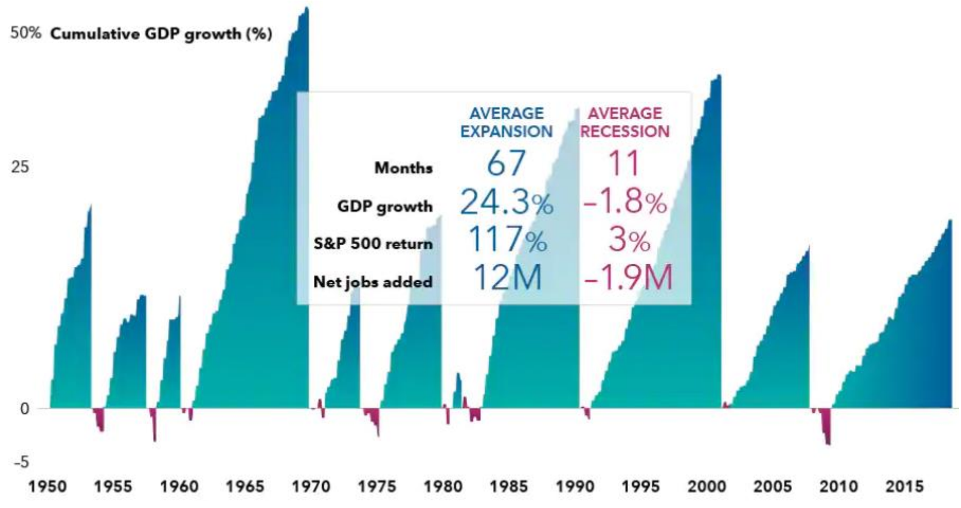
ACG Insights: Economic Recessions

Introduction

It's been over a decade since the last economic downturn, is the next recession looming? "A recession is a period of falling economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales.[1]" Since 1945, the United States has experienced 11 recessions. The most recent recession began in December 2007 and ended in June 2009, a period of 18 months, the longest since World War II. On average, the most recent recessions have lasted less than one year.

To put recessions in context of the broader economic cycle, it is important to look at both expansions *and* recessions. Recessions can be painful, but expansions can be powerful. From 1950 to 2015, the US has been in a recession less than 15% of all months. As shown in Exhibit 1, the average expansion increased economic output by 24%, whereas the average recession reduced GDP by less than 2%.

Exhibit 1: Cumulative GDP Growth in Expansions and Recessions[2]



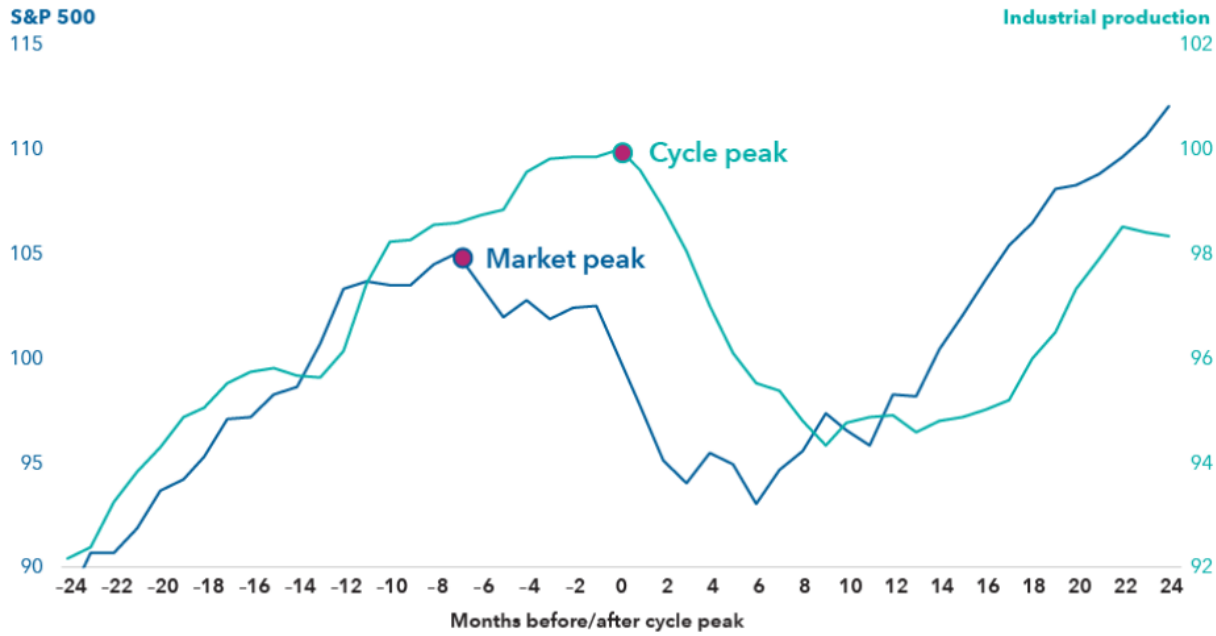
[1] Source: National Bureau of Economic Research (NBER)

[2] Sources: Capital Group, National Bureau of Economic Research, Thomson Reuters

How do equity markets behave during a recession?

