Managing Your Investment Portfolio Through a Recession

Announcer: Welcome to the Empowered Investor Podcast. Have you ever felt overwhelmed by the sheer volume of choices and voices telling you how to plan or invest for your future? With a straightforward approach, host Keith Matthews of Tulett, Matthews & Associates cuts through the noise to help you create a winning action plan for you and your family. The decision-making framework discussed in this show could transform you and your investment experiences and will increase your odds of becoming financially secure. Learn more and subscribe today at TMA-invest.com.

Keith: Welcome to the Empowered Investor. My name is Keith Matthews, and I'm joined by my co-host Marcelo Taboada. Marcelo, how are you today?

Marcelo: Keith, I'm doing great. We're actually two weeks away from the World Cup, so I'm extremely happy about that.

Keith: Which team, which country do you think is going to take the entire tournament?

Marcelo: Oh, that's a big question. Obviously, I want Canada to do really well. I think everybody in this country wants that. It's the first time we qualify since '86, I think. It's big for the country, right? When you think about how far Canada has come and how low they were in the last qualifying for the World Cup. But I think the top candidates are, if you ask me, gun to the head, I would say Argentina, Germany, Brazil. Those are the three. And France, obviously. How can I forget France? They're the current champions, right?

Keith: I know the world will be watching soccer intensely. I look forward to seeing your reactions as we go through the fall.

Marcelo: I'm sure you'll enjoy it as a rugby fan.

Keith: Yeah. So let's jump into today's show. It's really about recessions and managing money through recession. Key topics that we'll be discussing will be simple things like whether or not we're actually in a recession or whether people feel we're going into one. So we'll review some of that. We'll discuss how recessions are defined and who actually officiates and makes those calls, and how it works. And more importantly, we're going to spend the majority of today's episode on what we've learned from past recessions with regards to managing money and what we recommend investors should do and how they should behave. And then finally, we're going to outline what we think are winning investment strategies through recessions.

Marcelo: Perfect. Sounds like a great episode.

Keith: Yeah. Let's jump in right away with are we in a recession? And let's talk about some of the qualifiers for that.

Marcelo: So contrary to a lot of buzz in the media and popular opinion right now, we are not officially in a recession. So there is a lot of talk. You hear about it everywhere. You hear about it on the radio, in the news, the newspaper, talking to your friends, going to cocktail parties. It's everywhere, but officially, no, we're not in a recession.

Keith: So what are the official guidelines to define a recession?

Marcelo: The official definition is two consecutive quarters of negative GDP growth. That's it. That's the official definition. So, you'll have two consecutive quarters of negative growth. So, if you're coming from, let's say, your mid-year or first quarter GDP number was 2% and then the next reading you get is -2% and then -3%, that's officially a recession. But it has to be declared, right?

Keith: It's got to be declared. And then at the same time, there's a few other things that are used to declare that recession. So first of all, who typically declares whether or not we are in a recession?

Marcelo: In the U.S., it's the National Bureau of Economic Research, or NBER. In Canada, it's the C.D. Howe Institute. So those are the two officials that will come out and say we are officially in a recession. Like you said, it's not only the negative consecutive GDP growth in two quarters, but they look at other things like personal income, unemployment, and a range of other factors before officially coming out and declaring a recession.

Keith: Okay. Because in the United States this year, we've already gone through a period of two negative quarters. They were two slightly negative quarters, but what occurred, of course, was that unemployment was still fairly strong and there weren't enough of these other qualifiers that allowed NBER to state we're in a recession.

Marcelo: Yeah. So if we look at what they define as the other factors, they would be non-farm payrolls, industrial production, retail sales, and unemployment. So it's not necessarily just because you go through two negative consecutive quarters that we're going to have a recession. Like you said, in the U.S., we did get two readings of negative GDP numbers in two quarters, but it wasn't declared a recession because we're still seeing a lot of economic activity that doesn't point out that we're in a recession.

