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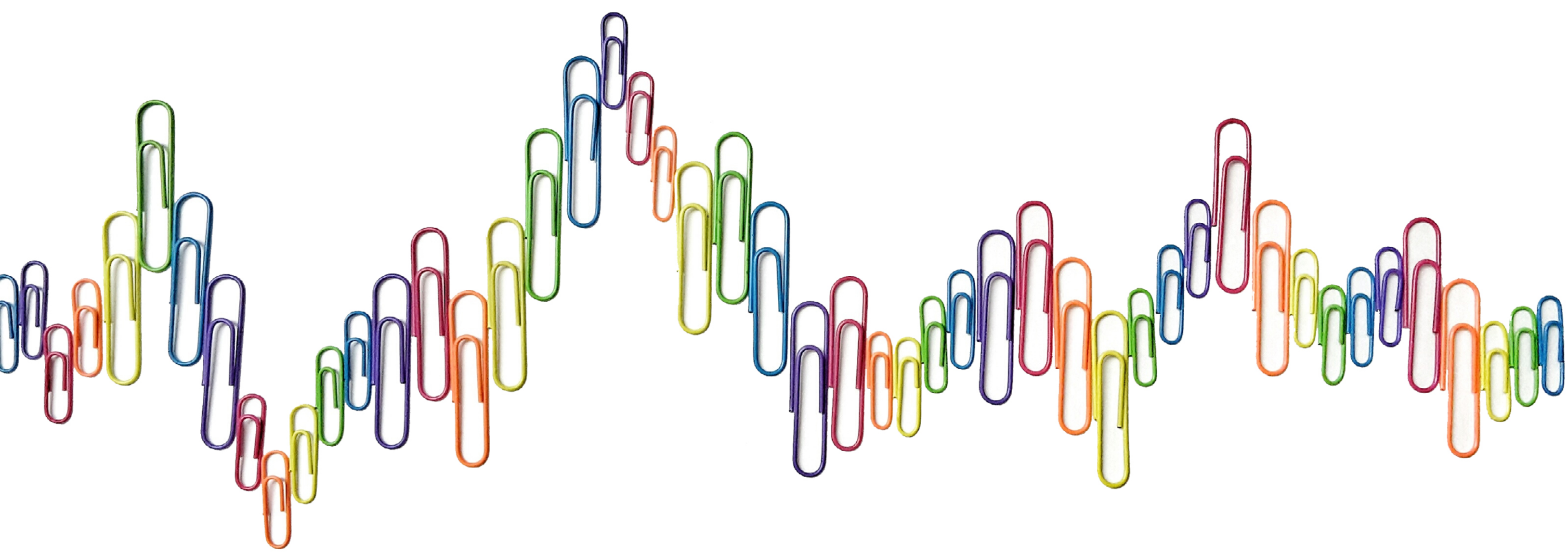
Markets and Recessions

Market performance during a recession can be surprising



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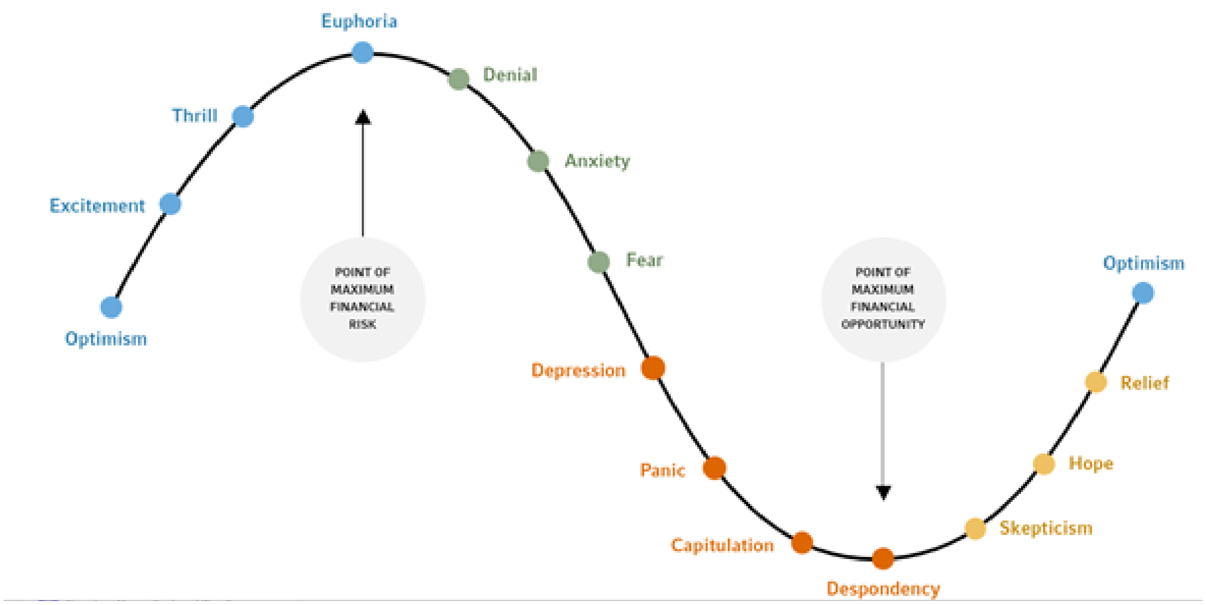
No one can accurately predict when any country’s economy will slip into recession.

