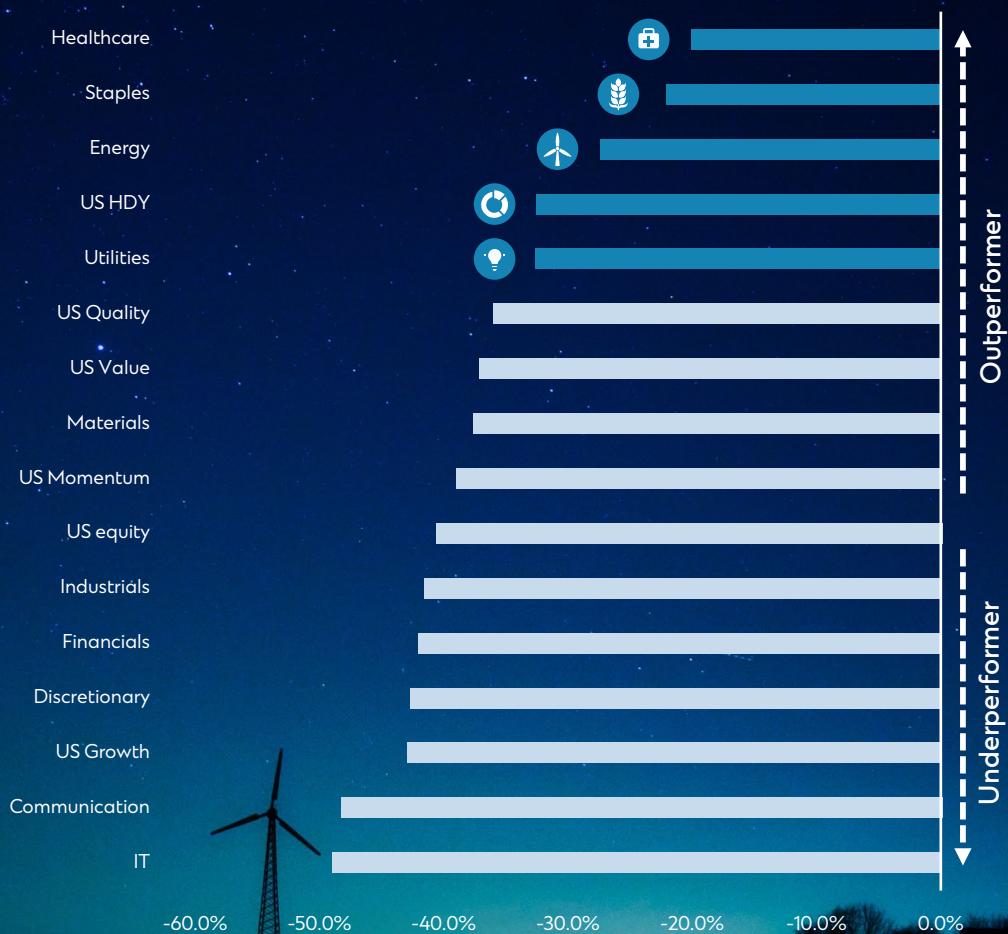
Equities often do poorly during a recession. However, the wide dispersion in performance during past recessions across sectors (see chart below) suggests some stocks are less affected by recession risks than others. These defensive stocks are companies and sectors that have a track record of generating stable revenue regardless of the declining economy. Healthcare, Consumer Staples, Energy and Utilities are often classified as defensive equities. Evidently, their historical performance has been more resilient compared to the broad equity markets in past recessions. Similarly, investing into established companies with consistent cashflows to pay dividends may be beneficial as income received can provide some cushion for any capital losses.

Investors that do not have any existing equity exposure can consider taking advantage of the recent undiscriminate sell-off in equities to start building positions in some of these defensive and high dividend equities.

For those that currently hold equities in their portfolios and do not wish to completely reposition their portfolios, incrementally substituting the broad equity exposure with these defensive/ income-paying stocks can be an effective way of reducing overall portfolio risk.

Defensive and high dividend equities outperformed in the past recessions

Average returns of various US equity sectors during the past recessions (2000, 2008 and 2020)



Source: Bloomberg, Standard Chartered.