Keith: Yeah, absolutely correct. So if you look across all the general economies that we would follow—Canada, the United States, Euro, China—you've got these sort of wishy-washy numbers where it doesn't feel like it's strong growth and clearly there's issues popping up, inflation and worry, and rising interest rates. So there's a lot of discussion that even though we may not be in a recession, perhaps we're going to go into one.

Marcelo: It's very confusing. The U.S. had two negative consecutive quarters, and the latest reading for Q3 was a positive growth of 2.6%.

Keith: Yeah, absolutely. And then again, back to this interest rate concept, I think with interest rates rising, the concern or worry is that there will be a recession sometime possibly in the next few quarters or early parts of 2023. But that's essentially what the stock market is saying.

Marcelo: Yeah, exactly.

Keith: Let's gravitate a little bit about the market being a leading indicator and what it's telling us right now. So, if we go into Q3 of this year, September 30th, and we look back in time and we say how have the stock markets and bond markets reacted? What would you want to share with the listeners on that?

Marcelo: Yeah. So when you look across the board, we see a lot of red. So anywhere from bonds, you look at the Canadian bond universe, it's down 9.8% for the year to date. So that's as of September 30th. You look at Canadian stocks, down 11%. U.S. stocks, 16%. International stocks, -20%. So we've alluded to this concept before in many episodes, right? I always like to call the stock market a meat grinder of opinions. So the stock market processes information every single day and it's projecting that information into the future. So everything we know today is already projected into the future. So when there are surprises in the numbers, I think a good example was just this week. So we're the week of October 28th. The central bank announced another hike of interest rates and the expected number was 0.75%. People say it's already baked into the equation. So the stock markets were already pricing in a 0.75% increase. The reading came at 0.5% and the stock market reacted positively because it wasn't taking into account that it was going to be actually lower than 0.75%. So imagine this over millions and millions of traders in the market and then a lot of data points that come in every day. So it's constantly processing information, digesting it, and projecting it into the future.

Keith: And if we think that the stock market is a leading indicator or leads the economy, when stock prices go down, it's already pricing in a potential slowdown. It's already pricing in this idea that interest rates are going up and we may find ourselves in either mild recessions or moderate recessions or even a difficult recession. And we don't know exactly what that might look like. We might not even have one technically on paper. And we'll speak about the complexities of trying to manage money through periods where you're trying to identify are we in something or not. Cause it's virtually impossible to do.

Marcelo: Yeah. And all this economic data, GDP numbers, unemployment, it's always backward looking. They're lagging indicators because you get to know them when it's already happened in the past. So it's really hard to mix the two together.

Keith: You're absolutely right, Marcelo, because recessions are announced based on looking at backward information and the stock market is a forward-thinking machine. So the two don't connect very well and they're misaligned. And this is what individuals have a tendency of not recognizing or not seeing, and it's critical to understand this concept because it does help manage money through these periods. We'll speak about that a little bit later, but what are some of the major themes that we're seeing so far this year in 2022? And then let's talk about what's going on in the three major economic powerhouses.

Marcelo: So one of the biggest themes this year is the world reopening. A lot of sectors that were really hit hard by COVID, like hospitality, are getting positive news and doing better. And some of the things that did really well during COVID, so all the tech darlings that we talked about in previous episodes, they're struggling right now. The tech industry is struggling. You look at Shopify in Canada. You look at Amazon, Google, Facebook in the U.S., DocuSign, Zoom, those things are struggling. So those are the two themes that we're seeing now. And then on the more macroeconomic side, like you said before, interest rates, this discussion about recessions, inflation, we're dealing with high inflation for the first time in a long time. So that's the biggest theme when it comes to the economy.

Keith: And there's the three powerhouses: the U.S., Euro, and China, and each one is struggling with a slightly different backdrop. Let's speak about that briefly because it does fit into the overall narrative of today's episode.