But there is an old adage in investing that states the stock market knows when the economy is slowing down, before anyone else does. There’s some truth in this. Financial markets move on expectations while economic data looks backward.

In fact, we usually don’t know that we’ve lived through a recession until it’s over. That’s when gross domestic product (GDP) data confirm the economy contracted over two consecutive quarters, which is the definition of a *technical* recession. But it’s not considered an *official* recession until the CD Howe Business Cycle Council (CDHBCC) says it is. The The CDHBCC defines an official recession as a pronounced, persistent, and pervasive decline in aggregate economic activity, with broad contraction in activity across multiple industries and employment. And by then, often the economy is already in recovery.

Contrary to popular belief, financial markets don’t usually decline at the start of a recession and revive during the economy’s recovery. Remember, the markets are usually driven by what investors think is going to happen. So, if market participants believe the economy is slowing because corporate profits are down, trade flows are declining, job growth is stagnating or retail sales are weak, they will likely reduce their exposure to riskier assets like equities. And that drives the stock market down. At a certain point the price of equities will have fallen enough that certain investors will determine the potential reward outweighs the current risk and reinvest in the equities. That drives the stock market higher. Then as the price of equities gain, more and more investors move back into the markets, driving the stock market even higher.

We call this the cycle of investor emotions.



Because markets move on the perception by investors of what could happen, stocks generally do worse in the year leading up to a recession than during the recession itself. Indeed, markets often climb even when the economy is contracting. The S&P 500 Index (representing U.S. stocks) rose an average of 0.4% during the recessions that have taken place since 1945.[1] Moreover, markets generally start climbing ahead of the economy’s recovery as investors begin to see signs of improvement and their expectations become positive. In other words, the worst is over for equities before it’s over for the economy.[2]

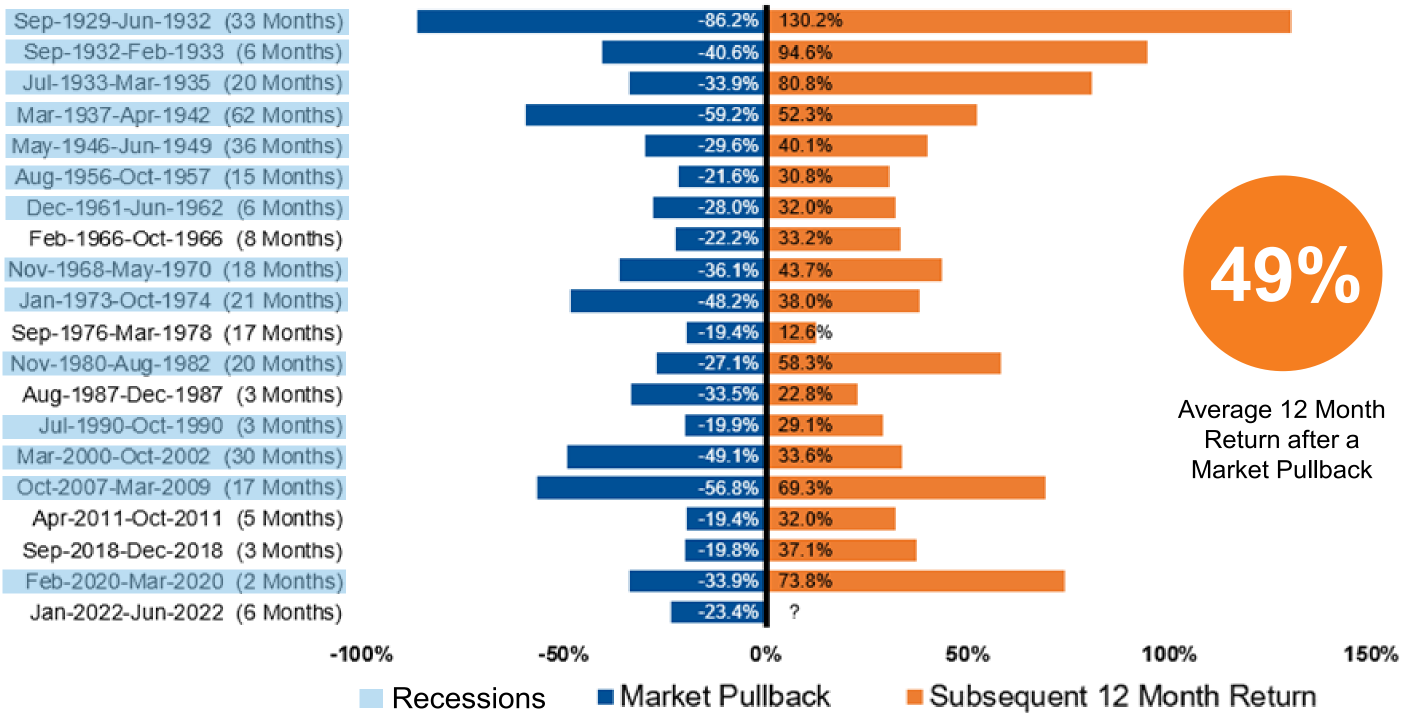
It’s also important to note that not all market pullbacks are tied to recessions. The chart on the next page shows that while most major market declines coincided with a recession, not all did. And the depth and length of market pullbacks varied widely, no matter the cause. But most importantly, every market decline was followed by a strong recovery over the following 12 months, generally far outpacing the downturn.

