Why I've Become More Cautious

Evidence for a near-term recession is slowly building.

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Ken Orchard
Portfolio Manager,
Diversified Income Bond Strategy

I've become more concerned about the possibility of a recession. The picture is far from conclusive, and it's still possible that markets will stabilize and the economic cycle will be extended further, but I've seen enough to convince me to become defensive in my portfolios. It's always better to act quickly rather than wait until asset prices have already begun moving.

One reason for my caution is that I believe that all of the potential positive news out there has already been priced in. We know that the U.S. Federal Reserve and other central banks will cut rates; there are renewed hopes for a US-China trade deal; and China has already taken steps to stimulate its economy to offset the threat of sanctions. Realistically, what other positive surprises can we hope for?

At the same time, I'm seeing warning signs in U.S. data. Manufacturing survey data, such as the PMI and regional federal reserve reports, show a marked slowdown this year, and the June data have been especially weak. Monthly payroll reports have softened, averaging 151,000 versus 223,000 in 2018. Metals and oil prices peaking in early April complete the picture of a weak economy. Rising initial unemployment claims—a classic "tell" of an oncoming recession—haven't occurred yet, but claims have not provided much advance warning in the past, so it's probably best not to rely too heavily on these (though we will be watching them closely).

More concerning is the fact that U.S. Treasuries have been rallying and the yield curve remains inverted. Federal funds and eurodollar futures are now pricing in an average path of 100bps of rate cuts over the next 12 months. The Fed will only cut by 100bps if there is a recession, so we can say that the interest rate markets are pricing a high probability of recession. Given where the stock market is today, it's worthwhile asking yourself: Whose side are you on—Treasuries or equities? I'm with Treasuries. They're usually right late cycle.

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I don't see the point in waiting around and risking getting whacked by a rapid price adjustment, so I've already become more defensive in my portfolios. In practice, this has meant becoming longer duration via Treasuries and other high-quality sovereigns. It has also meant adopting an underweight credit stance and pairing our credit exposure with some very high-conviction positions. We have not taken our high yield exposure down to zero, but we have taken it to a level that we're comfortable will not cause us much trouble if things turn bad.

Many are hoping that central bank rate cuts and ECB QE will support the market and the economy. That, too, is typical ahead of recessions: In the autumn of 2007, high yield spreads rallied 65bps in the four weeks following the first Fed cut, then widened 200bps in the following five weeks. That's not the kind of reversal you want to get caught out by.

There are a number of things to watch out for over the next few weeks. The weekly initial unemployment claims will give us real-time evidence about the strength of the economy, as will June/July survey data from the Purchasing Managers' Index, Institute for Supply Management and regional federal reserves. Will the stock market hold firm and hit new highs, and will Treasuries continue to price in 100bps of rate cuts? If all of these things point to a stabilizing or improving economy, then I will be wrong: we may be starting a new leg of the current economic cycle.

Otherwise, strap in.

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