Marcelo: I think that's creating a lot of uncertainty across the board, right? You have a situation in North America where if we have a recession, it's going to be a consumer-driven recession based on higher interest rates. We've alluded to this term before of the central banks in North America being hawkish right now where they're trying to raise interest rates to bring down the inflation. We know the BOC has a—the Bank of Canada has an inflation mandate. The Federal Reserve also has an inflation mandate with taking a look at—they need to curb inflation to the target rate of 2% while also maintaining the stability of the financial markets and the employment market. Then you have Europe, which is dealing with the war and an energy crisis. That's definitely going to affect a lot of people. I think it's 40 to 50% of energy that Europe consumes comes from the Nord Stream 2 pipeline that comes from Russia and that's been completely shut down. So you're in a situation where a lot of people in Europe will have to spend a significant amount of money that they were spending elsewhere. It's going to be going to energy now. It's creating a lot of risks. And then you have the situation in China with zero COVID policies. You're dealing with an authoritarian government that just arbitrarily makes decisions. And that's the three big risks that we're facing.

Keith: Absolutely. And it all points to, as we opened the show, this constant chatter in the media or wherever you turn about the word recession. So this is what we're trying to figure out here is managing money through recessions. And let's switch to history. Let's go over—we've got some really nice charts provided by Vanguard on stock market returns since 1970, and clearly they highlight the recessions of '73, '81, '91, 2008. And so it's pretty clear how markets react vis-a-vis periods of recession. So let's spend some time on that right now, Marcelo. We've got 50 years of evidence.

Marcelo: Yeah, and the crazy thing about this chart is what's interesting. Whatever you want to call it is that it is exactly what we were saying before. This reflects this idea that when we're at the bottom of the recession or in the middle of the recession, the stock market tends to shoot off and peak or recover from the drop. And it alludes to this idea of markets being forward-looking. So at the point where you're in the middle of the recession, you see the market taking off and recovering. That's what I take from this chart. Unless you have a different interpretation.

Keith: You've got part two absolutely bang on. I'm going to add part one. In every single one of these recessions, stocks come down before the recession. Of course. So stocks lead going down before the recession. So we're looking across the chart here, and there'd be recessions that last anywhere from six months to nine months, and they're bolded out in gray. The stock market goes down before any one of these gray lines and these gray zones appear. So it's anticipating. And Marcelo, your point is bang on, which is the stock market shoots up halfway through these gray periods. So they don't even wait till the end of the recession. And usually, when any of these statistic bureaus come and say the recession's over, guess what? It's too late. Stocks are up already. And so if you're the type of person that says I'm going to wait until I see something positive and I read something positive in the news before I either add more money to my portfolio or buy stocks, you will have missed the boat completely. In these charts, it's dramatic. The upswing in the stock market, it's almost like within three to six months, things improved dramatically during those periods.

Marcelo: I think that's the one thing that I would say people struggle the most with: how do you deal with this idea of the stock market being a leading indicator and recessions being a lagging indicator, right? You don't know when you're in a recession until it's already passed, and it is a tough thing to bring together. But I think once you understand the concepts and you really understand why it works like that and that stock markets are forward-looking, projecting machines, if you have a well-diversified plan and you understand that if you have any extra money, that's the time to put in money. Because once you're out of the recession, it's already too late.

Keith: Yeah, 100%. I don't think I've seen or actually history has shown that anytime you have purchased diversified stocks or stock baskets or stocks during recessions and you look out four or five years after, investors are always happy. The returns are always positive. The other thing that I think is important about recessions—again, we're not suggesting, we're not predicting, we're not trying to make any call in any of these comments—but if there was to be one, they're typically short-lived relative to an investor's time horizon.

Marcelo: Of course.

Keith: So recessions tend to last technically on paper a few months to sometimes a year, but relative to an investor's time horizon, that's a fairly short period.

