MarketWatch

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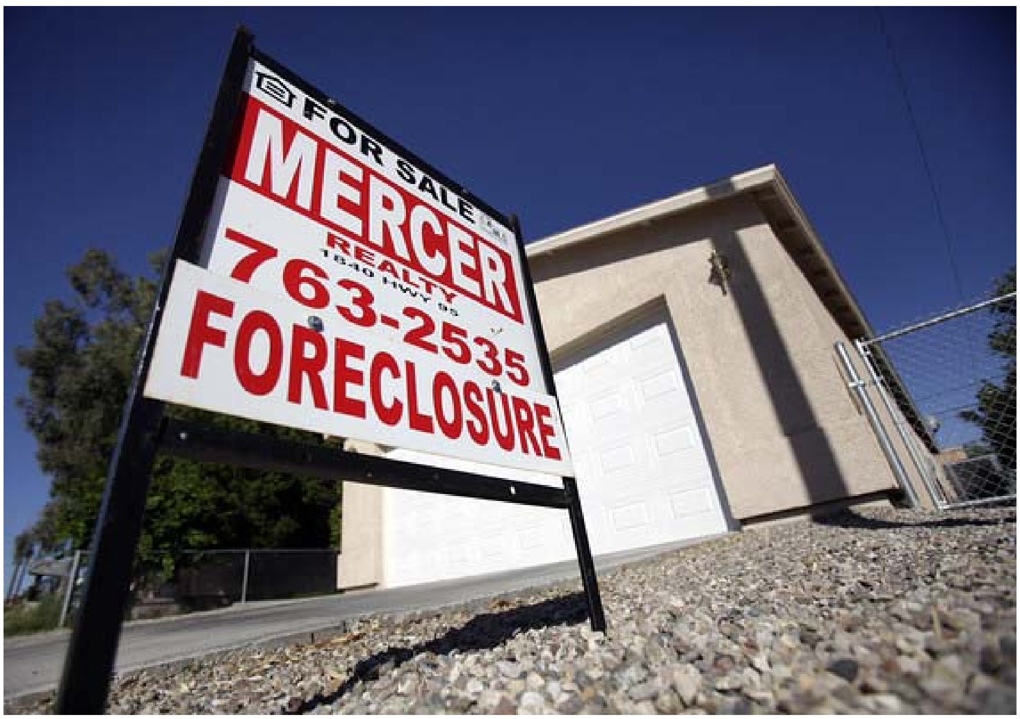
How to brace your portfolio for another recession

U.S. stocks, emerging markets, bonds, gold all need attitude adjustment

By Jonathan Burton, MarketWatch



Reuters

SAN FRANCISCO (MarketWatch) — The risk of another recession in the U.S. is growing and investors need to adjust their portfolio holdings accordingly.

The downgrade of U.S. Treasury debt late Friday only underscores the need to examine the investments you own, why you own them, and the risk you're taking. The types and amount of domestic and international stocks in your portfolio, and your opinion of emerging markets, cash and U.S. government bonds — even the reason for owning gold — all need to be reassessed in order for your investments to thrive in a challenging, slow- or no-growth environment.

"At this point it's only a question of whether [a recession] has already begun," said David Rosenberg, chief economist and strategist at Toronto-based investment manager Gluskin Sheff.

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Investors clearly believe they already know the answer, given the punishing selloff in stocks worldwide over the past week.

They saw it coming

Few predicted a market crash this summer, but, reports Al Lewis, money managers Michael Gayed and Edward Dempsey sounded an alarm in early June.

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The waterfall-like plunge in equity markets on Thursday, the roller-coaster trading on Friday and the sharp rally in safe-haven Treasurys suggests that investors are locking into a defensive posture they may be reluctant to give up easily.

And now that debt-ratings firm Standard & Poor's has stripped the U.S. of its triple-A rating for the first time, dropping it a notch to AA+ out of concern over the U.S. political process, both stock and bond investors have yet another imperative to consider new ways to take advantage of less-forgiving market conditions. Read more: U.S. debt rating cut by S&P.