Recessions are tied to economic activity, not stock market performance. However, equity market drawdowns and recessions often coincide. Markets tend to peak before the economic cycle does and can even experience strong performance in the late stages of a recession. Exhibit 2 shows the market (S&P 500) and the economy (using industrial production as a proxy). On average, the market peaks seven months before the economic cycle and the market begins to recover at least two months before the economy begins to show improvement. In the most recent recession, the S&P 500 trough occurred on March 6, 2009 while the recession did not officially end until June 2009.

Exhibit 2: Market Returns vs. Industrial Production[3]



Given the relationship between the market and the economy shown in Exhibit 2, Exhibit 3 shows that the S&P 500 generated positive performance during four of the last nine recessions despite the equity market drawdown in the interim. Further, equity markets tend to undergo strong recoveries after recessions. Following the nine most recent recessions, equity markets had an average cumulative return of 78.7% in the subsequent five years while the average cumulative return during the recessions was -1.6%.

When equity markets experience a drawdown and the economy struggles, investors often get nervous and may be tempted to liquidate the risk assets within their portfolios. The data show that long-term investors who maintain their equity allocations during difficult market environments can generate strong portfolio returns in the ensuing years.

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[3] Sources: Capital Group, Federal Reserve Board, Haver Analytics, National Bureau of Economic Research, Standard & Poor's
Data reflects the average of all cycles from 1950 to present, indexed to 100 at each cycle

Exhibit 3: Recent United States Recessions[4]

			S&P 500 Cumulative Return			
Peak Month	**Trough Month**	**Duration (Months)**	**During Recession**	**1 year after**	**3 years after**	**5 years after**
December 2007	June 2009	18	-35.5%	14.4%	57.7%	136.9%
March 2001	November 2001	8	-7.2%	-16.5%	8.4%	34.2%
July 1990	March 1991	8	7.6%	11.1%	29.9%	98.3%
July 1981	November 1982	16	14.4%	25.5%	66.4%	102.4%
January 1980	July 1980	6	16.4%	13.0%	56.0%	100.0%
November 1973	March 1975	16	-18.2%	28.3%	21.6%	54.8%
December 1969	November 1970	11	-3.4%	11.3%	20.4%	24.8%
April 1960	February 1961	10	18.3%	13.5%	34.8%	67.7%
August 1957	April 1958	8	-6.4%	37.2%	66.1%	89.3%
Average		**11.2**	**-1.6%**	**15.3%**	**40.1%**	**78.7%**

Why all the talk of an inverted yield curve?

One data point that economists often consider a signal of a coming recession is an inverted yield curve. A normal yield curve is upward sloping whereby short-term debt has a lower yield than longer-term debt. An inverted yield curve is most often defined as the yield on a 2-Year US Treasury Note exceeding the yield on a 10-Year US Treasury Note. When the health of the economy is more uncertain, the yield curve may become inverted as investors will demand a higher interest rate on short-term debt compared to longer-term debt.

Exhibit 4 shows the changes in the yield curve since the beginning of 2015. From January 2015 to January 2019, the yield curve flattened as the short end of the curve rose. The Federal Open Market Committee (FOMC) raised the target Federal Funds rate nine times between December 2015 and December 2018. The FOMC's changes to this target rate impacted the short end of the yield curve and contributed to the flattening of the curve.

Following the equity market volatility in the fourth quarter of 2018, the FOMC pivoted its rhetoric about future rate moves and indicated the potential to cut rates in the near term. They followed through by cutting rates on August 1, 2019. The yield curve has shifted downward during 2019 with the intermediate maturities (colloquially called the belly of the curve) falling below shortest and longest maturities.

On August 14, 2019, the yield curve inverted briefly intra-day as the yield on the 2-Year US Treasury Note exceeded the yield on the 10-Year US Treasury Note for the first time since the global financial crisis. This resulted in news outlets spending a lot of print space and air time discussing the possibility of a recession. That is because an inverted yield curve has preceded every recession in the last 40 years.