Marcelo: What's interesting is that behaviorally, it's proven that there's a lot of research on this that losses in the stock market hurt more than people enjoy winning in the stock market. And I think that translates into this idea that when we're going through a bad period, people tend to feel like, "Oh my God, this is lasting forever. It's so painful right now." But when things are going well, we tend to think, "Oh, you know what? It's okay. Things are going to last forever." You don't have that sense of urgency in the same way that you feel when things are going down. So I think this affects people's perception of time and their time horizon, and psychologically, it's like their time horizon seems to shrink. Whereas you sit down and you're doing this asset allocation for the next 30 to 35 years in the end, and really the horizon or the time horizon for an investor is usually long-term if you have done things properly, right?

Keith: Yeah, but even you mentioned 30, 35 years. We have lots of clients or lots of investors, lots of friends who would say I have a time horizon of 15 years. That's still long-term.

Marcelo: It's still long, yeah.

Keith: So what are the three things that we suggest people keep in mind when they think about a recession? If they say, how do I come to terms with we might be in a recession? What are the three things we're recommending?

Marcelo: One, we can't avoid them. It's part of the business cycle; it's just how things work. Then the second one is we can't avoid bear markets either, right? So they don't usually go hand in hand. Sometimes you can have a bear market without a recession. History has proven that, but you can't avoid them. And then inflation, same thing—you can't avoid it. So these are just part of the business cycle. They're part of the economy, and we just have to live with them. And it's also the reason we get paid in the stock market because if there wasn't this risk of the business cycle or us going through a bear market, we wouldn't get paid. Because if there was no risk, you don't get the reward.

Keith: Yeah, when you say you wouldn't get paid, meaning you wouldn't get the extra return over a non-risky asset.

Marcelo: Of course, yeah.

Keith: Okay. And I guess the last one is, I know that inflation is a difficult topic now, but unfortunately, individuals can't avoid it. It's not something that you can manage out of your life. It's here. You have to think about your budgets. You have to think about financial plans. You have to maybe adjust your spending and your saving. Clearly, it brings hardship for many Canadian families. And the idea of a recession is one that's a bit counterintuitive because you might need rising interest rates to quash or squash or eliminate inflation, but that might come with its other unintended consequences.

Marcelo: That's been the tune of Tiff Macklem, the person heading the Bank of Canada, right? He said publicly that the pain of longer inflation, so long-term inflation, is higher than the pain of going through a recession. And that's why the Bank of Canada pretty much said they won't stop at nothing when curbing inflation. And I think people have to understand that because if inflation becomes sticky, for lack of a better term, it could be very damaging for a lot of people.

Keith: Correct. Much more damaging than perhaps the consequence of hopefully what might be a short-lived recession. Let's talk about, can we trade through this? Can professional managers trade through recessions? In other words, can they make bold moves and try to get out of the stock market and then get back in at the right time? What does the research, what does our evidence show on that, Marcelo?

Marcelo: So the evidence shows that it doesn't work, in plain terms. We've looked at that Morningstar report that did a pretty thorough analysis of the tactical model. So the tactical models are the ones where the portfolio manager has the leeway of doing changes as the economy is shifting. So you could move in and out of markets; you can overweight different sectors, overweight different economies to avoid all these downturns, right? So they looked at this and then they plotted against a very plain vanilla 60/40 portfolio. So plain vanilla 60/40 portfolio is like the most boring portfolio you could get. And by the way, in the investment industry, boring is good, right? So they looked at both. And what we find is that in every single time period—one, five, ten, twenty years—the balanced plain vanilla boring portfolio ends up doing better than the tactical model. So the tactical model, even though you're getting the perception that you're doing something and that you're trying to avoid this like bear markets and recessions and downturns in the market, it just doesn't work. The evidence is not there. When it says it doesn't work, the returns are less; they're worse.

Keith: Correct. So you're paying for something you're not getting.

Marcelo: Correct.

