THE AUSTRALIAN

Recession the US needs to have ... and how to make the most of it

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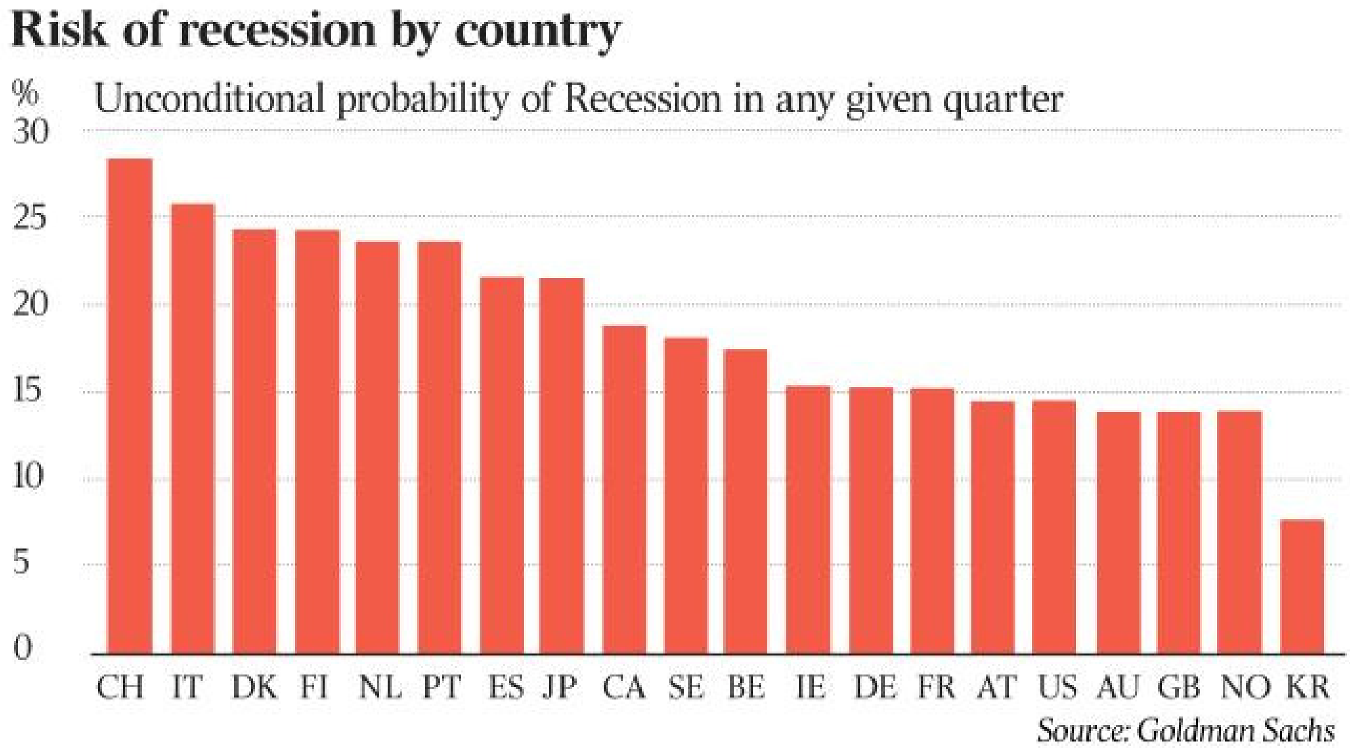

We've all heard the expression. Be careful what you wish for.

And when it comes to market commentaries in mid-2016 most wishful thinking still argues the case for why avoiding a recession in the US benefits investors.

There exists an even stronger case for why a US recession — which is inevitable — benefits Americans, Australians and the global economy at large. And good cause to suggest that a recession would be welcome this year.

Analyst consensus suggests the US has a 15 per cent probability of recession this year, but it must be remembered that these consensus contributors have a woeful track record when it comes to accuracy.