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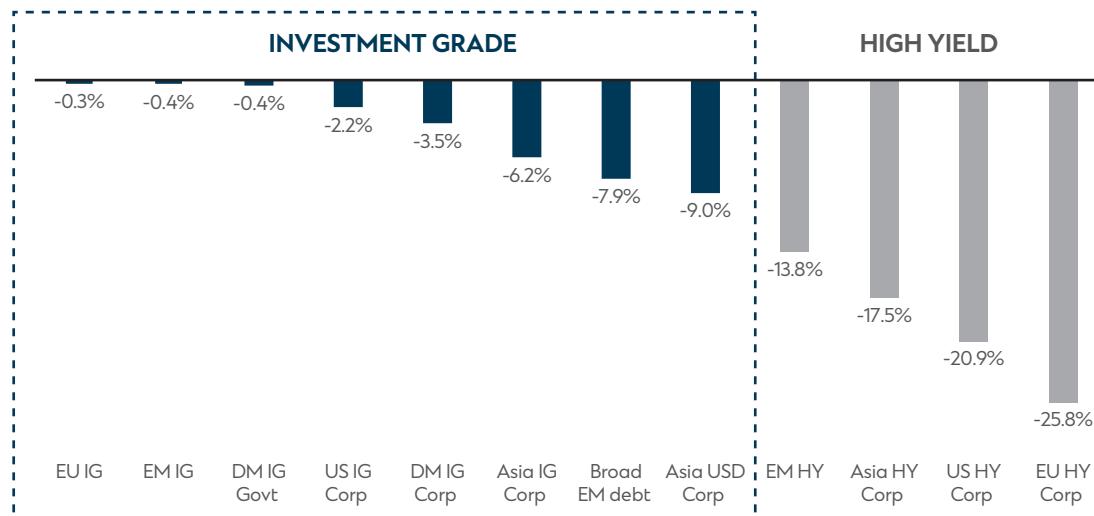
Buy quality assets

Most recessions are preceded by central bank hiking cycles, especially in an environment of high and rising inflation. This is because raising interest rates is the most effective tool most central banks have available to combat inflation. However, this effort is often done at the expense of slowing economic growth as higher interest rate means higher cost of capital for corporates, which can reduce their incentive to invest in new business opportunities. This pain tends to be felt first by companies that are highly indebted because higher interest rate payments can quickly become an increasing burden, putting a strain on their cashflows and hence future growth.

Higher rates can be good for bond investors over the long term as they increase returns in the future. However, for those investors that believe recession risk is high on the horizon, moving up in the credit quality spectrum would be a prudent approach in bond investing. Evidently, in the past recessions, across all regions, high yield bonds suffered much larger drawdowns compared to investment grade bonds.

Titling bond exposure toward higher quality assets would be a prudent approach to bond investing during recessions

Average returns of various bond components during the past recessions (2000, 2008 and 2020)



Source: Bloomberg, Standard Chartered.

Use dollar cost averaging to add exposure incrementally

With a lot of uncertainties present in the financial markets, it is extremely difficult to resist the temptation to hold on to cash and wait for the 'right opportunity' to go all in – basically, timing the markets. That said, timing the market is incredibly difficult even for professional investors. It is only in retrospect you can identify what favourable prices would have been for any asset – and by then, it's too late to purchase. Therefore, as we believe time in the markets is more important than timing markets, investors should consider adopting a dollar cost averaging (DCA) approach to add to their portfolios. There are two common ways to do dollar cost averaging:

