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How to Prepare Your Portfolio for the Worst When the Worst Is a Real Possibility

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Doomsday scenarios don’t have to come with the hype, speed, and spectacle of a Hollywood blockbuster. The biggest threats today are slower-moving and decidedly less visual: The U.S.-China trade war could become an all-out conflict that plunges the world into recession and undoes globalization; a Japan-like deflationary funk could spread through the U.S. and Europe; or state-sponsored hackers could paralyze critical infrastructure, undermining confidence and sparking a cyberwar.

A relatively healthy U.S. economy, along with global central banks’ willingness to cut interest rates, have allowed some measure of optimism, despite alarming headlines. In fact, investors’ equity holdings as a share of their financial assets hovered around 30% earlier this year; the last time it was higher was in the late 1990s.

But that’s exactly why some strategists, fund managers, and financial advisors are beginning to consider the investment versions of survivalists’ supplies, including Spam, gas masks, and gold. “It’s really the first time in seven or eight years that we are starting to meaningfully derisk across portfolios,” says David Carter, chief investment officer at Lenox Wealth Advisors, which oversees $2 billion. “Whether the tariff war escalates or lingers, the downside is a no-growth world where risk sentiment evaporates. And central banks around the world are trying to provide a safety net, but it’s a small net with a lot of holes.”

Each doomsday scenario calls for its own strategy, but Treasury bonds, gold, and cash are bunker staples. That said, not all of them may offer the same amount of protection as in the past, and some hoped-for havens might not do much at all. And while some of the scary scenarios looming over markets—like a no-deal Brexit or a conflict with Iran—may create regional turmoil or roil markets in the short term, they tend to not top fund managers’ and strategists’ worst-case list. For example, while a war with Iran could cause oil prices to spike, the shale boom could mute the blowback as the U.S. moves toward energy independence.

We canvassed investment strategists, fund managers, and financial advisors to see which developments could be the most nightmarish for markets—and what they would take into the investment bunker. Here’s what tops the list:

###### **Doomsday Scenario No. 1: The Debt Bomb**

Debt, not geopolitical headlines about Iran or China, is what advisors say clients ask about most frequently. And with good reason. The U.S. budget deficit is on pace to hit $1 trillion next year, global debt is at a record high and triple the size of the world’s gross domestic product, and $16 trillion of debt yields negative interest rates. The nightmarish scenario many think is most plausible: a “Japanification” of Europe and the U.S., with more economies stuck in a rut of anemic growth and perpetually low interest rates. Loaded with debt, economies can’t grow. Investors reach further for yield, feeding a credit bubble that pops and ripples through financial markets. After years of easy monetary policy, central banks are impotent and unable to stem the crisis.

Liquidity is king, and investors will want to sell less-liquid securities like high-yield debt or floating-rate bonds and increase cash and long-term Treasury bonds—moves Ed Perks has been taking in recent months in the [Franklin Income](https://www.barrons.com/quote/mutualfund/FKIQX)fund (ticker: FKIQX) amid worries of slower economic growth, monetary policy uncertainty, and the risk of political missteps rising. Defensive assets aren’t cheap, but Treasury bonds will look cheap in hindsight if Japanification plays out, says Gluskin Sheff strategist David Rosenberg, who expects the global economy to slow in the next year, even if the U.S. and China come to a truce. He expects long-dated Treasury bonds to deliver double-digit returns in the next year. Not bad for a hedge. Gold would also be part of the playbook. While it is typically a hedge for inflation, strategists say it still belongs in the bunker, as central banks keep cutting interest rates or resort to more desperate measures. Plus, it should hold up if Trump trash-talks the dollar down. One way to get exposure: the SPDR Gold Trust (GLD).

Though the Nikkei 225 index lost two-thirds of its value during Japan’s lost decades, from 1992 to 2002, some businesses were durable enough to prosper. Nevin Chitkara, co-manager of the [MFS Value](https://www.barrons.com/quote/mutualfund/MEIAX) (MEIAX), typically likes durable businesses and has been looking for companies with differentiated products and services and the wherewithal to adjust to shifting or disrupted supply chains. Chitkara favors companies such as [AT&T](http://barrons.com/quote/stock/T) (T) and [JPMorgan Chase](http://barrons.com/quote/stock/JPM) (JPM) over traditionally defensive consumer staples sellers that are pricey and would be vulnerable to increased tariffs. If deflation takes hold, fund managers should lean toward companies with more cash than debt and preferred stocks that can generate income in the absence of growth. Also attractive: steady—rather than highest-yielding—dividend payers, like those favored by [T. Rowe Price Dividend Growth](https://www.barrons.com/quote/mutualfund/PRDGX) fund (PRDGX) and the recently reopened [Vanguard Dividend Growth](https://www.barrons.com/quote/mutualfund/VDIGX) fund (VDIGX).