[4] Sources: National Bureau of Economic Research and *A Wealth of Common Sense*

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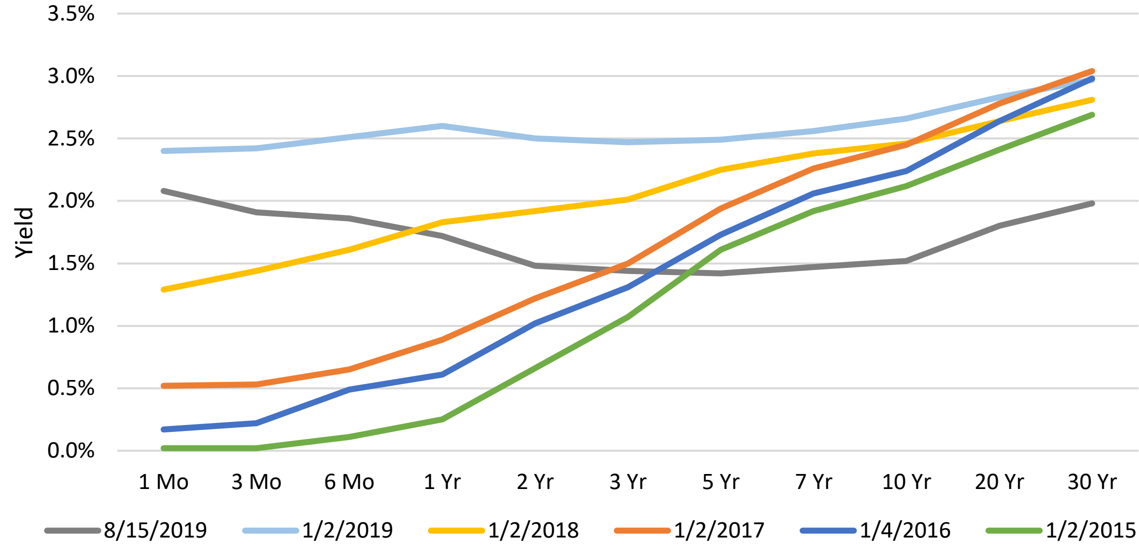
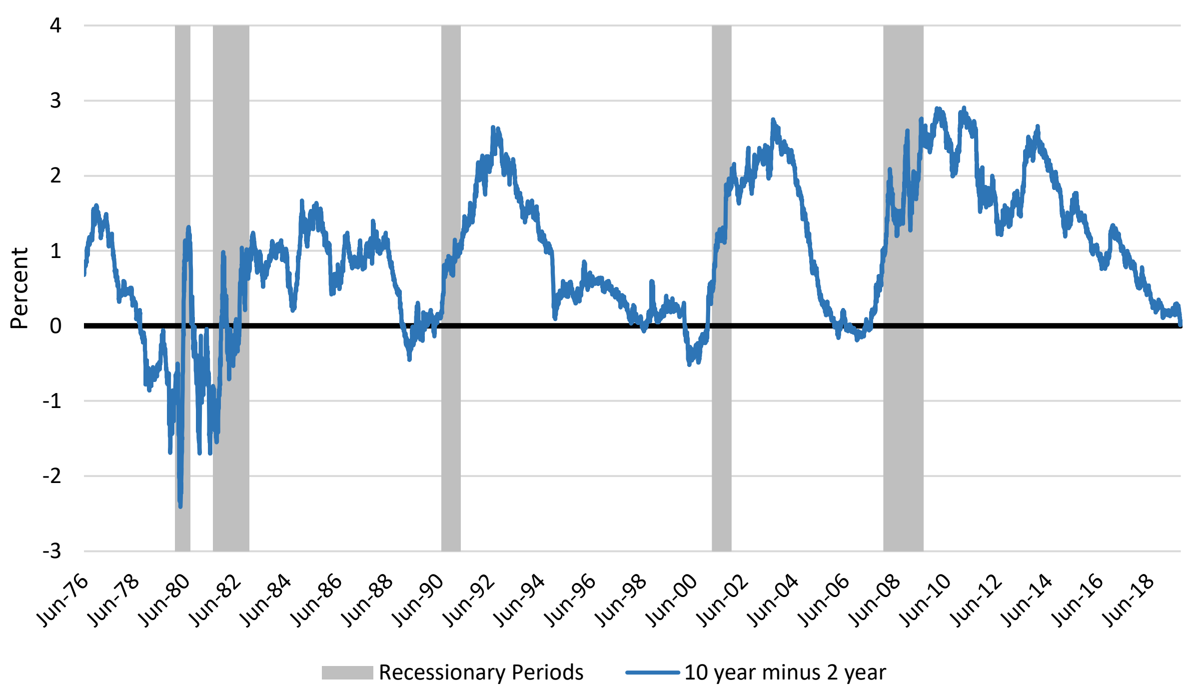
Exhibit 4: Yield Curve[5]