"We are not likely done with this correction, as the factors that triggered this selloff have yet to be addressed, let alone successfully resolved," said Sam Stovall, chief investment strategist at Standard & Poor's Equity Research, in a note to clients on Friday.

While another recession within 12 months is more likely — many observers now put the odds at about one-in-three — those who believe the economy will escape this mud-stained "soft patch" without a setback may ultimately be right. Read more: Investors to address debt downgrade, Fed moves.

Regardless, it's clear that the investing playbook is changing. Here's what you need to know to stay ahead in the game:

1. Review U.S. stocks

Stock investors realize the U.S. economy has been on a slow track, but until last month the overriding belief was that domestic growth would improve over time.

So when the Federal Reserve's stimulus package known as QE2 stopped at the end of June, investors also knew the frail patient would still need help getting around. The hope was that a robust corporate sector would provide support with capital spending and job creation.

Then the picture darkened. The confidence-sapping debt-ceiling debate, Washington's newfound austerity and economic data that cast doubt about the efficacy of QE2 has stoked fears that recession, not inflation, is the gravest threat to fragile U.S. and global markets.

"What we had was an artificial recovery propped up by deficit spending and monetary stimulus," said Rob Arnott, founder of Research Affiliates, a Newport Beach, Calif.-based investment management firm.

"If the private sector failed to have its animal spirits invigorated by the fiscal and monetary stimulus, then the stimulus failed," he added. "And that puts us back into a recession that never really ran its course."

Such a backdrop isn't conducive to either corporate or consumer spending. Accordingly, risk-averse investors are now focusing on the return of capital more than return on capital. Stock buyers are embracing traditional "recession-proof," dividend-rich sectors such as utilities, health care and consumer staples. Read more: 5 money moves one recession believer is making now.

Within those sectors, look for companies that sport above-average dividend yields, are flush with cash, and sell goods and services that people need regardless of the economy. In the best cases, solid businesses can take advantage of weaker rivals to gain market share and emerge from a downturn even stronger.

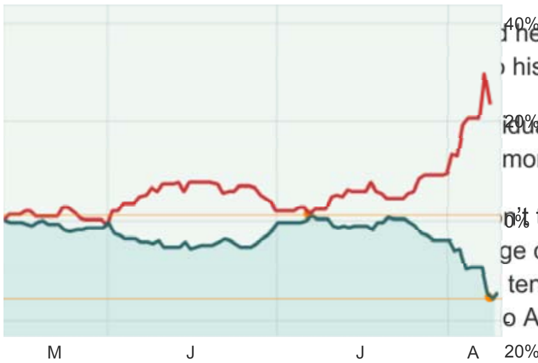
"A focus on hybrids or income-equity portfolios that generate a yield far superior than what you can garner in the Treasury market makes perfect sense," Gluskin-Sheff's Rosenberg said in an email.

More sophisticated investors can maximize their return potential by reducing exposure to riskier assets such as small, aggressive growth stocks and adopting a bigger-is-better approach, Rosenberg added.

"Relative-value strategies that can go short low-quality and high-cyclical equities while going long a basket of high-quality and low-cyclical equities will be a money-maker in this environment," he said.

DJIA **10,792.82**, -446.95, -3.98%

GRZZX **15.59**, -0.78, -4.76%



Mutual funds designed to make money when the market loses are also worth considering as a hedge. Jeffrey Hirsch, editor-in-chief of the Stock Trader's Almanac, favors two so-called bear-market funds, Grizzly Short Fund (MFD:GRZZX) and Federated Prudent Bear Fund (MFD:BEARX) .

he expects further stock declines: "My number is Dow 10,000," he said, his near-term target for the Dow Jones Industrial Average (DJI:DJIA) .

al stocks and the broad market," he added. "You can probably buy months."

't take anything for granted. Investors need to keep an especially close ge quickly. Health care and consumer staples, for example, are two areas tend to lag when the market begins another upward move, said Stuart o Advisors.

2. Be wary of China and emerging markets

Stock investors can expect to see further pullbacks in emerging markets in the event of a U.S. recession.

"The emerging markets are very closely tied to the U.S, which remains the largest market in the world and therefore their largest consumer," said Usha Haley, an expert on emerging markets and chaired professor of international business at Massey University in Auckland, New Zealand.