Keith: And why would you do that? So if somebody says, give me your money, I'm going to trade through this, you would only do that if their evidence shows that they actually win. And all the evidence over thousands and thousands of professional money managers is that they don't win doing that approach because they can't predict because things are so fast.

Marcelo: And they're counterintuitive. It's so fast, and you're competing against millions and millions of people. If something we've learned is that the markets incorporate all available information and process it instantly, right? Especially now that we have more technology. So it consistently is very hard to do it. I don't think we can deny the fact that some managers may be able to do it short term or maybe a one-off, but consistently over long periods of time, we have the evidence. It doesn't work.

Keith: Yeah, 100% agreed. 100%. So Marcelo, let's talk a little bit about human emotions right now. And this is more around the psychology of how people are feeling and the whole idea of if we are going through more difficult or more challenging financial times—and I'm not just talking about portfolios; I'm talking about portfolios, cost of living, risk levels, debt levels, interest rates. Let's just talk a little bit about how people feel, and then we're going to add a few extra things on that.

Marcelo: Recessions can be tough on people. They can be tough morale-wise. If you have people who are losing their jobs, it's tough on people's self-esteem, people's motivation, how they feel overall as valuable human beings. It can be tough on people who are having trouble affording things, right? So if you're struggling to go to restaurants or buy the things that you want, that may put you down a bit. So I don't think it's easy on the human psychology. It's not only the financial aspect of going through a contraction in the economy and going through a bear market, but it also affects people emotionally. And that's just a reality.

Keith: You're absolutely right. You've got a couple of different groups of individuals that will have different emotions as you go through these challenging times. You just highlighted some of the broad Canadian marketplace. There are those perhaps also that see their net worth shrink—either their home prices, real estate prices, stock values. We would say that. Yes, it's shrinking dramatically, I would say, on the home front, maybe on equities in the last nine months, but it also went up dramatically. So you can't only get the positive side without sort of the readjustment side.

Marcelo: We saw this during the pandemic where they were calling it the wealth effect where people saw their values of their home going significantly higher. So they have this idea of, "Oh, my net worth is so high. I can spend so much on trips, on a new car, on going out, material things, you name it," right? So I think psychologically, just like you said, the same way that it affects you positively, when the opposite is true, you're going to see a negative effect. And people may say, "You know what? My net worth is down. There's a recession. Maybe we won't take that trip. Maybe we won't buy that new car." So it happens the opposite way as well.

Keith: But I will say, I think I've lived through a variety of recessions. The first recession, Marcelo, that I remember is 1981. I was 17 years old, and back then, anybody who would remember the '81 recession, individuals were concerned about things like, can I actually keep my home? That's what families were discussing, and it was an open discussion. Moms and dads would sit at the dinner table and worry about this, and kids would hear it. Or you would have a discussion. I remember my dad in that '81 recession came to us and said, "I don't think we can afford to have a car." My dad was an engineer. And so these were the challenging—and any listeners that lived through those recessions—'81, '91, where unemployment was 10, 11, 12 percent, remembers that they were very difficult, high super, and I don't think we're going to be in that type of a difficult recession. Not even close. What I think is interesting about what's going on now is we're coming off the back of the pandemic. And that pandemic put tremendous strains on our society, on our health system, on people's nerves, on their worry. And I think we're in this zone where hopefully we're in the endemic, which is feeling a lot more positive. We're out, we're socializing, we're doing things, we're meeting family members, we're going to parties, we're going to gatherings. But at the same time, there's more financial worry. So it feels different. And I don't think anybody's suggesting that unemployment is going to shoot anywhere near some of the levels that we saw before. So it's a very different feel right now, even though there is financial worry.

Marcelo: I agree. Do you remember distinctively those recessions changing the way you think about things, how you view money, or words?