In Exhibit 5, the yield curve is inverted when the blue line falls below zero. For the five most recent recessions, the yield curve was inverted for an average of 243 trading days between the end of one recession and the beginning of the next with a maximum of 339 days and a minimum of 190 days. If history is any indicator of the future, it may be a bit premature to predict a recession in the near term based one brief intra-day inversion.

Exhibit 5: 10-Year Treasury Yield minus 2-Year Treasury Yield[6]

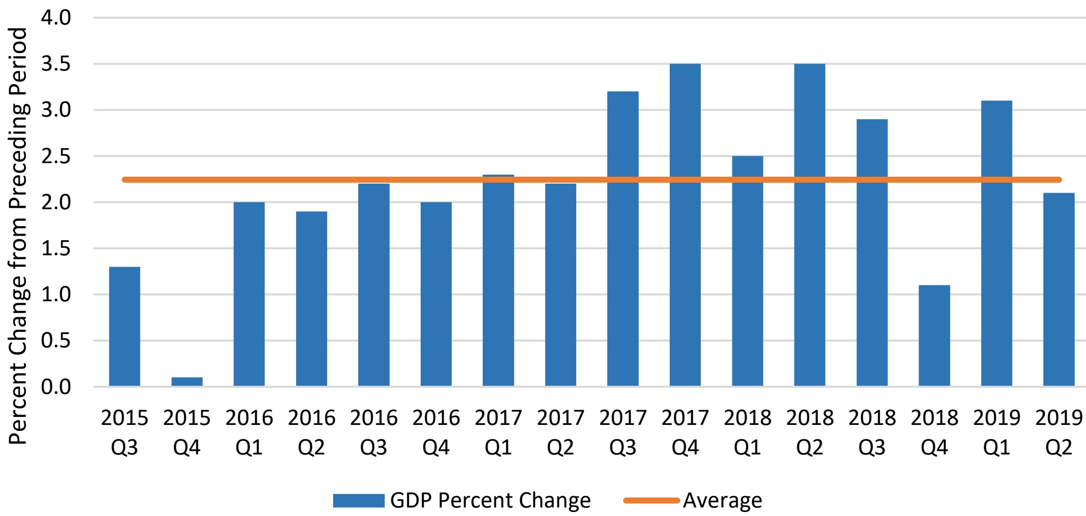


[5] Source: US Department of Treasury
[6] Source: Federal Reserve Bank of St. Louis

How healthy is the economy?

A recession is generally identified by two consecutive quarters of negative GDP growth. As shown in Exhibit 6, US GDP has had positive growth in each of the last 16 quarters. The growth rate slowed in the second quarter of 2019 compared to the first quarter, but is still near the quarterly average of the last four years.

Exhibit 6: US GDP Percent Change from Preceding Periods[7]
Seasonally adjusted at annual rates



Another important economic indicator is employment. Unemployment levels began to decrease in late 2009 as the economy recovered from the 2007-2009 recession. This decline has continued for nearly a decade. As of July 2019, the unemployment rate was 3.7%. Full unemployment is considered 5% so an unemployment rate less than that is a positive indicator for the economy.

A third economic indicator is industrial production. The Federal Reserve maintains an Industrial Production Index. The index peaked in December 2018 and has declined during 2019. Through the latest data point in July, the index had declined 1.2% from the peak but remained higher than the pre-global financial crisis peak. The index declined by 5% from December 2014 to May 2016, with the absence of a subsequent recession, before reaching new highs.

Although the GDP growth rate and industrial production may be showing signs of softening, they are still strong on an absolute basis while unemployment remains at historically low levels. These indicators would suggest that the economy is showing signs of continued growth rather than signs of a recession in the next few quarters.

Conclusion

Historical yield curve data and current economic indicators suggest that a recession is not looming in the short-term, barring any unforeseen disruptions. The timing of the next recession may not be certain, but it will most certainly happen. As investment consultants, it is our job to help clients navigate through difficult times in the economy and financial markets in order to overcome behavioral biases that may cause irrational portfolio decisions that work against long-term investment goals. We would be happy to discuss our consulting process and the ways in which we partner with clients.

[7] Source: Bureau of Economic Analysis

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