

Market Bulletin

20 May 2019

How to hedge against a downturn

This is close to being the longest economic expansion on record. Nobody knows exactly when it will end, so it's worth considering what investments could rise in value when equities and other risk assets fall during the next downturn. By including some hedges, investors can create a more balanced portfolio and help reduce overall portfolio losses when the next economic downturn eventually arrives.

Traditionally, investors turn to government bonds to balance the riskier assets in a portfolio. However, government bond yields in the UK are very low by historical standards. Having barely raised interest rates since the financial crisis, the Bank of England (BoE) has very limited room to cut interest rates.

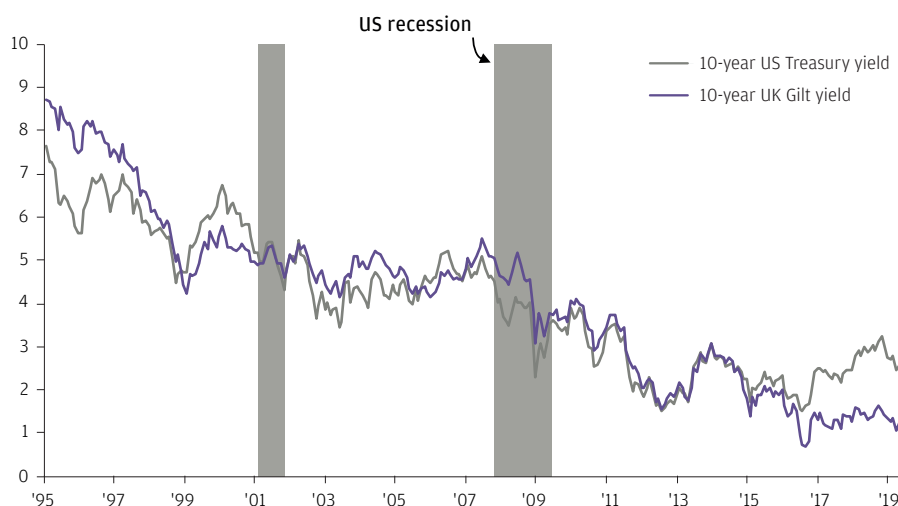
Furthermore, the current political landscape complicates the outlook for UK government bonds (Gilts). In the event of a relatively soft Brexit deal being reached, the BoE would be likely to raise interest rates at a faster pace than is currently priced into Gilts. Failure to agree a deal could potentially require an election to resolve the Brexit impasse. While the outcome of an election would be hard to call, the prospect of a change in government could change the outlook for public spending and in turn put upward pressure on UK borrowing costs.

Investors may therefore want to consider government bonds outside of the UK, particularly in markets where the central bank has more room to cut interest rates during a downturn. Having raised rates by more than the BoE, the US Federal Reserve (Fed) has more room to cut interest rates during the next downturn.

Treasury yields have more room to fall than Gilts

EXHIBIT 1: US AND UK 10-YEAR GOVERNMENT BOND YIELDS

% yield



AUTHOR



Michael Bell
Global Market Strategist

Source: Refinitiv Datastream, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 30 April 2019.

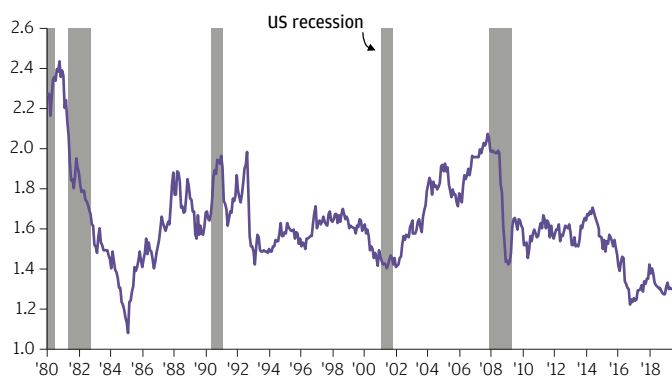
If the Fed cuts interest rates back close to zero and global central banks restart quantitative easing during the next downturn, 10- year Treasury yields could fall back close to the lows they reached in 2012 and 2016. A fall to the post-crisis low of 1.4% over the next year would generate a total return of about 11% - lower than the returns provided by Treasuries in past equity bear markets, when the Fed had the ability to cut rates by more, but still a welcome gain in the context of a recession and the associated downturn in risk assets.

But what about the currency risk? With all the uncertainty around Brexit, the direction of the pound against the dollar is hard to predict. During the last recession, sterling fell against the dollar, but recessions haven't always led to sterling weakness and the pound has already fallen a long way against the dollar.

Sterling doesn't always fall against the dollar during recessions

EXHIBIT 2: GBP TO USD EXCHANGE RATE

US dollars per GBP



Source: Refinitiv Datastream, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 30 April 2019.

Given the uncertainty about the currency outlook, investors looking to buy Treasuries as a hedge for their equity risk may also wish to consider hedging out the currency risk - or at least reducing it to a level that reflects their degree of conviction in the direction of the pound. Currency risk relative to benchmark should also be considered if running a relative portfolio rather than an absolute portfolio.

Hedging the currency risk comes at a cost. Today, that cost would amount to around 1.8% per year, reducing the yield from around 2.4% to 0.6%. However, while hedging the currency reduces the yield on US Treasuries, it doesn't remove the capital gains that investors would benefit from if Treasury yields fell during a recession, as the Fed cut rates. So even though the hedged yield on a US Treasury is low, the potential for capital appreciation during a downturn remains.