[1] Source: Russell Investments, Morningstar Direct

[2] How does the Market Perform During an Economic Recession? You may be Surprised. By Sergei Klebnikov. June 2, 2022. https://tinyurl.com/ynybakt4

Volatility presents opportunity

S&P 500 Index pullbacks of at least 15% since 1926



Source: S&P Dow Jones. Stocks: S&P 500 Index. Index returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment. Indexes are unmanaged and cannot be invested in directly.

As for what causes a market pullback? Well, in the chart above the reasons have ranged from a global health crisis, a global oil crisis, a global credit crisis, geopolitical conflicts, and the precipitous rise and fall of technology stocks. Some pullbacks have been sparked by technical factors, which often is due to stock prices reaching a level that triggers automatic selling by some large investors. And that in turn causes other investors to worry that prices will fall further, causing further selling. It becomes a self-fulfilling prophecy.

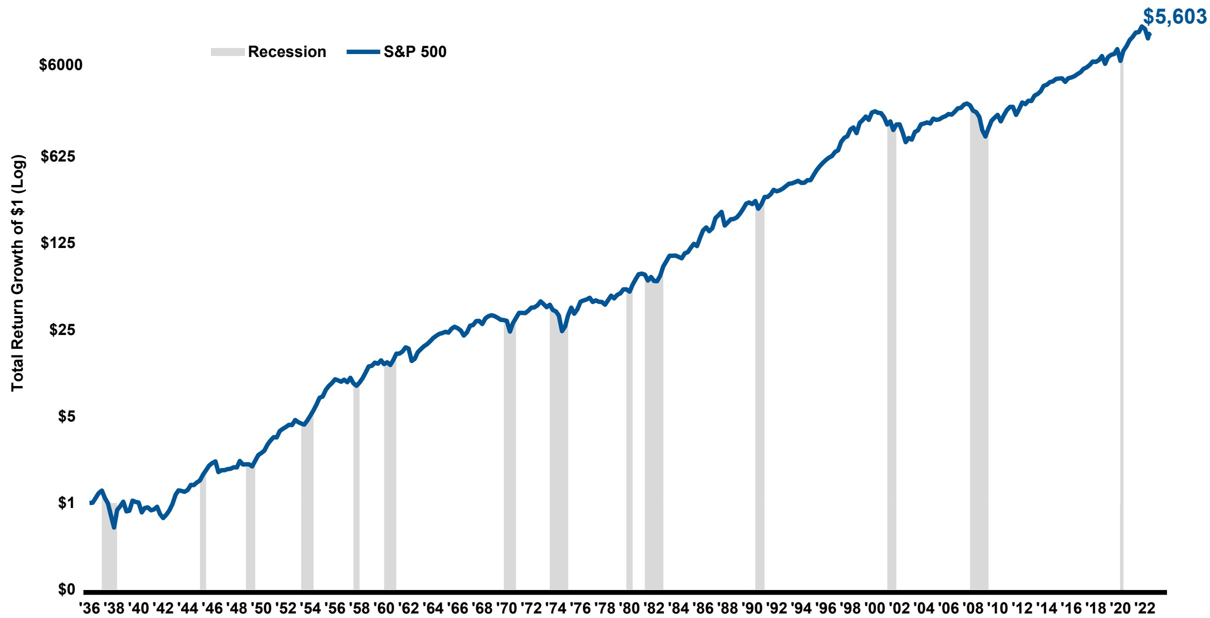
That's why it's impossible to predict when the markets will go down and when they will go up. The most prudent policy is to hold a diversified portfolio and remain invested over the long term.

In the end, recessions are a normal part of the business and economic cycle. Since the turn of this century, we've already had three recessions: in 2001 because of the Y2K scare, rising interest rates, and then the 9/11 attack; in 2008 after the bursting of the U.S. housing bubble; and a short-lived one in 2020 when governments around the world shuttered business activity and trade in an effort to contain the COVID-19 virus.

But as the next chart shows, recessions represent only minor setbacks in the stock market's general tendency to climb higher. Technological change, increased productivity, growing globalization, the ongoing industrialization of developing nations and other factors have propelled markets higher in the past and will likely continue doing so in the future. While past performance doesn't guarantee future returns, it does provide a historical perspective.

S&P Growth of $1

Since 1936



Source: St. Louis Fred & Morningstar Direct. S&P 500 index as of 8/31/2022. Log: Lognormal scale. Total Return: Includes dividend reinvestments. Indexes are unmanaged and cannot be invested in directly. Past performance is not indicative of future results.

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