Australian ultra high net worth investors have time and patience for this particular conversation, if for no other reasons than that many amassed their respective wealth during periods of economic flux and respect that, as important it is to grow their net position, "capital preservation" becomes front-of-mind when economic cycles turn, as they are about to.

Even more poignantly, recessions, albeit painful, are healthy and unavoidable.

Unless, of course, you happen to be "Australia", which has magically avoided a technical recession since September 1991 — but more on that later.

Behind investment markets sit real economies, and more than two centuries of aggregated economic knowledge has taught us that these economies, through one process or another, predictably roll through "business cycles".

These cycles represent the journey that any economy takes through times of expansion and then contraction, known as "recession".

During expansions, economies grow in real terms — meaning they develop organically and not through artificial means such as asset or price inflation, such as the recent quantitative-easing programs — as evidenced by increases in indicators such as employment, industrial production, sales and wages.

During recessions, economies contract, and these contractions are particularly healthy because they correct over-allocations of investment, spending and inefficient uses of employment, but they also help bring real prices back into line.

In other words, recessions are the only natural way for runaway prices or gross inefficiencies in real economies to be corrected — there exists no other way of achieving these disciplines. None.

Those across investment communities who argue that the era of recessions can be avoided or indefinitely postponed, need only look to Australia as the world's best example of a real economy that may, indeed, need a recession it has to have:

● Real inflation metrics in Australia have never successfully gauged the creep of prices across both the real economy and asset markets, particularly Australia's residential housing market.

● The immediate consequence of perennially avoiding nationwide recessions in Australia is that real economic costs balloon, as evidenced by this week's graph.

● Australia remains "expensive" across numerous measures and this ultimately benefits nobody. Except, of course, our nation's competitors.

However, as a global investor, the advent of a US recession could be beneficial for a number of key reasons.

First, no matter what style of investing to which one subscribes — technical, event-driven, value or fundamental — over time investment markets always remain correlated to their respective underlying real economies.

For the global investor wishing to continue participating in the world's most robust, developed and deep markets, found in the US, identifying where in the business cycle the US economy is currently at allows for proactive tactical positioning today. In other words, if we accept that the US real economy is about to turn towards recession, and we know from experience that recessions take about 12 quarters (or three years) to unfold, then it becomes crystal clear where we should tactically allocate today to remain safe during these contraction phases, and then actively position our portfolios for the foreseeable recovery at or nearer to 2019.

Traditionally, during bouts of recession "defensive" stocks — those that deliver constant dividends and stable earnings regardless of economic conditions, such as utilities — perform well and, then, when economies begin to recover, cyclical sectors, such as consumer discretionaries, most often prosper better than most.

Given that most US financial variables are now at levels usually associated with recessionary or near-recessionary conditions — S&P 500 prices slumping and benchmark fixed-income yield curves remaining stubbornly flat — we know that:

● During 13 US recessions since 1937, the median S&P 500 earnings per share declined an average of 12 per cent.

● Also, remembering that the median peak-to-trough fall of the S&P 500 during these prior business cycles averaged 21 per cent, if we accept that the US is turning into recession then we can statistically predict the S&P 500 will fall to a level nearer 1700 or 12 per cent below today.

● Of course, relying on "medians" can be deceptive, as the minimum US EPS drop was 4 per cent during the 1945 downturn while the maximum occurred during the Great Recession, when EPS plunged 57 per cent.

But, for all those investors crying that markets remain distorted — due to unconventional stimulus programs — overvalued and misrepresentative of their true underlying real economies, a recession in the world's flagship economy should be welcomed.

And, for Australian investors who cannot discernibly match real local economic conditions to domestic investment markets, such as the ASX200 or local real estate markets, seeing that global markets such as the US do ultimately match brings some reassurance long-term, fundamentally-driven investing still does reward the diligent and patient global investor.

No one enjoys recessions, but denying the inevitable makes for a horrible investment plan, whomever you are.

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