

[MUSIC PLAYING]

In December, equity investors reacted to rising interest rates and tumultuous trade wars by pricing at a higher likelihood of a near term recession. With US large caps down 9% and small caps down almost 12%, we think this is a knee jerk reaction. Equity investors should stay the course but adopt a more defensive posture with the caveat that there is a right way and a wrong way to get defensive. Let's explore the issue.

We still don't foresee a recession in the next five years, especially with the Federal Reserve sending dovish signals in early January. Even though corporate earnings are expected to decelerate, we feel equity markets were fairly valued going into the fourth quarter. Despite this, equity multiples based on trailing earnings contracted in the fourth quarter by more than 20%, one of the largest declines in market history.

We know that when valuation shocks of this magnitude occur, the recovery has historically taken 12 months or less. Taking yourself out of the game may be a very costly move. Of course, you still want some insulation from all of this volatility. The natural inclination is a rotation into defensive sectors. However, these defensive sectors can be interest rate sensitive and have become quite expensive with defensive sectors currently trading upwards of a 75% premium to cyclicals.

A better defensive posture is to remain sector neutral to your benchmark but tilt your portfolio toward high quality stocks that have strong profitability, good cash flow, and prudent use of capital. These securities had strong excess returns and lower volatility in December but are not overly expensive. So what does this mean for investors? The macroeconomic picture still looks reasonable, and now equity valuations are quite attractive. To avoid locking in losses prematurely, investors should maintain their equity exposure but tilt toward high quality stocks that may provide volatility reduction and downside mitigation.

[MUSIC PLAYING]