Markets

Time to Start Preparing for a Recession Is Now, Rob Arnott Says

- ‘Recessions are usually created, they don’t happen naturally’
- Business owners should give thought to decreasing spending now

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The Federal Reserve was in denial about inflation and moved too slowly in trying to quell rising prices. That’s now put it on a trajectory to create a recession, if it hasn’t already done so.

“That the simple fact is recessions are usually created -- they don’t happen naturally,” Arnott said in an interview. “Economic expansions don’t die of old age -- they’re murdered by the Fed. And we’re seeing that happen again now.”

The crux of the matter is that the Fed ignored inflation for far too long. The central bank's own forecasting record is rarely better than an Ouija board, the duo said, and being late to the game
increases the chance that it overreacts. In addition, many of the root causes of inflation right now stem from supply-chain disruptions, which higher interest rates cannot fix. A hard landing, in their view, means the economy goes into a serious recession, like the one associated with the 2008 crisis.

It’s a tenuous time. Inflation is at a four-decade high and could – averaging out the past 12 months and pulling the figure forward through year-end -- finish 2022 at 10.8%. Arnott and Harvey point out that “our current problems are self-inflicted by an extended period of negative real rates.”

Arnott is telling business owners to manage risk. “If you’re spending money that you don’t need to spend, you might give some serious thought to stopping it for a little while,” he said.

Arnott is founder and chairman of Research Affiliates, a smart-beta pioneer and sub-adviser to money managers including Pacific Investment Management Co. He is one of the inventors of the “smart-beta” philosophy of weighting indexes according to fundamental traits like cheapness and momentum instead of market capitalization.

Peak Fear
As for what he recommends equity and bond investors do, Arnott said they should buy when fear is at its highest point.

“We’re probably not at peak fear, the bear market probably isn’t over, but you could do worse than starting to average back in if you were smart enough to lighten up before this,” he said. “If you were already fully committed, then I’d say hold off. Don’t top up unless you were already risk off.”

Arnott currently prefers non-US value stocks because -- going by certain long-term valuation metrics -- US stocks are still over-valued. Meanwhile, emerging-markets equities are trading at “abnormally cheap levels,” he said.

“You’re not at peak fear on the bond market,” Arnott said.

*(Updates with more info about Research Affiliates in seventh graf)*