MULTI-ASSET

Should Markets Heed Recession Warnings?

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Amid a renewed US-China trade spat and additional tariff tensions between the United States and Mexico, investor concerns about a possible recession have heightened, according to Ed Perks, executive vice president and chief investment officer, Franklin Templeton Multi-Asset Solutions. He discusses how markets are reacting to the possibility of a US recession and explains why he favors a defensive stance during this period.

Across the globe, we've seen markets start to react differently to the likelihood of a US recession, whether they expect it to come later this year or sometime in 2020.

While we don't expect an imminent US recession, we don't think investors should ignore the possibility entirely. However, we tend to look at the broader backdrop and don't think things are as bad as the market's reaction to the latest trade fears might suggest.

In our view, the fundamental backdrop for the US remains pretty strong.

While Federal Reserve (Fed) Chairman Jerome Powell recently said the Fed would "act as appropriate" to sustain the US economic expansion, we don't think a simple slowing of the very strong economic activity seen in the first quarter of this year would be sufficient to spur the US Federal Reserve to cut interest rates. We think it would take a bit more stress in the system for the Fed to loosen monetary policy, such as a significant shift in consumer and business sentiment or weakness in the labor market.

Still, we believe the Fed is at a point that it needs to set out its motivations for the market in the next two to three months, depending on economic data and continuing tensions between the US and Chinese governments.

Taking a Defensive Approach

As multi-asset investors, in light of recent geopolitical uncertainties, we're looking to take a more defensive stance in our portfolios.

It doesn't seem we are alone in our view, as more defensively oriented sectors have outperformed recently, including utilities. Health care is an area we see opportunity due to its recent weak performance as a result of the US political election cycle. We also believe US financials are well-positioned to handle a mild recessionary environment as banks' capital positions generally look positive to us.

In addition, we're exploring opportunities in the US corporate credit space. We've tended to take a more tactical approach and think there may be opportunities for investors willing to be selective around exposures in investment-grade bonds, to benefit from any incremental yield pick-up.

However, we remain more cautious about non-investment grade, lower-credit-quality assets, particularly in a worsening economy.

How Will US Trade Disputes Impact the Inflation Outlook?

The escalating trade dispute between the United States and China, and the US's heightened tensions with Mexico as US President Trump announced new tariffs on Mexican goods, are causing consternation for investors. There's certainly a chance that things could get more difficult more quickly.

As we look for a resolution to the trade disputes, we'll be keeping a close eye on the US inflation outlook over the next three to nine months.

If we start to see the impact of the higher tariffs on Chinese and Mexican goods filter into consumer prices and elevate inflation in the US economy, that could be a game-changer in terms of the economic and interest-rate outlook.

The question is how much of the tariff fallout is passed through to consumers and how much is absorbed by the companies themselves. We have been seeing high profitability in general among US companies, and US corporate fundamentals are very strong.

Productivity is also very high. Margins generally are elevated and have some room to give back.

US and Chinese Leaders Meeting Later This Month

Presidents Donald Trump and Xi Jinping are due to meet at the Osaka G20 summit on June 28-29, so we'd hope to avoid a further escalation between now and then. Meanwhile, Mexico Foreign Minister Marcelo Ebrard recently met with US Vice President Michael Pence to work out a solution to avoid potentially crippling tariffs of up to 25% on Mexican imports.

To the extent that global leaders can resolve some of the situations that are causing these jitters in the market, we believe we could see some of the recessionary fears ebb.

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