In the last few months, a seemingly more dovish Fed also appears to have reduced some of the upside risk to Treasury yields, and hence the downside risk to their price. While Treasury yields could still rise further from here if growth, interest rates or inflation expectations pick up, as a recession hedge, Treasuries hedged into sterling should be pretty reliable.

In addition to Treasuries, strategies such as global macro funds, which can bet that volatility will rise or that equities will fall, also have the potential to make money during a downturn, if the fund manager correctly anticipates the risk. These strategies* are one of the few types of fund that made gains during the last two recessions.

So while the timing of the next downturn remains uncertain, investors might want to consider adding in some portfolio hedges in the form of currency-hedged Treasuries and global macro funds to help balance the riskier assets in their portfolio, as we move later into the economic cycle.

* HFRI Macro index. See "On the Minds of Investors: How should we prepare portfolios for the next downturn?", Michael Bell, J.P. Morgan Asset Management, October 2018.

The Market Insights program provides comprehensive data and commentary on global markets without reference to products. Designed as a tool to help clients understand the markets and support investment decision-making, the program explores the implications of current economic data and changing market conditions. For the purposes of MiFID II, the JPM Market Insights and Portfolio Insights programs are marketing communications and are not in scope for any MiFID II / MiFIR requirements specifically related to investment research. Furthermore, the J.P. Morgan Asset Management Market Insights and Portfolio Insights programs, as non-independent research, have not been prepared in accordance with legal requirements designed to promote the independence of investment research, nor are they subject to any prohibition on dealing ahead of the dissemination of investment research.

This document is a general communication being provided for informational purposes only. It is educational in nature and not designed to be taken as advice or a recommendation for any specific investment product, strategy, plan feature or other purpose in any jurisdiction, nor is it a commitment from J.P. Morgan Asset Management or any of its subsidiaries to participate in any of the transactions mentioned herein. Any examples used are generic, hypothetical and for illustration purposes only. This material does not contain sufficient information to support an investment decision and it should not be relied upon by you in evaluating the merits of investing in any securities or products. In addition, users should make an independent assessment of the legal, regulatory, tax, credit, and accounting implications and determine, together with their own professional advisers, if any investment mentioned herein is believed to be suitable to their personal goals. Investors should ensure that they obtain all available relevant information before making any investment. Any forecasts, figures, opinions or investment techniques and strategies set out are for information purposes only, based on certain assumptions and current market conditions and are subject to change without prior notice. All information presented herein is considered to be accurate at the time of production, but no warranty of accuracy is given and no liability in respect of any error or omission is accepted. It should be noted that investment involves risks, the value of investments and the income from them may fluctuate in accordance with market conditions and taxation agreements and investors may not get back the full amount invested. Both past performance and yields are not a reliable indicator of current and future results. J.P. Morgan Asset Management is the brand for the asset management business of JPMorgan Chase & Co. and its affiliates worldwide. To the extent permitted by applicable law, we may record telephone calls and monitor electronic communications to comply with our legal and regulatory obligations and internal policies. Personal data will be collected, stored and processed by J.P. Morgan Asset Management in accordance with our **Company's Privacy Policy** (<https://www.jpmorgan.com/global/privacy>). For further information regarding our local privacy policies, please follow the respective links: **Australia** (<https://www.jpmorganam.com.au/wps/portal/auec/PrivacyPolicy>), **EMEA** (www.jpmorgan.com/emea-privacy-policy), **Hong Kong** (<https://www.jpmorganam.com.hk/jpm/am/en/privacy-statement>), **Japan** (<https://www.jpmorganasset.co.jp/wps/portal/Policy/Privacy>), **Singapore** (<http://www.jpmorganam.com.sg/privacy>) and **Taiwan** (<https://www.jpmorgan.com/country/GB/en/privacy/taiwan>).

This communication is issued by the following entities: in the United Kingdom by JPMorgan Asset Management (UK) Limited, which is authorized and regulated by the Financial Conduct Authority; in other European jurisdictions by JPMorgan Asset Management (Europe) S.à r.l.; in Hong Kong by JF Asset Management Limited, or JPMorgan Funds (Asia) Limited, or JPMorgan Asset Management Real Assets (Asia) Limited; in Singapore by JPMorgan Asset Management (Singapore) Limited (Co. Reg. No. 197601586K), or JPMorgan Asset Management Real Assets (Singapore) Pte Ltd (Co. Reg. No. 201120355E); in Taiwan by JPMorgan Asset Management (Taiwan) Limited; in Japan by JPMorgan Asset Management (Japan) Limited which is a member of the Investment Trusts Association, Japan, the Japan Investment Advisers Association, Type II Financial Instruments Firms Association and the Japan Securities Dealers Association and is regulated by the Financial Services Agency (registration number "Kanto Local Finance Bureau (Financial Instruments Firm) No. 330"); in Australia to wholesale clients only as defined in section 761A and 761G of the Corporations Act 2001 (Cth) by JPMorgan Asset Management (Australia) Limited (ABN 55143832080) (AFSL 376919); in Brazil by Banco J.P. Morgan S.A.; in Canada for institutional clients' use only by JPMorgan Asset Management (Canada) Inc., and in the United States by JPMorgan Distribution Services Inc. and J.P. Morgan Institutional Investments, Inc., both members of FINRA; and J.P. Morgan Investment Management Inc.

In APAC, distribution is for Hong Kong, Taiwan, Japan and Singapore. For all other countries in APAC, to intended recipients only.

Copyright 2019 JPMorgan Chase & Co. All rights reserved.

LV-JPM52106 | 05/19 | 0903c02a825cb2cf