



**Philip Petursson**  
Chief Investment Strategist,  
Manulife Investment Management

# Commentary

## Investment note

various indices/asset classes performed. Specifically, we looked at the performance of U.S. stocks (S&P 500 Index), U.S. government bonds, U.S. investment grade corporate bonds, U.S. high yield bonds, gold, oil and the Canadian dollar through the 12 and 24 months prior to the recession (viewed as late cycle), during the recession, from the equity market peak to trough, 1 year following the trough and finally 12 and 24 months after the recession (viewed as early expansion).

What perhaps may be surprising to many is that there was not a clear and consistent relationship of performance with respect to commodities and currencies in each of the previous six recessions. For example, the year prior to the recessions of 1974, 1980 and 2008, gold was a great investment with an average return of 67%. But gold was a terrible investment during the recessions of 1981-82, 1990, and 2001 with an average loss of -16%. A similar inconsistent relationship occurred for oil and the CADUSD (Source: Bloomberg 2019).

However, as the table below illustrates, there are some ‘big picture’ themes that emerge and none of them should be a surprise

All	S&P 500	US gov't	US credit	US high yield bonds	CAD USD
<b>R - 24 months**</b>	8.3%	6.1%	3.2%	4.6%	0.8%
<b>R - 12 months</b>	5.5%	6.3%	2.6%	1.7%	1.2%
<b>Recession period</b>	-7.7%	12.5%	11.0%	0.6%	-3.1%
<b>Equity peak to trough</b>	-36.4%	13.3%	6.9%	-16.7%	-6.4%
<b>Trough +1 yr</b>	44.1%	9.1%	17.1%	45.8%	7.6%
<b>R + 12 months</b>	8.8%	6.9%	9.0%	17.3%	0.5%
<b>R + 24 months**</b>	6.2%	8.5%	10.8%	17.9%	1.0%

\*\* CAGR (Compound Annual Growth Rate)  
U.S. Government & U.S. Credit data as of 1980. U.S. High Yield data as of 1990  
Source: Manulife Investments, Bloomberg. As of March 31, 2019

The first theme that we would highlight is that a shift from equities into fixed income as early as two years prior to a recession has not historically sacrificed significant equity upside.

It should come as no surprise that the S&P 500 Index typically outperforms U.S. government bonds over the two-years leading into a recession. During the previous five recessions, the average annualized

### Milestones

As of this past July the current US economic expansion is now the longest since World War II. And while there is little evidence to suggest it is over, we do need to consider that it is closer to its end. Let's be clear, recessions are difficult to predict. But then again, in the context of asset allocation it isn't as black or white as whether we are in a recession or not. There are multiple shades of grey. And we may want to consider how to position during the transition from one to the other.

In this context, investors need to consider the potential of an upcoming recession. While we fail to see many typical economic signs of a recession, we are comfortable to suggest we are clearly in the later stages of this economic cycle. Although the play is not over, we are clearly in the third act.

Knowing that we are closer to the end than the middle stage of the economic cycle, how should we consider an asset allocation strategy to weather the next recession? To answer this question, we looked at the previous six recessions in the U.S. (1974, 1980, 1981-1982, 1990, and 2008) and how

returns of the S&P 500 and U.S. government bond indices have been 8.3% and 6.1% respectively (it should be noted fixed income data was not available for the 24-month period ahead of the 1974 recession).

In the twelve months prior to a recession the decision between equities and bonds isn't quite as clear cut. Equities outperformed government bonds in three of the six recessions by an average of 9.5%. However, the benefits of holding bonds during a recession becomes abundantly clear with the S&P 500 Index and U.S. government bond index returning on average -7.7% and 12.5% respectively during the past six recessions.

We continue to hear (and in fact have preached it ourselves) that equities historically continue to rally following an inverted yield curve and ahead of a recession. While this is true, what we would highlight from our work is that if investors are concerned with regards to the risk of a recession within the next 24 months, then it is not too early to start shifting an asset allocation more defensively. Or in other words, don't pick up nickels in front of a steam roller. This metaphor was created to illustrate the willingness of investors to pick up historically small relative gains from equities while ignoring the massive destruction that slowly bears down on them (pun intended). Keeping this in mind and given where we are in cycle, taking advantage of rallies to reduce equities and allocating the proceeds into fixed income may be worth considering. This strategy may result in underperformance over the short-term, but performance would be validated should the recession (and bear market) strike.

The second theme we would highlight would be that history has shown investors have been well served to move up credit quality in advance of a recession.

Apart from the 1990 recession, investors were rewarded by improving the quality of their bonds twelve months leading into a recession. On average, U.S. government bonds have outperformed U.S. credit by approximately 4.0% twelve months leading into a recession. The exception of 1990 saw U.S. credit outperform U.S. government bonds by less than 1.0% so investors were not necessarily penalized materially by increasing the quality of their fixed

income. U.S. high yield data does not exist prior to the 1990 recession but since that period U.S. government bonds, U.S. credit and U.S. high yield have returned on average 9.5%, 8.1% and 1.7% respectively, fitting nicely with the narrative of the importance of improving the credit quality of the fixed income in a balanced portfolio prior to a recession.

The third theme we noticed would be to shift back into equity, and/or down the credit spectrum coming out of a recession.

Nothing groundbreaking here but the speed in which a portfolio is transitioned back into equities will likely be more important coming out of the next recession with respect to capturing the upside of a recovery. Generally, investors have not given up material returns by holding either U.S. credit or U.S. high yield over equities coming out of a recession. Over the past four recessions (three for high yield), the S&P 500 Index, U.S. credit and U.S. high yield averaged approximately 44%, 17% and 46%.

We believe in the next recession, the shift back into equities will become more important with respect to upside potential over bonds since fixed income yields today are materially lower than in the past. For example, by the end of the recessions in 1990, 2001 and 2008 the yield on a 10-year U.S. government bond was 8.1%, 4.8% and 3.5%. Since the financial crisis of 2008, the low of the U.S. 10-year government bond yield was 1.36% (July 8th, 2016) and may likely be much lower by the end of the next recession (Source: Bloomberg 2019). Due to the prevailing low interest rate environment, we expect it will be more important to allocate back into equities faster with respect to maximizing portfolio returns.

We believe where we are in the economic and market cycle, and where we may be heading in the next 24 months, that starting to shift from equities into bonds can help reduce the potential downside risk without materially giving up much upside. The average peak to trough sell-off in equities over the past six recessions has been approximately -36%, and with many Canadians' investment horizons becoming shorter over the past decade (i.e. older median population age and therefore closer to retirement), investors may not have the luxury of time nor the appetite to wait and recoup the losses experienced in an equity bear market. We are not suggesting a recession or bear market are imminent, however we do need to be respectful of the duration of the current economic cycle and where we are within it. And therefore, we believe that a balanced asset allocation with an eye to shifting more defensively over the coming year may serve investors well.

Best regards,



Philip Petursson