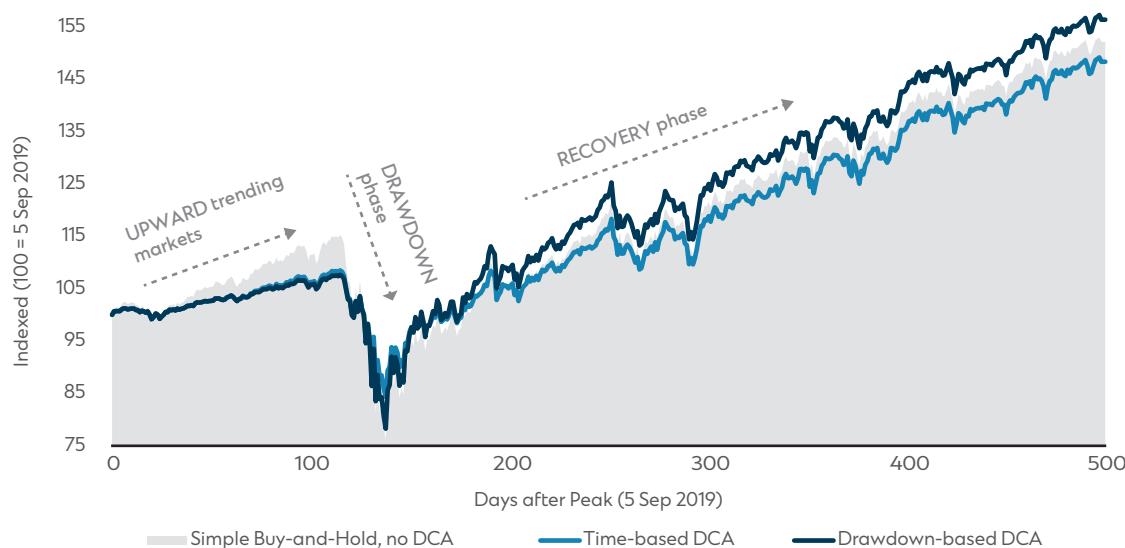
- 1 **Time-based DCA** is an approach in which investor can deploy a fixed amount of capital into investment following a fixed time frequency. For example, one can consider adding \$1000 into their investment portfolio every month.
- 2 **Drawdown-based DCA** is another approach of investing a fixed amount of money into an asset whenever it drops by a predetermined percentage in value. For example, investors can schedule to add \$1000 into US equity every time the S&P 500 index drops by 5%.

In the chart below, we ran simulated returns of different investing strategies through different phases of an equity market. Four observations emerge:

- A** In an **upward trending market**, buy-and-hold strategy (i.e. deploying all the capital at the beginning) tends to outperform both DCA strategies.
- B** A **time-based DCA** could be superior if one believes a market decline could be prolonged.
- C** A **drawdown based DCA** could be more effective if a market decline is sharp and swift, allowing investors to capture opportunities in a timelier manner.
- D** For the same reason, a **drawdown based DCA strategy** can result in higher returns during the recovery phase (all else equal).

Both DCA strategies show limited downside when equity markets go through the drawdown phase

Simulated returns of various investing strategies



Source: Bloomberg, Standard Chartered. Full deployment: An investor deploys all his/her capital at today's level of drawdown, mapped to the Covid-19 crisis (5 Sep 2019), then simply holds. No subsequent DCA tranches. Drawdown-based: An investor deploys 50% of his/her capital at today's level of drawdown, mapped to the Covid-19 crisis (5 Sep 2019). Every -5% lower from the current level, he/she adds 10% of his/her capital, up to 5 tranches. Time-based: An investor deploys 50% of his/her capital at today's level of drawdown, mapped to the Covid-19 crisis (5 Sep 2019). Every 1 month onwards, he/she adds 10% of his/her capital, up to 5 tranches

