Finance

How to Invest and Profit in the Next Recession

A slump is likely in the next year or so. There are ways to prepare for it.

By Barry Ritholtz
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There are more practical solutions. Photographer: Fox Photos/Hulton Archive

Ever since the Great Recession ended in June 2009, investors have been treated to a stream of forecasts warning that another slump is right around the corner. As we have seen, none of these predictions have come to pass. Smart investors paid little heed to predictions that were subjective and of little value.
Enter Campbell R. Harvey. He's a finance professor at Duke University's Fuqua School of Business. He also is a research associate at the National Bureau of Economic Research, which among other things provides the official start and end dates of expansions and contractions. Most important of all, he maintains one of the more rigorous models for analyzing the potential for a future economic contraction.

Harvey is not an alarmist; to the contrary, he is a sober-minded researcher. In a recent YouTube discussion of the warning signs of an impending recession, he cited four signals. One is the CFO Global Business Outlook survey, which this month found that more than two-thirds of corporate chief financial officers expect that a recession will be underway by the end of 2020. His second factor is “the realization of anti-growth protectionism,” aka tariffs and rising trade-war tensions; the third is market volatility, which he notes frequently gives false signals, but has generally been on the rise the past few months.

The last, and most important component, is the yield curve, or the schedule of bond yields based on maturity dates. His focus is on the five-year Treasury bond yield, which now is lower than the yield on three-month Treasury bill. According to Harvey’s research, when this inversion -- short-term rates being higher than long-term rates -- lasts for a full quarter, or 90 days, then a recession will occur in 12 to 18 months.

Inversion occurred on March 7 and earlier this month we crossed the 90-day threshold. Thus, all four of the conditions for a future recession in Harvey’s model now have been met.[](https://www.bloomberg.com/opinion/articles/2019-06-17/how-to-invest-and-profit-in-the-next-recession)  

I am not in the business of predicting recessions. However, since the previous one was a decade ago, I am quite comfortable with the idea we are closer to the next one than we are to the last
Since we can all agree that another recession is inevitable, I am going to go out on a limb and suggest that now is the time to plan for it. Maybe these will help you get through relatively unscathed:

**No. 1. Clean out your portfolio:** We all accumulate holdings for reasons that are too silly to go into and look terrible in hindsight: your brother-in-law’s stock recommendation, the initial public offering that didn’t work out, the hot tip from a broker.

_Sell ‘em all!_ With markets near record highs, this is your best opportunity to minimize your losses, since this might be as good as it gets. Remember, weaker companies will do much worse than average ones in recessions. If you own any junk bonds sell them, too.

**No. 2. Pay down debt:** Today, markets are near all-time highs, unemployment is near 50-year lows and wages are rising. It might not be this easy to lower your outstanding obligations for a while. Give yourself a little maneuvering room and maybe sock away some cash in your emergency fund.

**No. 3. Be ready to buy when stock prices plunge:** Markets typically tank in recessions. Use the cash you raised from selling your garbage holdings and develop a plan of action while you are still calm and objective. Have the confidence to act when the time comes.

It can be simple, too. For example, plan on deploying your cash in tranches: Buy a U.S. index fund when markets are down 20 to 25%; add a developed global index fund when markets fall by 30%. And if we are lucky enough to enjoy a 35 to 40% decline (that's assuming you prepared for this moment), buy emerging-market stocks.

The trick to create this plan NOW, set some alerts and be prepared to put the cash to work when the predetermined levels are hit. You might look (and feel) foolish for a few months, but seem like a genius a few years later.

**No. 4. Check and clean up your credit score:** I found an erroneous blemish on my credit rating some time ago that took two years of arduous work to remove. Improving your credit score allows you to borrow at more advantageous prices. This helps if you want to refinance when mortgage rates drop, which usually happens during recessions, or take advantage of falling prices to buy a home. Improve your credit score when you don’t have to.
I hope I am wrong, and we don’t see a recession for a long time to come, although that seems unlikely. But even if we are fortunate enough to never have another recession, all of the steps described above will serve to help you get your financial house in order and make you a better investor.

1 Harvey says the model has delivered no false signals in the modern era, and a variety of out-of-sample evidence has also validated the model.

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