###### **Disaster Scenario No. 2: Frenemies No More**

The U.S.-China conflict goes from hot to hotter, particularly if that happens overnight. Friday, China said it would [impose tariffs](https://www.wsj.com/articles/china-to-impose-tariffs-on-more-u-s-products-11566562931?mod=hp_lead_pos1&mod=article_inline) on another $75 billion of U.S. goods, in retaliation for President Donald Trump’s threat to place 10% levies on the remaining $300 billion of Chinese goods it hasn’t already targeted—even though he said he would delay some of those tariffs until December. To add another wrinkle, Trump tied the fate of a trade deal to how Beijing handles pro-democracy protests in Hong Kong.

The worry is that the trade conflict spirals. Tariffs on all trade would be just part of the nightmarish scenario. The U.S. could take a harder line to further restrict China’s access to U.S. technology, curtail visas to Chinese nationals, and even delist certain Chinese stocks from U.S. exchanges. Either country could start a currency devaluation war. And China could retaliate with boycotts, restrictions on U.S. corporations’ access to its 1.4 billion consumers, and—in a truly doomsday scenario—escalate geopolitical tensions in the South China Seas or with Taiwan and possibly restrict access to [Taiwan Semiconductor](http://barrons.com/quote/stock/2330.TW) (TSM), a supplier crucial to a Who’s Who of global technology and industrial complexes.

Countering a China-related Armageddon means buying gold and Treasury bonds—and also Japanese yen. That currency acts as a haven when tensions flare, but also does relatively well in a world in which major central banks are easing because the Bank of Japan is likely to do the least. The idea is to create multiple ways to “win,” says Michael Kelly, global head of multi-asset at PineBridge Investments, which oversees $97 billion.

What would definitely not be a winner: technology stocks, which Lisa Shalett, chief investment officer at [Morgan Stanley](http://barrons.com/quote/stock/MS) Wealth Management, describes as ground zero, especially because the sector hasn’t been bloodied as much as others in past flare-ups. Shalett favors large-cap U.S. health-care concerns and banks. Counterintuitively, investors might also want to tilt toward foreign stocks. Valuations are one reason: Emerging markets are trading at their lowest level versus U.S. equities since 2003. And history also helps: Over the past 50 years, leadership between the MSCI EAFE and S&P 500 index reversed from the prevailing trend five out of the seven times after the U.S. had a bear market, says Leuthold’s Ramsey, noting that the S&P has been leading for years. But selectivity is warranted, with some foreign markets much more vulnerable to a trade war and global economic slump than others. And in a world where growth becomes increasingly scarce, Gluskin Sheff’s Rosenberg says companies with sustainable free cash flow, such as [Microsoft](http://barrons.com/quote/stock/MSFT) (MSFT), or steady dividend growers, including telecoms and pipeline companies, will be in demand.

The slow-burn nightmare: broken global supply chains. Growth and margins would suffer as companies become less efficient and productive. But because this is more of a frog-in-the-boiling-water scenario, strategists say it requires a recalibration of portfolios, not just a hedge. That includes tilting toward national brand leaders in the U.S.—and China—and domestically focused U.S. small to mid-size companies with the wherewithal to be nimble, says Joseph Quinlan, chief market strategist for U.S. Trust.

###### **Disaster Scenario No. 3: “All Bets Off”**

The most drastic of all scenarios is something that sparks a broad loss in confidence in the U.S.—from successful state-sponsored cyberattacks on key infrastructure to a crisis of confidence in political leadership or elections. For Morgan Stanley’s Shalett, the Armageddon-type scenario that gets the most attention is a cyberattack on the banking system. Gold would be a natural hedge. A less passive option that could actually make money if there was a cyberattack: cybersecurity companies, technology consultants, and cloud stocks, which Shalett favors. One way to get quick access to some of them is through the $1.6 billion EFTMG Prime Cyber Security ETF (HACK).

**Any of these developments** could trigger a recession. Leuthold’s Ramsey estimates that the S&P could lose about a third of its value in even a garden-variety economic downturn, if valuations fell to 15 times earnings, their high point in 2002’s bear market.

Treasury bonds are a natural hedge, but won’t offer the same level of protection as they did when rates were higher—a reason that Nuveen Chief Investment Strategist Brian Nick says investors might also want long-short or market-neutral strategies in the bunker. Among the cheapest: The [Vanguard Market Neutral](https://www.barrons.com/quote/mutualfund/VMNFX) fund (VMNFX), which has shown little correlation to the S&P 500 since 2010. Kipley Lytel, head of Montecito Capital Management, has increased clients’ allocations to alternatives to 15% from 9%, using funds like the $5 billion [Catalyst/Millburn Hedge Strategy](https://www.barrons.com/quote/mutualfund/MBXAX)(MBXAX) to help minimize losses. If a doomsday scenario hits, Lytel says he would move 10% from his 40% pure equity allocation into Treasuries and gold if the S&P 500 starts logging 5% to 6% daily losses on fundamental reasons, but wouldn’t go to all cash.

After all, another doomsday scenario is missing out if none of the nightmares materialize