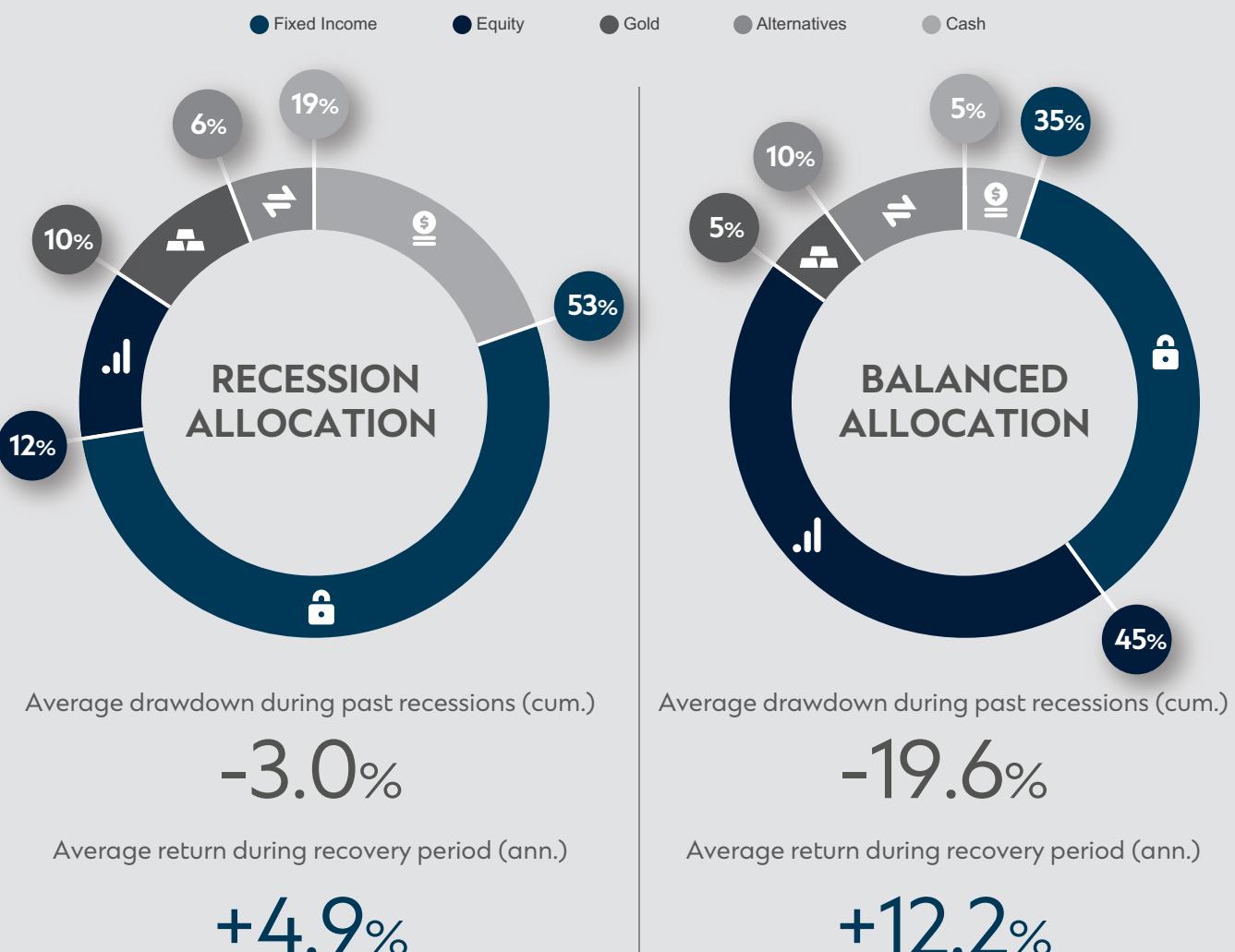
A recession portfolio can be helpful but will not be likely to take you far (in your investment journey)

Predicting and timing recessions is incredibly difficult. Therefore, a prudent approach would be to prepare for it by shifting incrementally towards safer assets if one's conviction in an imminent recession becomes stronger. Practically, for a 'recession allocation', we would dial back risk from our balanced allocation by reducing equities in favour of bonds, gold and cash. Among equity regions, US equities have been generally most defensive. Within fixed income, historically, higher quality Developed Market bonds tend to outperform lower quality credit and Emerging Market bonds. Our back-testing results (the chart below) show that, on average, such a recession allocation posted -3.0% vs.-19.6% by a balanced allocation in the past recessions.

However, we must acknowledge that while a recession allocation can help alleviate worries of an immediate recession, it comes with the risk of underperforming in the future. For long term investors, it can mean compromising the chances of achieving their investment objectives in the following years. Based on our analysis, while a recession allocation was resilient during past recessions, it underperformed a diversified balanced allocation significantly in the recovery phase.

A comparative review of a recession allocation* vs. a balanced allocation

Average drawdown during the past recessions and average 12-month returns following the equity market troughs



Source: Bloomberg, Standard Chartered.

* Recession allocation is constructed based on the strategic asset allocation of the balanced risk profile by tilting toward asset classes that have performed well relatively during the past recessions while respecting various investment bandwidths/constraints for the risk profile

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