Slowing Growth Demands the Right Style

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Recent data show a slowing economy, but no recession. Russ discusses how to position a portfolio in this environment.

Despite the recent weakening in U.S. survey data, a recession is not imminent; a slowdown is. The September ISM surveys, both manufacturing and non-manufacturing, sent a clear signal: The economy continues to decelerate.

The question for investors now is how to best protect their portfolios?

The slowdown is not just evident in the economic data, but also in expectations, both explicit and implicit. Since the peak last November, economist expectations for 2020 GDP have fallen by roughly 0.30%. Beyond economist forecasts, investors can simply look at what the bond market is saying. Since mid-July, U.S. long-term interest rates have fallen by over 50 basis points (bps, or 0.50% points).

Growth down, volatility up

As growth expectations have slowed, volatility has risen. Volatility, as measured by the VIX Index, averaged 13 in July but rose to 17.5 during the past two months.

As I’ve discussed in previous blogs, a modest rise in volatility is what you should expect when growth slows. Easier financial conditions have kept a lid on volatility rising much above 20, but slowing growth will generally result in some modest increase in volatility.

If slow growth and recession fears are driving investor angst, the multi-asset playbook is fairly straightforward: Emphasize U.S. Treasuries and, to the extent real or inflation-adjusted rates stay low, some gold.

What about equities?

While the knee-jerk reaction may be to simply abandon stocks, equities can still produce decent returns in a non-recessionary slowdown. The challenge is to pick the right type.
Looking at the last 12 months, a period characterized by falling growth expectations, the best performing equity styles in the United States have been low volatility, with quality a distant second. What about value? It is down about 8%, well below the other style factors.

This pattern is consistent with the post-crisis norm. Since 2010, U.S. value has generally underperformed the broader market when the ISM Survey was below 50 and falling (see Chart 1). During these periods low volatility stocks have generally outperformed the market, by an average of nearly 2% a month.

**ISM manufacturing overview**

In one sense this seems counter-intuitive. Shouldn’t cheap valuations protect you in a downturn? The problem with this line of reasoning: Value is harder to assess when growth slows. In this scenario, earnings—the “E”, in the P/E—become uncertain, particularly for more cyclical companies. Instead, investors prefer the safety of less volatile and higher quality companies.
To be clear, a weak and falling ISM need not lead to a recession. In fact, since the start of the recovery the ISM has dropped below 50 on 12 occasions, none of which culminated in a recession. That said, even in the absence of a formal recession slowing growth suggests over-weighting less volatile and higher quality companies. As for value? The best time to own value the style is at the bottom. Unfortunately, it is not clear we're there yet.

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