A real option to counter recession

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Fears that the interest rate hikes instigated by central banks to tame soaring inflation could spark a deep recession have weighed on markets since last year. These fears have yet to be realised, but the threat of recession is far from gone.

The global economy, and especially the US, has proved remarkably resilient, but the jury is still out on whether a recession will happen and how deep it might be. Some pessimists have pointed to recent inversions in the yield curve.

Worries were also exacerbated in September when the US Federal Reserve signalled that interest rates would have to stay higher for longer to tackle inflation.

Evidence is emerging elsewhere too that the aggressive monetary policies seen since 2022 are starting to bite. Latest figures showed that UK economic activity fell in September at its fastest pace since January 2021; US consumer confidence declined in September; and eurozone industrial production fell more than expected in July. Finally, the already complex macro environment has been made even more complicated by an escalation of geopolitical risks over the last few weeks which will no doubt provide a challenge to the risk appetite of investors.

Real assets offer a wide choice

With the threat of recession so real, investors might wish to consider limiting the risk in their portfolios using real assets.

Real assets are tangible assets that derive their value from their availability to, and usability by, consumers and businesses. They are extremely varied and include, for example: buildings; infrastructure such as roads, railways, energy grids and phone networks; and commodities such as energy (oil and gas), industrial and precious metals, and agricultural produce, such as wheat and orange juice.

The wide choice that real assets offer means that their various attributes can be applied in different market conditions and at different stages of the economic cycle. In some cases, their intrinsic value means they can be used to protect against inflation over the longer term, while other assets offer a defensive, lower-risk quality, especially during recessions, because of their critical role in the economy.

Infrastructure assets can provide reliable income

Infrastructure assets are the physical structures, facilities and networks that enable the economy and society to function. Power suppliers are of major interest to investors because of the opportunities created by the ongoing transition away from fossil fuel (oil and gas) suppliers to the renewable sources of wind, hydro and solar (photovoltaics) power.

The complexities involved with investing in infrastructure and the resources required are extensive. Building, identifying, buying, selling and maintaining facilities such as bridges, power stations and dams, for example, involve large sums, detailed contracts and high levels of technical expertise. But they can provide inflation-indexed revenue streams that are resilient in recessions because the end products to which they are linked are usually essential staples, such as energy and transport.

Such assets also offer an 'illiquidity premium'. The higher risks implied by tying up investments for longer periods, plus the larger sums required acting as a barrier to entry, mean that investors can expect a premium on their investment returns.

Selective real estate exposure can provide downside protection

As a more cyclical sub-sector of real assets, real estate prices will often fall in anticipation of a recession, so for the brave investor they can provide an attractive forward looking return opportunity during and post recessions. Clearly, there will be cyclical or fundamental challenges amongst some real estate sectors and securities, especially those more exposed to the economy.

For example, commercial real estate in travel and leisure industries will likely suffer in economic downturns, whereas defensive sectors such as healthcare facilities, residential homes and student accommodation are likely to fare much better.

Real estate investments offer the advantage that they can deliver regular rental income that is often linked to inflation through index-linked leases (with caps and collars) plus the potential rise in their capital values, especially if they trade at deep discounts. Managing and maintaining them requires a lot of time and effort, however, and they are also 'illiquid', so they can offer premiums, too.

Gold can shine in recessions

Commodities such as oil and wheat do not provide income, and their prices can go down in a recession as demand falls in the wider economy.

Gold, however, has historically been a reasonable hedge against recession; the volatility seen on stock markets in a recession can cause investors to seek value preservation in gold, which has low correlation with equities. For example, in US recessions in 2020, 2007 and 2001, gold delivered positive returns when the S&P 500 fell.

An attractive entry point

Given the material risks of recession, investors might well wish to consider the benefits of investing at least part of their portfolios to protect against it, and how they might do it. The real assets universe is broad, and given some types are more defensive than others, an active approach can help to select the right types of assets given the economic and market conditions.

Now is also a good time to be considering real assets. The last 12 months have been challenging for real asset investors due to their implicit 'long duration', so they are sensitive to interest rates. The challenging performance has led to meaningful discounts across much of the real asset universe such as real estate investment trusts and infrastructure, in some cases at valuations similar to 2008 levels owing to the central banks' aggressive monetary policies.

If a recession hits and central banks cut rates to stimulate the economy, then today's current price discounts could represent a memorable entry point into real assets driven by the tailwind of falling rates.