While developing economies aren't so directly dependent on the U.S. as they used to be, their fortunes increasingly are linked to China — which is.

And if China's growth cools in the wake of U.S. recession so will its huge appetite for commodities. That would hurt Brazil in particular. China has overtaken the U.S. as Brazil's biggest trading partner, evolving into one of the largest purchasers of oil, natural gas, coal and minerals to fuel its expansion, Haley said.

"Markets that are tied to the U.S. as trade partners are the most vulnerable," said Matt Lasov, practice leader of Frontier Strategy Group's Quantitative Analytics.

Still, trade partners such as China and oil-exporting countries have built tremendous reserves that can be used as stimulus, Lasov said.

Trade partners such as Mexico may be at greater risk because of a lack of oil reserves, he said. And, he noted, "markets that rely strongly on domestic consumption for growth, including India, Poland, Turkey and Indonesia would be impacted least" by a U.S. recession.

3. Embrace Treasurys and corporate bonds

Treasurys already have attracted risk-adverse investors and remain the safe haven of choice, while riskier high-yield bonds, or junk bonds, are likely to see a drop in prices as in previous recessions, according to analysts and bond managers.

Meanwhile, investment-grade bonds, issued from companies with stronger underlying fundamentals and high ratings, will follow the trend in Treasurys. But yields won't fall as much, increasing the gap between the two known as the "yield spread."

“Yield spreads will widen if we get into a recession and Treasurys will continue to do well,” said Kathy Jones, fixed-income strategist at Charles Schwab.

Yet don’t ignore the fact that corporate balance sheets are generally in pristine shape, with less debt and positive cash flow.

“If there is anything out there that is remotely close to ‘recession proof‘ it is corporate balance sheets, and so an emphasis on credit is going to be critical,” said Gluskin Sheff’s Rosenberg. He suggests that income-seeking investors hunt for companies with single-A credit quality but sport a triple-B yield, now averaging about 5%.

Even so, many strategists are more bullish on Treasurys in an unforgiving economic climate.

“If your choice is among bonds, you want to buy Treasurys, because they have historically done the best in recessions,” said James Swanson, chief investment strategist at MFS Investment Management.

A bit of cash never hurts either, said investment strategist Barry Ritholtz, chief executive officer of FusionIQ and author of The Big Picture blog.

“When you’re in a secular bear market, which we are in, I think of investors’ jobs as managing risk and preserving capital,” Ritholtz said. With that in mind, about 50% of his recommended portfolio allocation is split evenly between cash and bonds, with the remainder spread across stocks and commodities.

4. Go for the gold

Gold has been a safe haven during at least the two most recent U.S. recessions. Between December 2007 and June 2009, which marked the longest recession since World War II, gold futures gained 18%. In the same period, the Dow Jones Industrial Average lost 37%.

During the recession of 2001, which lasted between March and November of that year, gold gained 3.3% while the Dow lost 5.7%.

“We are close to a ‘double dip’” recession, and gold is still the fear trade, said James Cordier, a portfolio manager at Optionsellers.com in Florida.

A recession would keep near-zero interest rates for longer in Europe and in the U.S. and bring currency devaluation, both key pillars of support for gold. The metal, seen as the ultimate store of value, would do well in a recessionary environment even as its price marches higher, Cordier said.

“A double-dip recession is more reason yet to buy gold,” he added. “Gold as a currency will become more and more popular.”

“Gold is in the process of getting re-established as a reserve asset for most central banks because it’s a natural hedge to their other reserve assets, mostly government bonds,” said Dan Amoss, editor of the Strategic Short Report, a newsletter dedicated to uncovering irregularities in financial reports. Read more: Central banks step up gold purchases.

“All central banks will be looking to increase their physical gold reserves in lockstep with the increasing sizes of their balance sheets,” Amoss added. “So should wealthy individuals. And institutional investors, as usual, will probably be last to buy gold at much higher levels.”

MarketWatch reporters Claudia Assis, Myra Picache, Sara Sjolin and Kate Gibson contributed to this report.