Keith: Listen, Marcelo, I joke, but I graduated both the times—I graduated high school in 1981. And so here I am going off to university, and the summer job, it was tough. People didn't spend as much money on discretionary items back then. And then I graduated my MBA in 1991, which was, I think, the last difficult recession that Canadians have lived through. 2008 was a credit crisis and it had its own peculiar look and feel. Unemployment hit sort of nine percent, but it didn't last long. But those recessions, '81 and '91, were very difficult. I don't think Canadians have seen a difficult recession in close to 30 years. And that, unfortunately, does influence the way people behave in their current day-to-day lives.

Marcelo: I totally get that, Keith. And you know what the funny thing about all this and this discussion that we're having is that even if there's a lot of chatter about us having a recession and it being a buzzword, it is still a possibility that we may not get a recession also. So it's impossible to predict in that sense that even though we're getting a lot of the leading indicators saying that we may get a recession, it may not happen still.

Keith: Let's even switch gears on top of that and look at what I think are some of the positive things in financial markets right now. So number one thing right now, if you speak to a lot of investment professionals, they'll say, "Wow, we have higher expected returns." What does that mean? That means the bond market, even though we've produced negative returns in the last nine months, yields, current yields are much higher. So that means anybody investing in bonds today will have a higher expected return.

Marcelo: 100%.

Keith: Stock market expected returns are higher today. What does that mean exactly? That means that valuations, stock prices, because they've come down, they have lower valuations, whether their P/Es, price to book, and usually, usually all the time, lower valuations tend to lead to higher future returns, which is why a lot of investment people say it's actually this readjustment, it's positive right now in the sense that when you invest today going forward, you will have higher returns. So let's, Marcelo, let's wrap up today's episode and discuss our takeaways. Top five things we want either clients or investors at large, individuals, listeners to think about in terms of managing their portfolio.

Marcelo: So the first one is stick with your well-planned portfolio mix. If you have a portfolio, you've worked hard with your advisor in setting up that asset allocation and that portfolio for the long term, there's no reason why you should be changing it now. Rebalance periodically to stay on target. So that's good because you're buying and selling and maintaining the risk level of your portfolio and that should stay constant throughout. Then do tax-loss harvesting in your taxable accounts if appropriate and when you can. Add even more assets if you have. So if you have any extra cash, now is a great time to add it to your portfolio because, again, you're buying a great portfolio at a very reasonable price. And you think about it like as if you're getting a discount. It is actually better, Keith, if you buy right now because the expected return is higher than if you're buying after a year where your portfolio has gone up 10%. So obviously, if you have money lying around, it's a great time to add more money into your portfolio, into your long-term strategy. And number five is more on the personal side. Take a look at your discretionary spending. So that will help, especially when it comes to inflation. I think if people start changing their behavior and say, "You know what? I'm not going to pay those high prices on milk, on Greek yogurt." Like the other day, I saw Greek yogurt in the supermarket at almost $8. And I said to my wife, "It's not that we can't afford it, it's the principle, right? So I better find a substitute or change my habit and buy something else." And if we do that at a large scale, we can curb the inflation problem.

So I think now it's a good time to evaluate our discretionary spending and maybe change it a bit and that'll help the inflation problem.

Keith: Those are five great takeaways. What I would add that really the big one is do not try to time the market. The markets will rally and get better way before any challenging economic times finish. And we will get through this and be patient. So with that, Marcelo, thank you so much for today's episode. It's an important one. There's a lot of chatter about this subject matter, and we wanted to address it. And to our listeners, thank you so much for listening, and we will see you in the next episode.

Announcer: You've been listening to the Empowered Investor Podcast hosted by Keith Matthews. Please visit TMA-invest.com to subscribe to this podcast, learn more about how his firm helps Canadian investors, or to request a complimentary copy of *The Empowered Investor*. Investments and investing strategies should be evaluated based on your own objectives. Listeners of this podcast should use their best judgment and consult a financial expert prior to making any investment decisions based on the information found in this podcast.